Investment Commentary

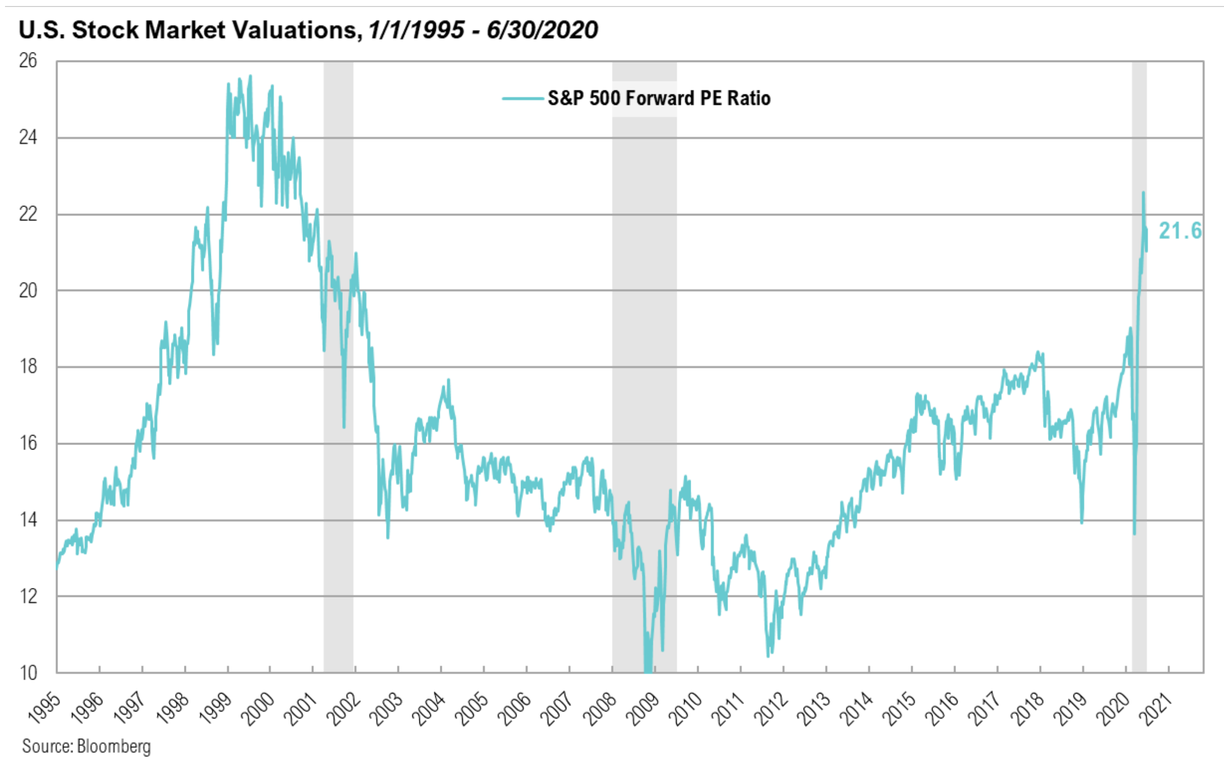
Echoes of Past Cycles

July 16, 2020

As tumultuous as the first quarter of 2020 was, the second quarter was almost a perfect mirror image. Many asset classes recovered to end the first half of the year at levels that show no signs of a bear market, let alone a global economic shutdown. For the quarter, the S&P 500 Index gained 21% while the tech-heavy NASDAQ Index increased 31%. This leaves the S&P 500 down 3% for the year while the NASDAQ is higher by 12%! High-yield bonds finished the quarter by gaining 10% and are down just 4% in 2020.

The past several months have echoed some of the most extreme periods in history, demonstrating parallels to the Great Depression, the tech bubble, and the global financial crisis (GFC) all at the same time. In some respects, the economic destruction from COVID-19 is worse than anything seen since the Great Depression. In early 1933, the unemployment rate peaked at 25%.[1] That dark time in economic history was also known for its plunge in gross domestic product (GDP), which declined by 30%.[2] Based on already released data, the Atlanta Fed forecasts second-quarter GDP to be down 35%.[3] In April, the unemployment rate was reported as 15%.[4]

The enormous rally in stocks paired with massive downward revisions in corporate earnings as a result of COVID-19 has created a dynamic reminiscent of the tech bubble in the form of extremely high valuations. The one-year forward P/E ratio for the S&P 500 sits at nearly 22 times, as compared to a one-year forward P/E ratio of 26



[1] Britannica: https://www.britannica.com/event/Great-Depression
[2] Wikipedia: https://en.wikipedia.org/wiki/Great_Depression
[3] Federal Reserve Bank of Atlanta: https://www.frbatlanta.org/cqer/research/gdpnow.aspx
[4] U.S. Bureau of Labor Statistics: https://www.bls.gov/cps/employment-situation-covid19-faq-may-2020.pdf

times during the tech bubble. Part of the reason for the significant rise in equity prices during the second quarter was the euphoria (and relief) of a partial re-opening of the economy. As the numerator (prices) in that equation rose substantially, the denominator (earnings expectations) plummeted. Consensus estimates for S&P 500 earnings per share (EPS) for 2020 were cut by more than 28%, from $174 on January 1 to $125 at the end of June.[5] Forecasts for 2021 and 2022 EPS have also been cut by 17% and 10%, respectively.[5]

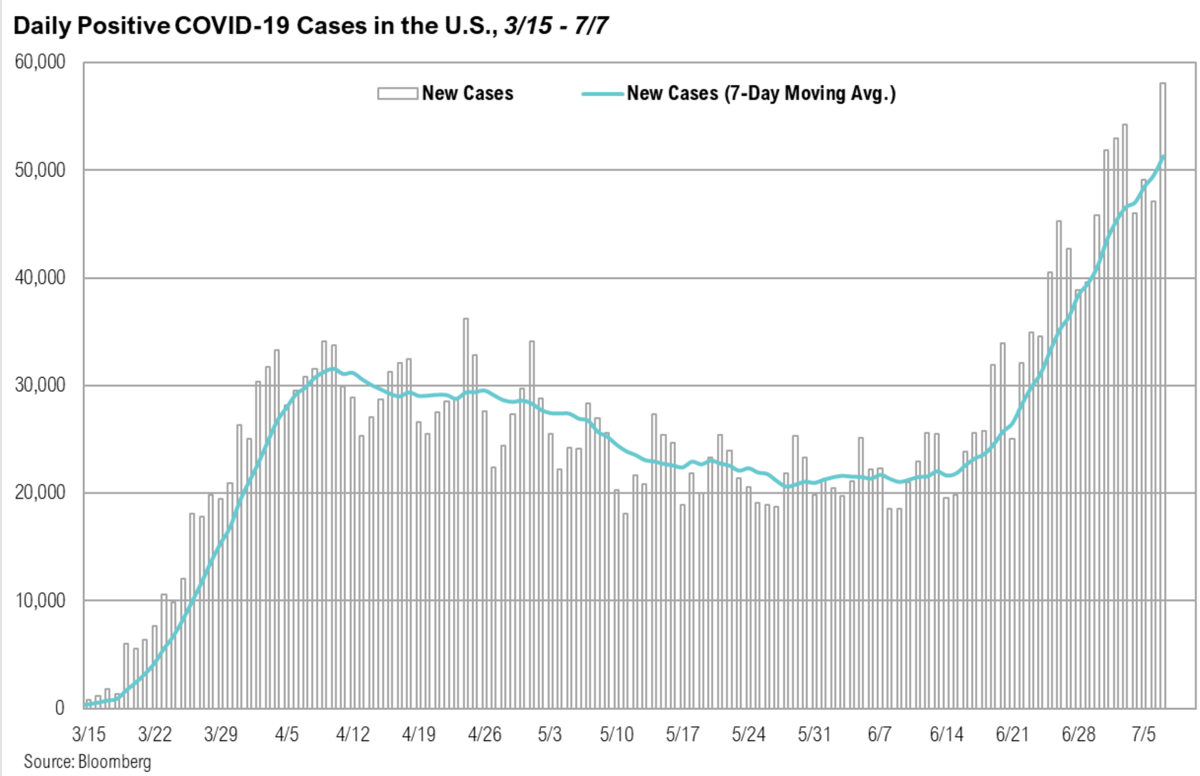
The Federal Reserve is propping up today's market environment in many ways. Although its actions are similar to its GFC response, it has been much more decisive, aggressive, and controversial during this crisis. Its monetary policy decisions include the same zero interest rates, a resurgence of programs like the Term Asset-Backed Securities Lending Fund (TALF), and an increase in quantitative easing. According to Chairman Jerome Powell, "We crossed a lot of red lines that had not been crossed before; this is that situation in which you do that, and you figure it out afterward." Presumably, this is meant to acknowledge that new programs, such as the Secondary Market Corporate Credit Facility, in which the Fed has purchased billions of dollars of fixed income exchange-traded funds (including funds that hold high-yield bonds), are outside of policy orthodoxy—and even possibly the Fed's legal authority.[6] Powell could also be referring to another aspect of the program whereby the Fed purchases the bonds of corporations such as Apple, Toyota, and Walmart.[6] It took the Fed nearly a decade after the GFC to increase its balance sheet by $3 trillion,[7] but just three months to match that feat during this crisis. The Fed has also been much more aggressive in its quantitative easing program, in which it has purchased as much as $125 billion of securities per day, significantly more than it did during the GFC.[7]

Unfortunately, absent a vaccine or effective therapeutics to address the virus, additional fiscal and monetary support will likely be needed in the second half of the year. A recent study by Austan Goolsbee and Chad Syverson of the Becker Friedman Institute for Economics at the University of Chicago addressed the question of how much of the economic collapse resulted from government-imposed restrictions versus people voluntarily choosing to stay home to avoid infection.[8] Using cellular phone data from SafeGraph, which collects information on almost 45 million cellular phone users (or about 10% of devices in the U.S.), they estimated overall consumer foot traffic fell by 60%—and that only 7% of that reduction was due to legal restrictions. Also according to SafeGraph, in states where positive cases are on the rise—such as Florida, Texas, Arizona, and California—foot traffic remains at depressed levels or has deteriorated into July. Other data point to a similar lull in activity. According to TSA travel checkpoints, the number of airplane passengers in the last seven days of the quarter averaged just 579,000—down 77% from the same period last year.[9] OpenTable data revealed that reservations at sit-in restaurants declined over the past few weeks and are down more than 60% when compared to last year. This all comes at a time when new COVID-19 cases are exceeding 50,000 per day in the U.S.[10]

On the bright side, the Treasury market appears willing to tolerate trillion-dollar relief plans, as well as the Federal Reserve's decision to monetize a large percentage of new debt. As a result, yields and inflation remain low, and the dollar is relatively stable—for now, at least. The U.S. Treasury issued an astounding net $2.683 trillion of debt in the second quarter.[11] And while the Federal Reserve bought $868 billion[7] through its quantitative easing program over the same time period, the 10-year Treasury yield was stable, moving lower by 4 basis points to end the quarter at 66 basis points. As long as bond markets remain so accommodating, low yields

[5] Bloomberg
[6] Board of Governors of the Federal Reserve System: https://www.federalreserve.gov/files/smccf-transition-specific-disclosures-6-28-20.xlsx
[7] Federal Reserve Bank of New York: https://www.newyorkfed.org/markets/soma/sysopen_accholdings.html, SpringTide calculations
[8] https://bfi.uchicago.edu/working-paper/2020-80/
[9] Transportation Security Administration: https://www.tsa.gov/coronavirus/passenger-throughput, SpringTide calculations
[10] The CovidTracking Project: https://covidtracking.com/data
[11] TreasuryDirect: https://www.treasurydirect.gov/instit/annceresult/press/press_cashpydwn.htm, SpingTide calculations

could pave the way for a massive infrastructure spending bill as pressure builds on policymakers to help millions of out-of-work people find new careers.



Looking Forward

Describing the current market environment as unprecedented is not hyperbole. With trillions of stimulus dollars already distributed and the Federal Reserve spending trillions more to buy assets, policy makers have collectively pushed asset prices back to pre-COVID levels. Yet the virus has not gone away or even slowed its spread in the U.S. And, as if the range of outcomes was not wide enough, we are now approaching a U.S. election that will have a direct bearing on the size and shape of future policy initiatives. We understand that the challenging combination of circumstances investors are faced with can cause uncertainty around what to do with investment portfolios. We believe the recovery in asset prices, however justified, provides a good opportunity for investors to re-evaluate risks in portfolios, which we believe are now tilted to the downside for risky assets. Investors who added to stocks when they were down should consider rebalancing and taking some profits. We will look for additional opportunities to selectively increase risk, if further stock market pullbacks develop. In the meantime, we continue to focus on dislocations in various niche markets that present attractive risk/reward opportunities.

All market pricing and performance data from Bloomberg, unless otherwise cited.