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Absolute and relative stock market valuation unattractive

June 2020

- Fiscal and monetary stimulus as the last pillar of the bull market
- Strong performance of all risk assets
- Underweight equities and fixed-income securities, overweight liquidity

Economic, political and health risks are ignored

Our opportunism approached its limits. So far, we have “played along” with the liquidity boom born out of extreme pessimism and massive central bank intervention. “Do not fight the FED” was very obviously the right motto. However, stock markets are now overvalued in absolute and relative terms. Hence, we are moving from a neutral to an underweight position. The current valuation seems particularly inflated as it does not take into account the prevailing economic, political and health (Covid-19) risks. The liquidity boom may well continue for a while, however, it is only a matter of time until valuations return to their historic mean. Stretched valuations can also lead to bitter investor disappointment as the drop height can be expected to be larger than usual. Put in simple words, the higher the valuation, the larger the potential fall in asset prices. Thus, the current combination of great uncertainty with high valuations can be expected to lead to a more important correction.

The same applies to fixed-income securities: “Everything has it’s price”! Since our last report, prices of high-yield corporate bonds have increased by an average of approximately 5%, leading to a sharp decline in credit spreads over government bonds. We consider these valuations unjustified as well as unsustainable and therefore move to an underweight position in fixed income.

Sound Capital Investment Navigator

Valuation Bonds: -

	low		Yields		high		low		Spreads		high
	- -	-	0	+	+ +		- -	-	0	+	+ +
New	X					**New**			X		
Old	X					Old					X

Valuation Equities: -

	expensive		Shiller PE		cheap		low		Risk Premium		high
	- -	-	0	+	+ +		- -	-	0	+	+ +
New	X					**New**		X			
Old			X			Old				X	

	Contraction		Leading Indicators		Expansion		Euphoria		Risk-Index		Panic
	- -	-	0	+	+ +		- -	-	0	+	+ +
New	X					**New**					X
Old	X					Old					X

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Overall, fixed-income securities are assessed negatively, as credit spreads are no longer attractive and are now in the neutral range. Furthermore, equities are reassessed negatively, as both valuation indicators (Shiller P/E ratio & Risk premium) have deteriorated by two notches. Hence, the absolute valuation is no longer neutral, but extremely expensive. The relative valuation is no longer considered attractive but unattractive.

Asset classes: Liquidity is now strongly overweighted, bonds and equities are now underweighted and alternative investments continue to be neutrally weighted.

Fixed Income: Government bonds and inflation-linked bonds are upgraded from underweight to neutral. Investment grade corporate bonds are downgraded from positive to neutral and convertible bonds from positive to negative.

Equities: USA and emerging markets are downgraded from positive to neutral.

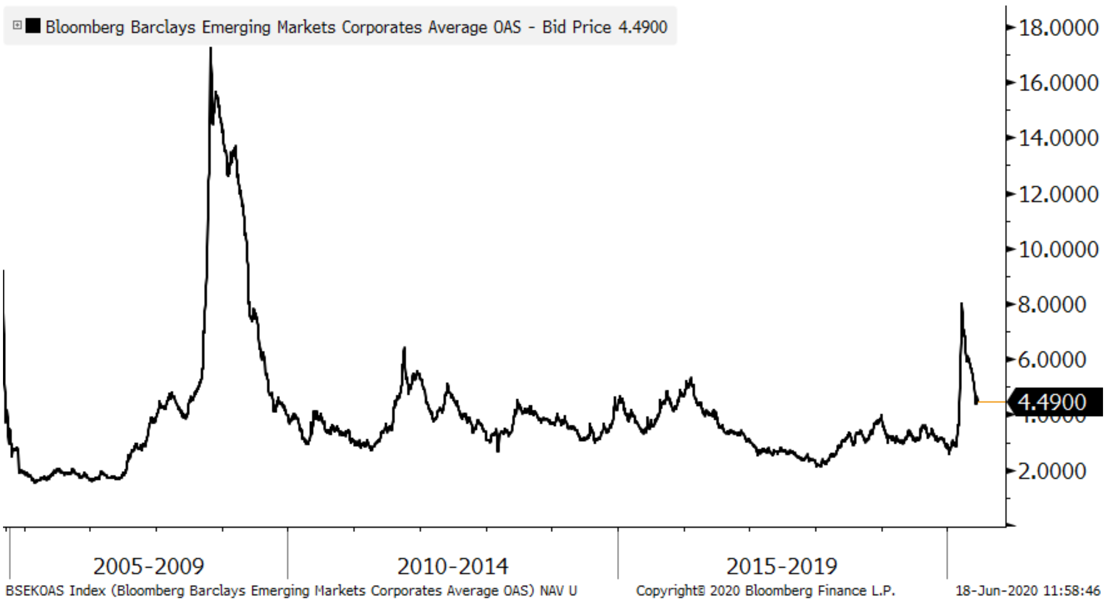
Interest rate level (Indicator --) / Spreads (Indicator 0)

Assessment unchanged / Assessment changed from ++ to 0

The interest rates on government bonds are still at an extremely unattractive level.

«Spreads» of corporate bonds have dropped back strongly and do not look very attractive (especially considering the large economic risks).

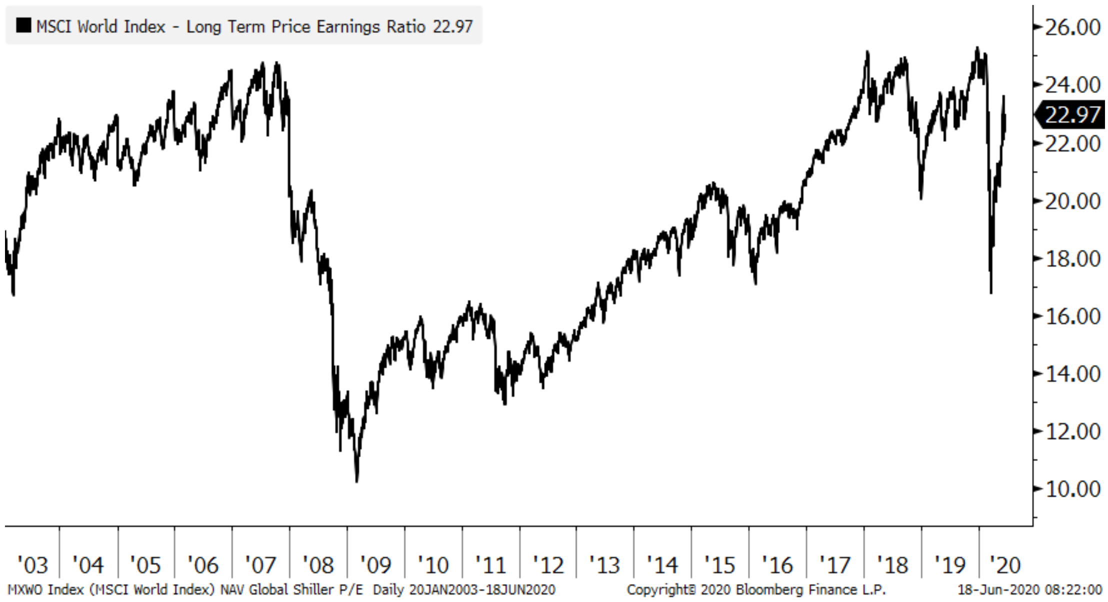
By contrast, emerging market corporate bonds remain relatively attractive.



Shiller P/E ratio (Indicator --) / Risk premium (Indicator -)

Assessment changed from 0 to --/ Assessment changed from + to -

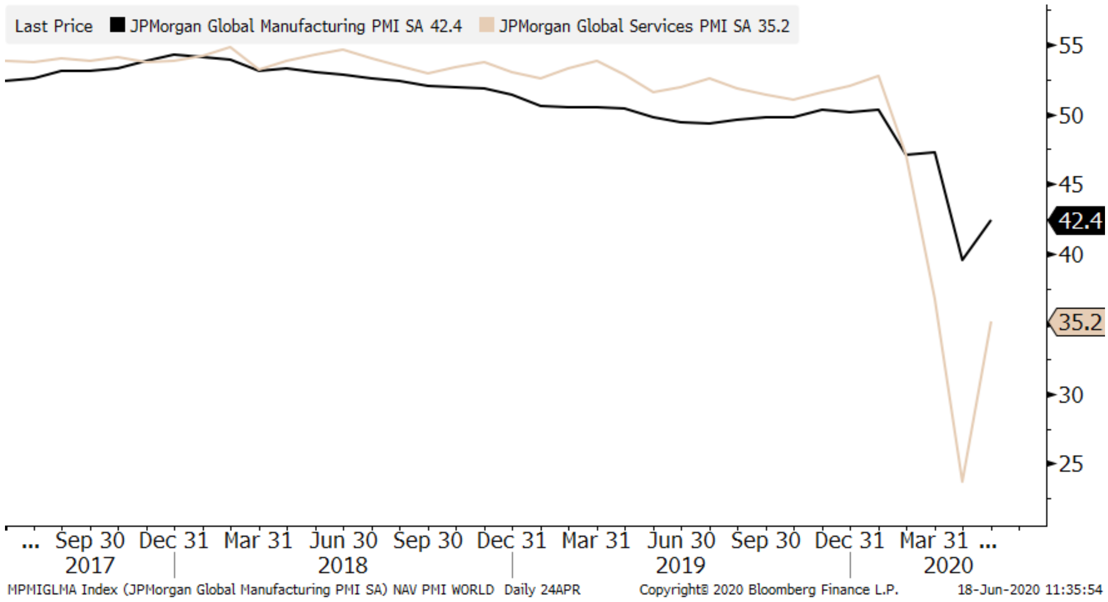
We use cyclically adjusted earnings when assessing the absolute and relative attractiveness of equities. For both indicators, levels have deteriorated significantly mainly due to a sharp rise in equity prices. With regards to our current underweight assessment, these factors are the pivotal elements for the shift in our evaluation.



Macro leading indicators (indicator --)

Assessment unchanged

The global manufacturing PMI data for May rose to 42.4 from 39.6. Even more notably, the global PMI data for the services sector rose from 23.7 to 35.2. Despite the slight improvement, the global economy is still facing intensive care with an uncertain outcome.



Risk index (indicator ++)

Assessment unchanged

The positioning of market participants as well as investment flows show an extremely defensive attitude of investors. For this reason, the contrary risk index remains in extremely positive territory.