Reasons (Not) to Be Cheerful

By James Montier *Wed, Aug 26, 2020*

'Voltaire observed, "Doubt is not a pleasant condition, but certainty is absurd." The U.S. stock market appears to be absurd,' writes the member of the asset allocation team at GMO LLC.

Never before have I seen a market so highly valued in the face of overwhelming uncertainty. Yet today the U.S. stock market stands at nosebleed-inducing levels of multiple, whilst the fundamentals seem more uncertain than ever before. It appears as though the U.S. stock market has drunk from Dr. Pangloss' Kool-Aid – where everything is for the best in the best of all possible worlds. It is as if Mr. Market is taking a tail risk (albeit a good one) and pricing it with certainty.

Now let me be clear, I don't claim to know the answers to any of the deep imponderables that face the world today. I have no idea what the shape of the recovery will be, I have no idea how easy it will be to get all the unemployed back to work. I have no idea if we will see a second wave of Covid-19 or what we will do if we do encounter such an event. But I do know that these questions exist. And that means I should demand a margin of safety – wriggle room for bad outcomes if you like. Mr. Market clearly does not share my view.

Instead, as best I can tell, the driving narrative behind a V-shaped recovery in the stock market seems to be centered on "The Fed" or, even more vaguely, "liquidity creation." It is tricky to argue for any direct linkage from the Fed's balance sheet expansion programs to equities. The vast majority of QE programs have really been about maturity transformation (swapping long debt for very short-term debt). Nor can one claim a good link between QEs to yields to equities.

In fact, during each of the three previous waves of QE, bond yields actually rose. In addition, yields around the world are low but you don't see other equity markets sporting extreme valuations. So, I think that Fed-based explanations are at best ex post justifications for the performance of the stock market; at worst they are part of a dangerously incorrect narrative driving sentiment (and prices higher).

The U.S. stock market looks increasingly like the hapless Wile E. Coyote, running off the edge of a cliff in pursuit of the pesky Roadrunner but not yet realizing the ground beneath his feet had run out some time ago.

Investing is always about making decisions under a cloud of uncertainty. It is how one deals with the uncertainty that distinguishes the long-term value-based investor from the rest. Rather than acting as if the uncertainty doesn't exist (the current fad), the value investor embraces it and demands a margin of safety to reflect the unknown. There is no margin of safety in the pricing of U.S. stocks today. Voltaire observed, "Doubt is not a pleasant condition, but certainty is absurd." The U.S. stock market appears to be absurd.

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