



When Optimism Meets Reality: A Bearish View

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Introduction

We don't recall a more difficult or dangerous investing environment in the past 40 years. Nearly everywhere we look – gold, equities, cryptocurrencies, credit spreads – valuations are at or near all-time highs. What makes this even more extraordinary is that these extremes are occurring against the backdrop of a shifting global order, where the forces that once defined globalization, such as efficient supply chains, cheap labor, low taxation, and limited tariffs, are now reversing.

One could argue convincingly that the 35-year period from 1985 to 2020 was the most favorable investing environment in history. Interest rates, as measured by the 10-year Treasury yield, declined from roughly 10.5% in 1985 to less than 1% during the COVID era. Growth and profitability driven by globalized trade were unprecedented. As these trends unwind, it seems irrational that risk assets would continue to advance unchecked.

As Keynes famously observed, markets can remain irrational longer than you can remain solvent. Valuation alone is a poor timing tool – expensive assets can always become more expensive – but if mean reversion over long periods is ultimately a law (and we believe it is), then much of what investors are doing today in most asset classes – particularly equities – is speculation, not investing. There is nothing inherently wrong with speculation; the mistake lies in mispricing risk.

Today's markets resemble the proverbial act of picking up nickels in front of a steamroller. At a minimum, we should recall Bernard Baruch's response when asked how he became wealthy: "I sold too soon." For investors who share our view that equities are living on borrowed time, selling too soon may be prudent, but it raises an equally important question: where does one deploy capital in the current environment? We have specific thoughts on how to protect capital, which we will outline in our next missive.

It may seem unusual for corporate credit investors to opine so extensively on equities, but investors of all types are massively overweight stocks, and equity markets set the tone for risk premiums across asset classes. The prevailing belief is that equity markets simply reflect the underlying economy whose valuation ebbs and flows with economic growth. We disagree. Today, equities are actively driving the economy – the tail is wagging the dog.

Never before has stock ownership been so widespread among the general public. Consumer spending is increasingly driven by the top end of the income and wealth distribution, supported largely by asset inflation, particularly equities. When equity markets decline, the resulting impact on consumer spending is likely to be outsized.

Leverage in the system is also at unprecedented levels, whether measured by credit card balances or margin debt against equities. The standard policy response of cutting rates and reintroducing quantitative easing ("QE") will almost certainly be attempted again. However, recent history suggests this playbook may no longer work as intended. Over the past 15 months, the Federal Reserve has cut

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rates by 175 basis points, yet the 10-year Treasury yield has risen from 3.65% to over 4.2%. This outcome is unprecedented. Across seven prior rate-cutting cycles since the 1980s, the 10-year yield was lower 100% of the time after 100 days. Not this time.

We are once again hearing the familiar refrain that “this time is different,” often justified by the claim that today’s companies are more “real” than those of the dot-com era. History suggests otherwise. It is always different until math reasserts itself.

Andrew Ross Sorkin’s 1929 is a fantastic history lesson, and we highly recommend it. One quote, in particular, stands out. Irving Fisher, a Yale economics professor and one of the most influential economists of his era, stated:

“Stock prices are not too high, and Wall Street will not experience anything like the nature of a crash. We are living in an age of increasing prosperity and consequent earning power of corporations and individuals. This is due in large measure to mass production and inventions such as the world never before has witnessed...”

September 5, 1929.

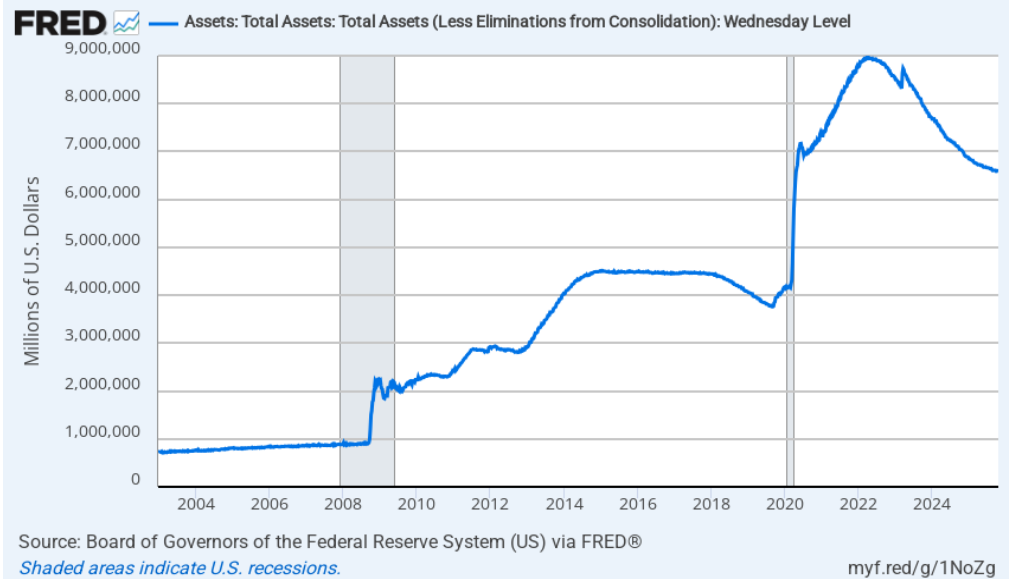
It doesn’t sound all that different today.

Cause & Effect

How did we get here? The root cause of today’s equity and asset inflation is money supply. The first wave began in 2009, when the Global Financial Crisis introduced QE, allowing the Federal Reserve to purchase large quantities of fixed income assets. This flooded markets with liquidity and suppressed interest rates, ushering in the era of zero interest rate policy (“ZIRP”).

The Fed’s balance sheet expanded from approximately \$2 trillion in 2010 to nearly \$9 trillion at its peak in mid-2022. COVID triggered an especially aggressive, parabolic response, as can be seen below. Over the same period, nominal GDP rose from \$15 trillion in 2010 to roughly \$29 trillion in 2024, a significant increase. Historically, money supply growth tends to track GDP. This time, GDP doubled while the Fed’s balance sheet expanded by roughly 450%. The excess liquidity, far beyond what the real economy required, inevitably flowed into financial assets.

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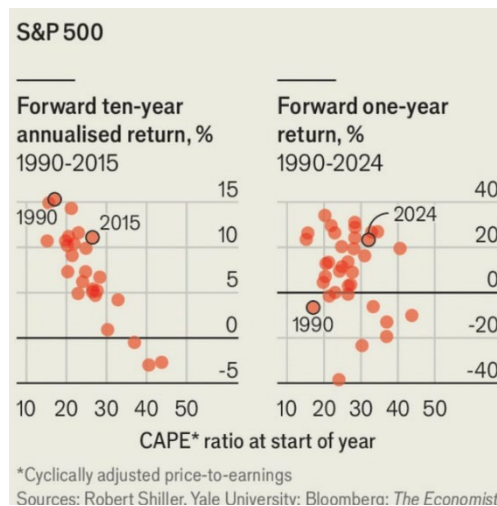
This surplus liquidity has been a primary driver of equity prices. Stocks are now trading at the second-highest valuation in history, as measured by the Shiller P/E ratio.

Shiller P/E Ratio Sounds a Warning for Richly Valued S&P

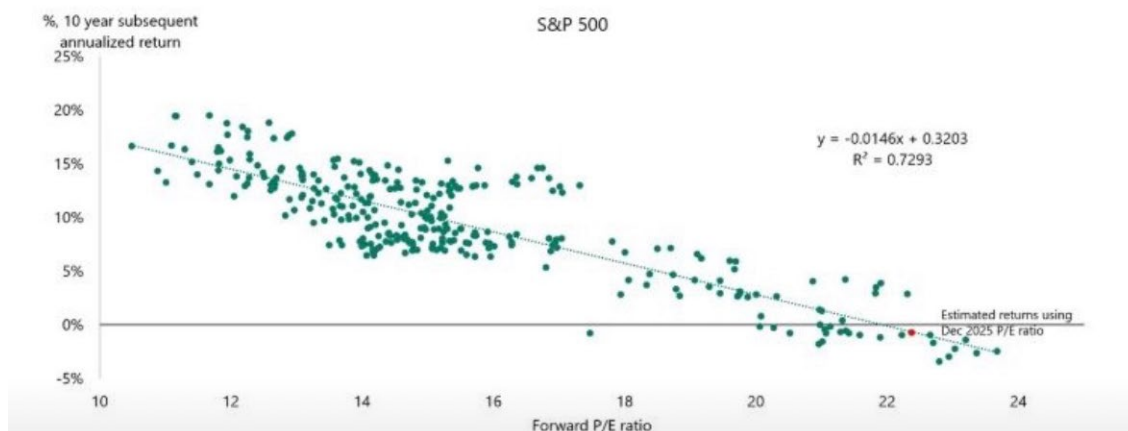


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While valuation has little correlation with short-term returns, its predictive power over longer horizons is compelling. Over the past century, whenever **the Shiller P/E has exceeded 35, the subsequent 10-year return for the S&P 500 has been negative, without exception.** For those who prefer simpler metrics, the forward P/E tells the same story: **once it exceeds 23x, 10-year forward returns have always negative.** With today's Shiller P/E near 40x and forward P/E around 23.5x, history suggests the next decade will be unrewarding for equity investors. Could it be different this time? Perhaps – but is that a bet worth making?



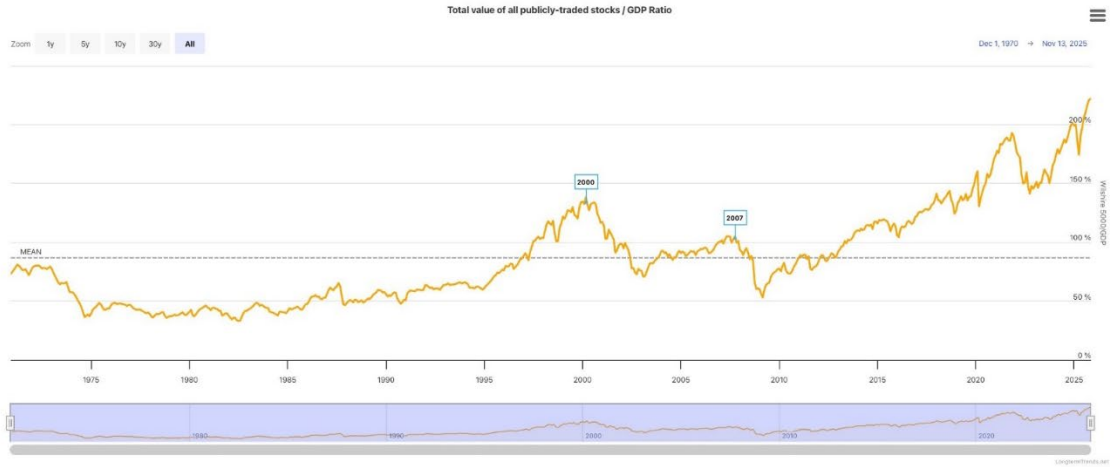
S&P 500 forward P/E ratio vs subsequent 10-year annualized returns



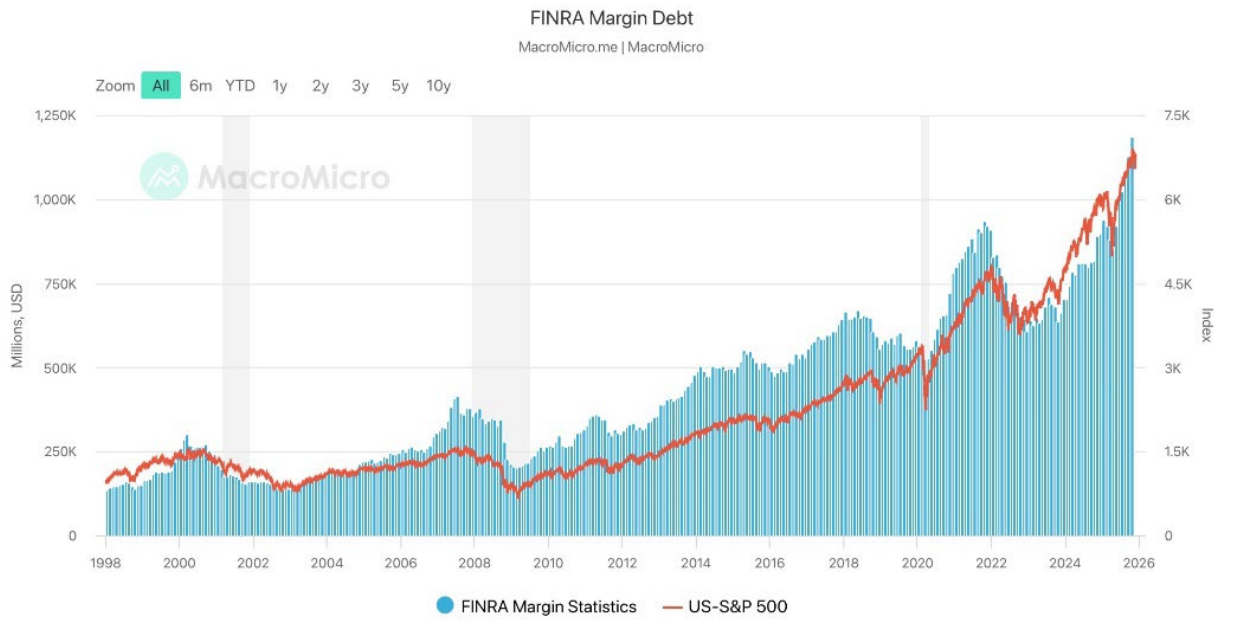
Another key valuation metric – Warren Buffett's preferred measure of total stock market capitalization relative to GDP – is flashing red. At over 200%, it has reached levels never before observed, further evidence that equities have become detached from the underlying economy.

The Buffett Indicator: Market Cap to GDP

Wilshire 5000 to GDP Ratio



These extreme valuations have been amplified by leverage, with margin debt reaching new all-time highs.



The Economy & the Consumer

The economic foundation supporting these asset prices remains puzzling. After barely growing in Q1, GDP surged to 3.8% in Q2, followed by a preliminary 4.3% in Q3, with Q4 estimates even higher. Much of this growth, however, has been driven by **data center and AI-related investment, which accounted for an estimated 92% of GDP growth in the first half of the year.**

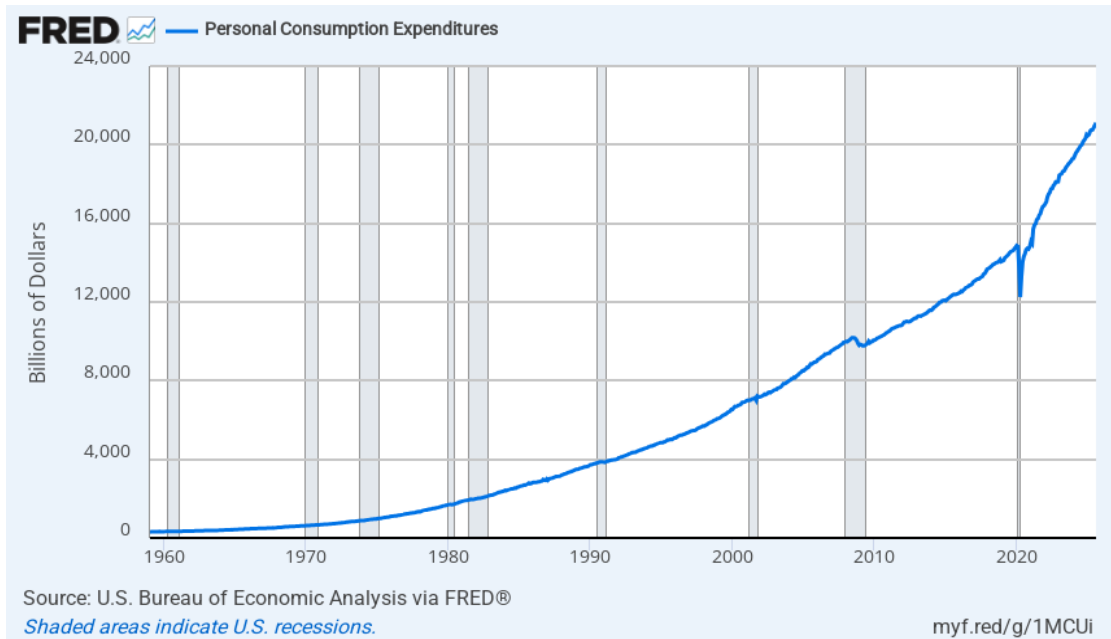
While hundreds of billions have already been spent and nearly \$3 trillion committed to AI development, much of this spending appears circular, concentrated among a small group of firms. At some point, investors will demand tangible returns or at least a credible path to profitability. It remains unclear how sustainable this growth engine truly is.

Employment is another area of concern. With unemployment around 4.3%, conditions are typically considered near full employment, yet the Federal Reserve felt compelled to cut rates as “insurance” against the labor market weakness. Ironically, these cuts have pushed long-term yields higher, the opposite of the Fed’s intention. Bond market participants appear unimpressed by ongoing fiscal mismanagement and are pricing in higher inflation and growing deficits.

Moreover, it is difficult to see how modest rate cuts will help the tens of thousands of workers laid off by companies such as Amazon, UPS, Verizon, Microsoft, Intel, Salesforce, ConocoPhillips, Shell, and Chevron.

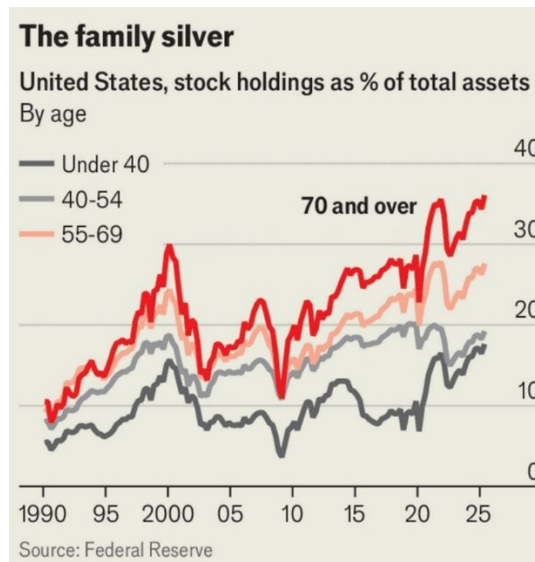
Despite widespread layoffs and limited hiring, consumer spending has remained remarkably resilient. Personal consumption expenditures – roughly 70% of GDP – have surged over the past five years, a trend that appears inconsistent with labor market conditions.

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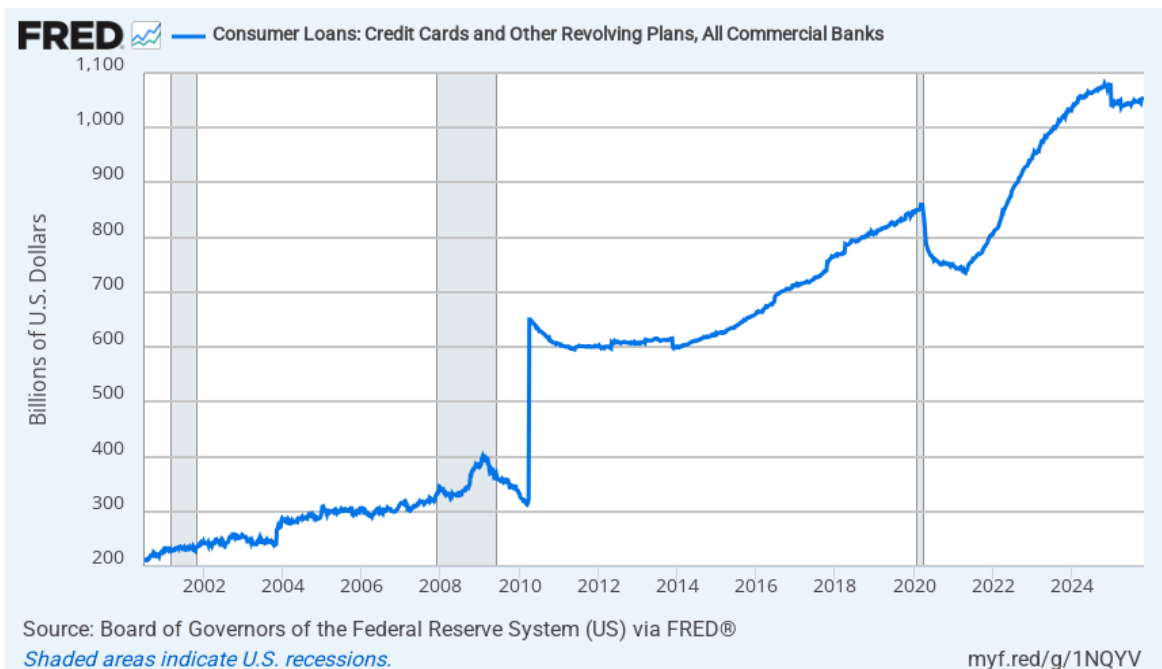
The top 10% of earners now account for a record 50% of total consumer spending. Income growth alone does not explain this resilience; the wealth effect from inflated financial assets likely plays a far greater role. **For the first time in recent history, equity markets appear to be driving the economy rather than reflecting it.**

Stocks now represent a record share of household assets, and the “buy-the-dip” mentality has even spread to investors over 70. Meanwhile, Wall Street forecasts remain nearly unanimous in predicting another year of strong equity gains.



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Consumer credit card debt has also surged alongside spending, reinforcing the view that consumption is increasingly driven by asset values rather than income. If the consumer is truly strong, why are they loading up on 20% debt?



We are left with a bifurcated economy: asset-rich households buoyed by inflated markets, and the rest struggling under mounting debt. When speculative asset markets inevitably correct, today's "haves" risk becoming "have-beens." A sharp decline in discretionary spending could follow, triggering a significant recession.

The Fed will likely return to rate cuts and quantitative easing – but this time, inflation and fiscal deficits may limit their effectiveness. Since September 2024, despite numerous rate cuts, the 10-year Treasury yield has risen materially. Across seven prior easing cycles, yields fell every time. Again, not this time.

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This brings to mind James Carville's famous remark (the former advisor to President Clinton):

"I would like to come back as the bond market. You can intimidate everybody."

Conclusion

Investing should always begin with a simple question: can you get your money back? A high degree of confidence about return *of* capital matters more than your expectations for return *on* capital. Equities, by their nature, are speculative – future prices are unknowable and dividends are discretionary, not contractual.

Given the dramatic shifts in the global macro environment and historically extreme valuations, this appears to be an appropriate moment to reduce risk and increase certainty, even if that means selling too soon.

About the Author



Timothy J. Gramatovich serves as Principal of Invico Credit Partners and brings more than 40 years of experience in the leveraged finance and high yield markets.

He was the Co-Founder and former Chief Investment Officer of Peritus Asset Management, where he spent 23 years developing investment strategies, leading portfolio construction, and making investment decisions across high yield bonds and leveraged loans. During his tenure at Peritus, Mr. Gramatovich launched and managed several cash flow CDOs and was instrumental in the creation of the first actively managed high yield bond ETF, which grew to more than \$1.2 billion in assets within its first three years. He also oversaw bespoke high yield credit portfolios for both individual and institutional clients.

Prior to founding Peritus, Mr. Gramatovich served as a Portfolio Manager at Travelers Asset Management in Los Angeles, managing high yield portfolios for high-net-worth and institutional investors. Earlier in his career, he was a Senior Vice President at Aegis Asset Management Inc., where he established the firm's buy-side high yield investment platform.

Throughout his career, Mr. Gramatovich has acted as a qualified expert on financing and valuation matters for the U.S. Trustee in the Federal Bankruptcy Courts of Los Angeles County. He began his career at Drexel Burnham Lambert in 1986, supporting the development and marketing of high yield corporate cash management products.

Mr. Gramatovich is a CFA Charterholder and a graduate of the New York Institute of Finance.

About Invico Credit Partners

Invico Credit Partners ("ICP") is a U.S.-based credit research firm providing specialized market insight and underwriting support across the institutional leveraged loan market. Guided by a disciplined and active investment process, ICP focuses on identifying persistent inefficiencies in corporate credit markets while supporting family offices, multi-family offices, and other institutional investors through bespoke investment structures and portfolio solutions.