By Prabhu Palani (Chief Investment Officer)

I recently commented on how expensive US equity markets were. The Shiller P/E ratio (or Cyclically-Adjusted P/E Ratio) stood at 37.09 yesterday, not too far from its monthly high of 38.44 on August 1st, 2021, the second highest monthly reading in the last 150 years after the period between December 1st, 1998 to Nov 1st, 2000 when it was consistently above this level (it touched an all-time monthly high of 44.19 on December 1st, 1999). Even during the Great Depression, the CAPE only hit a monthly high of 32.56, on December 1st, 1929. Given this backdrop, current market volatility should not surprise anyone. I looked at S&P 500 price data and in the first six months of 2021, there were 7 price drops of 1% or greater. But more recently, since 9/10/21, we've already had 6 price drops of 1% or greater. I'm no chartist, but recent market volatility does raise the question – where is the market headed short and long term?

Unlike the Nasdaq bubble of 2000 or the Great Financial Crisis (GFC) of 2008/09, corporate profitability continues to be strong, we are in an expansion phase economically, and there seem to be no lurking structural issues (barring Black Swans). Moreover, countries are starting to open, albeit slowly, as vaccination rates continue to increase. This should result in greater consumer spending and confidence. According to the University of Michigan Survey of Consumers, consumer confidence is still below its pre-pandemic levels, which means that a recovery in confidence will lead to greater consumer spending and bolster economic recovery.

There is no question that risk assets have been supported by Central Banks since the GFC. Bond buying has kept interest rates low and greased the wheels of economies. A natural consequence has been the reach for yield, which has benefited risk assets immensely. One potential market overhang is the Fed's recently announced taper strategy. But BCA Research has rightfully pointed out that the Fed's strategy is one of 'taper' and not 'tightening'. The central bank's balance sheet will continue to expand, though at a slower pace. The Fed's taper is a sign of underlying economic strength.

Inflation can also have a negative impact on asset prices. However, despite recent high levels of inflation caused by supply chain disruptions and pent-up demand, longer term forecasts continue to be benign. However, a nasty shock on the upside can greatly upset the applecart and force the Fed's hands into raising rates sooner than expected.

This brings us to China. The size and strength of the Chinese economy dictates that what happens in China will have global implications. Recent moves by the Chinese government to exercise greater control in the tech sector as well as the well-publicized woes of Evergrande have factored in recent market declines. The Chinese government has considerable control over its economy and should be able to prevent these problems from posing a systemic risk to the global financial system.

Finally, let us look at bond yields. The US 10-year has sold off in recent weeks, with the yield now at 1.5%. While this is quite a bit higher than the 0.68% yield a year ago, it is still below the 1.6% yield of 5 years ago and 1.91% of 10 years ago. Historically low bond yields should continue to support asset prices, especially in an expansionary economic phase.

Shorter-term expect greater stock market volatility – more price swings of 1% or higher in equity prices. A correction (technically defined as a fall of greater than 10%) is very much on the cards. If history is any indication, the Shiller P/E will moderate and revert towards mean. Whether it does so by a sharp price contraction or a gradual increase in earnings remains to be seen. For now, low bond yields, an expansionary economic phase, increase in consumer spending, and improved Covid outlook (the Merck pill could be a game changer), favor elevated asset prices. Nasty inflationary shocks, unexpected spike in bond yields, abnormally high valuations, China, and Black Swans can pose headwinds.

US equity market data over the last century shows that over 10-year periods, investors can lose value in the markets. This is particularly pronounced when the start of the period is characterized by abnormally high valuations. Fortunately, as pension plan investors, we have a long-term horizon. Volatility can also be a friend and help us take advantage of price fluctuations by periodically rebalancing to our strategic asset allocation targets. The prudent course will be to stay long risk assets, diversify across asset classes, minimize costs, and follow the data. Reduced capital market expectations will be the norm.