Capital Risk

# GLOBAL PORTFOLIO STRATEGY

# A Collision of Sentiment & Value


*Photo: Jen Theodore on Unsplash*

**It was the triumph of hope over despair.** Equities reigned supreme in the year of the Pandemic. The vaccine arrival delivers relief for the despondent economy, in particular the leisure and hospitality sectors. In contrast, unemployment is at levels not seen in generations, and investors salivate as equity valuations reach multi-decade highs. At the same time, government debt and deficits achieve levels unseen for seventy years. The confluence of Millennial investors focusing on familiar companies with unprecedented monetary stimulus drives the divergence between equities and the economy. Valuation levels suggest the continued primacy of equities is doubtful, particularly for US technology. The quandary is that valuation gaps can endure for years. With dividend yields above government bond yields, cash flow investors face a parallel dilemma. The primacy of sentiment makes it a year of tactical investing. Timing is everything.

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All asset classes come with risk this year. Sentiment drives equity. Monetary policy compresses bond yields. Credit offers little return for the risk. Alternatives are crowded.

Value will emerge by managing these risks. The performance of active managers will determine whether they play a paean or a requiem. Their business depends upon it.

- Jason Prole

## Highlights

- **High equity valuations** suggest allocation and stock selection is vital.
- **Value** and the **Emerging Markets** may offer the best reward to risk.
- **Interest rates** provide negative real rates and further losses as rates rise.
- **Credit spreads** are too narrow and don't compensate for the risk.
- Gold fever may fade as economic and political stability returns.
- The falling **US dollar** may reverse as the global economy recovers.

# The Macro View

**A price for everything.** Euphoria and fear sometimes overcome markets and places their *current* value in doubt. This year was no different. The fear of a global pandemic sent the markets tumbling in March as fear embraced investors. Prompt fiscal and monetary actions vanquished the fear. Euphoria now reigns as the price of the broad equity markets and some sectors exceed their pre-pandemic levels. With earnings still below their prior peaks and the economy about five percent below apex, the battle is between price and value.

Markets have long provided buyers and sellers a place to decide on a price to exchange an item. A mutually agreed price suggests a fair price for that moment. Whether the price reflects the future value is another question. This relationship is particularly relevant in the financial markets, where income streams are projected decades into an uncertain future. The cyclically adjusted price-to-earnings (CAPE) ratio is a well-known measure of equity valuation, capturing the relationship between prices and earnings. The *current* high valuation tends to bode poorly for *future* returns, but only time will tell whether the price is *too high*.

**Equity valuation appears high.**

Exhibit 1. Cyclically Adjusted Price/Earnings Ratio


***Source**: Robert Shiller. Ratio is price to the average 10-years trailing real earnings.*

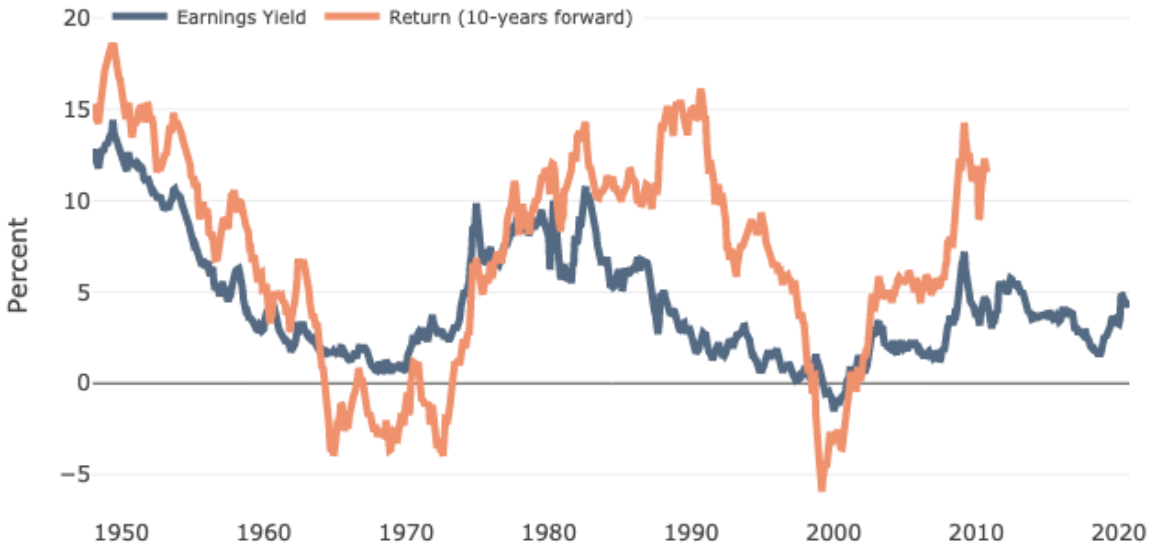
# The Macro View

**Value is in the eye of the beholder**. There are as many ways to measure value as there is to cut a cake. While the way the cake is divided does not change the size of the cake, the way value is measured can change the perceived value. Modest changes to the assumptions underlying the model can change the perceived value, even though the base data is the same. Indeed, an altered decision can occur from a different *framing of the question*.

The CAPE model measures current equity prices relative to the trailing ten-year real earnings. Missing from the valuation are competing assets that an investor may choose. The model is arguably incomplete without a comparable risk-free investment. The model is adjusted to account for Treasury bonds' real interest rate level to account for this deficiency. This small adjustment yields a significantly different value perception with equities expected to earn about *five percent more than* Treasury bonds in real terms (exhibit 2). While this number is roughly consistent with the long-term average, the range of outcomes is quite wide. Similar data, different conclusion. This outcome emphasizes that measuring future value is a nebulous affair where the *frame of reference* can alter the conclusion.

**Another equity valuation suggests average returns.**

Exhibit 2. Excess Earnings Yield




***Source**: Robert Shiller, CRM calculations. Excess earnings yield is the real equity return above the real 10-year Treasury bond yield. This measure is analogous to the equity risk premium.*

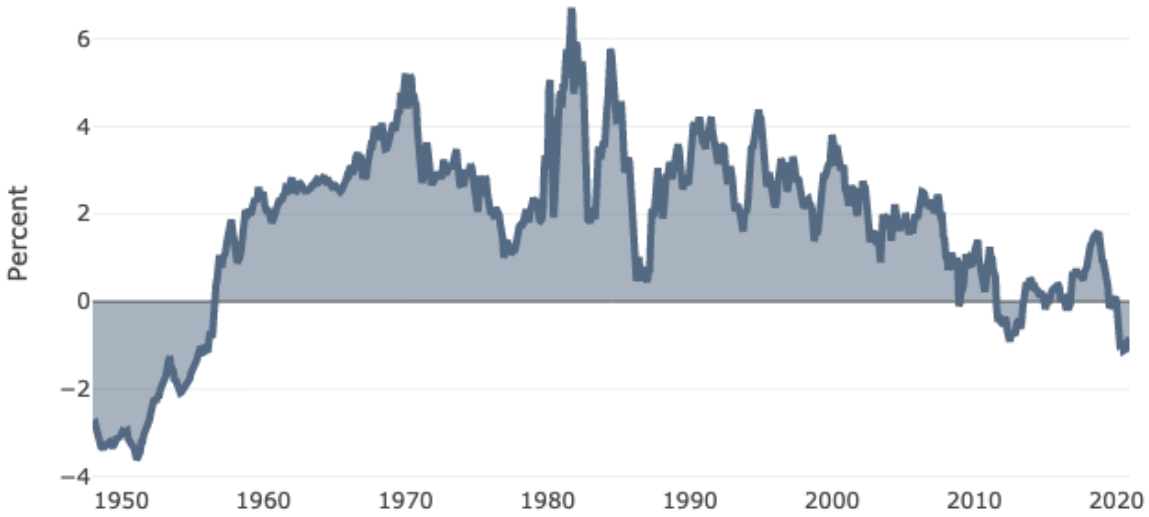
# The Macro View

**Aim big, miss small.** A way to overcome the sensitivity of a measure is to assess another object that is less sensitive to the framing. Ideally, the market is highly liquid, large, and has a valuation measure linked to the market. The Treasury bond market displays these attributes and is one of the world's largest and most liquid markets. The uncertainty comes to the value measure. Fortunately, it is *less sensitive* to framing than equity markets.

Treasury bonds reflect the full faith and creditworthiness of the United States. Through their elected government and their tax policy, the people have a full call on the assets of the country. In essence, a bond is a debt issuance on the country's future growth, which is the *fully diversified portfolio* and is the risk-free (correctly minimized risk) investment. The implication is that deviations of Treasury bond yields from the economy's nominal growth rate indicate valuation gaps. By this measure, real Treasury bond yields are at levels not seen in 60-years, when a *multi-decade bear market* for Treasury bonds began (exhibit 3). The measurement error comes from whether *prior* inflation is indicative of *future* inflation.

**Real Treasury yields are historically low.**

Exhibit 3. Real 10-year Treasury Yield




***Source**: Federal Reserve Database. CRM calculations. Current bond yield minus the trailing 10-year inflation rate.*

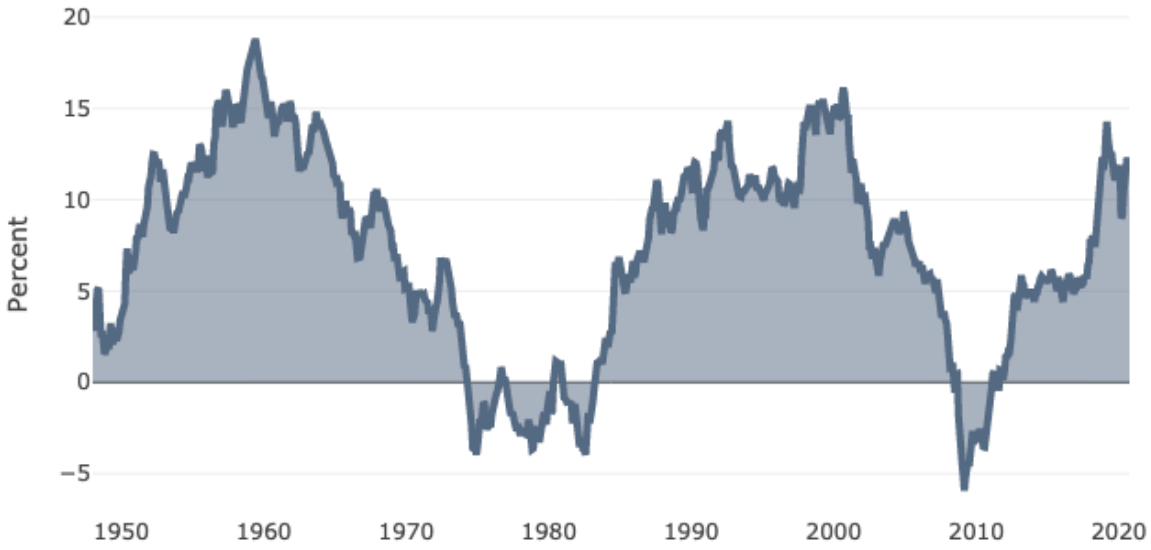
# The Macro View

**A relative reality**. The error term for the measure of future inflation hinges on whether inflation is a *monetary phenomenon*. The Federal Reserve adopted a numerical inflation target of *two percent* and will do whatever is possible to achieve this outcome through its monetary tools. Even though realized inflation for the past decade is *under* this level, it may increase in the future. The implication is that this current valuation measure of Treasury bond yields may *understate* the level. Regardless of the future direction of inflation, investors are most likely to receive *nothing or less* on their Treasury bond investment in real terms.

One equity measure shows low expected returns, while another displays average excess returns. The reconciliation is straightforward. Since the real interest rate is lower, so is the equity return. The average ten-year real return for equities over the last seventy years is about 6.8% (exhibit 4). The corresponding excess equity return is 4.7%, slightly above the current reading of 4.3%. Thus, a high valuation for equities merely reflects the outcome that *all returns* are expected lower than the average. If the low real yields on Treasury bonds continue and the equity valuation correct, it still will result in expected total real equity returns of merely *three percent*. It is the best of a scant litter.

**The current cycle of equity returns is short.**

Exhibit 4. Real 10-Year Total Return of the S&P 500 Index



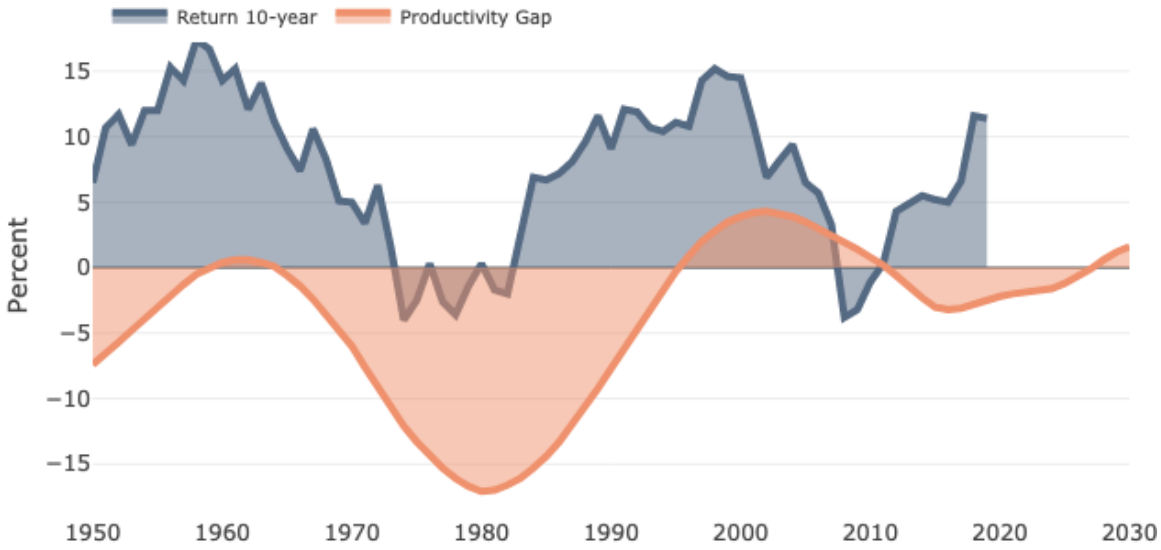

***Source**: S&P CapitalIQ, Robert Shiller, CRM Calculations.*

# The Macro View

**An echo of the past.** While valuations may give the investor pause, the future may exceed these paltry expectations. A hallmark of higher productivity in the US economy is the proportion of the prime work-age people (e.g., 35-50 years old). This group has two beneficial characteristics for equities: a higher level of productivity versus their peers and a higher propensity to invest for the future. When this cohort is in the ascendance, they lift company earnings through high productivity and increase equity prices by higher demand. This group will continue to grow in the workforce for the next decade (exhibit 5) and should *support equities* for the period with their ascendance.

**Demographics may provide a boost to equties.**

Exhibit 5. Productivity Gap




***Source**: S&P Indices. 10-year total return. United Nations, Department of Economic and Social Affairs, Population Division (2015). CRM calculations. The workforce is prime age between 19-65 years. The Learners are ages 20-34, the Producers are ages 35-49, and the Managers are ages 50-64. The gap is the Learners minus the Producers as a percent of the workforce.*

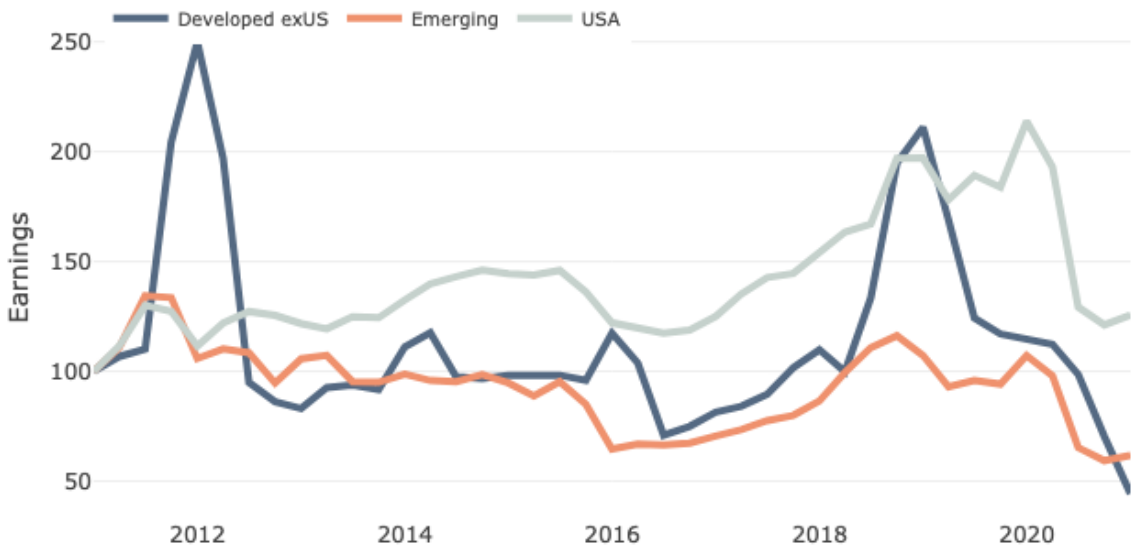
While there are few guarantees for investing, demographics are inevitable. As investors clamor for the next game-changing technology, the people's mundane reality of progressing in a service based-economy lumbers forward. This action supports the thesis that equities can continue their run for quite a while, whether driven by sentiment or fundamentals. In contrast, Treasuries or other bonds offer a meager outlook. Risk should have a reward.

# Equity Markets

The equity markets found new highs in 2020 despite the Pandemic. This rosy outcome contrasts with most of the global economy set to end the year about four percent below where it started. Lower growth should result in lower earnings for companies and is what occurred across all global regions (exhibit6). However, equities look to future earnings and are expecting a material rebound based on their price increase. The juxtaposition of the economic carnage and the effervescent equities price suggests that the investor's reality may be less than expected.

**Only US earnings have increased in the *last decade*.**

Exhibit 6. Equity Earnings by Region




***Source**: Siblis Research, S&P CapitalIQ, CRM Calculations. Earnings are normalized.*

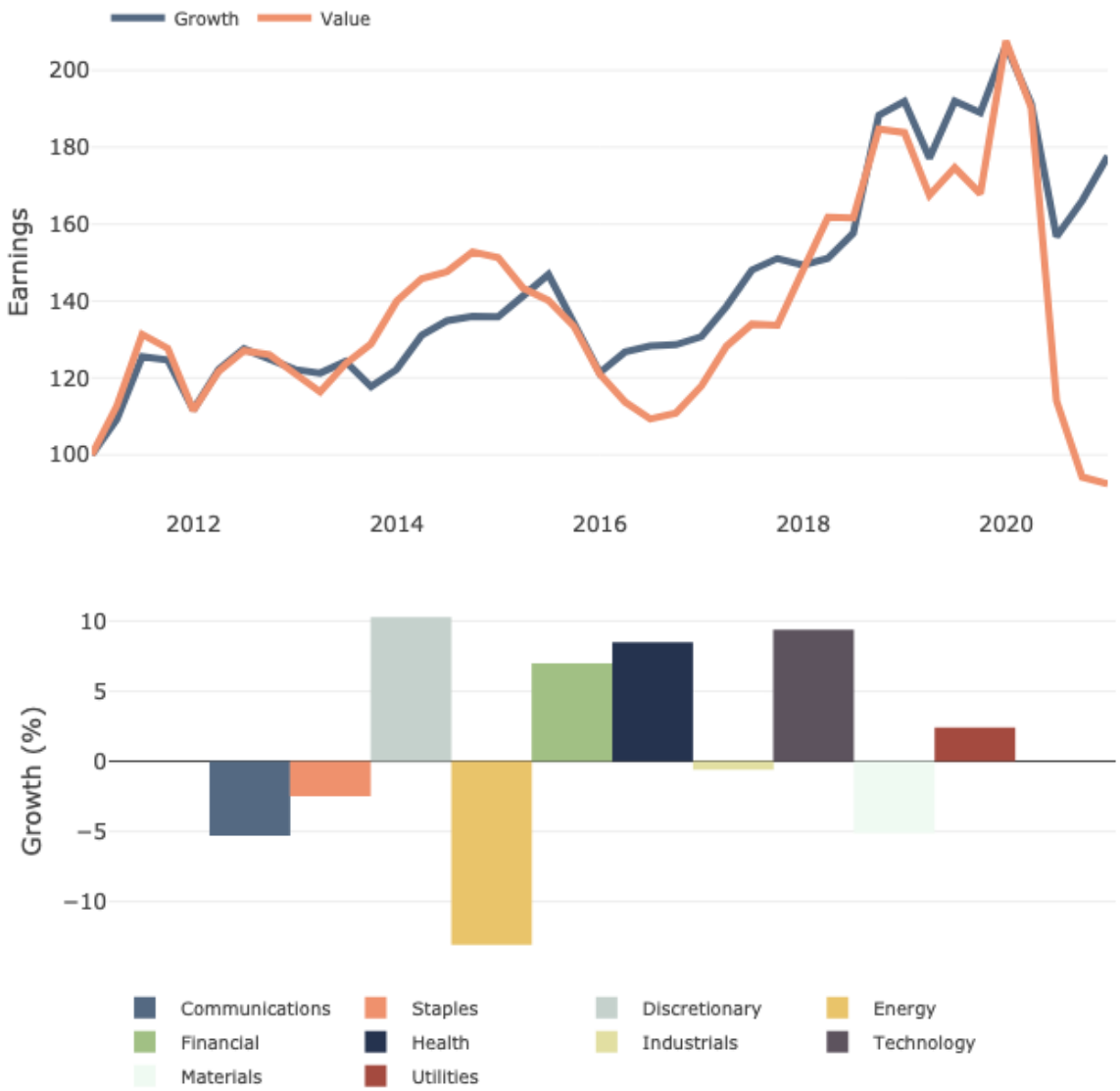
The United States is alone in enjoying growth in earnings over the last decade, with most of it occurring in the previous four years. Earnings for the Developed ex-United States and Emerging markets are unmoved in a decade (exhibit 6). Indeed, this divergence helps explain the performance difference between the United States and the rest of the world over the last decade. The performance follows the earnings. In the battle for future earnings supremacy, the conflict is between whether technology (i.e., the US) or economic development (i.e., the Emerging Markets) delivers the earnings boost.

# Equity Markets

Demographic trends are promising in the US as the Producers cohort, and their higher productivity enables higher earnings growth. The other favorable trend is the resilience of earnings for growth companies during the Pandemic (exhibit 7). While both styles enjoyed considerable earnings gains over the last decade (with the most occurring after 2015), only the growth style endured the Pandemic. This bifurcation hides who the real winners were.

**Growth companies, particularly services, endured the Pandemic better.**

Exhibit 7. US Equity Earnings by Style & Sector




***Source**: Siblis Research, S&P CapitalIQ, CRM Calculations. Earnings are normalized.*

# Equity Markets

Sectors provide a clearer insight into the winners from the policy response. Stimulus checks increased savings *and discretionary spending* as employment for most was unaffected during the Pandemic. Lower interest rates lifted the financial sector as mortgage rates were historically low. Health care and technology monopolies endured while people kept the lights on with the utility. With a fifth of the population facing unemployment and the resultant loss of income, core economic sectors all fell, including communications, staples, industrials, and materials. The policy response tragically missed the mark: the *next generation* will bear the cost through increasing tax burdens.

Notwithstanding the uneven fiscal response to the Pandemic, the US markets lead the rest of the global equity markets (exhibit 7). This leadership is doubtful as the poor policy is trumping technology prowess. The enduring leadership of US technology and their global monopolies may end in the future as anti-trust policies come to the forefront. In the near-term, the likelihood of the reversal of their earnings is unlikely. Whether their prices shift direction is another story as a compelling narrative can endure.

**The decade was kind to US equities.**

Exhibit 8. Global Equities Relative Performance of US/World ex-US


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

# Equity Markets

**People Matter.** The bifurcated earnings give fuel to the fire of continued growth supremacy. Higher earnings should deliver higher equity gains. The critical difference between value and growth companies is capital goods. The leaders are driven more by people and their services rather than enduring capital goods such as machinery. This distinction is critical because it provides more *flexibility* to a company. When investing in capital goods with a 30-year useful life, the ability to adapt is non-existent. Thus, service-focused growth companies are more adaptable to their customers.

**Growth out-performance is a recent trend.**

Exhibit 9. Global Equities Relative Performance by Style (Growth/Value)


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

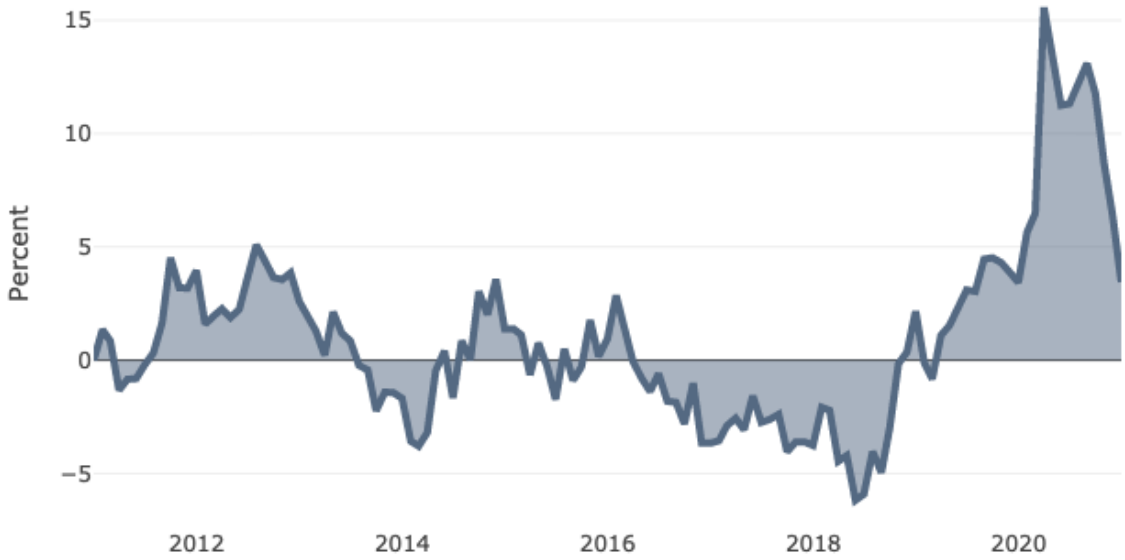
The dominance of growth is not solely from their adaptability. It is also a function of a new generation of investors (e.g., the Producers) entering their prime investing accumulation years. As was the case in the technology bubbles in the 1960s (i.e., Kodak) and the 1990s (e.g., Cisco), each generation has their familiar darling. The case for Tesla as the current sweetheart is probably unrivaled as their valuation exceeds all their major competitors combined while only manufacturing one-fiftieth of the cars. History shows that investing fads come and go. Some growth companies will endure, while others will be lucky to return anything to investors. *Stock selection matters*.

# Equity Markets

Smaller companies traditionally enjoy higher growth rates as their innovations take market share from the incumbents and deliver higher growth. Until 2019, this relationship was non-existent. Large capitalization stocks then reached a pinnacle of outperformance at the Pandemic's height (exhibit 10). Safety in large stocks was the mantra of the time, as more accessible financing would enable them to endure the storm. As the turmoil receded, investors returned to small-capitalization stocks. Whether the relationship continues is a function of earnings.

**A returning economy drives investor into small stocks.**

Exhibit 10. Global Equities Relative Performance by Size (Large/Small)




***Source**: MSCI. Total Return. Capital Risk calculations. Ratio increases reflect large outperformance.*

The trouble with small-cap stocks is that the leaders increasingly remain private rather than entering the public markets. With access to plentiful capital in the private markets, the need to enter the public markets with its higher costs and scrutiny is minimal. This saps the sector of some of its earnings growth. This dynamic may favor large-cap stocks as they have the wherewithal to buy private companies *before* entering the public markets. While the acquirer's earnings impact is a function of price and potential, the small-cap market deficit remains. The result is a *better relative performance* for the large-cap stocks.

# Equity Markets

The potential for the Emerging Markets (EM) remains enticing. Large numbers, increasing urbanization, and higher productivity growth are captivating narratives. While the euphoria of the BRICs (i.e., Brazil, Russia, India, and China) in the 2000s is long past, the EM region maintained its levels versus the US for the last four years (exhibit 11). Where they go in the near-term is a question of the Pandemic response. The inadequate policy response of the US may enable emerging competitors to gain market share. This structural impediment may reverse, but the timing is uncertain. In the near term, the Emerging economies appear a better bet to spring forward from the Pandemic.

**Emerging Markets may again have their moment.**

Exhibit 11. Global Equities Performance of US/Emerging Markets


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

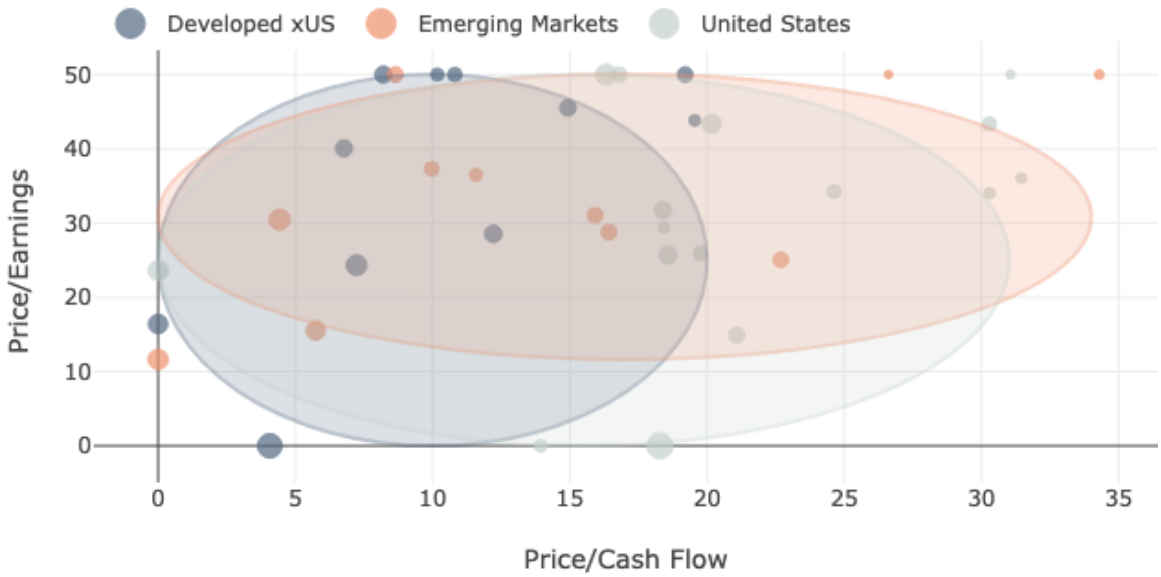
Technology is the determining factor for long-term dominance. Also crucial is the political environment that permits the technology to proliferate and command above-average earnings. The recent actions of China against Ant Group suggest that type of environment may be coming to an end. Similar actions against Facebook and Google in the European Union suggest a similar theme. If the US joins the collective to rail against monopolies, their primacy may not endure. If not, US technology may further cement its leadership. *Sentiment trumps value* in the political discourse. This time is not different.

# Equity Markets

Diverging policy responses globally and within a country results in varying outcomes for sectors and regions. This artifact of the policy response necessitates that investors discriminate between regions, sectors, and companies. At the global level, there is a clear dispersion in the regions and sectors (exhibit 12). Critically, the elevated cash flow multiples in the US versus the rest of the developed world is evident. The US sits on average *double* the cash flow multiples of the other developed markets.

**Stretched cash flows means allocation is critical.**

Exhibit 12. Global Equity Valuations by Region and Sector




***Source**: S&P Indices. Size of the marker reflects the dividend yield (larger is higher). Valuation limited to zero and fifty for ease of exposition.*

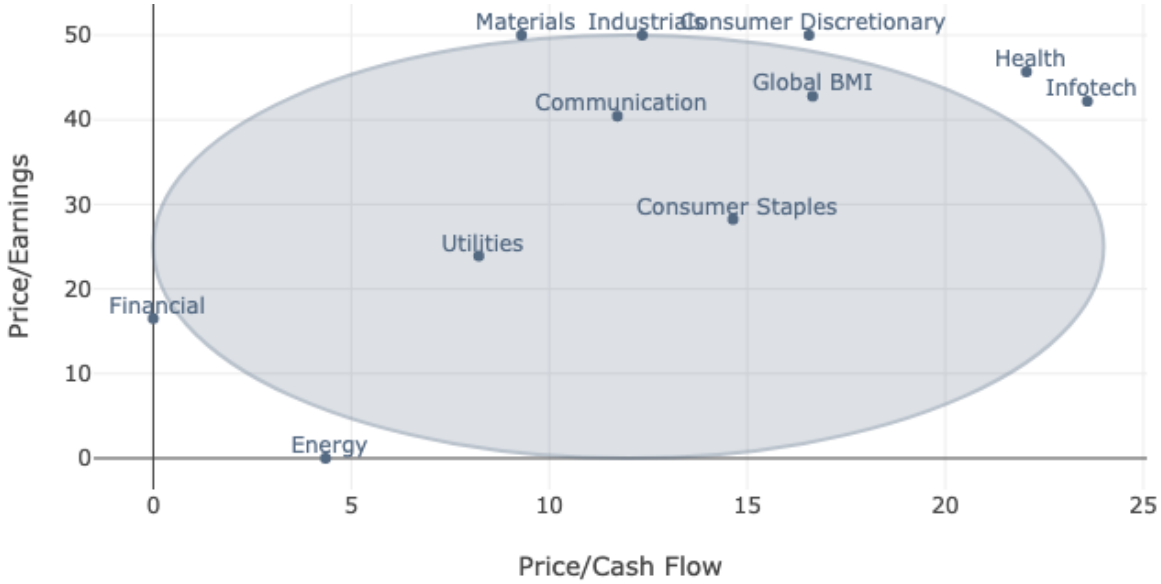
These dramatically higher multiples suggest either US cash flows will grow double the rest of the world or that the repatriated foreign earnings will increase dramatically through some combination of growth and a falling US dollar. Indeed, US operating cash flows doubled over the last decade while other developed and emerging markets were *mostly unchanged.* This result suggests that the US should be priced higher than other markets based on past performance. The challenge is that investing is about *future* performance and is where sentiment collides with valuation as the market's price may *already reflect future performance*.

# Equity Markets

Fully valued future earnings indicate that the focus of investing should shift from a passive to an active stance. The reason is simple: manage risk and opportunity. This task may materialize on tactical asset allocation across regions and sectors or focused stock selection. The dominance of the asset allocation decision on returns suggests the latter. The enduring investment performance of Warren Buffet suggests adding a layer of stock selection within a sector or region. This decision is not about choosing which companies or sectors will win; instead, it is about removing the companies or sectors that don't offer a reward for their risk. The moment's mantra is *risk management.*

**Sector dispersion provides opportunity.**

Exhibit 13. Global Equity Valuations by Sector




***Source**: S&P Indices. Valuation limited to zero and fifty for ease of exposition.*

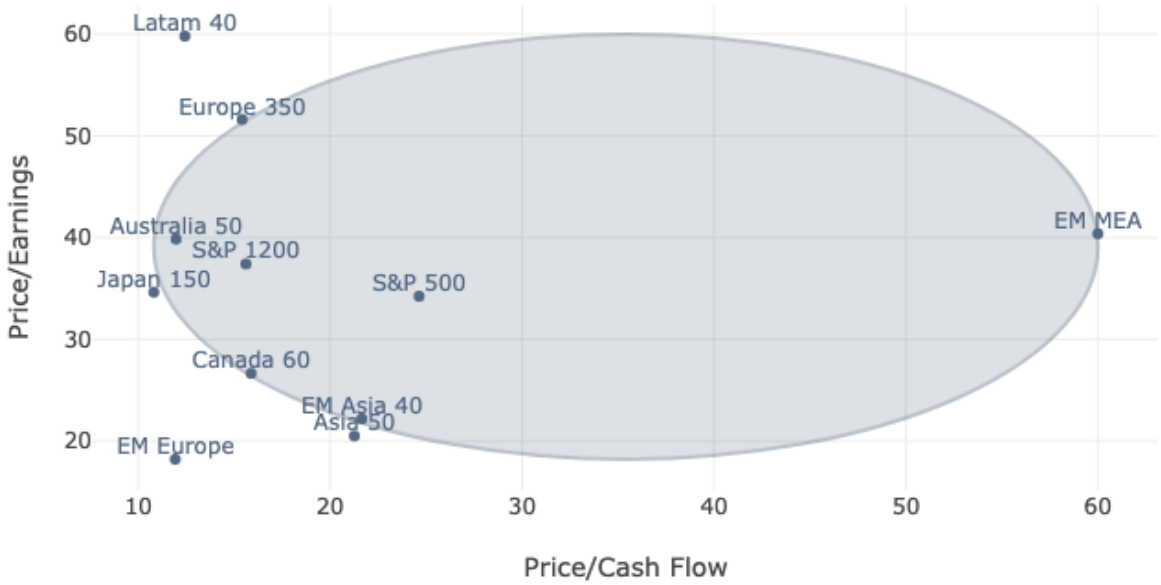
Global sectors suggest that Technology and Health Care valuations are high, while Financials and Energy are low (exhibit 13). A *fallacy of division* occurs when applied to individual companies within a region or sector. A technology company may deliver on its valuations, while numerous others will fail to live up their potential. This uncertainty is why stock selection is critical, not to choose those that will prevail; instead, *remove those that are set-up to disappoint*. This moment is the clarion call for investors to separate the prevailing narratives and the hard facts of businesses with enduring cash flows.

# Equity Markets

**Cash is king**. Earnings are subject to management from varying accounting and corporate performance incentives. In contrast, operating cash flows are less amenable to management. Significantly, this is the accurate measure of a business: the ability to return cash to investors. As before, the US investors' challenge is the cash flow multiple is about double that of the rest of the world (exhibit 14). The high level of this measure poses challenges to future equity returns. *Managing risk* is thus a critical success factor.

**Regional variations provide opportunity.**

Exhibit 14. Global Equity Valuations by Region




***Source**: S&P Indices. Valuation limited to zero and sixty for ease of exposition.*

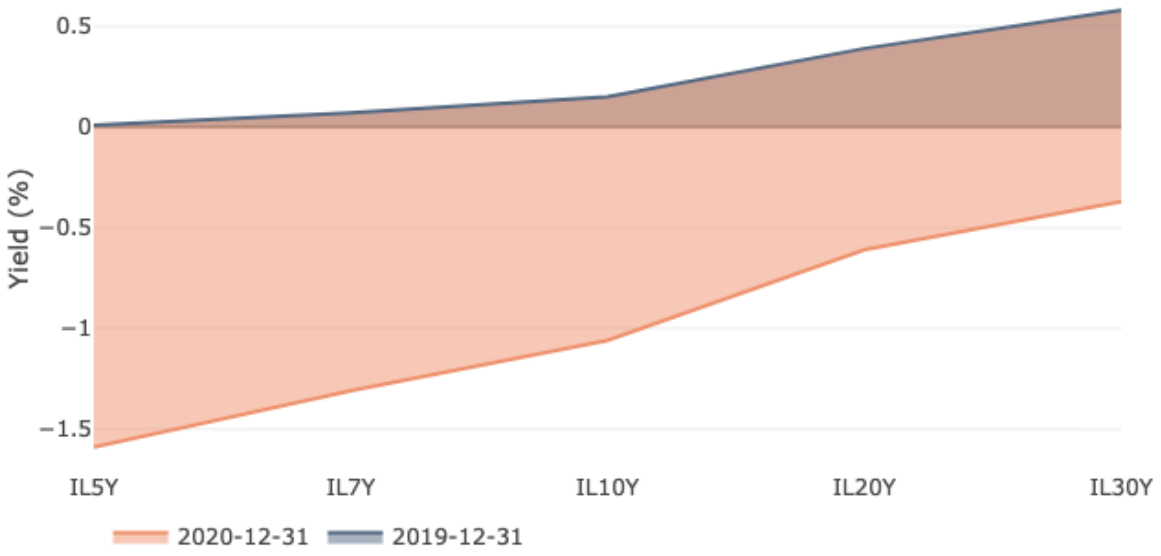
The vaccine's arrival suggests that the global economy will begin the long climb back to normal in 2021. Investors should shift focus from regions and countries to sectors and companies. The key is to reduce exposure to companies priced to perfection. At the height of the tech bubble in 1999, Cisco's value was more than the top thirty companies in the US. Yet its earnings were merely a single-digit percent of those combined companies. While it endured as a company, investors were sorely disappointed with their future returns. Investors should heed this lesson during this time. Sentiment will drive prices in the short-term; their value will drive prices in the long-term. *Differentiating the two is critical to success.*

# Interest Rates

**Productivity's Paradox.** A feature of productivity is that the cost to deliver a good or service declines as it rises. With the expanding proportion of Producers in the US economy, this suggests that inflation will remain constrained for the next decade. The financial markets are pricing in this outcome (exhibit 15) with negative rates for the next *30 years*. Granted, the embedded option in TIPS makes this an inexact projection. Regardless, the expectation is for low inflation for an enduring period, where even the achievement of the fed's target of two percent would be *below* the past rates.

**US inflation expectations are negative *everywhere.***

Exhibit 15. US Treasury Inflation-Protected Yields




*Source: Federal Reserve Economic Database*

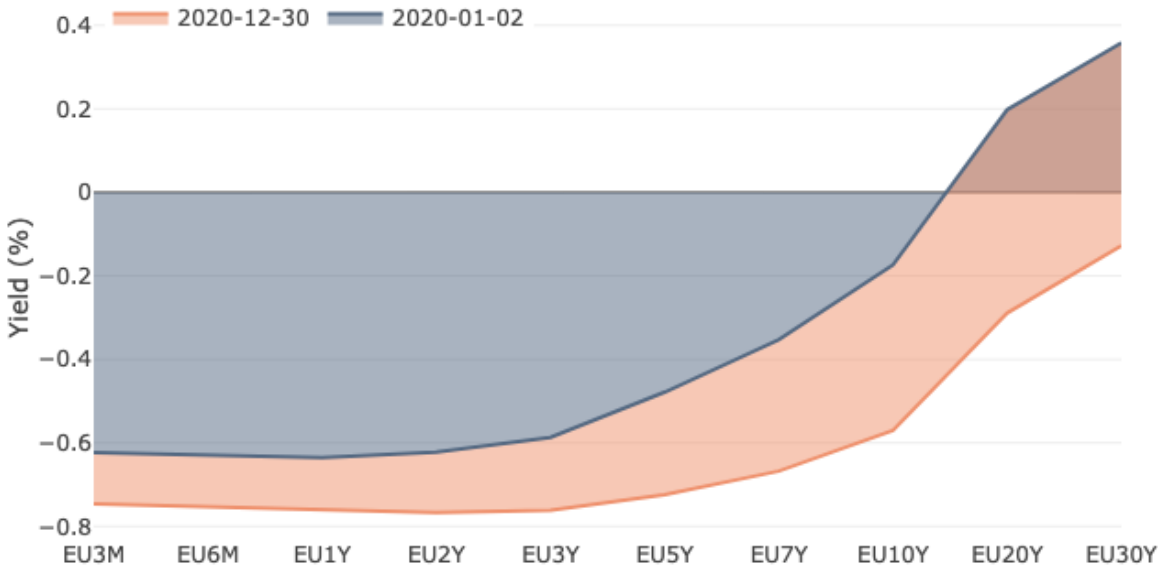
While an activist monetary policy helped avoid a collapse of the economy, it has created asset inflation, with Treasury bonds among the most impacted. Lowering interest rates below their natural rate provide investors and consumers incentives to take on more debt or speculate in other assets (e.g., equities). While Main Street endures economic hardship, Wall Street regales in lofty valuations. Critically, it changes Treasury bonds from a diversifier to a risk-enhancer. Merely a 100 bps rise in the 10-year yield would result in no investor returns over the next five years. This outcome suggests that the benefits to bonds in the portfolio are trivial, particularly when diversified equities provide a higher comparable yield. Caveat emptor.

# Interest Rates

Like Japan before it, Europe is growing old. The absolute level of the workforce is in decline and suggest lower growth. The effect is lower interest rates. When combined with the deleterious impact of the Pandemic on growth, yields fell further (exhibit 16). Nominal yields are negative in Europe *30-years forward*. This abnormal development alludes to zero nominal growth in Europe for decades. While this outcome is familiar in Japan, it is novel in Europe. Critically, Japan required bursting one of the enormous asset bubbles in history to deliver the result. Europe merely eased into deflation without the push. Indeed, these are novel times.

**Euro sovereign yields are pricing zero growth.**

Exhibit 16. Euro Sovereign Yields




*Source: ECB Database*

The recently concluded Brexit impacted the United Kingdom and its Brexit similarly. Inflation expectations are *negative* two percent for the *next 30-years*. The message to Gilt investors is clear: debt deflation waits for the United Kingdom. The implication for investors is that there is little reward in sovereign bond markets for the risk. Cash flow investors may find better yields in the equity markets that provide them a call option on future growth, albeit at the price of higher portfolio volatility. Long-term investors in sovereign bonds should mind the gap between expectations and reality.

# Credit Spreads

**Risk Without Reward**. Investors usually want compensation for bearing risk. This desire is not evident in the credit markets. Investment-grade credit spreads are at their lowest level of the last decade, which is a period that *does not include the Great Recession*. In the face of an economic collapse not seen in over eighty years, this outcome is incongruent with reality. The Federal Reserve time acting as the buyer of last resort for all bonds is nearing an end. This observation makes the current quality spread ratio (i.e., BBB to single-A) near a decade low incomprehensible (exhibit 17). While the cost of debt financing is low, the burden of *debt service remains*.

**The quality spread is *too low* for the risk.**

Exhibit 17. US Corporate Spread Quality Ratio (BBB/A)


*Source: Federal Reserve Economic Database*

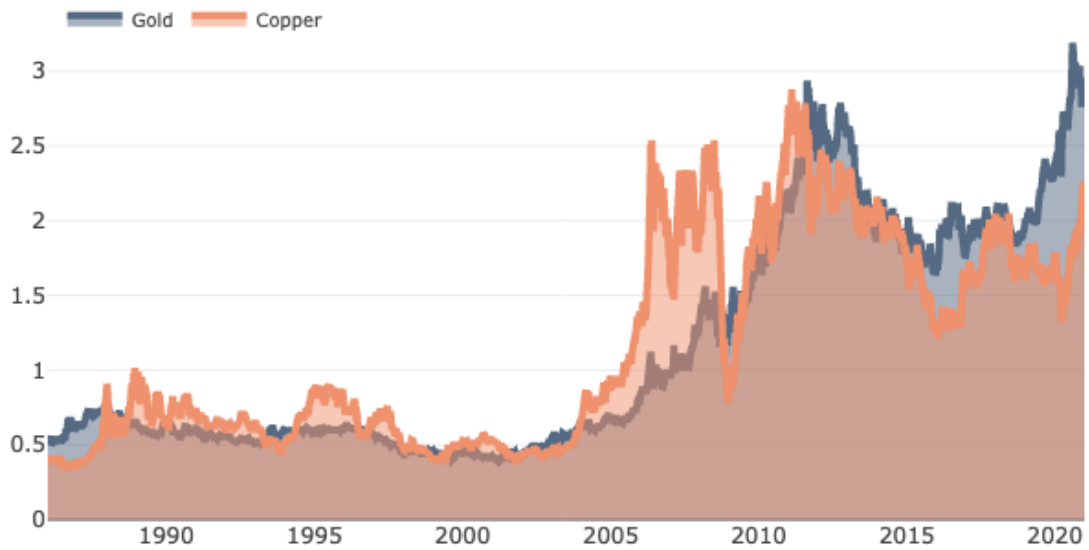
Investing is always a relative game. The corporate bond investor must weigh the choice of a yield for a 10-year term equal to the dividend yield on the S&P 1500 Index. These investments consist of roughly the same constituents, but one provides a call option on the equity market for the next 10-years with the same cash flow. This event has not occurred in the data going back 50 years. While high valuations burden the equity markets, the relative valuation between equities and corporate bonds is far more extreme. Investors should heed the warning for corporate bonds.

# Commodities

**Golden Moment**. The type of sentiment varies from market to market. While euphoria reigns in equities, gloom is the mantra in gold. What they share is that sentiment is driving their prices higher. Gold retraced modestly from its peak in August yet remains at a level far above its average of the last few decades (exhibit 18). Whether it is pricing the end of the world or future inflation is uncertain. The urgent question is where it goes from here. The arrival of the vaccines may take the end of the world scenario off the table for now. So, investors must weigh the prospects for inflation, which other markets are pricing as non-existent. Without any embedded return in gold, the reward approaches zero while the risk is high. Buyers beware of the asymmetry.

**Gold's demise may occur as the Pandemic passes.**

Exhibit 18. Price Ratio of Gold and Copper to their Average Values




*Source: Quandl.*

China continues to lead the post-COVID economy. Its draconian response enabled a quicker containment of the virus then its more democratic peers. The rebound in copper prices shows that it is willing to continue to build. The trouble lies in global demand that will remain dampened for years as unemployment, debt service, and higher taxes impede growth. With the price approaching a decade high, the upside is limited. This insight suggests that the reward may not equal the risk of reversal.

# Currencies

**An exorbitant privilege**. Currency rates indicate the direction of capital flows. For most of the fourth quarter, it continued running from the US (exhibit 18). For the Euro, Canadian Dollar, and the Chinese Yuan, the gain against the US dollar is about 10% since the peak in March. Various factors drive the exodus. China's economic rebound appears well established ahead of the US. The bull market in commodities is giving a lift to commodity currencies like Canada. Europe seems to have managed the Pandemic better than the US. In the zeitgeist of the times, political certainty may be the largest factor.

**A US currency reversal may parallel the economy's rebound.**

Exhibit 19. Normalized Currency Rates


*Source: Alphavantage. A higher level indicates a stronger US dollar.*

A weaker US dollar is consistent with the looming fiscal deficit, expanding debt loads, and low savings rate. Yet, currencies are a relative trade based on growth and capital flows. The argument for lower growth prospects in the US relative to Canada and Europe seems dubious, particularly when they face similar increased deficits, debts, and savings rates. As political stability returns to the US, so might capital. Further, the price levels are near extreme levels over the last five years (exhibit 19). Sentiment may drive the USD lower in the short run. Notwithstanding abrupt policy changes, demographics are destiny with the US preeminent in the developed world in the long-term. *An exorbitant privilege indeed*.

Capital Risk

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## Disclosures