3Q 2020 Market Insights
Hope Springs Eternal
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Integrated|Capital|Management

"The individual investor should act consistently as an investor and not as a speculator."
- Benjamin Graham

Much like winter giving way to spring, the panic selling that embodied the end of the first quarter gave way to green shoots and new growth throughout the second quarter. Global equity markets rallied in broad fashion on massive amounts of central bank stimulus, fiscal relief efforts, as well as hopes for a speedy "V-shaped" recovery and life returning to our old normal. From trough-to-peak, the S&P 500 has now staged a 44% rally, erasing all losses year-to-date and moving within a stone's throw of its all-time high. While the *Economics of Fear* drove us to our steepest decline in more than a decade, it is hope that has pulled us from our lowest point to where we are today. It is the hope of a "V-shaped" recovery, people returning to work, businesses resuming operation, people dining in restaurants and congregating with friends. My intention for this quarter's Market Insights, *Hope Springs Eternal*, is to pause at mid-year and realistically assess the state of affairs in our economy and within financial markets, as they once again approach all-time highs. This projects a level of optimism that may be a bit exuberant for what lies ahead. While hope may spring eternal, hope does not always cooperate with our wishes and certainly not with our timelines.

Taking Inventory

It is difficult to even fathom that for the US, most of this began just three months ago. Chronologically, the duration may be short, but much has happened economically, and in our day-to-day lives that it certainly feels longer. Let's begin with a review of what has happened economically.

- As the COVID-19 pandemic accelerated within US borders, life as we knew it began to change. Beginning around March 9th, the restaurant industry started to show the first signs of stress with year over year sit-down traffic declining by 14% in the US and across the globe. Just 10 days later, the decline in year over year sit-down dining reached 99% in the US with nearly all restaurants nationwide being closed to sit-down traffic.

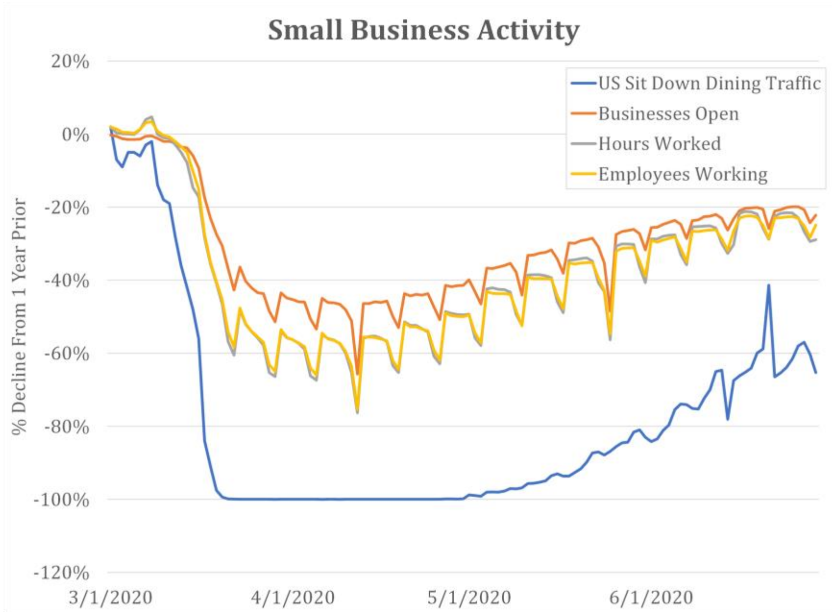
- On March 6th, 211k people filed for first-time unemployment benefits. Just two weeks later, 3.3mm people filed first-time claims and by June 30th, a total of 48mm people had filed for first-time unemployment benefits.

- In total as of March 31st, US households lost over $6.5T of net worth and business profits declined by 14%. Not surprisingly, US Real GDP declined by 5% in the first quarter of 2020 vs. the prior quarter with much of the damage expected to come in the second quarter. The initial reading on 2q GDP will be released in late July with numbers that are projected to be a near -30% decline, making this one of the worst economic disasters in history, landing squarely in the bottom 10%.

In the prior section, I felt compelled to make note of the precarious state of business and labor markets to impress upon each of you the extent of the challenge that lies ahead. While I, like many of you, have full faith in the resolve of our country to overcome, I am realistic enough to acknowledge that it will not be without pain or casualty. Some businesses will fail and not emerge from this. Some will not return to the same job and need to seek employment elsewhere. Restaurant traffic will return, but at what level and when? So many variables and pitfalls impeding the likelihood of a 100% immediate recovery. After all, that is what financial markets are telling us by trading within a few percentage points of all-time highs, full and speedy recovery. Right?

Amidst this chaos, there are bright spots. A quarter ago I wrote that the real risk to our society and economy was negative feedback loops or, put simply, one bad thing causing another, which makes the first thing worse and so forth. Profits, personal savings, and consumer spending are some examples of potential circuits that have certainly been impacted but the effects have been modest thus far. The negative feedback loop is created when businesses attempting to preserve profits cut wages or lay off a portion of the workforce. When this is done in a broad manner, like what is happening now due to pandemic-related shutdowns and layoffs, it has the potential to create further reduced profits in a vicious cycle of cost cutting by business and reduced spending by consumers. At an aggregate level, businesses derive their profits from consumer spending. If business interferes with the consumer's ability to spend, they can subsequently destroy profits for themselves as a whole. To date, the impact seems to have been mild, likely saved by fiscal intervention such as the CARES Act and Payroll Protection Program loans to small businesses, which have kept incomes flowing and more receiving paychecks than would otherwise. Additionally, the Fed has done a sound job of maintaining liquidity in credit markets and thereby preventing, at least temporarily, a wave of defaults on corporate debt that could have initiated another negative feedback loop. This list extends well beyond the two prior examples (mortgage defaults, bank failures, pension losses…etc.). Given that any/all of them could have made for a disastrous outcome, the fact that we are mentioning their effects as being only modestly felt is certainly a positive.

Repairing the Damage



Source: Open Table, Homebase(https://joinhomebase.com/data)

Small business activity has slowly started to rebound, as stay at home orders have been lifted across the country. This is reflected across a number of metrics including the number of businesses open and hourly employees working, hours worked, as well as sit down restaurant traffic.

Avoiding feedback loops are likely to be the most overlooked, but perhaps the most important positive achievement to date. However, we are also seeing some real progress in other areas.

- Restaurant traffic remains greatly diminished but has rebounded from complete shutdown and is now operating at about 40% of their levels from one year ago. Relative to the near 100% shutdown in sit-down dining, this is a positive first step.

- As many states have emerged from shelter in place orders, which prohibited all but essential business from operating, the number of hourly workers actively employed has steadily increased, as has total hours worked.

- First time unemployment claims have declined from a peak of 6.9mm on March 27th to 1.4mm on June 26th. While this remains very elevated vs. prior periods of job loss, again this shows progress. Continuing claims have also declined to 19mm.

Disconnected Valuations

While we face a myriad of economic landmines and opportunity to come, US financial markets have recovered to near peak levels. Fed Chairman, Jerome Powell, in his remarks on June 10th stated that he expects real GDP to decline by 6.5% in 2020, which would place the economic decline in the worst 10% of all economic environments since 1926. The year over year change, 2nd quarter 2020 compared to 2nd quarter 2019, is likely to be multiples of that number. Should this tell us anything about equity market performance? Probably not in the very short-term, amidst immediate and continued Fed support and intervention. Therein lies the problem. As the Fed “fixes” the economy are they creating an unsustainable bubble of equity valuations, with not much more than diminished earnings and zombie companies to support it?

Absent Fed intervention, what is typical for stocks during poor economic environments? After all, the answer to this question is relevant once the tide goes out and stimulus is tapered or removed. To study this, we need to look beyond GDP data which is limited in availability prior to the 1940’s and substitute Gross National Product (GNP) for Gross Domestic Product (GDP). The differences between the two are subtle, GDP measures domestic production that is only produced within our borders. Gross National Product (GNP) includes production from abroad, but only by US citizens. Over long periods both have grown at about 3% per year and generally follow the same pattern, so for purposes of this exercise, GNP is a more than reasonable proxy.

From 1926-2019, the average of 1-year returns for the S&P 500 was 12.38% per year. Isolating the worst 20% of economic environments, as defined by GNP, saw economic output drop by 4.03% on average (1926-2019). Under these conditions, the average 1-year gain for the S&P 500 was a somewhat shocking 16.85% per year, nearly 4.5% better than the overall average. The opposite scenario, the top 20% of all economic environments led to stock market gains of 10.46% per year on average, still good, but well shy of what was generated during times of economic strife. So, bad economies lead to good stock performance? They can. You see, markets typically lead economic results. By the time the economy is in rough shape, stocks would have typically fallen in anticipation of that, leaving investors with lower valuations and conditions that are ripe for recovery.

The average valuation for US stocks from 1926-2019 was nearly 20x earnings, using one of our favorite metrics for studying long-term stock results, the cyclically adjusted price to earnings ratio using 20-year earnings. The quick explanation is that we prefer this metric because it tends to do a good job of smoothing things that may be distorted by normal cyclicality. Isolating the worst economic climates confirms our prior theory that stocks usually become discounted in anticipation of tough times. The average valuation in these environments, that bottom 20% that we discussed earlier, is just 12x earnings vs the aforementioned average of 20x. How about when stocks are cheap (1 standard deviation or more undervalued) in this type of environment? In these environments, gains were 40% per year on average. Therefore, it should not be surprising that well below average valuations accounted for above average gains. What occurs then if valuations are not discounted? That is, what if the market isn't cheap when the economy experiences its rough patch? In bad economic environments (bottom 20%) where stocks trade at fair value or above, the average one-year gain for stocks is about 8.4%, half of the overall average for the bottom 20% economies. Increasing the valuation has clearly had an impact on what can be expected. That being said, most of us would probably be quite satisfied with an 8% gain in a rough patch such as this. However, if stocks are just modestly overvalued (defined by ½ standard deviation above fair value or more), the average gain is only 1% per year. Today, markets have recovered from their March lows and trade at 34x earnings on a PE20 basis, an expensive level to put it mildly.

Bad Economies Can Lead to Good or Bad Stock Returns

Market Performance During Worst 20% of Economic Environments[1] 1926-2019		
Valuation Level	**Valuation Multiple (P/E20)**	**1 Year Performance**
Most Expensive (Top 20%)	21.67X	1.01%
Above Average (>50%)	19.33X	8.40%
Below Average (<50%)	11.49X	24.15%
Least Expensive (Bottom 20%)	10.49X	40.61%
Overall Average	**12.37X**	**16.85%**

[1] *Economic performance measured by Real Gross National Product (GNP)*

Source: NBER, MPI Stylus, Standard & Poors

Most expect that poor economic environments simultaneously lead to poor stock returns. This is not always the case, since equity markets typically anticipate the poor economic environment and experience their pain prior to the event. This leaves a heavily discounted market with rock bottom, but improving fundamentals that are ripe for a rebound. But when valuations remain expensive in these environments, results can be poor. After rebounding from recent March lows, the S&P 500 now trades at 34x earnings (PE20), one of the most expensive levels in the past 100 years.

While we have many challenges ahead, we have also made great progress. It appears we've dodged the worst of the economic crisis by containing events that could spiral badly out of control. Our central bank, acting as a lender of last resort, restored order and liquidity to financial markets amidst the chaos of the COVID-19 outbreak. Policy makers were quick to throw a lifeline to workers and businesses alike and, as a result of these measures, markets have recovered most, if not all of their losses. But, to say caution is warranted is an understatement. We do not know at what capacity our economy will be able to operate and for how long, if schools will reopen, how many businesses might fail, and if we will have another spike in COVID cases come Fall. Each of these present a fair amount of risk individually.

Collectively, I would call the risk substantial. Historically, we have shown that markets typically do well during times of economic strife, but this is primarily due to discounted valuations that come as a result of the damage. In environments where valuations remain high, as they are today, the results are quite poor, especially when considering the elevated risk that exists.

We continue to encourage investors to take this opportunity to work with their financial advisors and properly assess your tolerance for risk given your goals and objectives. Did you feel a bit anxious in February and March? If so, it might not be a bad idea to reduce your risk level while markets remain elevated. What else can you do? If investors are to meet their objectives, we believe that we all must dare to be different, embrace over-diversification, and do what is painfully obvious, at least to us. That is, to own assets that are likely to generate better returns in greater quantity, in place of those that are unlikely to meet investor needs. These include larger weights to assets outside of US equities.

As we normally do, we began this article with a Benjamin Graham quote, *"The individual investor should act consistently as an investor and not as a speculator."* What does that mean? Investors acquire the earnings, profits, and cashflows from viable businesses at a reasonable price because they have made an informed decision about the business. This can be done at a market level through an ETF or index mutual fund or through individual stocks and bonds. Speculators acquire assets because they believe that the price will be higher without regard for the fundamentals. We take pride in being investors, never speculators, and for the privilege of acting as informed advocates on behalf of our advisor partners and their clients. Thank you as always for your trust and confidence. Please be safe and be well.

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