

Party Pooper or Prudently Prepared?



By Jonathan Caplan

Equity investors have witnessed one of the most remarkable bull markets in memory. In the wake of the spreading global pandemic in early 2020, the stock market plummeted in one of the sharpest and most dizzying bear markets in history. Even in the early days of the economic shutdown, market participants were willing to look beyond the steep economic decline and embarked on a buying spree on the expectations of an equally sharp recovery. So, the market hit a nadir on March 23, 2020, less than a month after the government mandated shutdown. As a student of market history, I was not particularly surprised that the market was able to find its footing in the early days of the pandemic. The stock market is usually a leading economic indicator. But I have been stunned by the magnitude and the swiftness of this seemingly one-way rally since the lows.

Now I have been in the investment business for multiple decades and I have witnessed several market cycles. While stock market cycles are never identical, they usually do rhyme somewhat. With the historical perspective of previous bull-market rallies, I feel that it is an opportune time for investors to “take stock” of their expectations for future returns and to determine the best strategy to help weather some of the looming risks from potential “speed bumps” in the future.

Danger Ahead?

Are we predicting that the bull market is about to end anytime soon? Not really.

Am I suggesting that stock investors should sell everything in anticipation of a better entry point? Certainly not! Even professional traders find it difficult to time the market. And in retrospect, one who sold in March 2020 in anticipation of a prolonged economic decline made a costly mistake. But it may make perfect sense to review the positioning of one’s portfolio for the economic recovery and the emerging risks that lie ahead. Not only have valuations changed dramatically from 16 months ago, but the macroeconomic risk factors have evolved significantly.

While we can never anticipate every potential risk that could change the prospects for any stock, sector or the overall market, there are some potential risks that are relatively more easily recognizable. If an investor can identify those risks and determine how the advent of these events could expose their holdings, they can hopefully protect their portfolio and limit the potential downside.

Our Top 3 Concerns

I would like to share our top three macroeconomic concerns for the coming quarters and years and their possible impact on stocks, both positive and negative. First, we believe that interest rates are unsustainably low due to the unprecedented monetary accommodation by the Federal Reserve. As the monetary stimulus abates and interest rates begin to normalize, there will be potential negative consequences for growth stocks (as we saw earlier this year). Conversely, a gradual rise in interest rates due to a growing economy would likely benefit bank stocks that have been held down by slow loan growth and slim interest margins on their loan portfolios.

The second major concern is the rise of inflation. Because of the rapid economic expansion and continuing COVID-related supply-chain issues, prices of many commodities and finished goods are rising rapidly. Surging housing prices, rising gasoline prices and the shortage of new and used automobiles are symptoms of this problem, just to name a few areas of concern. The Federal Reserve is sticking to the party line that these inflationary effects are “transitory.” But if they are wrong, and later this year we see inflationary pressures continue unabated, which stocks and sectors of the market will benefit and which are vulnerable to downside risk?

Finally, we are concerned that the recovery has been precipitated by multiple fiscal stimulus packages from Washington, which have resulted in an unusually rapid pace of economic recovery. As fiscal stimulus wanes and the economy decelerates back to the slow growth trend during the years following the Great Recession, will corporate profits fall well short of expectations? And which stocks and sectors could be impacted most by a profit recession?

Don’t Get Me Wrong!

I would like to close by reiterating that the sky is not falling and that equity investors are better served by staying invested for the long term. But when you have such strong performance in a relatively short period of time, it may be beneficial to plan for a potential change in market leadership as well as to reassess the durability of the portfolio in weathering the evolving risks.

In conclusion, I would like to recall a misguided quote from the CEO of Citigroup in July 2007, just before the housing bubble burst. Then-CEO Chuck Prince fa-

mously threw caution to the wind in the face of a spectacular and speculative surge in the housing market. Prince notoriously remarked that Citigroup’s participation in the mortgage market would remain unabated: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.” For equity investors, let us not wait for the music to stop. Let us make sure we are prepared for any and all risks that may lie ahead!

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