2020 Mid-Year Review

After the Deluge, What Next?

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Executive Summary

- Massive monetary and fiscal stimulus has lifted asset prices

- The disconnect between asset prices and fundamentals can continue

- Equities close to new highs while bond yields have plummeted to new lows

- Era of low rates, “financial repression” here to stay

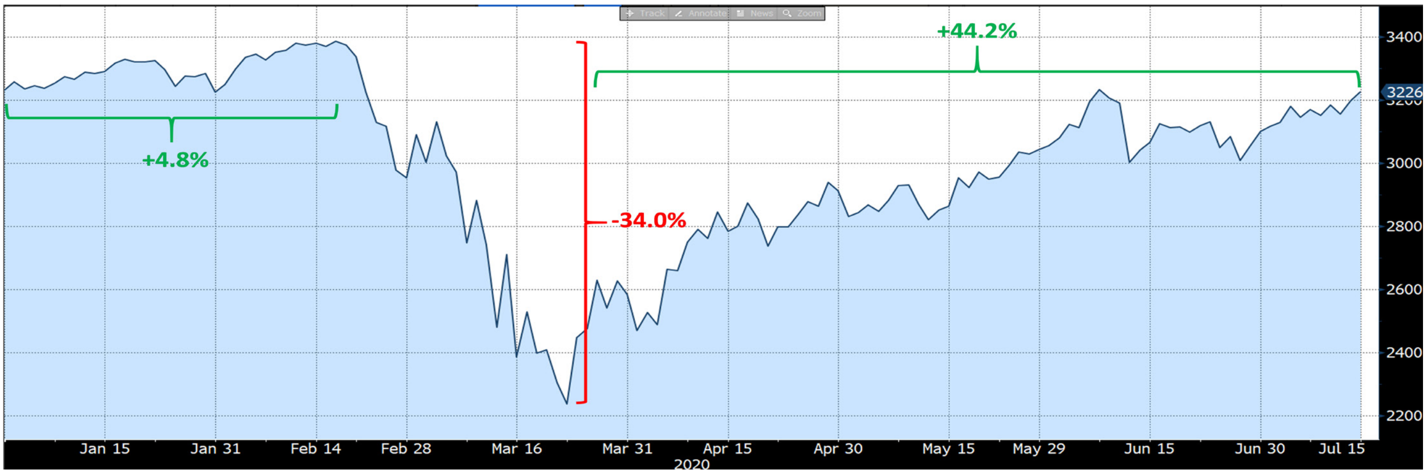
The longest US economic expansion of modern times ultimately wasn’t brought down by ‘conventional’ setbacks, like the bursting of a speculative bubble or a downturn in the business cycle. The Great Lockdown of 2020 was the tail event that nobody foresaw, creating economic dislocation we haven’t witnessed in our four decades of investing. The magnitude of the government’s fiscal and monetary countermeasures has been equally unprecedented and awe-inspiring. Markets will be dealing with the aftershocks of both events for years to come.

Year-to-Date Recap

The first 7 weeks of 2020 were unremarkable, with the S&P 500 closing at a fresh all-time high of 3,386 on February 19th, at the time a modest +4.8% price return. But as we all know, the COVID-19 shoe was about to drop, and this benign environment quickly gave way to one of the most volatile markets in history.

From the February 19th all-time high to the March 23rd trough – a mere 23 trading days – the S&P 500 lost a full 1/3rd of its value, coming close to 2,250. That wiped out nearly $10 trillion worth of wealth, the equivalent of almost half of US GDP (or the value of everything our economy produces in a year). The subsequent recovery was just as robust– from the March 23rd trough through July 15th, the index steadily rebounded to 3,226, +44% from that low. On net, we’re basically back where we originally began the year, and just 5% away from the all-time high. Equities are seemingly behaving as if the pandemic is largely over and now just an unpleasant memory.

S&P 500



Source: Bloomberg

The action in Treasuries was the polar opposite – yields plummeted as investors fled to the relative safety of Treasuries while the Federal Reserve anchored short-term rates at zero. The decline in longer maturities was particularly notable, as the 10 Year Treasury yield settled in far below its prior all-time low of 1.36% (previously reached in mid-2016).

Treasury Yields

	As of 12/31/19	As of 2/19/20	As of 3/23/20	As of 7/15/20
1 Year	1.58%	1.47%	0.14%	0.14%
2 Year	1.57%	1.42%	0.32%	0.15%
3 Year	1.61%	1.39%	0.34%	0.18%
5 Year	1.69%	1.41%	0.41%	0.29%
10 Year	1.92%	1.57%	0.79%	0.63%
30 Year	2.39%	2.02%	1.36%	1.33%

Source: Bloomberg

But most other fixed income markets weren't as benign. For example, corporate and municipal bond yields spiked several percentage points higher during mid-March's liquidity crunch (for more details, see our previous publication Fixed Income Alert: Market Illiquidity vs. Credit Defaults, 3/23/20), but eventually followed Treasuries to historic low yields.

In summary, the prices of financial assets essentially across the board have rebounded, in some cases setting new all-time highs. This ostensibly "all clear" signal is remarkable given that over 20 million Americans are unemployed and re-openings are facing a rocky road.

Bringing Out the Big Guns:

Before we discuss our outlook, we must emphasize that the government's response to the pandemic's economic impact has been nothing short of massive. The unprecedented breadth and reach of the interventions is unmatched in American history:

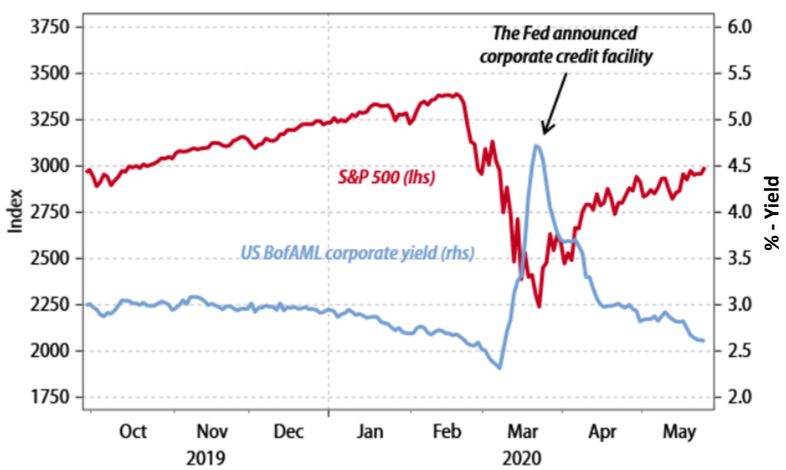
- Massive federal stimulus programs- deployed in record speed- totaling at least $2.5 trillion. For context, the federal government spent only $4.1 trillion for the entirety of 2018. Moreover, the odds of yet another significant fiscal package in the near future are high.
- Traditional monetary policy followed in lockstep, as the Federal Reserve cut short-term rates from 1.50% to 0% in just 2 weeks.
- Non-traditional monetary policy caused the Fed to venture into uncharted waters by purchasing corporate and municipal bonds, corporate bond ETFs and junk rated bonds.

The mere knowledge that this cheap and plentiful liquidity is available has been enough to reassure markets, bringing credit spreads down for all types of borrowers and creating positive spillover effects into equity markets. Having witnessed 4 decades of Fed action beginning with the Volcker Fed of the early 80's, we'll chalk this one up as the most aggressive. But beware of the consequences- eating too many sweets leads to indigestion.

Impact

This tsunami of fiscal largess and Fed liquidity are significant factors in propping up the prices of financial assets. Despite the still-awful economic reality, the unconventional interventions were successful in their stated goal of delinking market prices from deteriorating economic fundamentals. In a sense, it's a bizarre feedback loop; the more bearish or concerned the Fed grew, the more bullish it became for the stock market and bond credit spreads. The Fed's impact was decisive and undeniable – it immediately halted the financial panic and changed the narrative from crisis to a simultaneous and sustained recovery in financial asset prices which is reflected in the chart below. Specifically, the stock market found a bottom once the Fed announced it would begin lending directly to corporations.

S&P 500 vs. US Corporate Bond Yields



Source: GaveKal

The corollary is that stocks have rocketed higher while forward earnings estimates are cratering, which means the price/earnings ratio has spiked. As a result of Fed liquidity and investor optimism, such prices imply expectations of a full recovery in 2021, essentially a quick round-trip back to the strong economic conditions of 2019. We disagree.

S&P 500 Corporate Profits vs. Levels

Source: Bloomberg

Fixed income offers no clear refuge either, as yields are truly lower than ever:

Example A-Rated Corporate and Municipal Bond Yields

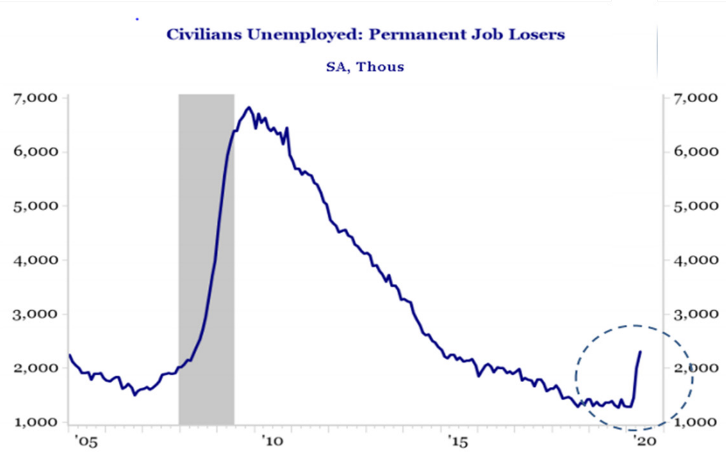
	Corporate Bonds	Municipal Bonds
3 Year	0.50-0.65%	0.30-0.60%
5 Year	0.80-0.95%	0.65-0.80%
10 Year	1.80-2.25%	0.95-1.30%

Source: Treasury Partners Estimates as of 7/15/20

Current Strategy

Equities

Fundamentally, the risk-reward proposition is elevated. The only outcome that could justify current P/E ratios and ultra-low yields is the rapid deployment of a COVID-19 vaccine and a robust return to pre-pandemic levels of economic activity. While we can't speak to the former, in our view the latter simply will not happen. Reopening doesn't mean a resumption of full economic activity and is likely to continue in a staggered, uneven pace that ends well short of full capacity. As time passes, businesses will fail, bankruptcies will increase, and a growing proportion of the "temporary" job losses will regrettably become permanent.



Source: Strategas

We've already seen 'household name' companies file for bankruptcy protection: Dean & Deluca, Hertz, Briggs Stratton, Borden Dairy, Cirque Du Soleil, General Nutrition, JCrew, JC Penney, Neiman Marcus, Pier 1 Imports, etc. These and others will have an impact on the economic recovery.

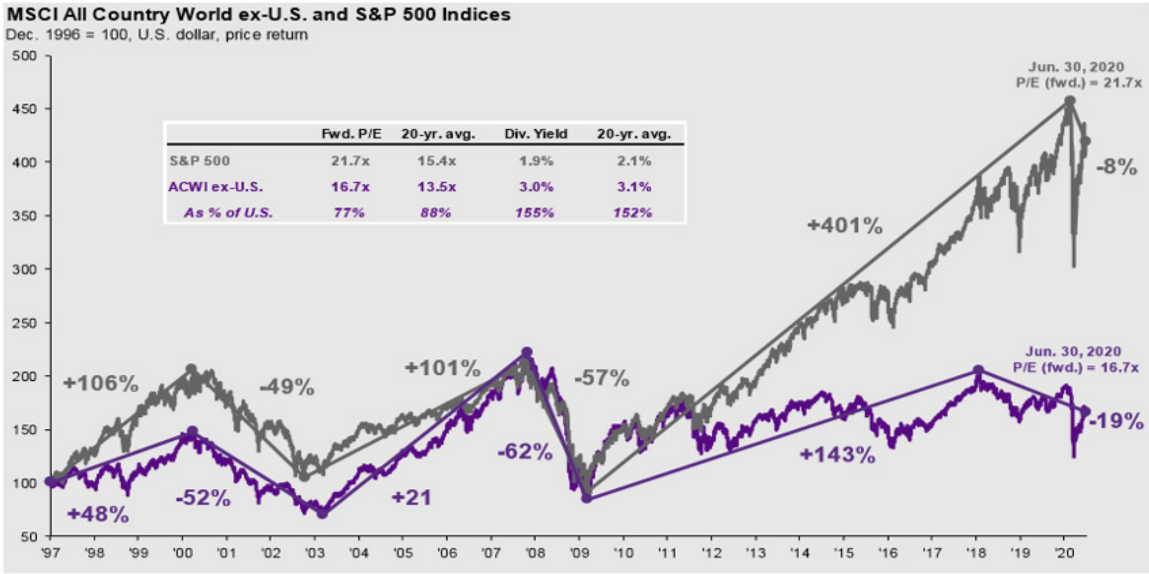
Remarkable market distortions are evident, which presents an investment challenge. For all the reasons we've outlined above, we believe the fundamental outlook remains weak, which calls for caution. However, an interventionist Fed is committed to keeping asset prices elevated, which supports a more risk-tolerant stance. In addition, extremely low bond yields support the case for revaluing equities higher. The weight of our experience calls for caution, but central bank firepower and ultralow rates call for maintaining current equity positions.

Ultimately, equity prices will depend on economic conditions and corporate profits, but current elevated price/earnings multiples are clearly the product of low rates and the ample liquidity that's available. Although stocks' high P/Es and sunken fundamentals don't sound appealing, this phenomenon can be quite persistent against a backdrop of low bond yields, so we continue to maintain equity positioning.

In this environment, stock picking is crucial, and knowing where to hold exposure is just as important as maintaining overall market exposure. We've therefore shifted a portion of existing equity allocations from passive to active managers and re-emphasized our existing tilt towards growth and technology vs. value, as the Great Lockdown has accelerated our "Bricks to Clicks" theme.

To illustrate why we're emphasizing selectivity, consider the phenomenal rise in mega-cap share prices over the last few years versus their earnings. Between 2014 and 2019, the combined after-tax profits of Facebook, Apple, Amazon, Microsoft and Google ("FAAMG") grew from $78 to $159 billion. That translates to a compound annual growth rate of roughly 15%. However, during this same period, FAAMG share prices rose even faster, increasing by the equivalent of 26% a year. Thanks to this compounded increase in multiples, this $80 billion increase in profits led to a stunning $3 trillion increase in combined market cap. In 2020 YTD, it's grown another 50% to $4.5 trillion, making the FAAMG companies the world's 5 largest public businesses. That's "bricks to clicks" in action.

Meanwhile, we're still massively underweighting exposure to European and non-US developed markets. Although there's been progress towards greater fiscal union and debt mutualization, the existential issues remain. Our complete shunning of Emerging Markets continues, as the pandemic only exacerbates the risks and challenges of this sector. Keep in mind that while US markets reached new highs in Q1 2020, both the MSCI International Developed Market and Emerging Market indices haven't reached new highs since 2007. We'll continue to avoid these markets.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

Source: JPM's Guide to the Markets

Bonds

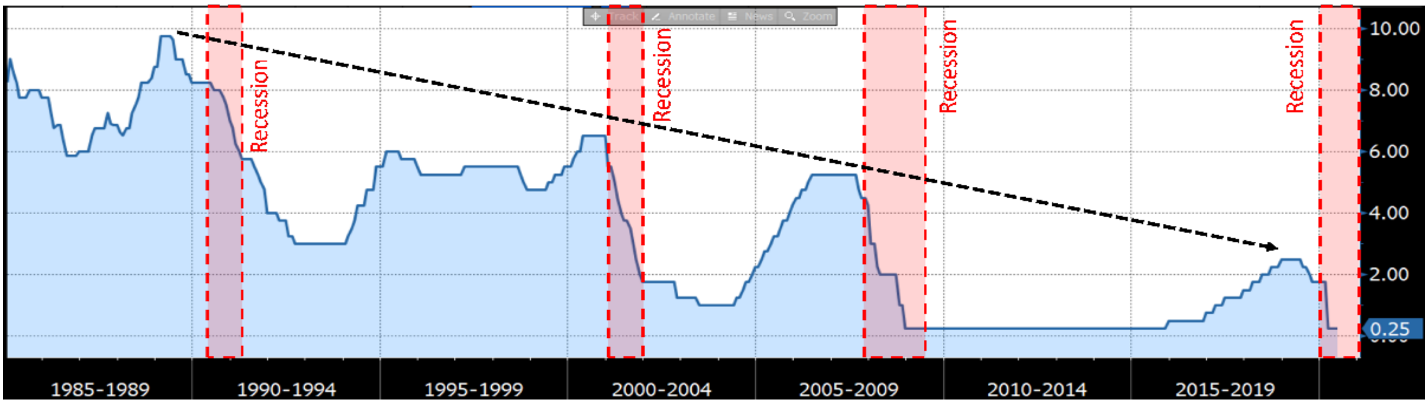
There's every indication yields will remain lower for longer, and potentially even go negative. It isn't an unrealistic fantasy; over $13.4 trillion or 22% of the world's developed market, investment-grade bonds already cross hands at negative yields. This anchor of persistent negative-yielding debt weighs down yields in our market.

Negative-Yielding Debt as a Percentage of Outstanding Global Investment-Grade Debt

Source: Bloomberg

The Fed is highly likely to stay accommodative and keep policy rates at zero. Although we've witnessed significant growth and prosperity since I entered the business in January 1982, this progress has been paired with an enormous buildup of debt. Looking at the chart below, there's also a clear long-term trend – lower highs and lower lows in the Fed Funds rate after each economic (expansion/recession) cycle. There's a linkage here; as debt loads have soared, the Fed has grown increasingly constrained in raising rates, afraid that higher costs in servicing the increased debt levels would stifle economic expansions. The last high in the Fed Funds rate was a mere 2.50% and now we're already back at zero.

Fed Funds Rate Upper Bound



Source: Bloomberg

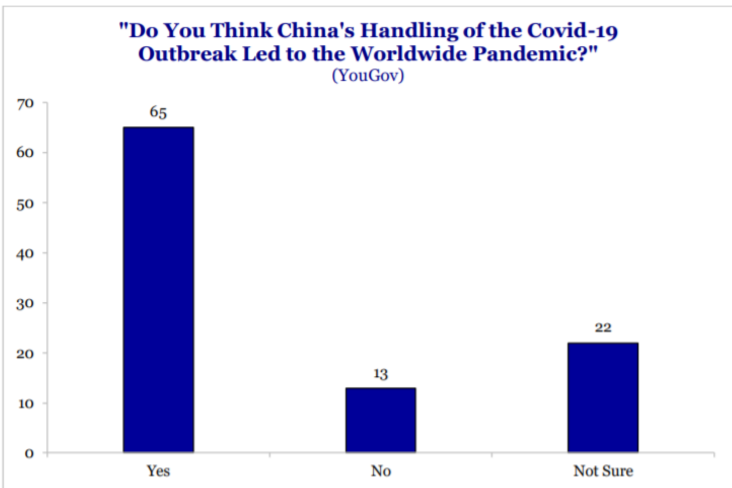
Our expectations of a slow economic recovery translates into rates staying low. Moreover, as we mentioned in our last alert (Unprecedented: Guideposts for a Deeply Uncertain Time, 5/12/20), the aging global population will keep demand for the relative safety of fixed income high, acting as a dampening influence on yields. As you know, where possible, in Q2 we aggressively extended maturities at elevated yields in our fixed income portfolios to guard against lower rates. We'll continue to add select longer-dated callable municipal bonds, as they provide attractive relative returns.

Political Concerns

Some volatility-inducing risks will arise in the home stretch of campaigning season, as they do in every presidential election year.

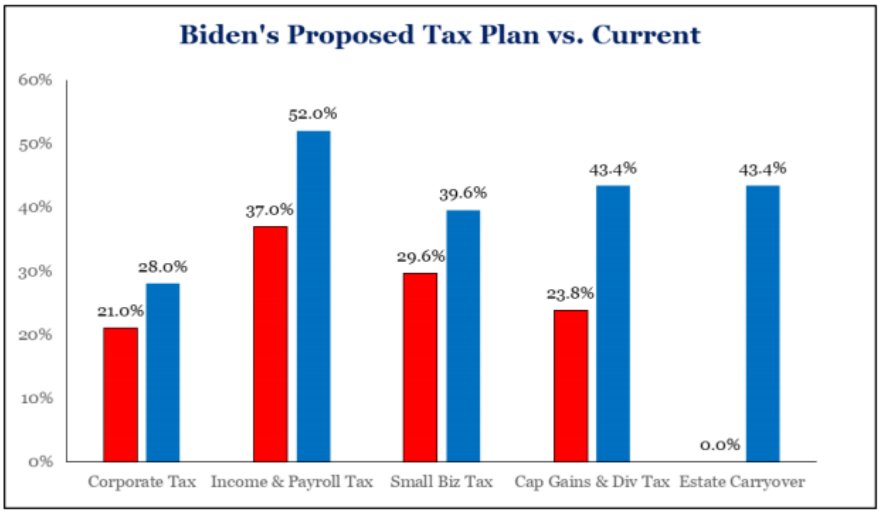
US-China relations will likely keep deteriorating regardless of which candidate pulls ahead. With most Americans holding an unfavorable opinion of our largest trading partner and blaming them for the pandemic's global spread, China criticism is likely to emerge from both parties. The range of practical implications are wide; for instance, abandonment of the existing "Phase 1" trade deal and imposing new tariffs or trade restrictions could bring back equity market volatility.

US-CHINA RELATIONS ARE DETERIORATING



Source: Strategas

Another threat is the tax code. Recall that 2017's landmark tax cuts and reforms were passed on party-line votes. It's clear the pandemic-induced fiscal deficits will have to be paid for, sooner or later, via higher taxes. Should the prospect of a Democratic sweep materialize, the potential for near-term tax hikes could roil markets.



Source: Strategas

Conclusion

It's an understatement to say we live in strange times. We're fundamental investors confronting an investing environment where the link between fundamentals and asset prices is distorted. For years we've highlighted the risks of central bank monetary adventurism as well as the risks of ultralow/negative rates. The vanguard of "financial repression" has finally landed on our shores and we're now witnessing the initial consequences: zero to near-zero returns on fixed income, mispricing of bond credit risk, and spillover effects into other asset classes. The far-reaching distortions will continue piling up as investors take on even more risks in the hunt for acceptable returns.

Navigating this new era of investing is a nuanced topic which affects every aspect of our investment approach. For now, we're staying the course in our asset allocations, maintaining our equity exposures with an emphasis on our managers vs passive indexes and an overweight to growth vs value. Importantly, we'll continue to avoid exposures to MLPs, REITs, and Emerging Markets, which have all performed poorly, and maintain only modest International Developed exposure.

In addition, we're using Alternatives selectively, seeking to improve returns beyond ultra-low yields in traditional fixed income, with a focus on dampening volatility and risk. We're unwilling to chase the myriad of new 'investment opportunities' we review regularly. But rest assured - we'll continue working diligently every day to find attractive risk-adjusted opportunities that fit into our investment framework.

As always, thank you for the opportunity to manage and safeguard your wealth. We hope you're staying happy and healthy, and enjoying your summer.

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