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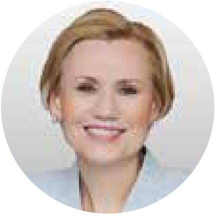
Stock market record highs: A case of rational exuberance



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US equities

Earnings reports for the last several quarters for the “Magnificent Seven” have largely confirmed the validity of the excitement around them.

European markets

Macro factors look relatively soft, but that offers some encouragement on the outlook for inflation — and the potential for a rate cut.

Japanese stocks

Despite the new high for Japanese equities, valuations are much lower than they were during the “bubble period” for the Tokyo Stock Exchange.

I love a good record-breaking performance. When I was a child, I voraciously read the Guinness Book of World Records. I was less inspired by such feats as the first gymnast to score a perfect “10” (since I knew I couldn’t even do a somersault) but I was very inspired by the person who was able to put the most socks on one foot in 30 seconds or the person who was able to stretch the most rubber bands across their face in one minute. (My 10-year old self thought those records were “beatable.”)

A few weeks ago, I celebrated another type of record as my daughter’s basketball team made school history with an undefeated season (making amends for my poor performance back when I played for the same high school team and ensured we would be a far cry from an undefeated season).

And then last week, a number of records were broken as major equity indices in the US, Europe and Japan hit all-time highs. But unlike sports-performance records, stock market-performance records tend to come with one key concern: Is this a case of “irrational exuberance?”

I don’t believe that to be the case - I think the exuberance is rational. Here’s why.

What prompted last week’s global record-breaking equity performance?

On Feb. 22, major equity indexes in the US, Europe, and Japan reached record highs:

- The Dow Jones Industrial Average and S&P 500 Index closed at all-time highs.[1]
- The Stoxx Europe 600 Index closed at 495.1, beating its previous record reached in early January 2022.[1]
- The Nikkei 225 Index closed at 39,068.[1]

What caused this performance? The catalyst for this global rally was the earnings report of one company, Nvidia, which helped propel positive sentiment for the tech sector, which in turn helped drive major indices higher. This has caused some strategists and market watchers to conclude that we’re seeing “irrational exuberance” - to borrow a term coined by then-Federal Reserve Chair Alan Greenspan more than 25 years ago - with overbought conditions and sky-high valuations. But is this really true?

It's hard for some to understand how one stock’s performance could be the most important factor driving indices around the world to reach new heights. But I’m old enough to remember how the possibilities of the Internet inspired investors in the late 1990s. Excitement about the tech sector - especially Internet-related companies - helped drive major US indices to new heights during that period.

However, back then, there were no strong fundamentals underpinning these companies - just hopes and dreams and a vague sense of its transformative potential for the economy. Back then, analysts were far more focused on price-to-sales ratios because tech companies with actual earnings were rather scarce, rendering P/E ratio comparisons rather moot. This time around is different. There are real fundamentals underpinning the excitement and dreams - just look at Nvidia's blowout earnings report.

Earnings for the "Magnificent Seven" confirm the market's excitement

There is a perception that the US stock market is trading at very lofty valuations. While it is true that the S&P 500 Index is trading at an above-average price-to-earnings (P/E) ratio,[2] much of that is driven by just a few stocks; that's why market observers describe the stock market as heavily "concentrated."

The good news is that this narrow group of stocks - dubbed the "Magnificent Seven" - have been meeting the high expectations set for them. Earnings reports for the last several quarters for the "Magnificent Seven" have largely confirmed the validity of the excitement around them. Given their collective performance, valuations for the Magnificent Seven remain elevated compared to the broader US equity market, but their earnings growth is expected to be almost five times that of the remaining 493 stocks in the S&P 500 over the next year.[3] This isn't "irrational exuberance" - it's more like "rational exuberance."

Rational exuberance is on display in Japan

It's rational exuberance in Japan as well. The new Feb. 22 high for Japan's Nikkei 225 Index surpassed the previous high that was recorded back when I was - gulp - in college in December 1989.[4] This new record comes on the back of a very strong recent rally.

But Japan's equity prices are still not in overvalued territory. In fact, the latest P/E ratio for the TOPIX 500 on a 12-months forward-looking basis was 16.18 times earnings, which is still lower than the past 15-year average of 16.58 times.[4] This is a far cry from P/E ratios during the "bubble period" for the Tokyo Stock Exchange - which reached more than 60 times earnings during 1989.[4]

As robust earnings growth expectations have driven the recent equity rally, I believe investors should be comfortable with the Nikkei 225's new record and think of it as just a milestone on a potential journey higher. I expect Japanese equity prices are likely to continue to rally.

Monetary policy could be a positive force globally

I think there are other reasons for the new records set by some of the major indices, and they relate to monetary policy. Relatively soft economic data and easing wage growth give hope for the potential for a rate cut by the European Central Bank in the not-too-distant future. And softer inflation in Japan suggests the Bank of Japan may be very gentle in starting to normalize monetary policy, as it wants to encourage a higher level of inflation rather than snuffing it out.

And we can't ignore the potential for US monetary policy to be a positive catalyst for equities around the world. That's because expectations are quite low for the Fed as markets have started pricing in fewer rate cuts that are expected to begin later in the year. Markets are telling us about this change in rate cut expectations in a variety of ways - the US dollar has shown strength, and US high yield bonds have outperformed US investment grade bonds.[5]

What I've learned from personal experience with my own family is that the lower I set the bar for my husband and children, the more likely they are to exceed it. And so I hold out hope that the Fed will continue to speak hawkishly and then positively surprise - that it will start cutting in the second quarter and that we will see more rate cuts than the market now expects. And that would serve as another rationale for positive risk asset performance this year.

Rate cuts, along with an improvement in real income, could help goose a re-acceleration in economic growth later this year. This could cause a broadening of the stock market, with smaller caps and cyclicals potentially performing better in anticipation of an economic rebound.

The week ahead

Looking ahead, we will all be waiting with bated breath this week for the Personal Consumption Expenditures Price Index. It is the Fed's inflation gauge of choice and will likely have a significant impact on Federal Open Market Committee members' looking for more confirmation of the disinflationary trend underway. I would anticipate a substantial market reaction if it is materially over or under consensus forecasts, as it will impact market expectations of Fed policy.

With contributions from Tomo Kinoshita and James Anania

Dates to watch

Date	Report	What it tells us
Feb. 27	US Conference Board Consumer Confidence	A monthly survey of US consumer attitudes, spending plans, and expectations for inflation, stock prices, and interest rates.
	US Durable Goods Orders	Tracks new orders placed with manufacturers for long-lasting goods.
	Reserve Bank of New Zealand Monetary Policy Meeting	Reveals the latest decision on the path of interest rates.
	GfK Germany Consumer Climate	Measures a range of consumer attitudes, including forward expectations of the general economic situation and households' financial positions.
Feb. 28	eurozone Consumer Confidence	Tracks consumers' views of their finances and the economy.
	eurozone Business Climate	Assesses the current business climate on a monthly basis.
	eurozone Consumer Inflation Expectations	Measures consumers' expectations of future inflation.
	US Gross Domestic Product (GDP)	Measures a region's economic activity.
	Japan Industrial Production	Indicates the economic health of the industrial sector.
	Japan Retail Sales	Measures consumer demand.

Date	Report	What it tells us
Feb. 29	UK Nationwide Home Price Index	Indicates the health of the housing sector.
	Germany Consumer Price Index (CPI)	Tracks the path of inflation.
	US PCE Price Index	Tracks the path of inflation.
	Canada GDP	Measures a region's economic activity.
	China PMIs	Indicates the economic health of the manufacturing and services sectors.
Mar. 01	eurozone CPI	Tracks the path of inflation.
	University of Michigan Survey of Consumers (final)	Assesses US consumers' expectations for the economy and their personal spending.

Notes

[1]Source: Bloomberg, as of Feb. 23, 2024. S&P 500 reached a high of 5088 on Feb. 22, 2024. The Dow Jones Industrial Average reached a high of 39,131.53 on Feb. 22, 2024.

[2]Sources: Bloomberg, as of Jan. 31, 2024. The S&P 500 forward 12-month P/E ratio is 20.4. This is higher than the 5-year average P/E of 19.0 and the 10-year average P/E of 17.7. Source: Factset, as of Feb. 16, 2024.

[3]Source: Bloomberg. Total return, forward price-to-earnings, and forecasted 1Y earnings per share data for the Magnificent 7 Index, S&P 500 Index, and S&P ex Magnificent 7 Index as of Feb. 23, 2024.

[4]Source: Bloomberg, as of Feb. 23, 2024

[5]Source: Bloomberg, as of Feb. 23, 2024. S&P 500 Investment Grade Corporate Bond Index vs S&P US High Yield Corporate Bond B Index.

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Diversification does not guarantee a profit or eliminate the risk of loss.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

High yield bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of high yield bonds fluctuate more than those of high quality bonds and can decline significantly over short time periods.

Stocks of small and mid-sized companies tend to be more vulnerable to adverse developments, may be more volatile, and may be illiquid or restricted as to resale.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Many products and services offered in technology-related industries are subject to rapid obsolescence, which may lower the value of the issuers.

The Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

The STOXX Europe 600 is an index of European stocks with a fixed number of 600 components representing large, mid and small capitalization companies among 17 European countries.

The Nikkei 225 Index is a price-weighted average of 225 top-rated Japanese companies listed in the first section of the Tokyo Stock Exchange.

The TOPIX 500 Index (Japan) represents the 500 largest stocks traded on the Tokyo Stock Exchange.

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

The price-to-earnings (P/E) ratio measures a stock's valuation by dividing its share price by its earnings per share.

The price-to-sales ratio (Price/Sales or P/S) is calculated by taking a company's market capitalization (the number of outstanding shares multiplied by the share price) and divide it by the company's total sales or revenue over the past 12 months.

Hawkish is to favor relatively higher interest rates if they are needed to keep inflation in check.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The eurozone (also known as the euro area or euroland) is an economic and monetary union of European Union member states that have adopted the euro as their common currency.

The European Central Bank (ECB) is responsible for the monetary policy of the European Union.

Inflation is the rate at which the general price level for goods and services is increasing.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

Personal consumption expenditures (PCE), or the PCE Index, measures price changes in consumer goods and services. Expenditures included in the index are actual U.S. household expenditures.

Yield is the income return on an investment.

Risk assets are generally described as any financial security or instrument, such as equities, commodities, high-yield bonds, and other financial products that carry risk and are likely to fluctuate in price.

The opinions referenced above are those of the author as of **Feb. 26, 2024.** These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.