WILSONS

Bubble Trouble?

Our weekly view on asset allocation.

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Are Markets Set for a Reality Check?

The past year has seen some spectacular performances in a concentrated number of equity sectors and some alternative asset classes.

US tech and Bitcoin are two noteworthy examples, and more recently we have seen a spectacular rise in heavily shorted US stocks and also the price of silver (the second surge in 12 months).

Bubbly price moves are raising concerns that many markets are becoming detached from reality and hence vulnerable to a major reality check. Indeed some commentators have gone as far as to label the entire US equity market as being in extreme bubble territory.

Just how big and how widespread are valuation excesses and how vulnerable are risk assets to a significant unwind? Moreover, why are we seeing a run of parabolic moves in certain asset classes

Bubble Ingredients in the Mix

- **Ultra-easy monetary policy** - At the heart of the explanation is the reality of ultra-easy monetary policy defined by ultra-low interest rates and ample liquidity. At its best this is typically a supportive environment for risk assets, and at its worst, the historical base load fuel for almost all investment bubbles.
- **Supportive fiscal policy** - Currently, we also have very supportive fiscal policy that is significantly larger than ever before, with direct support flowing out to many households. Some of this fiscal largesse has undoubtedly been re-cycled into speculative market activity.
- **A unique retail investor eco-structure** - Zero cost trading platforms and large scale internet-connected social networks can magnify retail trading activity very rapidly.
- **Seductive narratives** - Finally, we have a number of seductive narratives that are helping power many of the big moves in investment markets. This is often the case with financial market bubbles.This is not to say all the current narratives are without foundation, but we need to be aware that almost all financial market bubbles have the semblance of respectability, at least initially.

Exhibit 1: US tech nowhere near as stretched as 2000 and delivering strong earnings

Source: Refinitiv, Wilsons.

Exhibit 2: Stocks do not look expensive versus bonds

Source: Refinitiv, Wilsons.

Equities - Some Froth but No Clear Bubble

Generally, our view is that equities are not in a bubble and the end of the (recently renewed) bull market is not imminent.

Valuations are not cheap in an absolute sense (particularly for the US) but can be justified versus interest rates. That is the "equity risk premium" is still quite generous (exhibit 2). Of course, the reliance on such a relative value argument rests largely on the sustainability of the current low interest rate regime.

Central banks are certainly doing their best to convince investors that the current regime has many years to run. Yet the path of inflation will likely decide just how sustainable the current ultra-low interest rate regime proves to be.

Bond yields have started to move up but this has been from record low levels. So far this has been a good story for growth assets as the rise in bond yields primarily reflects rising optimism around global economic prospects. We believe this trend of moderately rising bond yields and rising equity markets could continue for some time (backed by a strong earnings revival). While this is our base case, the risk of a quicker and sharper adjustment in interest rates is clearly a risk to monitor for the stock market and looms as a potential bubble popper for some risk assets.

Investment Markets Bubbling up in Places

Beyond the general strength of equities (most particularly tech-related equities), what do we make of the explosive moves in other areas of the financial markets?

The US short squeeze – Retail traders strike back

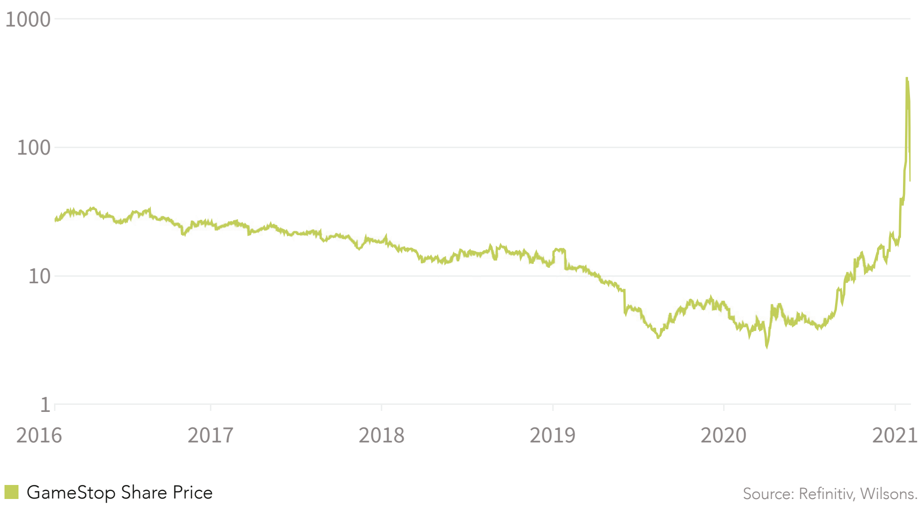
The recent explosive run in shorted US stocks is arguably the most obvious sign of rampant speculative behaviour and has already started to unwind. However, as discussed, the combination of large fiscal transfers to many households, zero-cost trading platforms and large internet-connected social networks suggests we may have to get used to retail investors periodically crowding into selected faddish ideas.

Silver – All that glitters is not gold

The silver market seems to be the latest target for the online retail crowd. While much of the most recent move in silver seems to be powered by pure retail speculation, silver also made a large move in 2020 which was perhaps more fundamentally based.

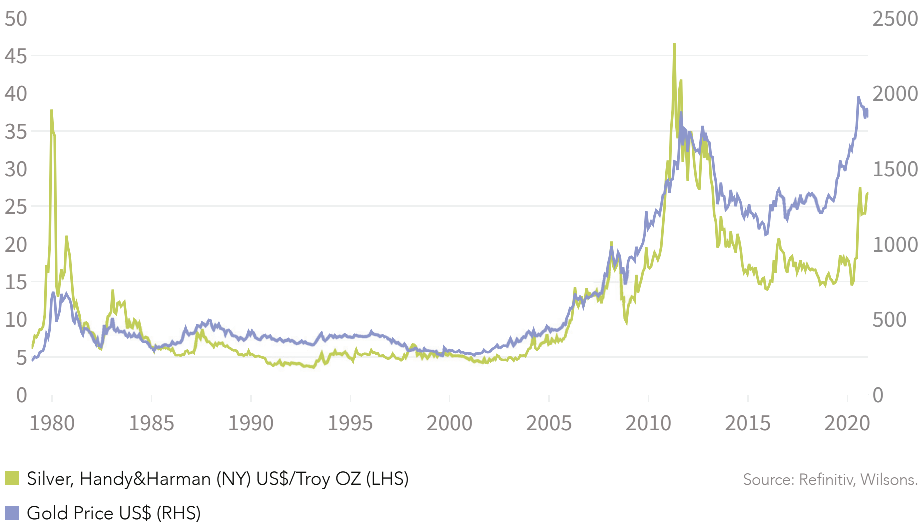
There are a number of potential long-term positive supports for silver. Silver still notionally trades cheaply relative to gold – the traditional alternative store of value. A significant share of the demand for silver comes from the industrial sector, and the potential for further upside in the global business cycle is consistent with the medium-term upside in silver prices. And finally, silver's superior conductivity and its use in solar power generation mean silver should benefit from the shift away from a carbon-based economy. All of which make it a respectable play on the green energy pivot. Meanwhile, investment in silver production has been limited in recent years, implying that supply could significantly lag demand in coming years. Silver does look overbought in the short-term on the back of aggressive retail buying, but a plausible medium to longer-term narrative is certainly present.

Exhibit 3: GameStop - an unloved company becomes flavour of the month



Source: Refinitiv, Wilsons.

Exhibit 4: Silver - gold's cheap cousin is moving up



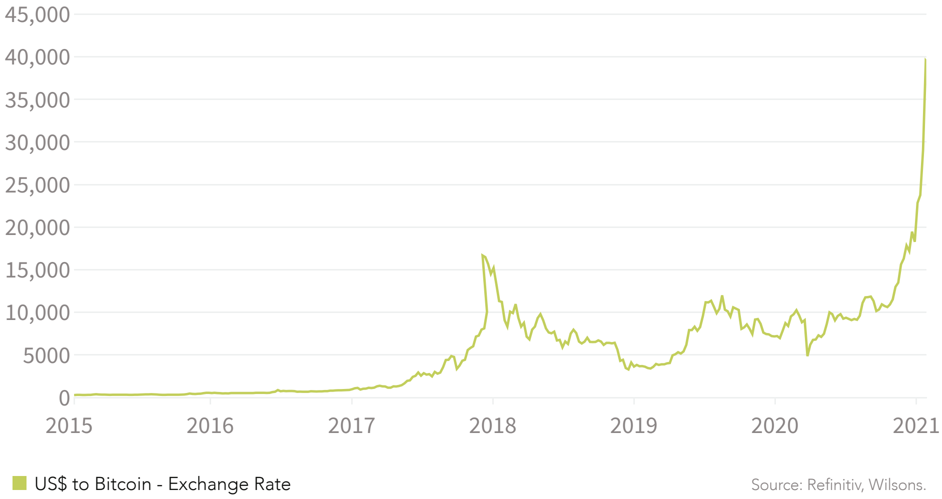
Source: Refinitiv, Wilsons.

Bitcoin – A risky hedge

Bitcoin has, of course, attracted even more attention recently with its 200% move in less than 6 months. Once again, the move does seem highly speculative, but the Bitcoin narrative is also not without some respectability. Bitcoin is just one of a number of crypto-currencies available but does seem to have captured a significant first mover advantage. To some extent, Bitcoin can be placed in the same basket as gold and silver as an alternative store of value (Bitcoin technically has a finite supply) at a time when long-term confidence in fiat currencies (particularly the US$) are being tested. The spectre of longer-term inflation risks does suggest some logic behind a store of value inflation hedges like gold/silver and the new kid on the block Bitcoin.

Whether an asset with an annualised volatility of around 90% makes sense as a portfolio hedge is highly debatable, but once again the longer-term bull case for Bitcoin - volatility notwithstanding - is not without some foundation.

Exhibit 5: Bitcoin - an interesting but very volatile US$ hedge



Source: Refinitiv, Wilsons.

Still in the Sweet Spot but Stay Disciplined

We will have to get used to dramatic moves in investment markets given the aggressive monetary policy backdrop and the increasing mobilisation of "cashed up" retail investors. Though we do not think it means the risk asset cycle is in its death throes. Equities have the support of a solid relative value argument as well as the prospect of a significant business cycle upswing, with little prospect of central banks taking away the punch bowl any time soon.

For the more niche asset classes, we think the case of overtly speculative or bubble-like behaviour is stronger, though there are tangible bullish scenarios to consider. Our preference now would be to not chase these hot niche asset classes but keep them on the radar screen. Ultimately, it comes down to maintaining prudent diversification alongside risk budgeting and overall investor risk tolerance.

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