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With equities looking expensive, where should investors turn?

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US stocks are highly valued, and our 10-step checklist suggests they're close to bubble territory. Non-US equities offer better value, but we still don't think investors should drastically pare back their US holdings at this time.

For more than a decade, stocks have been on a steady march upwards – and not even the global downturn caused by the Covid-19 pandemic has thrown them off for long. So are equities, particularly in the US, too expensive? Could they even be in bubble territory? If so, when might they pop?

To answer these questions, we developed a 10-criteria “bubble checklist” inspired by the work of Charles Kindleberger, an economic and financial-market historian. Each asset bubble throughout history has been unique in its own way – yet with few exceptions, each one also met essentially all 10 of these criteria.

Our analysis indicates that today, US equities demonstrate most of the characteristics of an asset bubble. Yet there are also compelling reasons to think that in the near term, US stocks will continue to move higher. As such, we still favour US equities and other risk assets – albeit with some hesitancy. That's why we don't think now is a good time for investors to drastically pare back their positions in risk assets, though it may make sense to shift to a more neutral to slightly “long” stance.

Key takeaways

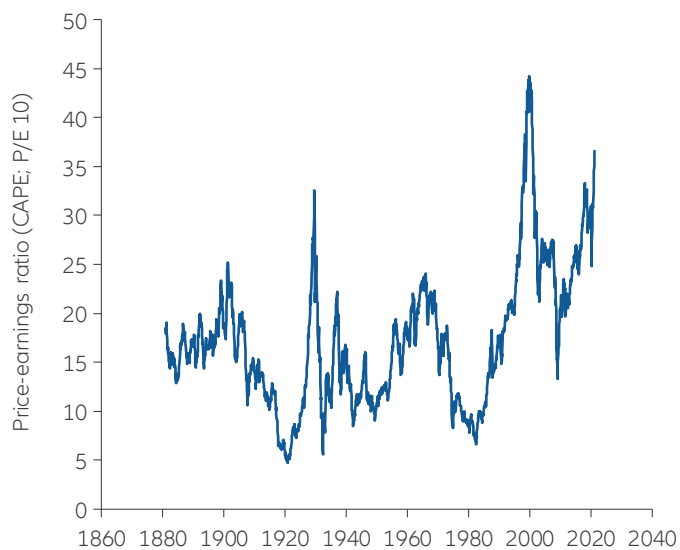
- Equities, especially in the US, are very expensive – around the level last seen before the tech bubble burst in the late 1990s
- High valuations are one of the 10 characteristics of an asset bubble that we've identified – and the majority are showing red flags
- But until the Fed starts to “taper” its bond purchases, likely in 2022, US equities may very well bubble up further
- We still prefer risk assets at this time and have a bias for value stocks, which are trading at a multi-decade discount to growth stocks
- Non-US equities – particularly in Europe, Japan and emerging markets – are much more reasonably priced than their US counterparts

Criteria (and colour status)	
1	Historically high valuations
2	Overvaluations of multiple asset classes
3	High hopes for a "new era"
4	Ultra-easy monetary policy
5	Financial-sector deregulation
6	Rising leverage
7	A boom in "innovative" financial instruments
8	Overtrading and exponential price moves
9	An influx of foreign money
10	A rise in serious fraud

less of a concern  more of a concern

Exhibit 1: US stocks seem expensive, reminiscent of previous market peaks

S&P 500 Index CAPE (1881-2021)



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

10 signs of a market bubble

1. Historically high valuations

In our view, valuation is the most important metric and US equities in particular seem expensive. We base this on the valuation measurement that we think is cleanest from a theoretical and empirical perspective: the cyclically adjusted price-earnings ratio (CAPE). This is the de facto industry valuation standard – and it is revealing.

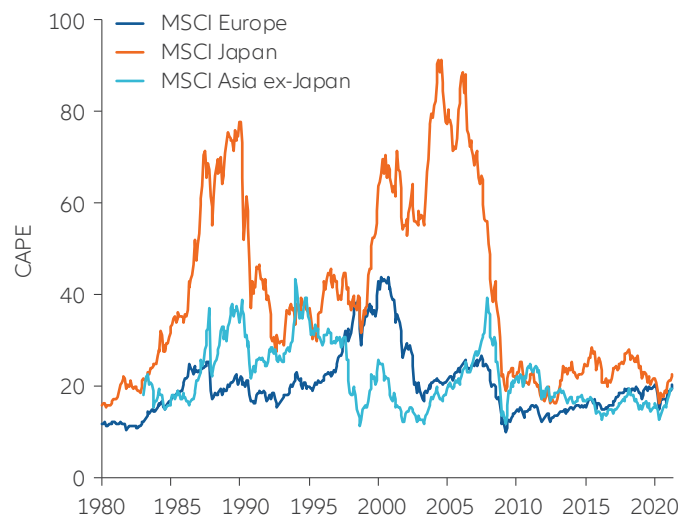
- At the end of April 2021, the S&P 500 traded at a CAPE of 37 – a reading last seen in late 1998 during the tech bubble (see Exhibit 1). It reached a peak of 44 in early 2000 before the bubble burst.
- The Nasdaq tells a similar story. Its CAPE of 55 in April 2021 is similar to its March 1998 level. But notably, today's high US valuations go well beyond the tech sector. Almost all sectors, with the exception of consumer staples and banks, are trading at high multiples.

In comparison, we don't find non-US equities to be at stretched valuations (see Exhibit 2). European, Japanese and Asian equities are trading at or below their long-term average valuation multiples. This points to another way in which today's elevated markets are different from the tech bubble of the late 1990s and early 2000s: back then, equity markets around the world were at elevated valuation levels.

And we are not convinced that high valuations can be justified by ultra-low bond yields. Low real yields have historically typically implied rather low multiples, since low yields point to a slow-growth environment and a higher risk of recession. Clearly, some other market forces are at work today, since yields are near historic lows and equity valuations (at least in the US) are near historic highs. Monetary policy over the decades has lifted investors' risk appetite to extremes, powering the run-up in equities.

Exhibit 2: Non-US equity markets seem more reasonably priced

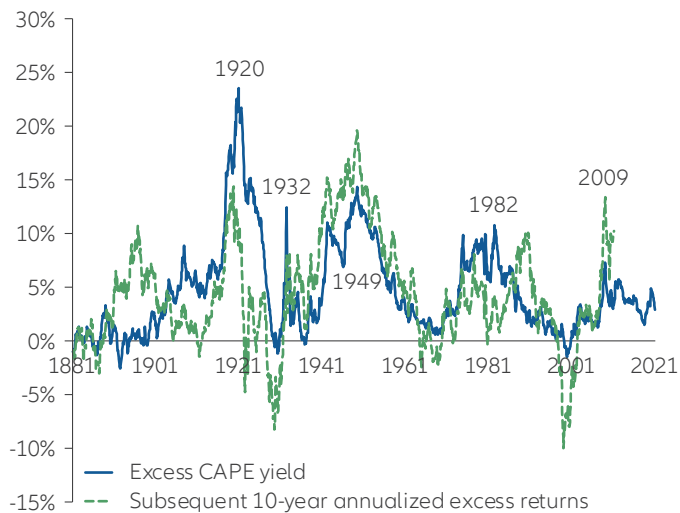
Equity market CAPE: MSCI Europe, MSCI Japan, MSCI Asia ex-Japan (1980-2021)



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

Still, today's ultra-low bond yields can tell us something about the equity market outlook. While US equity returns are likely to be low, on average, over the coming decade, they are still likely to outperform US bonds. We can estimate this based on the work of Robert Shiller, using the excess earnings yield of equities relative to bonds. (This can be calculated by subtracting the current bond yield from the equity earnings yield; see **Exhibit 3**). Using the late April 2021 yield of 1.6% for 10-year US Treasuries, we can estimate that in the US, equities are poised to outperform bonds by around 2.6% per year over the next 10 years.

Exhibit 3: Over time, the excess earnings yield has helped explain the relative performance of equities to bonds
S&P 500 excess CAPE yield and subsequent 10-year annualized excess returns



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

2. Overvaluations of multiple asset classes

US equities are not the only highly priced asset class – so are sovereign bonds, as our proprietary valuation approaches indicate. There are two reasons for this:

- Short-term interest rates are ultra-low, in some instances even negative, due to the interest-rate policies of central banks globally.
- The term premium for longer-dated sovereign bonds remains around 100 basis points below the long-term average of late April 2021. This is due to years of ultra-easy monetary policy.

3. High hopes for a “new era”

History has shown that bubbles occur alongside the perception of a “new era” – such as new technological breakthroughs or major political changes that cause widespread optimism. Clearly, this is true today, with major innovations in the field of artificial intelligence feeding these high hopes. Some call this the “fourth industrial revolution” or the “second machine age”; The Economist has even nicknamed the current decade the “roaring 20s”. In line with this optimism, US bottom-up

earnings growth expectations for the next three to five years soared. At one point in early 2021, these earnings expectations even dwarfed those seen in 2000, at the height of the tech bubble. Members of the tech-heavy FANG+ index were the key drivers for this sudden shift.

Even so, expectations for long-term economic growth overall remain rather moderate – though there is strong optimism for a continued rebound in 2021. The sharp rebound after the peak of the Covid-19 crisis certainly played a role here, and the economic outlook is very much dependent on continued fiscal and monetary policy stimulus in response to the pandemic.

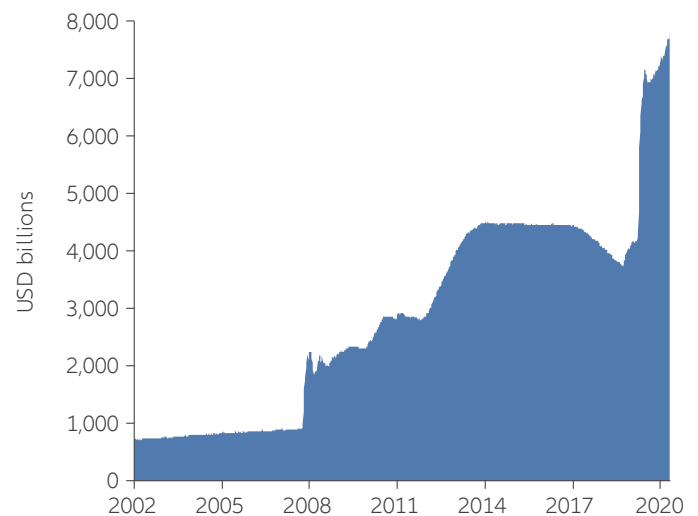
4. Ultra-easy monetary policy

All financial bubbles in history took place against the backdrop of “easy” financing conditions provided by central banks. In that respect, this bubble indicator is clearly present today. Central banks have not only cut rates close to zero – or even lower – but they have flooded the system with levels of liquidity that are unprecedented in peacetime. (**Exhibit 4** shows how the Fed massively expanded its balance sheet through asset purchases.)

This trend started with the financial crisis of 2007-2008, but it took off in 2020 during the coronavirus crisis. There has been massive growth in the supply of “narrow money” (such as coins, cash and highly liquid bank accounts) and “broad money” (which can consist of narrow money plus longer-term deposits) on the back of huge, “war-like” monetary stimulus measures. In fact, US broad and narrow money aggregates have grown at a rate that dwarfs any seen in peacetime. In developed economies, the growth rate was around 17% – around four to five times the trend growth rate of nominal GDP. All major central banks have pledged to keep rates unchanged in the coming years, and to continue buying sovereign bonds.

Exhibit 4: The Fed’s balance sheet expanded rapidly during the Covid-19 crisis

Fed balance sheet (2002-2021)



Source: Allianz Global Investors, Robert Shiller. Data as at April 2021.

Covid-19 caused a deep economic downturn – and a massive surge in equity performance

When the coronavirus outbreak became a global pandemic in March 2020, it triggered the deepest global economic downturn since the Great Depression in the 1930s. Major equity markets fell within five weeks by around one-third. But equities began to recover at the news of new fiscal and monetary policy stimulus measures – the scale of which was unprecedented in peacetime.

- US stocks in particular turned around sharply. In the 12 months following the trough in the S&P 500 on 23 March 2020, the index rose by 75%. Since late March 2021, US equity prices have moved up even further.
- In the same time period, the tech-heavy Nasdaq rose by 95% and the NYSE FANG+ Index rose by a staggering 146%.
- Non-US equities, measured by the MSCI World ex-USA Index in local currencies, rose by “only” 50% over the same time period – still a very impressive number.

5. Financial-sector deregulation

Deregulation in the financial sector is another typical feature of any asset bubble. Here we can tick the box as well – at least in the US. After a brief bout of re-regulation around the time of the financial crisis, US regulations have gradually been scaled back. During the administration of former President Donald Trump, the financial sector was freed from many regulations – as seen in the US Economic Policy Uncertainty Index devised by Scott Baker, Nicholas Bloom and Steven Davis (see **Exhibit 5**).

6. Rising leverage

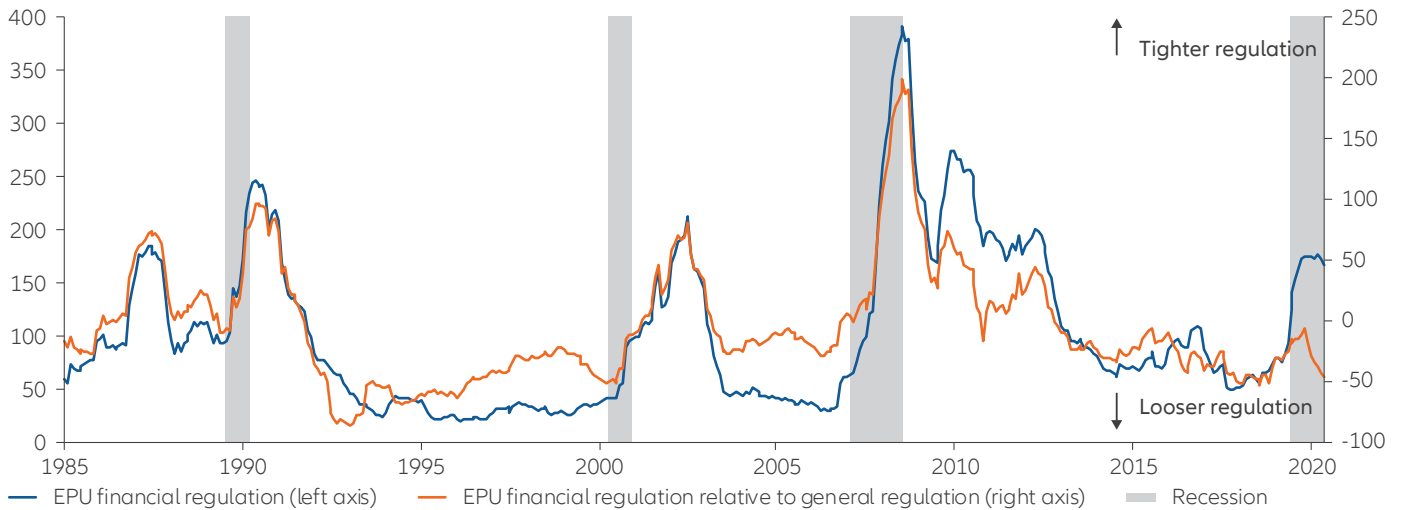
The combination of ultra-easy monetary policy, financial-sector deregulation and the Covid-19 crisis have contributed to a sharp rise in private-sector leverage – the debt of private businesses and individuals (see next page **Exhibit 6**). But the question of whether this does or doesn’t indicate we are in bubble territory requires a nuanced answer.

In the US non-financial business sector in 2020, the gross and net debt-to-GDP ratios climbed to all-time highs. But it’s a different story in the private household sector: even though the gross debt-to-GDP ratio of private households temporarily shot up during the Covid-19 crisis, it is far below the 2007 level. Moreover, private households today are sitting on excess savings.

As a result, while leverage is certainly high in some areas, we believe that financial-stability risks are rather low, and that a repeat of the financial crisis is not on the cards.

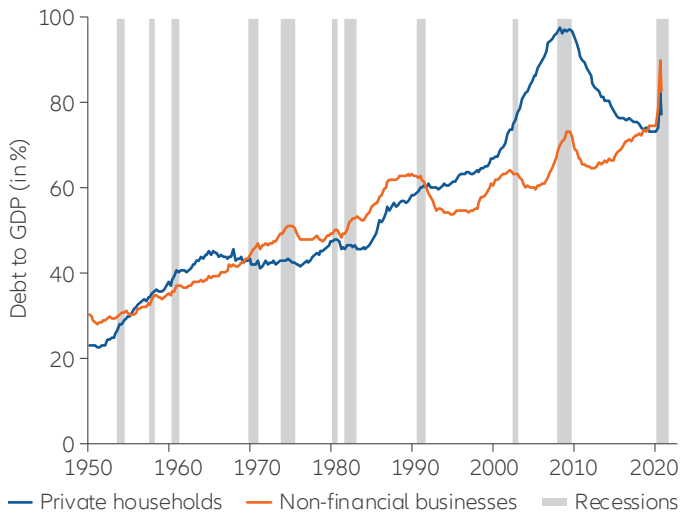
Exhibit 5: Since 2010, the financial sector has become less regulated

US Economic Policy Uncertainty Index (EPU): EPU financial regulation (absolute and relative to general regulation)



Source: Refinitiv Datastream, AllianzGI, Baker Bloom Davis. Data as at March 2021.

Exhibit 6: Trend shows leverage rising for non-financial businesses



Source: Bank for International Settlements, Refinitiv Datastream. Data as at September 2020.

7. A boom in “innovative” financial instruments

Today, two major innovations in the financial system are gaining speed at the same time: crypto-assets (cryptos) and special purpose acquisition companies (SPACs).

Amongst the thousands of names in the crypto space, bitcoin has gained the most attention. Cryptos still only play a minor role as a medium of exchange, but they have become a popular asset class among institutional investors thanks in part to the development of a regulated ecosystem. For example, bitcoin futures are now traded on regulated trading venues such as the CME (the Chicago Mercantile Exchange). Investors can also buy into bitcoin funds and exchange-traded funds (ETFs). At the same time, bitcoin prices have risen exponentially from slightly above USD 3,000 at the end of 2018 to above USD 60,000 in April 2021.

SPACs are shell companies that go public to pool funds. Their use dates back to the 1990s, but SPACs only really become popular in 2020, when they accounted for around 40% of all US initial public offerings.¹ In April 2021, SPAC activity was on track to quadruple for the second year in a row (see Exhibit 7). However, there is worrisome anecdotal evidence that some new SPACs are investing in low-quality companies or in industries outside their purported areas of expertise.

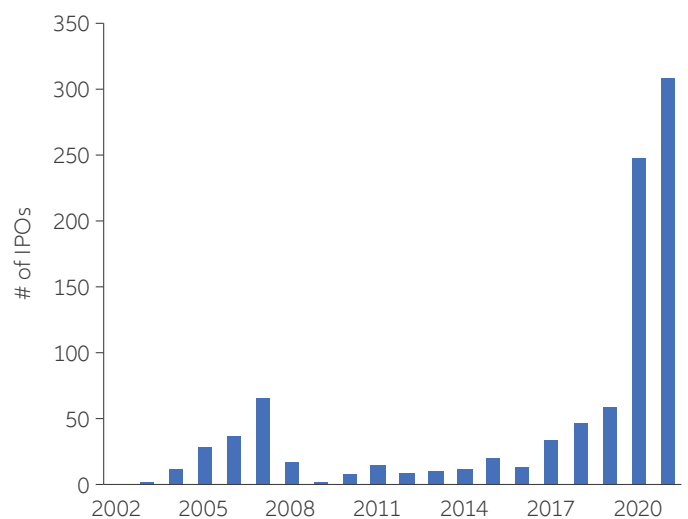
8. Overtrading and exponential price movements

The rising popularity of speculative assets is contributing to “overtrading” in the US market, with exponential price movements and signs of above-average risk taking:

- The overall outperformance of growth stocks in this economic cycle has been even stronger than it was during the tech bubble. Growth stocks outperformed value stocks by almost 200% in the four years leading up to mid-2020. FANG+ stocks outperformed by around 350% in the four years leading up to February 2021.²
- Margin buying of US stocks has skyrocketed – up 72% year-over-year in March 2021, one of the highest readings on record.³ True, relative to the market value of equities and the overall money supply, margin buying is still off its historical peaks. Still, in the past, US stock prices were down in six out of seven occasions once the year-over-year growth rate in margin buying peaked.⁴
- In early 2021, a group of US retail investors began to work en masse to push up the prices of certain stocks. The result was a series of weird and extremely volatile price moves, and a “short squeeze” among hedge funds that had bet that these stocks’ prices would fall.

Exhibit 7: SPAC activity soared in 2020 and could hit another high in 2021

Number of IPOs in US SPACs (2002 through April 2021)



Source: SPAC Insider. Data as at 28 April 2021.

¹ Source: Nasdaq.
² Source: Refinitiv Datastream.
³ Source: NYSE and FINRA.
⁴ Source: FINRA.

9. An influx of foreign money

Even though international capital flows in general have not been extraordinarily strong, international flows into US equities have been robust – attracted in large part by the boom in US stock prices. This international participation in an equity boom is a factor that has been present in most bubbles, though not all.

10. A rise in serious fraud

This is one of the few characteristics of a bubble that we have not observed so far in the US: evidence of major, widespread fraud related to the equity boom. This kind of fraud, however, generally tends to attract attention close to or after the end of a bubble. That means it may take some time before we know whether or not significant fraud has been a factor in the current run-up in US stock prices.

Investment implications

As we have seen, most – but not all – of the criteria required for bubbles are waving red flags, and there are many similarities between the current period and the tech bubble of the late 1990s. The rise in long-term US Treasury yields in 2021 will undoubtedly give some equity investors additional cause for concern. It could imply that bond holders are worried about an overheating economy and/or rising inflation – which would increase the probability of rate hikes by the Fed and weigh on equity prices. Indeed, some market participants see a rising probability that the Fed might start “tapering” its bond purchases and hiking rates earlier than anticipated.

However, we don’t think rising yields per se are a reason for equity investors to drastically pare back their US holdings. As we previously mentioned, equities still look better value than bonds from a long-term perspective. It would take a substantial rise in yields of another 100 basis points or more before the relative valuation argument would be really altered (as shown in **Exhibit 3**).

Still, recent surveys seem to indicate that investors may rethink their risk-on attitude if and when the yield of 10-year US Treasury rises significantly above 2%.⁵ Markets may then want to see if the Federal Reserve is truly committed to keeping monetary policy unchanged. The Fed’s pledge to maintain its current stance has been one of the drivers behind the equity market rally since March 2020.

Ultimately, however, history has shown that bubbles only burst once central banks start to hike rates or take other steps to rein in their “easy money” policies. And as of now, it seems like that may not happen for some time, at least in the US: the Fed has communicated that it will next hike rates in 2024. It will likely start to wind down (or “taper”) its bond purchases much earlier, possibly in 2022. Until then, we think there is a reasonable chance that US equities will continue bubbling up further. As a result, we stay nervously “risk on” for now, gravitating towards risk assets. And we have a bias for value stocks, which are trading at a multi-decade discount to growth stocks.

⁵ Source: BofA Fund Manager Survey.

With equities looking expensive, where should investors turn?

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Data as at 31 March 2021

The Nasdaq is an unmanaged, market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The Standard & Poor's 500 Index is an unmanaged index generally considered representative of the US stock market as a whole. The MSCI Europe Index is an unmanaged index that represents the performance of large and mid-cap equities across 15 developed countries in Europe. The MSCI Japan Index is an unmanaged index designed to measure the performance of the large- and mid-cap segments of the Japanese market. The MSCI Asia ex-Japan Index is an unmanaged index that captures large- and mid-cap representation across two developed-market countries and nine emerging-market countries in Asia. The NYSE FANG+ Index is an unmanaged index that provides exposure to 10 highly traded mega-cap tech firms. The MSCI World ex-USA Index is an unmanaged index that captures large- and mid-cap representation across 22 developed-market countries. Past performance is not indicative of future performance. Investors cannot invest directly in an index.

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