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The potential rewards of equities are looking riskier

◆ The S&P 500 closed at its highest since 6 March amid excitement about more stimulus in Europe.

◆ One of the first companies to start human trials on a Covid-19 vaccine reported positive early results.

◆ Stocks are trading at their highest valuation since the dot-com bubble by some measures.

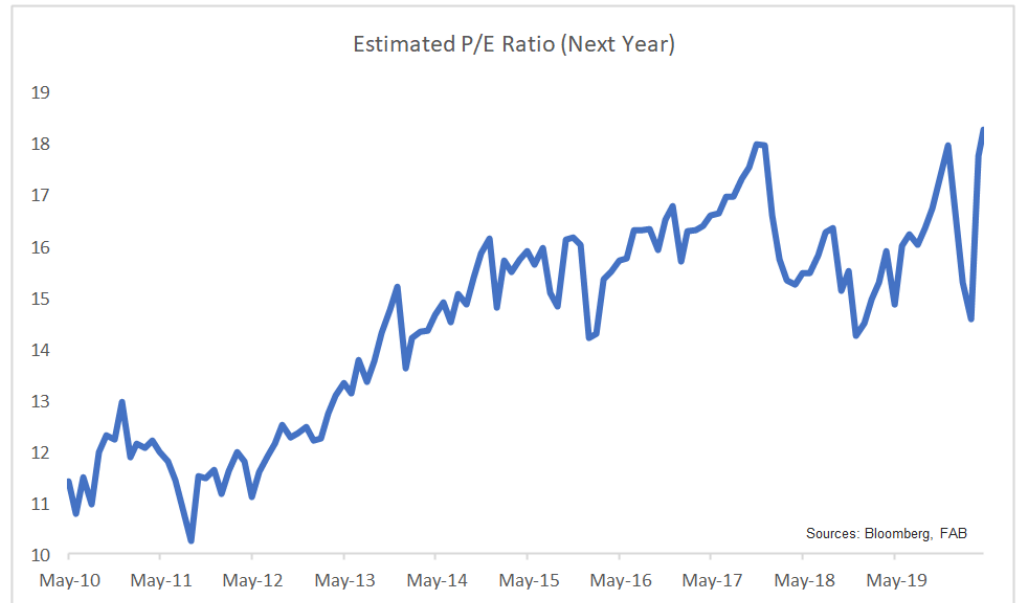
◆ Even if the S&P 500 were to revisit its all-time high, it could only rally another 15%, if it returns to its recent low it would drop nearly 24%.

◆ FAB AAC remains underweight in equities and overweight in gold.

The difficult part of investing is trying to predict the future. Since no one has a crystal ball, nobody can always get it right. But one simple exercise can save a lot of heartache: look at the potential returns of any investment before getting into it.

Doing that right now for US stock markets makes for a challenging proposition. Yesterday's rally brought the S&P 500 to its highest level since 6 March, before the Covid-19 lockdowns started and at a time when the market was just starting to price in the potential impact a global curfew could have on the economy. That has left the index at its highest valuation since the dotcom bubble by at least one measure. At yesterday's closing price the index was trading at 18.4 times the expected earnings of its components in 2021. The last time this valuation was so stretched was in 2002.

To be sure, super low rates in the US (negative in Japan and Europe) do



support part of that move. As investors look at the value of keeping their cash in the bank and compare that to the potential return from stocks, it looks much better to be in equity markets. However, even with such low rates the current valuation is starting to look stretched.

Which is why it is worth looking at the potential moves from here. If the S&P 500 were to revisit its all-time high, touched on 19 February, it would have to rally another 14.6%. At that 3,386.15 all-time high level, the index would be trading at 21 times its expected earnings for 2021 (expectations which, by the way, may be a bit too optimistic still), a level it only held for a few months during the dotcom bubble, and never any other time. That, therefore, leaves the maximum potential upside from here at around 15% and suggests that the probability of this full rally is relatively low.

On the opposite side of the spectrum, if the S&P 500 is to revisit the 2,237.4 low point of 23 March, it will have to fall more

Using the year-ahead expected earnings, the S&P 500 is at its highest valuation since 2002

than 24%. Even if an investor were to consider a 50% chance that either scenario will play out, the potential return is negative nearly 5%.

Naturally, the index is unlikely to revisit its recent highs or lows in the near future. The more likely scenario is that investors start to find it cheap when it starts to trade close to 14 times next year's earnings and expensive when it breaches 18.

All of these scenarios, however, point to the same conclusion. At any rate, stocks are looking expensive at this stage, and the same is true for most risk assets. That does not mean they cannot gain further, but for those who invest for the long-term it is not perhaps the best time to add risk.

Investment Strategy Update

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