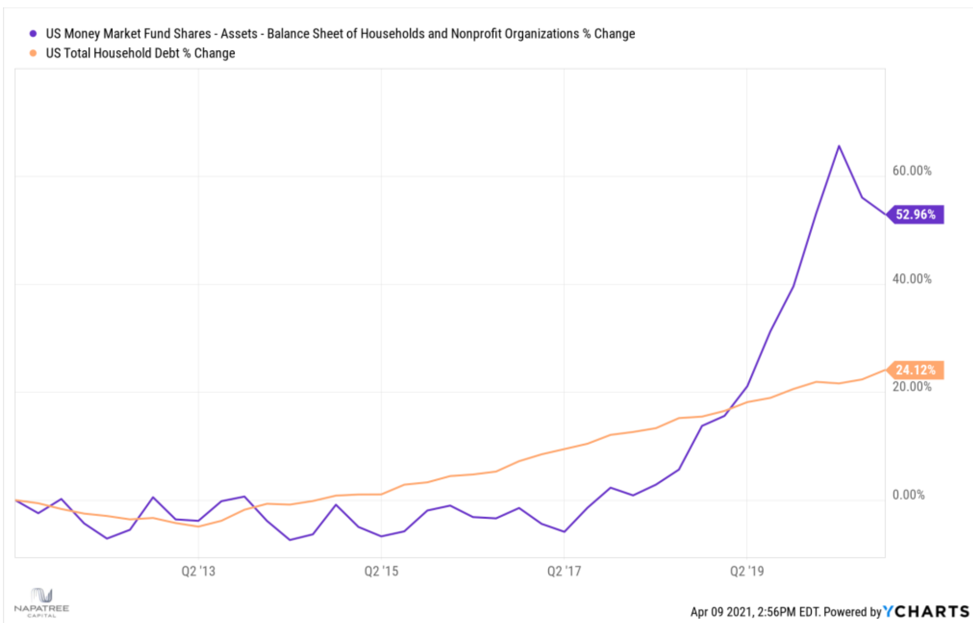
A NERVOUS BULL

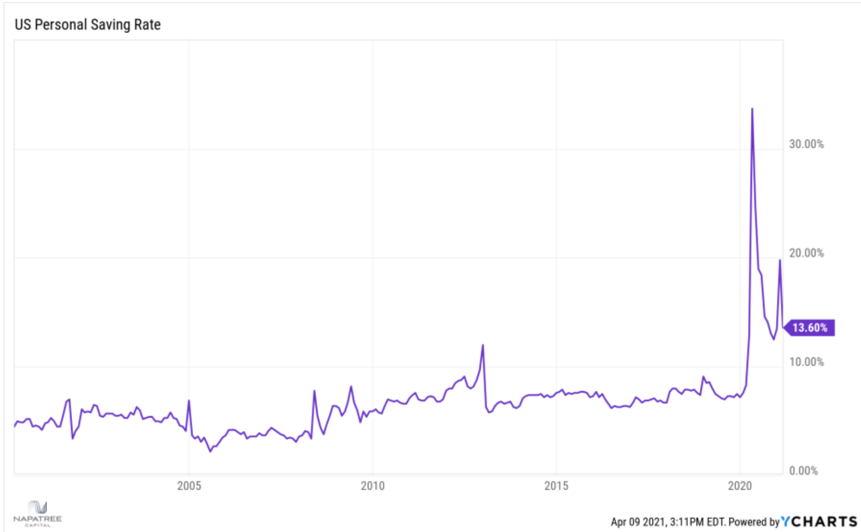
There's a phrase on Wall Street that the stock market climbs a "wall of worry". We've referenced it in past notes when describing the sentiment among market participants. The nervousness you may have about investing right now, as stocks notch all-time highs, is shared by many investors. That, quite simply, is what creates the wall of worry. Amid some concerning trends we see greater evidence why the bull should continue to run.

IS CASH REALLY KING?

One of the data points our investment committee monitors is the amount of cash held by individuals, as measured by money market balances. It can be a useful leading indicator. Currently there is $2.4 trillion in cash, a figure that needs some context, so let's look at the change in cash relative to the change in household debt:



As seen in the graph, cash and debt are tightly correlated, trending in the same direction. From 2011 to mid-2019, debt increased faster than cash. But since 2019, Americans have been sitting on a growing cash pile, even as debt has steadily increased. One dynamic that explains this is that disposable income – the amount of money we have to spend after paying our essential bills – increased 43% between 2011 and 2020. Then the pandemic hit, and we all started hoarding cash, halting any unnecessary spending virtually overnight. Below is an illustration of the personal savings rate:



We can gain insight into human behavior by examining how Americans save. The U.S. personal savings rate hit an all-time high of *nearly 34%* in March 2020, which translates to 34 cents of every dollar going into the mattress. As we near the end of the pandemic, we are still holding on to almost 14 cents of every dollar, which is *still higher* than the peak savings rate at the worst part of the Great Financial Crisis in 2008-2009.

We recognize many factors contribute to the performance of the stock market, but the level of cash should not be ignored. It may also help illustrate the persistent worry on behalf of many investors today.

IS THE MARKET REALLY OVERVALUED?

It is becoming common to hear that the "market is (wildly/exceedingly/scarily) overvalued". Fill in your favorite adverb. On a simple price-to-earnings basis, this is true. Our estimate is that the companies that comprise the S&P 500 will earn about $170 in aggregate per share this year. The index level or "price" of the S&P 500 is around 4,000. Here's the calculus:

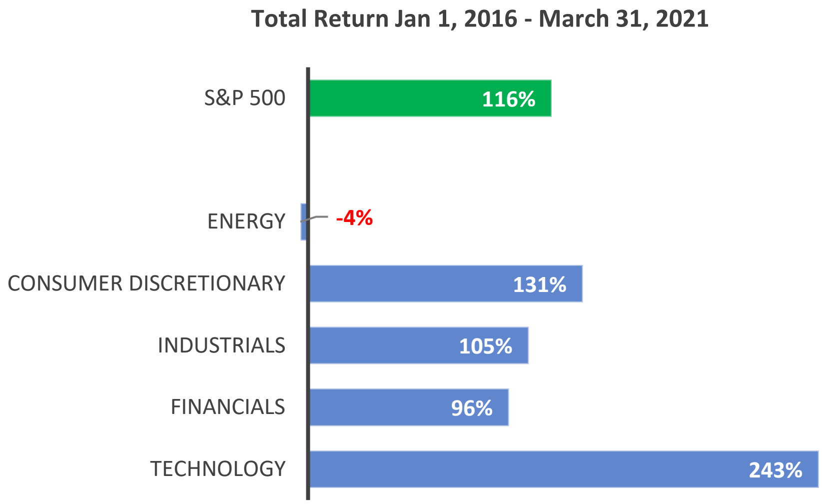
4,000 divided by $170 is 23.5, which implies investors are expecting significant growth in earnings from 2020.
The 25-year average multiple is about 17 times earnings. Using that logic, the stock market is overvalued by a whopping 30%! Or is it?

The real estate market is a good analogy. Homes are appraised at a certain value, which is done by a professional appraiser using multiple comparable home sales. In strong economies, homes generally sell above appraised value. In today's real estate market we are seeing homes listed at a premium over an appraised value and then often selling well above even that premium. Similar behavior.

What could cause this overvaluation, relative to history? First, earnings could come in higher than expected, which would make the valuation more reasonable. We are seeing better than expected earnings from the most recent reports. Second, the market looks forward. That is evident from the last twelve months of returns during an economically crippling global pandemic. So, an analysis using 2022 earnings estimates should be part of the calculus.

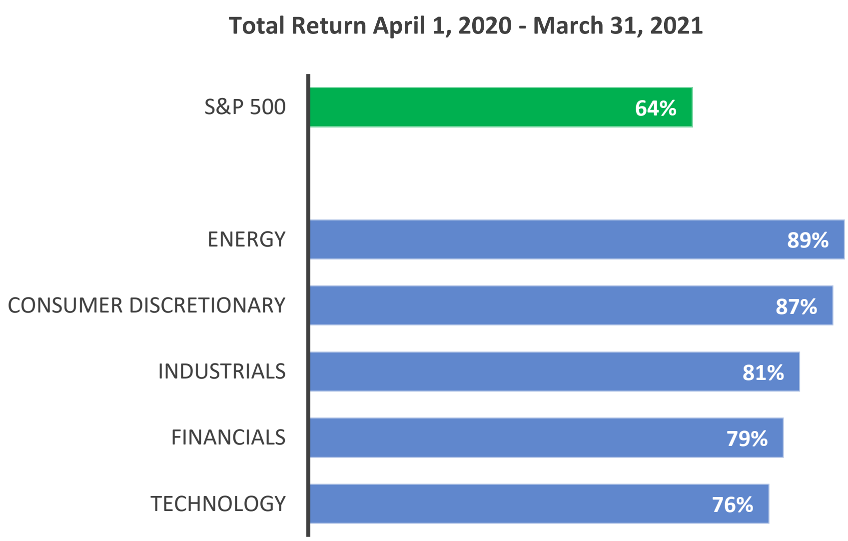
4,000 divided by $200 (consensus earnings estimates for the 500 companies in the S&P 500) is 20.

This is still expensive relative to a historic multiple of 17 times earnings. But now let's dig a bit deeper. The "market", or the S&P 500, is an index, weighted toward the largest public companies (Apple, Microsoft, Amazon, Facebook, Google, Tesla make up roughly 22% of the S&P 500). Performance of the "market" is largely dependent on the performance of those stocks. Five of them are in the technology sector, with Tesla in the consumer cyclical sector. Looking at sector performance during two different time frames reveals what we believe is a changing trend.



It is no surprise that over the past 21 quarters, Technology and Consumer Discretionary (Tesla) sectors outperformed the broader market – in the case of tech, by more than double. Industrials just barely underperformed, Financials lagged, and if an investor had any exposure to the entire Energy sector, she *lost* money while the market generated a 116% return during that time.

The picture has changed in the past year, however:



The most obvious dynamic is that there has been broad participation across sectors; that is the sign of a healthy market. (This is not a complete list of all sectors.) More interesting is that the worst-performing sector from January 1, 2016, Energy – by a wide margin – has been the best performer in the past twelve months. Raise your hand if you bought energy stocks when people stopped driving, planes stopped flying, and Saudi Arabia decided to *not* cut oil production despite the slump. It was a disaster scenario: too much supply combined with a complete halt in demand for oil virtually overnight. In fact, energy companies were paying to offload their oil, incurring losses as a means of keeping their businesses intact. Yet, stocks in the energy sector are up 89% from that period.

These charts illustrate several factors when thinking about market valuation and performance.

1. In the long run, it often pays to adopt a contrarian stance.
2. If the market (S&P 500) performs poorly, you can still make money, because the index is dominated by the largest tech companies.This explains 'active management', a term that means an investor allocates funds based on comprehensive analysis of individual companies or sectors, vs 'passive management', where an investor buys an index fund to own the entire market. (Napatree Capital is an active investment manager.)
3. We still see pockets of value in overlooked stocks in often undervalued sectors.

1ST QUARTER WRAP-UP

By most measures, investors with exposure to equities enjoyed a decent quarter. Bonds have underperformed as interest rates crept higher in the first three months of the year. Below is the first quarter performance for a selection of indexes:

Market Category	Q1 Return
S&P 500	6.1%
Dow Jones Ind Avg	7.8%
Nasdaq	1.8%
Russell Mid Cap	7.9%
Russell Small Cap	12.7%
International Developed	4.0%
Emerging Markets	3.2%
Commodities - Agriculture	6.0%
Commodities - Metals & Mining	7.7%
US Aggregate Bonds	-3.4%
Investment Grade Corporate Bonds	-4.8%
High Yield (Junk) Bonds	0.6%
Global Treasuries	-6.6%

Looking forward, we are encouraged by the high levels of cash, earning little in money markets and bank accounts; we believe this cash will find its way into the stock market. The change in the underlying behavior of the S&P 500, where there is greater participation across sectors and categories, and our ability to uncover value in such areas, is also a positive sign for the remainder of the year.

Optimism toward stocks is currently high – which as a contrarian is not a good sign – and there are some troubling signs of speculation. Please refer to our January 29 note "The Gamestop Frenzy" as an example of such behavior. But we believe that there is more *discussion* about speculation than there is actual speculation. It is hardly a novel phenomenon. A few volatile trading days typically makes investors more nervous, which we would welcome. After all, calm bulls don't run.