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"Einstein was right about relativity, but even he would have had a difficult time applying relative valuation in today's stock markets."

- Aswath Damodaran

The stock market has recovered from the pandemic trough with double-digit gains in the second quarter, a surge back from the depths just as unprecedented as the sharp decline that preceded it. What is underpinning this comeback?

The contrast of the ongoing economic deterioration from the pandemic versus the increasingly high valuation level of stocks seems to defy logic. It appears the quick, aggressive action of central banks to provide massive amounts of liquidity into financial markets effectively put a floor under stock prices.

Yet, at this writing, more than three-quarters of S&P 500 stocks have reported Q2 2020 earnings and, so far, most have beat analyst expectations. It appears that the outlook for business performance was more than adequately rebased during the pullback period.

Also supporting optimism is the July restart of production at factories across the US, Europe, and parts of Asia, though export orders remain soft, according to research firm IHS Markit. Developed-country governments have rolled out stimulus measures amounting to 10% or more of GDP, which has prevented a collapse in consumer demand that could have led to crippling deflation.

The most supportive factor for buoyant asset prices may be near-zero rates across developed economies. Equity valuations are historically high due to interest rates being historically low, which lifts the present value of a stock's future cash flows, making buyers more willing to pay up.

The broad-based optimism is leading some market participants to buy into a narrative that valuation is no longer relevant to equity investing. In a recent Bloomberg story, the co-chief of Bloomberg's systematic equity group said "comparing share prices to fundamentals like corporate profits or book value is essentially futile in complex markets," and recommended that investors "end their obsession with valuation metrics." An official representative of the world's largest asset manager publicly stating that valuation is irrelevant to investment decision-making may be an indication of a paradigm shift, but whether this view stands on sound economic logic is open to question.

Yet another factor supporting the strong stock market is the forward march of an army of retail traders. With many spectator sports cancelled, new investors—especially millennials and Gen-Z—have logged onto online trading platforms for speculative entertainment in staggering numbers. At E*TRADE, investors opened 260,500 retail accounts in the month of March 2020 - more than any full year on record. Robinhood, a platform offering a zero-commission, user-friendly trading app targeted at inexperienced investors, had 3 million new accounts in Q1 2020. Schwab opened more than one million new accounts in the first half of the year, with people under 40 driving over half of all new openings.

Trades by individual investors this year were double the usual level of retail activity; individuals now account for a fifth of all stock-market activity, and a much more during the busiest sessions. The trading platforms have faced questions about the ease of access they provide to options; less-sophisticated traders fantasizing about big scores may not fully understand the risks associated with margin and leverage.

The allure of rock-bottom or even zero commissions is likely to continue to attract these new participants, at least as long as an upward-trending market persists. These retail traders' impact on stock prices is challenging to quantify. Their holdings are dwarfed by those of major institutions. That said, in capital markets prices are set at the margin, so speculators can "punch above their weight" in contributing to volatility. When others are speculating or ignoring valuations, it becomes even more vital for long-term investors to prudently assess risks.