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Reality Check

On February 19th, the S&P 500 peaked and, over the next 22 days (including weekends), declined just over 10%—officially hitting "correction" territory.

Interestingly enough, on February 19th of 2020, the S&P 500 peaked and, over the next 32 days (including weekends), declined over 33%.

The drop five years ago was very clearly related to the pandemic.

The most recent decline has been attributed to several things, most notably the questions surrounding President Trump's proposed tariffs. There is truth to that. Last month we discussed the potential disruptions from these actions and how uncertainty is spilling over into the stock market. But lost among the tariff headlines was a two-week stretch of economic data suggesting consumer spending may be waning: the Michigan Consumer Confidence Report showed a significant drop, retail sales declined in January, and Walmart—an important gauge of consumer behavior—gave a weak outlook for the year. Consumers are the powerhouse of our economy, and when spending slows, it's an economic red flag.

However, in our opinion, these concerns were not the reason for the stock market correction. They were merely the catalyst that set it off. We have been saying for a long time that this stock market was "expensive." By any historical measure, this stock market was looking for a reason to decline – a bug in search of a windshield.

The recent AI-fueled tech boom has driven many stocks to unjustifiable prices. Eventually, some less-than-favorable news (Trump tariffs, federal spending cuts, consumer spending concerns) was bound to come along and deliver a reality check.

One way to measure a stock's value is through the Price-to-Earnings (PE) ratio. When stock prices rise significantly *relative* to earnings, the PE ratio increases, indicating that stocks may be overvalued and carry higher risk.

The chart below shows the PE ratio of the commonly reported S&P 500 Index (gold line). This index is heavily skewed toward the largest companies (which all happen to be tech stocks). It also shows the PE ratio of the *Equal-Weighted* S&P 500 Index (white line) which gives an equal weight to each stock in the index.

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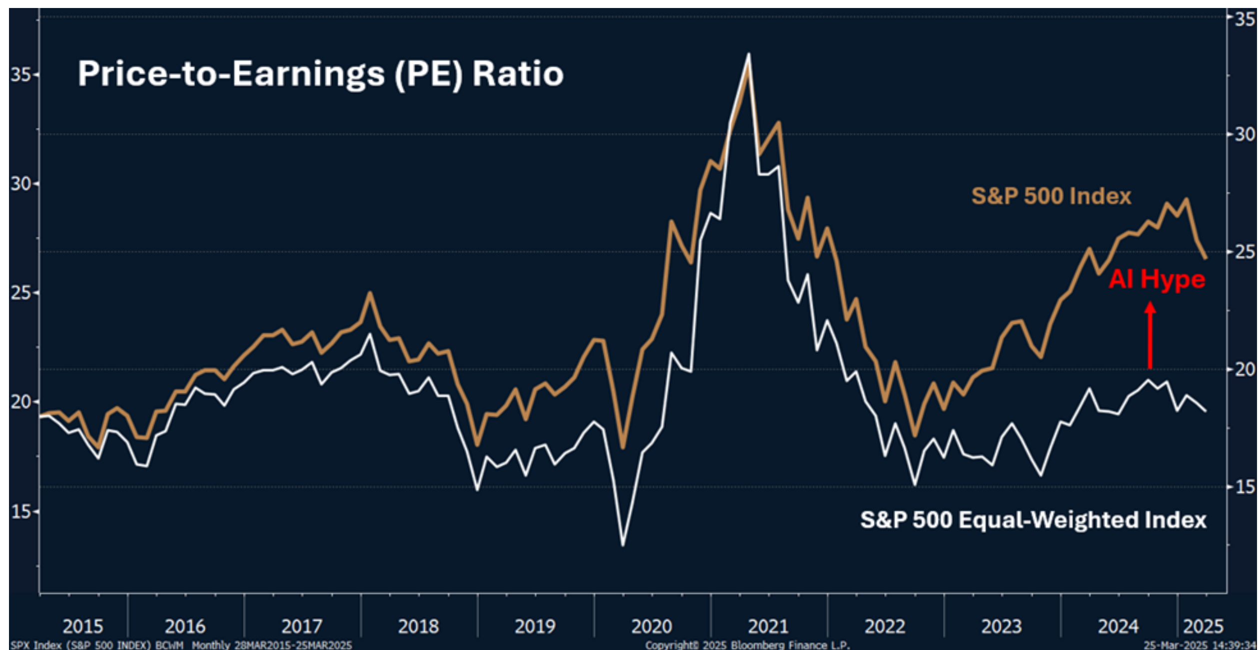
A couple of things stick out on this chart. First, there is the exuberance in 2021 that drove most stocks to very expensive levels, setting up the nasty sell-off in 2022 as valuations came back to "normal" levels. Second, and more importantly, there is the divergence, beginning in 2023, between the S&P 500 and its Equal-Weighted (less tech-focused) counterpart. This is the AI hype.



Yes, AI is transformative, and there is a lot of money to be made. But if stock prices climb too much, too fast—before profits materialize—investors are setting themselves up for pain.

The recent market correction wasn't as pronounced in the Equal-Weighted Index because it is not concentrated in the hot tech names. This chart suggests there is *still* potential for more pain in overvalued stocks.

This Monday marked the 25th anniversary of the Dotcom Bubble peak, and it's worth remembering that it took seven years for the market to recover after that crash. While today's situation isn't as extreme, history serves as a reminder that valuations matter.

Looking forward, the economic picture is murkier than it was at the start of the year. On the one hand, hard data points to strength: low unemployment, moderating inflation, and rising manufacturing production. On the other hand, softer data, based on surveys about how people feel, indicates a more tepid future. Small business uncertainty is growing, trade war concerns are escalating, and even Trump himself refused to rule out a recession.

The stock market selloff was no surprise to us, as we've been vocal about stocks being priced for perfection. We viewed this recent drop as an opportunity to buy select growth-focused stocks at more reasonable valuations. At the same time, we have improved the credit quality of our bond portfolio to ensure it remains resilient in the face of potential economic headwinds. Above all else, our focus is on risk management. If a recession does materialize, we expect our portfolios to be prepared.

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