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# Record Breakers

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At the beginning of 1990, Japan's stock market accounted for 50% of the global equity market capitalisation. A year later, it was only 30%, and that was not because everything else had gone up. On the contrary, the TOPIX Index fell 40% during 1990, which is one reason why investors always tend to look over their shoulders when markets end the year at all-time highs (ATHs). The same fate befell the US and UK stock markets exactly ten years later. With US equity indices ending 2024 in a flurry of ATHs, should we worry?

Starting closer to home, the UK's FTSE 100 Index has delivered a total return of 12% this year, which, in isolation, looks good. It's still about a hundred points shy of its ATH (8445) made in May. However, the US's S&P 500 Index (SPX) has gained 29%. The more technology focused NASDAQ Composite Index is up 32%, whilst the Magnificent 7 group of leading technology companies have collectively put on 65%. Had you put all your eggs in the Nvidia basket, you would almost have trebled your money.

It's obvious what we should all have done had we been armed with this knowledge at the beginning of the year. However, the average end-2024 target for the SPX this time last year was 4755, implying gains of just a couple of precent. Even allowing for the fact there were some rapid revisions made, taking the average target closer to 5200, that is still well short of the current 6090. Last December, the average one-year-ahead Price Target of analysts for Nvidia was $66, against the current share price of $142!

It has been a case of playing catch-up all year, with the SPX making fifty-six (and counting) all-time highs, which is the fifth highest number in history. A contrarian or mean-reversionist might conclude that this means trouble for next year, whilst a fan of momentum would think the opposite. Is there anything we can take from history by looking at the top four?

If we start back in 1964, the SPX made sixty-five new highs. Although my mum told me that I was reading pretty fluently by my third birthday in August of that year, it was obviously not the business pages, and so I have had to resort to Google and Bloomberg for more information on that era. The SPX, having celebrated my birth in 1961 with a 21% rise, had come unstuck in 1962 as investors baulked at high valuations, the threat of higher interest rates and geopolitical worries. It suffered a 28% drawdown, although it rallied strongly once the Cuban Missile Crisis was resolved in October. It didn't properly break its previous peak until the very end of 1963 and that opened the path to higher ground in 1964. The fact that it only racked up a 12.4% gain in 1964 suggests a year of steady incremental gains, which it certainly looks like on a chart. There were three relatively small 3% pullbacks during the year, which is well below the long-term average.

More importantly, what did that augur for 1965? It turned out to be a pretty average year with a 9% return. Market historians will find that interesting because the incidence of the SPX delivering returns around the average long-term return (let's call it 8%) is very low, with only eight years in the last one hundred being in the 5-10% range. And that was despite a 10% drawdown on the way.

Equity market bulls will immediately be drawn to 1995, which established a record-setting seventy-seven new highs as the index rose 35%. Bearing some similarity to now, the US had achieved an economic "soft landing" following tighter monetary policy and a bond market rout in 1994. But this was just the prelude to +21% in 1996, +29% in 1997, +31% in 1998 and +15% in 1999. That delivered a compound capital return of 227% over the whole period. And those figures understate the euphoria of the Telecoms, Media and Technology bubble of the late 1990s, when the NASDAQ Composite Index rose by 40%, 24%, 22%, 50% and finally 73% in five consecutive years (for a cumulative return of 455%!).

Arguments in favour of the bulls are that we are in a similar interest rate-cutting environment and on the cusp of a tech-driven productivity boom (with AI replacing personal computers and the internet as the driving force). The main argument against is that the starting valuation today (22x forward PE) is much higher than it was it was then (13x). One could also throw in a much less friendly geopolitical environment vs the mid-1990s when the world was beginning to appreciate the effects of the end of the Cold War. And globalisation was really only just picking up steam whereas today it has stalled.

Also in favour of the sceptics – apart from the valuation - is that inflation seems to be stickier today and that unemployment is ticking up not down. Finally, one could add that the fiscal position was a lot healthier then, with the government running a fiscal surplus by the end of the decade, which contrasts with entrenched deficits today.

Another factor in my mind is that the "financialisation" of western economies was also still in its early years whereas today I would say it is much more mature. I have done some separate analysis looking at the changes in US Household Net Worth, and it's immediately apparent from looking at the data that there was a big positive shift in the accumulation of wealth which started in the mid-1990s. There are, subsequently, much bigger swings in wealth associated with moves in the stock market, but, owing to interventionist monetary policy, the bounce backs are always bigger than the losses. No wonder US consumers and investors must feel that someone has always got their back - thirty years' worth of "muscle memory" has been built. But has that led to overconfidence?

I would add a personal reflection of that period. It took until the mid-1990s for investors to break the habit of worrying about inflation that had been ingrained by the experiences of the 1970s and (to a lesser extent) the 1980s. Once they stopped worrying about interest rates and bond yields going up, the "path of least resistance" for equities was higher. Today, if anything, the ingrained psychology is of a period of disinflation with periodic outbreaks of deflation risk. I don't think that mindset has been entirely broken even by the events of 2022, especially as inflation has come down again so quickly. But I remain concerned that the inflation risk is to the upside now, bearing in mind: the geopolitical background; the prevalence of support for "populist" political parties (which have a bias towards fiscal expansion); demographics (higher dependency ratios); climate change; and what seems to be a shift in favour of labour over capital (viz the UK Budget and increasing levels of labour unrest).

And so, what about the other two years - 2017 (61 ATHs) and 2021 (70 ATHs)? 2017 followed two years when the SPX had been pretty flat, a period during which there had been a disruptive currency devaluation by China (August 2015) followed by OPEC's assault on oil prices (which hit US capex very hard) and a broader commodity bear market (where the loss of value outweighed any potential positive impact of lower prices on the rest of the economy). The logjam was broken by Donald Trump's 2016 election victory, setting up a 21% market gain in 2017, the first year of his presidency (which tend to provide good returns for equities, on average). You can see where the bulls are going to go with this one!

The differences, as I have pointed out before, are higher inflation today (2.6% vs 1.7%), much higher interest rates (4.75% vs 0.5%) and equity valuations (22x vs 16x) and less scope to pull fiscal stimulus levers owing to a much higher deficit.

What happened next is more salutary. Following a further run up in early 2018, the SPX suffered an 11% drawdown in just five trading days in February as a couple of ETFs which had been selling volatility blew up and there was an aggressive deleveraging, not unlike what we witnessed in August this year. This is the episode that's gone down in market history as "Volmageddon". Although the index did reclaim its peak by September, the year ended with a gut-wrenching 20% reversal as the Federal Reserve (Fed) persisted with policy tightening and the world fretted about... the effects of trade tariffs being imposed by President Trump.

Finally, we reach 2021, the first full year after the start of the pandemic, when post-vaccine euphoria was in the air, the US government was throwing money around like confetti and the Fed was keeping interest rates at zero

whilst also pursuing Quantitative Easing. We can look back on an era of rampant speculation (remember the first round of "meme stock" madness?) and the effects of TINA - There Is No Alternative (to owning equities) in an age of zero interest rates and negative bond yields. The SPX gained 30%... a rise which came to grinding halt on the last day of 2021.

In 2022, everyone sobered up and realised that inflation was back in the system and that interest rates were going to go up. This was only exacerbated by Russia's invasion of Ukraine and the SPX suffered a drawdown of 25% which ended in October.

I think it might have already become clear that we cannot draw any firm conclusions from these four examples (which is admittedly a pretty thin data set). Two of the years of persistent and frequent new ATHs were followed by further gains and two by steep falls. As always, we have to face the facts in front of us. On the supportive side are that US interest rates look set to fall further with inflation settling in a 2-3% range. The consensus GDP growth forecast for 2025 is a steady 2.1%, with earnings per share growth of 12-14% expected. That should be a recipe for more gains. And even though the PE ratio is high, we continue to believe that valuations are more acceptable when one considers the scale of free cash flow margins and growth and the high returns on capital generated by US companies. We also believe that it's rarely a good idea to stand in front of a market that has strong momentum unless there are very good reasons.

The negatives pertain mostly to the headline PE valuation, sentiment and positioning. The percentage of consumers expecting the stock market to make further gains in the next year is at an all-time high, as is households' exposure to equities. Volatility remains low, meaning that equities are once again vulnerable to any increase in volatility. The equity risk premium (over bonds) is low.

But we need more than that to call a turn. The key reason would be a recession leading to lower profits and earnings and, potentially, an increase in the equity risk premium. Of that there is no evidence, and economists and investors are somewhat chastened by having forecast one that never materialised in 2022 or 2023. Another reason might be some sort of pressure on margins (especially those of the market leaders). That could come from wage pressure, regulatory intervention, imprudent spending or new competitive forces. Finally, any loss of faith in the US bond market could see yields rising further and putting downward pressure on equity valuations. We are always scanning the horizon for such threats and they seem to be contained for now. And so, we have to conclude that we should remain fully weighted and stay on for the ride for the foreseeable future.

# Economic Commentary

### FTSE 100 weekly winners

| | |
|---|---|
| Just Eat Takeaway.com N.V. | 9.2% |
| International Consolidated Airlines Group SA | 8.6% |
| Legal & General Group Plc | 7.3% |
| Admiral Group plc | 6.1% |
| Rolls-Royce Holdings plc | 5.0% |
| Whitbread PLC | 4.8% |
| Rightmove plc | 4.7% |

### FTSE 100 weekly losers

| | |
|---|---|
| St. James's Place Plc | -5.2% |
| British Land Company PLC | -5.1% |
| SSE plc | -4.0% |
| SEGRO plc | -3.7% |
| National Grid plc | -3.5% |
| DS Smith Plc | -3.4% |
| DCC Plc | -3.1% |

### FTSE 100 index, past 12 months

### EuroStoxx 600 index, past 12 months

### S&P 500 index, past 12 months

All data shown in GBP.

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