The Trades

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Irrational exuberance or rational optimism?

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On 7th January 2021, the US registered over 4,000 daily Covid-related deaths for the first time since the pandemic began. The following day the S&P500 index hit its all-time high, 13% higher than its pre-pandemic level. If this disconnect between the stock market and the pandemic is difficult to understand, the examples of Tesla shares (+800% in 12 months) and Bitcoin (+280% in 3 months) are incomprehensible. So, are we in dangerous bubble territory as some warn, or is there rationality to the exuberance?

One explanation for the performance of the stock market is that there is no alternative (or 'TINA' for acronym-lovers). At the onset of the crisis last March bond yields fell to new lows as investors sought safe assets (yields move inversely to prices). As central banks have pumped huge amounts of money into their economies, they do so by buying bonds, keeping yields low. Add in the impact of inflation and many government bonds yields turn negative. In comparison to the bond market, equities look cheap.

Another factor is the innate optimism of equity investors. That is somewhat of a generalisation, but since last March many have been willing to look past the pandemic when investing. Initially stocks such as Amazon and Procter & Gamble, who benefitted from people staying at home, were in favour; more recently it has been the likes of JP Morgan and Royal Dutch Shell, in anticipation of an acceleration in economic activity. The share prices of many of these cyclical companies remain well below their level of 12 months ago and offer good investment opportunities, which the Endeavour Fund aims to take advantage of.

The final piece to the puzzle is the pandemic itself. While the spread of the virus is a concern, we now have vaccines that will bring an end to the pandemic; but how quickly is a whole other question. The varying speeds of the rollout even within developed markets, let alone emerging ones, mean a return to normality remains some way off; but just a loosening of restrictions is a big step towards a more sustained economic recovery. This needs to happen for many companies to deliver the earnings that their current share prices warrant.

None of this explains Tesla and Bitcoin. I am still not even convinced that Bitcoin should be classified as an investment when 20% of the entire asset is estimated to be in lost "wallets", including £200m in a landfill in South Wales, but that's just me. Nevertheless, those buying Tesla shares or Bitcoin now are not doing so because of low bond yields, or an end to the pandemic, but in speculation that there will be someone in the future prepared to pay a higher price than now, and that is dangerous territory for any investor.