Capital Risk

GLOBAL PORTFOLIO STRATEGY

America: Pandemic Pariah

Photo: Mick Haupt on Unsplash

Global problems require global solutions. The United States is a pariah for its inability to address the Pandemic. Most of the world fought COVID19 as if their societies' very fate rested on it and won a reprieve from the virulent effects. The US dithered and legendary leadership failures resulted in little abatement of the deluge. The result is uncertainty for a quarter of the world's economy that prevents the other three-quarters from engaging consumer number one. The investing implications are profound. Conveniently, an election arrives in November. Whether the US corrects course is debatable until the counting of the final ballot. Without election and virus certainty, volatility reigns as the malevolent monarch of the markets.

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A resolution to the disastrous US national policy response to COVID19 is unlikely until a vaccine or after the election (or the transition).

The implication is that most non-tech US sectors are too highly valued, interest rates are too high, and the currency could fall further.

\- Jason Prole

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Highlights

- High non-tech US **equity** valuations advise other markets or sectors.
- **Interest rates** should decline further to align with inflation expectations.
- **Credit spreads** are not pricing in economic risk, despite Fed actions.
- The rebound of **copper** appears to reflect restocking, not future growth.
- The rise of haven **currencies** (CHF, EUR) suggest US dollar weakness.

The Economic View

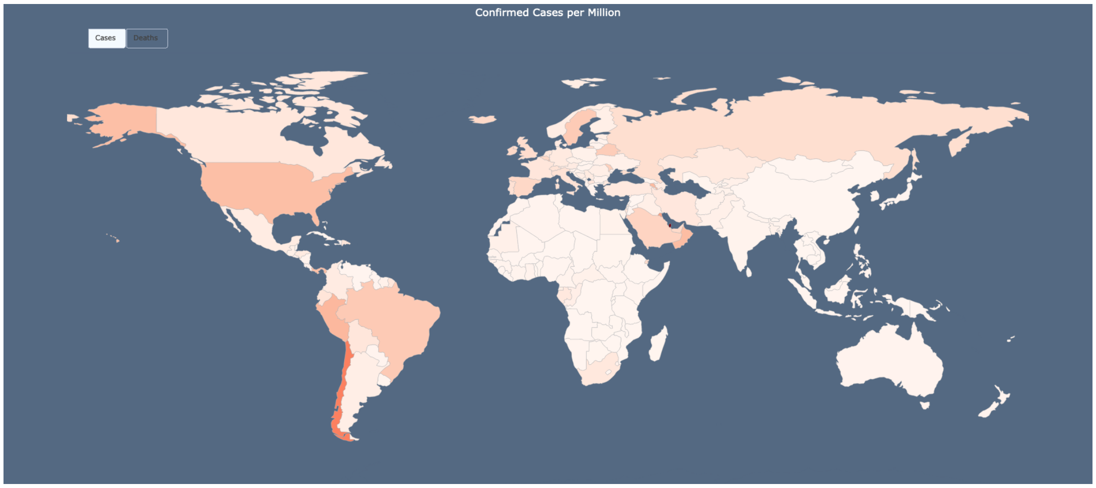
Risk without reward.

A reward doesn't exist for all risks. Investors believe that increased return requires increased risk. The truth is that the outcomes depend upon the risk measure. There are good risks (i.e., rewarded risks) and bad risks (i.e., unrewarded risk). The United States is a pariah because it conflates the two measures without distinction. Investment risk is good, and virus risk is bad. That the statement is necessary indicates the state of political discourse in the US. Tragically, the result is the first wave of the virus continues unimpeded in the US and places the world economy at risk.

The US sits as the shining country on a hill with an uncorralled virus among a sea of viral recession (exhibit 1). While Chile is a world leader in cases per million and the virus is contained within the barriers of the Pacific Ocean and the Andes. Crucially, Chile is not material to the world economy. Unfortunately, the US is the largest global economy and consumer number one for world consumption. Therein lies the problem.

The US, a world leader, for the wrong reasons.

Exhibit 1. COVID19 Confirmed Cases per million by Country



Source: Federal Reserve Economic Database

The rest of the world is cautiously restarting their economies after putting the virus at bay. While a return to normalcy will not occur until a vaccine arrives, the tentative steps to operating under virus mitigating measures can mediate the global economic collapse. Public events are off the agenda for a while.

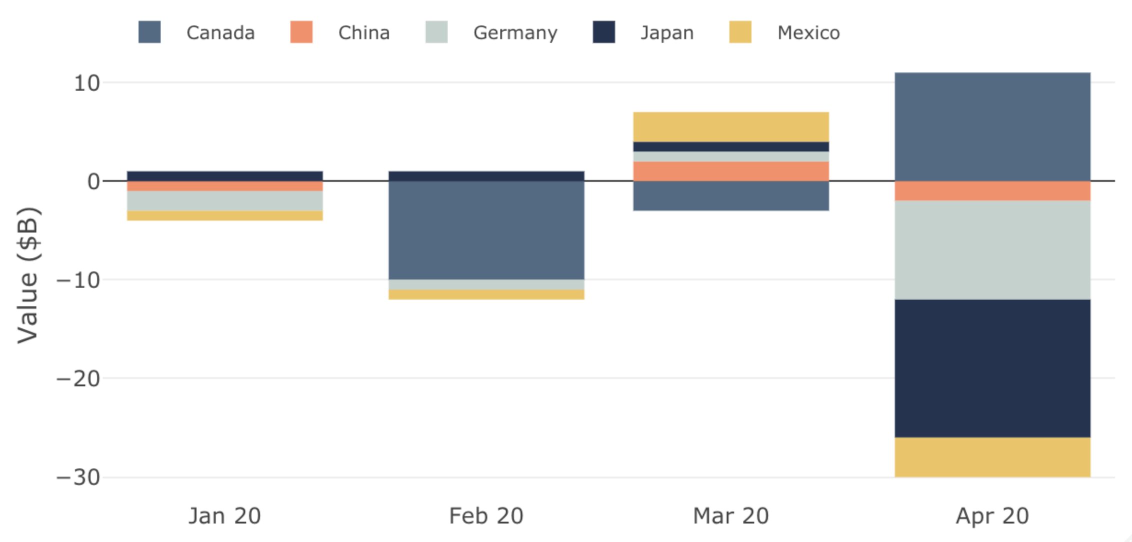
The Economic View

Fortunately, technology is providing numerous means to divert ourselves while awaiting the vaccine.

The world depends on US trade.

The US experience demonstrates the outcome when opening before eradicating the virus. As little as one super spreader can place the world at risk. This quirk is why the US situation is perilous for the world economy. The US is a signficant importer of goods and services from other countries (exhibit 2). The collapse of imports was $370 billion at an annual rate in April. Indeed, a country's spending is another's income.

Exhibit 2. US Import Change by Major Countries



Source: Federal Reserve Economic Database

The US is consumer number one.

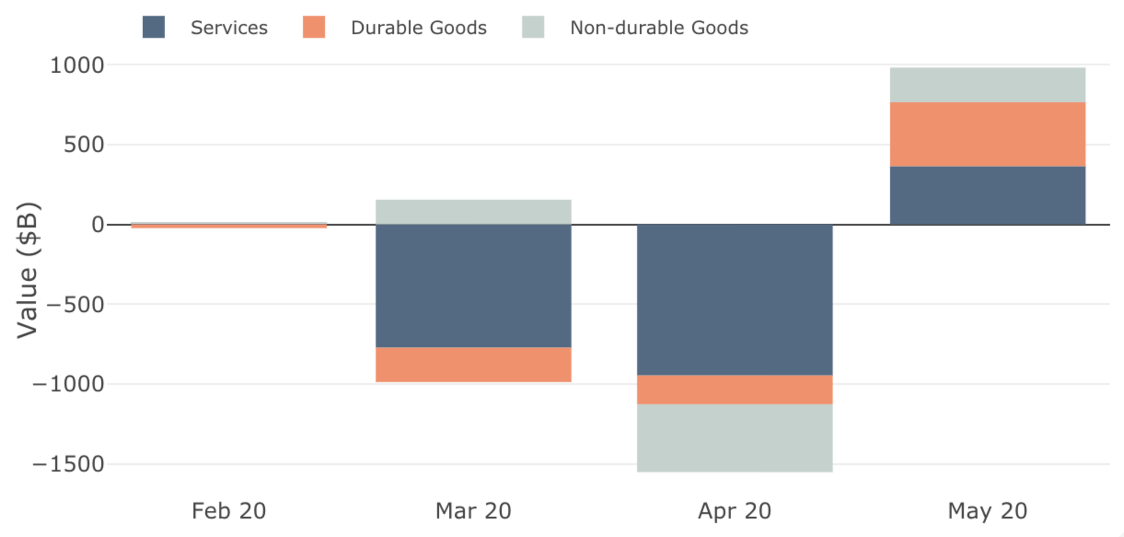
An uncontrolled virus is sufficient to impair world trade. The addition of the America First mantra only exacerbates the burden. As trade falls, so does growth. The world has long ago availed itself to the virtues of specialization and trade. While conceding trade displaces the employment of those within the tradeable goods sector, adequate policies can address them. For those in Northern Canada who have enjoyed Florida oranges in January, the benefits are palatable. Thus, the reversal of the US portends prolonged economic uncertainty. A bad risk (the virus) imperils a good risk (economic recovery).

The Economic View

Increased savings drove the rebound

All dropped objects bounce. The rebound of US consumption in May is of no surprise. Roughly half of the US States opened, and the other half took tentative steps to reopen in stages (exhibit 3). All three major categories (Services, Durables, and Non-durables) rebounded from March and April's virus induced trauma. This rebound was the result of the extraordinary expansion of savings brought on by the inability to spend and the fiscal stimulus. Demand meets supply.

Exhibit 3. US Personal Consumption by Type



Source: Federal Reserve Economic Database

The US is still 7% below peak.

The challenge is in both the magnitude and the composition. The consumption remains $1.5 trillion below the February level. This amount is roughly 7% of GDP. Any future shutdowns that transpire in States where the virus is resurging (e.g., California, Florida, Texas) adds to the damage.[1] In context, the remaining 7% gap is the largest US recession since the Great Depression.

Motor vehicle sales account for *half of the rebound* in consumption. Dining & drinking, leisure, clothing, and furniture compose a further 40% of the gain. The pent-up demand from the stay-at-home order conspired with the fiscal

[1] See *Prelude to a Pandemic* from Capital Risk (June 17th, 2020) for more details.

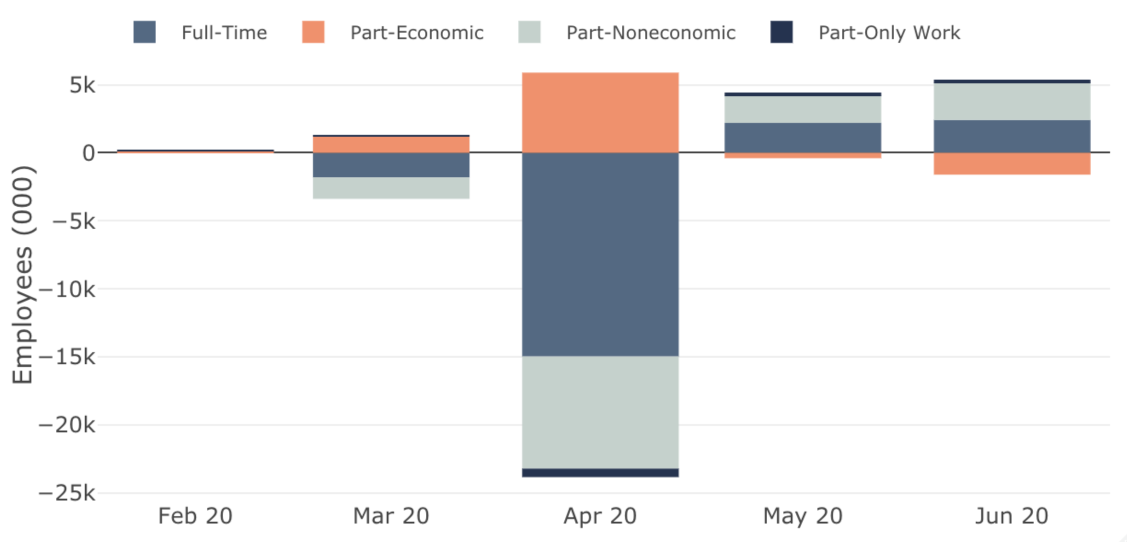
The Economic View

rebate payments and expanded unemployment benefits to drive the rebound. Unfortunately, the latter is a one-off payment while the second is expiring in July. Thus, the durability of the bounce is questionable.

Employment growth was merely reclassified workers.

The remarkable decline permeated all types of employment. The decrease was dramatic for full-time and those that worked part-time by choice. Evidently, those that shifted to part-time began a transition back to full-time employment (exhibit 4). The reality is that there was no real gain in full-time jobs, only a changing of classification by employers. This is not a cause for exuberance given the uncertainty of their permanence.

Exhibit 4. US Employment Change by Type



Source: Federal Reserve Economic Database

Workers may disappear with wage support.

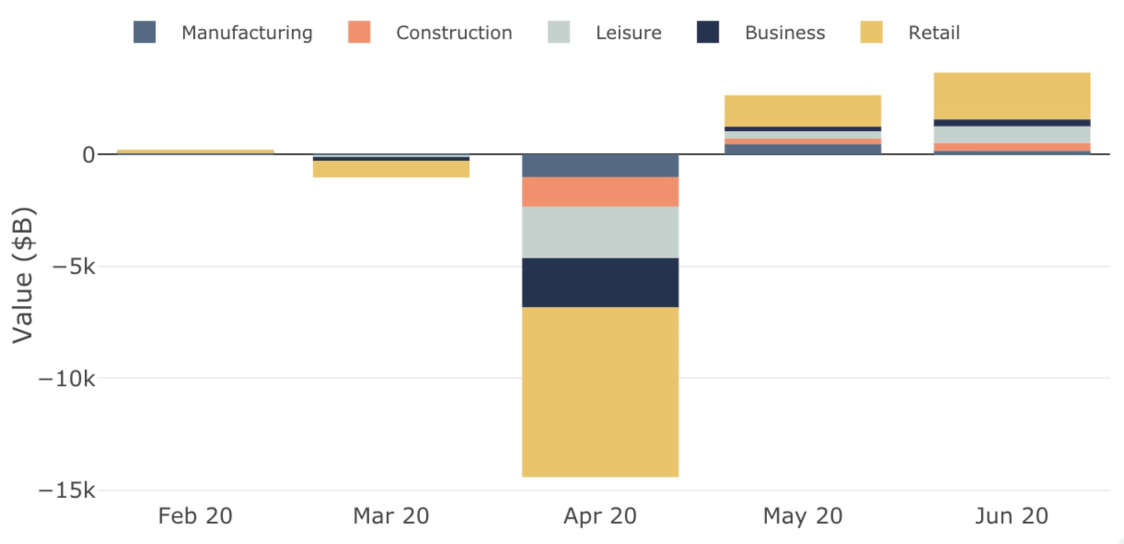
There are further concerns about these employment gains. Employers' ease of switching their employees from part-time to full-time requires that investors view increases cautiously. With the expiration of the wage support and declining demand, the incentive to keep employees is non-existent. In combination with the prospect of future economic closures, a reversal is highly probable. The cessation of extended unemployment benefits will assure any further closures are more severe than the former.

The Economic View

The return of retail jobs may be brief.

The employment rebound materialized in the sectors in which they originated. The retail sector was the dominant sector for employment gain with leisure in second place (exhibit 5). They led the fall and are leading the return. Given their tenuousness, these jobs will disappear again with a rebound in the virus. In this event, the presence of fiscal support is doubtful.

Exhibit 5. US Employment Change by Sector



Source: Federal Reserve Economic Database

Risk abounds and is magnified by politics.

The world is waiting for the US to act. The domestic political paradigm ensures that this unlikely before the election. A loss by the incumbent President may usher in unforeseen policy responses on the exit. Given the importance of the US to the world economy, this uncertainty is unenviable. This situation precludes a fast rebound of the economy, which is at a level not seen since in a century *despite* an unparalleled fiscal and monetary expansion.

There are good risks and bad risks. The political uncertainty is an unrewarded risk that makes taking investment risk problematic. Even with the Federal Reserve protecting corporate bonds, the investor confronts a simple question. Are US equities worth more than they were before the Pandemic? The answer lies in whether the investor wants a reward for their risk.

Equity Markets

The equity markets seem agnostic to the impending peril embedded in the US pandemic response. Peculiarly, the US equity market remains elevated versus the rest of the world (exhibit 6). The dominance of the technology darlings with their global platforms and monopolistic profits account for much of the outperformance. Nonetheless, tentative signs of reversal are apparent. The durability of their franchises and US prominence is questionable.

Investors are exiting the US.

Exhibit 6. Relative Performance of Equities by US/Non-US

Source: MSCI. Capital Risk calculations. Ratio increases reflect US outperformance.

Technology can endure in the near-term.

In the near-term, there is little to challenge the prominence of US technology. In the middle term, they will most assuredly face anti-trust actions in the US. As Microsoft's experience shows, this does not prevent them from maintaining the positions for decades *after* these actions. Of course, in the long run, anything is possible, as prior leaders MySpace, Blackberry, and Yahoo will attest. The immediate threat is the US pandemic response that may make the US the global economic laggard.

The crucial ingredient to enduring company performance is earnings growth. Investors routinely mention the durability of earnings (i.e., their "earnings moat") as the prime factor for investment outperformance. In the past, this

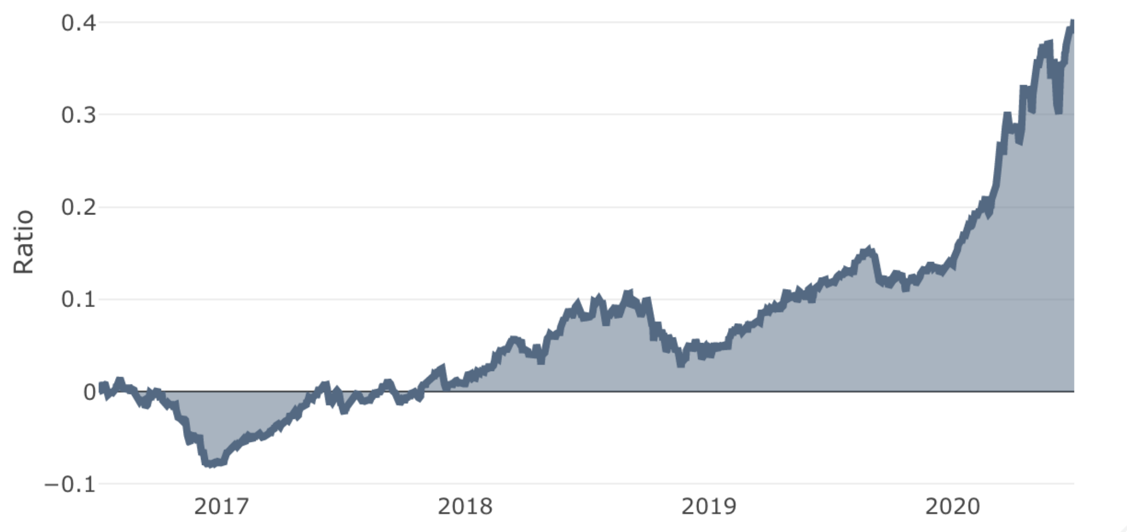
Equity Markets

stability was the fixed assets domain and their place on the balance sheet. The focus is now on the durability of the earnings within the income statement.[2] This focus aligns with investment theory: earnings drive investment value.

Earnings are the only measure right now.

Three factors account for the decline of value measures. Intellectual property increasingly accounts for asset value, low inflation maintains book value, and the depreciation of the physical asset is accelerated with technological change. The latter two suggest high costs for tangible assets. In contrast, the first suggests high value to people whose costs manifest in the income statement, not the balance sheet.

Exhibit 7. Relative Performance Global Equities by Growth/Value



Source: MSCI. Capital Risk calculations. Ratio increases reflect growth outperformance.

The tech bubble may have hidden the 'value' in growth.

This shifting measure of value is evident in the performance of growth over value (exhibit 7). Over the last four years, global growth stocks outperformed value stocks by 40%. This number is not trivial. The enduring pain of value investors extends back eleven years. Without the technology bubble in 2000, this superior performance might be reaching *three decades*. For investors, the simple answer is to follow the earnings.

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[2] See *Requiem for Value Investing* (Capital Risk, May 2020) for further insight.

Equity Markets

An artifact of the prodigious earnings of technology companies is that they provide the opportunity to buy their competitors before they are well-financed challengers. Until anti-trust action materializes, this is an enduring benefit. While investors dumped small stocks at an extraordinary pace in March, they are gingerly entering back into the market segment (exhibit 8). As the adage states, cash is king when everything is on sale.

How long will small stocks perform?

Exhibit 8. Relative Performance Global Equites by Size (Large/Small)

Source: MSCI. Capital Risk calculations. Ratio increases reflect large cap outperformance.

Low rates will drive further mergers.

Acquisitions are most certainly in the cards with copious amounts of cash on the balance sheets of large technology firms. This action provides an opportunity for the astute investor to focus on specific firms that align with the technology and finance leaders' strategic focus. Investment analysts can earn their salaries in this environment.

The emerging markets provide another vehicle for investing. While the US markets continue to lead, the segmentation of global markets (i.e., Chinese technology and European anti-trust) offers other firms an opportunity to emerge. These are not necessarily a current threat to the hegemony of US technology firms, but they will arrive in time, most assuredly.

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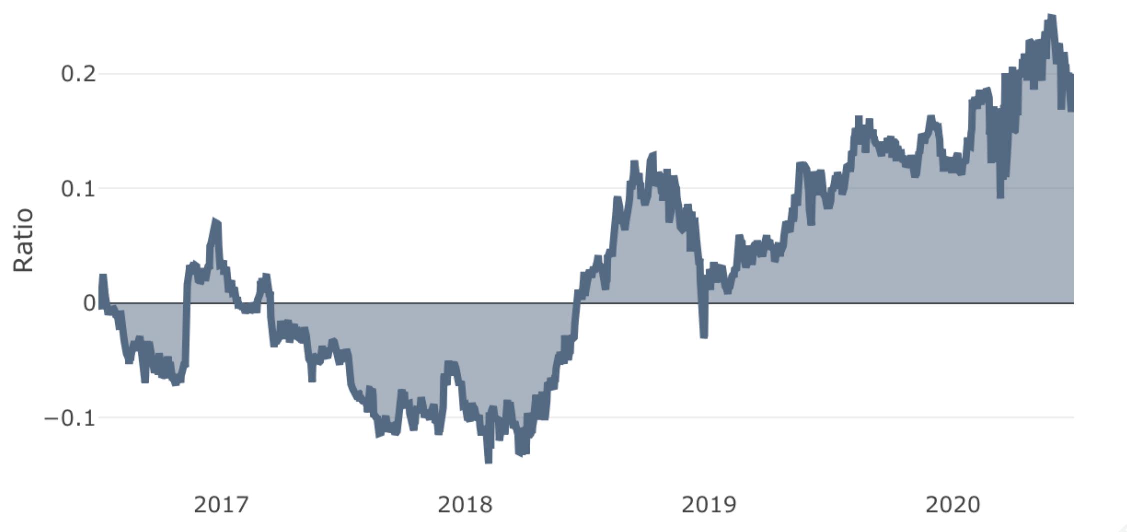
The US mistakes provide opportunity in the EM.

Strength in numbers. In the age of data science, numbers speak. The emerging markets are copious in numbers. Higher growth rates on a higher absolute number of people. The reality of 80% of the global population conveys the potential. The darling of the past two decades was the rise of China and its billion-plus consumers. While its ageing and inverting population pyramid foretell future problems, the size of numbers draws the investor. Significantly, there are other countries without these disadvantages (i.e., India) to continue the leadership.

Exhibit 9. Relative Performance of Equities by US/Emerging Markets



Source: MSCI. Capital Risk calculations. Ratio increases reflect US outperformance.

Non-tech sectors in the US face material headwinds.

The critical question for the investor is the permanence of US technology. Without political constraints or anti-trust behavior, they can endure. The changing political culture in the US may presage a change, which the equity market is beginning to grasp (exhibit 9). Further, the magnitude of the fiscal expansion in the US will most assuredly require *increased taxes that impair future earnings*. Thus, US companies uniquely face a future peril weighted against them.

Emerging economies are not all the same. As in the small company dimension, knowledge matters for investing in the best company *and country*. The scope of

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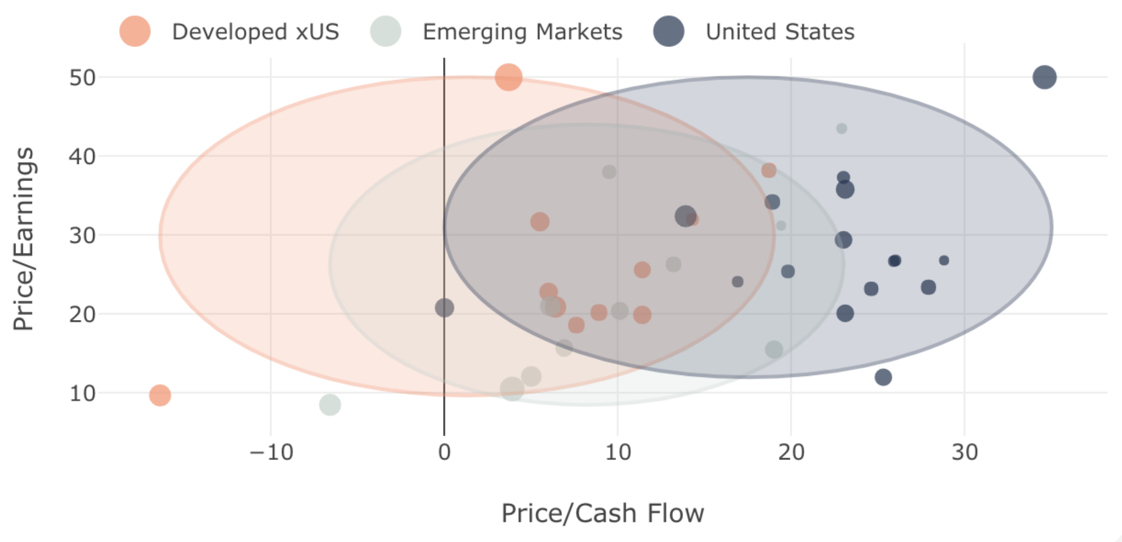
investing is varied with the principal risk residing in currency exposure. The primacy of the US dollar as the currency of last resort ensures that it can endure in the near term. As investors look for opportunities globally, managing their currency exposure is the critical dimension for success.

US valuations are high.

US valuations remain stretched versus other regions' markets. How stretched? Price to cash flow is universally double their counterparts in other markets (exhibit 10). The challenges the US faces with the virus and the probable change in political direction make the valuations a harbinger of change for equity leadership. US sectors excluding technology confront the most immediate threat from a reversal.

Developed xUS markets offer the best value.

Exhibit 10. Global Equity Valuations by Region and Sector



Source: S&P Indices. Size of marker reflects the dividend yield (larger is higher). Valuation max in 50.

The higher dispersion of the Emerging Markets compels a more nuanced stance across sectors and countries. Commodity and external demand dependent locales seem ill-positioned to rebound in the near term. Sectors, including *consumer staples, infotech, and materials,* should provide sufficient dispersion of risk across the countries while providing a means to participate in growth.

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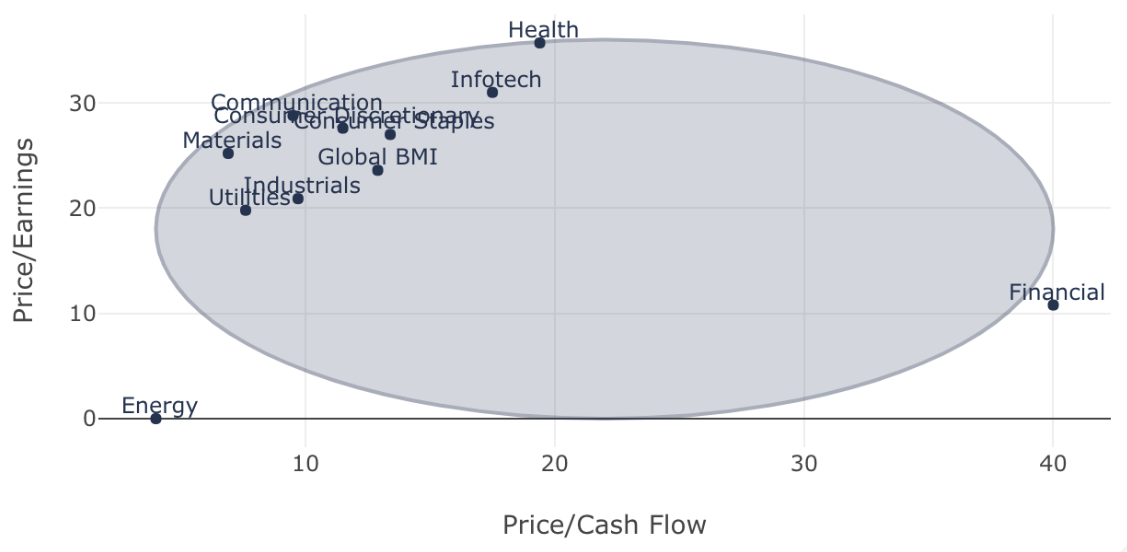
The EM offer high dispersion.

Valuations in the US are out of line with the Emerging Markets. The US displays less dispersion than Emerging Markets (exhibit 8). While the earnings multiples are similar, the EM shows lower cash flow multiples. This divergence is partially the result of the EM Financial sector's negative cash flows. The higher dispersion in the Emerging Markets provides an opportunity for selection while providing modestly less risk valuation risk.

Globally, the challenge is understanding which sectors will endure uncertainty. With an underlying premise of continued global contraction through the end of the year, the outliers on the global level remain Financial and Energy (exhibit 11). Avoid Health Care as it most likely exhibiting extreme valuations induced by the Pandemic. While it seems easy to determine where not to invest, choosing where to invest is not.

Exhibit 11. Global Equity Valuations by Sector

Financials and Energy reflect the poor economy.



Source: S&P Indices. Valuation limited to zero and forty.

In the muddle of the moment, valuations are rich for consumer staples relative to the consumer discretionary sector. Unquestionable risks exist to discretionary spending while low margins constrain the consumer staples sector. Stability is the tune of the time and suggests the relative trade is for

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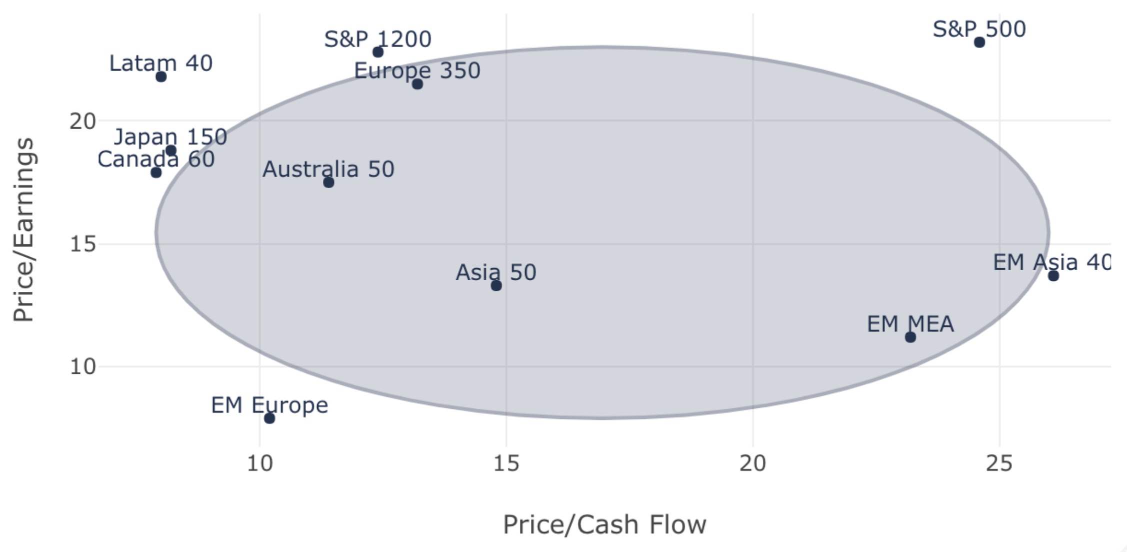
Economic uncertainty suggests a risk-averse stance.

consumer staples. With stability in mind, the Communication sector provides modest improvement in valuation and risk reduction versus the Information Technology sector. Of course, the past six months demonstrates all this can change in an instant.

Across global regions, the S&P 500 is an outlier to such an extent that it is a relatively easy decision to avoid all non-technology sectors in the US (exhibit 12). Where to invest is a question of valuation and risk-adjusted return. Weighing these trade-offs suggests a preference for Europe and Asia.

Relative stability is offered by Asia and Europe.

Exhibit 12. Global Equity Valuations by Region



Source: S&P Indices.

Evaluating where to invest is within the context of a global recession. The deteriorating demand suggests avoiding commodity and export-dependent countries such as Canada, Japan, and Australia. Their investment requires a positive outlook for commodities and expanding global trade. This argument is difficult given the environment. The US and Emerging Markets come with high relative valuations and volatility. Thus, prudence dictates a posture that prevents vulnerability from risk.

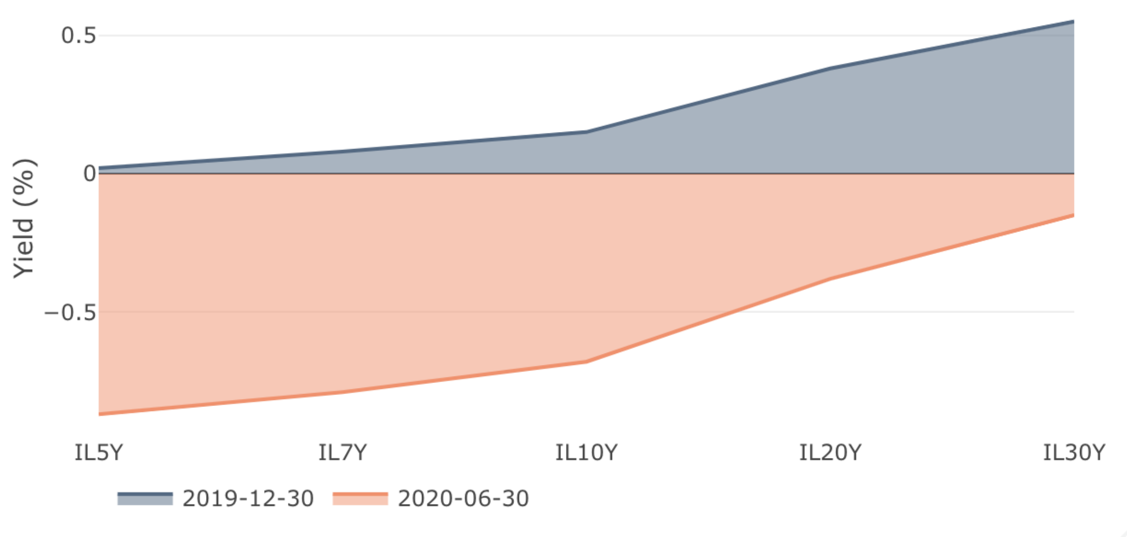
Interest Rates

Inflation expectations don’t exist.

Interest rates are shouting their story. Investors took little heed to their message at the beginning of the year after nominal yields fell globally. While they did not portend the Pandemic, they did suggest a faltering global economy. The virulent impact of the shutdown only hastened the arrival of the recession. Their message is apparent: *little growth or inflation for years*.

The US Treasury Inflation-Protected (TIPS) yields exhibit an exploding economy. Yields are below zero out to *30-years* (exhibit 13). These levels are particularly significant because of the embedded deflation protection in the bond that rewards zero or the inflation rate. Thus, markets are paying a premium to protect against falling prices. The implication is that US nominal yields are too high for this environment.

Exhibit 13. US Treasury Inflation-Protected Yields



Source: Federal Reserve Economic Database

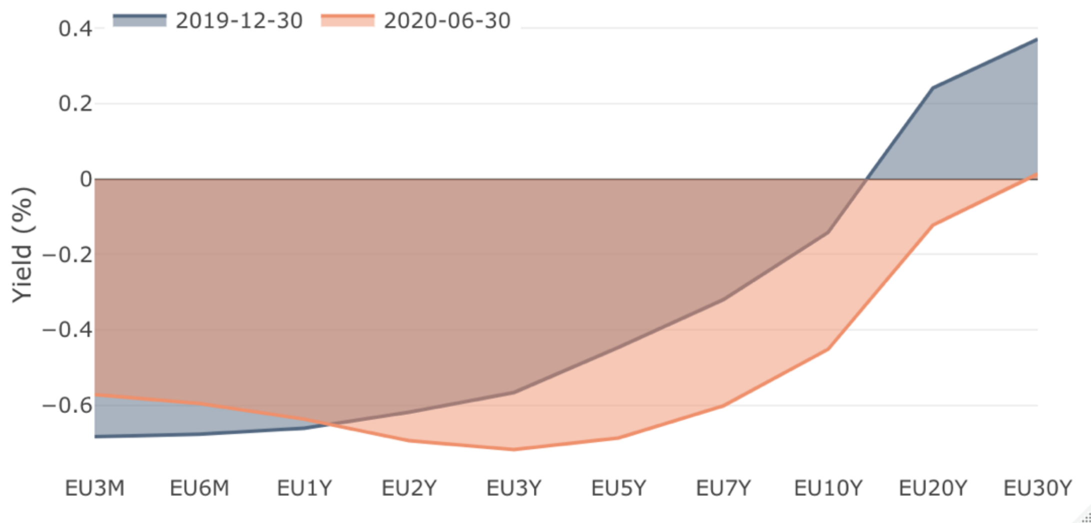
All major markets indicate negative inflation yields.

Europe faced the same expectations *before* the Pandemic. Now, the rates do not exceed zero for all terms with the three- and five-year terms falling even further into negative territory (exhibit 14). Sharing the same unique payoffs as their US counterparts, the expectation is for little inflation over the *next five years*. These times are indeed different.

Corporate Yields

Exhibit 14. Euro Sovereign Yields

European yields fell further!

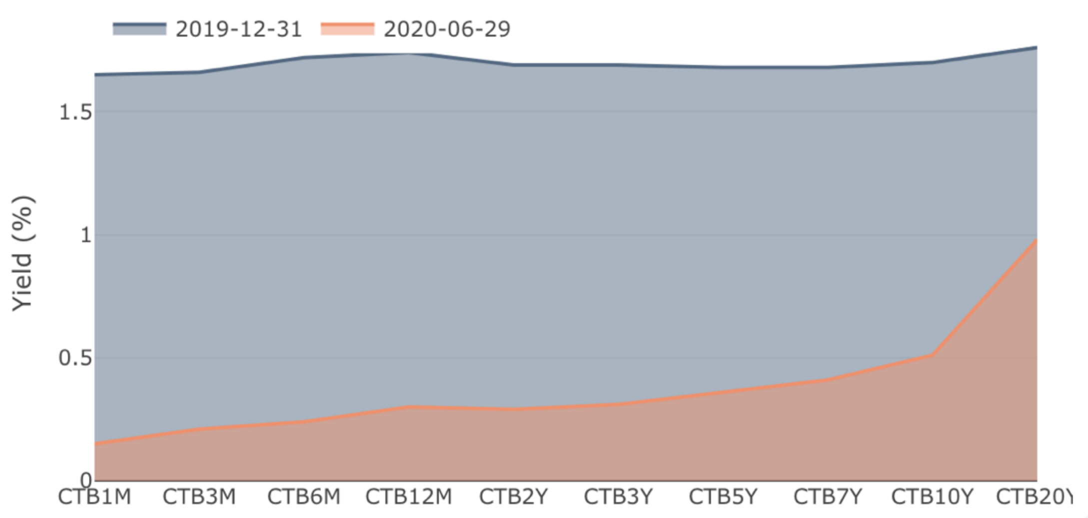


Source: ECB Database

The fall of Canadian yields is a strong indication that the return of commodity demand is not imminent (exhibit 15). Nominal yields are below one percent over the whole term and are below 0.5% from 10-year and nearer. The implication is little expected growth or inflation for a *decade*. While lower rates support housing, without demand, the housing market is dubious.

Exhibit 15. Canada Treasury Yields

Canadian yields do not bode well for commodities.



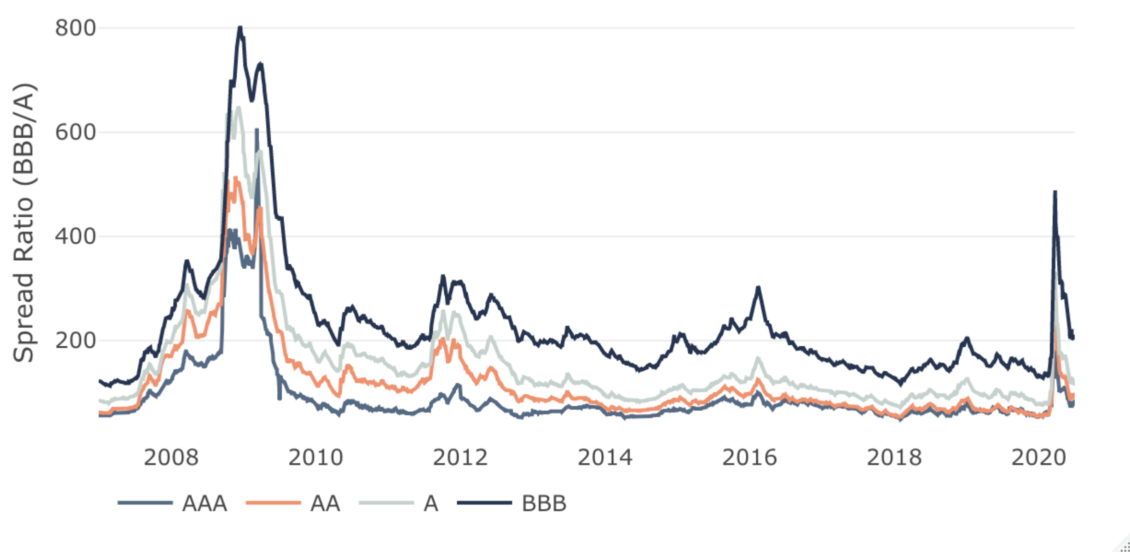
Source: Statistics Canada

US Corporate Spreads

Spreads reflect Fed actions, not reality.

Credit spreads are returning the average levels seen over the *last decade* (exhibit 16). While the Federal Reserve's support is compressing yields as the buyer of last resort, the juxtaposition of these spreads against the economic backdrop is incoherent. The Fed is risking the Japanification of US corporations by supporting untenable 'zombie' companies operating in name only. There is, however, a more considerable risk.

Exhibit 16. US Corporate Spreads



Source: Federal Reserve Economic Database

Spreads offer risk *without* reward.

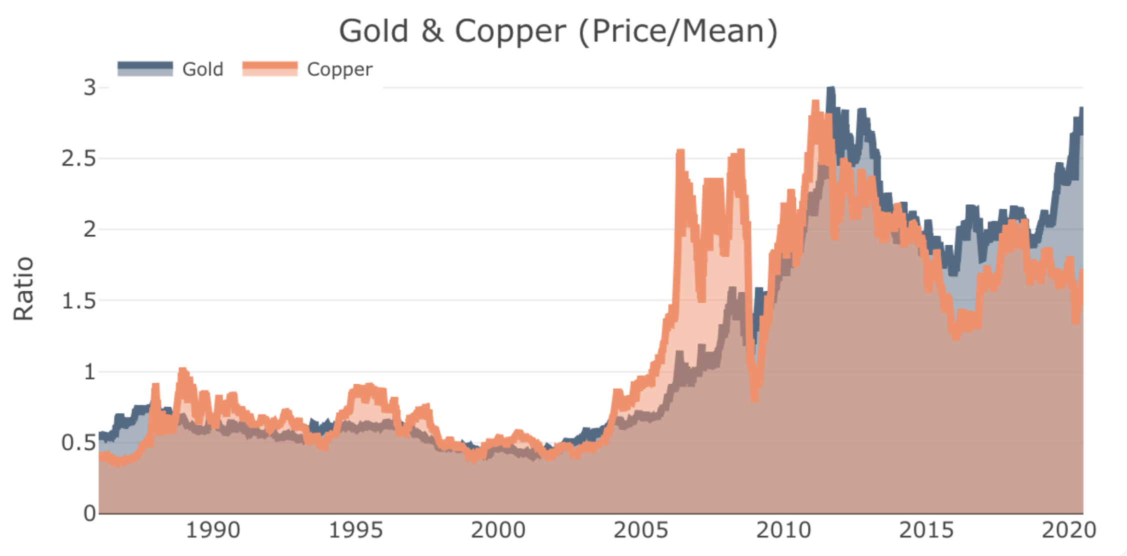
Supporting the debt market provides coverage to the equity market. This action induced equity markets to launch because if the debt can't default, the risk to equity is trivial. While this appears supportive of the economic environment, it magnifies the growing wealth inequality in the US. Further, it places most of the population at a disadvantage to the holders of equity capital. This asset inflation hits the consumer at their home by pricing real estate higher than justified by wage and population growth. Thus, the Fed's action may sacrifice long-term wealth inequality for short-term liquidity in the financial markets. Given the wage experience of the last few decades, this decision appears a poor policy prescription.

Commodities

Rising copper and gold is surprising.

Commodities are the ever-present cyclical indicator. As demand increases, so does the prices for industrial commodities. In contrast, as fear increases, so does the price of Gold. Relative differences in these prices augur changes in the economy. The challenge for the moment is that these beacons are moving in the same direction (exhibit 17). This outcome is complicated.

Exhibit 17. Price Ratio of Gold/Silver



Source: Quandl.

The persistence of gold prices is not remarkable given the environment. The path of COVID19 remains highly uncertain in the US and Latin America. The policy response is crucial to containment, and their permanence is required to keep the virus at bay. Thus, a credible argument exists for the price of gold.

The copper rebound probably reflects restocking, not demand.

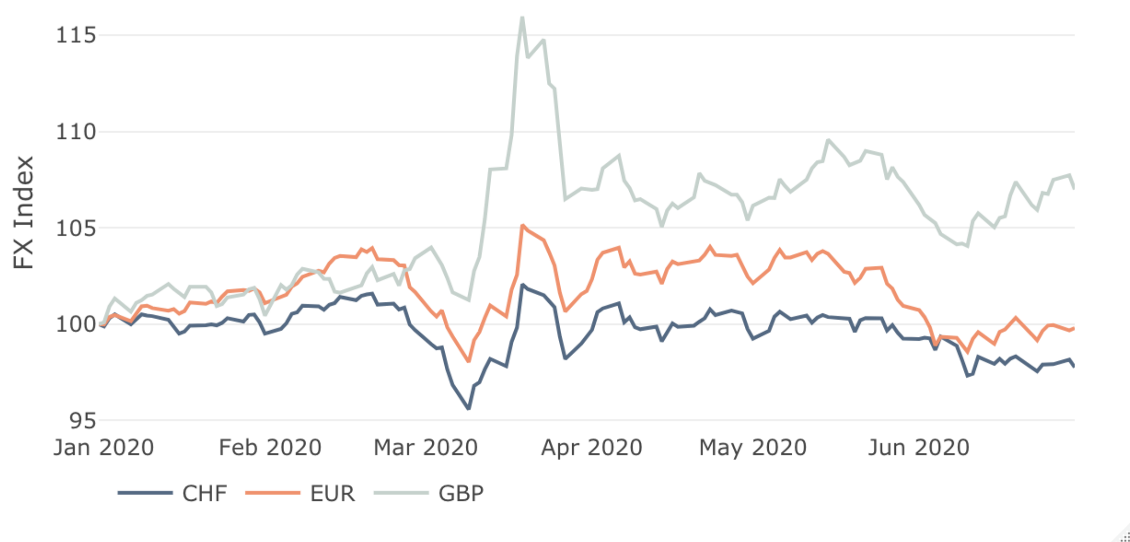
In contrast, copper rebounded from the lows induced by the panic in March as economic shutdowns emerged. China was the material marginal consumer of copper, but as it migrated to consumer-led growth, that impact waned. China is leading an economic rebound as the first-in-first-out economy. The prominent position of exports in their economy requires the rest of the world, which does not appear ready. These copper prices most likely reflect restocking rather than demand. Be wary of Dr. Copper morphing into Mr. Hyde should the economic rebound not materialize.

Currencies

Investors' affinity for the US dollar is waning.

The linkage between commodities and the US dollar is ever-present. As the infiltration of the virus continues, so will the economic vulnerability. In another time, this would lead to continued strength for the US dollar. The ineffectual US policy response gives qualms to the durability of the US dollar. Indeed, these times are different.

Exhibit 18. Normalized Currency Rates



Source: Alphavantage

The currency markets apprised the story of the US response to the virus. Since early June, the markets began to sell the US dollar versus major trading pairs (exhibit 18). The Euro and Swiss Franc strengthened to the point of exceeding their levels at the beginning of the year. Markets are indicating that the US will lag the rest of the world in economic recovery.

Risk is here to stay until a vaccine.

Juxtaposed against these two currencies, the Sterling reversed its initial strength and is weaker now against the US dollar. This reaction reflects the inadequate parallel response to the virus in the UK and the continued uncertainty from Brexit. The US has made efforts to reverse prior poor decisions that may mollify the markets. In opposition, the US is a pariah condemned until resolution of their politics in November or a vaccine. Until then, the market's bemused viceroy reigns, volatility.

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