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OPINION

Markets Insight

Certainty is now a scarcity in markets

Capricious policies from Washington have created a very unpredictable economic environment

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Every introductory economics student knows that prices go up when demand outstrips supply. Accordingly, investing in scarcities has typically been a good longer-term strategy.

The economic term "scarcity" is often used to describe physical capacity or resources, but the stock market has historically taken a broader view. Earnings growth, for example, typically becomes limited during profit recessions, so valuations expand for those companies that can continue to increase earnings despite the challenging backdrop.

In today's financial markets, certainty appears to be an extremely scarce resource. Capricious policies from Washington have created a very unpredictable economic environment in which forecasting is virtually impossible.

Whereas investors over the past several years have embraced speculative investments such as the Magnificent Seven technology stocks, cryptocurrencies, and shell corporations, they are now realising that pie-in-the-sky forecasts are useless when one can't anticipate tomorrow's policy changes.

Most dispassionate investors are not interested in whether government policies are the proper ones or not. Rather, they want clear communication in order to assess business and investment opportunities. Such clarity has suddenly become fleeting.

Investors should always try to ignore politics, but the current US administration seems to want to interfere with the private sector considerably more than others have in the past. Fluctuating policies are significantly interrupting the sector's ability to strategically plan.

More importantly, impulsive policy changes keep investors guessing whether opportunities are real or mirages. I'm not sure how any analyst can predict a company's quarterly or annual earnings with any conviction under these conditions.

Standard barometers of uncertainty are fittingly at record highs. The NFIB Small Business Uncertainty Index and the Baker, Bloom, and Davis Economic Policy Uncertainty Index for Trade Policy are two of the most cited measures. Both suggest the uncertainty is at or near a high in their multi-decade histories.

There is never perfect insight, and some level of uncertainty should be expected when making any investment. Risk premiums are the markets' natural adjustment. Lower quality or more unpredictable investments tend to offer higher expected returns to compensate investors for their relatively volatile range of outcomes.

Dramatically increased unpredictability is the cause of the market's recent volatility. The US stock market is simply resetting its risk premium and valuation based on a sudden and broadening range of uncertain outcomes. Perceived certainty drives higher valuations, but policy fickleness drives multiple contraction.

Since January 1, the S&P 500's forward price/earnings ratio has decreased from 25 to 20, a 20 per cent devaluation. This reflects the desire of investors for a higher risk premium to invest in US equities because earnings and cash flows are becoming more nebulous.

Uncertainty rises among US small businesses

NFIB Uncertainty index, sum of 'uncertain' and 'don't know' answers on six questions*

*Seasonally adjusted 1986 = 100
Source: National Federation of Independent Business

If certainty is indeed a scarcity, then stable, forecastable earnings streams should begin to command premium valuations. It seems the stock market hasn't yet fully appreciated this.

Consider the S&P Common Stock Rankings, a sometimes overlooked metric of the growth and stability of earnings and dividends. Higher quality non-technology companies — those with rankings of A+, A, or A- — currently sell at a 25-30 per cent discount to the S&P 500 technology sector.

Cash returns are more assured than those related to future growth, and these high-quality non-technology stocks also have a dividend yield that is nearly four times greater than the yield of US technology stocks.

Similar statistics apply to European equities as well. Higher quality European stocks sell at a 15 per cent discount to US technology shares and have a dividend yield three times greater.

In other words, certainty is not only scarce, but also cheap.

If consistency and clarity don't become policy norms, then investors should expect the recent revaluation to continue. If Washington continues to alter trade, geopolitical, and employment policies at a whim and not allow companies and investors to fully assess economic fundamentals, investors are likely to shift portfolios towards the security of stable earning streams.

Scarcities tend to drive secular investment returns. Sometimes growth is scarce, sometimes value is scarce. Today certainty and confidence are very scarce resources indeed.

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