# GLOBAL PORTFOLIO STRATEGY

# Infectious Investing

*Photo: Brian McGowan on Unsplash*

The speed of the equity market decline shares a common trait with the bull market that preceded it: they are both unprecedented in their length. The longest bull market gave way to the fastest crash in US history. Investing was infected with the economic calamity that results when whole segments of an economy close their doors. Uncertainty abounds. How long will the virus mitigation strategies endure? Do fiscal and monetary policies meet the moment? How are corporate earnings affected? Since the moment is unparalleled, prior references are inadequate guides. This outcome is the paradox of an era of copious data and abundant analytics: investors must forecast based on the coherence of their argument, rather than the precision of their analysis. Our argument is simple: this too will pass, and companies with a defensible market position and robust financing will endure.

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The economic challenge of the time is consumer behavior: how can we minimize a permanent reduction in consumer spending?

Investing is, and always will be, about value. What companies or sectors will weather the storm and consolidate their market position?

- Jason Prole

"

## Highlights

- US **equity** valuations are high, and value is contingent on the sector or region.
- **Interest rates** will maintain their levels for years.
- **Credit spreads** look too low based on the extent of economic uncertainty.
- Demand will constrain **commodities** with energy facing a reckoning.
- The absence of safe-haven alternatives supports the **US dollar.**

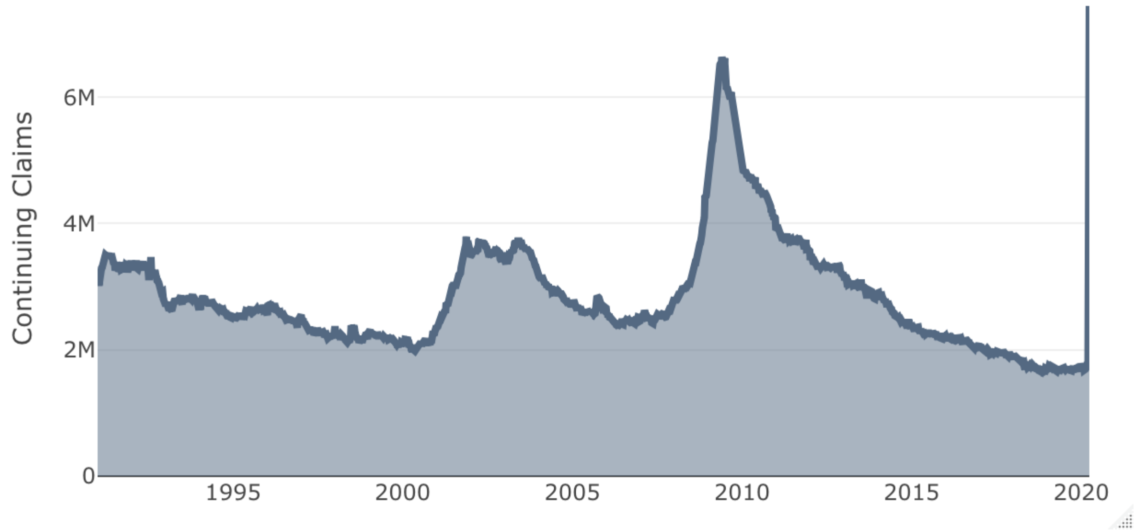
# The Economic View

**This time is different** is often the most incorrect phrase in economics. For once, it may be true as this moment is unrivaled in our collective economic memory. While the Spanish Flu of 1918 is an apparent reference, we have neither the experience of anyone who lived through the episode nor adequate data to infer conclusions. Fortunately, all is not lost. Today's economy is understandable and abundant data exists to use in the analysis of the argument. The critical element is a coherent argument and consideration of the sensitivity of the outcome to our assumptions.

**For once, this time might be different.**

There is never any certainty in forecasting the future. All we can do is deal with the data in front of us and deduce logical conclusions. In this context, initial claims for unemployment provides high-frequency data that is sobering: unemployment claims have already exceeded the peak in 2009 that took a year to achieve (exhibit 1). This time: *two weeks*. This time *is different*.

Exhibit 1. US Initial Claims for Unemployment Insurance




*Source: Federal Reserve Economic Database*

**Will consumer behavior change?**

The vital question for investors is whether consumer behavior will change *permanently*. The answer is contingent upon the duration of the pandemic. As consumer behavior changes are ingrained, the impact on consumption will

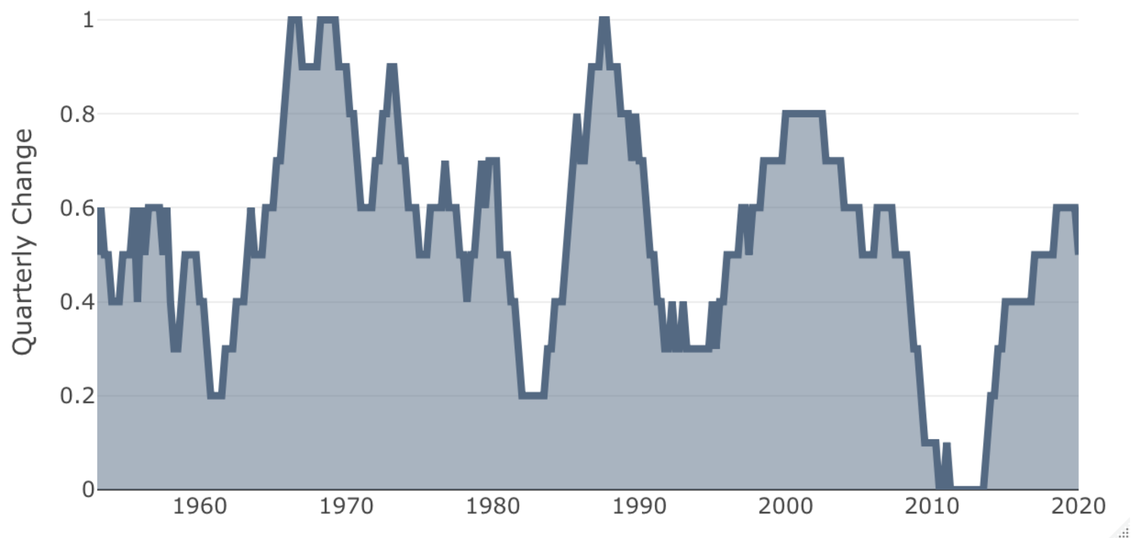
# The Economic View

endure. The effect of the Great Depression on consumer spending endured for decades as frugality dominated, and savings increased.

**Consumption may return to Depression levels.**

The difference in consumption is significant. In the two decades after WWII, real consumption per capita was roughly half of the boomer rates for the following four decades (exhibit 2). How does this apply to today? The Millennial generation entered the workforce over the prior decade. Yet, consumption did not exceed the rates that occurred immediately following WWII. This result is related to both the Great Recession and the Boomer generation entering retirement and their slowing consumer spending. The Coronavirus Pandemic sets them financially back again, this time as they enter the prime household formation and consumption years.

Exhibit 2. US Real Consumption Per Capita




*Source: Federal Reserve Economic Database*

**Consumer spending slowed for decades.**

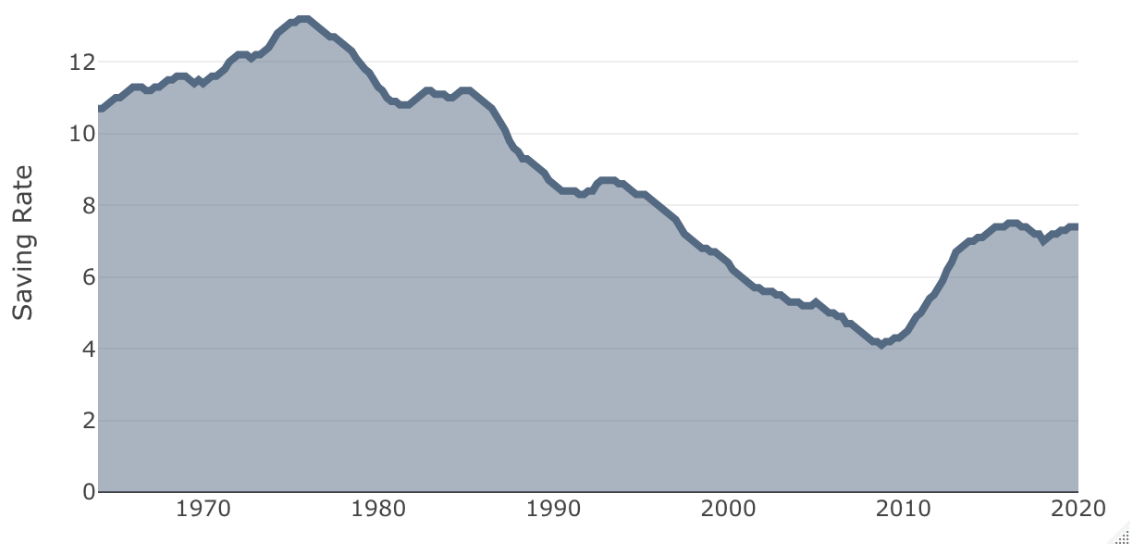
Changes in consumer behavior take time to infer. While we can monitor the growth rate in consumption and changes to the composition of the basket, their variability leads to uncertainty to any conclusion. The most likely indicator is the savings rate. The memory of the Great Depression kept the savings rate going up well into the 1970s, which was over *three decades* after WWII and *four decades* past the Great Depression (exhibit 3). The recent Great

# The Economic View

Recession led to an increase in the savings rate; however, the rate is *unmoved in 6 years!*

Exhibit 3. US Private Savings Rate

**Saving rates increased for *four decades.***




*Source: Federal Reserve Economic Database*

The Millennial generation should be saving more to begin household formation, but they are not. Consumer behavior changed after the Great Recession as the savings rate increased, then the rate of increase plateaued. This outcome portends *weak consumption growth* after the world returns to normal from the Pandemic period.

**Reduced consumer spending may reduce GDP growth by 0.5%.**

Overstating the significance of this outcome is difficult. One-half of a percent increase in savings would reduce personal consumption GDP growth by a similar amount. This consequence is a staggering amount over decades that would resemble a reduction in output nearing *two trillion dollars*. This magnitude would undoubtedly exceed the current expectations for the Pandemic induced recession of one-two trillion dollars. The conclusion is apparent: fiscal policy should be targeted, enduring, and promote behavior that reduces the chance of permanently reduced consumption.

# Equity Markets

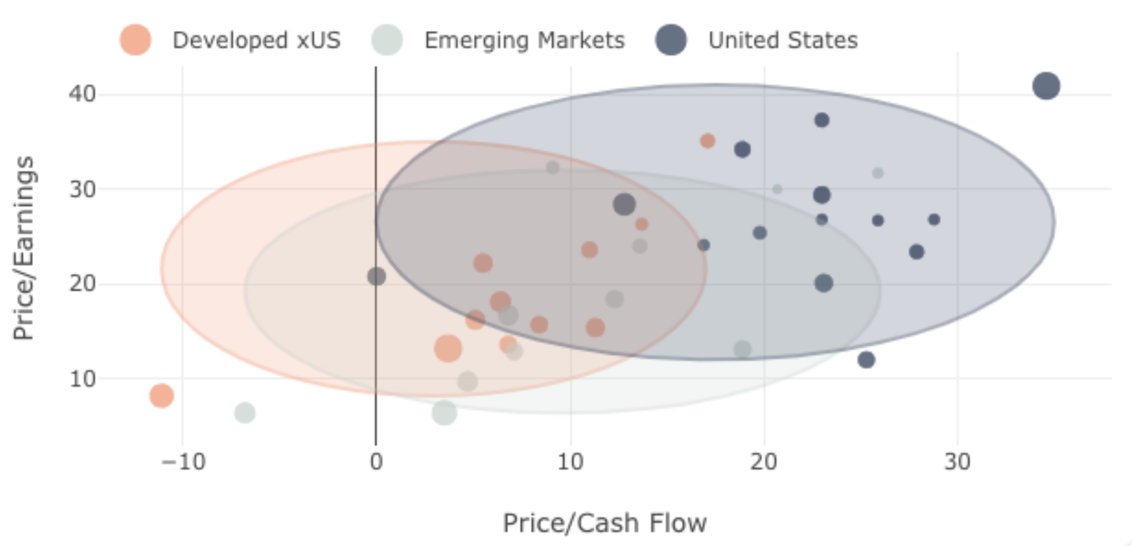
**Closure length will determine the impact extent.**

The collapse of the equity market provides one saving grace: value is emerging. Whether the current state is a value trap is the crucial question. Under the usual circumstances, a thirty percent decline in equity markets provides a strong impetus to buy.  The problem, particularly for US investors, is that the initial starting point was high in absolute terms. The high starting point and the uncertainty to the long-term impact of the Pandemic combine to make it difficult to answer the question if the market fell enough? The quick answer: any rebound should be short-lived as the extended length of the mitigation strategies becomes apparent. The critical question is *when and where will value emerge*?

While the global equity rebounded roughly ten percent after a fall of more than thirty percent, it remains at a level achieved before implementation of the US tax cuts in 2017. This implication is ominous: the market is signaling that the destruction of wealth is in the *trillions*. A further recovery in markets can occur from here; however, its durability is questionable. Value existed outside of the US before the Pandemic and provides an avenue for investing; however, a recovery in US markets should be consistent with the expectation of *lower profits and the prior high valuations*.

**Relative valuations are high for the US.**

Exhibit 4. Global Equity Valuations by Region and Sector




*Source: S&P Indices. Size of marker reflects the dividend yield (larger is higher).*

# Global Equities

**Risk assets are well priced versus bonds.**

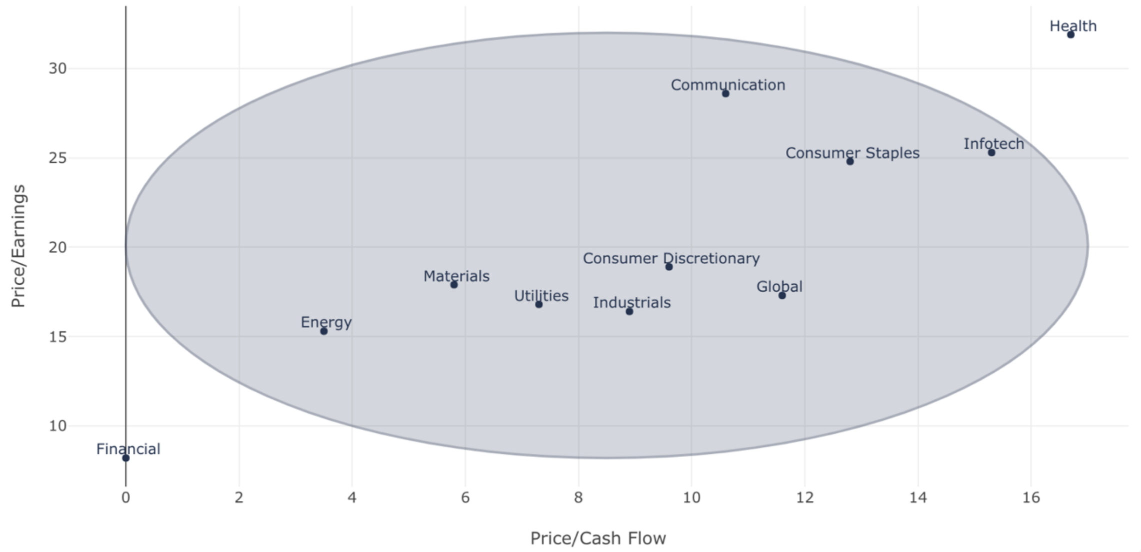
Globally, valuations seem at fair value. The price of cash flows is under 12 and the price of earnings around 17, which are yields of about 8% and 6%. Relative to the approximate 0.6% yields on US Treasuries and Non-US dollar debt, they are compelling yields that offer sufficient equity premium.

The regional variation of valuations is stark (exhibit 4). The US valuations are high in relative terms, with the Developed Markets ex-US the lowest and Emerging Markets wedged between them. The implicit assumption is that the US growth will dominate the other two regions. The US maintains a demographic advantage over the other developed countries but lags the Emerging Markets, which could explain the gap. The gap, however, is *too large*.

The US valuation gap is so extreme that only two US sectors, Utilities and REITS, sit within the sphere of the developed markets valuations (exhibit 3, orange).  While an argument exists for the dominance of the US Technology sector, it is challenging to extend this same argument to *every other US sector*. This conclusion would suggest that the US sector valuation is inconsistent with the other Developed markets and, to a lesser extent, Emerging Markets.

Exhibit 5. Global Equity Valuations by Sector

**US health and Financial Sectors are outliers.**



# Global Equities

*Source: S&P Indices.*

The United States is a bastion safety in a world of unknowns. The trouble is that its response to the Pandemic is erratic and inconsistent, which lengthens the time until normalcy returns. A further complicating factor is the high valuations. How high? Even after the current market retracement, the overall valuation multiples are 24 for cash flow and 23 for earnings. Simply put, these are not market bottom valuations.

**Health Care is richly valued.**

The Pandemic does increase demand for one sector: Health Care. This sector is an outlier in global valuations (exhibit 5). As always, the vital question is whether the higher valuation relative to the rest of the market is sustainable? Indeed, higher demand for prevention equipment will occur; however, this level of valuation suggests monopolistic profits. While this could prevail in the US private sector, it is unlikely in the other global markets where the public provision of health services dominates.

**Financials offer good relative value.**

At the other extreme, the valuation of the Financial sector is depressed as they face an economic downturn of unknown duration and severity that will deliver credit losses. Fortunately for them, the unprecedented monetary stimulus by global central banks places a protective put underneath their risk. High dividend yields in the sector provide a further backstop. Dividend cuts can preserve cash if credit losses overwhelm reserves. Thus, the Financial industry may have a more robust backstop relative to other sectors making the risk of these depressed valuations manageable.

**Narrow breadth in the US may portend further declines.**

The challenge for equity markets is understanding that *this time is different*. The speed of the economic collapse, particularly in US labor markets, is unrivaled. Any expectation for a prompt return to normal must overcome poor starting conditions. The non-US global economy was already entering a recession. US equity valuations were high on a relative and absolute basis. Narrow equity market breadth focused on a few US technology stocks. Add to these starting points a possible change of consumer behavior that will increase costs and lower revenue as savings rise suggests *buyer beware.*

# Interest Rates

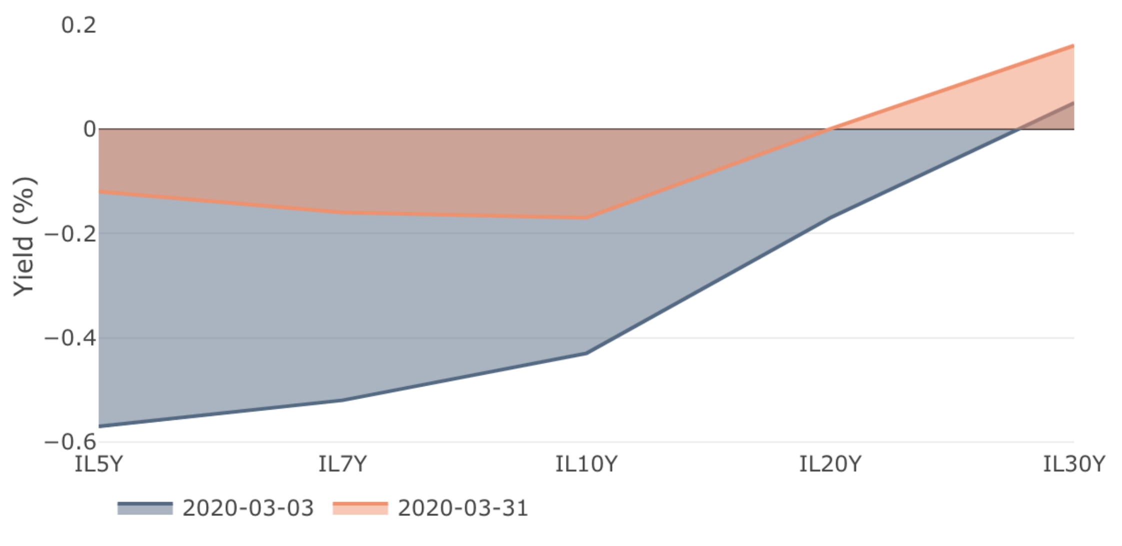
**Negative yields are expected *everywhere*.**

The world of developed market interest rates is entering territory where only the brave venture: negative rates as far as the eye can see. Investors need solely focus on the two primary drivers of nominal government bond yields: expectations for real growth and inflation. The drop in demand indeed entails lower real growth expectations over the near term. Inflation expectations, however, should take the most significant hit and drive short-term yields into negative territory for *all the leading economies*.

Inflation was already below most policy targets in the developed world *before the Pandemic*. Growth expectations are undoubtedly negative for this year and, at best, muted for 2021. In a low growth environment, then expected inflation becomes the dominant force on yields.  This result is the case of Europe and Japan, where nominal yields are materially below zero out to the 20-year term. In the US, negative nominal yields are non-existent, and inflation yields have increased over the last month (exhibit 6). *Increased* inflation expectations since the start of the economic Pandemic seem incoherent, even with unrivaled monetary stimulus.

**TIP yields are *too high*!**

Exhibit 6. US Treasury Inflation Protected Yields



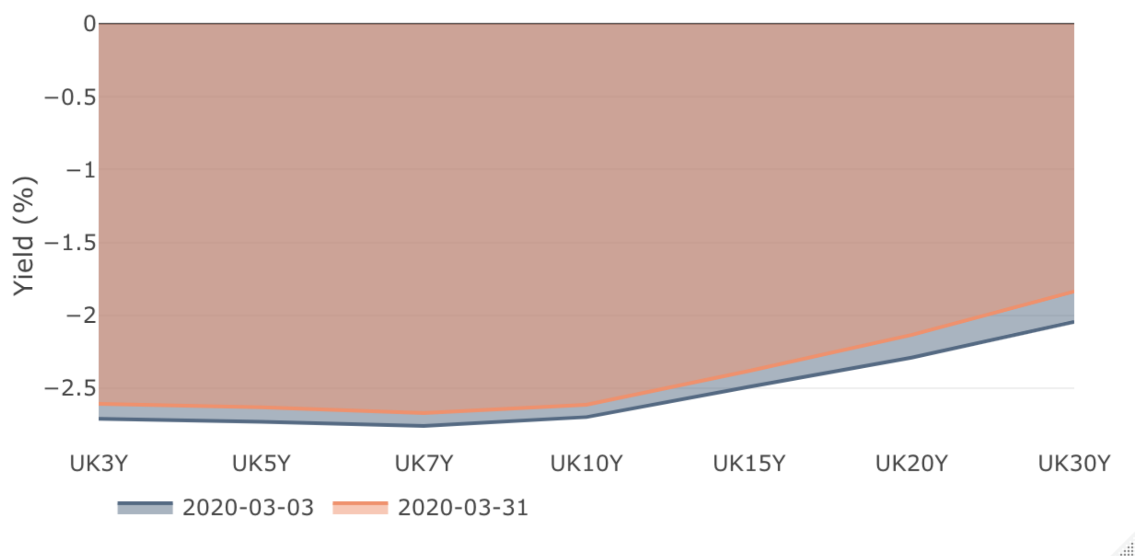

*Source: Federal Reserve Economic Database*

# Interest Rates

**Nominal yields in the UK are *too high*!**

The United Kingdom shares the same positive nominal yields as the US. There is one significant difference between the two: the level of inflation-protected yields that are under *negative two percent* (exhibit 7). Combining the inflation yields with the nominal yields arithmetically implies negative real growth across all terms for the UK. In contrast to the positive expectations for growth in the US, the UK valuation appears extreme.

Exhibit 7. United Kingdom Inflation Protected Yields




*Source: Federal Reserve Economic Database*

**Canadian yields are rich, given their economic outlook.**

A similar outcome occurs in Canada, with all of the nominal yields positive. Unfortunately, they must contend with the crumbling global energy sector that accounts for a quarter of their exports and about eight percent of their GDP. A ten percent contraction in the energy sector reduces aggregate GDP by about 1.5 percent. Thus, even in the absence of the Pandemic, Canada would be facing a recession. When combined with the Pandemic and the high leverage in the household sector, the positive nominal yields are incoherent with the situation they face. We are in a world of deficient demand and job losses that have no reference in living memory. Canada and the world require monetary stimulus that enters the shallows of negative interest rates before they find themselves in the abyss.

# Interest Rates

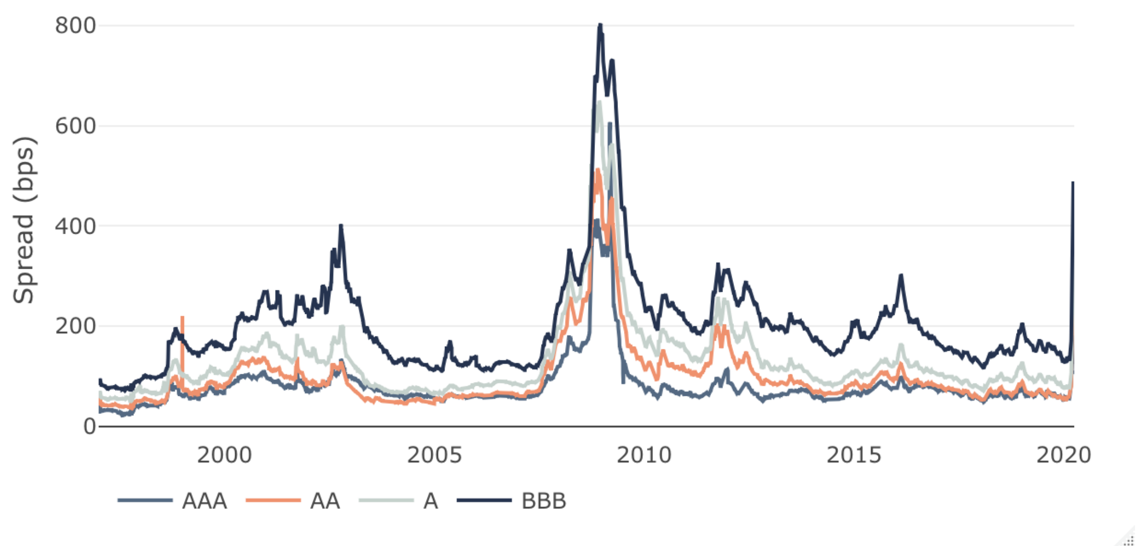
## Corporate Yields

**Spreads are not below financial crisis levels: *why*?**

The Great Recession of 2008 was a function of poor risk management by financial firms, particularly banks, which seeped into the real economy partially by the inadequate fiscal response. Critically, the mortgage loans had real assets behind them, namely the residential houses. Despite the existence of the asset, the financial industry was unable to cope and saw credit risk, as measured by spreads over the government bond, approach levels unseen since the Depression. The relevance of this outcome is material to the current situation. The dramatic toll on the real economy will probably be closer to the Great Depression rather than the Great Recession. Yet, spreads have not approached this prior level of stress.

Exhibit 8. US Corporate Spreads

**Spreads will widen as the economic impact becomes evident.**




*Source: Federal Reserve Economic Database*

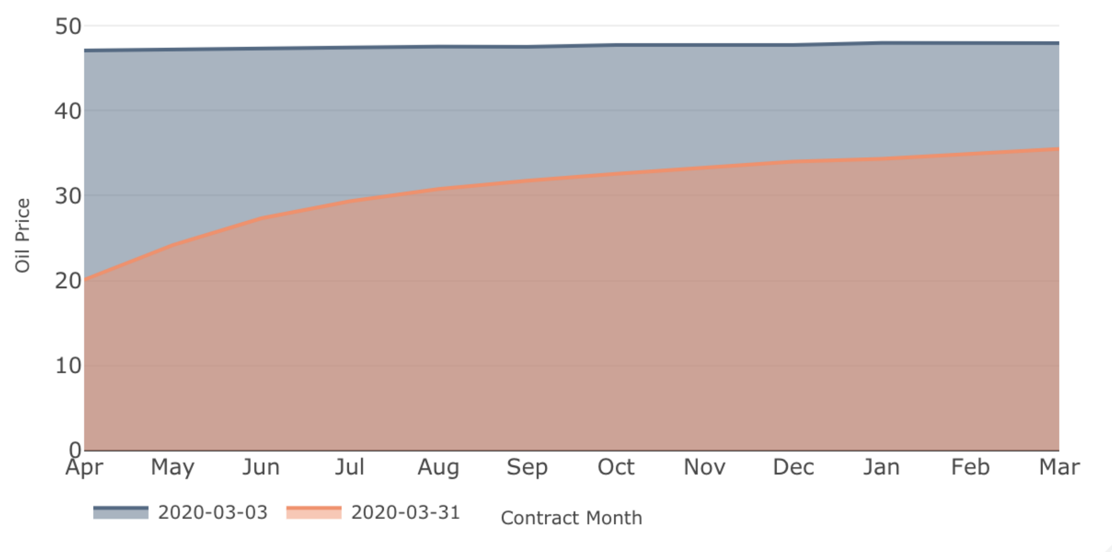
The story globally is similar to the US example. In the presence of an unmatched demand shock, it is highly likely that demand will return slowly and cause pain for those companies where leverage is high. Consumer-facing sectors, particularly discretionary spending, are highly vulnerable to this demand shock. This time the credit cycle *is not different*.

# Commodities

**Low oil prices will endure.**

Commodities have enjoyed the last two decades as the convergence of increasing demand from China with a somewhat constrained supply. Now, the dynamic is in reverse as Chinese demand abates, and supply expansion may have gone too far, particularly in the energy sector with oil fracking. This outcome was the catalyst for the Saudi-led effort to flood the market with oil in the first week of March. Unfortunately, the Coronavirus Pandemic hit, and their strategic plan to lower the price of oil was supercharged as global demand cratered. The critical question is who can weather the storm in the oil sector? The answer lies in production costs and expected prices.

Exhibit 9. WTI Crude Oil Future Strip




**The US oil sector will retreat.**

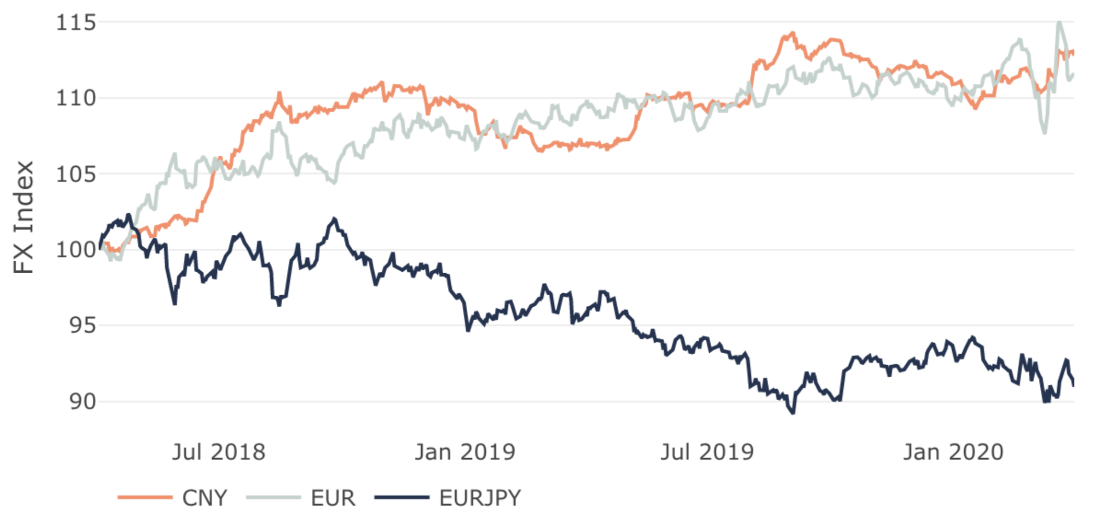
Credit oil futures for West Texas Intermediate are trading at about $20 a barrel for the near-term contracts, which places it below the variable cost of production for most North American producers. The problem, however, is the future strip a year from now that rises to $35 a barrel (exhibit 9). The contract price for March 2021 reflects the probability that global demand returned after the Pandemic. This price level, however, is still not viable for most North American producers. The implication is rather stark: the timescale of the Saudi-led price war may be compressed and lead to the acceleration of the retreat by the US fracking industry. While this time may be different, the reality of prices may be the canary in the oil patch.

# Currencies

**There is no alternative to the US dollar.**

During an economic storm, the US dollar reigns supreme as the haven of choice. Combined with the decline of crude oil, there are two strong winds at the back of the US dollar. The durability of this rally is much a function of the latter as it is the former. The pivotal questions are the extent of the demand destruction from the Pandemic on the global economy and the oil sector? Uncertainty to the depth and length of the Pandemic makes answering the question challenging to achieve with any reasonable range of confidence. The quick response: the US will reign supreme until there is a certainty of the Pandemic's extinction.

Exhibit 10. Normalized Currency Rates




*Source: Federal Reserve Economic Database*

**Chinese Yuan weakness augurs economic fragility.**

The currency market provides a good measure of the economic expectations for a country. Since the beginning of 2018, the Chinese Yuan and Euro lost value against the US dollar (Exhibit 10). The prospect of higher than lower crude oil prices saw the US dollar respond inversely versus the Euro; however, the Euro/Yen rate was mostly unmoved. Significantly, the Chinese Yuan continues to fade versus the US dollar, signaling that economic concerns dominate the commodity-led linkages. Yields, demographics, and uncertainty all provide support for the US dollar. For now, this time is *not different*.

Capital Risk

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