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Is this Time Different?

In the investing world, anytime you hear someone say "but this time is different", you usually want to grab a helmet and dive for cover. You often hear the phrase "this time is different" just before the dung hits the fan. See Dot-Com boom in late 1990's (it's eyeballs that count, not profits), or the Great Recession of 2008-9 (house prices never drop). Today there are rumblings about this time too being different. Some of today's differences are positive; others not so much. The challenge is, which ones should you pay attention to?

On one hand, what is different is that interest rates are still historically low and they may well stay that way for some time; profit margins are at historic highs (in large part because of those low interest rates). Low rates mean a couple of things. One, the cost of debt is low and therefore borrowers can afford to carry more debt than usual. Two, the discount rates used to value stocks are lower than normal and therefore a higher present stock price is calculated using common discounted cash flow analysis.

On the other hand, today we have: record margin debt (buying stocks with borrowed money), record median P/S on the S&P 500, very high CAPE (margin-adjusted CAPE is within 7.5% of its all-time high in 2000), near record high market cap/GDP (20% higher than 2007), debt of U.S. corporations as a ratio to revenues is *more than double* its historical median[1] and covenant-light loans are back in vogue (borrowers get the key to the city).

Historically, when conditions such as the aforementioned exist, stocks are ripe for a correction. Often a big correction. Risk is high and likely reward is low. But one can argue that we are not yet in "bubble territory". "During the tech boom Microsoft became overvalued in 2000. Its net enterprise value was 35x ebitda. It took until 2014 for Microsoft to regain its 2000 price high, as earnings caught up to that multiple. Cisco traded at roughly 80x in 2000; today Cisco trades at 7x, having tripled its ebitda over the past 17yrs. Google's net enterprise value is roughly 12x its ebitda today. Apple is less than 8x. Facebook is roughly 13x. Expensive, but not bubbles.[2]

Is this time different? Yes, but every market has its own defining characteristics. Every market extreme is most probably different from the previous one. There are similarities between market cycles too. Markets ebb and flow according to investor willingness to participate in them. Today investors are still showing an appetite for risk and the US stock market price trend remains upward. Will the market ever correct? Yes, they always do. When the correction will occur is unknowable. The characteristics of today's environment are such that every investor would be well-served to revisit their tolerance for risk within the context of their investing time horizon. It is well documented that future stock (and bond) returns are highly correlated to their valuations at the time of purchase. Some would say don't sweat it – over time markets always go up. That is true over a given time horizon. However occasionally the time horizon can be rather extended. The Japanese stock market peaked in December 1989 and then experienced an 80% decline over the next 20 years. Today, more than 27 years later, the Nikkei is still 49% below its all-time high in 1989[3].

[1] Hussman Funds Commentary, May 8, 2017
[2] From Eric Peters, Wknd Notes
[3] Data from Yahoo Finance.

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