ALTMAN
INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

AUGUST, 2020

"Prediction is difficult especially if it's about the future"

Niels Henrik David Bohr, Nobel Prize; "Quantum Mechanics and Atomic Theory", 1885-1962

IN FOCUS:

Markets remain in an optimistic mood, with global equities and credit at or near highs, broad commodity price benchmarks trending up, and "safe-haven" government bonds holding firm. Despite high and/or rising global and U.S. COVID-19 cases, investors exhibit confidence that the economic recovery will not be unduly disrupted, and the monetary authorities will continue to provide downside protection against any capital market risks. Investors have been further encouraged by medical progress on therapies and vaccines to address the pandemic. At this juncture, we believe markets are pricing in widespread and effective vaccine availability in 2021, although it seems reasonable to conclude that sentiment could still be bolstered if and when it becomes definitive. But as Niels Bohr the famous physicist - considered father of atomic theory models that explain phenomenon that we can't see - has been quoted as saying, "prediction is difficult especially if it's about the future"

The market technical characteristics have improved markedly and remain powerful forces that could further extend recent trends in the near term. Nonetheless, we believe the path ahead will inevitably be more challenging. Valuations for most risk asset classes already appear to discount a solid recovery in fundamentals as well as perpetually supportive monetary policy. In the past, it has not been beneficial for portfolio returns to fight the Fed, especially as Chair Powell recently reaffirmed its commitment to increase support if needed. However, it is also imprudent to assume that today's super-low interest rates are appropriate for discounting normalized prospective corporate earnings or cash flows. Our base-case scenario is that the economic recovery will persist but will be choppier than many expect, and we should be wary of expanding portfolios too aggressively for a continuation of recent trends.

We also stress that the current wobbly U.S. dollar and surging gold prices are rarely indicators of a stable investing climate. Over the past month, interest rates have moved lower while commodities and equities have risen. Gold in particular by the end of July reached its all-time high of $1900 per ounce. We believe that the combination of geopolitical tensions with China and the record printing of money, combined with a near zero interest rate monetary policy, account for this phenomenon. The U.S. has run large budgetary and trade deficits for years because of its current status as a global reserve currency. Currently, we are negative longer term on the dollar and neutral on gold (while acknowledging the former is oversold and the latter is crowded), but capital market risks could build if these recent trends continue as they would signal diminishing confidence in global monetary stability.

While an economic rebound from the COVID-19 driven recession is underway, we caution that the underlying global economic backdrop is less favorable than at the start of the year. Policy has filled the hole the pandemic created, but even in the event of large-scale availability of an effective vaccine by early-2021, we expect the level of global demand to remain below its end-2019 level for some time to come, most importantly in the developed economies. Moreover, the excesses that existed before the crisis, such as elevated U.S. corporate leverage and overblown commercial property and housing markets in select economies, are still present.

We continue to believe that policy support for the global economy is still needed, but the increase in public and private sector debt as a result of the crisis adds to the challenges confronting investors as the economic recovery unfolds.

Momentum, sentiment and policy can be crucial drivers of capital markets over a 3-6-month horizon, but ultimately fundamentals determine asset performance. Even with an improvement in global trade, policy uncertainty would still be a headwind surrounding the upcoming U.S. elections. Predicting the direction of markets in the short term remains a humbling process and helps to solidify our conviction that fundamentals take precedent versus technical indicators to drive our process. Our investment policy at this juncture is to tread carefully and selectively.

Second Quarter Revisited

U.S. stocks advanced higher during the second quarter of 2020, continuing their rebound off the March 23rd market low, as investors cheered the Federal Reserve's seemingly limitless approach to backstopping the economy. This reflected an uptick in business activity, as states started the process of reopening and news surfaced on coronavirus (COVID-19) vaccine developments. The broad market S&P 500 Index rose 20.5% on a total return basis, its largest percentage gain since the fourth quarter of 1998. Technology stocks were an area of particular strength, accounting for 39% of the S&P 500 Index's total return, while comprising 26% of its market capitalization. The technology-heavy NASDAQ Composite Index posted a 30.9% gain during the quarter, according to Bloomberg data.

After adding a broad range of policy stimulus earlier this year, in June the Fed began buying individual corporate bonds as part of its Secondary Market Corporate Credit Facility (SMCCF), adding to the corporate credit exchange traded fund (ETF) purchases it had begun a month earlier. The Fed also announced that it expects to continue buying $120 billion of Treasury and government agency debt each month as part of its ongoing quantitative easing (QE) program.

At the end of the second quarter, the Fed's balance sheet was approximately $7.0 trillion, up from approximately $4.2 trillion at the beginning of the year according to the Federal Reserve. The U.S. economy contracted by 5.0% in the first quarter of 2020 at a seasonally adjusted annual rate, according to U.S. Department of Commerce data on real gross domestic product (GDP). This was the largest decline in output since the fourth quarter of 2008. New unemployment insurance claims trended lower, falling to 1.4 million as the quarter ended. The total number of workers receiving jobless benefits was 19.3 million, down from a peak of 24.9 million in early May. The unemployment rate was 11.1% at the end of the quarter according to Bureau of Labor Statistics. Inflation pressures remained muted, as measured by the Personal Consumption Expenditures Price Index (PCE), the Fed's preferred gauge. On a year-over-year basis, the Core PCE was up 1.0%, well below the Fed's 2.0% target. Yields on longer-dated U.S. Treasury securities remained low and were largely range bound during the quarter. The yield on the benchmark 10-year Treasury note declined to 0.65% from 0.68%, as measured by the Bureau of Economic Analysis and Bloomberg.

CLOSE-UP: The Economic Landscape as the Third Quarter Unfolds

Is the U.S. Economy Booming or Stalling? There are still plenty of economic indicators showing V-shaped recoveries from the severe lockdown recession imposed by state governors to slow the spread of the COVID-19 virus. They all tumbled during March and April and since have rebounded during May through July. We have outlined a quick update of the upbeat ones and a couple of downbeat ones:

Purchasing Managers Indexes: Both the M-PMI and NM-PMI in the U.S. have bounced back smartly in recent months. At 54.2 and 58.1 during July, both exceeded their January readings of 50.9 and 55.5 respectively. The orders indexes were very strong, as were the production indexes. Lagging behind were the employment indexes at 44.3 and 42.1. These reports suggest that one of the consequences of the Great Virus Crisis (GVC) could be a big cyclical, and maybe even a big secular, rebound in productivity, as companies scramble to produce more goods and services with fewer employees.

Housing: The GVC has convinced lots of urban renters that now may be the time for them to purchase new and existing homes in the suburbs and rural areas. The resulting surge in housing activity has boosted home prices. Bolstering that development are record-low mortgage interest rates. The Pending Home Sales Index compiled by the National Association of Realtors has soared from a recent low of 69.0 during April to 116.1 during June, the highest reading since February 2006 according to Yardeni Research. It is highly correlated with existing home sales. A similar rebound has occurred in the Housing Market Index compiled by the National Association of Homebuilders.

CEO Confidence: There is a dichotomy between all those upbeat purchasing managers versus CEO outlooks. The Business Roundtable's CEO Outlook Index fell to 34.3 during Q2, the lowest reading since Q2-2009. That doesn't augur well for capital spending over the rest of the year unless CEO confidence recovers soon, as we expect it will.

Gasoline Usage: One of our favorite high-frequency indicators for gauging the economic recovery is the weekly series on gasoline usage. It bottomed at the end of April and rose 62% without pause through early July - but recently has stalled around the current level of 8.7mbd.

Employment: July's employment gain once again was better than expected. Payroll employment climbed 1.76 million following a slight downward revision to June's 4.79 million. Private payrolls climbed 1.46 million, dwarfing the ADP's report of 167,000 increase last month. Total and private payroll employment advanced 9.28 million and 9.44 million, respectively, during the three months ending July, after plunging 22.16 million and 21.19 million during the two months through April. Service-providing jobs rose 1.42 million in July and 8.20 million the past three months, while the goods-producing tally was a more subdued 39,000 and 1.23 million, respectively, over the comparable periods—though these industries weren't as hard hit as the services sector. Leisure & hospitality jobs jumped 592,000 in July—accounting for one-third of the gain in total employment and 40% of the rise in private payrolls, according to Yardeni Research.

Federal Reserve Policy

The Federal Reserve Chairman, Jerome Powell, reiterated at a press conference on July 29th : "We have held our policy interest rate near zero since mid-March, and have stated that we will keep it there until we are confident that the economy has weathered recent events and is on track to achieve our maximum employment and price stability goals." After acknowledging the Fed's policy responses since March 23rd have stabilized the financial markets, the Chairman indicated they would keep them in place to support the Fed's macroeconomic objectives. Prior to the press conference, the Fed extended through December 31st its lending facilities that were scheduled to expire on or around September 30.

- **Slowing recovery**. The most important sentence in the FOMC statement was the following one: "The path of the economy will depend significantly on the course of the virus." Like many economists in the private sector, Powell and his colleagues at the Fed are watching high-frequency indicators of the economy such as credit-card data and hotel occupancy rates. He observed that the rebound in COVID-19 cases since June has slowed the recovery, although housing and auto sales have been strong.

- **Unlimited Power.** Powell confirmed that there is no limit to his power to print money: "We are committed to using our full range of tools to support the U.S. economy at this difficult time. And we will always remain committed in that sense. We feel like we have ways to further support the economy, certainly through our credit and liquidity facilities which are effectively unlimited. We can adjust those programs. We also can adjust our forward guidance. We can adjust our asset purchases. So there are things that we can do. We feel like we have the ability to do more."

- **"A Good Place".** Powell again reiterated that he thinks "our policy is in a good place." Since the beginning of this year, Powell has used this phrase in "a good place" in reference to the U.S. economy perhaps all too frequently. We would prefer he not use that phrase since he used that same expression to describe the economy during his February semi-annual congressional testimony on monetary policy. As you may remember, the stock market peaked that day at a record high - and then proceeded to plunge 33.9% through March 23.

- **Inflation vs. Disinflation**. Powell observed that "there is a lot of discussion" about how the Coronavirus might set the stage for higher inflation. However, he concluded that it is fundamentally a disinflationary shock, reiterating that "I do think for quite some time we're going to be struggling against disinflationary pressures rather than against inflationary pressures." Given our contrarian instincts, this comment has put us on alert.

- **No Shortage of Money.** The panic attack, as investors made a 'mad dash for cash' during February and March, abated after the Fed's March 23 policy shift. However, the result was a flattening of the yield curve close to zero. The result was that the return on bonds wasn't much better than on deposits. Bonds have been turned into the equivalent of money. The big difference is that if inflation makes a comeback, bond yields could rise, resulting in capital losses. Depositors and bond holders both would suffer a loss of purchasing power if inflation increased, but the latter also would have capital losses. So the mad dash for cash has resulted in a rebalancing out of bonds and into cash. That can be seen in the major measures of the monetary aggregates in the U.S., as well as many of them overseas.

Risks of the Rising Debt Trajectory

If Goldman Sachs Investment Research forecast is correct that another $1.5 trillion in fiscal stimulus is realized, total fiscal stimulus in the U.S. will amount to about 20% of GDP. Such an increase in U.S. debt is expected to push the debt-to-GDP ratio from 78% in 2019 to 101% in 2020, and to 121% by 2030, far exceeding the peak levels seen after WWII. The Federal Economic Policy at the Brookings Institute and the Committee for a Responsible Federal Budget, considered strong proponents of fiscal discipline, concluded that the fiscal stimulus at the current pace will not lead to a fiscal crisis anytime in the foreseeable future and the debt trajectory shouldn't be a concern at this time.

Note: *For a more in-depth analysis of their findings, please refer to Addendum 1.*

Covid-19: Economic Implications in the Third Quarter

The recent surge of COVID-19 cases in the southern and western states is negatively impacting the case for a strong third quarter economic recovery. It is likely that the growth rate of other economic statistics that have been improving during the May-July period will experience a setback. This is because many of the affected states will pause their reopening procedures - causing a negative impact on the reopening of businesses as well as creating a dampening effect on consumer spending. While the current outbreak could get worse, it could also be peaking. State governments are learning more about the virus as time passes and should be able to deal more effectively with local outbreaks.

We are living through a pandemic-induced depression. Fortunately, the Federal Reserve acted quickly with massive monetary expansion while the federal government did the same with the $2 trillion Cares Act that supported unemployment compensation and support to small businesses. At present, Congress is working on a second round. Whether state and local governments will get further aid beyond help with the corona virus is currently unknown. We expect the government fiscal deficit now forecast at $3.8 trillion to rise further, depending on the size of the current aid package. As we mentioned earlier, the reason that financial markets have rallied during a depression period is primarily because of Federal Reserve purchases of Treasury and corporate bonds as well as mortgages and municipal bonds. Also of course, is the belief that the future will get better.

Stronger economic statistics have been recognized by the equity market since April. Now the major question for investors is what happens if the numbers start to slow once again due to increasing virus cases in the south and west. Certainly, the market weakened after its huge rally when the unemployment claims data were published. However, there is another major factor affecting markets in a positive way, namely the progress being made in developing the vaccine for COVID-19. In May, the Trump Administration formed a public-private partnership to accelerate a national program for the development, manufacturing and distribution of COVID-19 vaccines, therapeutics and diagnostics.

There are many leading epidemiologists who currently believe that a successful vaccine against COVID-19 can be developed by year-end, with distribution set for the first quarter of 2021. At present, there are over 100 companies world-wide working on the development of a vaccine. The recent surge of virus cases in the southern and western states strengthens the case for a U-shaped recovery in 2020 - but if a vaccine was developed sooner, the outlook for 2021 would strengthen. Returning to normal in the shortest period of time would prevent an extended depression-like economy.

VALUATIONS:

U.S. Price-to-Earnings Ratios and Bond Yields

The average price-to-earnings (P/E) over various market cycles is affected by inflation and interest rates, which trended upwards from the 1960s through the 1980s, and then trended downwards since the 1980s. The P/E was generally below the historical average when inflation and interest rates were rising and high. It was generally above the average when inflation and interest rates were falling and low. Nevertheless, it is widely believed that the P/E tends to revert to its historical mean. It certainly did so during the bear market of 2000, when a rapid tumble took the P/E to its historical average mean. It fell below its mean during the bear market of the Great Financial Crisis (GFC) and reverted above the mean during the subsequent bull market. Now it is at the higher end similar to December 2001.

After adjusting for record low bond yields, there is the potential for the mean P/E to revert to a higher multiple than its historical averages. Relative to the P/E of bonds, the Forward Stock Valuation Model is clearly signaling the S&P 500's current forward P/E is too low. Of course, it is worth considering that it is just as easy to argue that bonds are substantially overvalued relative to stocks. The truth may lie somewhere in between.

The P/E ratio on our earnings forecast of $153 per share for 2021 is now 22x. For this year's earnings estimate of $122 per share, the P/E ratio would be 26.3. In fairness, one must mention that the S&P 500 index is no longer quite as representative of a broad market index, since it is capitalization weighted and six Technology stocks account for 23% of the index. The stock market is bifurcated between virus-damaged stocks and beneficiaries of the virus, namely those that are part of the virtual economy. As a result, there are cheap stocks mixed with expensive ones in the overall stock market. The virus only reinforced trends that were already underway, namely the development of online commerce versus the bricks and mortar economic world.

Note: *For a deeper analysis on this topic kindly refer to Addendum 2.*

Global Earnings Expectations and Valuations

The global 12-month forward earnings have edged fractionally higher as the third quarter unfolded but are still down nearly 20% from their pre-crisis level. We believe that 12-month forward earnings will lift steadily in the months ahead to reflect the expected recovery of earnings next year, as economic activity strengthens. The rebound in the global manufacturing PMI is also consistent with positive 12-month forward earnings growth next year. Yet consensus earnings expectations next year could be a bit too optimistic, incorporating a full recovery before yearend with forecasted earnings above the 2019 level.

On a global basis, Capital Economics observes that the aggregate trailing return on equity would only be modestly below the historical average despite a G7 capacity utilization rate that they expect to remain under pressure. Similarly, they pointed out that consensus estimates indicate that the profit margin for the global benchmarks next year will exceed pre-pandemic levels. The same holds for margin estimates for the U.S. and global ex-U.S. benchmarks. This partly reflects the impact of strong earnings among global tech stocks and their high weights in equity benchmarks, but still reflects a high bar for companies and thus the benchmark indexes to meet, especially since tech margins are already high.

THE CASE FOR EQUITIES:

While it is difficult to make a fundamentally bullish case for equities based on earnings and valuations, there is also no clear case to bet against them given an expected economic recovery and sustained fiscal and monetary policy support. COVID-19 remains a threat, but would likely cause only temporary disruptions to equities, since investors will assume an available vaccine will arrive at some point in the next year. Overall, we expect equities to be range-bound over the next several months as earnings gradually catch up to prices. We still await more indications that earnings will be on a strong and sustainable upward trajectory to warrant a more bullish stance on equities in the near term.

Against this backdrop, we remain cautiously optimistic and remain very selective starting new positions at this juncture. Despite elevated relative valuations, we remain overweight equities in balanced accounts given continued positive earnings trajectory. Rising relative earnings in the U.S., versus international markets, above average exposure to technology, and a smoother economic re-opening underpins our moderately bullish tilt. We have been encouraged by the increasingly cohesive euro area policy backdrop, but have not fully embraced the idea that the region's earnings are poised to lift sustainably in relative terms.

IN SUMMARY:

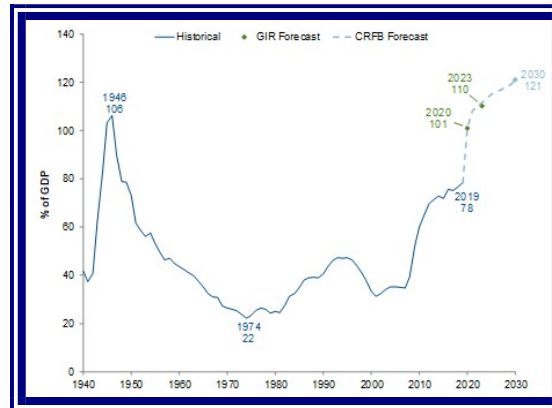
At present, the investor is faced with cash and bonds yielding close to zero, while equities have diverse earnings trends because of a pandemic whose end is unknown. Commodities are trending higher, led by gold, as the U.S. dollar weakens. All of this is happening against a financial background of a historically high level of money printing and record budget deficits last seen during World War II.

While it may appear that the equity market has only climbed a wall of worry, we think it is helpful to see that the S&P 500 has also responded to important fiscal and monetary policy measures, and to announcements regarding progress in COVID-19 therapies and vaccines. Given the enormity of policy measures on a global basis, as well as the massive resources devoted to the development of therapies and vaccines, we believe that this rally has been driven by fundamental shifts in policy in the economic outlook and in healthcare. The macro and policy backdrop are directionally positive for equities, but we believe they are largely discounted given the current run up in overall indices.

ADDENDUM 1: ***Risks of the Rising Debt Trajectory***

If Goldman Sachs Investment Research forecast is correct that another $1.5 trillion in fiscal stimulus is realized, total fiscal stimulus in the US will amount to about 20% of GDP. Such an increase in US debt is expected to push the debt-to-GDP ratio from 78% in 2019 to 101% in 2020 and to 121% by 2030, far exceeding the peak levels seen after WWII, as shown in Exhibit 1 below.

Exhibit 1: US Debt to GDP Ratio:
Realized + GIR/CFRB Forecasts Through 2030



Source: Goldman Sachs Research and the Committee for a Responsible Federal Budget.

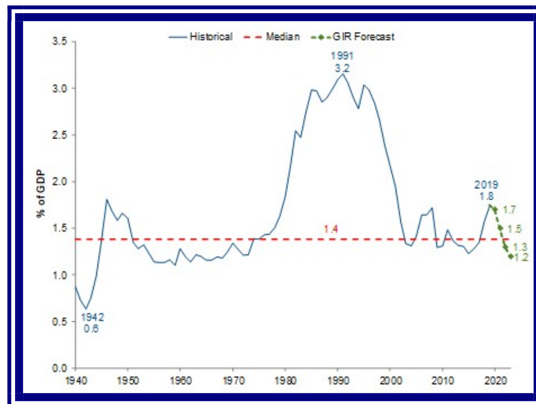
The key question affecting the investment outlook is whether such high debt levels will lead to a fiscal crisis in the US. To address this question, Goldman focused on two sources: Federal Economic Policy at the Brookings Institute and the Committee for a Responsible Federal Budget. Both sources conclude that the current fiscal stimulus was necessary to offset the shutdown of the economy as a result of COVID-19. They both reiterated that the economy is ailing right now and it's more important than worrying about the budget deficit. They referred to the fiscal stimulus as fiscal relief. The following issues were emphasized:

- **Healthcare support for state and local governments, payments to the unemployed and some form of rent support** to avoid evictions were stressed as important components of the next stimulus package.

- **Inflation** was not a near-term concern, but it could become an issue in the more distant future. The probability of high inflation further out in the future was estimated at 10–20%.

- **The very low level of interest rates** will keep the cost of servicing the debt low and is forecasted to represent 1.2% of GDP by 2023, the lowest level since the 1960s, as shown in Exhibit 2. While both sources believe that this was not a financing burden, they also concluded that it will be important to think of fiscal discipline once the US overcomes the pandemic and economic activity reverts to trend growth. See Goldman's Exhibit 2 below.

Exhibit 2: US Interest Expense (% GDP)
Realized + Forecasts Through 2023



Source: Goldman Sachs Global Investment Research.

- **The US continues to attract foreign direct investment flows**. Both organizations were concerned that the US will be more vulnerable with such high levels of foreign indebtedness and highlighted the importance of building a more resilient economy, and less dependence on foreign investors as a component of that resilience.

- **It was broached that if the US reduced its debt burden by selling assets it would only provide temporary relief in bringing debt down on a one-time basis**, but not solve the long-term shortcomings of the current budget process.

Both sources, considered strong proponents of fiscal discipline, concluded that the fiscal stimulus at the current pace will not lead to a fiscal crisis anytime in the foreseeable future and the debt trajectory should not be a concern at this time.

ADDENDUM 2: *Valuations: Price Earnings Ratios (P/E) and Bond Yields*

The average price to earrings over various market cycles is affected by inflation and interest rates which trended upwards from the 1960s through the 1980s, and then trended downwards since the 1980s. The P/E was generally below the historical average when inflation and interest rates were rising and high. It was generally above the average when inflation and interest rates were falling and low.

Nevertheless, it is widely believed that the P/E tends to revert to its historical mean. It certainly did so during the bear market of 2000, when a rapid tumble took the P/E to its historical average mean. It fell below its mean during the bear market of the Great Financial Crisis (GFC) and reverted above the mean during the subsequent bull market. Now it is at the higher end similar to December 2001.

Is it different this time? While the current P/E undoubtedly will revert to the mean eventually, that might not be a very useful insight if the mean has moved higher when adjusted for record-low bond yields. In other words, it could just as easily revert to a higher P/E which would still be above the historical average. In a world of zero interest rates, maybe the new normal mean P/E is 30, twice what it was during the old normal. Although we don't have a model that says that 30 is the new normal, the new normal mean P/E might be higher than the current reading of 22.1 rather than lower and closer to the old normal 15.0 average.

Bond yields and valuation. Many years ago, from the late 1970s through the late 1990s, there was a reasonably good correlation between the 10-year US Treasury bond yield and the forward earnings yield, which is simply the reciprocal of the forward P/E. Surprisingly, this ratio hasn't worked as a useful valuation tool since the early 2000s. However, we are gaining more confidence that this correlation might be starting to work again now. The Forward Stock Model Valuation (FSVM) has been signaling that stocks are increasingly cheap relative to bonds since the early 2000s. Over the past month and a half through the end of July, stocks have been undervalued relative to bonds by a record 86%.

The bond's recent record-low yield of 0.50% in early August implies a P/E for the bond of 200, using the reciprocal of the yield. In other words, the FSVM is clearly signaling the S&P 500's current forward P/E is too low relative to the bond's P/E. Of course, it worth considering that it is just as easy to argue that bonds are substantially overvalued relative to stocks. The truth may lie somewhere in between, i.e., stocks are relatively cheap, while bonds are relatively expensive. Indeed, if the bond yield would be, say, 1.50% but for the Fed's quantitative easing policy (i.e., zero interest-rate policy and quantitative easing forever) interventions in the bond market, its P/E would be still be elevated.

In summary, since the start of the current bull market, there has been a relatively good (but not great) correlation between the S&P 500 forward P/E and the inverse of the bond yield. This correlation seems to have gotten much tighter since the bond yield fell below 1.00% in early August to a record low of 0.50%, while the forward P/E has risen from a recent low of 12.9 on March 23 to 22.1 at current price levels.

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