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INVESTOR INSIGHTS – SECOND QUARTER 2020

The Worst Quarter We Have Experienced

Let's start by reviewing the first quarter. The S&P 500 started the year at 3,257 and rose peaking on February 19 at 3,386. From there the market fell with only a few minor corrections hitting a low on March 23 of 2,237. In slightly more than one month, the index fell by one third and March finished as the most volatile month in the history of the index. It rose to end the quarter at 2,584.

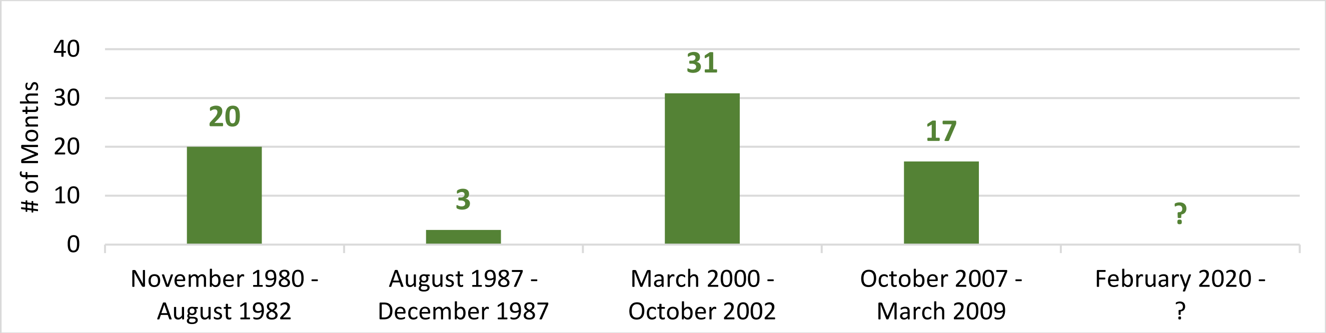
Dow Jones defines the technical definition of a bear market as a decline of 20%, and this decline happened faster than at any other time in history. So, we are in a bear market, which is not news to any of you, but the contrast of where we were and where we are is a surprise. Last year the P/E expansion of the S&P 500 was 27%. Investors were giddy with the expectation that our economy and stock market were in great shape and that the P/E expansion of last year was justified, yet here we are just 90 days later and the illusion of a great economy and stock market has disappeared. We are in a recession. Q1 will show negative growth of 1% or 2%, but Q2 will show negative growth of 10% to 15%.

John Templeton often talked about the four stages of a market: pessimism, skepticism, optimism and euphoria. 2019 was certainly euphoria, a 31% rise after nine years of an unbroken rise in stock prices. So, where are we now? Let's look at bear markets to gain some insights.

Bob Farrell, the great Merrill Lynch analyst, has ten rules for investing and number eight deals with bear markets. Bob wrote, "Bear markets have three stages: a sharp down, reflective rebound and a drawn-out fundamental downtrend". By any standard, February 19 to March 23 is a sharp down! From March 23 to March 26 the S&P 500 went from 2,237 to 2,629, a 17.5% rise. Was this phase two, the reflective rebound? As of today, we do not know. It certainly was reflective, but the speed of it makes one wonder if there may be more to come. Also, Bob did not have a rule that the fall or the rise after the fall had to be uninterrupted; markets are almost never uninterrupted.

The important point about Bob Farrell's analysis is the third phase, a drawn-out fundamental downtrend. Let's look at the two parts of that phase. Drawn-out was chosen because Bob observed that bear markets, especially those connected to a recession, are not a short-term phenomenon; they last many quarters. Chart 1 shows the length of the last four bear markets.

Chart 1



Source: S&P Compustat

Fundamental means investors change what they need or want. In the euphoria phase, investors are looking for participation in the rise of stocks without regard for the quality of the companies they buy; while at the bottom of the pessimist phase, investors want safety and quality. In the heart of euphoria, investors will buy anything without regard to its price; while in the heart of pessimism, investors are often too scared to buy anything, even bargains.

Now one can never be certain exactly where we are in the bear market cycle, but what we can say with surety is we are not in pessimism. We certainly have left euphoria. Some may be thinking we are headed to new highs this year and more of the same next year, but that group today is very small. The uncertainty of the duration of the coronavirus is what makes it difficult to say with precision where we are.

So, where do we go from here?

You have likely read that there are three possible recovery cycles for this retrenchment of stock prices: a V-shaped recovery, a U-shaped recovery and an L-shaped recovery. The definitions are quite simple. A V-shaped recovery means we will bounce back to exactly as we fell and everything will be back to where we were in December. A U-shaped recovery means it will take some time, perhaps a year or so, for us to hit bottom and be on the upswing. The L-shaped recovery is the most bearish; it suggests there has been permanent damage done to our economy and it will be many years before we recover.

We think the V-shaped recovery is a fantasy. We are not going back to thinking that 20 times earnings is the right price level after we have been quarantined and seen our federal government pass a stimulus bill 2.5 times the stimulus of the Great Financial Crisis of 2008. Part of the last phase of any extended bull market is capitulation, which is where disciplined investors see themselves missing out on index returns at high levels and just give up and buy in. That certainly happened last year, but the pain those disciplined investors are feeling today will not support a return to a 20 P/E. They will remember this pain for a long time.

The L-shaped recovery is certainly a possibility but not likely. The scenario that would cause an L-shaped recovery is one where the coronavirus returns in the fall with a second strain and causes the globe to have a closed economy for the rest of this year and part of 2021. The displacement of businesses, jobs and assets in this environment would mean it would be years before we recovered, and recovery would have a different look than what markets looked like in 2019.

We will have a U-shaped recovery. While the numbers are not reported until after the end of each quarter, we are most likely experiencing negative GDP growth this quarter and will absolutely experience large negative GDP growth in Q2. Likely GDP will be -2% on Q1 and -15% in Q2. GDP estimates after Q2 are guesses and will depend on how our recovery from the coronavirus plays out. Some reports suggest we will snap back into our old habits of travel, using restaurants and going to movies, plays and sporting events while others suggest this process will be gradual. The former would result in positive GDP for Q3 and Q4 while the latter would suggest very muted GDP numbers, perhaps positive but very low.

The reality is we do not know what this will look like, but we do know that we are all experiencing a trauma. Mothers and fathers are effectively home schooling their children while holding full time jobs. Senior citizens are paranoid of what might happen to them or their friends if they come down with the virus. It is nearly impossible to have a conversation today without inquiring how everyone is doing.

The likelihood of us moving from this trauma to spending like we did last year seems highly unlikely. We think there will be an adjustment. We will not be taking vacations like we did in the past, at least for some time. We will not rush out to our favorite restaurants nor even be having friends and family at our homes. In addition, we likely have found some new books we have enjoyed and movies or television series we like, and we have found there is peacefulness to a slower life.

This is why we think the U-shaped recovery is likely. The U-shaped recovery is what Bob Farrell is suggesting in his description of the three stages of bear markets. It is important not to take the shape of the U literally. This description simply means we will recover, slower than a V-shaped snapback, but there will be a recovery.

While this is a traumatic time, it is important to remember this will be part of our history at some point. We will recover from this, have a vaccine and be able to move freely in the ways we have historically. In addition, no government will ever again be caught unprepared as we and the world were by this pandemic. There will be a group in Washington studying this and future pandemics, so we will have a plan when the initial signs of the next pandemic hits us. This will be true of every nation.

How Will Investing Change during and after the Recovery?

To date, stocks have fallen indiscriminately, high-quality or low-quality, prices are down. Some of this was caused by margin calls. When one gets a margin call, they may need to sell not what they do not want to hold, but what they can sell. So, companies with great balance sheets and low debt declined as much as highly leveraged companies that may have a tough time remaining in business. This is reminiscent of the 2008 decline, when all correlations went to 1 and everything declined.

The next phase, which Bob Farrell calls the fundamental drawn-out downtrend, will be more discriminate. Our Global Core Equity portfolio has a yield of 5.75% at quarter end. We have stress-tested these holdings with our managers and all of them believe we will have dividend stability and likely dividend growth this year. So, if we see a stock decline of 30% from these levels and our portfolios fall with the market, the yields would be over 8%. Possible, sure. Likely, absolutely not. We think the safe investments that investors will gravitate toward are our portfolios.

Fine, When?

Given that no one knows, here is our best answer to that question. We will look at it three ways: valuations, our personal recovery from this trauma and what the best strategists and Fed data are suggesting.

The decade of the 2010s was the worst decade ever for earnings growth. Top line growth of companies after the Global Financial Crisis was not good. The last six years of the decade saw almost no growth. What investors substituted for top line growth was P/E growth. The 2017 corporate tax cut was used to buy back shares. Certainly, there were other uses, but the level of buy backs was extraordinary. The impact of share buy backs reduces the divisor, thus increasing quotient. In P/E terms, this means the same earnings divided by fewer shares results in the earnings expanded per share. So, P/Es expanded but cash flow and top line growth did not. This cannot go on indefinitely; in fact, it is surprising it went on as long as it did. That is what Euphoria does.

What this means for valuations is we have likely seen the peak P/Es for this period. The logic of a 20 P/E was that with rates as low as they were, a high P/E was justified. Analysts compared what they called reasonable P/Es to the P/Es of 1998 and 1999 during the Tech bubble. It is true we did not hit those levels, but we would ask why this was even a consideration. During this period, dotcom stocks were priced based on members not earnings or earnings potential, and the Nasdaq fell 80%. This argument did not hold water last year and looks even sillier today. After we come out of this crisis, we will still have low rates, but we will also have much higher debt. We just passed a $2.5 trillion stimulus package, 2.5 times the amount of the 2008 stimulus, and we now have QE to eternity. Might we have another stimulus package? Absolutely, unemployment claims for the last three weeks have totaled more than 12 million, and this does not include anyone working in the Gig economy. So, will investors take all of this into account when valuing companies in the future? We think it is logical they will.

The consumer represents 70% of our economic activity. So, we need to ask ourselves are we returning to our share of that 70%? Will we take as many vacations in 2020 and 2021? Will we go to as many plays, eat out as often or go to as many movies? How do we feel about cruises? These relate to our personal recovery. And what do we think the 12 million people who are not unemployed will be doing? We all read the surveys of how many Americans could not withstand a sudden need for $400 expense. What we know unfortunately is that there will be millions of these folks who will face that dilemma. Our best guess is we will be slow to move back in. We may have learned some things about the enjoyment of staying home, playing board games and watching movies as a family or a couple. In addition, millions of us will need to find loans just to survive.

What we see is a slow recovery. We see lower GDP levels and all governments filled with more debt. We see budgets bursting with lower income levels personally for our population and at all government levels. None of this suggests a bounce back to a high P/E stock market.

The strategists we admire are all urging caution. Now it is true you can find analysts suggesting a V-shaped recovery and a return to a 20 P/E multiple. We just cannot understand their calculus. We will look at two analysts we admire and a Fed survey that shows a remarkable change in business attitudes.

Mohamed El-Erian gets wide exposure in the press and on television. He is the chief economic advisor at Allianz, the parent of PIMCO where he served as CEO and Co-Chief Investment Officer. Mohamed has been warning for some time of caution, mirroring our analysis of the euphoria of 2019. When the market started its decline in February, he warned not to buy on the dips, and he continues with that advice today. His advice suggests we understand this crisis as a health crisis which needs to be fixed before we can fix the economic and investment crises that have accompanied the health crisis. He suggests we will have sharp profit declines, which will continue to cause high levels of unemployment and will require government intervention. Mohamed suggests we focus on the impact of the sudden stops this crisis has created, and the difficulty of restarting an economy after the shutdown. Mohamed is telling us we will have a very slow recovery and our normal will be a new normal.

The Dallas Fed does a monthly survey on manufacturing activity and business outlook. The production index fell from 16.4 to -35.5. The general business activity index went from 1.2 to -70.0, and the company outlook index went from 3.6 to -65.6. The index measuring uncertainty went from 11 to -62.6. If you have an interest, you can go to the Dallas Fed website and read about the details of each survey. What we find important is that all of these represent the lowest recordings since the survey was started in 2004. In other words, all of these are currently worse than they were during the 2008 Global Financial Crisis.

Many of you may know of David Rosenberg from Rosenberg Research because he was widely followed during his days at Merrill Lynch. He warned investors while at Merrill Lynch to raise cash in late 2007 and to be aggressive about investing in March 2009. He recently published a piece and one quote summarizes our view best. After saying cash is king, David said this, “I’ll tell you when it is safe to start getting bullish again and in size. When the NBA and NHL hold their playoff games in front of crowds, when the baseball season begins, and when Broadway reopens. These happen, and yours truly will be doing a wholesale asset mix shift!”

So when will David Rosenberg’s time come? After we have a vaccine! We will see all of us moving freely, filling stadiums and theaters. We wish we knew a date certain for when that was, but it is reasonable to assume it could very well be one year from now. Could it be sooner? Certainly, it could be, and that is our prayer every day. But we do not think it is prudent to expect it. If it happens, we will all be thrilled, and we would suggest we be realistic about the news. The issue for our country and the world is not just that we get a vaccine, but that we find the ability to manufacture it in quantities we have never imagined. We need 300 million doses, Europe 450 million, China 1.4 billion and India 1.3 billion. This leaves out the entire southern hemisphere and a good deal of the northern hemisphere. What we think we will see is enormous cooperation among nations. The reality is we live in a global economy, and in order for us to do well, all nations need to be safe.

Our Perspective

We know it’s tough for your clients to stay calm when markets are volatile and bad news fills the airwaves from morning until night. We understand that you are most certainly the touchstone for much of the economic worry and angst they are experiencing. We want you to know we are here to help with whatever you need. Just say the word. We are taking and encouraging the long view but understand the difficulties you are facing. If you need something that can make your life, or your clients’ lives better, please let us know.

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