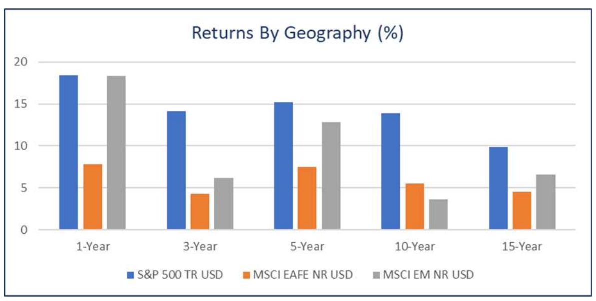
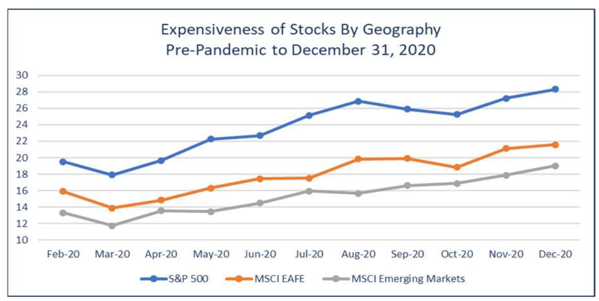
Are Stocks in a Bubble?

After the rapid rise in stock prices since the bear market associated with global economic lockdowns in 2020, a common question we get is “aren’t stocks too expensive?” Referring simply to “stocks” glosses over a lot. The S&P 500 is comprised of, obviously, 500 stocks and 11 economic sectors. This short paper strives to look under the hood at just what has driven market activity over the last year. It is important to note two things: (1) history demonstrates that expensive stocks can stay expensive for extended periods and (2) stock market returns and economic activity tend to have little to do with one another. So, let us break down stock returns by geography, sector, and style. We use stock prices relative to company earnings (P/E ratios) to measure the expensiveness of stocks.

Geography

While it is generally true that US stocks trade at levels that are more expensive than their international counterparts, it is those stocks that have benefitted the most from the extended bull market over the years since the 2008 financial crisis. Emerging Markets have staged a strong rally and kept pace with the US, but as can be seen in the graph on the right, the gap in expensiveness between US and non-US has widened since Covid-related lockdowns began in March of 2020.

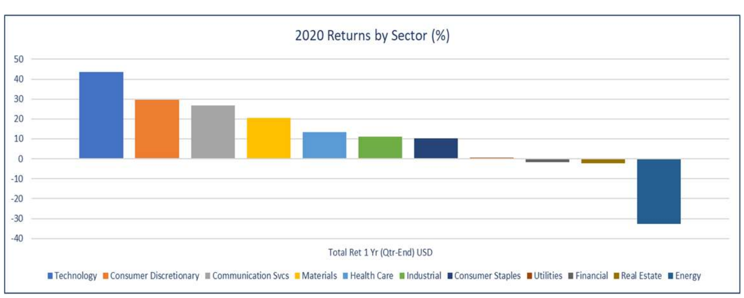




Source: Morningstar; As of December 31, 2020

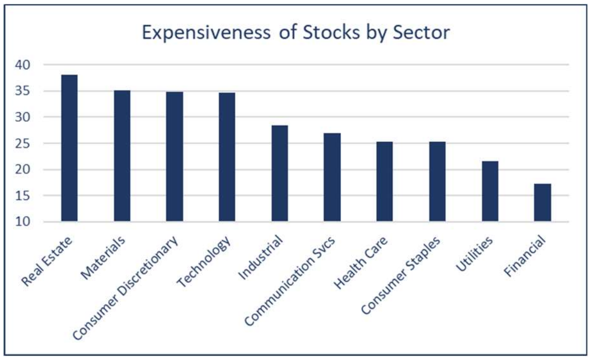
Sector

If we accept the premise that US stocks are more expensive than their overseas peers, has it just been one uniform rise in all 500 stocks? Surely not. There was a dramatic differentiation in the stock returns of sectors that benefit from the “stay at home” trend versus those that suffer. For example, in 2020, Technology stocks returned over 40% while Energy stocks delivered a return less than NEGATIVE 30%!



Source: Morningstar; As of December 31, 2020

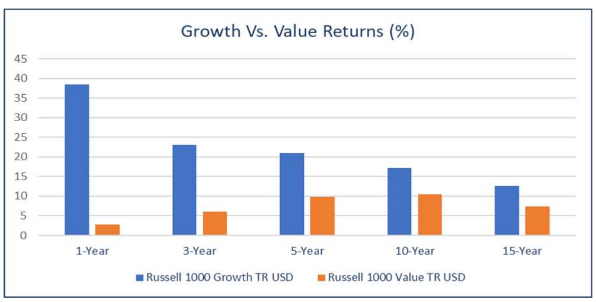
This resulted in a deep chasm in the valuation investors have placed on sectors like Consumer Discretionary (Amazon) and Technology (Microsoft and Apple) over weaker sectors like Financials.

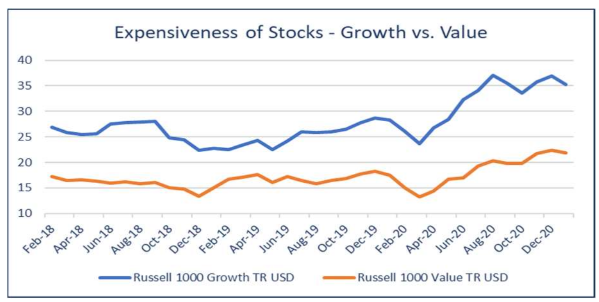


Source: Morningstar; As of December 31, 2020; Excluding Energy

Style

Another common way to think about investment returns is by style, i.e., the old Growth versus Value argument. Because of isolated returns in places like Technology, 2020 witnessed a gap between the two styles not seen in more than a decade. While cheap stocks should naturally be less expensive than growth ones, that gap widened meaningfully in 2020, despite a recovery for Value since the US election.





Source: Morningstar; As of December 31, 2020

Conclusion

So, are stocks in a bubble? Are they too expensive? The answer is it depends on where one looks. The stock market is not one uniform thing and doesn't exist in one country. Leadership is constantly changing depending on the prevailing sentiment. The question about a bubble also just raises new questions: does it mean US stocks will underperform going forward? Will value stocks re-take the reins because they aren't as "tired"? Or will growth stocks continue their dominance? Timing markets to avoid corrections or to rotate sectors or styles tends to be futile. This is why we prefer to stay invested and diversify among the factors that drive returns and let a long-term view rule performance.

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All US sector returns and P/E ratios measured by State Street SPDR US sector Exchange-Traded Funds (ETFs).