GFG CAPITAL
A FAMILY OFFICE

VIEWS FROM THE BRICK

THE 'B' WORD

There is a collection of four-letter words we're told we shouldn't use in conversation growing up. We'd sneak them in with our friends, or let them slip when we were upset, but for the most part we listened to our parents and kept a clean mouth. There's a word that gets thrown around a lot these days that we are going to add to that list for the next generation, but it's not four letters. And it's not Voldemort. No, this word has 6 letters and it starts with a 'b'. Can you guess it? Bubble.

YOU KEEP USING THAT WORD, BUT WE DO NOT...

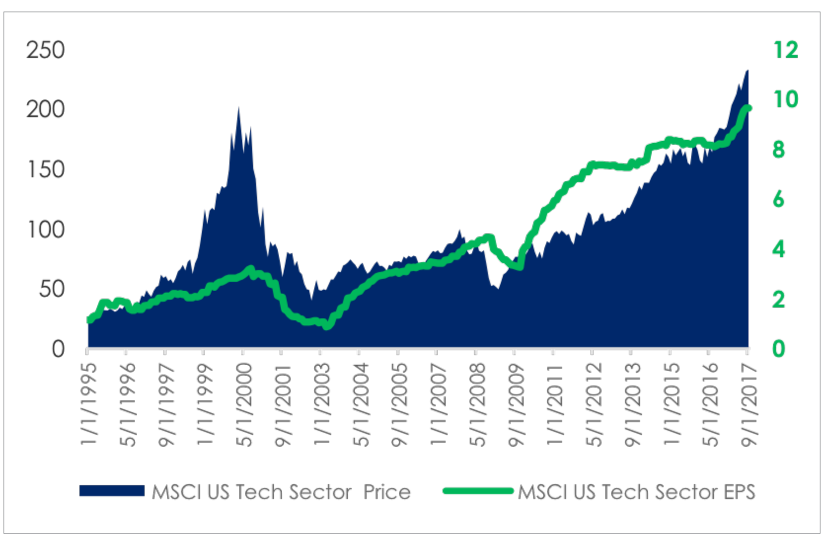
Bubble is a word used around Wall Street and investment offices across the globe far too frequently for our liking. We find it offensive. (You can call us snowflakes but we are adding that to the list too.) Kind of like those four-letter words, if you use the term too frequently it loses its oomph. And ever since 2000 or 2008 it is used to describe any (and every) instance of questionable valuations. We hate to burst your bubble (sorry that's our only one) but these things don't just happen all the time. A bubble is generally used to refer to a period when assets are being valued way beyond their comprehendible intrinsic value. The commonly accepted definition isn't exactly objective (remember what we said about market corrections?) but it is what we've got. Let's try to bring this basic understanding a step further. Using the term bubble should only be reserved for when asset valuations move beyond comprehension, or vision.

DON'T FORGET WHERE YOU CAME FROM...

Pick a valuation metric and you'll be hard pressed to find evidence that stocks and bonds aren't expensive today, nearly across the board. But there is one important factor to consider that is often overlooked by many during this conversation: context. Sure, the S&P 500's CAPE ratio (Cyclically Adjusted Price-to-Earnings Ratio) is at its highest level since 2000. But this elevated valuation, coupled with that comparison isn't as scary as it comes seems. The Fed Funds rate in 2000? It peaked at 6.5% in May, which was after the equity market declined in March of that year. At the time the CAPE ratio for the index hit 44, vs the average of 17 (today it's at 31). Interest rates topping 6% isn't exactly an environment that should be breeding bullish equity behavior. Fast forward through a tech bubble, housing bubble, the most extreme monetary easing that the world has ever seen and 17 years later: we're not close to the same environment we were in. An effective interest rate of 0% has done what should be expected: increased asset prices. You could even say inflated them. But we're not talking bubble here. A way to look at it and a way to think about valuations, rich or not rich, is to think that P/E ratios are really, an inversion, that they're very similar to interest rates; and that when you have low interest rates something in the future is worth more because it's discounted at a lower interest rate.

THIS ISN'T YOUR FATHER'S TECH INDUSTRY

Let's rewind to the last time euphoric behavior was running rampant throughout Wall Street (setting the housing bubble aside here) to the infamous dot.com bubble. In 2000, tech stocks associated with the new frontier of the internet were coming to market nearly every day. Each with valuations that at the time didn't give investors pause, all while it should have. Tech at its peak accounted for nearly 35% of the index, while today it stands closer to 21%. In 2000, the tech sector was valued at more than 70x earnings. Today, that price tag sits below 25x for the second highest earnings growth rate in the S&P 500. The tech sector has made its way back into the limelight of these bubble talks and instantly comparisons to 2000 are drawn. But here's the difference: these companies are making money. Lots of it. So while tech has been the scapegoat of anyone pointing to this market as euphoric in nature, here's a piece of trivia. Name the one company with a $10B market cap, 40% growth and margins of at least 30%? Facebook[1].



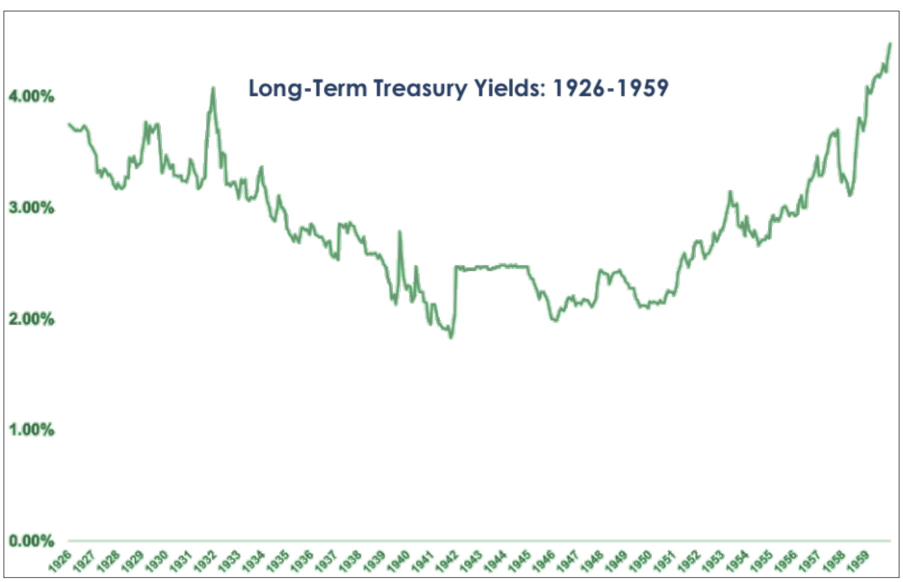
SOURCE: [1] Data Provided by Bloomberg database. Past performance is not indicative of future returns. [2] Data Provided by Bloomberg database. Past performance is not indicative of future returns.

SORRY ALAN, BUT NOT SEEING IT IN BONDS EITHER

Former Fed Chair Alan Greenspan has been quick to use the 'b' word over the years. He's also coined the phrase "irrational exuberance"[3] (which is an accurate description of the dot.com bubble above, but not quite the 1996 energy market where he dropped this term on us). Mr. Greenspan reiterated his thoughts that the current bond market was in a bubble this year, citing long term rates being far too low and would have little choice but to move higher and potentially at a rapid rate[4]. This is quite similar to his comments in 2010 on this same market. What is dangerous in this assumption is just that: it's an assumption. Nothing is written anywhere that says low yields can't remain low. In actuality, they often times do. From the 1920s' through 1959 it's exactly what bond yields did. Interest rates on long-term government bonds were range-bound between 2% and 4% for more than three decades. Real returns in the 1926-1959 period were 63% in total or roughly 1.5% annually[5]. But, for arguments sake, let's say there is an extreme re-rating on the horizon within the bond market. What does a bond bubble's aftermath feel like relative to equities? Do all bubbles pop equally?

This stint of relatively subdue bond yields was followed with an ascension in yields for about twenty years (1960-1982). The Fed rose rates by 20% in this time. The most extreme move saw yields climb from 1980-1981 when yields rose by just about 5% (started at 10% finished near 15%)[6].

The impact felt by bond investors? This entire period saw a max drawdown of -20.96%. For reference sake, Black Monday in 1987 saw a 22.61% in the Dow Jones in one day alone 7. So the worst bear market we've seen in bonds, has produced less than what an average bear market in equities has done in one day.



SOURCE: [3] Alan Greenspan December 5th, 1996. [4] Alan Greenspan: "The bubble is in bonds, not stocks" CNBC. [5] Data Provided by Bloomberg database. [6] Data Provided by Bloomberg database, performance analysis attained form "Bond Bubbles Tend to Slowly Deflate, Not Burst" by Ben Carlson. 7 ID. 8 Data Provided by Bloomberg database.

TURN DOWN THE NOISE

So what do we need to take away from this? Well, hopefully it's that words lose their luster after using them over and over again. And within the world of investing, you shouldn't be so quick to throw a term around in a broad fashion without considering the implications. These terms can become hot topic talking points for media to use and like we've covered in the past; we need to be cautious on the motive of these outlets. Your investment goals are almost always not aligned with their best interest. Sometimes the best thing to do is tune out the noise and seek out the tangible evidence of the situation.