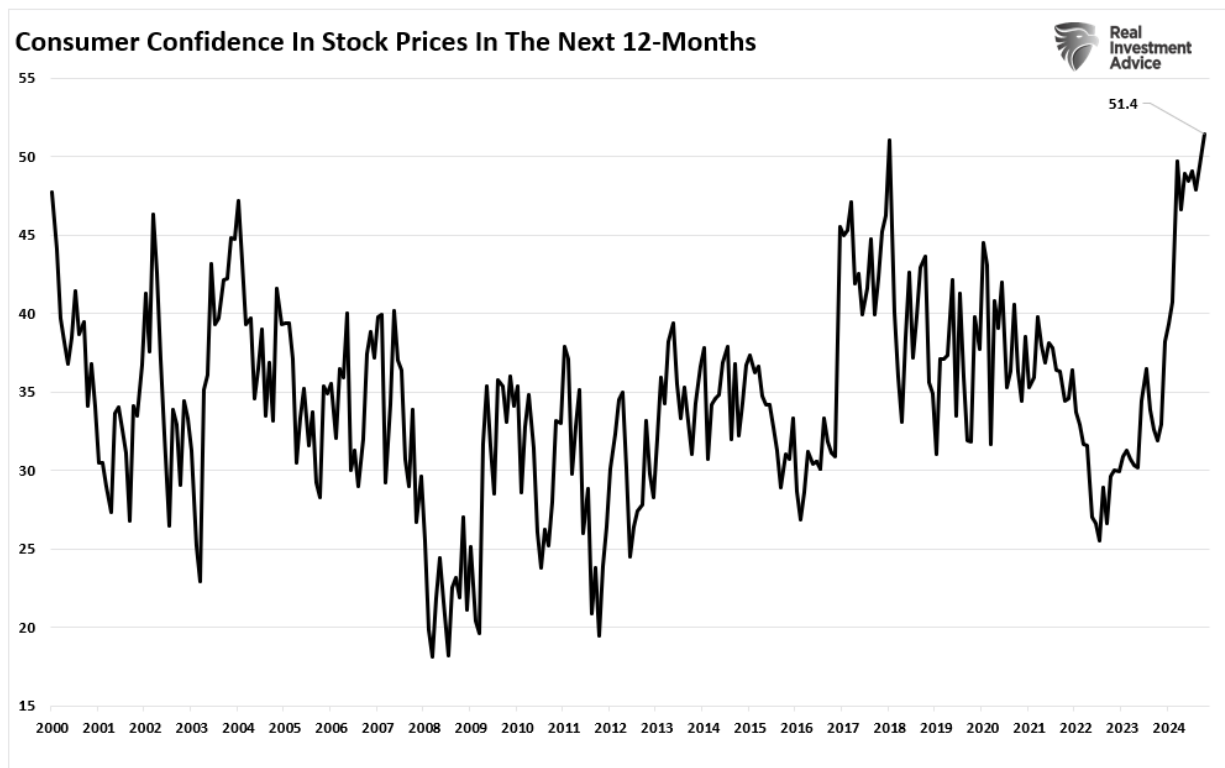
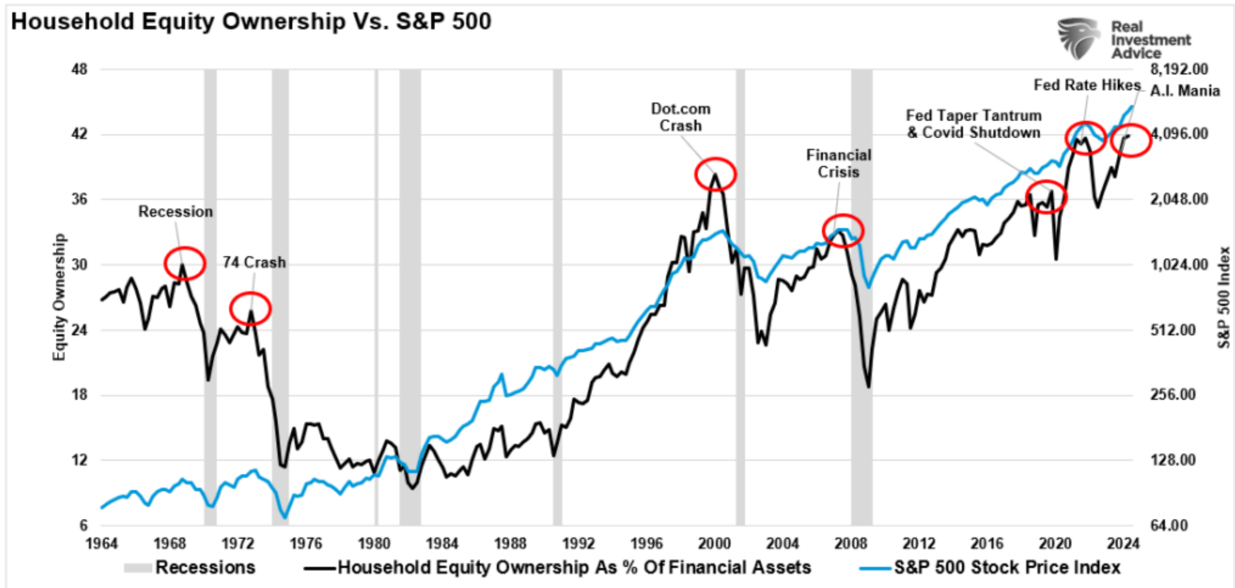
RIA Advice

Investor exuberance has rarely been so optimistic. In a recent post, we discussed investor expectations of returns over the next year, according to the Conference Board's Sentiment Index. ***To wit:***

> *"Consumer confidence in higher stock prices in the next year remains at the highest since 2018, following the* ***2017 ?Trump? tax cuts.*** *" (Note: this survey was completed before the Presidential Election.)*



We also discussed ***households' allocations to equities,*** which, according to Federal Reserve data, have reached the highest levels on record.

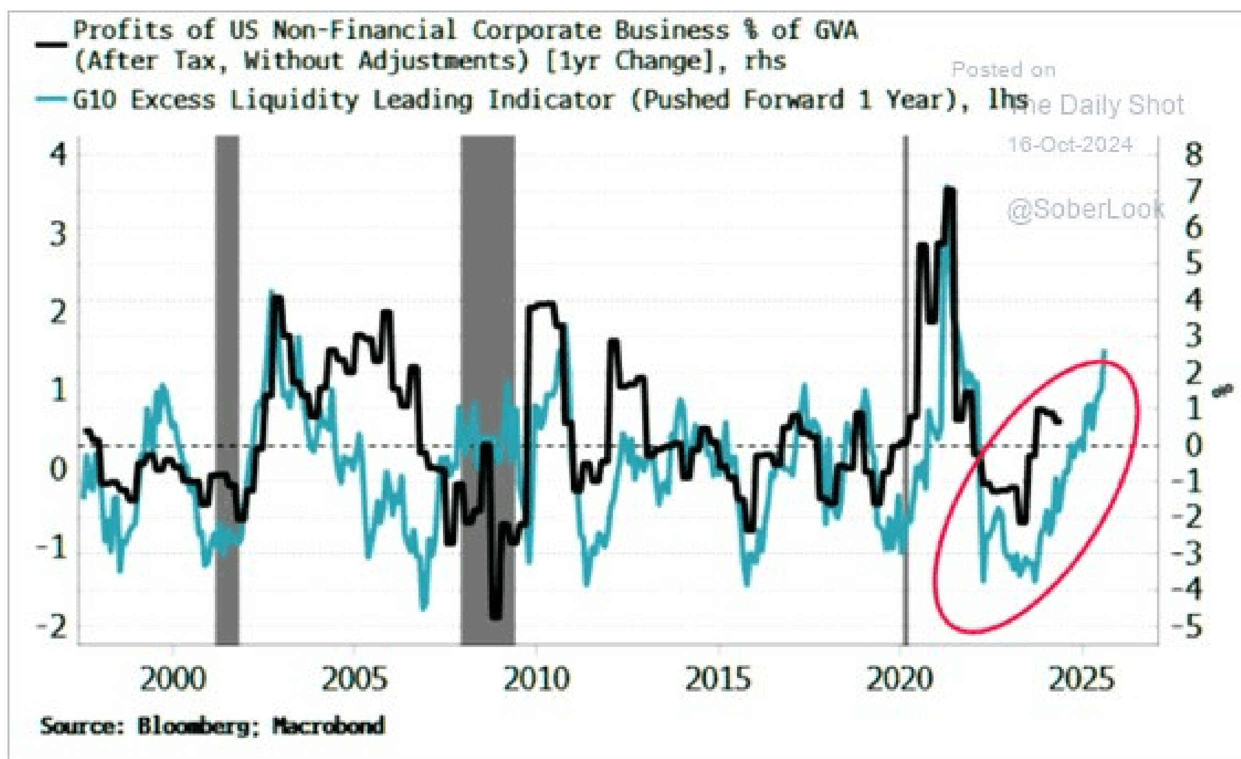


In that article, we discussed the risk associated with high levels of investor exuberance.

> *"Risk isn?t always what it seems. When the market feels the safest, that?s often when it?s often the riskiest. Think about it ? when everything is going smoothly, people tend to take more risks, which can lead to market bubbles and crashes."*

However, it is crucial to understand that *"exuberance"* is a necessary ingredient for pushing asset prices higher. This is why ***"sellers live higher, and buyers live lower."*** In every market and asset class, the price is determined by supply and demand. If there are more buyers than sellers, then prices rise, and vice-versa. While economic, geopolitical, or financial data points may temporarily affect and shift the balance between those wanting to buy or sell, in the end, the price is solely determined by asset flows.

Currently, a liquidity surge supports investor exuberance, marked by enthusiastic buying and excessive risk-taking. As we will discuss, such activity often precedes significant market corrections. While optimism can drive short-term gains, history shows that when sentiment runs too hot, and valuations detach from fundamentals, such leaves the markets vulnerable to declines.



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The Psychology of Market Euphoria

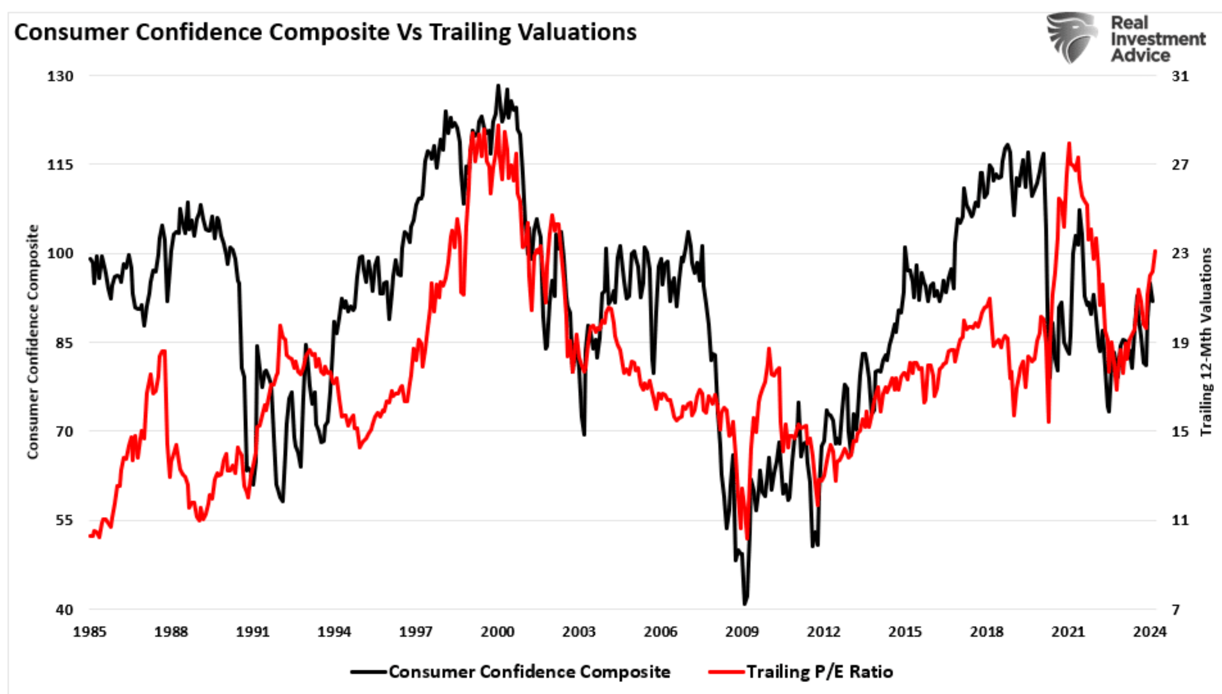
Nobel Prize-winning economist Robert Shiller famously coined "*irrational exuberance"* to describe situations where speculative behavior pushes asset prices far above intrinsic values. Shiller's research shows that emotional narratives and herd behavior dominate in bull markets, fueling market increases that eventually revert under the weight of reality. He warned that *?markets can stay irrational longer than you can stay solvent,?* reflecting how unpredictable and dangerous excessive optimism can become.

Similarly, Jeremy Grantham, a seasoned investor known for identifying bubbles, recently described the post-2009 bull market as an *?epic bubble?* driven by speculative behavior and extreme overvaluation. Unsurprisingly, as market prices increase, exuberance builds, and investors rationalize overvaluation by believing that *?this time is different.?*

However, with that said, as we discussed in ***?Low Forward Returns,?*** valuations are a terrible market timing tool. Valuations only measure when prices are moving faster or slower than earnings. **In other words, valuations are a measure of psychology in the short term.** To wit:

> *?Valuation metrics are just that ? a measure of current valuation.* ***More importantly, when valuation metrics are excessive, it is a better measure of ?investor psychology? and the manifestation of the ?greater fool theory.?*** *As shown, there is a high correlation between our composite consumer confidence index and trailing 1-*

year S&P 500 valuations.?



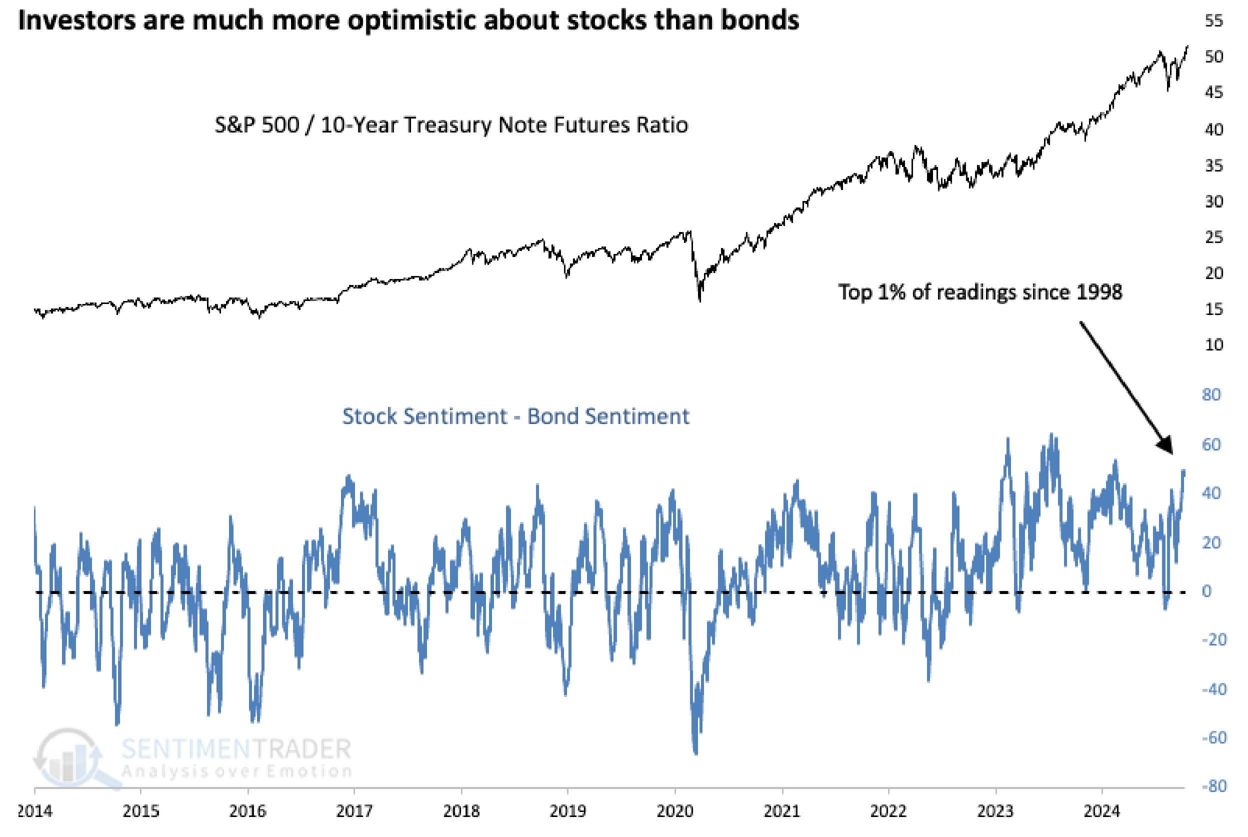
Investors repeatedly make the mistake of dismissing valuations in the short term because there is no immediate impact on price returns. **However, as noted above, while valuations are HORRIBLE predictors of 12-month returns, they indicate *"exuberance,"* which impacts markets in the near term.**

Understanding that valuations reflect psychological exuberance, what can we expect from markets over the next 12 months?

Expect Increased Volatility

As noted recently by *Sentiment Trader*:

> *"It almost doesn't matter what measure we look at. There are some isolated exceptions, but most indications suggest that investors are optimistic about the prospects for stocks in the months ahead. It's a different story in the bond market. After a brief bout of not-pessimism a couple of months ago, bond investors are back to feeling gloomy.*
>
> *That difference of opinion on the relative merits of the two markets has caused the spread between stock and bond sentiment to spike close to a multi-decade high. Over the past 25 years, there haven't been many times when the Intermediate-term Optimism Index for stocks was more than 50% higher than the Bond Optimism Index."*



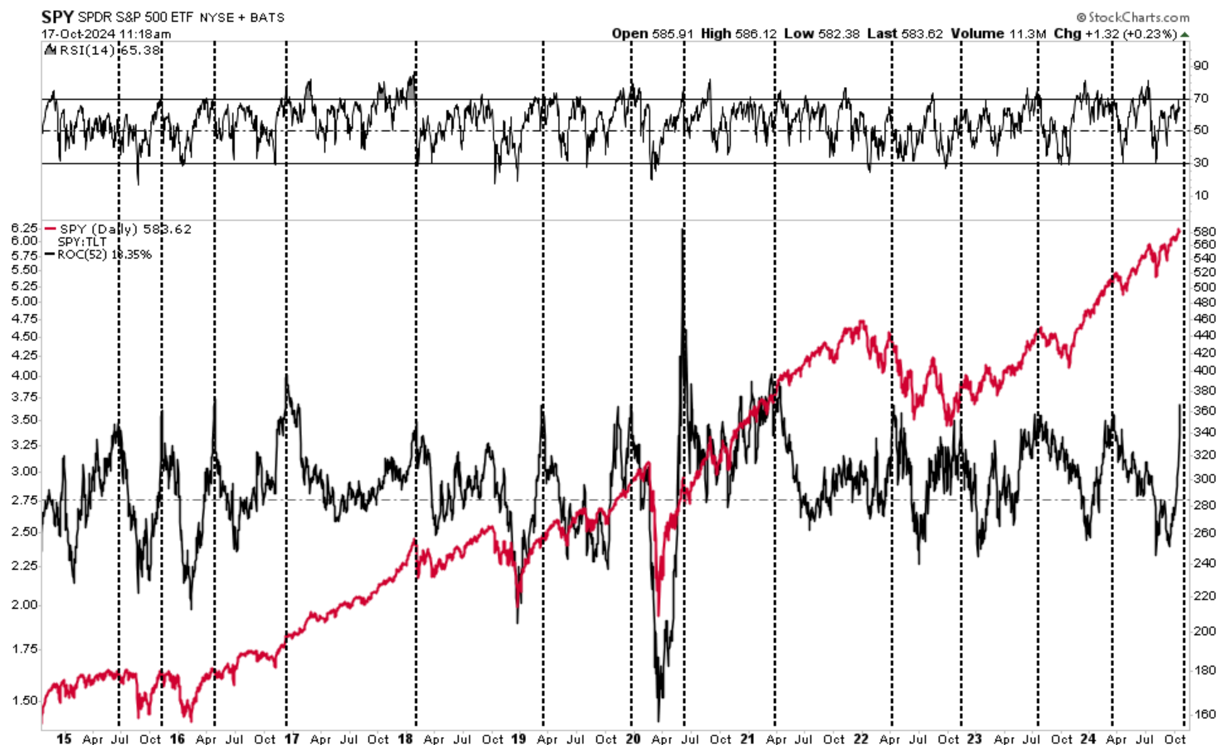
"As for whether such a wide disparity in sentiment makes any difference, the table below shows S&P 500 returns after the spread between the two optimism indices reached 50%. And for the S&P, it was a short-term headwind. Its returns were particularly poor over the following month, with only two winners and five losers. However, only the signal during the post-dotcom bubble resulted in a sustained decline." - Sentiment Trader

S&P 500 after stock sentiment > bond sentiment by 50%

Dates of 8 Signals	1 Week Later (%)	2 Weeks Later (%)	1 Month Later (%)	2 Months Later (%)	3 Months Later (%)	6 Months Later (%)	12 Months Later (%)
2000-01-12	0.9	-2.4	-3.2	-5.1	2.4	4.4	-7.4
2002-03-19	-2.7	-3.8	-3.9	-5.4	-11.4	-25.4	-25.3
2003-08-21	0.0	1.8	1.9	4.3	3.9	13.7	9.2
2009-06-01	-0.4	-2.0	-2.5	4.7	9.1	15.8	13.6
2010-04-06	0.7	1.5	-2.0	-10.5	-13.6	-4.4	12.1
2023-02-02	-2.4	-2.1	-3.1	-1.9	-2.8	7.1	18.3
2024-02-12	-0.9	1.1	2.9	2.0	4.0	8.2	
2024-10-04	1.1						
Mean	**-0.5**	**-0.8**	**-1.4**	**-1.7**	**-1.2**	**2.8**	**3.4**
Median	**-0.2**	**-2.0**	**-2.5**	**-1.9**	**2.4**	**7.1**	**10.6**
% Positive	**38%**	**43%**	**29%**	**43%**	**57%**	**71%**	**67%**
Avg Max Loss	-1.3	-1.9	-3.7	-6.4	-7.4	-10.0	-12.5
Avg Max Gain	0.6	1.2	1.7	2.7	4.1	9.3	13.8
Z-Score	-1.2	-1.4	-2.1	-1.4	-1.0	-0.2	-0.6

© SENTIMENTRADER Numbers are % return after signal; Risk = avg max loss; Reward = avg max gain; Z-Score +/- 2 suggests significance.

We see the same warning of investor exuberance by looking at the stock/bond ratio. The following chart compares the 52-day rate of change between the SPDR S&P 500 Index ETF (SPY) and the iShares 20+ Year Treasury Bond ETF (TLT). The vertical lines correspond with both high levels of the stock/bond ratio rate of change and the Relative Strength Index of the S&P 500 index. Unsurprisingly, high levels of investor exuberance in stocks versus bonds have preceded either short-term pullbacks or larger corrections.



High levels of Investor exuberance increase correction risks because markets are more fragile when built on sentiment rather than fundamentals. As the enthusiasm fades, a small negative event, like disappointing earnings, geopolitical tensions, or concerning economic reports, can trigger a reversal between buyers and sellers.

When markets are propped up by speculative exuberance, corrections tend to be more severe. The recent ***"Yen Carry Trade"*** blow-up shows that a sudden, unexpected, exogenous shock caused a sharp fall in asset prices. The problem with an exuberant market is that price declines create a feedback loop that accelerates the decline. Historical data confirms that pattern, where market exuberance, fueled by liquidity and investor mania, typically ends in rapid, painful corrections.

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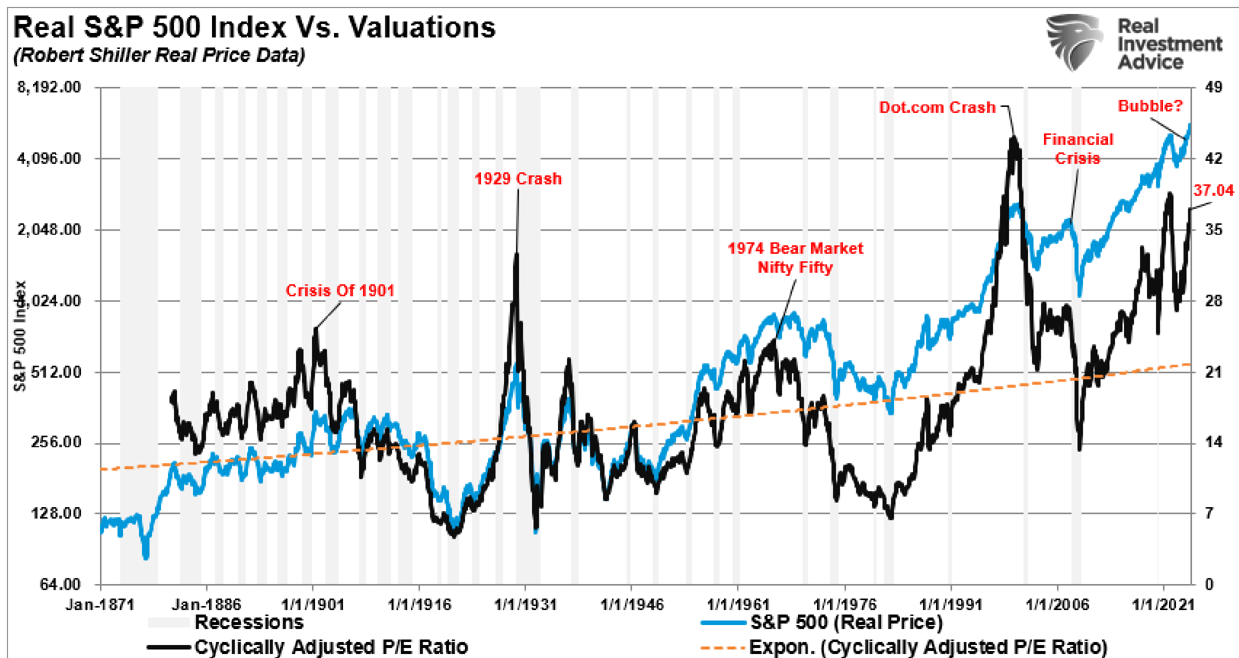
A Word of Caution: Timing Is Unpredictable

While investor exuberance sets the stage for corrections, predicting the exact timing is difficult. Alan Greenspan's famous *"irrational exuberance"* speech in 1996 came three years before the dot-com peak. Markets can remain euphoric longer than expected, but corrections are inevitable as valuations eventually revert to more sustainable levels, as shown in the chart below.



However, as noted, timing is critical. Investors always make two primary mistakes when investing in an exuberant market. **The first is overreacting to signals, believing a more severe correction is coming. The second is taking action too soon.** Therefore, we must continue to navigate the market within the context of the current bullish trend.

As Sentiment Trader concluded:

> ***"Sentiment and momentum are often in direct opposition.*** *Just when things are looking best for trend-following momentum chasers, it looks the most at-risk for contrarian-minded investors. We're reaching one of those times now, as momentum is impressive and compelling. There is little to no evidence that the gas has run out, as breadth remains robust and sector performance is supremely healthy. Extremes in sentiment tend to work better when there is less buying interest underlying the indexes. If we saw more divergences with breadth metrics, the extreme disparity in stock-bond sentiment would have more meaning.* ***As it stands, it's probably most useful as an early heads-up that conditions are ripe for disappointment, and we should be on guard for any signs of a buying strike in the weeks ahead."***

Practical Takeaways for Investors

Given the signs of elevated exuberance today, investors should consider the following strategies to manage risk:

- ***Rebalance Portfolios****: Shift allocations toward defensive sectors or cash to reduce exposure to speculative assets.*
- ***Limit Leverage****: Avoid excessive use of margin to minimize forced selling risks.*
- ***Monitor Indicators****: Pay attention to the technicals, positioning changes, and fund flows for early warning signs.*
- ***Consider Bonds****: If bonds are out of favor as stock demand increases, a rotational "safety trade" is likely when volatility arises.*

In summary, while optimism plays a role in market growth, unchecked exuberance often leads to corrections as markets adjust to reality. By recognizing the signs of market excess and managing

risks proactively, investors can better navigate these uncertain periods and protect their portfolios from excessive drawdowns.

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