



Market Commentary  
March 2024

English Version

# Are we in a Bubble?

Get guidance on investments, and the major structural factors behind your clients' portfolios.

**insigneo**



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## Executive Summary

Although a small subset of technology stocks may be in a bubble, we do not think that the overall market is currently in bubble territory.

The current technology driven rally could potentially be derailed by a shift in positioning from the Fed, or the failure of companies to meet the lofty expectations placed upon them by the market.

As equity valuations continue to rise, fixed income emerges as an attractive option for portfolio coverage.

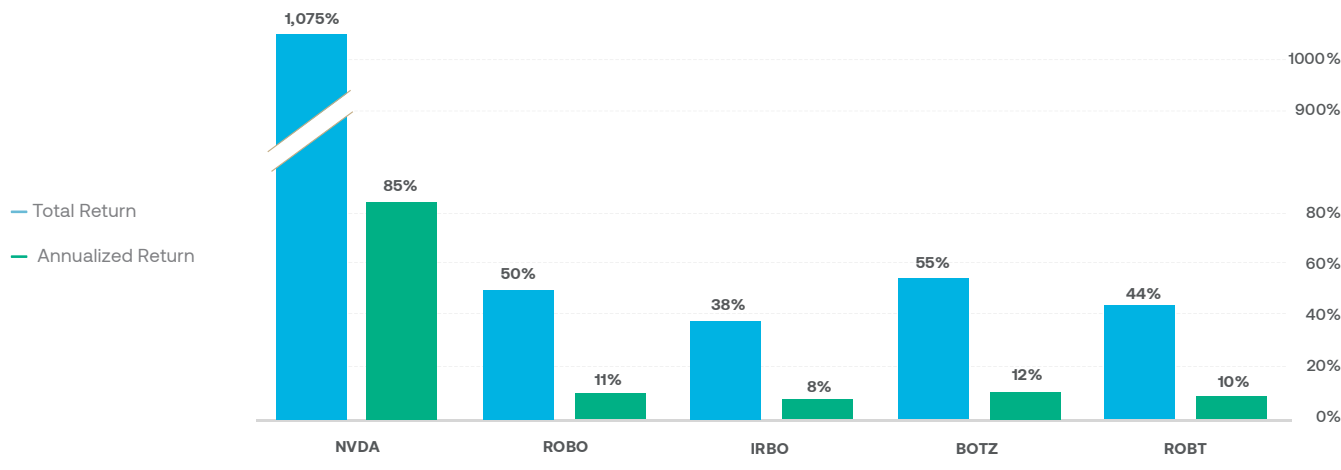
## Our thoughts on the current market rally in relation to historical market bubbles

Are we currently in a market bubble? This question has gained traction in the minds of investors and the media alike. This should not be a surprise though; all we have to do is look at the seemingly unstoppable meteoric

rise of AI-related stocks like Nvidia, ARM Holdings, and Super Micro Computers. The number of companies that have incorporated the term "Artificial Intelligence" into their earnings calls over the past couple of quarters is astounding, prompting investors to wonder whether we are witnessing the early stages of a tech bubble... and rightly so. Sky-rocketing interest in Artificial Intelligence has evoked memories of the dot-com bubble, which has led us to question, what exactly is a bubble? The short answer is a bubble is an environment where market prices vastly exceed the fundamental value of a company or an asset. This has been evident in historical market and asset bubbles, where we have seen instances of rapid and substantial valuation growth within a short period of time. To this point, we have all heard references to the tulip-mania of the 1600's in what is now the Netherlands. During this period, tulip prices jumped to exorbitant levels, the main driver behind this increase being "investors" hoping that someone else would buy tulip bulbs at prices higher than where they bought them themselves. There was no real intrinsic value behind this move; that was a bubble. More recently, we saw another bubble in the 1980s, when the Nikkei 225 experienced a 492% increase during Japan's stock market bubble. And of

**NVDA's Return vs AI ETFs (Feb 2020 - Feb 2024)**

Source: Bloomberg



course, who can forget the end of the '90s, when the Nasdaq 100 surged over 476% prior to its peak during the dot-com bubble. Even a few years ago, the Electric Vehicles (EV) industry witnessed extraordinary returns, exemplified by companies such as NIO (NIO) and Lucid (LCID), which soared over 400% during the EV rise of 2021.

Although such trends provide contextual insights into the current AI boom, they do not necessarily dictate the presence of a market bubble. That being said, if we look at NVIDIA's (NVDA) rise over the past four years, the company's stock has posted an astonishing return of 1,075% (85% annualized) from February 2020 to February 2024. However, it is essential to note that NVDA's exceptional performance alone does not signify a market bubble. If we examine the performance of AI-focused ETFs over the same period, contrary to NVDA's performance, their returns exhibit modest, low double-digit annualized returns, on average, as observed in the chart above.

True, when we examine the holdings of these AI-focused ETFs, we encounter a highly diverse set of companies contributing to the artificial intelligence "supply chain." Said a different way, not all companies in these ETFs are the pure-play picks and shovels of

the AI industry. The current leaders of this ecosystem, the chipmakers like Nvidia, truly stand out, benefiting from robust demand for their products, within a backdrop of limited supply. Meanwhile, other companies, mainly those leveraging AI technology to enhance and develop products and services, are still trying to gain traction. In other words, the enablers of AI are leading the pack, while the users of this technology still have room to catch up. As an example, Nvidia, ARM Holdings, and Super Micro Computers, have risen 90%, 170%, and 300% over the past six months. This period only includes a portion of Nvidia's dizzying rise over the past four years mentioned previously. A small subset of stocks, mainly those in the semiconductor industry that are the main enablers of the AI revolution could very well be reaching bubble territory, if not in a bubble already. However, this does not mean that the market as a whole is in a bubble.

Within this context, an important question to explore is "how does the current environment differ from the early 2000s?" To start, during the dot-com bubble, many companies were rushing to market before they had even posted any type of profit, a notable difference from today's landscape. Currently, chipmakers are not only experiencing soaring stock market prices but also experiencing significant profit growth, something many

companies back then did not demonstrate. To give some context, BCA Research recently published a report comparing the sales and net income metrics of blue-chip tech stocks today, compared to the blue-chip tech stocks in the early 2000's. This report shows that, back then, this group was earning about \$150 billion in revenues and \$35 billion in profits, represented by net income, where we define net income as revenues minus expenses. The current cohort of blue-chip tech stocks is generating approximately \$1.9 trillion in revenues and close to \$395 billion in net income. Granted, these are different times, and it is possible that earnings in the AI industry may have been "pulled-forward" by insatiable demand for AI chips. Regardless, the difference in revenue and profit numbers is astounding. Additionally, many of the current tech names leading the markets higher are themselves the symbols of high quality, boasting strong balance sheets full of cash and devoid of debt. So, what does this mean in terms of market bubbles? Drawing from experience, it seems that we are not yet in the middle of a market bubble, like the one seen during the dot-com era, nor are we facing an industry bubble yet, like the recent ones surrounding Electric Vehicles or Cryptocurrencies. While it is possible that we are seeing a bubble in a small subset of stocks, mainly the chipmakers, other players in the AI sector are still far from exhibiting bubble-like behavior.

## What comes next?

Just because we do not believe that we are currently in a market bubble, it does not mean that we should throw caution to the wind. Historically, market bubbles have been fueled by FOMO (Fear of Missing Out) and easily accessible money. FOMO is clearly in the market today, as retail and institutional investors alike have jumped into the tech-led rally, or risk being left behind by the markets. However, unlike previous bubbles, there is a component that has not yet appeared in the

— "...it seems that **we are not yet in the middle of a market bubble**, like the one seen during the dot-com era..."

equation: cheap access to capital. Unlike many times in the past, the current rally developed in an environment where rates were high. Why might this have happened? In our opinion, possibly because of two reasons: 1) The market rallied in anticipation of the Fed cutting rates and 2) the rally has been driven by AI and the Magnificent 7 stocks, companies that do not need cheap access to capital, given their strong balance sheets. This combination engendered a powerful surge in stocks despite the Fed's restrictive monetary policy cycle. Again, we do not believe that we are currently in a market bubble, and if we think about it, the "party" could continue, as fuel could be on the way in the form of lower rates. Cheap access to capital would potentially broaden out the rally, giving companies with a high need of capital a chance to grow revenues and earnings.

This brings up two important questions though, which are: "where are we now in the context of the rally and what could derail it?". As we said before, we can't just throw caution to the wind. Emily Roland, Co-Chief Investment Officer at John Hancock Investment Management, said it best when she recently stated: "It is like the Fed gave a last call at the party to end last year and now is trying to stop serving, but no one is leaving the party. This 'everything is awesome sentiment' is likely priced into the markets" (Emily Roland, Bloomberg). We are in a stage of the rally where sentiment is propelling the market higher. Coming into the year, the most bullish strategists on Wall Street had

year-end price targets for the S&P 500 between 5,150 and 5,200. However, from the beginning of 2024, the number of strategists raising their year-end price targets continues to increase, with bullish calls approaching 5,500. Jonathan Golub, Chief US Equity Strategist at Credit Suisse, raised his year-end price target twice since the end of last year, something he said he has never done before in more than 20 years. Although we believe that we are not yet at levels of euphoria, which is where market bubbles form and subsequently pop, we are in a powerful, emotionally driven stage of FOMO, with investors not wanting to get left behind. Given that we do not think that we are in a market bubble, we do not envision it popping any time soon. However, we would not be surprised by a 10% to 15% correction in the market in the near future.

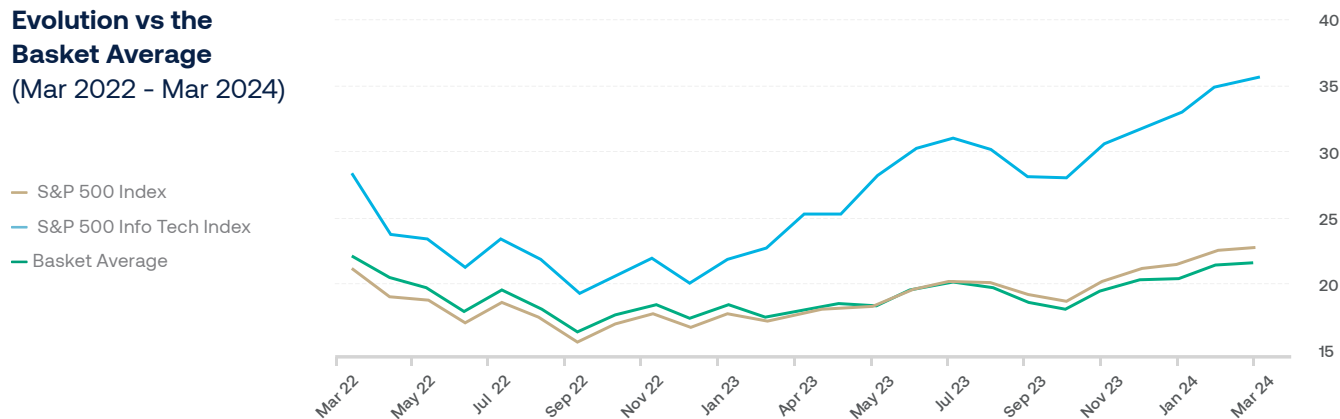
What could cause such a pullback, derailing the current rally? First, it is important to keep in mind that market pullbacks in the 10% range happen on average once a year. Believe it or not, we had such a pullback at the end of the summer of last year, before the market rallied higher after the Fed indicated that it was likely done raising rates. For one thing, a shift in the positioning of the Fed could derail the rally. The market has done a remarkable job at adapting its expectations of rate cuts, going from 7 cuts priced in for this year,

beginning this month, to 3 cuts as of today beginning after the June meeting... According to the Fed, it remains data-dependent in its decision of when to cut rates. As inflation has recently proven more resilient than expected, we would not be surprised if the Fed chose to cut once or twice this year, staying in a “wait and see” mode, effectively keeping rates higher for longer. However, there is now talk in the markets that the Fed might not cut at all this year and could even raise rates, as recently proposed by Larry Summers. We believe that we are still in an environment where inflation will trend lower over time; however, the possibility of the Fed keeping rates higher for longer than Wall Street anticipates could potentially derail the markets.

Another important point to keep in mind is the market’s current valuation, particularly in the tech sector. Trading at 23x forward earnings, the S&P 500 does not appear cheap. In fact, if we look at the market’s trailing earnings, it is trading in the 95th percentile of its valuation range, going back to the 1990s. Much of this stretched valuation can be attributed to the Technology sector. As observed in the graph below, Technology became the only game in town, as investors have flooded the sector over the past two years, causing the S&P 500 Technology sector P/E to highly diverge from the rest of the market. However, valuation is not the be all end

**S&P 500 Technology Sector P/E 2Yr Evolution vs the Basket Average (Mar 2022 - Mar 2024)**

Source: Bloomberg



all, being a traditionally inconsistent indicator over the short term. Just because valuations are high does not necessarily imply that the next move is down. The important point to keep in mind with valuations is the expectations that come attached to those valuations. The higher the valuation of a stock, the higher the expectation for it to deliver, and the smaller the room for error if it does not. We saw this phenomenon play out this last quarter, where great technology companies like Palo Alto Networks (PANW) and Snowflake (SNOW), both with stretched valuations, failed to deliver on the market's lofty expectations. Both fell 30% and 25% respectively on the days of their earnings reports. Another factor that could derail the markets are indications of cracks in the earnings trajectories of stocks with hefty valuations.

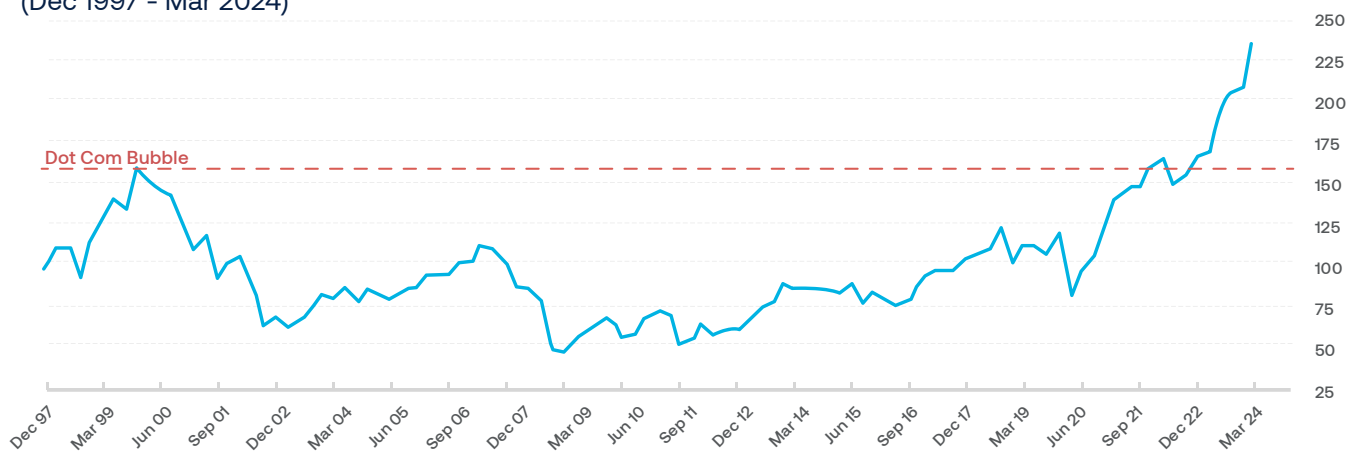
As John Maynard Keynes famously said, "markets can stay irrational for longer than you can stay solvent." Attempting to time the rise and fall of a potential AI bubble may result in missing out on investment opportunities, both on the upside and the downside. That said, by no means are we recommending exiting the equity markets. In fact, maintaining a diversified portfolio, with a focus on the long-term, that includes responsible exposure to the technology sector, is the best

approach to navigating the markets over time. Tactically though, trimming overweight positions in highly appreciated stocks or buying "insurance" on the markets in the form of put options could make sense at this time. Another approach could be to consider increasing allocations to fixed income assets.

As equity valuations continue to rise, fixed income emerges as an attractive option for portfolio coverage. As observed in the graph below, the S&P US Equity Risk Premium Index (SPUSERPT) which currently sits at all-time highs, shows that investors are demanding larger premiums for bearing the risk associated with equities. In simpler terms, bonds appear more attractively priced compared to stocks. As highlighted during our 1Q24 Quarterly Call, we reiterate that one of the most favorable trades for investors this year is to tactically purchase longer-dated U.S. Treasuries. At the time of this writing, the U.S. 10-year Treasury yield stands close to 4.2%. Our projections indicate that in a soft-landing scenario, this is likely to stabilize between 3.6% and 3.9%, while in the case of a mild recession, it may trade within the range of 2.9% and 3.2%. As previously mentioned, equities are expected to continue delivering positive returns over the long term. However, we believe that tactical investments in Treasuries or

**S&P 500 Equity Risk Premium Index**  
(Dec 1997 - Mar 2024)

Source: Bloomberg



Investment Grade Corporate bonds, to gradually reallocate portfolios as momentum continues to carry the tech rally make sense.

Including commodities as tactical trades could also enhance portfolio performance. In a soft-landing scenario, industrial metals are poised to outperform given the improved macroeconomic environment. As we mentioned in our 1Q24 Quarterly Call, industrial metals are expected to see the long-term benefits of reduced inventories, geopolitical uncertainties, and the shift towards EVs and renewable energy sources. In a no-or-hard-landing scenario, oil and gold are likely to outperform. These commodities serve as natural hedges against high inflation environments and should

offer protection against potential energy supply disruptions in the Middle East or Russia.

Warren Buffet once said that you want to sell an asset when people are greedy and buy when people are fearful. We do not believe that we are yet in the all-out euphoric state of greed that typically marks asset bubbles. However, many times the market does not recognize a bubble until it pops. Although a subset of AI stocks could potentially be nearing bubble territory, we do not believe that the overall market is in this stage. That said, keeping a focus on the long term, while being prudent and tactically taking advantage of opportunities as greed increases, could prove to be a wise investment decision ■

# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
<b>Global Asset Allocation</b>		
Equities	NEUTRAL	NEUTRAL
Fixed Income	OVERWEIGHT	OVERWEIGHT
Cash	UNDERWEIGHT	NEUTRAL
<b>Regional Breakdown</b>		
US Equities <sup>1</sup>	OVERWEIGHT	OVERWEIGHT
European Equities	NEUTRAL	NEUTRAL
Japanese Equities	OVERWEIGHT	OVERWEIGHT
Emerging Market Equities	NEUTRAL	UNDERWEIGHT
Chinese Equities	NEUTRAL	UNDERWEIGHT
US Treasuries <sup>2</sup>	OVERWEIGHT	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	NEUTRAL
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	OVERWEIGHT	NEUTRAL
US Dollar	NEUTRAL	OVERWEIGHT
Energy <sup>3</sup>	OVERWEIGHT	NEUTRAL
Precious Metals	UNDERWEIGHT	OVERWEIGHT

<sup>1</sup>Relative to global equities in USD

<sup>2</sup>Relative to aggregate fixed income markets in USD

<sup>3</sup>Relative to an overall commodity allocation

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