July 20, 2020

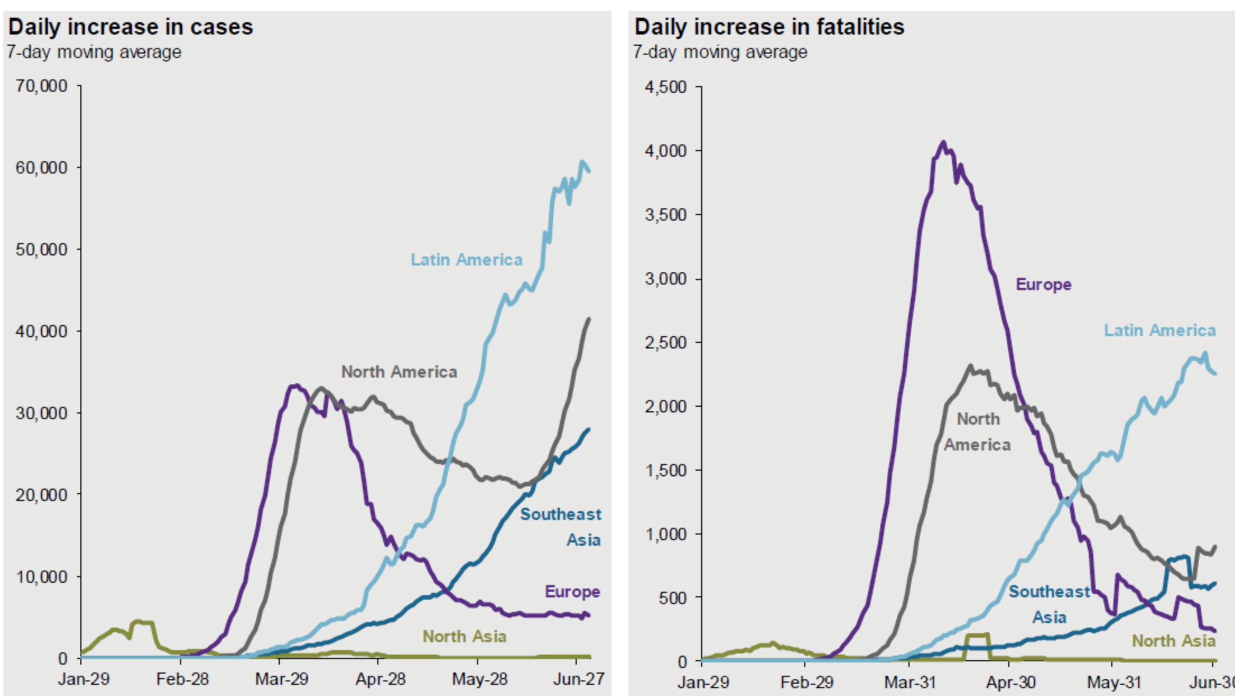
Waves and Tides

Money Tsunami Drives Recovery

The wild ride continues. After the COVID-19 virus prompted an economic shutdown resulting in roughly a 17% drop in global economic output, economies around the world are rapidly re-opening and growth is quickly accelerating. The US stock market, which dropped almost 35% in five weeks, has now rallied 45% from its March lows. Unlike during the ‘08/’09 financial crisis, credit markets have quickly re-opened: US high yield bond issuance set an all-time monthly record in June, and mid-year 2020 issuance was 55% higher than the first half of 2019. Contributing greatly to the rapid market recovery is the aggressive policy response to the crisis, (both in the US and globally), which has seen trillions of dollars of fiscal and monetary stimulus pumped into the global economy. Additionally, the Federal Reserve has indicated that it will keep short term interest rates at 0% for at least two years. This flood of cheap money and the Federal Reserve’s expanded purchases of debt represent powerful tailwinds for the economy and financial markets, which (for now) have overwhelmed concerns of a resurgence in the virus, and a possible double economic dip.

In fact, a resurgence in virus infection rates has been occurring. Graph 1 illustrates the rise in infection rates in Latin America, North America, and Southeast Asia, which fortunately has not yet been matched by a commensurate increase in fatality rates (at least in the latter two regions). While a second virus wave had been widely anticipated by markets, and so far has not dented the market and economic recovery, persistence of this trend could prompt a second shutdown wave, putting the recovery at risk.

Graph 1



Source: JPM, Johns Hopkins, CSSE

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While we are quite skeptical of the accuracy of Wall Street forecasts for a number of reasons (including the propensity for groupthink), it's nevertheless important to follow consensus expectations, as it is those expectations that are largely reflected in market prices. Graph 2 shows the economic growth forecasts of several major Wall Street banks, the average of which reflects an expectation of a 6% decline in US growth for 2020, followed by a 4.6% rebound in 2021. These forecasts imply that the US economy will equal peak output sometime in the middle of 2022, which is also when company earnings are expected to equal pre-COVID highs. While we at Santa Fe Advisors do not delve into economic forecasting, these expectations seem to be plausible and they provide a basis for us to make risk decisions.

Graph 2

Sell-side US GDP Forecast

US GDP Growth (qoq saar)	2020 (yoy)	2Q	3Q	4Q	2021 (yoy)
GS	-6.3%	-39.0%	29.0%	11.0%	6.1%
MS	-5.8%	-37.9%	20.7%	15.9%	5.3%
JPM	-6.6%	-40.0%	23.0%	10.0%	3.7%
BAML	-8.0%	-40.0%	7.0%	12.0%	4.0%
Citi	-3.3%	-27.6%	22.2%	9.9%	4.1%
Average	-6.0%	-36.9%	20.4%	11.8%	4.6%

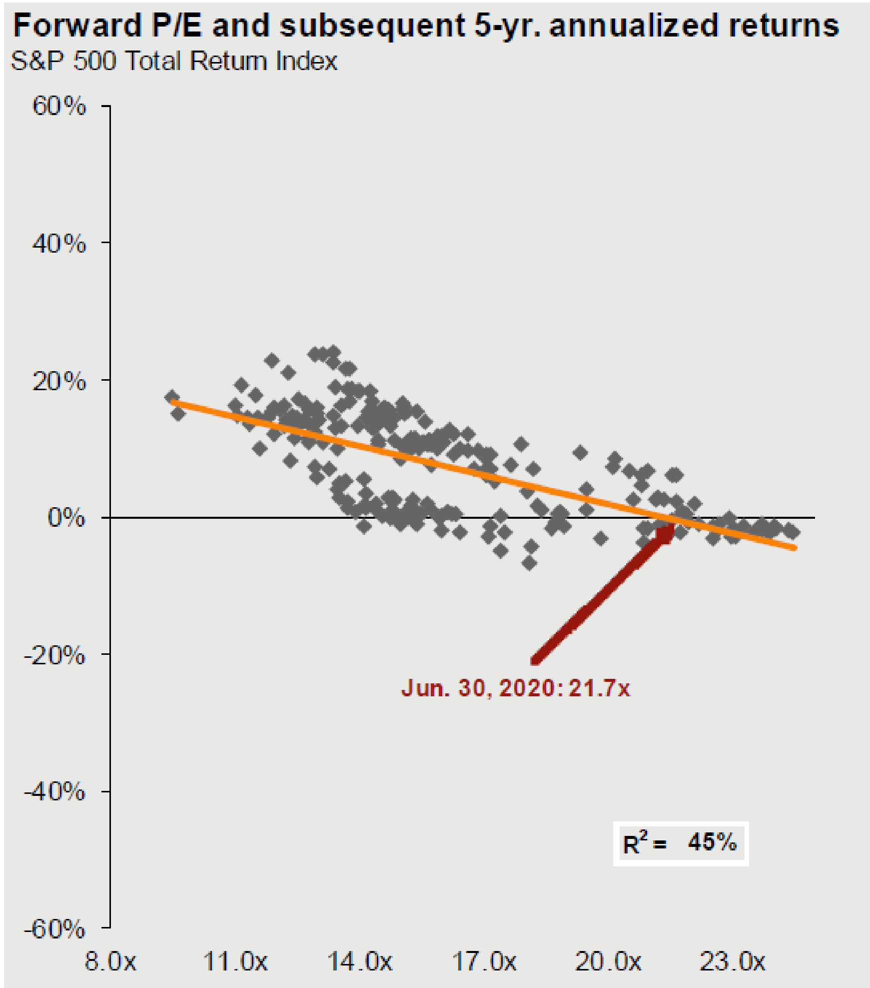
Source: Neuberger Berman, GS, MS, JPM, BAML, Citi

Valuations and Swimming with the Tide

We are well aware that the determination and magnitude of policymaker support is likely to drive markets higher in coming weeks and months. Cash has to be deployed, and investors are being given significant incentive to buy risky (assets such as stocks) given the paltry yields available in high quality bonds in the current low rate environment. Nevertheless, we invest with an intermediate timeframe, and believe that an assessment of valuation is critical, even in the face of a powerful trend. Currently, the S&P 500 is trading at a price/earnings (P/E) multiple of 22x expected earnings for the next year, a lofty level which is more that 45% above the 20 year average of 15.5x. In other words, stocks are quite expensive…even if consensus earnings forecasts are met (which is hardly a given).

Market trends tend to persist, and valuations are poor predictors of returns over short time horizons. However, valuations have historically offered at least some insight into returns over subsequent intermediate time periods. Graph 3 illustrates the historical relationship between S&P 500 valuations and subsequent 5 year annual returns, and shows that when stocks have traded at today's forward P/E multiple of 22x, subsequent 5 year returns have been close to zero.

Graph 3



Source: JPM, FactSet, S&P

So, while the tide of free money and the dearth of attractive alternatives to stocks are likely to propel the rally further, we are reminded of one of Warren Buffet's most famous quotes: ***"Only when the tide goes out do you discover who's been swimming naked".*** While we are agnostic about swimwear choices (or the lack thereof), we find the idea of taking excessive equity risk at these valuations to be decidedly unappealing. As a result, after adding portfolio risk in early March, we recently made a tactical change across our portfolios, in the form of a material risk reduction. We trimmed positions in US and developed international stocks, as well as in REIT stocks, and international fixed income. We also shifted floating rate high yield bond exposure to fixed rate high yield, anticipating that the former will not benefit from rising interest rates for some time. The net of our tactical change took our portfolios from a modest risk overweight position to a modest risk underweight, which we think is prudent in this environment, regardless of the way the tide is currently swiftly moving.

Thank you for your support and trust, and please don't hesitate to contact a team member if you'd like more details on our recent tactical move, or if you'd like a strategic review of your financial situation given the rapidly changing environment. Above all, be safe and enjoy your loved ones during this interesting and challenging time.

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