Market Commentary

WASHINGTON CROSSING ADVISORS

Five Reasons for Caution

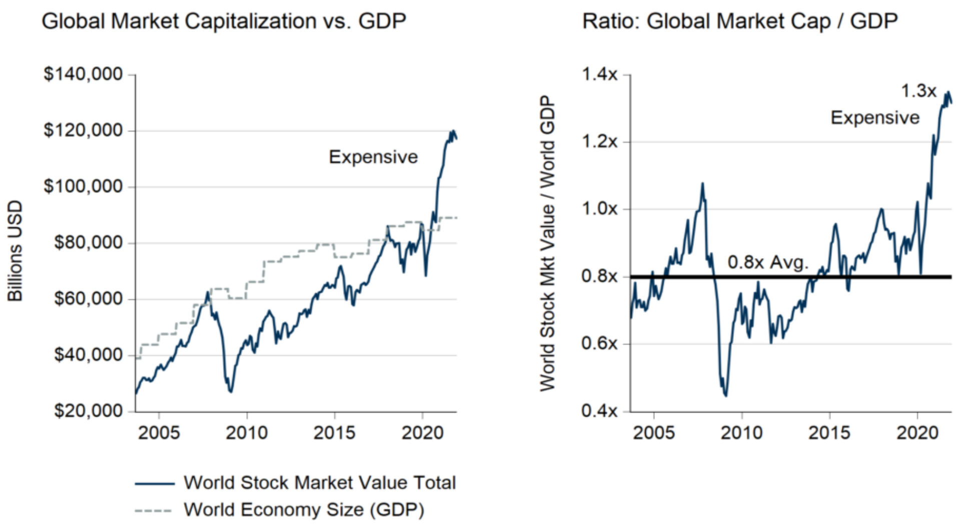
December 6, 2021

Despite an ongoing economic recovery and bull market in stocks, we see a growing set of reasons suggesting some caution may now be warranted. This week we will lay out a few of these reasons and offer some ideas for navigating more challenging market environments.

Reason #1: High Starting Valuations

It is no secret that the world's stock markets are now worth $120 trillion, far above the global economy's $90 trillion size (Chart A, below-left). While up 13% from a year ago, the two-year return since just before the pandemic is a massive 36%. The ratio of global stock values to the global economy is now 1.3x, well above the historical average (Chart A, below). Such high valuations are likely to weigh on returns at some point.

Chart A
Global Market Cap Rises Faster than Global Economy



Source: Bloomberg; WCA

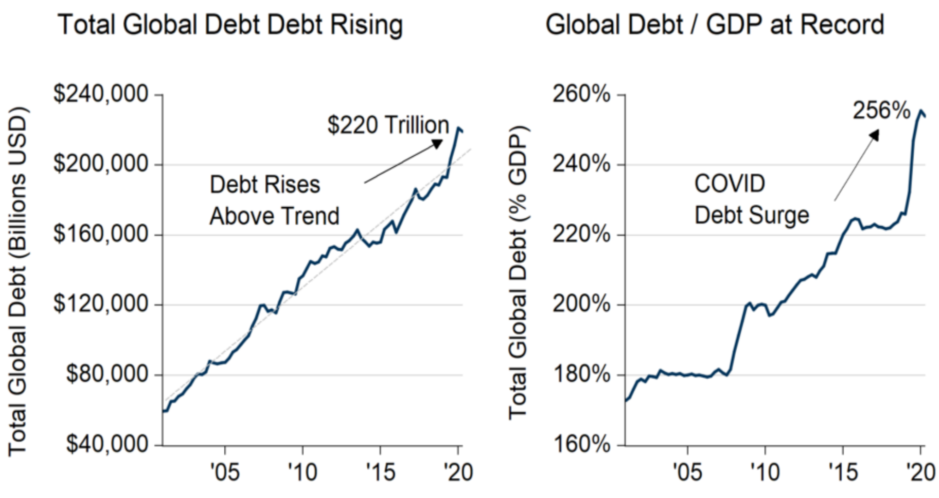
Reason #2: Surging Debt

The pandemic led to a record surge in global debt, another reason for caution. According to the Bank of International Settlements, total global debt grew by a record $27 trillion to $220 trillion in 2020 (Chart B, below-left). The addition of $27 trillion of debt came in a year when the global economy only grew $3 trillion. While this might be acceptable for a short while in response to an extraordinary event, continued lopsided growth in the debt/economy ratio is not sustainable in our view. Pandemic-related debt-financed government spending caused global debt to surge to a record 256% of global GDP (Chart B, below-right).

Unfortunately, the globe's debt dynamics have not been a one-year event, as debt has grown far faster than the economy since the 2008-2009 financial crisis. Over the 2008-2020 period, global debt obligations rose $92 trillion, but the global economy only grew by $23 trillion. In other words, it took $1.00 of debt to generate $0.25 of growth. The failure of debt to translate into an equivalent rise in worldwide output and income points to an unsustainable path for debt growth.

As debt growth outstrips increases in global income, the likelihood of default rises, especially for borrowers who lack credibility or are overly dependent on borrowing. A sharp rise in interest rates would further complicate matters for heavily levered economies, households, and firms.

Chart B
Surge in Global Debt



Source: Bank of International Settlements

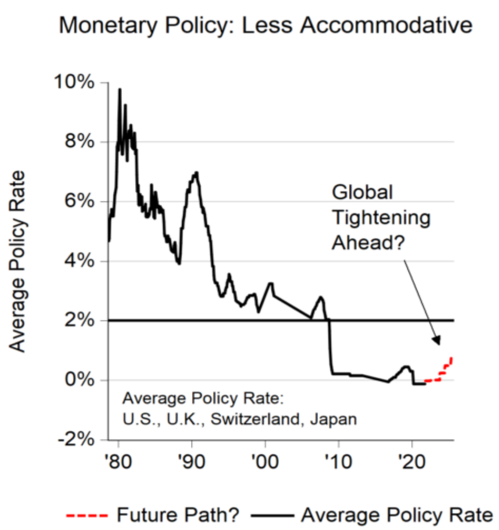
Reason #3: Weakening Policy Supports

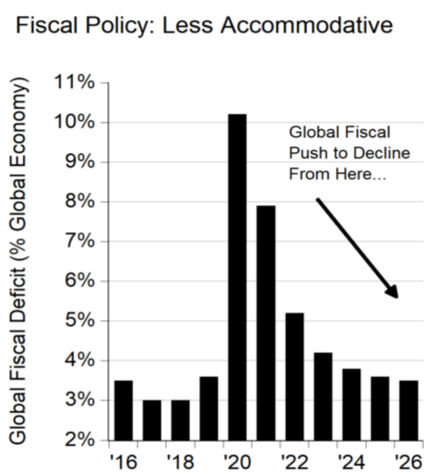
A significant catalyst for markets in 2020-2021 came from government policy. The two main policy spigots, monetary and fiscal policy, were wide open worldwide. Now, the flow from those spigots seems ready to slow to a trickle. Recent pronouncements from the Federal Reserve (Fed), for example, point to a faster-than-expected wind-down of asset purchases. Interest rate hikes could also come faster than expected. This acceleration toward monetary tightening comes in response to a wave of unanticipated inflation (+6% year-year). These actions set the stage for less accommodative global monetary policy, in our view, after a long and extraordinary period of ease.

Chart C (below-left) shows how global rates have been held well below 2% for over a decade. Now, amid rising inflation, it seems plausible that global rates could again begin to creep higher over the next couple of years. This, coupled with a lessening of asset purchases, would constitute a meaningful shift away from the ultra-accommodative policy to which markets have become accustomed.

Lastly, global government fiscal deficits are also set to come down. Chart C (below-right) shows the IMF's forecast path for the aggregated fiscal deficits of all governments worldwide. Deficits surged to 10% of global GDP as direct payments were made to households and businesses at the onset of the pandemic. These payments helped to support demand and employment when needed. However, these same deficits which provided a source of needed funds to the private sector during the pandemic are now set to fall away. If so, the short-term economic impulse of transfer payments to households and businesses should also subside, creating a drag on near-term growth.

Chart C
Less Accommodative Policy Ahead



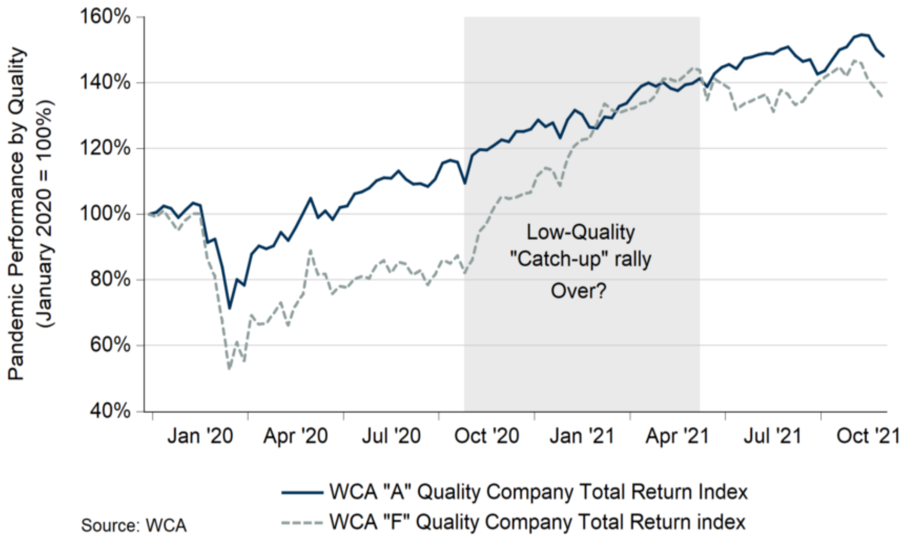


Source: Bloomberg, IMF

Reason #4:
High Quality Outperforming Low

It is worth noting that leadership seems to be shifting inside the market. Specifically, we are starting to see greater relative strength in high versus low quality issues, just as the omicron variant fears grip markets. Based on our WCA Quality grade indices, for example, low-quality stocks are down roughly 3% compared with a 1% decline for high-quality stocks in the past month. Should this trend continue, it will end the period of low-quality leadership we've chronicled over the past year (Chart D, below). Markets tend to gravitate toward lower debt, higher profitability, more consistent businesses when uncertainty is on the rise.

Chart D
Low-Quality Ceding Leadership to High-Quality?



Source: WCA

Reason #5: Fading WCA Barometer

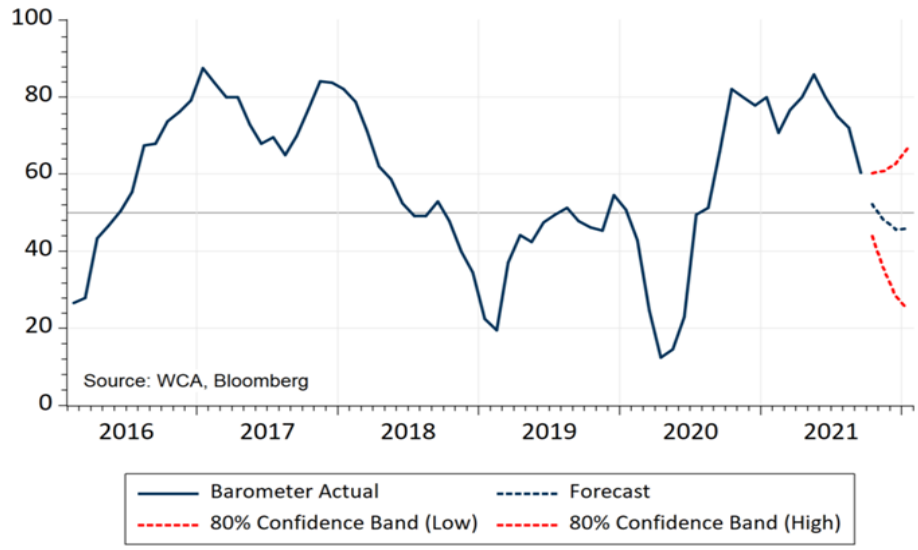
We have been watching our WCA Fundamental Conditions Barometer fade through the summer and into the fall (Chart E, below). While not in "bearish" territory — we would consider a forecast reading well below 50 to be "bearish" — some cooling of momentum in the underlying data began to materialize. The barometer tracks, consolidates, and forecasts a range of indicators from market based risk measures, to industrial activity, employment, trade, and a range of foreign inputs. As our forecast for the barometer cooled, we scaled back equity exposure to a more neutral posture (in tactical asset allocation portfolios).

Portfolio Posture

As we near the end of 2021, our top-down tactical observations and bottom-up work led us to pair risk in recent months to a more neutral stance. Likewise, a bottom-up designed portfolio should now focus on flexibility, consistency, and durability and less on high-yield and outsized growth, in our view. The set of challenges outlined above makes such principles even more relevant today.

While it is impossible to time bouts of market turmoil, high valuations, greater debt, and slowing growth can all contribute to unexpected negative surprises. This is why we think it makes sense to focus now on building a flexible, high-quality portfolio for whatever may come next.

Chart E
WCA Barometer Returns to Earth



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