Cαpital Risk

GLOBAL PORTFOLIO STRATEGY

A Volatile Season

Photo: Johannes Plenio on Unsplash

It is the best of times for equities. It is the worst of times for employment and interest rates. Cooling temperatures augur the imminent arrival of a resurgent virus that threatens further closures. The earnings season arrives with its insight into the durability of business during the Pandemic. Into this mercurial maelstrom steps a duplicitous debate on justice with a cost measured with integrity. To further heighten this noxious brew, a polarized election arrives with widely divergent outcomes for capital markets. The contest is the continued primacy of the return on capital at the expense of growth in the laboring economy. Even the probity of the election is impugned. These hallmarks assert that anarchy will usurp indifference with volatility reigning across markets. For the prepared, risk will offer opportunity.

"

The market risk is high with stretched valuations and uncertain earnings from the economic carnage.

Adding an election with a choice between widely divergent economic beliefs and its own integrity contested ensures the only certainty is uncertainty.

- Jason Prole

"

Highlights

- Election uncertainty is manifesting in the **VIX market.**
- 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 rebound of the **US dollar** reflects a more certain election outcome.

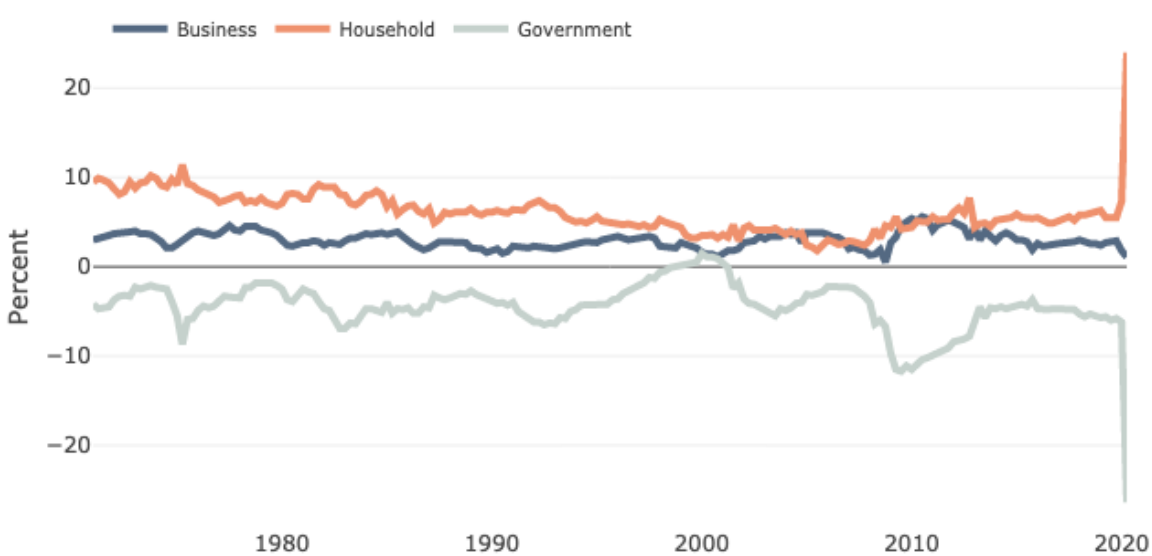
The Economic View

Prepare before the storm. As long as people have sailed the seas, this adage has echoed in their ears. It is sound advice for this season. The world is awash in economic and political uncertainty. Yet, the equity and credit markets dance to their merry tune. Indeed, the rebound in the equity market is unequaled in its speed, and the pricing of credit risk is near *cyclical lows*. The brief justification for the disconnect between the real economy and the financial markets is insufficient fiscal policy and unprecedented monetary policy. A full economic recovery requires a role reversal. The risk is a collapse of the US dollar that may rattle financial markets.

Savings from one pocket to another.

The fiscal stimulus's hallmark was the unrivaled surge in household savings from the constructive combination of stimulus checks and no place to spend the budgetary largesse. As students of double-entry accounting know, a debit exists for every credit. The surge of $800 billion in private savings mirrored a collapse of *$1 trillion* in the federal government saving rate (exhibit 1). As the economist long proclaimed, there is no free lunch. The present borrowed money from the future. Therein lies the problem.

Exhibit 1. US Saving by Sector as a Percent of Gross National Income



Source: Federal Reserve Economic Database

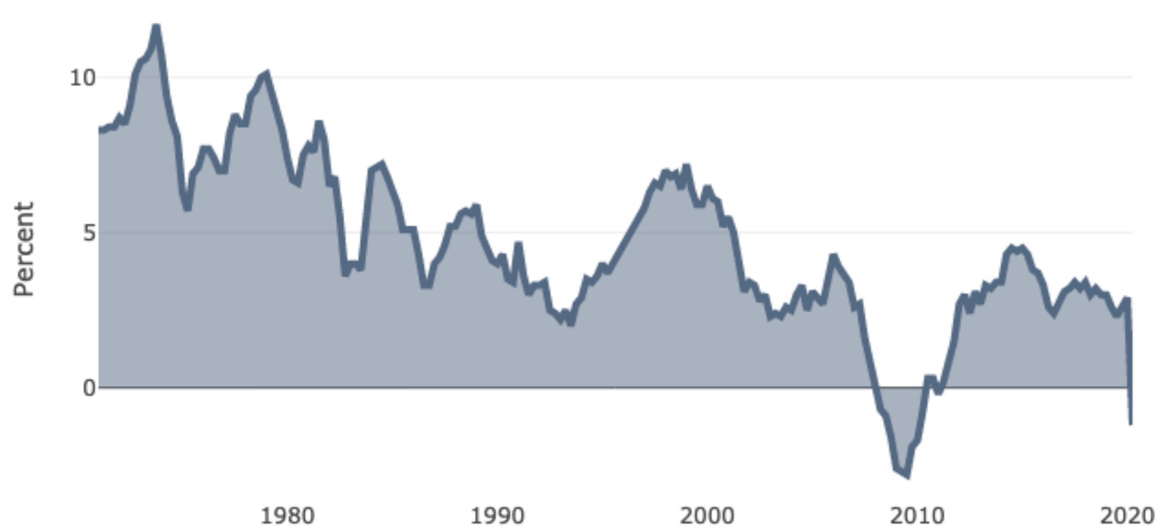
The Economic View

As the world's reserve currency, the US enjoys an *exorbitant privilege*. After World War II, this beneficial legacy emanated from the Bretton Woods system that established the US currency as the de facto currency for global trade. In possession of the world's mightiest industrial production and most of the world's gold reserves, the choice was self-evident. The former meant that the US possessed the goods everyone wanted to import, while the latter ensured the faith in the US dollar with their trading partners. That era is a distant memory. Yet, its legacy endures.

The US primacy in trade is at risk.

An indication of a robust domestic economy is a healthy savings rate. The measure is vital because savings and investment are a reciprocal identity. One is the mirror of the other as high savings means high investment. Low savings implies low investment. The US's total savings was at the lowest level in 50 years (excluding the Financial Crisis) *before the Pandemic* (exhibit 2). Investment increases productivity, which raises wages, which leads to higher growth. Thus, the virulent combination of a generational low savings rates and a jump in debt that is the largest outside of a world war suggests growth may slow as debt service expands. The debt service is not necessarily the problem; instead, it is *who holds the debt*.

Exhibit 2. US Total Saving as a Percent of Gross National Income



Source: Federal Reserve Economic Database

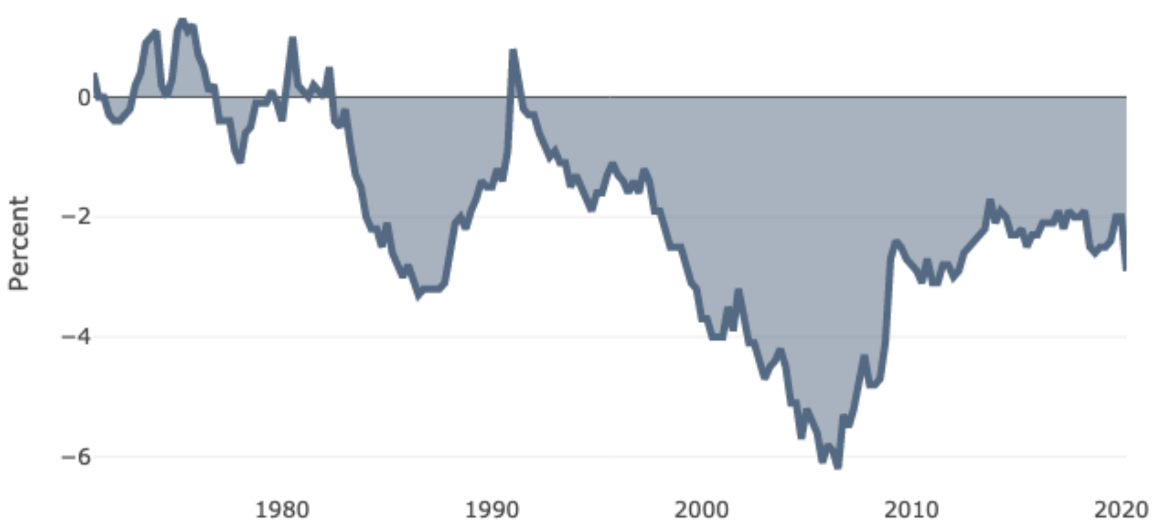
The Economic View

All voids are filled. A low savings rate alone is not a problem. The supplier of capital also matters. If the US generates insufficient capital, it must turn to its trading partners to fill the void. They can do so in two ways: investing in business or lending to the Federal government through the purchase of Treasury Bonds. As the rest of the world supplies capital to the US, the capital account and US dollar increase. The result is cheap capital for the US and lower prices of imported goods for consumers.

Capital may leave the US.

The reciprocal of a positive capital account is a negative current account, as the two must balance. The US current account, which measures net trade, is profoundly negative (exhibit 3). This situation places the US at risk of changes to the perception of US fiscal stability. If investors decided that they no longer wanted to provide capital to the US, then the currency would fall, and interest rates would rise.

Exhibit 3. US Current Account Deficit as a Percent of Gross Domestic Product



Source: Federal Reserve Economic Database

This risk is material because the US would need to fill its savings gap. Issuing more debt while interest rates rise would imperil fiscal stability. Asking households to save more would sacrifice growth. That leaves business as the lever to increase savings. What would be the cost? Higher savings leads to

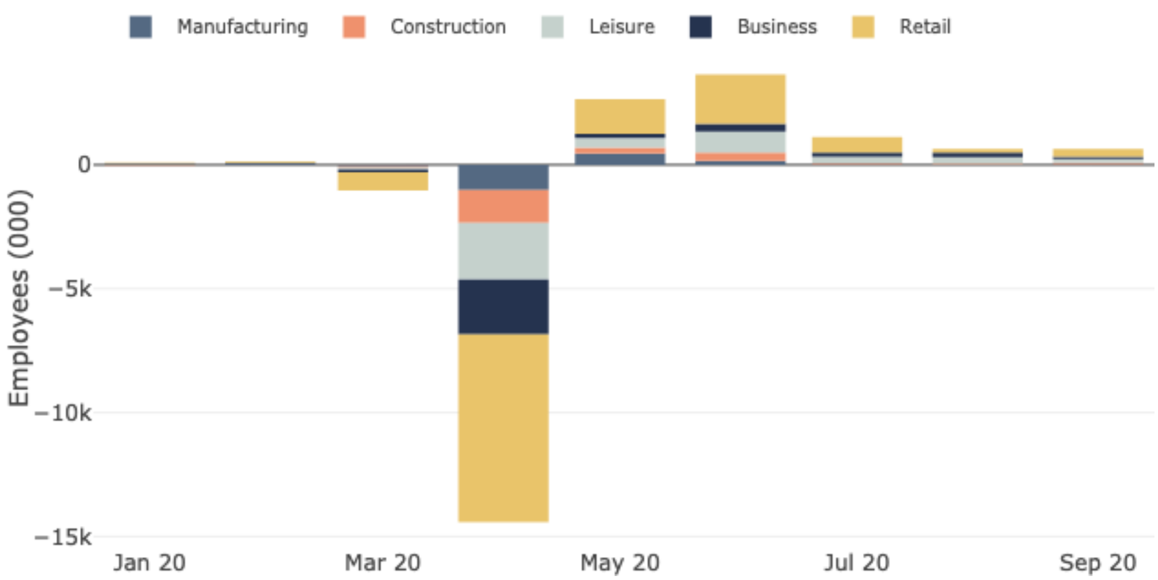
The Economic View

increased investment, which *should* lead to higher productivity and increased profits. This result occurs if the cost of capital level is not insurmountable.

Low growth of consumer spending from higher taxes and higher prices would impede growth. A smaller contribution from the government would occur as higher debt service detracts from growth. Critically, it is the composition of the workforce that will detract from growth. Most of the job losses during the Pandemic were in service industries (exhibit 4). These jobs are less amenable to productivity advances from capital investment as they *require people, not capital*. The implication is a higher cost of capital as slow growth permeates the economy.

Service jobs are not returning quickly.

Exhibit 4. Change of US Employment by Sector



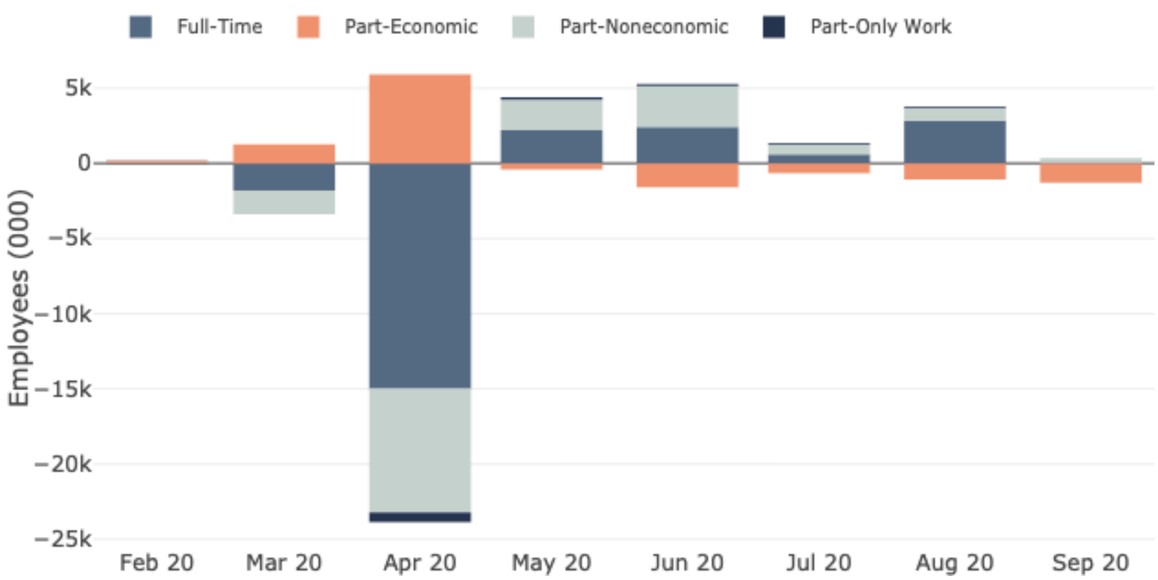
Source: Federal Reserve Economic Database

While the rebound from the lows is material and singular in its speed, employment remains *10 million* below its peak in February. This rate of job losses only has one comparable in the last century, the Great Depression. Growing out of this malaise requires a strong fiscal stimulus that is tempered by the debt growth *before* the Pandemic and an unfocused fiscal response during it. Constrained growth limits the ability to rebalance the current account expediently and manage declines of the US dollar.

The Economic View

The type of employment indicates that growth may not return promptly. The recovery in jobs saw a reduction in part-time workers, who initially saw their hours reduced, returning to full-time employment (exhibit 5). Further, those that were working part-time by choice and those furloughed have returned to work. Yet, full-time employment remains at a depression level. The implication is that constrained spending will endure, and household savings will fall. The result could be calamitous for the US dollar.

Exhibit 5. Change of US Employment by Type



Source: Federal Reserve Economic Database

Investment is the solution.

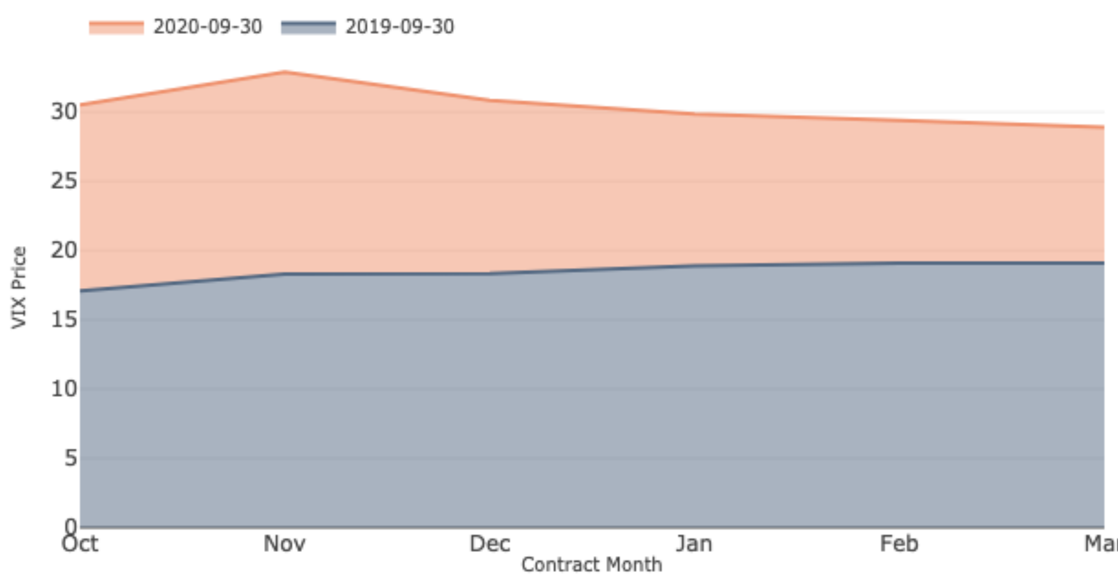
Currencies are a relative game. If other economies are in worse shape, then the US dollar may not fall. After all, capital needs a home and will reside in the best *relative* abode. The disastrous US response to the Pandemic may strengthen its strategic rival, China. Against the rest of the world, the outcome is uncertain. The US remains the home of the most favorable demographics in the developed world and a technology leader. Public policy can swamp these advantages with poor choices. *Investment is the way forward.*

Equity Markets

The equity markets are not the economy. If they were, they would see a five percent reduction in global growth for what it is: reduced earnings and thus lower stock prices. While the stock price level is not reflective of the current economic environment, VIX futures reflect the price of risk well. Volatility is more than double the level seen this time last year (exhibit 6). In a nod to the uncertainty infiltrating the election, the November contract price is ten percent higher than the preceding and subsequent contracts. It is a season of *expected* volatility.

Political risk is priced into the markets.

Exhibit 6. VIX Futures Strip



Source: CBOE.

The cost of protecting against uncertainty in November is about double the price of a year ago. For those considering hedging equity risk, the cost of hedging through the election is about *four percent*. The ramification is that an investor would concede half their expected annual return on equities. With an expectation that a decline in the equities markets of four percent is more probable than not, the action is logical. The spectacle that could ensue after the election may make the price of admission worth it. Investors will need to decide if it is a show they want to watch.

Equity Markets

Despite the farcical response to the Pandemic, the US markets remain the leader versus the rest of the world (exhibit 7). This outperformance results mainly from a strong US dollar whose continued strength is doubtful. The possibility exists that US equity markets are worth 60% more than the rest of the developed world over the last four years. The primacy of US technology companies is a global phenomenon, not a local one. Thus, their monopolistic profits may persist, and the relative outperformance of US equities linger.

Investors continue to support the US.

Exhibit 7. Relative Performance of US/Non-US Equities

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

A bellwether of US capital markets is its *political stability*. The volatility markets increasingly questioned this virtue. The tenuous state of the US savings rate alludes to the significance of a reversal of capital flows. The question is where they go. Europe confronts Brexit in the immediate term and poor demographics in the longer term. Japan and China face a similar demographic headwind. A familiar investment refrain applies here: the return *of* your investment may be more important than the return *on* the investment. Stability in Washington may obviate a reversal of capital from the US. Until its certainty, hedging or diversification of US equities is a logical path.

Equity Markets

Monopolies Matter. Economic theory deeply embeds the primacy of growth over value. Higher growth *should result in higher stock prices*. That value stocks long prevailed was disconnected with economic theory. The challenge is determining *which* stocks will have higher growth *in advance*. Only *four percent* of US companies explain *all the equity market gains over the last ninety years*. The collective return of the rest equaled cash.[1] The result is even smaller for international stocks, with 1.3% accounting for all the gain since 1990.[2] In winner-take-all markets, growth appears the only measure of success.

Exhibit 8. Relative Performance Global Equities by Growth/Value

Follow profits, not assets.

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

The recent dominance of growth over value echoes the technology bubble of 2000 (exhibit 8). Three factors account for the decline of value measures. Intellectual property increasingly accounts for asset values. Low inflation maintains book value, and the depreciation of the physical asset accelerates with technological change. The latter two suggest high costs for tangible assets. In contrast, the first suggests high value to people whose costs manifest

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[1] Bessembinder, Hendrik, "Do Stocks Outperform Treasury Bills?", *Journal of Financial Economics*, 2018, 129, 3, pp. 440-457. https://doi.org/10.1016/j.jfineco.2018.06.004

[2] Bessembinder, Hendrik, et al, "Do Global Stocks Outperform US Treasury Bills?", working paper, 2019, pp. 84. http://dx.doi.org/10.2139/ssrn.3415739

Equity Markets

on the income statement, not the balance sheet. The investor's action is simple: follow the profits.

The Pandemic saw investors jump into large-capitalization stocks with abandon. Whether the cause was familiarity with the brands, a fiscal bonus to gamble, or disintermediating brokers allowing more access to equity markets remains to be seen. For the quarter, the relationship is flat (exhibit 9). The question to investors is not who is investing; instead, how does the Pandemic impact companies?

Policy may sacrifice small for large stocks.

Exhibit 9. Relative Performance Global Equities by Size (Large/Small)

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

The monetary spigot is open entirely and strongly supports those companies that can avail themselves to the financial markets. Larger companies have more ready access to capital, and while those with prodigious operating cash flows have a further advantage. The implication is that monetary stimulus may further magnify larger companies' advantages as they engage in a prolonged buying spree of taking out their smaller competitors. There is a case for merger arbitrage in this environment. Stock selection is critical in this environment.

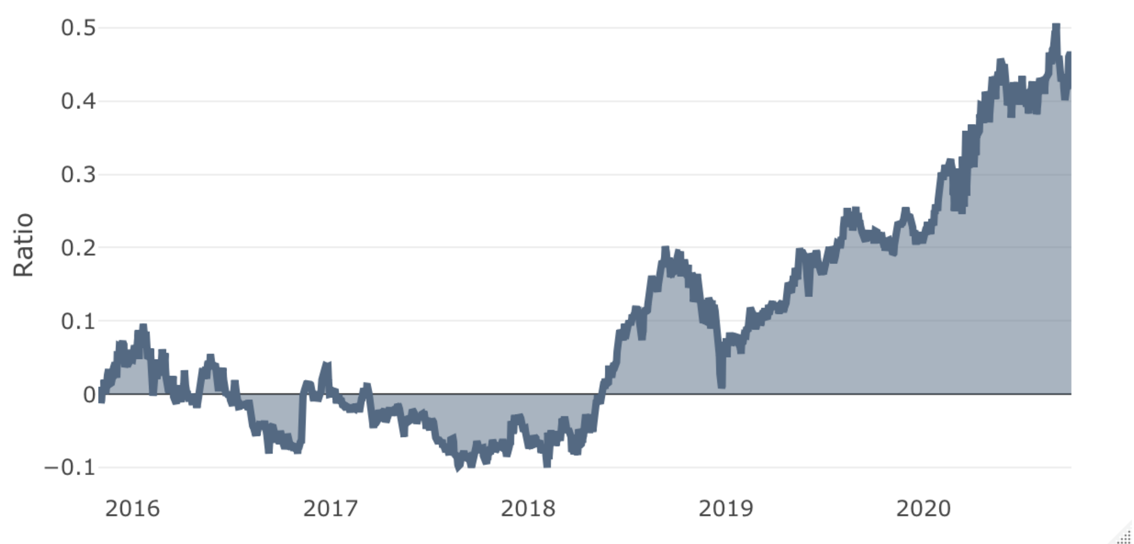
Equity Markets

The growth prospects of the Emerging Markets remain tantalizing. So, do the risks. Smaller countries face currency and political risks that may result in reward or loss. Unquestioned is the primacy of the demographics of most emerging economies. While the developed countries and China age, the emerging countries have the prospect of growth through their younger populations. Yet, investors do not seem to favor this long-term outlook.

The US markets enjoyed a material climb relative to the Emerging Markets since 2018. Proximate causes are the decline of the commodity cycle and structural rebalancing in China. These themes appear dated as the US and Emerging Markets followed a similar path over the last quarter, albeit a volatile one (exhibit 10). The way forward depends upon the responses to the Pandemic. If the US continues to lag, then the relationship will reverse.

Exhibit 10. Relative Performance of US/Emerging Markets Equities

Emerging Markets are a long-term play.



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

The critical variable in the longer-term is technology. China developed local leaders that ensure they do not need US technology. Notwithstanding the success of TikTok, its applicability outside the friendly environs of China is not certain. India's technology is thriving, but not yet the match for the US

Equity Markets

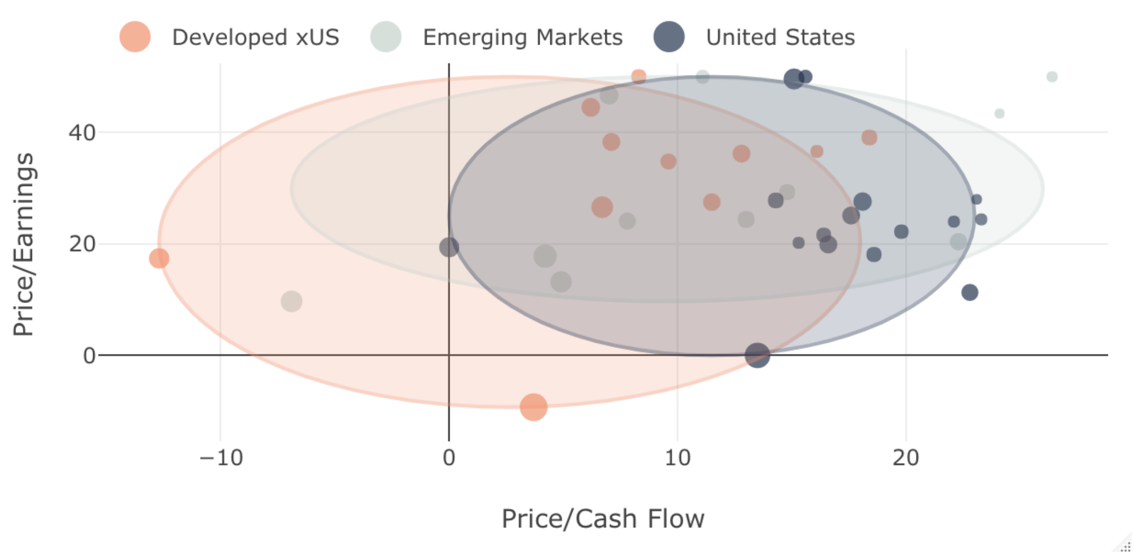
juggernauts. This situation may change, but it will take years. The significance is that the US advantage may persist.

The case for the US seems compelling in the near-term. The primacy of the US dollar as the currency of last resort has endured, yet it may not endure. Unfavorable trends in savings and the current account place US dollar primacy at risk. International exposure, whether in Developed or Emerging Markets, may mitigate currency risk. As investors look for opportunities globally, the critical dimension for success is country selection and *managing currency exposure*.

Earnings ratios moved higher.

A noticeable shift occurred in global valuations this quarter. The expected collapse in earnings transpired across the world. The outcome was price-to-earnings ratios moving upward for the Developed and Emerging Markets (exhibit 11). These markets still offer price-to-cashflow multiples that are half of their US counterparts. The ability to generate cash is a strong indication of relative value. Thus, the generally higher US cashflow valuations suggest finding value in non-US markets.

Exhibit 11. 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.

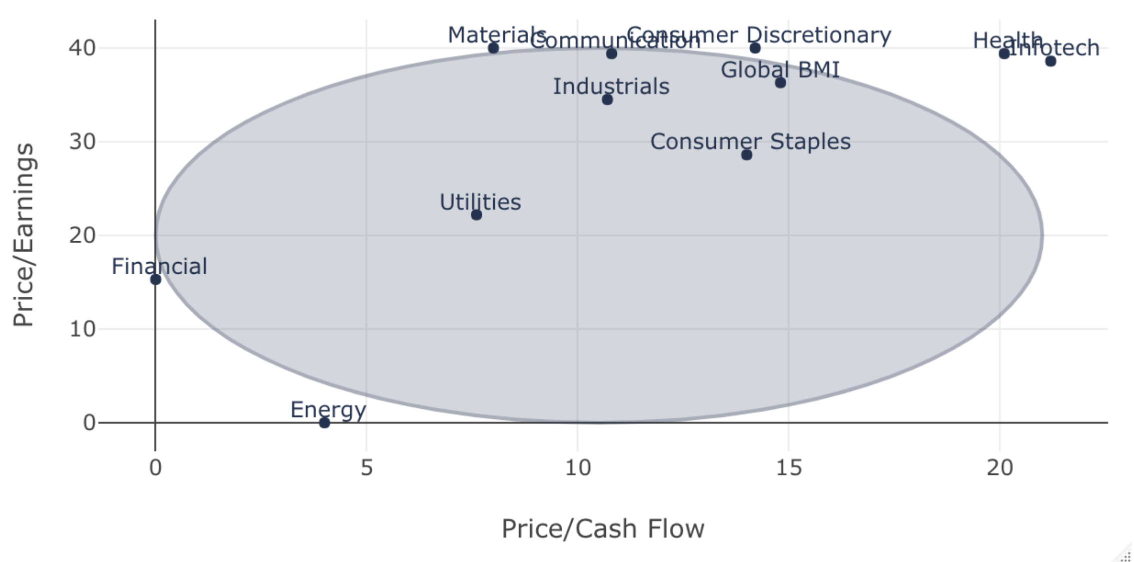
Equity Markets

The higher dispersion evident is mostly a visual artifact resulting from the low valuations for the Energy and Financial sectors. While the Emerging Markets show the highest degree of dispersion across the global markets, they necessitate a more refined stance. The short-term prospects for commodity and external demand dependent markets are dim. Sectors, including *consumer staples, infotech, and industrials,* should provide diversification across the Emerging Markets while providing a means to participate in growth.

Sector selection is key in Non-US markets.

While the economic collapse imperils all sectors, the damage is particularly acute for the *Financial and Energy* sectors. The credit cycle has just begun for Financials, while cyclical and structural forces impede Energy. Thus, their valuations suggest a value trap (exhibit 12). In contrast, the pricing to perfection of the *Health Care and Information Technology* sectors is worrisome. Prudence dictates that investors focus on sectors less economically sensitive. Cash flow investors should concentrate on *Utilities and Industrials*, while total return investors consider the *Consumer Staples and Communications*. The critical dependency on fiscal and monetary policies means that these dynamics can change in an instant. Thus, a core construct should be *risk management*.

Exhibit 12. Global Equity Valuations by Sector



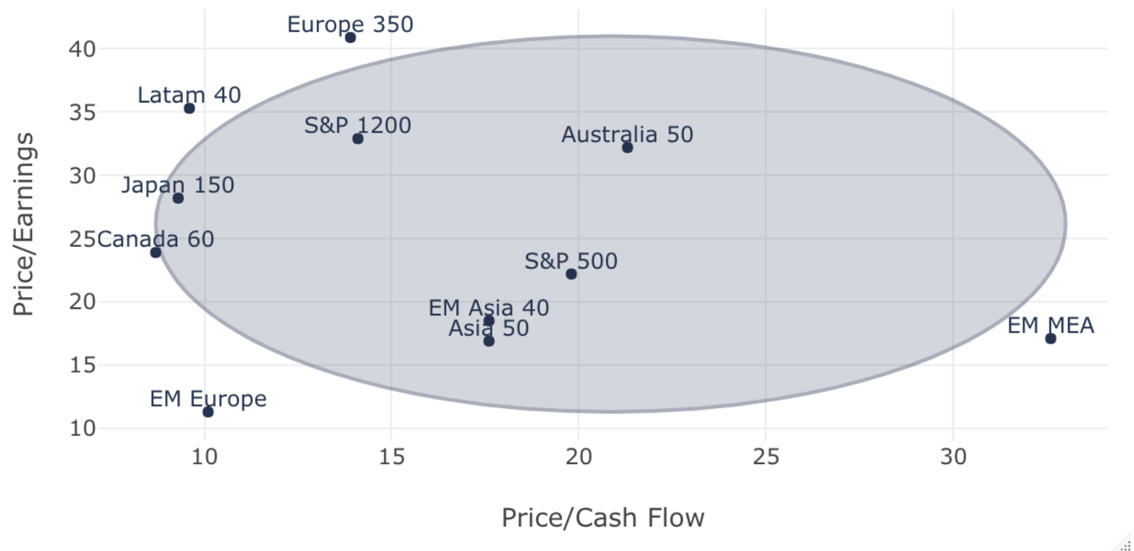
Source: S&P Indices. Valuation limited to zero and forty for ease of exposition.

Equity Markets

First In, First Out. Those that experienced the Pandemic first are natural candidates to lead the recovery out. This statement merely arises from the fact that they had more time to address the issue. China's draconian response to the virus is positioning it to lead out. Compelling relative valuations help (exhibit 13). Both *Developed and Emerging Market Asian* equities offer comparative valuation advantages that can leverage their imminent recovery.

Asia offer comparative value.

Exhibit 13. Global Equity Valuations by Region



Source: S&P Indices.

Decaying demand advises against commodity and export-dependent regions such as Australia, Europe, and non-Asian Emerging Markets. Poor relative valuations add to the argument. The uncertainty of the economic environment because of winter's looming onset and its potential to spark a second Pandemic wave prescribes prudence. Until the clarity of a *distributable* vaccine arrives, the portfolio positioning's focus should be on risk management, not return enhancement. Investing is uncertain in all seasons, an environment with political, fiscal, and monetary uncertainty more so. This situation suggests focusing on the long-term with modest adjustments to risk exposures within the portfolio that *meets the investor's needs*.

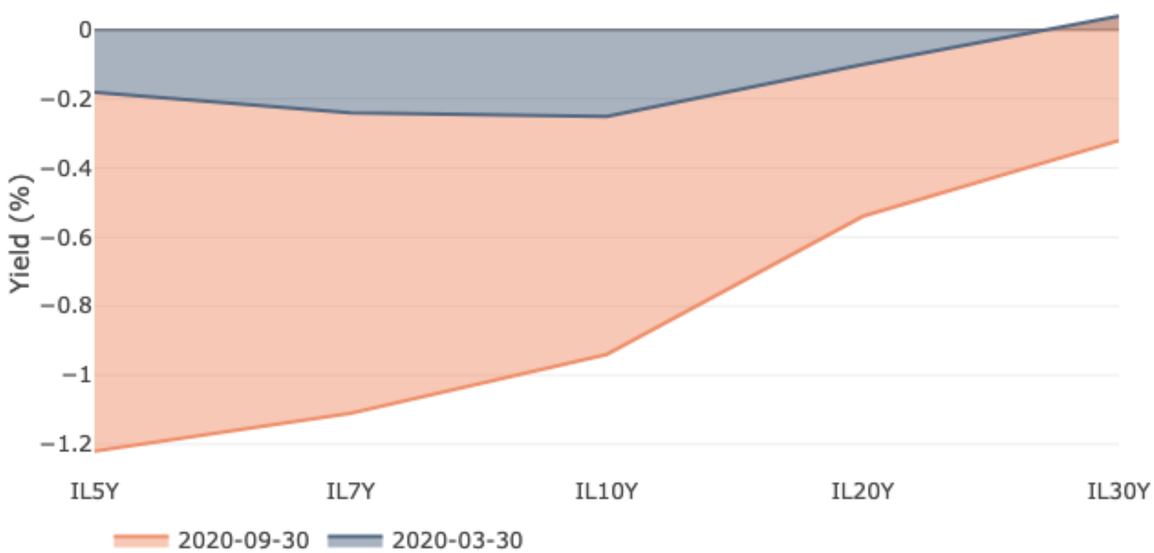
Interest Rates

Deflating Expectations. Higher productivity brings lower prices for goods and increased purchasing power for consumers. This beneficial outcome, *goods deflation*, is emblematic of a healthy economy. Yet, most central banks go out of their way to avoid deflation in the economy. They are trying to avoid *debt deflation* where higher interest rates may lead to default and forced liquidation of assets at continuously lowering prices. This outcome occurred during the Great Depression, and its avoidance is the primary objective of a central banker.

The objective's tragedy is that they may cause debt deflation by continually lowering interest rates below their natural rate. This action provides incentives for investors and consumers to take on more debt. With its liquidation of housing backed by defaulting mortgage debt, the Great Recession is a contemporary example. Thus, when markets price negative inflation expectations for decades, they signify that the forty-year run of debt-fueled growth probably ends at some point.

US Inflation expectations are negative *everywhere.*

Exhibit 14. US Treasury Inflation-Protected Yields



Source: Federal Reserve Economic Database

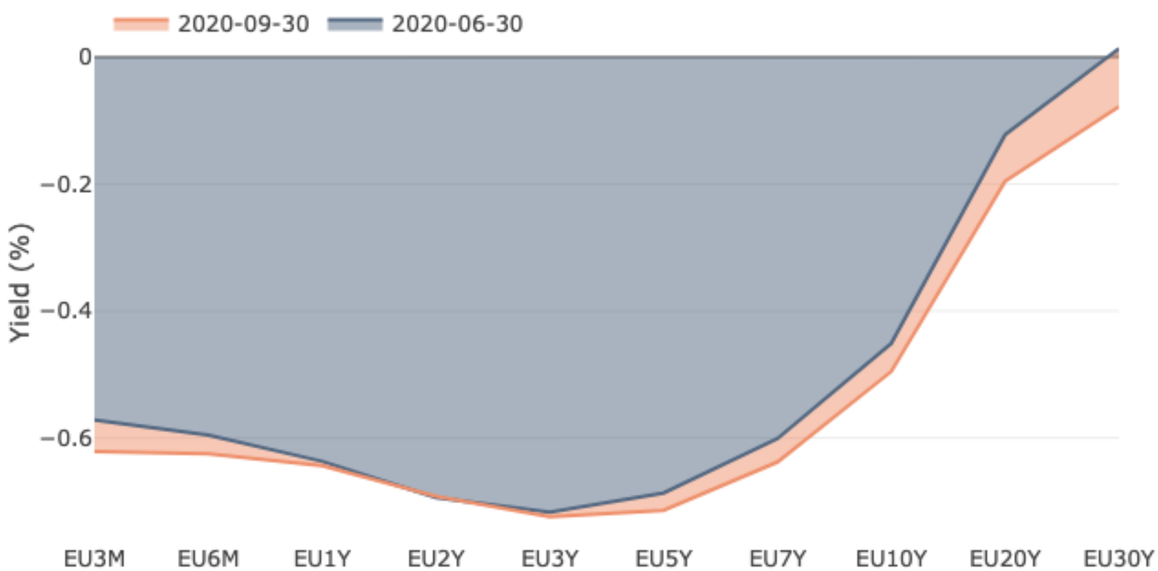
Europe, United Kingdom, and Japan are showing deflation expectations for the next few decades. The US joined the club this quarter with deflation

Interest Rates

expected for the *next 20-years* (exhibit 14). The significance of this outcome is dire to the income-focused investor: low yields. With markets paying a premium to protect against falling prices, US nominal yields are too high.

Europe may be a prelude to where the US interest rates head. Nominal yields in the Euro area are effectively negative for the *next 30-years* (exhibit 15). This outcome is extraordinary as it implies zero nominal growth in the Euro area during the period. Even if beneficial goods deflation were to occur, the expectation is still for *negative* real growth. These times are unprecedented.

Exhibit 15. Euro Sovereign Yields



Source: ECB Database

All sovereign bonds show fear.

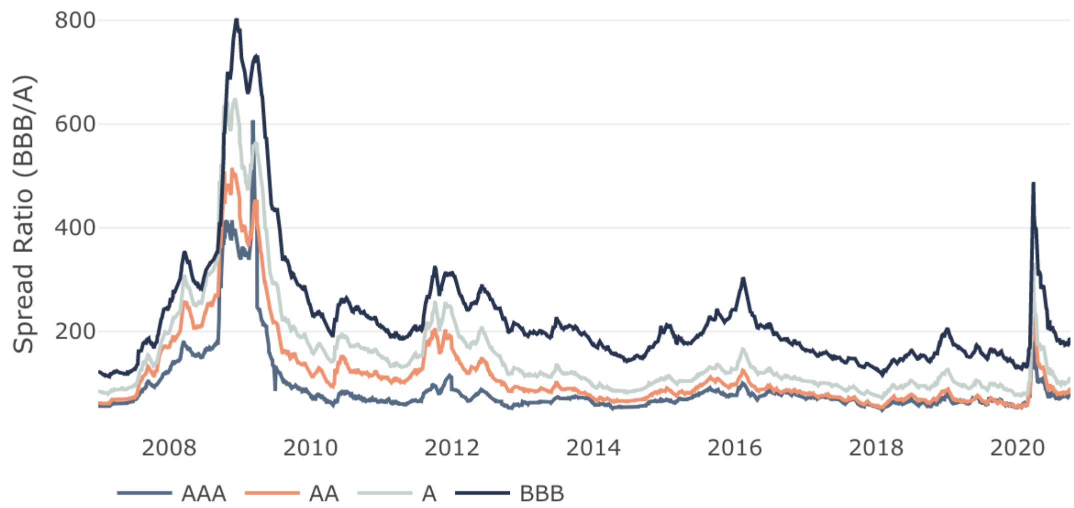
The market expectation for the United Kingdom and its Brexit is less flattering: the expectations for inflation is *negative* two percent for the *next 30-years*. The market's message is that exiting the European Union will lead to debt deflation for the United Kingdom. Investors are paying for protection against that outcome there, in Europe, and the US. While the equity markets float above the economic fray, the staid bond markets show a singular aversion to risk. Long-term investors should heed the message.

Credit Spreads

Risk Without Reward. Investors usually want compensation for bearing risk. This desire is not evident in the credit markets. Credit spreads are below their mean value of the last decade, which is a period that *does not include the Great Recession* (exhibit 16). The catalyst for this outcome is the Federal Reserve's support for credit markets. For A-rated or above credits, spreads are near decade *lows*. Credit spreads are incongruent with the economic situation. The Fed is turning US corporations into over-levered and unviable *zombie* companies. They risk their dreaded debt deflation.

Spreads offer risk *without* reward.

Exhibit 16. US Corporate Spreads



Source: Federal Reserve Economic Database

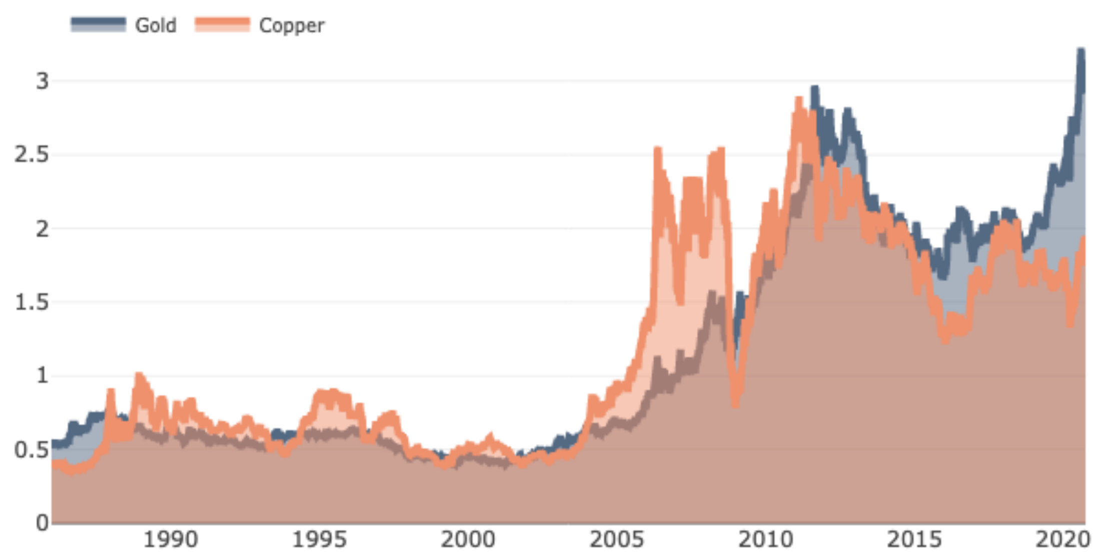
Equity investors need not look any further than the bond markets for justification for their rise. Lower interest rates bring lower debt service that offset some of the lost revenue. If the Federal Reserve prevents debt default, then equities are also protected in the capital structure. It's not evident that supporting capital helps the broader economy other than delaying a reckoning. The outcome would be a more severe debt deflation as all capital comes under pressure *at the same time*. Even if central banks are willing to support capital indefinitely, it's not clear this policy is effective for the *real economy*.

Commodities

Golden Moment. The uncertainty in the financial markets is evident in the commodity markets. Gold is an investment of last resort as its use as an industrial commodity is limited. The heightened uncertainty in the financial markets drove it near all-time highs (exhibit 17). The surprise is that copper continues its ascent. These are opposing indicators where one signals fear, the other a nascent recovery. Unpacking these outcomes is difficult.

Gold's rising price signals fear.

Exhibit 17. Price Ratio of Gold and Copper to their Average Values



Source: Quandl.

An economic rebound may be at hand in some parts of the world, specifically China. The first-in, first-out argument is logical. The rising copper prices are a viable indication that China is restocking and preparing for the return of global trade after the Pandemic induced closures. Copper prices will wane from any delay of the economic resurgence.

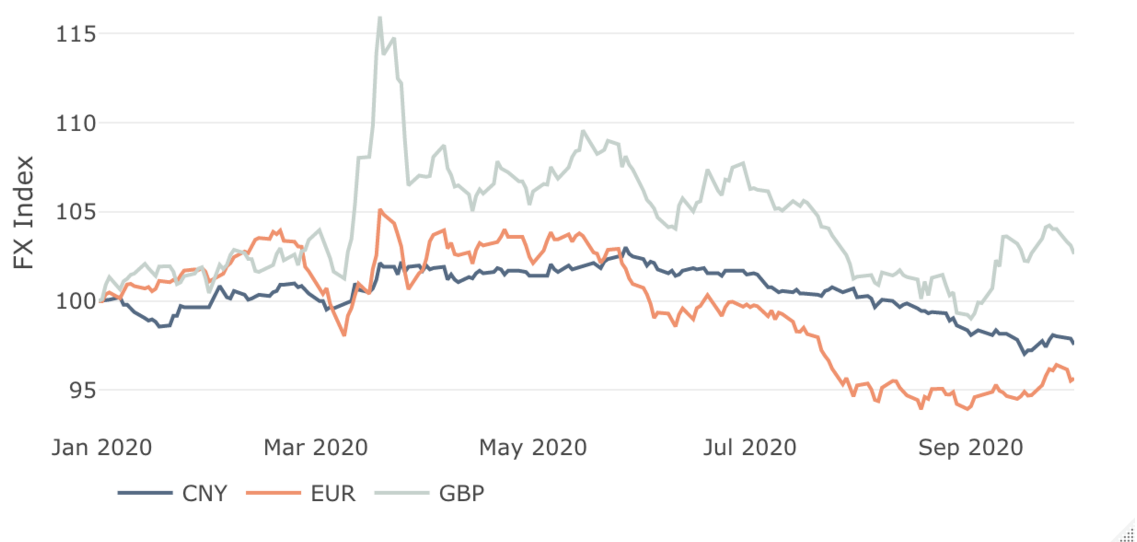
The elevated expectations for risk in equity markets are consistent with higher gold prices. The negative inflation expectation is also coherent with heightened uncertainty. While the credit markets and the equity market's *level* are outliers, the general theme for the markets is uncertainty. With the economics and political risks high, the justification for higher risk is easy.

Currencies

Capital must find a home. Currency rates show where capital is flowing. For most of the third quarter, it was away from the US (exhibit 18). The Euro, UK Pound, and Chinese Yuan gained against the US dollar. The unending drama of Brexit upended that trend for the UK Pound in September. In the last two weeks, the Euro and Yuan joined in the reversal. A resurgence of COVID19 could be a catalyst for the stronger Dollar; however, the European Union and China better managed the Pandemic than the US. A more credible argument is political certainty.

Investors return to the US.

Exhibit 18. Normalized Currency Rates



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

Political uncertainty in the US *should* drive investors *away*. The Dollar's rise probably reflects the increased likelihood of a change in the US administration. The belief is that this would bring more coherent management of the Pandemic, a robust fiscal stimulus plan, and less volatility in public policy. As always, the markets prefer certainty for their planning. While a stronger US dollar seems incoherent with the looming fiscal deficit, expanding debt loads, and low savings rate, the reality is a function of time. In the short run, the US Dollar is the best of a bad bunch. Whether that remains the case is a function of policy decisions across the world.

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