Third Quarter 2020 Investment Outlook

Rough Waves and Sea Change

"And the men who hold high places, must be the ones who start, to mold a new reality, closer to the heart"

– RUSH – Closer to the Heart from the Farewell to Kings album - 1977

"There are decades when nothing happens and there are weeks when decades happen."

– Vladimir Ilyich Lenin - 1917

"My confidence is rising quite rapidly that this is, in fact, becoming the fourth, real McCoy, bubble of my investment career. The great bubbles can go on a long time and inflict a lot of pain but at least I think we know now that we are in one."

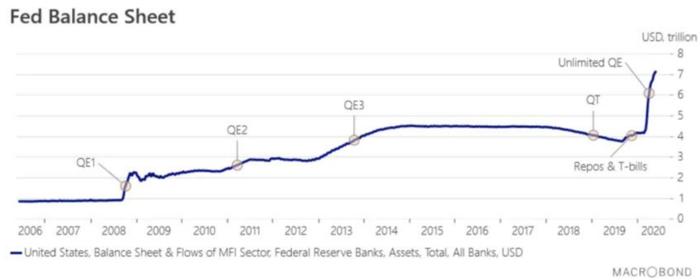
– Jeremey Grantham - founder of investment management firm GMO

The untimely death on January 7th of Neil Peart, the drummer of RUSH and one of the greatest drummers in rock history, was an early sign that 2020 may not be a great year. Most drummers are head banger types, focused on keeping the beat and twirling their sticks between their fingers for added showmanship. RUSH fans were memorized by Neil's unique syncopation in every RUSH song and his incredible talents that made his drumming the centerpiece of the band. Neil was a rarity in rock for a drummer in that he was also the band's main lyricist with Alex Lifeson providing the lead guitar riffs and electronic effects and Geddy Lee the bass beat and lead vocals.

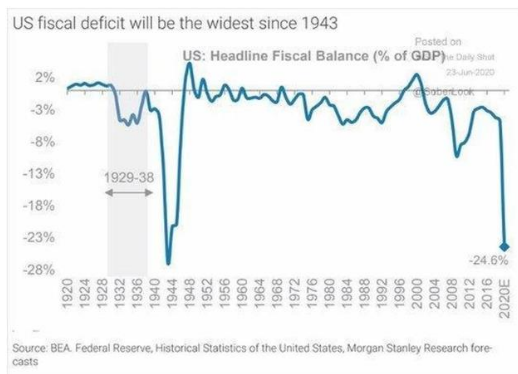
The Farewell to Kings album contained one of the bands biggest hits, Closer to the Heart. The essence of the song's lyrics are about how governments and its leaders have a responsibility to bring society towards greater harmony. The current societal upheaval over the past few months and ongoing protests against racism, capitalism, and inequality are hitting at the same time the U.S. dealing with a huge exogenous shock and greatest economic collapse since the Great Depression due to the COVID-19 virus outbreak. Lenin's quote from 1917 feels very real today as it seems American society has gone through a decade of change in just the past 12 weeks. Our nation seems about as far away from being closer to the heart than any time in our Nation's history except for 1968-1970, when Kent State, Civil Rights marches, Martin Luther King and Bobby Kennedy assassinations, and Vietnam War protests were all society rattling events.

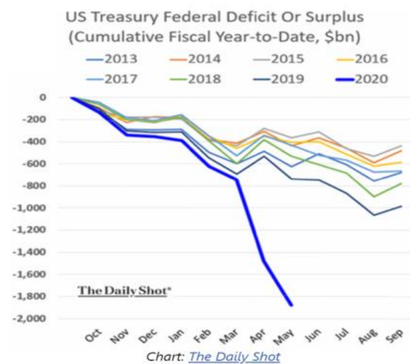
Stephen Roach wrote recently that the sudden shift in which America finds itself at present often exposes deep-rooted structural problems that can impair economic recovery and spark abrupt asset-price movements in response to the unmasking of long-simmering imbalances. The widening wealth gap of the past 30 years was created by central bank policies that produced large gains in financial assets for the affluent but little in the way of economic growth and real wage gains (income after the impact of inflation) for the vast majority of Americans. The upper income portion of society has disproportionately benefited from the former while the majority of Americans have been overly burdened with the latter. All it took was economic stresses brought on by COVID-19 combined with recent police brutality events to strike a match and the ugly undercurrents simmering below the surface are now on full display in America society. America will experience more rough waves into the fall election and that election is likely to lead to a sea change of new policies across America.

Asset price inflation returned quickly during the second quarter due to unprecedented actions taken by the Federal Reserve to support credit markets and provide liquidity support. Once the Fed announced these policies in late March and early April, risk assets recovered and began to price in a V-shaped recovery and expectations for a return to normal. These policies most likely mean we will not see another large and rapid sized market decline like was experienced in March. Since COVID-19 started, the Fed's support programs to date have totaled over $3 trillion and its balance sheet from security purchases has expanded to just over $7 trillion with some predicting it could top $10 trillion by the end of this crisis.



In addition to Federal Reserve monetary actions, Congress has also acted with unprecedented speed to enact fiscal spending programs to help businesses and individuals avoid a worst-case scenario outcome. The next two charts show that the U.S. fiscal deficit (based on spending through June 30th) has never been greater since the World War II years. Even the Great Depression (shaded grey area) never experienced anything close to the levels of spending bills Congress has passed over the past three months. 2020 federal spending and the resulting deficit (blue line, right chart) will be the largest in the nation's history relative to GDP. How we will ever pay for all of it is tomorrow's business while saving the economy from total collapse is today's business.

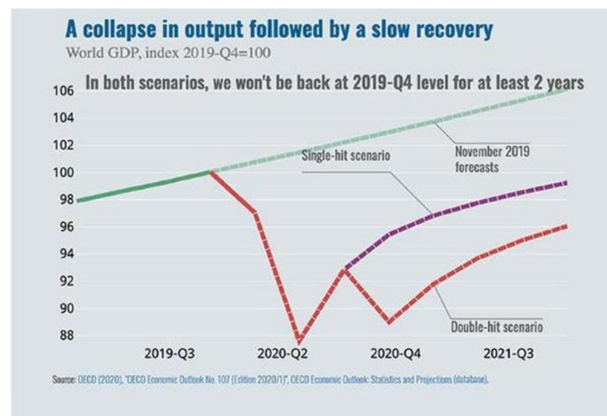




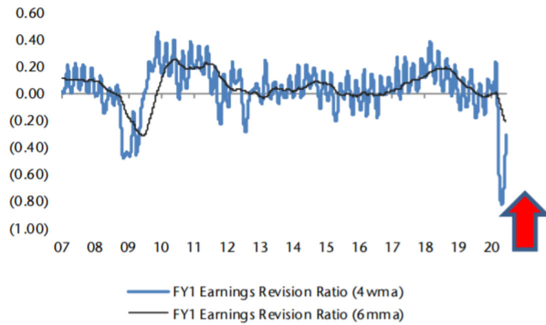
All of the support from both fiscal and monetary policy makers has been huge but what matters the most, and which no one can predict with any timing accuracy, is whether COVID-19 has a second wave later this year. The first wave of COVID-19 was a rogue wave without precedent while a potential second wave would lead to a relapse in the fledgling economic recovery to date. Starting in mid-June, COVID-19 cases began to climb again in states that first re-opened and did not adhere to more strict social distancing and mask wearing policies. Governors in those states have been forced to restart lockdown orders on some businesses. No one can predict when a therapy or vaccine might be ready to go into mass production, which would allow for economic activity to resume at pre-COVID-19 levels and result in a rapid V-shaped catch-up from all the monetary and fiscal stimulus flowing through the economic system. However, during the

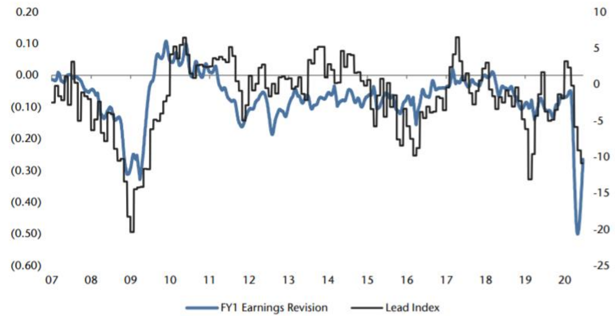
second quarter, the stock market's nearly 20% increase priced in an eventual positive medical breakthrough and V-shaped recovery.

The green line in the next chart shows how world economic growth was forecast to progress from early 2019 out into late 2021 before COVID-19 hit and assuming the OECD's former economic forecast was accurate. The purple line (V-shaped) plots how the OECD forecasts the global economy will recover if there is just one wave of COVID-19 outbreaks. The red line (W-shaped) shows how the global economy may turn out if there is a second wave of COVID-19 outbreaks. Under either scenario, world GDP growth will not get back to its pre-COVID-19 output level until sometime in late 2021 at the earliest. An effective vaccine would certainly be the most important variable that would accelerate economic growth the fastest and allow for a quicker return to normal.

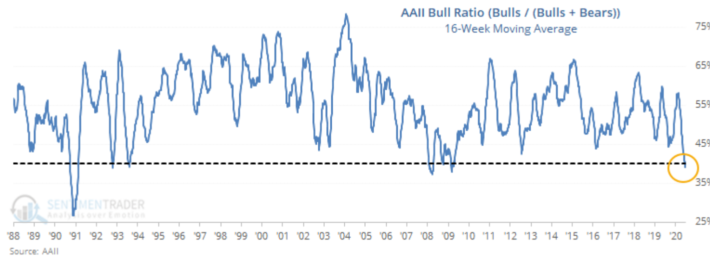


Once Wall Street started to understand the magnitude of the impact of COVID-19 on the global economy, analysts began to dramatically slash earnings forecasts for 2020. However, as economic re-openings have begun and as companies were able to provide more guidance on near-term demand trends, analysts have since reversed some of those large cuts and earnings revisions trends have come off of their extreme lows and begun to reverse higher for both U.S. earnings and global earnings estimates. As shown in the next two charts below, these now positive revisions from the recent very negative revisions have been a positive catalyst for stocks over the past two months. However, it remains to be seen if the economy can continue to recapture lost ground and if the resurgence of cases in the latter part of June in many parts of the country cause new business shutdowns until COVID-19 cases recede again. This time around there are more instances of COVID-19 cases in younger people between the ages 18-25, as they quickly embraced getting out again and went back to bars and congregated in large crowds without masks and proper social distancing. Some states are being forced once again to close down bars and restaurants and limit public gatherings in response.

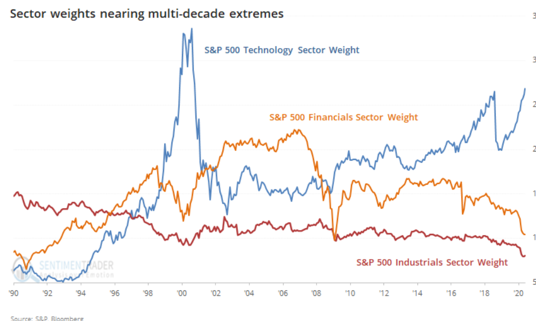




Despite a nearly 20% return during the second quarter in the broad stock market indices, investors generally remain wary of the stock market. The next chart from AAII is a gauge of investor sentiment and looks at the moving average of the ratio of the number of bulls vs. bears on a rolling 16 week basis (4 months) from the AAII Investor surveys. Investor sentiment still remains low, similar to the 1991 and 2008/2009 recession sentiment levels, and despite one of the largest quarterly rallies in U.S. stock market history. One could argue that even with the large snapback rally of the second quarter, there are still many investors not onboard and that represents future potential for more gains ahead.

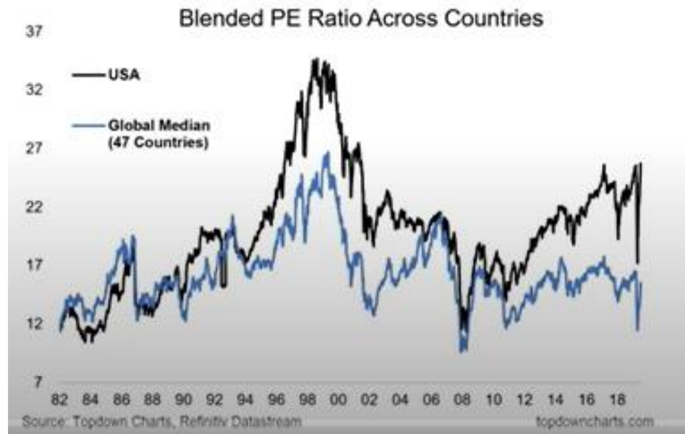


However, there are other market datapoints indicating that investors are crowding or speculating to an excessive degree. For example, the next chart shows that the tech sector weight as a percentage of the overall S&P 500 Index is now back to multi-decade highs while other cyclical sectors such as financials and industrials are near multi-decade lows. The data suggests there is not much conviction in a cyclical recovery but if investors have to own stocks they are paying up and crowding into stocks they perceive can still do well in the new work-from-home environment or from growing online retail activity.

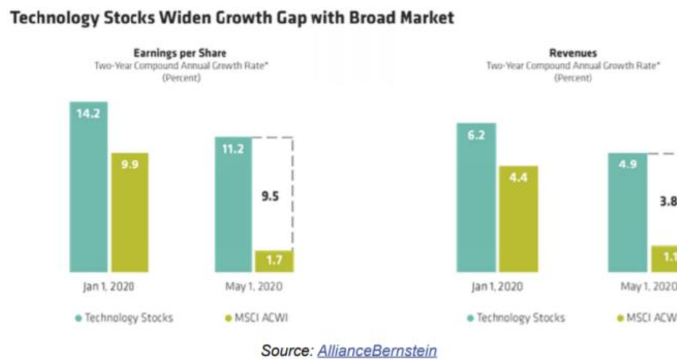


As an example of speculative excesses, the next chart captures options market data and shows how call option volumes (typically bought when one believes stocks are going higher) are overwhelming put option volumes (typically bought when one believes stocks are going lower) well beyond anything the market has seen in its history. It is a very rare window in market history considering that close to 20 million are unemployed, the Federal government is providing $600/week of income support, and casinos are still closed or have maximum capacity constraints which limit attendance. It is clear from the parabolic move in the chart that many ~~traders~~ gamblers are speculating in the stock market via highly leveraged options as a way to try and make income, much to the consternation and dismay of old school and very successful investors like Jeremy Grantham, Stan Druckenmiller, and Leon Cooperman. Even Warren Buffet is being called out by new school options traders as too old school and not with the times after Berkshire Hathaway sold out of its airline stock holdings near their lows and before they went on a big rip higher. Who knows if Warren will eventually have the last laugh, but as he once said, “only when the tide goes out do we know who was swimming naked.” Right now, it seems the options market is loaded with tons of skinny dippers.

Related to the tech sector chart and current popularity of the large/mega cap tech stocks dominating the stock market, the PE (price/earnings ratio) valuation profile of U.S. stocks relative to the rest of the world stocks has widened dramatically over the past five years. The next chart shows the two PE relationships going back to 1980. For the vast majority of the past 40 years, the chart shows that U.S. stocks have traded at a PE premium to non U.S. stocks. However, since 2015, this relationship has widened considerably, in part due the higher tech exposure in the U.S. stock market compared to the rest of the world. However, another important point of this chart to note is that the current PE level of the U.S. stock market is now at the high end of its 40-year trading history while the PE ratio of non-U.S. stocks is nowhere close to its highs and is in fact below its 40-year average. It is also important to point out the ebbs and flows of this relative relationship over time. The vast majority of investors now believe that U.S. stocks should trade at a permanently higher PE level and spread compared to other stock related investment opportunities. The chart shows that while overvaluations can extend on for many years, when a stock market correction occurs, that PE premium can disappear quite rapidly. It happened in the tech bubble peak of 2000 and it could happen again in the current market where tech stocks dominate and investor sentiment towards tech stocks is now at extreme levels. It is not necessary for tech stocks to plunge to rectify this valuation imbalance. In fact, while many tech stocks sports very high valuation, the situation is nowhere near as egregious as the 1998-2000 tech bubble era. Rather, tech stocks could just produce below average returns going forward while non-tech stocks finally get their day in the sun and catch-up.



A big part of the reason for the S&P 500 tech sector weight hitting new highs and the U.S. stock market PE valuation gapping higher relative to other global stocks is that the U.S. tech sector was experiencing higher sales and earnings growth before COVID-19 and that relative advantage has expanded even more post COVID-19. The next chart shows this data for January before COVID-19 impacts were felt and again in May after COVID-19 impacts started working their way through revenue and earnings growth forecasts by research analysts. Technology stocks have not been immune to experiencing lower earnings and revenue growth but the rest of the world across all sectors have seen a more material decline in both. This data goes a long way towards explaining the resilience and outperformance of the tech sector in recent years.

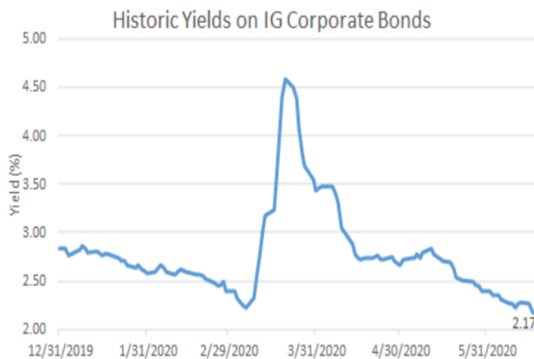


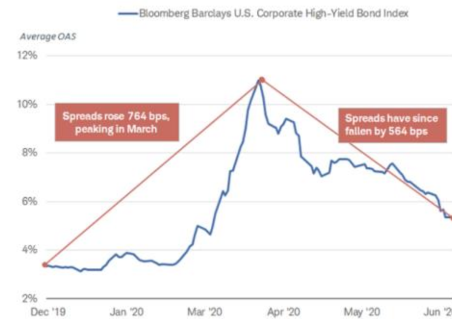
Source: AllianceBernstein

Another way to show how bifurcated the U.S. stock market has become is shown in the next chart, which captures the relative returns of the MSCI Growth and MSCI Value indices going back to 1975. The blue shaded areas are when growth stocks have outperformed value stocks and we can see that the most recent period is the longest since 1975 and 100% explained by the massive outperformance of tech stocks which make up 31% of the MSCI Growth Index. In fact, this relative performance relationship between growth and value stocks has never been more extreme. Note that the last peak of value over growth occurred in 2007, about the time that interest rates peaked and then the Fed instituted is Zero Interest Policy ("ZIRP") program in response to the Global Financial Crisis. More recently, growth has once again seen a large performance advantage over value in response to the Fed moving back to a ZIRP in response to the COVID-19 economic collapse. Tech stock valuations are more highly sensitive to declining interest rates compared to value stocks, which typically do better in rising rate environments. This is especially true of financial stocks, which has been one of the worst performing sectors since Fed went back to its ZIRP in March 2020.

On the fixed income front, the Fed in June announced it planned to maintain its ZIRP at least until the end of 2022. There has also been increased talk about the Fed instituting a yield curve control policy, meaning it would announce targeted bond purchases in certain maturity U.S. Treasuries in order to keep a cap on yields moving higher and potentially negative impacting the economic recovery. This yield curve control policy has not been formally adopted by the Fed but by announcing the no interest rate hikes for at least the next 2 ½ years, it was the Fed's way of telegraphing to the market that bond yields are unlikely to move meaningfully higher for a long period of time.

In April, the Fed announced that it would begin purchasing corporate debt for the first time in its history. The Fed was forced to take this action due to what was happening in corporate bond markets as shown in the next two charts below. As the COVID-19 spread globally, and full economic shutdowns occurred, corporate bond yields rose substantially. Both the investment grade credit (rated BBB or higher) and high yield (rated below BBB) markets became unhinged quickly as investors dumped everything in a flight to safety move towards U.S. Treasuries. Credit markets were freezing up and the Fed had to step in to provide liquidity and calm the bond markets down so that a liquidity crisis did not turn into a solvency crisis like what happened to Lehman Brothers, Merrill Lynch, and AIG during the GFC. Once the Fed announced multiple credit support programs, credit spreads quickly retreated, with investment grade credit yields now even lower than they were at the end of February while higher risk high yield bonds have yields that are still above the February lows. It should be noted that most of the Fed corporate bond buying will be focused in investment grade credit and not high yield, which explains why investment grade credits sport lower yields today than they did prior to COVID-19 but high yield bonds do not.





Source: Bloomberg, using weekly data as of 6/5/2020. Option-adjusted spreads (OAS) are quoted as a fixed

While the Fed policy moves have been quite positive in reversing corporate bond losses from the first quarter, it presents a conundrum to investors. With money markets now offering yields near 0%, the 10-

year U.S. Treasury bond yield under 0.7% (as of 6/30/20), the 30-year maturity U.S. Treasury bond yield near 1.4%, and intermediate maturity investment grade credit yields barely over 2.0%, fixed income investors have limited means to earn decent returns above the rate of inflation. Most of the U.S. Treasury curve offers negative real yields (after inflation). Although high grade bonds still offer risk diversification benefits to a portfolio over time, absolute yields should remain low for the foreseeable future. From a balanced portfolio perspective, bonds offer limited and very low return potential. This poor risk/return setup for fixed income represents a sea change in terms of how balanced portfolios are likely to be constructed in the future. It is difficult to see how the old 60/40 balanced portfolio has much chance to succeed for investors when the 40% fixed income portion at best may earn 2% returns. Investors will have to rely more heavily upon equities to carry more of load for balanced portfolio returns. This may lead to a "old" 60/40 balanced portfolio becoming something like a "new" 70/30 stock/bond portfolio over time. Of course, there is no free lunch in investing so this means investors would have to accept portfolios with higher risk and more price volatility in order to increase the odds of reaching their investment goals over time.

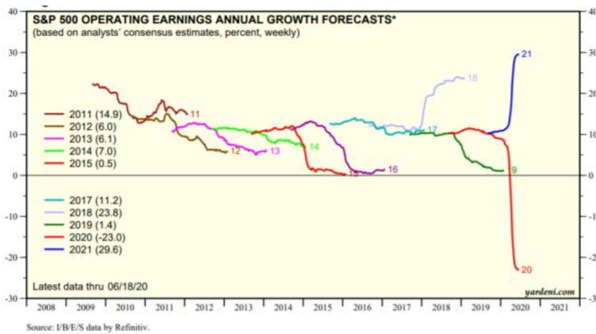
Looking out into the second half of 2020, the COVID-19 situation remains the major factor influencing whether or not the U.S. economy experiences a sharp, V-shaped recovery. A medical break-through in terms of drug therapy or vaccine would cement a strong global economic recovery given the magnitude of monetary and fiscal support already in place. However, there is one other major event that will have a sizable impact on investor sentiment and market prices in the second half of 2020 and that is the November election.

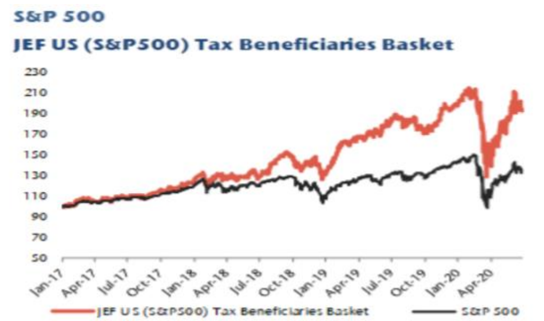
In politics, five months is forever but as things stand here in early July, we have a sitting President that has the worst economy and highest unemployment rate of any sitting President since Herbert Hoover heading into a major election. When combined with the political and social upheaval currently dominating news headlines, President Trump has a difficult uphill battle to get reelected. It is fair to say that back in January and without COVID-19 his chances were probably pretty solid. From the Democratic field of candidates, somehow old school, nearly octogenarian Joe Biden made it through to the nomination. Given his current polling lead in key battleground states, the former VP just needs to avoid pulling a, well, a Joe Biden, to ruin his shot at the Presidency. Stranger things have happened.

Regardless of one's political persuasion, investors need to expect tax policy will change under a Democratic Administration. If Democrats sweep both the House and Senate too then there is going to be a real sea change in government policies and especially tax policy. The large runup in stocks from Trump's election and until COVID-19 hit was largely a result of substantial cuts in corporate tax rates. Those tax cuts drove 2018 earnings substantially higher and had a very positive impact on stock valuations and gains during his first term. Today, the U.S. corporate tax is 21% but one should expect under the Biden Administration that corporate tax rates will go higher and tax rates on the wealthiest Americans will also go higher. With income imbalances and wealth disparity at extremes, these potential policy changes will help towards creating a more fair and just society, but it is not necessarily a good thing for stock market valuations.

The next chart on the left shows the annual earnings growth of the S&P 500 Index from 2011 to 2019 and forecasted earnings growth for 2020 and 2021 as they now stand. It is typical for analysts to begin each year with an optimistic view and then cut earnings over the course of the year. This trend explains why most lines start higher and then go downward to the right over time. Note that since 2011, the only year with a material uptick in earnings growth expectations was during 2018 and was a direct result of the 2017 tax reform act signed into law by President Trump in late 2017. The 2018 line shows what a material impact lower U.S. corporate tax rates had on S&P 500 Index earnings, which ended up being 23.8% higher than 2017 earnings due to lower tax rates. During 2019, the U.S. economy slowed down substantially

(China trade war, etc.) and earnings growth estimates (green line) ended up barely above 0% for the year. The 2020 plummet represents the large, negative impact of COVID-19 while 2021 estimates reflect expectations of a major rebound off of depressed 2020 earnings level. The right side chart shows the outperformance of stocks that were beneficiaries of the 2017 corporate tax cuts. According to Empirical Research Partners, all of the margin improvement experienced by S&P 500 companies since 2015 has been attributable to lower tax rates.





Keep in mind that the current earnings growth estimate of 29.6% for 2021 vs. 2020 assumes no change in the U.S. corporate tax rate. Should Biden win the election and if the new Congress prioritizes reversing portions of the 2017 Tax Reform Act, then 2021 S&P 500 operating earnings estimates will be much lower than the current estimate of $163/share. Some forecast a corporate tax increase from 21% to 28% would reduce 2021 earnings estimate by 8%. An increase in individual capital gains tax rates would also add to the potential headwind for stocks into 2021, especially high multiple tech stocks that are all the rage with most investors today.

Summary

2020 already feels more like a decade than a year and we are only halfway into it. Over the first six months investors experienced one of the biggest quarterly losses in stock market history followed by one of the biggest quarterly gains. COVID-19 was a rogue wave in its own right, but its resulting severe economic impacts have exposed deep rooted structural and societal problems plaguing America. Although financial markets have recovered on the back of unprecedented monetary and fiscal policy support, a V-shaped economic recovery is not a sure thing just yet. Recent flare-ups of COVID-19 cases in parts of the country that re-opened first are forcing governments to restart closure orders in order to get the new outbreaks under control. How the economy and markets handle virus related setbacks will ultimately determine future market performance while societal upheaval, trade frictions, drug developments, and the November election will also be major factors on how the second half of 2020 plays out. Rough waves and sea change are most likely in store over the next six months. Hopefully, the men (and women) who hold high places can step up to the difficult challenges ahead and mold a new reality for America.

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July 7, 2020

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