Spot the Difference

It has been a decade since the last equity bear market showed its claws. The S&P 500 hit a pre-credit crisis high of 1565.2 on October 9, 2007 before cratering all the way down to 676.5 during the "Great Recession" and a severe bear market followed. Of course, the stock market is now well-beyond that prior peak—the S&P 500 ended the past month near record highs at 2575.3. Yet even with a lengthy recovery under our belt, the prior downdraft is still fresh in the minds of many.

That is not terribly surprising—after all, there are some obvious similarities between the current timeframe and that fall season of 2007. In both cases, the bull market had experienced an extended run of stellar returns. The Fed was tightening monetary policy in early 2007, as it has this year. Perhaps most glaring, U.S. equity valuations are now getting quite stretched, just as they were a decade ago. With stock prices reaching new heights on a seemingly daily basis, it is fair to wonder whether we are once again near a market peak.

In our opinion, unlike 2007 we are not necessarily yet at a market top. Look a bit more closely, and there are quite a few differences between now and a decade ago, particularly with regards to underlying economic fundamentals.

Then vs. Now	October 2007	October 2017
Leading Economic Indicators	Falling (-2.1% Year-over-Year)	Rising (+4.0% Year-over-Year)
Corporate Profit Margins	Falling (-3.7% YoY)	Rising (+10.4% YoY)
Consumer Confidence	Falling (-9.4% YoY)	Rising (+24.9% YoY)
Housing Starts	Falling (-15.2% YoY)	Rising (+6.1% YoY)
Manufacturing PMI	Neutral (51.1)	Expanding (58.7)
Treasury Yield Curve	Inverted in prior months	Positively sloped in prior months
Monetary Policy	Peaking (4.5% Fed Funds Rate)	Normalizing (1.3% Fed Funds Rate)
Valuations (Cyclically Adjusted P/E)	Expensive (27.3)	Expensive (31.2)

As price/earnings ratios suggest, stocks are currently expensive relative to their earnings. But outside of that, the situation is clearly different from 2007. Back then the S&P 500 was reaching all-time highs in the face of deteriorating fundamentals—now the index is reaching new all-time highs but fundamentals are mostly improving. Remarkably high and rising profit margins may even be able to support elevated valuations, while low interest rates (the ten-year Treasury is currently yielding about half of what it did a decade ago) make bonds a less than stellar alternative to stocks.

Of course, we do not know exactly what the future holds. There may certainly be painful price corrections from time to time, especially as the likelihood of market-friendly tax cuts continues to ebb and flow. And stretched equity valuations put a damper on intermediate-term expectations. But with fundamentals on the upswing, rather than a 2007-08 type crash we may see valuations take their sweet time to revert to long-term averages via an extended period of subpar price returns. That does not sound like much fun, but it is a different scenario than a collapse.

Stock Performance	October 2007	October 2017
S&P 500 — Prior One-Year Return	+14.6%	+23.6%
S&P 500 — Next Year Return	-36.1%	???

While valuations are worrisome, it seems unlikely the next several months will turn out the same as they did back in 2007.
And a different set of macro symptoms calls for a different prescription. Rather than taking growth-oriented assets completely off the table (would have been ideal in 2007), in 2017's environment of high valuations it may make more sense to rotate amongst alternative solutions for generating appropriate returns. That includes increasing allocations to geographies with more reasonable valuations, as well as considering alpha-oriented strategies which rely on manager skill rather than market beta.

It is hard to argue that economic fundamentals and corporate earnings are not in much better shape than they were a decade ago. In 2007, a precarious economy in conjunction with elevated valuations put nearly all risk asset classes (overseas stocks, high yield stocks, real estate, energy, hedge funds) on the precipice of a steep decline. This time around, with fundamentals clearly in a more advantageous spot, markets will likely follow different path. Investors should as well.

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