Viewpoints | January 13, 2020

TIME TO PLAY DEFENSE.

The Napatree Capital Investment Committee recently decided to lower clients' exposure to equities due to mounting evidence that stock markets are vulnerable to a sell off. Below is a summary of the research that brought upon the decision:

Valuation: The fourth quarter of 2018 was harsh for the stock market[i], selling off nearly 20% before bottoming on December 26th. We feel the significant gain in stock prices in 2019 was driven largely by the panic condition from that market drawdown and a fear that the US economy was on the doorstep of a recession. Consequently, stocks – on average – appeared cheap. By contrast, today stocks – on average – are looking pricey. One data point to consider (there are many), is that the largest 25 public companies by market capitalization have a long-term earnings growth estimate of approximately 10.6% on average. The stock price of those companies increased by greater than 32% on average in 2019. Which means investors are "paying up" for stocks. This isn't a unique dynamic, but with an economy growing by about 2% per year, we don't see major gains in earnings in the near term, which is necessary to support the current valuation.

Sentiment: As mentioned above, there was clear panic in December of 2018 (see our note titled *A December of Extremes* on our website where we outlined why we thought stocks would bottom) which we believe was the catalyst for 2019 stock returns. Remember. . . it is better to buy on panic and sell on greed. Consequently, conditions today are quite different from 13 months ago. Studies suggest an "over" allotment to stocks and optimism by many measures is at an extreme level. Certainly, much more greed than fear.

Stocks vs Bonds: The bond market rallied into late summer of last year, pushing bond yields down. With little income generated from safe-haven assets, investors got "pushed" toward riskier assets. Stocks. That dynamic is changing as the yield curve steepens. Although longer term bond yields remain historically low, shorter term, ultra-safe fixed income assets (i.e. US Treasuries and Bank CDs) offer increasingly attractive yields. To put in perspective…today an investor can generate $1.73 annually in dividend income for every $1,000 invested in the S&P 500 or approximately $1.53 annually for every $1,000 invested in a 90-day US Treasury, which is *risk free and matures in 90 days*. Of course, there is no significant appreciation potential in a US Treasury and stocks offer capital appreciation over time. At 1.73%, the dividend yield on the S&P 500 is the lowest it has been since September 2018, prior to the market sell off, where it briefly touched 1.68%.

Given this scenario, we believe that caution is warranted. Risk management is central to investing. While we are not attempting to call the "end" of the bull market from 2009, we do believe that the risks are increasing for more turbulent markets and defensive posturing is warranted.

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[i] S&P 500 is proxy for 'stock market'