Market Risk and the Trump Bounce

Presented by Alex Vassey, CFP®

Although many were predicting a significant pullback on Mr. Trump's election, we, in fact, got a fairly significant *advance*. What's up with that? There are likely several reasons.

First, the nine-day pullback before the election—the longest since 1980—certainly was pricing in some of the probabilities of a Trump win. When he actually won, the uncertainty risk disappeared. That alone could have driven markets back up.

Second, a Republican sweep may have been perceived as positive for business and the economy, which would also have supported markets.

Finally, markets tend to sell the rumor and buy the news, and this could have been just a normal reaction. Whatever it was, clearly the financial markets are not upset by the Trump victory.

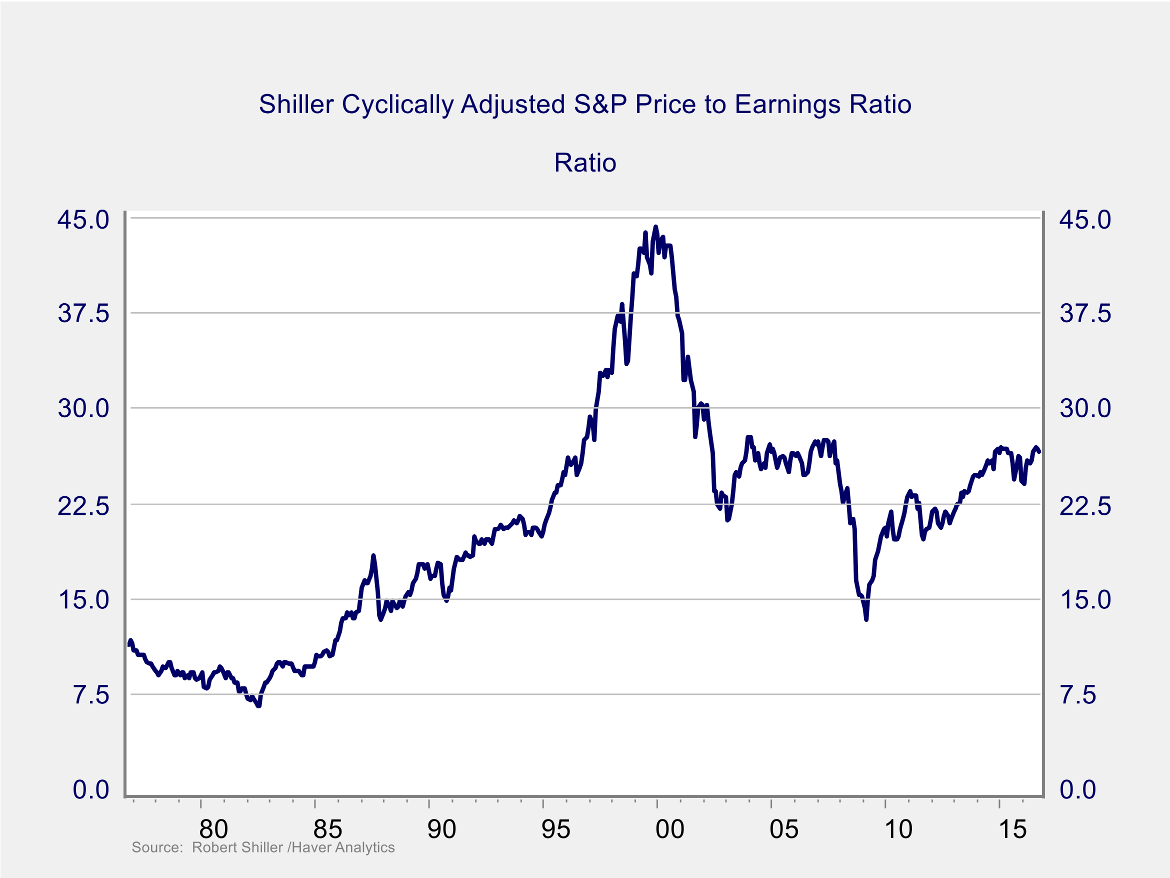
Market and economic fundamentals

On a deeper level, however, the reaction speaks to the fundamentals of how markets and the economy work. In the case of a bear market, you almost always have a recession, which we don't, as well as other supporting factors, such as rising oil prices and interest rates, which we also don't have. Current market risk factors (see below) are also generally on the positive side, although risks do appear to be rising. In other words, on a fundamental basis, there simply does not appear to be a reason for the market to pull back in a significant way. That doesn't mean it can't happen, but it does mean it is less likely.

The Trump news, therefore, hit a market that was reasonably solid and bounced. You could take this as further evidence of the market's strength given that we just experienced an event that was expected to knock it down 5 to 10 percent, or even more, and instead it rallied. Clearly, there is solid demand for stocks at this point, although valuations remain near record highs. Are there risks? Sure, and Chinese currency is at the head of the list of international concerns, but we are doing pretty well here in the U.S., which is something to keep in mind in the days ahead.

With that said, there are certain market risk factors we should pay attention to as we look ahead to a new administration and the effects that might have on our portfolios. For our purposes, two things are important: (1) to recognize when risk levels are high, and (2) to try and determine when those high risk levels become an immediate, rather than theoretical, concern. This update aims to do both.

Risk factor #1: Valuation levels
When it comes to assessing valuations, longer-term metrics—particularly the cyclically adjusted Shiller P/E ratio, which looks at average earnings over the past 10 years—can be especially useful in determining overall risk.

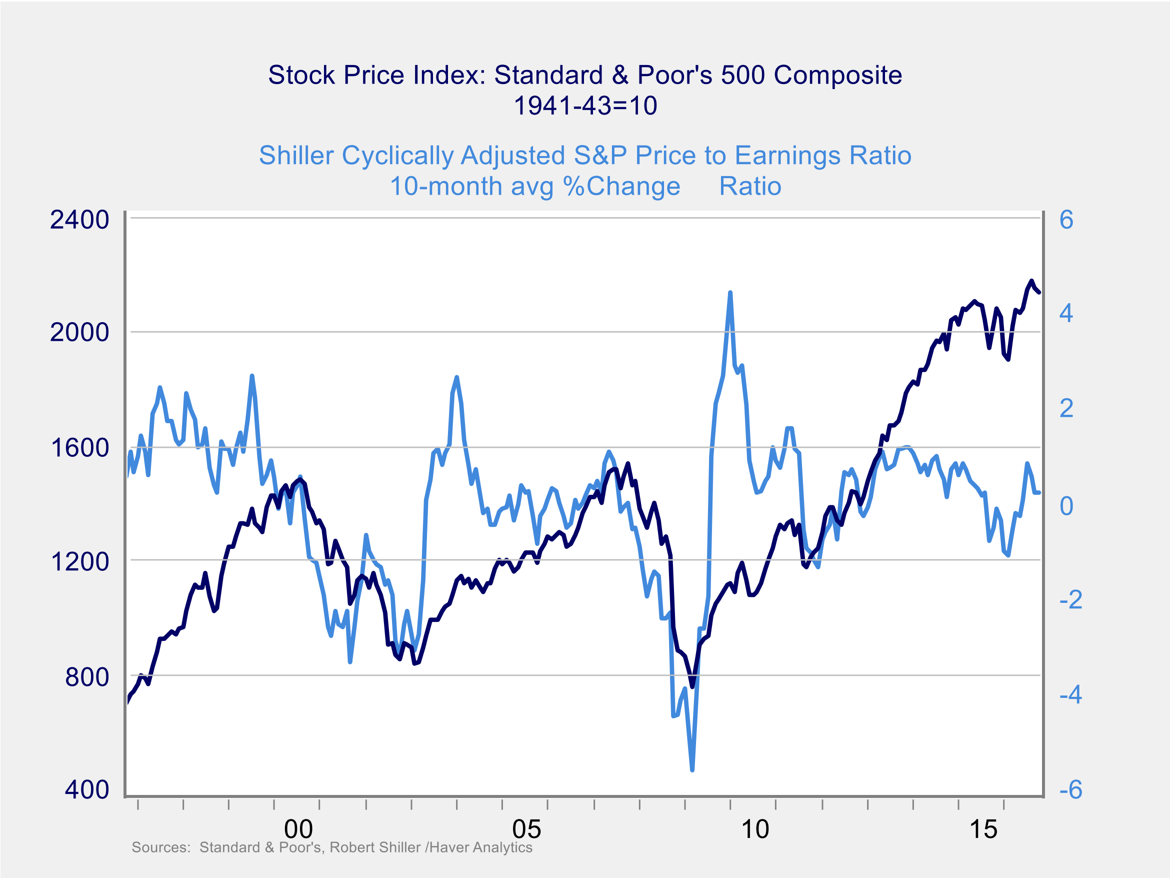


There are two things to take from this chart. First, after recovering from the pullback at the start of the year, valuations are nearing the levels of 2007–2008 and 2015, when previous drawdowns started. Second, even at the bottom of the recent pullback, valuations were still at levels above any point since the crisis and well above levels before the late 1990s.

Although they are close to their highest levels over the past 10 years, valuations remain below the 2000 peak, so you might argue that this metric does not suggest an immediate risk. Of course, that assumes we might head back to 2000 bubble conditions, which isn't exactly reassuring. In conclusion, risk levels remain high, although not immediate.

Risk factor #2: Changes in valuation levels

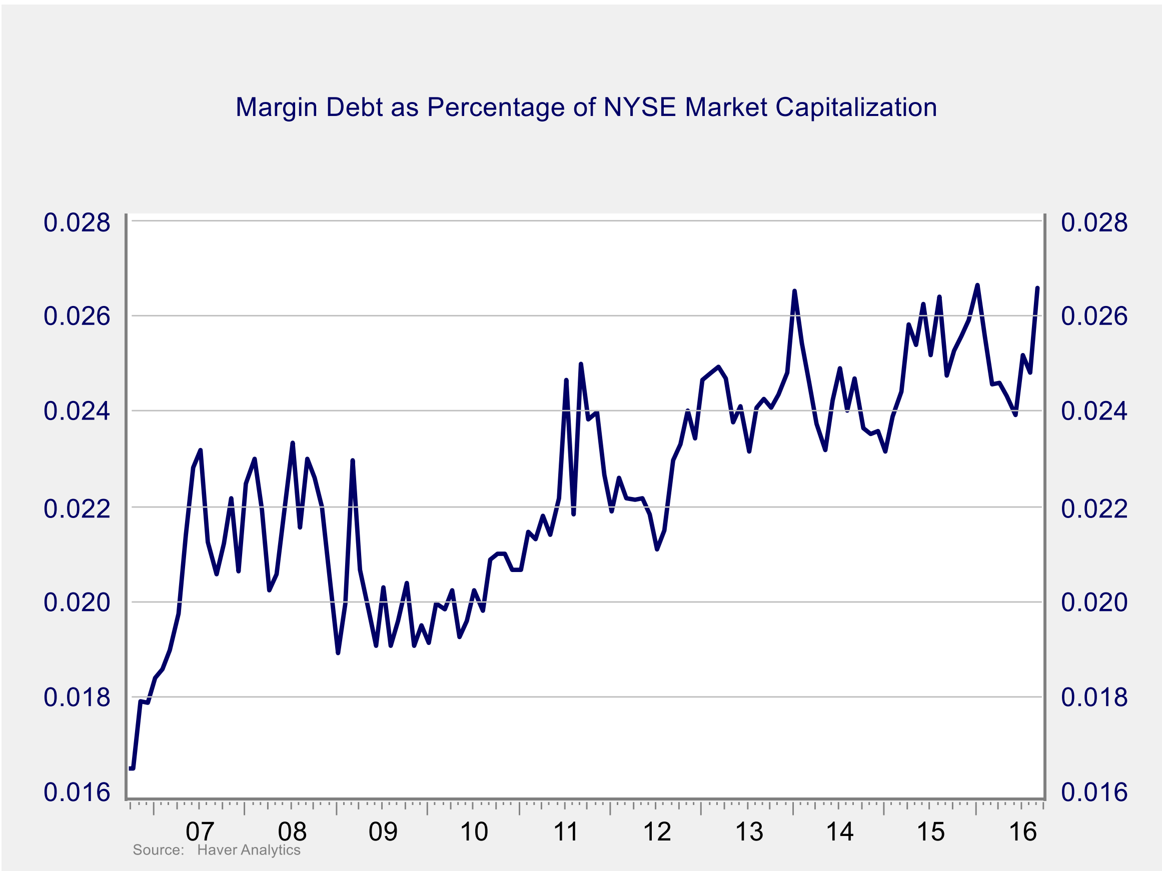
As good as the Shiller P/E ratio is as a risk indicator, it's a terrible timing indicator. One way to determine whether risks are immediate or not is to look at changes in valuation levels over time instead of absolute levels.



From this chart, you can see that when valuations roll over, with the change dropping below zero over a 10-month or 200-day period, the market itself typically drops shortly thereafter. With the recent recovery, we've moved back out of the trouble zone, and although the trend has turned negative again, we are still in positive territory. Although risks remain, they may not be immediate. Still, this metric will bear watching.

Risk factor #3: Margin debt

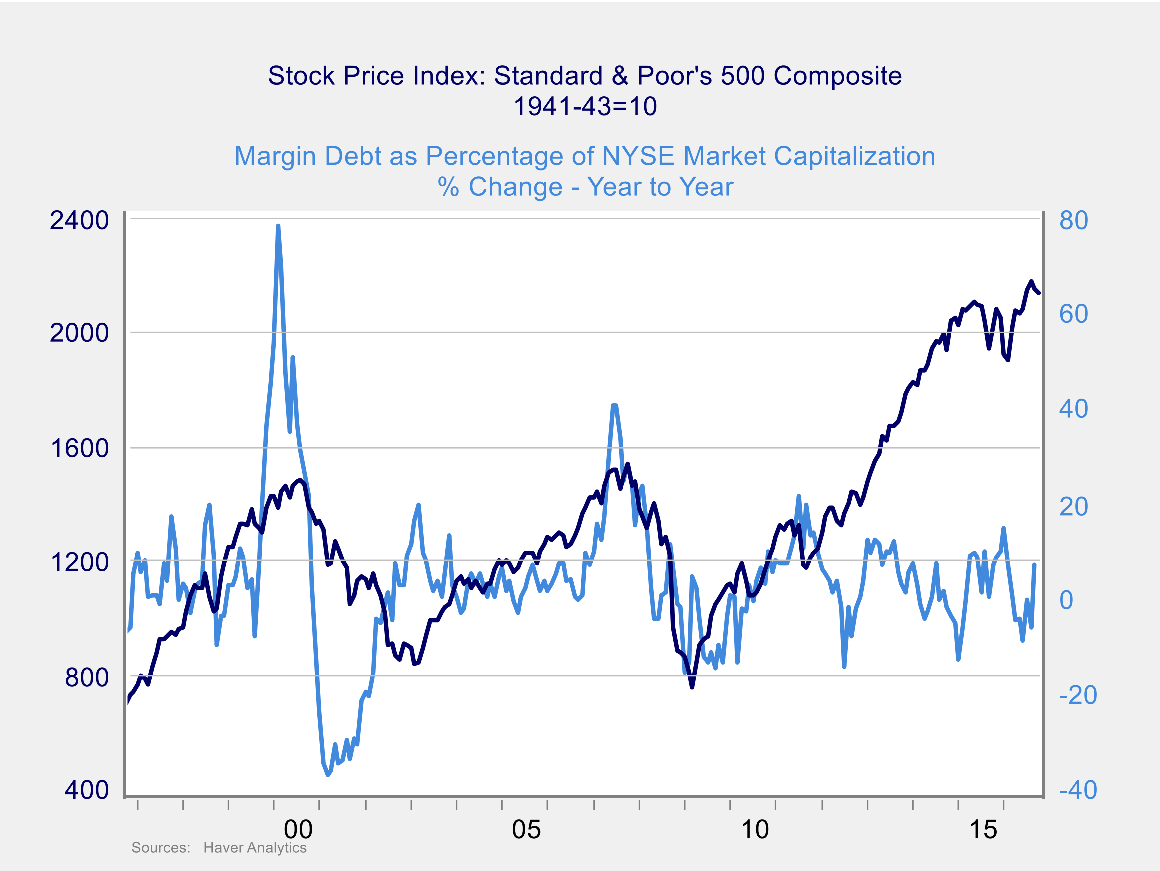
Another indicator of potential trouble is margin debt.



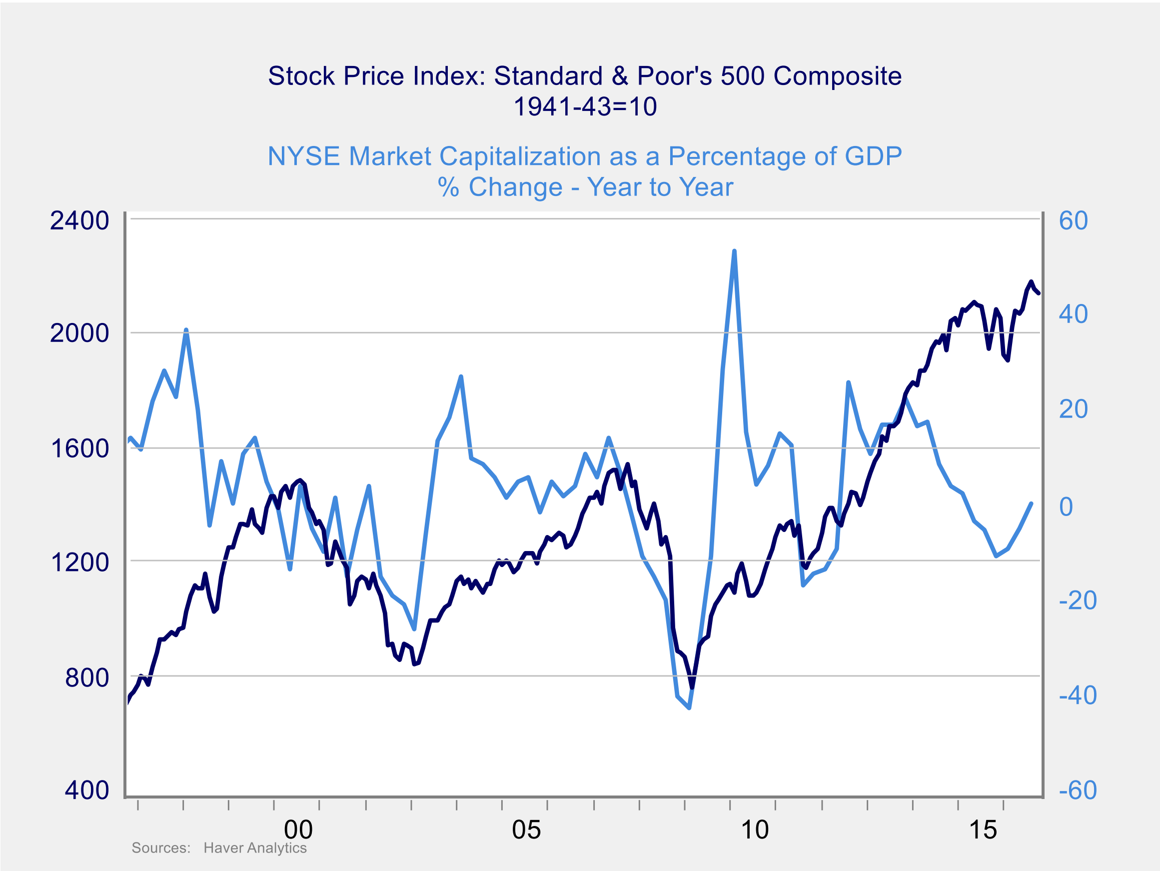
After declining at the start of the year due to the recovery from the pullback, debt levels have climbed in the past several months, back to the highest level since the financial crisis. This kind of increase suggests that risk levels are rising once again, and they certainly remain high by historical standards. Again, however, this does not necessarily appear to be an immediate risk, but we need to keep our eyes open.

Risk factor #4: Changes in margin debt

Consistent with this, if we look at the change in margin debt over time, spikes in debt levels typically precede a drawdown. With the absolute risk level high, the immediate risk level is also rising: the change in debt indicator is approaching, but not yet at, the 10-percent annual increase that suggests risk is has become more immediate.



Risk factor #5: The Buffett indicator
Said to be favored by Warren Buffett, the final indicator is the ratio of the value of all the companies in the market to the national economy as a whole.



On an absolute basis, the Buffett indicator is actually somewhat encouraging. Although it remains high, it has pulled back to less extreme levels. On a change-over-time basis, however, downturns in this indicator have typically led market pullbacks—and once again, we see that here. With the recent uptick, though, this indicator suggests the risks are not immediate.

Technical metrics are also reasonably encouraging, with all three major U.S. indices well above their 200-day trend lines despite a recent scare. Even as markets remain close to new highs, it's quite possible that the advance will continue. A break into new territory could actually propel the market higher, despite the high valuation risk level.

The difference between high risk and immediate risk

On balance, all of the metrics are in what has historically been a high-risk zone, so we should be paying attention. But, remember, there's a big difference between high risk and immediate risk—and it is one that's crucial to investing. As it stands, none of the indicators suggests an immediate problem, although several suggest risk may be rising.

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