# Market Commentary
June 30, 2022

ADVANCED ASSET MANAGEMENT ADVISORS

## Are The Bubbles Behind Us?

A bubble is a speculative mania, where asset prices are much higher than the underlying fundamentals can reasonably justify.

In the early stages of a bubble, few recognize the bubble for what it is. People notice that prices are going up and often think it is justified. Bubbles are usually identified in retrospect, after they have popped and prices have crashed.

Here is a listing of some asset values, including some of the most bubbly, and a few that cannot yet be identified as bubbles.

| | 12/30/2018 to High | High to 6/30/2022 | 12/30/2018 to 6/30/2022 |
|---|---|---|---|
| **Cryptocurrency ETF** | N/A | **-73%** | N/A |
| **Bitcoin** | 1705% | **-71%** | 429% |
| **SPAC ETF** | N/A | **-62%** | N/A |
| **IPO ETF** | 230% | **-60%** | 30% |
| **Long Term Treasury Bond ETF** | 46% | **-31%** | 0% |
| **Nasdaq 100** | 167% | **-30%** | 86% |
| **S&P 500 Index** | 91% | -21% | 51% |
| **Money Supply** | 426% | -2% | 416% |
| **Federal Reserve Balance Sheet** | 122% | 0% | 122% |
| **Case-Shiller Home Price Index** | 46% | 0% | 46% |
| **Consumer Price Index** | 15% | 0% | 15% |

(The SPAC ETF inception date was 10/1/20 and the Cryptocurrency ETF inception date was 10/19/2021)

We think it is fair to identify the top six listings as having completed a “bubble”—prices higher than reasonable and a subsequent decline of more than 25%.

The S&P 500 has flirted with a 25% decline this year, but hasn’t quite crossed that threshold. Home prices, the poster child of the 2008 financial crises, have not crashed. And the Fed’s balance sheet and inflation have not declined at all.

Housing prices are not as vulnerable today due to tighter lending standards, historically low mortgage rates (yes, even 6% is reasonable to many), and institutional buyers acquiring properties for rental portfolios.  The Federal Reserve’s current plans seem to indicate a new-found resolve to fight inflation which (indirectly) should curb the growth of its balance sheet and the money supply.

We do not have any indication for the logical valuation of crypto assets, the SPAC universe is dominated by money-losing operations, and the IPOs of the last few years need time to prove themselves.  However, the loss of paper value in these assets along with traditional stocks and bonds is in the trillions of dollars.

The decline will affect many things. Some down payments for a home or a car are gone. Some swimming pools will not be built. And some envisioned luxury goods purchases will not happen. The wealth effect of rising asset prices is currently in reverse and negatively impacts the 65% of our economy represented by consumer spending. However, the burst bubble leaves stock valuations well within the "normal" range.

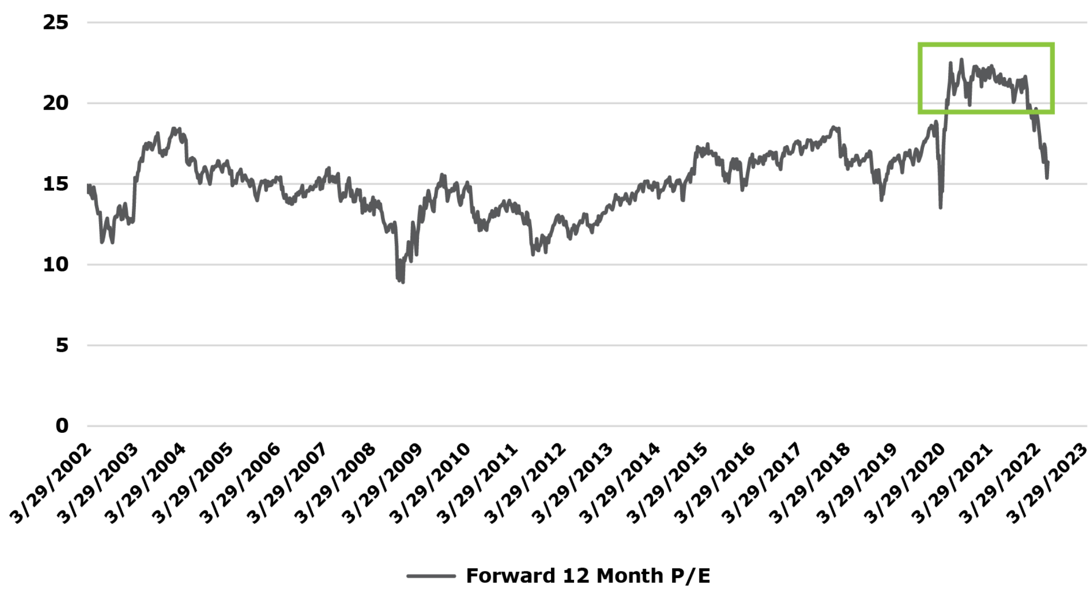
### The Wealth Effect:

*Spending changes that coincide with changes in perceived wealth, such as a rise in asset values (i.e. home values, investments).*

## Stock Valuations

The forward price-earnings ratio for the S&P 500 is a good measure of stock prices relative to the underlying fundamentals.

**S&P 500 Forward Price To Earnings Ratio**




The decline of stock prices has brought the forward P/E ratio down from its bubble levels (19-23) to a more reasonable level of 16.

The decline in the P/E has been entirely from falling stock prices. Estimates for 12-month forward earnings have been steady, although there are well founded concerns about the estimates. The elevated profit margins companies have enjoyed over the last two years have occurred before but were never sustained. Consumer spending is not likely to continue at the same pace as the last two years. A decline in corporate earnings would not surprise us in the least. A modest decline of 5 to 10% (an earnings recession) is probably baked into current stock prices. A broader economic recession would affect earnings and stock prices more negatively.

The "bubble" in stock price valuations is behind us and valuations are in the middle of the normal range. Whether we see a 12 P/E or a 19 P/E will depend on the strength of the economy, inflation, interest rates, and importantly, corporate earnings (the "E" in the ratio).

## The Economy

The economy has definitely slowed from its torrid rebound after the pandemic recession. We have often cited the large fiscal and monetary support for consumer and business spending during the pandemic. Those supports are behind us, and the economy needs to stand on its own.

First quarter GDP declined 1.6%. Second quarter growth is expected to be unremarkable. Asset value declines and inflation are hurting spending. Whether we technically avoid a recession or not, growth is likely to be modest at best over the next year or two.

Long term economic growth thrives on improvements in productivity, which we normally visualize as new technology and innovations. However, the pandemic threw a wrench in the mix.

The labor force has yet to return to pre-pandemic levels as many participants have retired early, chosen not to work, or are limited due to workplace rules. Delicate global supply chains have been fractured. Productivity over the last year has grown at less than half the long-term average. A recession is the opposite of an asset price bubble. Economic weakness percolates below the surface until suddenly unemployment spikes and the Bureau of Economic Analysis proclaims a recession has or is occurring.

These same factors weigh in the inflation question as well. American corporations spent 35 years incorporating lower foreign labor costs into their supply chains and cost structures. On-shoring and near-shoring trends are beginning and typically mean higher costs for components. The labor market remains tight with elevated job openings relative to unemployed, which brings us to the Federal Reserve and…

## Interest Rates

The Federal Reserve has adopted "fighting inflation" rhetoric since the chairman was reappointed late last year. To date it has largely been jawboning. They raised short term rates from 0.12% to a still unrestrictive 1.62%. Their balance sheet (ten times its size from 2010) is unchanged, although they promised a coordinated shrinkage plan to start this month.

The jawboning has worked to a degree as Treasury bond yields have risen across all maturities. The fact that yields were miniscule at the start translated into historically large losses for long dated bonds. It was a market risk that kept our bond portfolios in short-dated issues.

We will make a prediction that if the Fed continues to raise short-term rates and does commence a meaningful balance sheet shrink, they will break the economy before inflation comes down to their 2% target.

Essentially, they are attempting to land a Boeing 767 on an aircraft carrier. Two key factors come into play.

First, there are few components of consumer inflation they can influence with short-term rates. On the margin, demand for consumer durables that depend on financing will decline which should reduce some pricing pressure. They cannot fix supply chain issues, increase energy production, or force people back to work—especially not with higher interest rates.

There are too many sticky components to inflation that the Fed cannot control.

The second key factor is the negative impact from tighter financial conditions that would result from a smaller balance sheet.  If something breaks in the markets or in the economy, the Fed will blink and reverse course from their well-telegraphed "inflation fighting" position.

## How Is Advanced Asset Management Advisors Positioned Today?

We remain committed to our fundamental market pricing and sector valuation process.

As indicated in our previous commentaries, our equity portfolios are generally focused in large cap companies, making sure that more defensive sectors are represented—Healthcare remains a standout.

Our fixed income portfolios remain positioned in short-term and high-quality debt instruments to reduce the risk of principal that occurs in a rising rate environment.

**Your AAMA Team**

### Want to Discuss?

If you would like to discuss this content, please feel free to reach out to our President, Bob Baker, at **614-726-3622** or our National Sales Manager, Aaron Ploscowe, at **614-726-3627**. We'd love to speak with you.



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