AdvisorIntelligence
LITMAN GREGORY

Financial Markets: Risk & Opportunities

June 30, 2020

With the global economy trying to dig its way out from the voluntary shutdowns to contain COVID-19, we see both risks and opportunities for financial assets for the rest of 2020. Besides the risk of a severe second wave of the virus, the primary market risk we see is *overvaluation*, which implies poor forward-looking returns for both core bonds and U.S. stocks.

Core Bond Returns Will Be Very Low

The core bond expected return math is pretty straightforward. At a current yield of around 1.3%, their expected five-year annualized return in our base-case scenario is around 1%. If rates drop between now and then, they'll earn a bit more than 1% annualized. No matter how you slice it, the future return for core bonds from these very low starting yields is very low and probably negative in real terms (netting out future inflation).

This is why roughly half the fixed-income allocation in our balanced portfolios is invested outside of core bonds, in flexible fixed-income and floating-rate loan funds. These investments have expected returns several percentage points higher than core bonds, in our view. Those healthy expected returns are balanced against the fact that we are taking on more short-term risk from these investments compared to core bonds in the event of a COVID-19 resurgence or some other recessionary shock. But they are much less risky than U.S. stocks, and we believe they have better five-year return potential than U.S. stocks at this point in the cycle.

U.S. Stocks Are Overvalued and Offer Poor Expected Returns

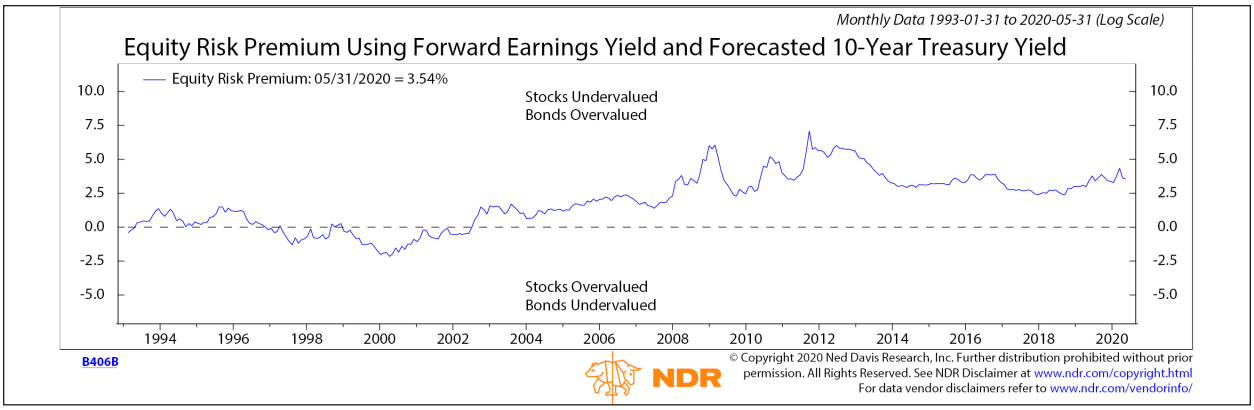
After rallying more than 37% from their March low, U.S. stocks are overvalued in our baseline scenario. We estimate a five-year annual expected return for the S&P 500 of only 1.5% in our base case. So, from an *absolute valuation* perspective—comparing the current market price (what you pay) to its expected stream of profits and dividends (what you get)—the U.S. market is expensive. Numerous and various absolute valuation metrics confirm this.

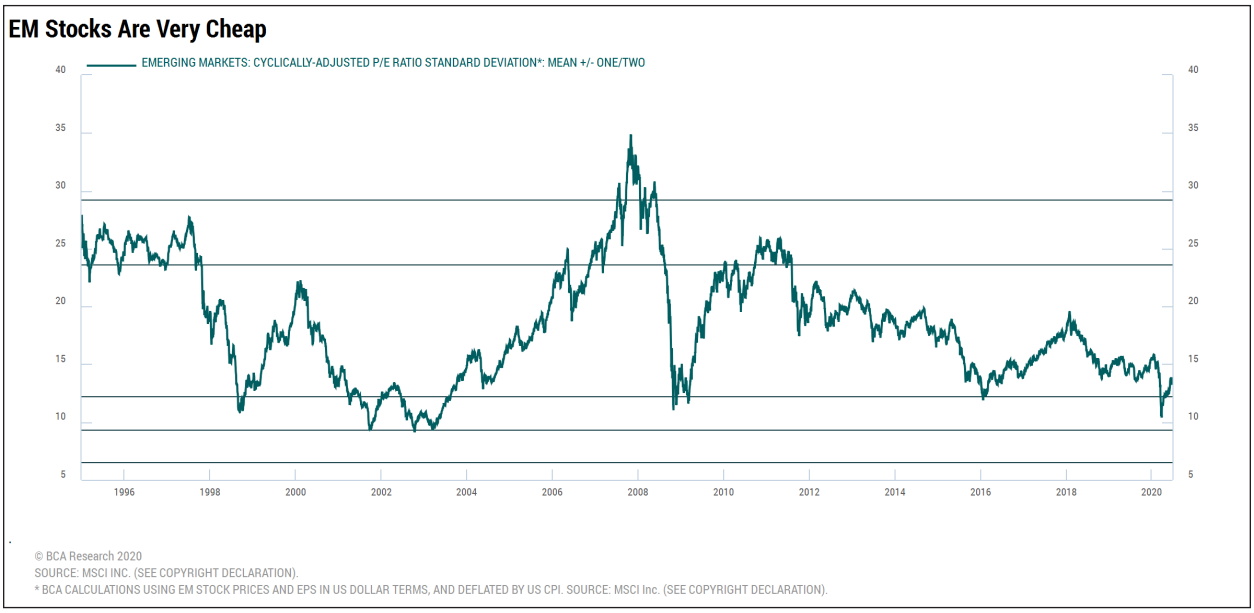
However, many investors seem to focus more on the *relative* return potential of stocks compared to bonds or cash. The *relative valuation* of stocks versus bonds is typically referred to as the equity risk premium (ERP). Because equities are riskier than bonds, investors should *always* expect to earn a risk premium—an additional return—from owning stocks compared to bonds. In practice, the ERP has varied over time as stock and bond prices (and yields) have fluctuated.

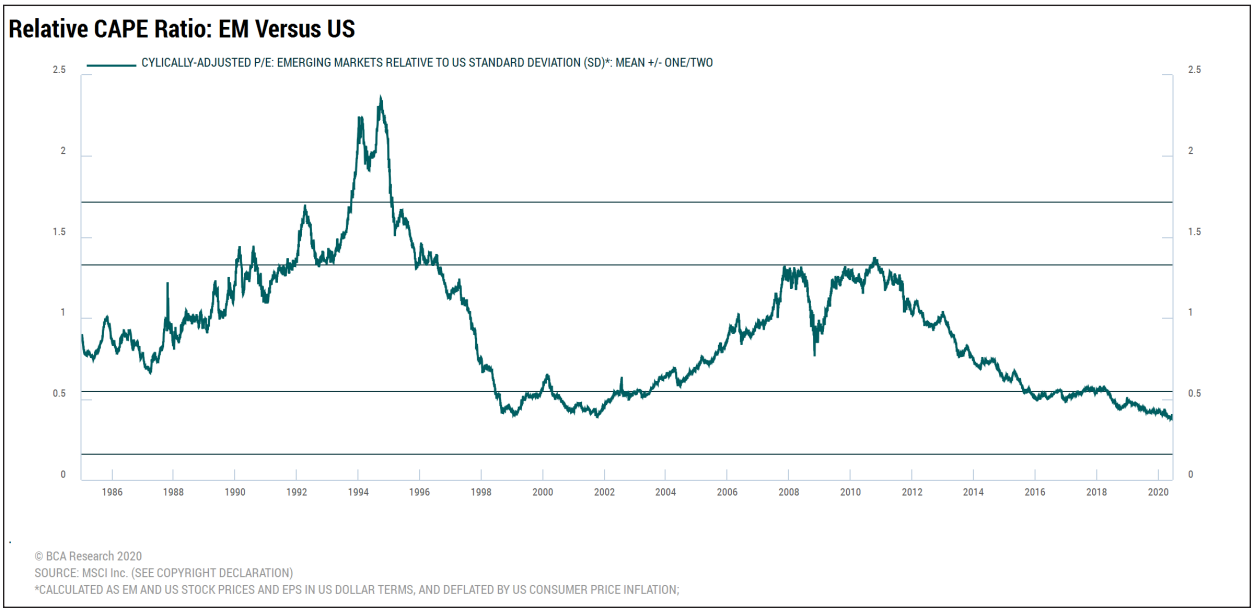
Because core bond yields are extremely low right now, stock valuations, despite being absolutely high, still look relatively attractive compared to core bonds. We can see this in the chart on the next page (a higher ERP implies stocks are cheaper versus bonds).

Our investment process puts more weight on absolute valuation than relative valuation because absolute valuation is the strongest predictor of expected returns over a full market cycle. Also, we manage our portfolios against an absolute risk threshold (12-month loss) not relative risk. So, just because U.S. stocks have a higher expected return than bonds doesn't make us automatically favor U.S. stocks over bonds.

For us to overweight stocks, we need to see that they offer an *absolute* expected return that more than compen-


Monthly Data 1993-01-31 to 2020-05-31 (Log Scale)
Equity Risk Premium Using Forward Earnings Yield and Forecasted 10-Year Treasury Yield
Equity Risk Premium: 05/31/2020 = 3.54%
Stocks Undervalued
Bonds Overvalued
Stocks Overvalued
Bonds Undervalued
10.0
7.5
5.0
2.5
0.0
-2.5
-5.0
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
B406B
NDR
© Copyright 2020 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html
For data vendor disclaimers refer to www.ndr.com/vendorinfo/


EM Stocks Are Very Cheap
EMERGING MARKETS: CYCLICALLY-ADJUSTED P/E RATIO STANDARD DEVIATION*: MEAN +/- ONE/TWO
40
35
30
25
20
15
10
5
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
© BCA Research 2020
SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).
* BCA CALCULATIONS USING EM STOCK PRICES AND EPS IN US DOLLAR TERMS, AND DEFLATED BY US CPI. SOURCE: MSCI Inc. (SEE COPYRIGHT DECLARATION).


Relative CAPE Ratio: EM Versus US
CYLICALLY-ADJUSTED P/E: EMERGING MARKETS RELATIVE TO US STANDARD DEVIATION (SD)*: MEAN +/- ONE/TWO
2.5
2
1.5
1
0.5
0
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
© BCA Research 2020
SOURCE: MSCI Inc. (SEE COPYRIGHT DECLARATION)
*CALCULATED AS EM AND US STOCK PRICES AND EPS IN US DOLLAR TERMS, AND DEFLATED BY US CONSUMER PRICE INFLATION;

sates us for taking on additional equity risk. This is not the case today for U.S. stocks. Our analysis shows both U.S. stocks and core bonds are unattractive on an absolute risk/return basis. So we are underweight to both.

However, over shorter time horizons relative valuations can matter more than absolute valuations. This is especially true if investors are making investment decisions based on relative metrics more than absolute ones. It can become a self-fulfilling prophecy, up to a point. With most investors confident the Fed will keep interest rates flat, the relative valuation ERP perspective may continue to dominate.

International and EM Stocks Offer Attractive Expected Returns

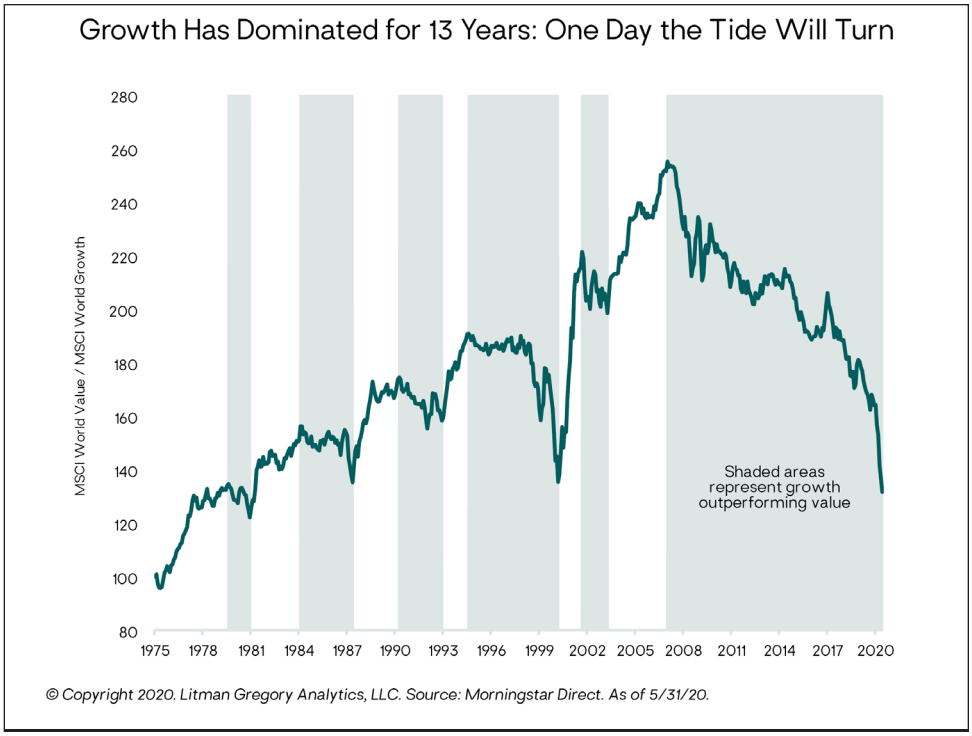
Foreign stock markets are more attractively valued on both an absolute basis and relative to U.S. stocks, and offer much higher expected returns, in our analysis. EM stocks look particularly attractive. Our base-case five-year expected return for EM stocks is roughly 12%. For developed international stocks it is roughly 10%. These are satisfactory returns for these markets on an absolute basis, given their risks. And they offer a very large return premium relative to the U.S. market.

We never know exactly when we will get paid for our tactical positions. The current health crisis makes the timing even more unpredictable. But when and as the global economy recovers from the COVID-19 lockdowns, we expect international and EM stocks will outperform the U.S. market, similar to what happened in 2017 during that broad global recovery. There are several reasons for this.

Low Valuations

First, as noted above, overseas stocks are more reasonably priced than U.S. stocks. The second chart on the opposite page shows the cyclically adjusted P/E ratio—an absolute valuation metric—for the EM stock index. It currently resides near its lowest level in 35 years of history. The relative valuation chart of EM stocks vs. U.S. stocks tells a similar story.

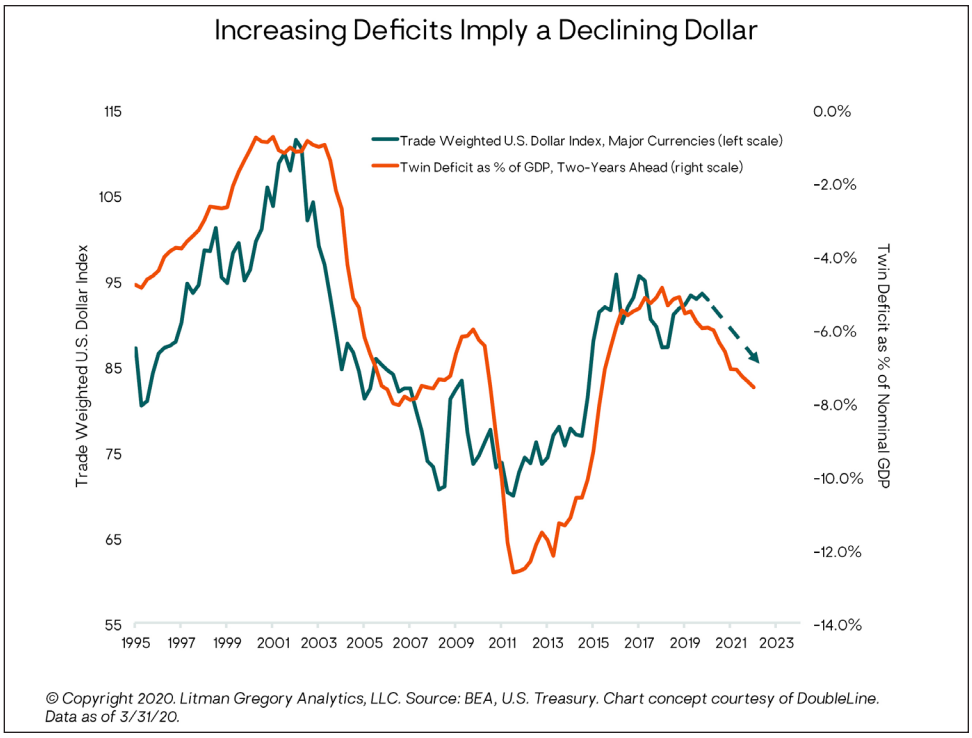
Low valuations reflect investors' pessimistic outlook for these regions. This creates the potential for a meaningful positive surprise. The bar is low. Things don't have to become absolutely great for emerging markets; they just have to get relatively better from their current depressed levels.



Cyclical Sensitivity

Second, in general, foreign economies and markets are more cyclically sensitive; their businesses and earnings are, in aggregate, more tied to the ups and downs of the economic cycle than the U.S. market. This explains much of their underperformance versus U.S. stocks over the past 10 years, a period of sub-par global economic growth. As global growth recovers, foreign business-

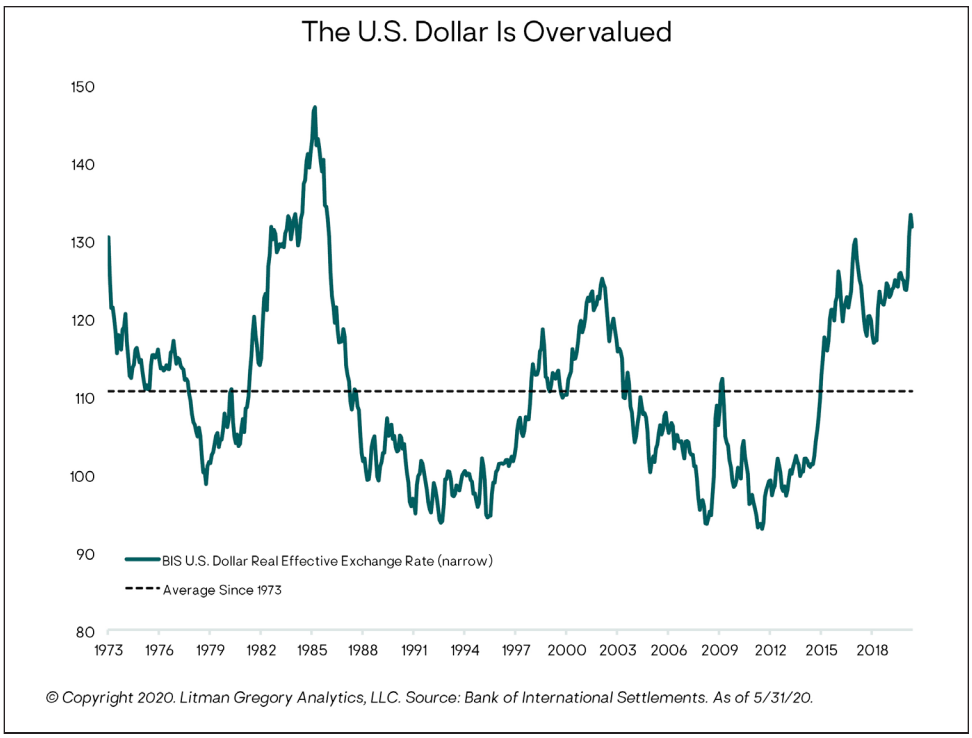
es' earnings should get a strong lift. And when that happens, their stock prices and valuations should move higher as investors start to incorporate a less-negative outlook for these regions and companies.



Similarly, a recovery in global economic growth should also give a boost to value stocks and sectors (such as industrials, financials, materials, energy), overseas and in the United States. In fact, it could mark the inflection point ending the extraordinary 13-year dominance of growth stocks over value stocks.

The U.S. Dollar: From Headwind to Tailwind?

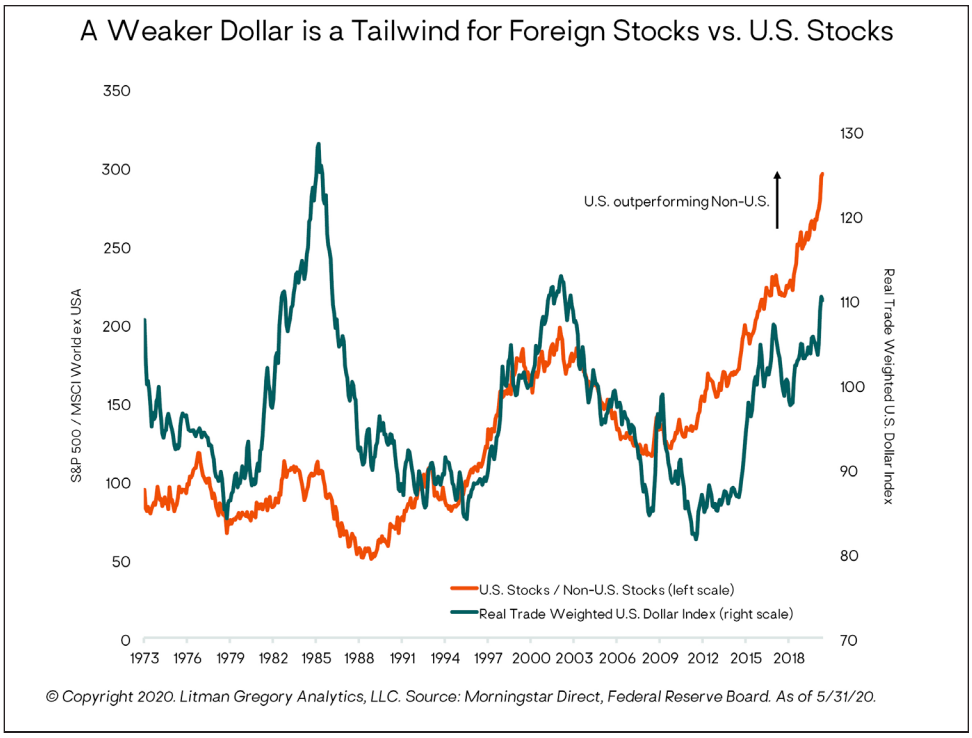
A third important driver of foreign vs. U.S. stock returns is the impact of currency appreciation or depreciation. The U.S. dollar has been on a strong run since 2011, appreciating more than 35% versus a trade-weighted currency basket. This has been a headwind to foreign stock returns for U.S. dollar-based investors (as foreign earnings are translated back into fewer dollars).



There are several reasons why the dollar may be headed for a sustained downturn soon, turning this headwind into a tailwind for foreign stock returns:

1. U.S. monetary policy has become extremely accommodative in the past few months, with the Fed cutting its policy rate

to near zero, restarting massive ongoing quantitative easing asset purchases ($120 billion per month), and signaling it has no intention of tightening policy any time soon. What was once a large interest rate advantage for the dollar compared to lower rates in other developed countries is no longer the case.



2. Because the dollar is considered a safe-haven currency and is generally a counter-cyclical currency—performing well in times of global stress or uncertainty—it is likely to depreciate as the pandemic fades and the global economy recovers.

3. The dollar is likely to face downward pressure from the large and expanding U.S. "twin deficits"—the federal budget deficit and current account deficit (the largest component of the current account deficit is the merchandise trade deficit).

4. Finally, after appreciating over the past nine years, the dollar now looks fundamentally overvalued relative to other currencies, so there is room to the downside if any of the above factors act as catalysts. Historically, a weaker dollar has been a tailwind for non-U.S. stock markets relative to the U.S. stock market (see chart above.) We expect the relationship to hold true again this cycle.

—Jeremy DeGroot, CFA