Weekly Market Flash

Fourth Quarter Could Be Bumpy

September 3, 2021

August is over, which means we can no longer lazily type in "dog days, low volumes, everyone's on holiday" as the go-to explanation for whatever is going on in asset markets. The kids are going back to school and the smell of pumpkin spice is already wafting through the air, though the air itself is not yet particularly fall-like as climate change extends the feeling of summer further and further into fall's former territory. It's time to take a look ahead and see what kind of fall may be in store for investors.

Risk Takers of the World, Unite

We're starting the post-Labor Day period with the S&P 500 sitting comfortably with a 20 percent year-to-date gain, with the tech-laden Nasdaq Composite nipping at its heels and making up for the big performance gap with value stocks earlier in the year. The vibes of 2H 2020 are in the air: tech and other growth stocks surging right along with new Covid cases. The speculative corners of the market are also doing just fine, thank you – cryptocurrency investors are resolutely ignoring all the regulatory pushback from governments around the world and jaw-jawing their beloved tokens back towards the nosebleed highs of the past spring. The meme stocks beloved of juiced-up trader bros are doing just fine. Any drawdowns in major indexes like the S&P 500 are brief and shallow. BTD (buy the dip) and TINA (there is no alternative) rule the Zeitgeist. It's a world for risk takers, by risk takers and of risk takers.

When the Denominators Change

Risk takers have had some cover this year to defend themselves against charges of excess. Earnings per share for S&P 500 companies for the second quarter came in at a whopping 92 percent, and are expected to register a 43 percent gain for the year as a whole. That is a pretty forgiving denominator for the price / earnings ratio. The last twelve months price-to-earnings ratio is still high by historical standards at 25, but below the peak of 30 it reached back in April. The next couple of quarters will keep a tailwind behind valuations getting too far out of control.

But the tailwind will not last forever. The market, being a forward-looking creature, will start to pay less attention to valuation based on trailing periods of one-off excess (e.g. the sharp earnings contraction periods in the middle of 2020) and more attention to what profits – and in particular profit margins – are going to look like down the road. One very constant theme in earnings calls with management teams during the Q2 season was margin pressure from inflation. The markets for both labor and raw & intermediate goods are distorted, while the global demand outlook is uncertain with the persistence of the pandemic and the low percentage of vaccinated citizens in much of the world. Earnings valuations have not mattered much in the frenzied speculative chase for riches that has continued for more than a year. But they will matter, and they might start to matter soon.

Elusive Risks Remain

"Risk" in the investment world traditionally has had a fairly specific definition: the likely variability of an asset's returns around an expected outcome. The greater the variability (which can be up or down) the higher the risk. That kind of risk is measurable via the toolkit of investment professionals – standard deviation, beta, value at risk and all the frills-full derivatives thereof. But these quantitative measures

based on probability theory do not work well as insights into the level of measurable risk posed by some of the biggest threats in our world. In our discussions with clients the conversation often comes around to the (in our opinion) four big ones: the 4Cs of cyber, climate, contagion and China (stay tuned for a forthcoming paper which will present our views on the 4Cs in more detail). Neither the timing nor the magnitude of these risks is knowable, but we know they are clear and present. We would perhaps add a fifth: capitulation, which is how we would define an environment where market opinion arrives at a broad consensus that the Fed and other central banks lack the means to fix whatever problem is at hand.

Nothing we have discussed in this paper is necessarily going to have any impact whatsoever on the performance of assets in the fourth quarter. If we had to guess (always a bad idea in this business) we would say that any threat actualizing as a present-day risk would have to pack a fairly sizable wallop to overcome the resolute optimism and complacency prevailing today. We used to speak of a "wall of worry" that stocks had to climb in order to get past investor fears during periods of disruption. Today that idea seems turned on its head – it is rather that the disruption itself has to climb a wall of optimism to make an impact. That wall is still fairly strong, but there may be some emergent cracks in the foundation.

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