ICON Insights

Market Commentary - July 2020

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What an interesting and even wild six months for the stock market. First, the market advanced to a new all-time high February 27. That move made sense to our system as we saw stocks still priced below our estimation of fair value, despite an eleven year, "unloved" bull market. Then the market crashed over the next 23 trading days as investors went from believing the coronavirus might not even get to the USA to realizing that we would have to shut down the economy to contain the virus. Typical of crashes, fear-driven investors went too far. By the end of the crash, March 23, 2020, we believed investors had more than priced in all of the bad economic news that would occur in the subsequent months and stated it on CNBC TV April 2, 2020, "We believe a bottom is forming and it seems like all the bad news is priced in."

The market has rallied off the March low, a move that appears sensible to our system and experience. In the April Portfolio Update we wrote, "We do not know the exact day of the bottom, but we expect it to be before we see the worst of the news regarding the virus and the economy" and pointed out that the stock market historically has led the economy by six to nine months at turning points. To us, this recent rally is simply anticipating an economic recovery late 2020 and early 2021. We still see stock prices, on average to be about 19% below our estimate of fair value. We believe the market advance can continue, expecting that there will be various bits of disappointing economic news and market dips along the way.

On TV and in print, you may have seen analysts claim that stocks are expensive. At ICON, we disagree, but this isn't anything new. During the eleven year bull market from March 2009 to February 2020, we heard those same claims of excessive pricing by skeptics. We believe they are just as wrong now as they were during that tremendous bull market and for the same reason; faulty use of the P/E ratio. It is easy and convenient, but deficient in our opinion, to simply take a stock's price and divide it by its earnings per share and then, based on historic averages, claim that the price is too high. It is deficient because it ignores the fundamentals of finance, which state the value of an asset is its future earnings discounted back to their present value. In other words, in times of low interest rates (and low discount rates) it is proper to have above historic average P/E ratios and stocks under-priced relative to intrinsic value. We believe that is the case today and those using P/E ratios are incorrect in their assessment of value.

It appears to us that an incorrect view of value is not the only reason many investors are not participating in this rally, based on comments from analysts on TV and in print. Some, from a technical analysis perspective state that the market had to "retest" its March lows. Others site the current bad economic data, apparently forgetting that the market leads the economy and that the data six to nine months out should be their focus. Some have computed average historical lag time between when recessions have started and when stock market recovery rallies have begun. Those skeptical professionals are not alone. A survey of individual investor sentiment, shows those surveyed to be extremely bearish by historic standards. It should be noted that this group has frequently been wrong in their outlook at major buying opportunities.

Besides value, what are doubters missing that we believe we are seeing? This recession, which was declared to have begun in late February, is not normal. It was self-imposed in order to contain a virus while scientists are working on treatments and/or a vaccine. Within weeks of when the recession began the Federal Reserve and the U.S. Government unleashed huge monetary and fiscal stimulus packages. We, therefore, do not believe historic charts, relationships and lag times apply. After trusting our value readings during the previous eleven year bull market, we are relying on them again. Value in combination with monetary and fiscal stimulus, plus Dr. Fauci's statement that a vaccine is a matter of "when" not "if" makes us believe the stock market will move higher over the next year.

ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. According to our methodology, a V/P reading of 1.00 indicates stocks are priced at intrinsic value. We believe stocks with a V/P reading below 1.00 are overvalued while stocks with a V/P reading above 1.00 are undervalued. For example, we interpret a V/P reading of 1.15 to mean that for every $1.00 of market value, there is $1.15 of intrinsic value which has not yet been realized in the market price.

P/E: Price/Earnings Ratio is the price of a stock divided by its earnings per share.

Sources: Bloomberg, FactSet

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Portfolio_Update (7/2020)