Minutes of the May 14th, 2021 Financial Advisory Roundtable (FAR) Meeting

Present:

FAR Members: Hayley Boesky, John H. Cochrane, Bennett Golub, Robin Greenwood, Bradford Hu, Ralph Koijen, Maureen O'Hara, Srini Ramaswamy, Til Schuermann, Joanna Welsh, Toni Whited.

Other: John Y. Campbell.

FRBNY: Jaison Abel, Ozge Akinci, Mary Amiti, Pablo Azar, Jim Bergin, Kristian Blickle, Nina Boyarchenko, Nicola Cetorelli, Rajashri Chakrabarti, Jennifer Crystal, Matteo Crosignani, Richard Crump, Rita Csejtey, Jeff Dawson, Rich Deitz, Marco Del Negro, Fernando Duarte, Thomas Eisenbach, Michael Fleming, Fulvia Fringuellotti, Linda Goldberg, Jan Groen, Naureen Hassan, Andrew Haughwout, Beverly Hirtle, Darau Johnson, Tom Klitgaard, Anna Kovner, Michael Lee, Matthew Lieber, Lorie Logan, David Lucca, Stephan Luck, Dina Maher, Jim Mahoney, Antoine Martin, Jonathan McCarthy, Rebecca McCaughrin, Susan McLaughlin, Helen Mucciolo, Wing Oon, Matthew Plosser, Jordan Pollinger, Paolo Presenti, Matthew Raskin, Julie Remache, Joshua Rosenberg, Joao Santos, Asani Sarkar, Or Shachar, Kevin Stiroh, Andrea Tambalotti, Katherine Tilghman Hill, Giorgio Topa, Desi Volker, Tim Wessel, John Williams, Patricia Zobel.

Agenda:

The Financial Advisory Roundtable considered whether valuations in various markets had diverged from fundamentals and the potential risks to financial stability. The meeting began with two presentations. These were followed by an open discussion focused on the topics listed in the meeting agenda:

1. Are markets increasingly likely to have prices that diverge from fundamentals? If so why? What forces could cause prices to revert and what is stopping efficiency?
2. Are high valuations or volatile prices in some markets more concerning than others? If so, what is the criteria to identify critical markets?
3. Are there markets whose current valuations are not high by historical standards but that you see as posing a risk to financial stability?

The Role of Policy on Current Valuations

FAR members observed that market participants do not seem to believe that asset valuations are currently diverging from fundamentals, despite being high by historical standards. It was also noted that measures of sentiment among market participants reached record highs in April 2021, likely driven by the sudden increase in consumer spending. FAR members highlighted that market participants ascribe the current level of market valuations to the stance of fiscal and monetary policy. It was noted that the global stimulus is unprecedented, with $17 trillion in global fiscal support and $13 trillion in monetary easing. With regard to monetary policy, FAR members observed that asset valuations are to a large extent naturally higher due to the large drop in discount rates driven by central bank efforts to lower interest rates.

FAR members emphasized that asset valuations are affected not only by policy measures per se, but also by expectations around policy actions. It was remarked that market participants expect the current policy stance to persist for two main reasons. First, emergency facilities create a perception of permanent policy support. Second, investors believe that some markets are "too big to fail."

In further discussions, FAR members reflected that the large stock of low to negative yielding debt, in a context where global debt levels are historically high, has induced investors to "reach-for-yield." It was noted that market participants face a shortage of high-quality assets and pressure to generate income. Hence, there is relatively high demand for illiquid and speculative assets, lowering the expected returns on risky assets.

Risks for Financial Stability

FAR members noted that market participants rank rising interest rates as the main concern for the future. Investors fear that a sudden increase in inflation could force the Federal Reserve to raise interest rates, leading to a sharp decrease in valuations.

In a broader discussion, FAR members reflected on the risks associated with an increase in interest rates. Some members highlighted that the expected rate at which interest rates rise is an important dimension to consider, while others observed that it would be important to understand if financial institutions are hedged against an increase in rates. FAR members cautioned that monetary policy should preserve price stability without undermining market discipline.

It was suggested, though, that longer maturity interest rates might increase irrespective of monetary policy because of selling pressures in the Treasury market. FAR members emphasized that the Federal Reserve should be mindful of this scenario.

In further discussion, FAR members highlighted the risk that economic growth might not meet current expectations. A negative revision of expectations about future economic growth could have a negative effect on asset prices given that valuations assume an optimistic path of growth. However, it was noted that the release of the disappointing April employment report was followed by a positive market reaction, as market participants expect continued policy support for the economy.

Finally, FAR members observed that cyber risk and other non-financial risks have the potential to affect financial stability and, hence, should be closely monitored by the Federal Reserve.

U.S. Equity Valuations

FAR members discussed the recent trends of the U.S. stock market in historical perspective. It was noted that, based on the time series of the "Cyclically Adjusted Price-Earnings" (CAPE) ratio, that is the S&P 500 Price to the 10-year Average Earnings ratio, current market valuations are at historically high levels. In fact, the CAPE ratio is currently well above its average over the last one hundred fifty years and close to the historical high of 1999-2000. It was also noted that the pattern observed for the dividend-to-price ratio, that is the S&P 500 12-Month Average Dividend to Price ratio, further confirms a high-valuation environment.

FAR members highlighted that, despite high equity valuations by historical standards, the equity premium is not that small given the very low level of government bond yields. For example, the 20-year constant maturity yield on Treasury Inflation Protected Securities (TIPS) turned negative in 2020, while it was roughly 4% in 2000.

As a result, the equity premium is currently higher than its level in the biennium 1999-2000, when stock valuations hit their maximum.

The discussion expanded to the drivers behind stock returns during the pandemic, as captured by the Fama-French three-factor model. FAR members observed that the most dramatic development in 2020 was the collapse of the "High Minus Low Book-to-Market" (HML) pricing factor, also referred to as the "value premium." This development occurred after three decades where value strategies underperformed relative to the market, with cumulative returns close to zero since 1990. It was discussed that the decline of the value premium triggered an outflow from value funds by individual investors and institutional asset managers, which led to the closure of some strategy-based funds. FAR members reflected that, in contrast to prior periods where the value premium performed poorly, this was not accompanied by higher returns for other factor-based investment strategies ("Small Minus Big" (SMB) and "Momentum"), making the overall environment challenging for certain types of asset managers.

FAR members observed also that the poor performance of value strategies during the pandemic can be explained by the combination of shocks to corporate profits, discount rates, and volatility that has occurred since the Covid-19 outbreak, all weighing particularly on value stocks. Specifically, value stocks are more exposed to a sudden and large negative shock to profits than growth stocks, as they are typically considered to generate stable profits. At the same time, growth stocks benefit more from decreasing discount rates and increasing market volatility compared to value stocks, due to their higher duration and optionality premium. It was also noted that value and growth stocks differ in their industry concentration. While value firms are usually characterized by physical assets, growth firms, such as technology companies, are typically characterized by intangible assets. Technology companies performed very well during the pandemic, contributing to the fall of the value premium. FAR members discussed more broadly if the collapse of the value premium is mostly driven by changes in the conditions of value firms vis-a-vis growth firms looking at the value spread. It was suggested, though, that the value spread may deliver different insights depending on how it is evaluated.

Finally, FAR members observed that the expansion of equity ETFs may have contributed to the current high equity valuations. It was noted that equity ETFs currently manage almost 16% of private clients' equity holdings, up from 2% in 2008. Since ETFs buy and sell jointly all the securities in the basket, they may cause premiums of certain asset classes to compress.

Other Asset Markets to Watch

FAR members recommended monitoring of several market segments that could pose risks to financial stability. The corporate bond and housing markets were identified as the most critical ones, as they exhibit extremely high valuations by historical standards, suggesting that prices might be diverging from fundamentals.

FAR members discussed that corporate bond valuations are reaching record high levels, with corporate bond spreads continuing to tighten. In the investor space, corporate bond ownership by insurance companies, mutual funds, ETFs, pension funds, and foreign institutions hit its historical high in 2021. Corporations appear to have taken advantage of this low cost of funding. It was noted that the first quarter of 2021 saw a record issuance of investment grade corporate bonds. In addition, the riskier category of BBB-rated bonds represents an increasing share of investment-grade corporate bonds, now accounting for roughly 50% of new issuances.

In addition to corporate bonds, FAR members noted that valuations in the housing market are currently elevated following a marked increase since the outset of the pandemic. FAR members observed that, while there is no evidence of a strong feedback effect of stock prices on corporate business activity, the housing market may significantly affect the real economy through consumer wealth effects.

FAR members expressed broad concerns about investors' increased risk-taking behavior and the rising participation of less sophisticated investors in markets. On the institutional side, members noted that pension funds allocation to illiquid assets (including private equity, real estate, and other alternative investments) increased dramatically in the last decade. FAR members highlighted that private clients are allocating an increasing share of their assets to equity. It was discussed that Special Purpose Acquisition Company (SPAC) deals experienced an issuance boom during the pandemic. In 2020, there were more SPAC deals than in the years 2005-2019 combined, and the number of deals in 2021 already exceeds that of 2020. FAR members also noted a speculative fever in some growth and "meme" stocks that has only partially reverted in 2021. Concerning the landscape of market participants, it was observed a surge of non-conventional investors, especially retail. Retail trading flow as percentage of total U.S. market volume increased significantly in the last two years and half. It was observed that this dynamic is likely not temporary and that retail investors might not fully understand the risk they are taking. FAR members also discussed the cryptocurrency market and the increasing participation of retail investors in it. While they believe that crypto assets and bitcoin do not represent an immediate concern for financial stability, they emphasized that this is an area worth monitoring as levered investors are becoming more exposed to these alternative assets.

In further discussion, FAR members noted that, while commercial real estate prices have not seen the same increases, the landscape might change after the pandemic if telework continues. Commercial real estate tends to be highly levered and a sharp decline in valuations would impact CRE lenders.

FAR members observed that emerging markets are currently concerning due to the high Covid-19 infection rates. However, it was discussed that market participants are ready to invest in these markets as soon as the pandemic is under control and confidence will improve.

FAR members observed that the insurance sector deserves attention. It was noted that the stock prices of life insurers underperformed the S&P 500 and banks in 2020. It was also noted that insurance companies might be under stress in case of a sudden increase in interest rates.

FAR members discussed the dynamics of the municipal bond market during the pandemic and the strong growth in muni mutual funds and muni ETFs. It was observed that the muni market suffered substantially in March 2020 before the Fed started accepting muni as collateral. FAR members discussed the differential treatment of muni and corporate bonds by the Fed.

Finally, FAR members noted that private equity and commodities are not concerning, as fundamentals explain the current price actions in these markets.