

Party Like It's 1999?

By: Henry Pizzutello, Chief Investment Officer

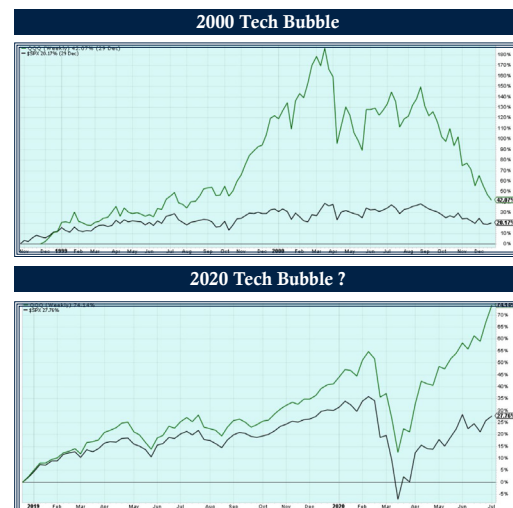
If Rip Van Winkle had woken up in March of 2020 after a twenty-year sleep, he might be forgiven if he thought he had only gotten his regular eight hours. The equity market—the technology sector in particular—is staging a repeat of the performance of that shown in 2000, which has again prompted talk about a “bubble” forming in stock prices. Indeed, there are very similar parallels to the 2000 market environment. We have seen technology lead the market, and the concentration of the top five names in the S&P now accounts for more than 22% of the index performance – a higher percentage than was found even during the heady days of 2000. We also see speculation at a level on par with the “dotcom bubble” – when almost any name with “.com” was bid up regardless of earnings, cash-flow, or assets. If a company had a growth plan tied to the internet, its reward in the marketplace was a rising stock price—that is, until the bills arrived to pay for growth and the stock prices started to mirror the negative cash flows. Today, the dotcom craze is old news, but growth potential is still being rewarded. Take the stock of Nikola Corp, a competitor to Tesla in the electric vehicle space, which went public last month with a higher valuation than that of Ford Motor Company, which has revenues of \$115 billion compared to ZERO for Nikola (in fairness, they expect to reach full production in 2027). For many long-time investors, these illustrate the unmistakable signs of a brewing “bubble” market environment (Note: NKLA stock price has declined by more than 50% since the first days of trading).

However, trying to time a bubble is seldom a good idea. First off, it is a dangerous practice. Secondly, it is impossible, but thirdly, it is very profitable if you can navigate through one and two. The most significant difference between the current situation and the 2000 tech bubble is liquidity. Today, the Fed is a veritable fountain of liquidity, while in 2000, liquidity was being drained after the perceived risks of “Y2K” proved to be false. But the flip side today is that the Fed liquidity has needed to stem off the greatest loss in employment and consumption in history due to the pandemic. There are currently more significant risks than were evident at the beginning

of the millennium. The virus has fostered an environment of economic uncertainty – even as the broad market averages have performed as if the risks from the Covid-19 pandemic are not skewed to the downside.

Then, as now, conventional valuation metrics have ceased to matter. If traditional valuation metrics truly mattered, they would have sold off a long time ago. In market environments characterized by extremes, expensive can always get even more expensive. The metrics to focus on are now technical rather than fundamental, and the collective behavior of market participants becomes critical to understand. Unfortunately, this means that investors need to be incredibly quick to be “risk-on” and “risk-off” before the market moves.

Understanding the role of behavioral finance in investment strategy reduces the risk of “timing the market.” Emotion drives the average investor to sell stocks at the point of greatest fear, as we saw in late March, and to buy in fear of missing out (FOMO) as we are perhaps witnessing today. Having a firm grasp of the behavioral side of the equation allows an investor to stay invested through the long-term and take advantage of the fears of the market, buying assets from those fearful of the end, and selling assets to those fearful of missing the party.



Four Things We are Watching in the Second Half

By: Henry Pizzutello, Chief Investment Officer

The current environment has been characterized as “The Great Reset” as economies and consumers start to rebuild after the greatest economic shock in our lifetime. Market participants are in uncharted territory. Today, we are not investing in purely “free markets”. Asset prices are being supported by the Fed and government policies and investors now have to evaluate a new series of criteria as a primary focus. Over the next six months, these are the factors we feel will be most important in shaping that view.

1. The Recovery

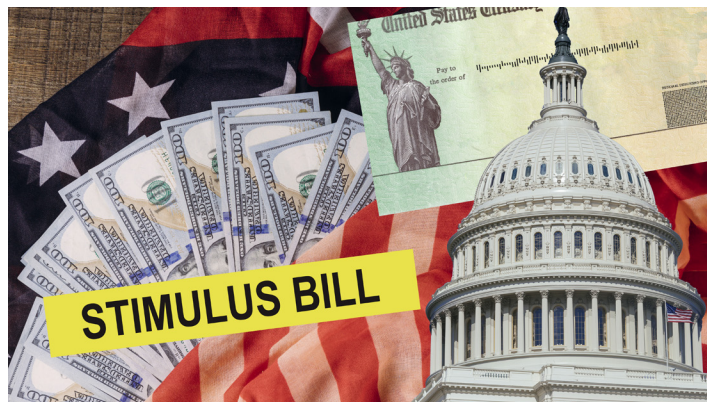
As we move past the initial phase of reopening, the next stage will be the ultimate reality check. It is a period that will reflect on the domestic and global economy, and will largely determine the “shape” of the recovery and how successful it will be. We can speculate on how this plays out, but the reality will be set by the factors relating to the reopening the global economy, the damage done from shutting down the global economy, and the success of containment of the COVID-19 virus. Globally, there seems to be a clear path to recovery with respect to the virus management, although there are pockets of higher incidence. The United States is one of those “pockets” as states started re-opening at the end of April, only to see a second wave of COVID-19 in areas of the U.S. Interestingly, the equity markets have largely discounted this increase, although the final script is yet to be written, as volatility remains elevated. Clearly, if cases continue to rise, there will be residual fallout in certain areas, such as restaurants, credit card spending, and airline traffic, even though those patterns are improving at the moment.

We continue to monitor and track data that will provide better visibility on the shape and pace of the recovery. Measures like public transit usage, airline traffic, hotel and restaurant bookings, and even pollution levels were all early indications of recovery when applied to China – the initial source of the virus. As these indicators paint a clearer picture, it will allow us to see the impact on the investment landscape. Given the full support of government and Fed policy actions, we are cautiously optimistic over the next six months and more broadly optimistic as we move into 2021.

2. Earnings

The big question for equity investors today is “what really matters?” It is clear that equity prices today do not reflect the current earnings prospects, and it is also logical to assume that the current crisis will not permanently impair earnings. It is also reasonable to make the assumption that some sectors of the economy (travel, restaurants, leisure) will suffer at least some level of permanent impairment, as consumer behaviors change in a post-pandemic world. However, at some point, all good investments must reflect the expectations that are built into the price of a security. As the current price incorporates market expectations for the present value of future earnings, the question remains as to what level of earnings are actually being discounted.

One of the reasons for the strong equity market rebound has been the unprecedented support of the Federal Reserve and government stimulus, which has had the dual effect of putting a floor to the crisis phase (the “Fed put”) and helping to create an environment where “less bad” is viewed as positive development. Expectations are for S&P 500 earnings to bottom out in the second quarter and rise sequentially in the back half of 2020. 2021 is expected to show a sharp rebound in earnings growth before continued strong growth in 2022. Given that equity markets are near the levels found at the beginning of the year, the expectations are that earnings in 2021 will have recovered to pre-COVID levels. With increased unemployment, a number of industry sectors that may be fundamentally impaired and a potential “second wave” of infections that could push out the expected earnings recovery, we see potential headwinds to that outcome. Longer term to 2022, we can see earnings and economic activity surpassing previous levels.



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3. Credit

In order for markets to function normally, the credit markets must be viewed as stable. When this does not occur, as was seen during the 2008 Financial Crisis and earlier this year, severe dislocation in asset prices tend to occur. Today, the credit landscape is positive. From a valuation perspective, current spreads reflect a much more reasonable risk / reward profile, both in the investment grade and high yield markets. Historically, when high yield spreads are above 650 bp (they are slightly lower than that currently) the following 12-month return has outperformed the return seen in equities. While there are more opportunities than what the marketplace has seen in years, one factor that must not be ignored is that yields are at or near all-time lows and durations are at or near all-time highs. While we do not expect these conditions to materially change given the Fed's posture on rates and liquidity, we must recognize that not all opportunities in credit will be equally rewarded. Opportunities still abound within the credit market, but heightened caution is needed.

4. The Election

With the election less than four months away, President Trump is losing ground as the combination of the global pandemic, recession concerns, continued trade war, and social unrest have weighed on his re-election bid. However, as we saw in the 2016 campaign, the polls often do not foretell the final story. As we head into November, the unemployment rate will still likely be in at recessionary levels, it is likely that there will not be an approved COVID-19 vaccine, and the media will still be focusing on the social unrest. However, it is also very likely that Congress will pass another \$1 trillion of stimulus ahead of the election, which will mitigate the effect of unemployment and recession fears on voter perception. While we tend to not be supportive of market interventions and policy that creates artificial markets, the moves by the Fed and the government were critical. The trade-off between government intervention and economic stability may have a number of unintended consequences in the future, but the potential of job losses, business failures and lack of confidence have been addressed in the near-term. The follow up to these actions will have lasting effect for not only the election but for the long-term future of the economic recovery.



The Ultimate Black Swan Event: Its Impact on The Economy, The Markets & The Political Landscape

By: Robert Borden, CFP®, EA, Chief Compliance Officer

The Black Swan has ancient origins. The Ancient Romans had the erroneous presumption that black swans didn't exist but that they theoretically could. As a result, the black swan became analogous to something that could occur but doesn't. A few millennia later, in 1697, they were discovered in Australia by Dutch explorers. The modern Black Swan Theory became popular after Nassim Nicholas Taleb published *The Black Swan* in 2007, and the term became a popular metaphor after the 2008–2009 Financial Collapse. While Mr. Taleb¹ argues the COVID-19 pandemic is not a purely Black Swan Event due to his interpretation that the effects were foreseeable and preventable, one could argue that the global spread of the disease was due to the obfuscation early on by the Chinese government with little knowledge by the rest of the world in December 2019 and January 2020 that the spread was occurring. Realistically, we don't yet know if the source of the virus is the Huanan Seafood Market in Wuhan or something more nefarious. We do know that many recent viruses have been sourced to Chinese “wet markets,” where common and exotic animals are slaughtered for human consumption on premises exposing individuals to novel or new viruses that can jump species. Regardless, we're learning every day how contagious the disease is and its far-reaching impact on the public, economy, national security, and the political landscape in 2020.

The Economy

Just over six months ago, at the turn of the decade, who could have foreseen that by July, the US unemployment rate would stand at 11.1% — up from 3.5% in December 2019? The pace of the economic shutdown and the effect on unemployment were felt most dramatically in April and May. The jobless rate skyrocketed to 14.7%, the highest ever since 1948, as over 30 million people were unemployed in April. Unlike 2008–2009, foundational economic underpinnings were quite healthy before the recession, but the forced shutdown froze the US and global economy. Brick and mortar retail and internet businesses that were doing well prior to the pandemic quickened the pace of decline among their smaller counterparts. Amazon, Walmart, Home Depot, and large national grocery retailers were all declared essential businesses. These companies were allowed to remain open while smaller retailers who didn't supply the vast array of products, or offer delivery options, were forced to shut down. The economic recovery will be dictated mainly by the fall & winter spread of the virus, the outlook for effective viral treatments, and, ultimately, a vaccine.

The Markets

The markets have proven remarkably resilient after declining over 30% between February 19 and March 23, which happens to be the quickest market drop of that magnitude on record. As information flow has become more efficient, the markets quickly responded to news and data. That, combined with the fact that large institutions are using ever more sophisticated algorithmic and quantitative trading strategies, has made these sharp moves even more dramatic. Both the President and Congress's unprecedented fiscal stimulus, along with the monetary stimulus supplied by the Federal Reserve, have provided what many have argued is a temporary sugar high, which may be unsustainable. While the equity markets may be looking ahead to 2021 and 2022, there are substantial headwinds that face global stock markets during the second half of the year. A major second wave may impact company earnings in 2021 and additionally influence the November election.

The Political Landscape

What a difference six months can make! In January, most betting markets had baked in a 60% probability of President Trump winning the November election. As of early July, those prediction markets have been turned upside down as they now show Mr. Biden with a 60%² chance of winning the election. Furthermore, they currently indicate the Democrats have a 60% probability of winning control of the Senate, which would mean a November *blue wave* and likely dramatic changes in US fiscal and foreign policies — at least over the short-term. While two-year market performance following a win by either a Republican or Democratic president is relatively close, with the Republicans maintaining an edge, a wave election is a far different matter, with stronger two-year market returns (by far) for the period following a *Republican Wave* compared to a *Democratic Wave*³. A *wave* in this context is defined as one party control of both the executive and legislative branches. However, after four years, this disparity has historically largely disappeared. History has shown us that the US economy and markets are remarkably resilient regardless of political party or exogenous events that may temporarily impact the country.

1. <https://www.newyorker.com/news/daily-comment/the-pandemic-isnt-a-black-swan-but-a-portent-of-a-more-fragile-global-system>

2. <https://www.predictit.org/>

3. <https://www.fidelity.com/learning-center/trading-investing/markets-sectors/stock-returns-and-elections>