An Uber bubble awaits

Anatole Kaletsky | GaveKal | 09 June 2014

Last week was clearly an important one for financial markets and the world economy. Friday's US payroll data confirmed that all the jobs lost since 2008 have been restored. The European Central Bank overcame the opposition of the Bundesbank and joined the US Federal Reserve, Bank of Japan and Bank of England in the ranks of growth-oriented central banks willing to do whatever is necessary to pump up inflation and nominal GDP. And, peace talks between Russia and Ukraine reinforced our view that Putin's annexation of Crimea marked the end, not the beginning, of the most dangerous period of geopolitical tension in Eastern Europe.

Considering all this good news, it is hardly surprising that "sell in May" this year became "buy in May", as we suggested it might. The S&P 500 hit new records on four days of five days last week and closed at a high just below 1950, at the top of a remarkably orderly bullish trading channel.

Yet it is possible that this week's most important financial event was neither the US payrolls nor the ECB initiative, nor the rapprochement with Putin. It was the pricing of Uber, a taxi-dispatching business that many people had not heard of until a few months ago. Uber was valued by second-round equity investors at $17bn, which was some 60 times its rumoured revenues and presumably a much higher multiple of its profits (if any).

To understand the significance of Uber's valuation, recall an observation we have often made in the past about asset pricing. The rise and fall of asset prices depends on three distinct factors. The obvious determinant is nominal economic growth (in the case of equity indices, bonds and other macro trades) or corporate cash-flow (in the case of individual equities or credits). The second factor, which attracts almost as much attention, is liquidity and monetary policy. But the third determinant, which is often overlooked by economists, is equally important. It is the valuation that investors decide to attach to any particular cash-flow. Given that asset prices are made at the margin and respond to events which are not expected, the main driver of bull or bear markets will usually be whichever of our three determinants is most uncertain.

Immediately after the 2008 crisis, this was economic activity. After a few years of gradual economic recovery, the market's attention shifted towards monetary policy, especially in the period of the euro crisis and the US taper tantrum. But what happens when both economic prospects and monetary policy become as clear and predictable as they have ever been, which seems a fair description of the situation in all the major economies, especially after last week's US economic figures and ECB policy announcements? The answer is surely that

investors will focus on the third aspect of the asset-pricing triangle - valuations.

Which brings us back to Uber and the other darlings of the mobile networking bubble. Two months ago, investors seemed to inaugurate the new valuation-driven phase of the equity bull market by shifting out of expensive growth stocks considered impervious to economic cycles into cheaper stocks which had been neglected in the phase of economic and monetary uncertainty. This rotation from growth to value contributed to the equity market weakness earlier this year, since the overvalued leaders retreated faster than the undervalued laggards could advance.

It seems, however, that this leadership rotation may now be over. Investors are again falling in love with miracle and fantasy stocks.

If this is true, then the bull market may now be entering a new phase that is both more exciting and more dangerous. As momentum-driven valuations keep rising, a severe correction of 20% or more will become inevitable. But the cause may not be weak growth, as bears have generally predicted; but simply, a recognition that valuations have become excessive, perhaps underlined by a modest increase in long-term interest rates. In this respect, conditions today are becoming reminiscent of the period before the stock market crash of 1987.

Then, as now, equity prices had risen almost without interruption for five years, the start of a structural bull market that nobody at the time believed to be sustainable. Then, as now, a period of extreme economic pessimism was giving way to greater confidence about the stability of the world economy. Then, as now, valuations were rising from above-average to very expensive (the S&P 500 peaked at 22x reported earnings) especially in comparison with bond yields that were creeping up from 8.5% to 10%, alongside a strengthening economy.

Do all these echoes of 1987 imply that investors should bail out of equities now? Not at all. To trigger a valuation-driven bear market, PE ratios would have to rise well above their present levels, since the S&P 500 presently trades at 19x reported earnings - and, in the absence of a recession or sudden margin squeeze, that will only happen if equity prices keep rising, probably with sharply accelerating momentum. That is what happened in the nine months leading up to October 1987. Of course, history never repeats itself exactly, but Figure 1 is worth a glance.

Figure 1: S&P 2009-14 and 1982-89

Sources: GaveKal Data/Macrobond

If we take the 1987 analogy literally, then nine to 12 months of massive (and massively dangerous) equity outperformance may be just starting. In that case, the best strategy will be to remain invested until equities become absurdly expensive, but buy lots of downside protection, especially while volatility remains absurdly cheap.

And, if you fail to get out at the top – as you almost surely will – don't worry. After a bear market that is caused by over-valuation, rather than recession, equities will recover quickly and eventually rise to much higher peaks. That, at least, is the lesson from 1987.

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