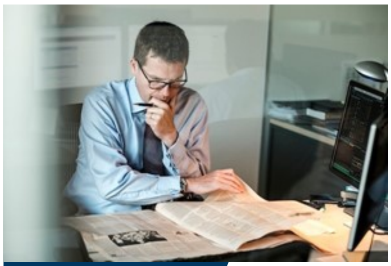


Friday Morning Coffee

Nr. 150 — Bubble talk

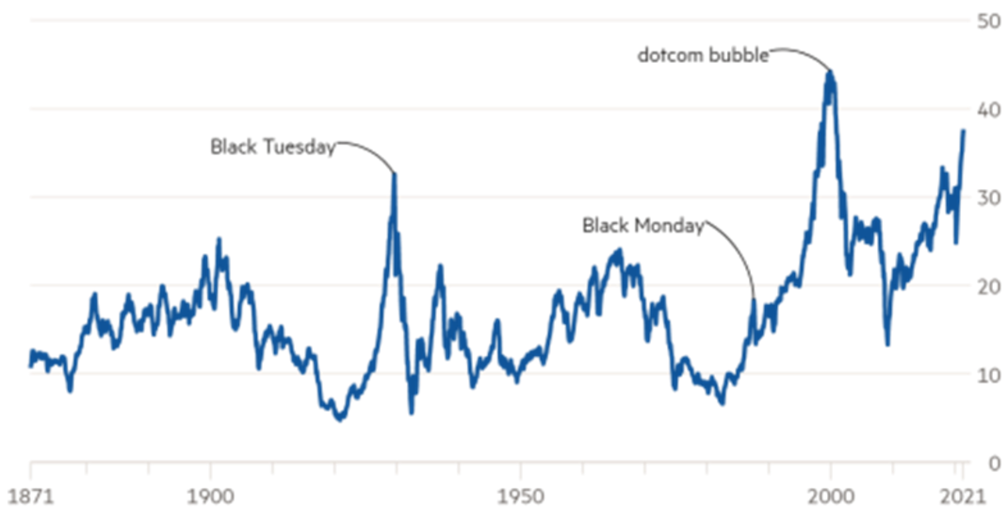
" "Vulnerabilities associated with elevated risk appetite are rising," Fed Governor Lael Brainard, the head of the Board's financial stability committee, said in a statement accompanying the report released Thursday. "The combination of stretched valuations with very high levels of corporate indebtedness bear watching because of the potential to amplify the effects of a re-pricing event." In this environment, prices may be vulnerable to "significant declines" should risk appetite fall, the Fed report noted.

Overall valuations of equity markets are high on most metrics used. The so-called Buffet indicator, measuring the market cap compared to GDP, is at an all-time high. Also, the cyclically adjusted price to earnings ratio, CAPE, dividing the current stock prices by the average 10 years inflation adjusted earnings of the US market, is at the highest since the dotcom bubble.

As value investors, we have a certain reluctance to state that these times are different, and valuations are justified. A lot can be explained by artificially low interest rates after years of quantitative easing by central banks following the financial crisis.

US stock market valuations are the highest since the dotcom bubble

Shiller's cyclically-adjusted price-to-earnings (Cape) ratio



Source: Multpl.com
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Furthermore, the composition of the market has changed with a higher weight to technology with intangibles on their books the standard valuation metrics may not fully capture. And finally, companies in the US are currently more profitable than they ever were over the last 20 years as shown in the graph below:

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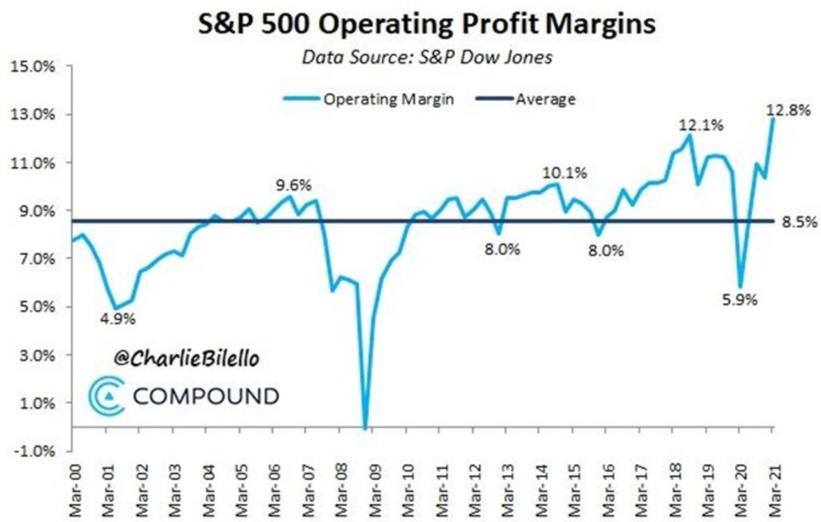
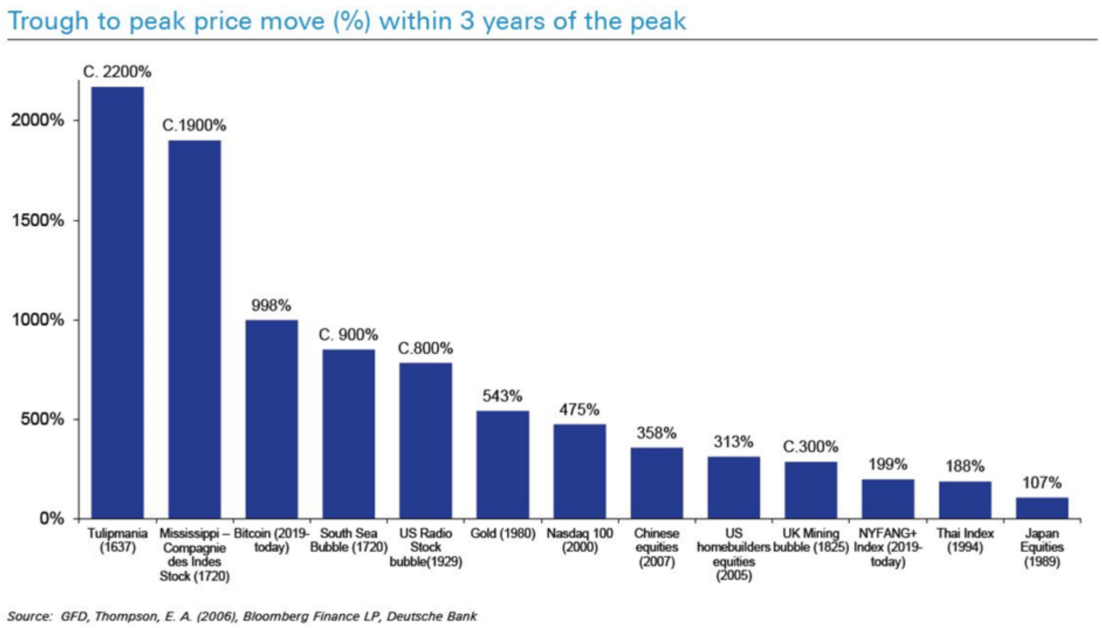


There are risks in equities overall. While the Q1 earnings season has been remarkable the clouds on the horizon are for example higher corporate taxes, cost inflation not passed through to the end consumers, a mutation of the virus and renewed trade tensions with China.

Nevertheless, beyond the surface we are still finding interesting investment opportunities of quality companies that do not show extreme valuations.

It is difficult to deny that bubbles are popping up in corners of the market. If we analyze things from a historical perspective, while we will only recognize the bubbles once they burst, bubbles have one common characteristic, which is the strong price appreciation in the years before they peak.

Here is a nice summary of the greatest bubbles in financial history where are included 2 assets, bitcoin and FANGS, that have not burst yet:



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As so often, Warren Buffett summarized it accurately: "Nothing sedates rationality like large doses of effortless money. Normally sensible people drift into behaviour akin to that of Cinderella at the ball." "They know that overstaying the festivities – that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future – will eventually bring on pumpkins and mice," Buffett continued. "But they nonetheless hate to miss a single minute of what is one helluva party," he said. "Therefore, the giddy participants all plan to leave just seconds before midnight. "There's a problem, though: They are dancing in a room in which the clocks have no hands," Buffett added.

Intellect is not a weapon against our behavioural biases. Famously Sir Isaac Newton lost a fortune after having made initial gains on speculating on the South Sea Bubble and not exiting his positions on time.

As value investors, we want to make sure we are not falling asleep at the wheel and continue to be incredibly careful about what price we pay for an asset. It does not always make us popular and does not always give us the comfort of being with the crowd. However, we remain convinced that it will ultimately help us to preserve capital once the party stops.

Have a nice weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
May 7th, 2021