ECONOMIC GROWTH REACCELERATES, EQUITIES OVERVALUED & A BIT ABOUT HEDGING

BUT FIRST … BE AWARE OF THIS SCAM

By now, you are probably familiar with the security measure called Two-Factor Authentication (2FA) which is also sometimes referred to as Dual-Factor Authentication. In general, 2FA is the security measure that results in a one-time passcode arriving to your cell phone immediately after you've entered your login credentials to access whatever online system you're trying to access. An entire industry exists where thieves try to piece together cell phone numbers, passwords, Social Security numbers, mothers' maiden names and the like with the aim of separating the public from its money.

Although 2FA adds another layer of burden to the honest public, this security measure often renders useless the data accumulated by the bad guys unless they can also figure out a way to intercept those one-time passcodes.

THE SIM CARD SWAP SCAM

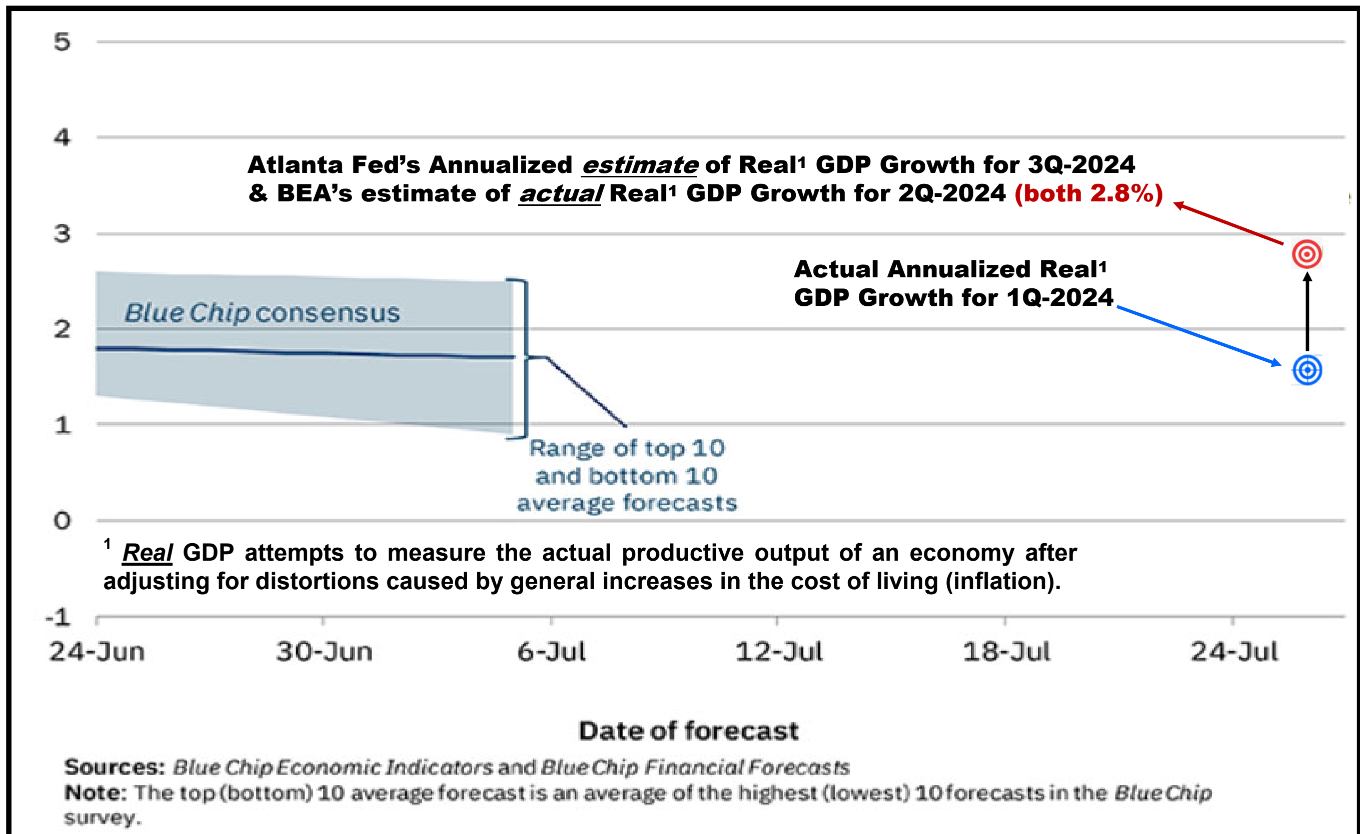
Your phone likely has a chip in it called a "Subscriber Identity Module" and this chip is known as a SIM card. The SIM card in your phone carries all kinds of information about your phone, the network you use, all sorts of authorization data and security keys, and your phone number.

Credit card holders are often victimized by an interloper who poses as the card holder and manages to convince the card issuer to issue, whether by providing stolen security data or simply by making up a compelling hard luck story, an additional card to the interloper. SIM card scams work similarly. If a scammer can convince your phone carrier to associate your existing phone number with a SIM card other than the one that's in your phone, the scammer has then prevailed over any Two-Factor Authentication systems that are programmed to send one-time passcodes to your phone number.

To the extent the thief has *already* accumulated other login and/or password information about you, any scammer who is able to associate your phone number with a SIM card that's in the thief's possession is in good position to begin emptying financial accounts. Any notifications that might also have gone to your phone to alert you to the possibility of unauthorized access to one or more of your financial accounts is, instead, received by the scammer who will certainly ignore them. **Consider contacting your cell phone carrier to establish an agreed upon PIN or other protocol in the event the carrier is later asked by a scammer to associate your phone with a different SIM card. This will help ensure you always remain in the loop.**

ECONOMIC GROWTH WITHIN THE U.S. REACCELERATING

The Federal Reserve Bank of Atlanta publishes a model that estimates the annualized rate of change of Gross Domestic Product (GDP), which is a measure of economic growth, within the U.S. for the next calendar quarter. As of July 26th, the Fed's model estimates GDP will advance at a seasonally adjusted annual rate of 2.8% during the third quarter of 2024. The U.S. Bureau of Economic Analysis' (BEA) initial, July 25th estimate of *actual* annualized GDP growth for the second quarter of 2024 was also 2.8% (both represented by the red bullseye).

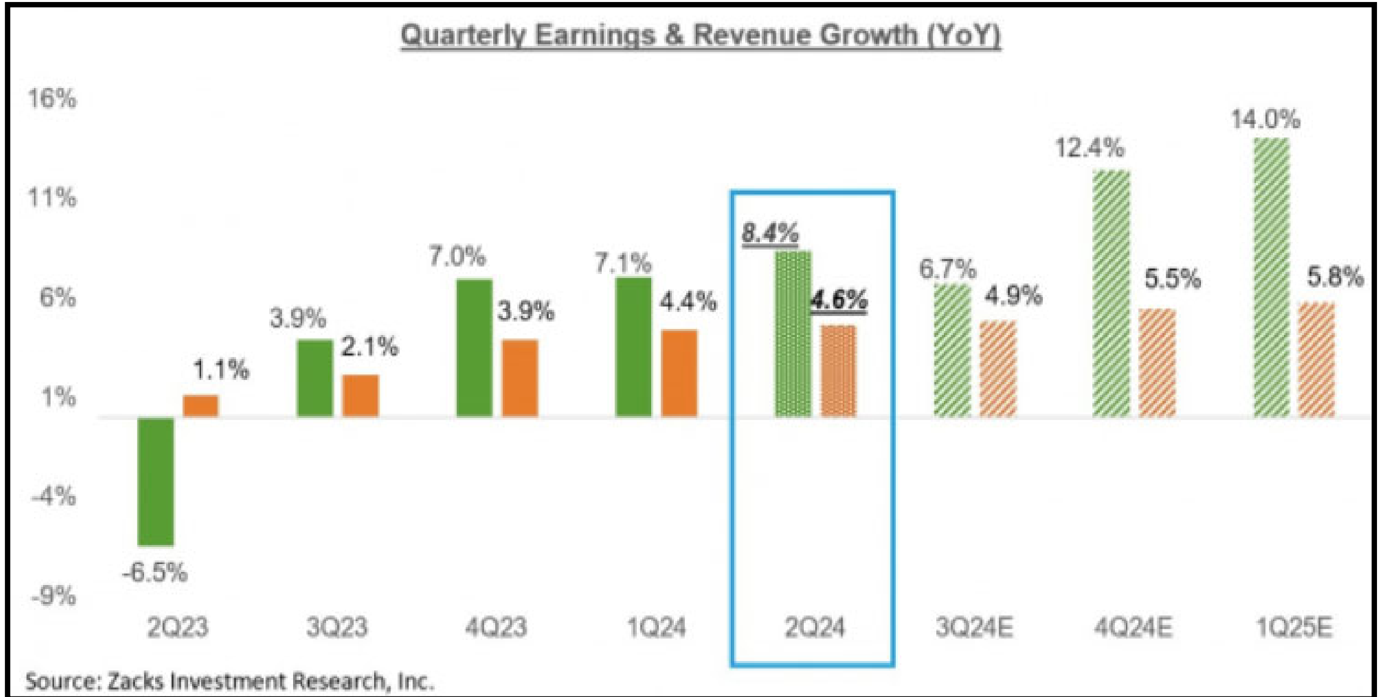


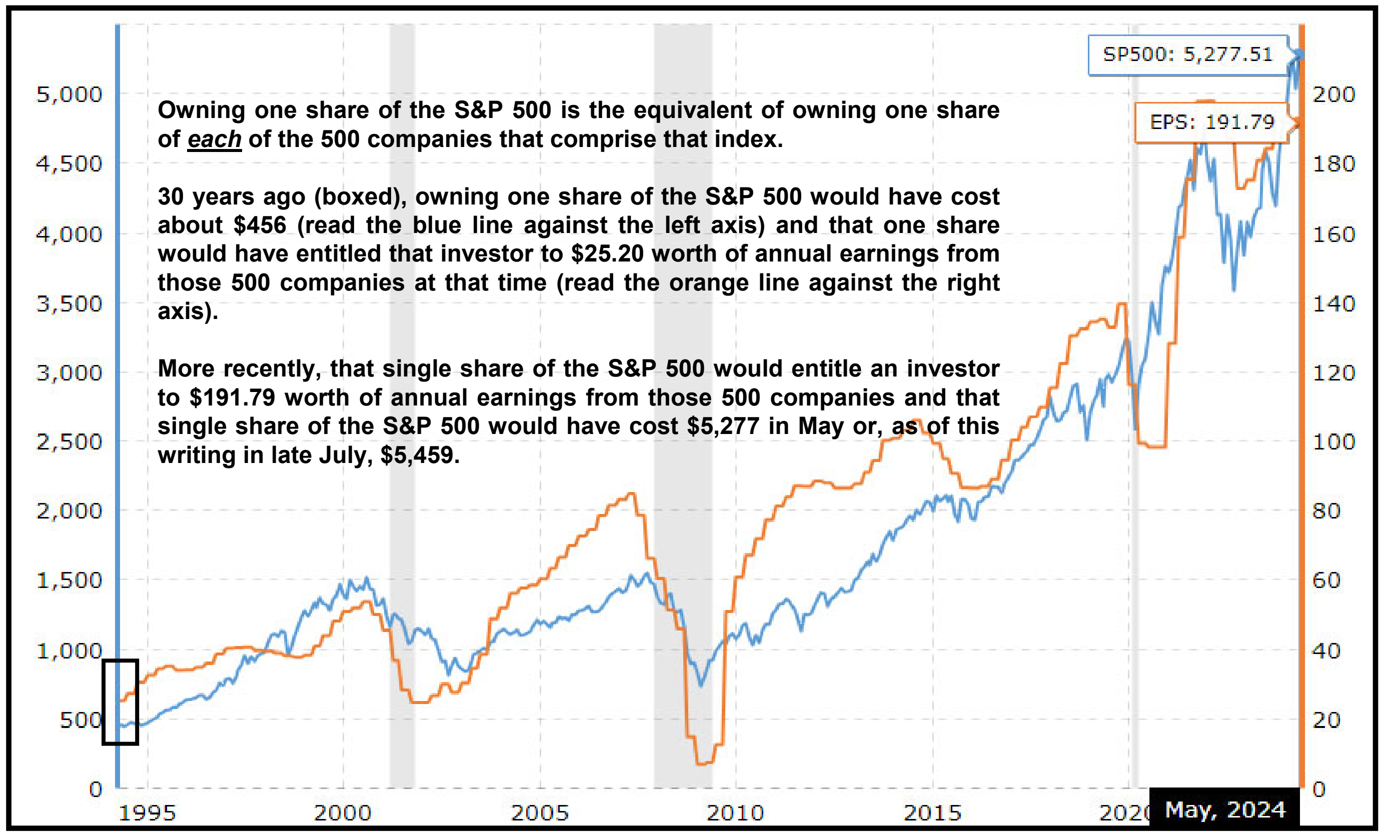
CORPORATE EARNINGS GROWTH ALSO REACCELERATING

Of course, an expanding economy in no way guarantees happy days for investors but, all else being equal (or "ceteris paribus" in honor of the Latin teacher who wrote that note about me not listening), it's probably better to hold stocks when an economy is growing than when it isn't.

The next image illustrates the rebound in corporate earnings and revenues since their respective nadirs of 2023 where aggregate corporate earnings of the 500 companies that comprise the Standard & Poor's 500 actually declined 1% versus 2022 even though annual revenues advanced by 4.7%. And don't stare too long at the outlandishly high, year-over-year growth figures associated with 2021 since the results of that year are being compared to the pandemic year of 2020 when everything was temporarily lousy.

Here's a blurry look at year-over-year growth rates, by calendar quarter, of corporate earnings for the 500 companies that comprise the Standard & Poor's 500. As you can see, Zacks Investment Research expects earnings and revenues to be materially higher during each quarter of 2024 than they were during 2023.





I included that last image to show that, except for a few setbacks along the way, corporate earnings have advanced steadily over the past 30 years and that, in my opinion, those earnings advances have been the primary driver of generous returns to those who continued to own a share of corporate America. Over those 30 years, per-share corporate earnings have increased at a compound average annual rate of 7%.

As you can see in the image below, 2023 was a flat year for earnings growth, but Zacks Investment Research expects earnings of the 500 largest companies in the U.S. to advance by almost 9% this year and increase by about 28% over the next couple of years.

I've mentioned many times in past notes that markets tend to react much more to what's next than to what currently is and 2023 provides an example of equity investors making decisions based on a collective peering around the next economic corner.

Even though 2023 was a flat year in terms of earnings growth, investors were collectively guessing that earnings would subsequently rebound. That collective guess resulted in the S&P 500 advancing by well over 20% during 2023 even though earnings growth was nonexistent.

Source: Zacks Investment Research, Inc.

That the S&P 500 index surged by over 20% during a year where corporate earnings stagnated is simply a matter of investors collectively reacting to the conditions they *expect*. In this case, returns accrued to investors in advance of the earnings that would or could support those returns. The converse can also happen. If we apply some mental accounting in a way that supposes that equity returns rose in advance of the earnings that will eventually support those earnings, we might then deem it reasonable for equity returns to take a bit of a breather while corporate earnings catch up.

EQUITIES APPEAR OVERVALUED BY HISTORICAL NORMS

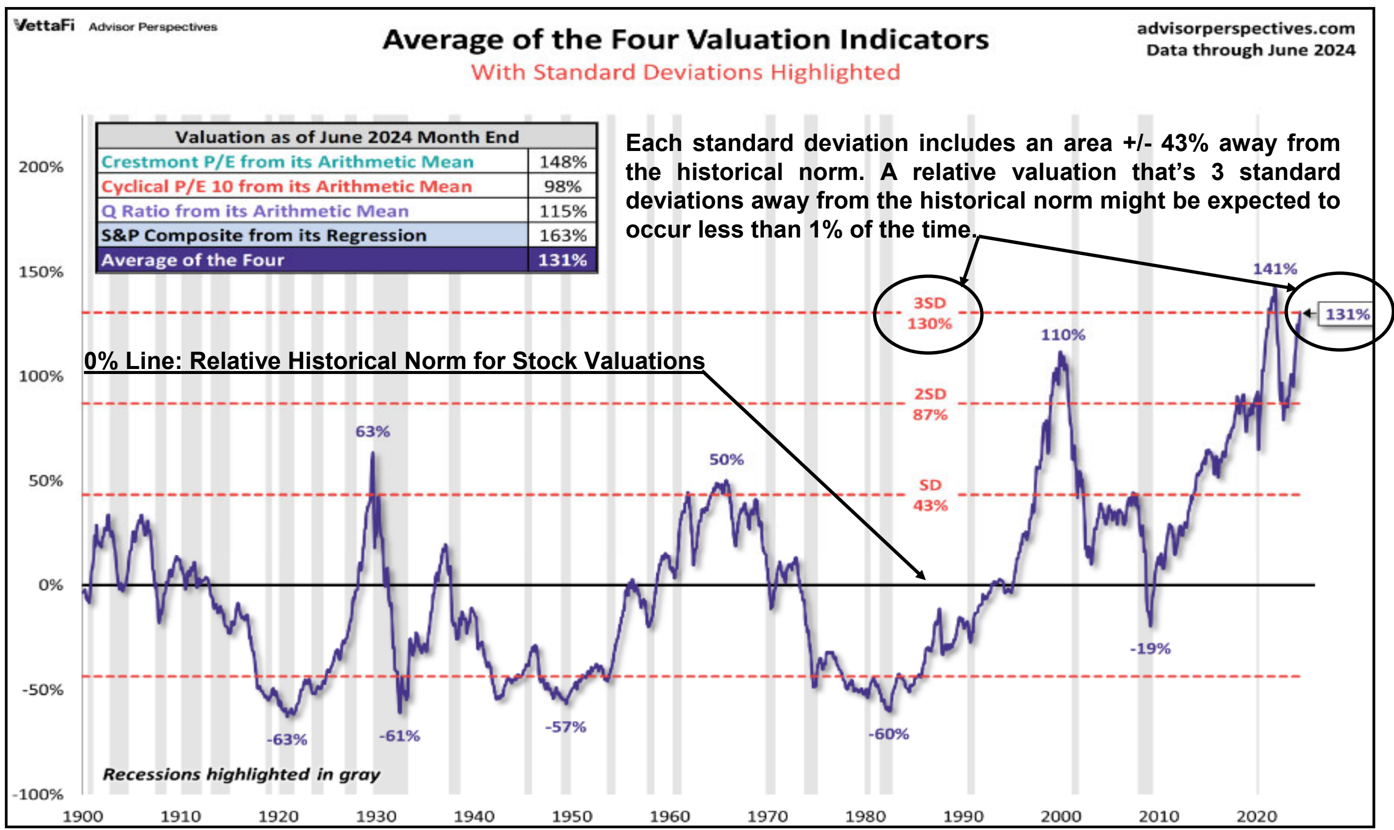
The image at the bottom of page 3 indicates that 30 years ago, an investor would have had to spend $456 to purchase $25.20 worth of corporate earnings resulting in a ratio of purchase price to earnings of about 18:1 ($456 divided by $25.20). Stated differently, each dollar of annual corporate earnings would have cost an investor about $18 back then.

More recently, investors who spend $5,459 to purchase one share of the S&P 500 index would be entitled to $191.79 worth of corporate earnings. The ratio of purchase price to earnings is now 28.5:1 ($5,459 divided by $191.79). Stated differently, each dollar of annual corporate earnings now costs about $28.50 which is about 57% more than one dollar's worth of corporate earnings cost 30 years ago.

Again, this premium may have developed as a result of investors expecting corporate earnings to grow generously over the next few years. Whereas Zacks expects earnings to increase by about 28% over the next couple of years, stocks appear to be trading at a relative premium of 57% versus 30 years ago. If stocks were undervalued 30 years ago, we could then convince ourselves that stock valuations have corrected themselves. However, if stock valuations are considered to have been relatively normal back then, it could also be true that the typical investor expects corporate earnings to grow at a faster pace than Zacks Research does.

SOME QUANTIFICATION OF THE OVERVALUATION OF EQUITIES

This following image compares the current, relative valuation of stocks to their historical norms from four different perspectives and then assesses the degree to which that average deviates from its historical norm. In short, the group that assembled this data concludes that equity valuations stood about three standard deviations (SD) above normal as of the end of June.



If stock valuations are considered to be statistically normal in terms of them temporarily trading at some relative discount or premium to their historical norms (i.e., not skewed one way or the other), one might then expect stocks to trade within one standard deviation of that "0%" line in the previous image about 68% of the time, to trade within two standard deviations of that line about 95% of the time and within three standard deviations of that line about 99% of the time.

There are many ways to assemble and analyze data, but the takeaway here is that the group that assembled the data shown in the previous image believes that the stocks are currently valued very richly. **However, it is important to note that market discounts and premiums can persist for years or even decades, so noting that equities have deviated from historical valuation norms should not be construed as any type of market signal. To the contrary, investors have a long history of playing fancy games with data, convincing themselves of false things, and then suffering as a result of their over-smartness.**

ZACKS ALSO SEES EQUITIES AS OVERVALUED, BUT LESS SO

When an investor buys a share of stock, that investor then becomes entitled to the corporate earnings attributable to that share of stock. Zacks Research estimates that, on average, investors who purchase equities have typically paid about $17 dollars for each dollar's worth of annual corporate earnings attributable to that share of stock (for a ratio of 17:1). Today, Zacks estimates that ratio to be on the order of 22:1 resulting in a relative premium of about 29%. Interestingly, Zacks places the current valuation of equities at approximately one standard deviation above the historical norm, which is much less than the three standard deviations shown on the previous page, but it is still a material premium nonetheless.

THE "BUFFET INDICATOR" ALSO SUGGESTS OVERVALUATION

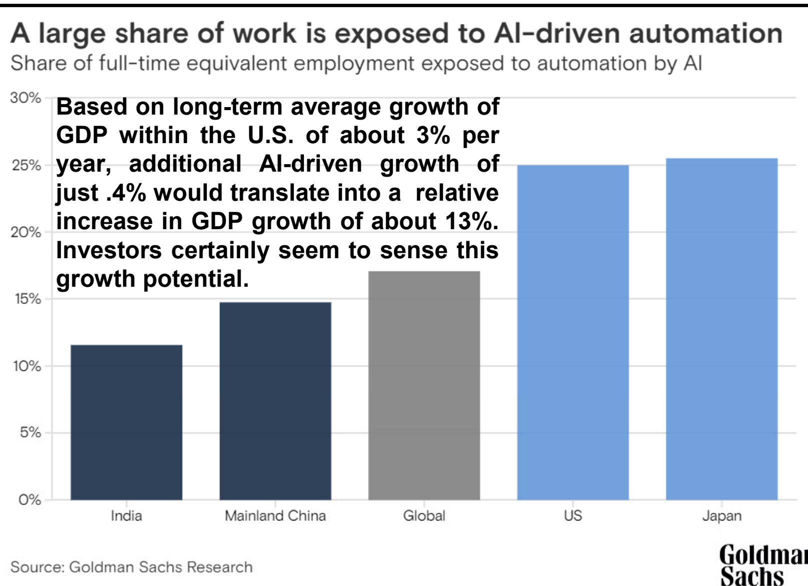
Warren Buffet has a penchant for getting to the heart of a matter in a hurry. The previous image depicts the Buffet Indicator, which simply divides the overall value of the U.S. stock market by the current, annual productive output of the U.S. economy (its Gross Domestic Product). The resulting ratio of 197% indicates that equities are currently valued about 97% higher than the Historical Trend Line (the historical norm) would suggest as being typical.

The upwardly sloping Historical Trend Line suggests that overall value of the stock market has been increasing faster than the rate at which the U.S. economy has been growing. This could mean that stock valuations have been creeping higher over time or that, as the capital markets have evolved, more companies have opted to become publicly held which would increase the overall size of the public stock market. Since that Historical Trend Line is dynamic, the standard deviations around that trend line are also dynamic.

In 2001, Buffett characterized this indicator as possibly being “the best single measure of where valuations stand at any given moment.” Although Warren Buffet has backed away from this indicator over the years, this indicator was two standard deviations above the Historical Trend Line in 2000 which was just prior to the S&P 500 declining by some 47% (recall the “Tech Wreck”). This indicator is once again two standard deviations above the norm, now.

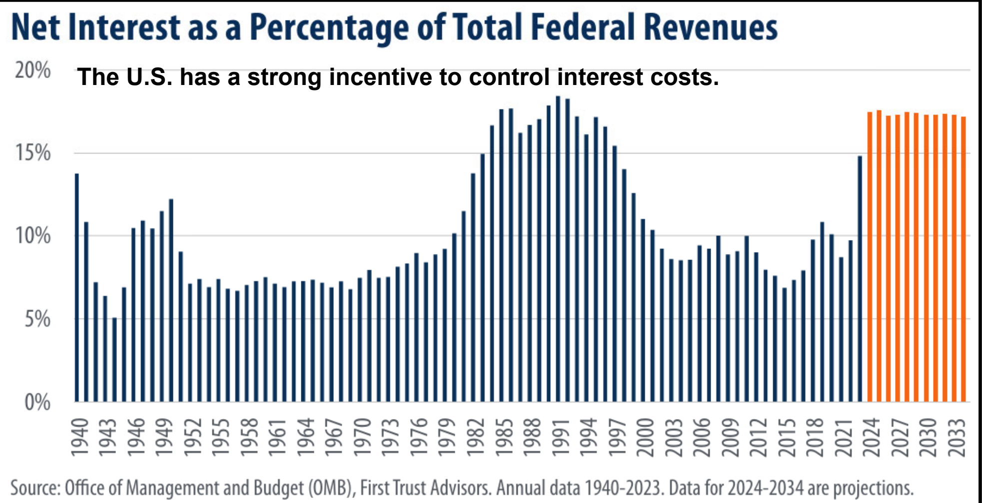
AI MAY BE ONE REASON EQUITY VALUATIONS ARE RISING …

Any number of forces could drive equity valuations higher. In a paper published last November, Goldman Sachs believes that generative artificial intelligence (AI) will begin having a measurable impact on U.S. GDP by 2027. For those who are not yet familiar with generative AI, it is a form of AI that can draw from inputs such as text, image, audio, video, and computer code to generate new content in one or more of these same modalities. (I’m thankful to finally be able to use the word “modalities” without a disease being involved.) Goldman Sachs estimates that by 2034, generative AI could boost GDP by .4% per in the U.S. and by .3% per year in other developed markets. As shown to the right, advanced economies such as the U.S. and Japan are especially ripe for AI-driven productivity gains.



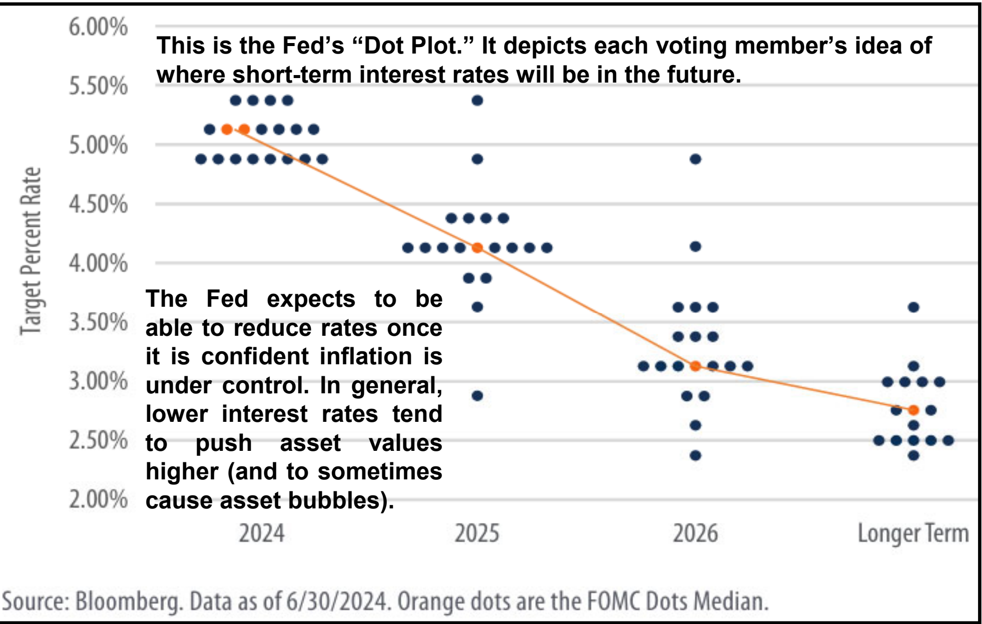
… AND A REDUCTION IN INTEREST RATES MAY BE ANOTHER

In the late 1970s, rising national debt and higher interest rates led to a significant increase in interest costs, peaking at 18.4% of federal revenues in 1991. However, smaller budget deficits and lower interest rates caused this ratio to decline over the following decade. From 2003 to 2018, interest outlays remained at or below 10% of federal revenues, despite substantial borrowing, due to low interest rates. Recently, the combination of rising interest rates and mounting debt has pushed net interest as a share of revenues to 17.5% in fiscal 2024, the highest level since 1992.



Source: Office of Management and Budget (OMB), First Trust Advisors. Annual data 1940-2023. Data for 2024-2034 are projections.

It is no secret that policy makers within our Federal Reserve wish to reduce interest rates, and the image to the right outlines a strong incentive to do so.



Source: Bloomberg. Data as of 6/30/2024. Orange dots are the FOMC Dots Median.

HEDGING EQUITY EXPOSURE

As one who is aware that trying to time the markets leads to worse results more often than not, I am not inclined to make drastic changes to the equity exposure of a given portfolio. Instead, I have begun to introduce exchange-traded funds that are designed to provide decent upside exposure to further gains in equities while simultaneously hedging away substantial portions of downside risk. For example, a fund might be designed to capture the first 15% of stock market upside while also providing protection against the first 9% of market downside. Any holding you see in your portfolio that includes the term "Buffer" is there to provide some downside protection to the equity portion of your portfolio. — Glenn Wessel