The Abernathy Group II

Family Office

Q2

Quarterly Market Review

Second Quarter 2020

2020 Second Half - Capital Markets Outlook

Is Mr. Market Confused?

Let me start this note to each of you with a well-known short story about our friend, Mr. Market[1]. It is a wonderfully instructive parable created by Benjamin Graham which describes how securities become incredibly overvalued and undervalued, depending upon Mr. Market's ever-changing mood.

Mr. Market is a jolly fellow who shows up at your doorstep each day, and never tires of offering each investor the ability to either buy or sell their investments.

Unfortunately, Mr. Market is a bit compulsive… meaning, at times he is incredibly euphoric, offering to buy or sell your stocks and bonds at meteoric prices. At times, he is manically depressed, offering to buy or sell your stocks and bonds at incredibly low prices. "The manic-depressive Mr. Market does not always price stocks the way an appraiser or a private buyer would value a business. Instead, when stocks are going up, he happily pays more than their objective value; and when they are going down, he is desperate to dump them for less than their true worth."[2]

The important point to remember is that Mr. Market is always available. He never tires of his work. In addition, he always leaves the decision up to the investor. Investors often forget that Mr. Market is at times emotional and bipolar. Mr. Graham asks, "Would you willingly allow a certifiable lunatic come by at least five times a week to tell you that you should feel exactly the way he feels? Would you ever agree to be euphoric just because he is, or miserable just because he thinks you should be? Of course not."

Unfortunately, "when it comes to their financial lives, millions of people let Mr. Market tell them how to feel and what to do, despite the obvious fact that, from time to time, he can get nuttier than a fruitcake."

The important point is that Mr. Market's offers are just that. Mr. Market's offers should not affect your actions any more than someone coming to your house and offering to buy it for ½ its current value, or to sell you the home next door for 2X its current value.

Intelligent investors take advantage of Mr. Market and sell him securities when the prices are too high *to provide an adequate return on their investment*, and purchase securities when prices are incredibly low, *providing an over-sized return* on your investment.

Most of the time however, the intelligent investor does nothing outside of politely saying "No" to Mr. Market's daily offerings.

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[1] Mr. Market metaphor is better developed in "The Intelligent Investor" by Benjamin Graham. If you read only two books about investing, this would be one of the two.

[2] Intelligent Investor (4th edition)

Remaining invested in a globally diversified portfolio of both equity and debt securities, with a slight factor weighting[3], has proven to be, by far, the most intelligent action[4].

"Benign neglect is, for most investors, the secret to long-term success. The biggest challenge in the stock market is not Mr. Market"[5]. The biggest challenge is the investor's emotion and reaction to daily events.

This brings us to the point of our letter. We want to answer the two most important questions we hear from investors all across the U.S.

Question 1: The stock market has eclipsed 2019 record levels, signaling the future is incredibly bright. The bond market is at telling us that Armageddon is soon to come. Which message should investors embrace?

- Is the stock market's message correct?
- Is the bond market's message correct?
- Is it possible for both to be correct?
- What does the answer tell us about the investment opportunities before us?

Question 2: With uncertainty about so many different potential risks before us, what are the *main risks* investors should be controlling within their long-term investment portfolios?

- Based on those risks, how should you be invested?
- Over the next 5 years, what should intelligent investors expect for investment returns in: a) the stock market? b) the bond market?

Stock Market vs. Bond Market
Which signals are correct?

The capital markets (stocks and bonds) are incredibly bright. With millions of highly motivated and incredibly well-endowed investors and investment companies, each with vast access to information

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[3] https://corporatefinanceinstitute.com/resources/knowledge/finance/fama-french-three-factor-model/. Factors are best described as the components of investment returns. In short, there are 3 scientifically proven factors. 1) "Beta" (this describes the fact that stocks outperform risk free bonds), 2) "Value" (this describes the fact that companies with a low price to book-value outperform companies with a high price to book-value), and 3) "Size" (this describes the fact that smaller companies outperform larger companies). The Science of Investing™ is based on data and facts in conjunction with the Fama/French research, which received the Nobel Prize in economics in 2013.

[4] https://faculty.haas.berkeley.edu/odean/Papers%20current%20versions/behavior%20of%20individual%20investors.pdfBrad Barber and Terrance Odean examined the results of 78,000 individual investors vs the market index and found that *individual investors* underperformed the market index by more than 7% per year (meaning individuals earned approximately 2.5% vs the markets 9.5% return) due to trading.

[5] Winning the Losers Game, Charles Ellis

sources, spending 60 hours or more per week, and voting with their dollars and cents, investors should expect current market prices to incorporate all public information[6].

Facts and science support this expectation. Under the vast majority of situations, the global capital markets - both stock markets and bond markets - are fairly priced[7]. The broad market indexes outperform over 90% of all actively managed funds with vast amounts of information at their fingertips. For those who don't believe the many academic studies, you should be able to answer the question: What future is currently priced into this (stock or bond), and what do I know that the rest of the world does not know?

Market UP, U.S. Economy down
Investor Misunderstanding?

Stock market prices are not aligned with our U.S. economy. Stock markets reflect future expectations for "corporate" growth, and they embrace expected growth 10 years or more into the future, discounted back into today's dollars. However, it is the "structure" or "indexation" of the stock markets, which have created the illusion of the stock market's incredible return.

Equity Index vs U.S. Economy

Stock markets are an index, *representing only public companies* (there are between 3,000 – 4,000 public companies in the U.S.[8]). Further, the indexes are "*market-capitalization*" weighted[9] and *this is where the confusion is created*. "Market-Capitalization" is shorthand for saying the largest *PUBLIC* companies, with the highest valuations, are most heavily weighted in the stock-index totals. *Today, the top 10 companies in the S&P 500 make up more than 25% of the index's value* – meaning 10 companies are largely dictating the index's value. *The outsized performance of these few is by-far the most significant reason the stock market "INDEX" is near all-time highs (as an example – Apple's (APPL) market capitalization as we write, makes it worth more than the Russell 2000 index).

[6] https://en.wikipedia.org/wiki/The_Wisdom_of_Crowds by James Surowiecki documented that groups of individuals all voting with their best interests in mind were far more accurate than any single individual's predictions.

[7] *Unanticipated events, both positive and negative, are the major source of markets becoming mispriced*. Unanticipated events often engender emotional reactions. Emotional reactions are the enemy of intelligent investment decisions. Unanticipated events often stimulate both fear and euphoria. Both tend to engender activity contrary to the intelligent financial plans and strategies created and embraced during calm, thoughtful times.

[8] The number of publicly listed **U.S. stocks** peaked at a record 7,562 during McGwire's record-setting summer of 1998, according to the Wilshire 5000 Total **Market** Index. Today, there are just 3,812 .Jul 9, 2015

[9] For example, if company "A" was valued at $1 billion dollars, and company "B" was valued at $100 million dollars, company "A" would influence the "stock-market's" *cumulative value* 10 times more than company "B". This skews the "stock-market's" cumulative price in a way that is NOT indicative of the U.S. economy. *The "market capitalization" framework is sending confusing signals to many investors who believe the U.S. stock market is aligned with the U.S. economy. Reason: a few incredibly large technology companies, particularly well-suited for this economic environment, have increased in value rapidly , while the vast majority of companies in basic industry have NOT kept pace*.

Our U.S. economy is largely the opposite. Our U.S. economy is more aligned with the 30 million *small businesses*[10], which employ almost 60 million Americans, representing almost 50% of all American employees. Many of those smaller companies are struggling.

In short, the S&P 500 "Index" or the NASDAQ 100 "Index" is NOT a proxy of our U.S. economy – although our U.S. and global economy do influence corporate earnings, thus corporate valuation.

Bond Index vs U.S. Economy

The bond market is more aligned with our U.S. economy. The bond market is telling us the U.S. economy is in a deep recession, and is currently bordering on a depression.

Bond prices and bond yields move in different directions. As bond prices rise, the yield bond buyers receive moves proportionately lower. The inverse is equally true. As bond prices decline, the yield bond buyers receive increases.

As of July 2020, *bond prices are as high as they have ever been*, in recorded history. *This means bond yields are as low as they have ever been in history*, both in the U.S. and around the world in general. This is a signal, and it is a global signal, not just a U.S. signal, that many economies around the world are struggling, and need the stimulus of low interest rates.

So, the succinct answer to the original question… it is quite possible for the U.S. stock market "INDEX" and the U.S. bond market "INDEX" to send conflicting signals – and often – for both to be correct. We believe the current environment, while unusual, is just one of those times.

"Which market "INDEX" Should Investors Take Cues From? What Does That "INDEX" Tell Us?

Unfortunately, history tells us the bond market offers more direction about the economy's future. The bond market describes our economy through its interest rate structure.

Since its creation in 1913, the U.S. Federal Reserve has had a hand in controlling interest rates within the U.S. economy. It increases interest rates to slow the economy when overheating, and it decreases interest rates to stimulate the economy when economic activity declines.

For decades, the U.S. Federal Reserve sent the world messages describing our U.S. economy, by setting interest rates higher (expanding economy) or lower (shrinking economy). Today, interest rates are as low as they have been in recorded history. Additionally, the U.S. Federal Reserve has been printing money. This increases the amount of U.S. dollars available, globally, by a significant amount.

[10] Small Businesses are defined as those employing less than 500 people. There are over 30 million Small businesses making up over 47% of America's workforce, employing almost 60 million people. https://www.fundera.com/blog/small-business-employment-and-growth-statistics#:~:text=How%20many%20people%20do%20small,the%20country's%20total%20employee%20workforce.

This combination of the lowest interest rates in recorded history combined with printing vast sums of U.S. dollars, tells investors the U.S. Federal Reserve believes our economy is in trouble.

What is Next?
Based on Current Risks, How Should Investors be Invested?

The investment environment during 2019 was almost ideal. Our world was seemingly moving forward on cruise control. The U.S. economy was growing at 2 – 2.5% (real rates). Interest rates were at almost record lows, taxes were at the lower bounds historically, and the world was dealing with the typical challenges and upsets, which gave the media plenty of scintillating headlines.

In short, the market was climbing the veritable "Wall of Worry", which is characteristic of so many bull-markets over the last hundred-plus years.

Then the virus hit. Our scientists and infectious disease experts had never seen this virus, and justifiably did not know exactly what to expect, or how to fight it. Country after country, which had transportation from, and to China, saw infection rates and deaths soar. Each country began to shut down sequentially. In March 2020, the U.S. sensed the seriousness of this virus, and our policy response was to shut down the economy, and protect the U.S. citizenry as much as possible.

Absent WWII, our U.S. economy had never experienced a global shut-down. *The U.S. stock markets experienced the sharpest downturn in history*[11]. The U.S. Federal Reserve, sensing the seriousness of our economic downturn, cut interest rates from 1.5% to effectively 0% and started printing money. Then, surprisingly to most, the U.S. stock market "INDEX" rebounded with the sharpest recovery in history!

Today, interest rates continue at the lowest levels in recorded history, thus signaling an enormously troubled U.S. economy. What is next for our economy and our capital markets?

As most of you know, we have been having periodic conference calls to discuss the State of the Capital Markets with each of you. We have tried to make our position clear.

There are at least five major uncertainties in front of us.

1) **The health crisis created by the COVID virus**;
2) **2020 Election**
3) **The U.S. vs China Cold War Escalation**.
4) **The Economic Downturn in the U.S. Economy**;
5) **The U.S. Federal Reserve's significant response to the economic shutdown**;

There are many more, yet the five uncertainties listed above are front and center when attempting to forecast the economic future. Let us discuss each in more detail below.

[11] https://www.cnbc.com/2020/03/23/this-was-the-fastest-30percent-stock-market-decline-ever.html

Uncertainties –
How Does a Prudent Investor Invest When the Future is Unknown?

Any *one* of the uncertainties above would make forecasting the future more similar to a guess than a science. The fact that all five uncertainties are demanding answers - all at once - makes forecasting nearly impossible today[12].

Here is what we know: ***This is a health crisis first***. The economic crisis cannot embrace a solution until we solve the health crisis. Decision theory says, before we deal with any other uncertainty, we must solve the first uncertainty. Therefore, our strategy must be to estimate the arrival of a solution to the virus.

NOTE: **This risk analysis is conducted based on our belief that there is a 90%+ chance of finding a solution to this virus by the end of 2021**. The earlier the solution, the less human suffering and the better the economic outcome[13].

Health Crisis: COVID 19 Solutions

Human ingenuity is fantastic. It is the often sited "X" factor, responsible for humanities progress over the last 200,000 years. Today there are over 140 well-endowed companies working on a solution for the virus. It would be hard to bet against those 140+ medical institutions, with almost infinite data, and computing power that most humans would envy.

A vaccine will be the best outcome. A therapeutic antiviral may provide a comfortable bridge until we find a vaccine. Additionally, *our global society has learned more about this virus*. We now understand how to deal with its infestation and its spread. Our research shows that shutting down the economy again is highly unlikely (however, smaller - geographic shut-downs are likely, based on local infestation).

Thesis: It is almost impossible to predict the approval of a vaccine.

A therapeutic solution is a bit easier, as therapeutics have a significant head start. Most therapeutic candidates have already cleared the "safety" hurdle, in that they have been in "patient use" for years, treating other similar maladies. As long as a potential remedy is safe, with years of active use, acceptance by the citizenry is more assured. Moreover, with more than 200 therapeutic candidates already being tested, it is highly likely that several, not one, will become potential solutions. (Important

[12] For one of the best articles on how to deal with uncertainty when making decisions, please reference the link below to an article by Howard Marks. It's a 15-minute read, and packed with valuable information about the mistakes people make when faced with uncertainties, and how to avoid those mistakes. https://www.oaktreecapital.com/docs/default-source/default-document-library/uncertainty.pdf?sfvrsn=0

[13] The remaining 10% probability represents the joint possibility that a) there is no cure, and humanity eventually gets "herd-immunity, b) the virus just becomes dormant or largely dies as was the case during the last COVID outbreak (SARS and MERS), c) an outcome take place we have not experienced previously. All components of our 10% outcome represent extremely negative economic outcomes. (This belief is our bias, based on hundreds of hours of meetings with epidemiological, infectious disease, and economic experts.

to note, these previously acceptable therapeutic remedies have already conquered the logistical hurdles involved with making vast quantities of the substance, putting them in a form ready for distribution (oral, syringe, or patch), and actually getting the therapy from point A (manufacturer) to point B (patient). Because these logistical hurdles are already in place, a therapeutic remedy gives us confidence that a solution will be available despite the likelihood of a vaccine being several to many months away.)

While no one wants to contract the COVID virus, the combination of distancing, masks, frequent hand washing and intelligent behavior, with a therapeutic remedy to control the virus in the *unlikely event hospitalization is needed*, will provide a less than perfect, yet potentially acceptable solution.

Vaccine: We have three scenarios.

Scenario 1 (vaccine probability 25%; therapeutic probability 60%): Solution time frame: **second half of 2020**. The current vaccine clinical trials have a hurdle rate of 50% or greater efficacy. There is a solid probability that one or more of the vaccines can exceed this hurdle, with safety, since several candidates are already in stage 3 clinical trials. If our first Scenario comes true, the question will quickly become one of trust. Will the public "trust" a vaccine that was developed as quickly as these vaccines are being developed? (Historically, vaccine development has taken (several to many) years, NOT months.) Current speculation is circling around several vaccine candidates, and rumors are they will take only months to approve. Today, we have advanced technology, almost infinite access to information, and more experience than ever. Yet every epidemiologist and infectious disease expert will remind us, the human body's operating system is complicated. Rushing the clinical testing process may not provide the best outcome. Further, actually making the vaccine, getting it in a syringe, and distributing what may turn out to be an unstable vaccine requiring care-related delivery systems (refrigeration for example) will all take time. However, as we write this summary, The New York Times reports there are over 240 therapeutic and 90 vaccines in various stages of testing. This helps shift the odds in favor of a solution (either therapeutic or a vaccine) emerging sooner than historical experiences. We will hope for the best, yet remember a 25% probability means a vaccine has a 1 in 4 chance of coming true before the end of 2020.

Scenario 2 (vaccine probability 50%; therapeutic probability 25%): Solution time frame: **First half of 2021.** Scenario 2 is the most likely outcome, as the fast-track approval process continues to provide favorable results for the vaccine, yet the logistical responsibilities around manufacturing the vaccine (or vaccines - as there may well be more than one acceptable vaccine), distributing the vaccine, which may demand refrigeration, and administering the vaccine, will all take time to master.

Scenario 3 (vaccine probability 15% therapeutic probability 5%): Solution time-frame: **2nd half 2021.** This Scenario will likely provide a viral solution which is acceptable, as we have more information about how to deal with the virus effectively, yet a very bad outcome economically. (Yet remember this solution is an unlikely one.) A Scenario 3 outcome likely means a U.S. economy with GDP well below 2019's levels of $21.4 Trillion. How far below is difficult/impossible to determine at this point. This will become clearer as our economy evolves. Bankruptcies may increase exponentially as one business's purchases are another business's life-blood.

2020 U.S. election

The Election cycle is among the most uncertain events in our future. However, the outcome is often anticipated with trepidation. Yet, if you will research election data relative to stock market performance, as you will see, investors little reason to fear.

Please feel free to take a quick tour of the footnote below[14] which offers data on elections back to 1928 for "stock market" related performance for each election cycle. For the sake of brevity, you will find the summary below.

1) If a Democratic President and Congress is split: The DJIA increases 7.8%.
2) If Republican President and Congress split: The DJIA has risen 3.3%.
3) If Democratic President with <u>BOTH</u> Houses in Congress **ALSO** Democratic: The DJIA has risen 3%.
4) If Republican President with <u>BOTH</u> Houses in Congress **ALSO** Republican: The DJIA has risen 7%.

The U.S. vs China "Cold War" Escalation.

The U.S. has been in a 2 steps forward and one step back "Cold War" with China for the last 4 years or more. China has become the second largest economy in the world, as their economy has grown an average of 10% per year for 30 years[15].

China's economic initiatives combined with their population of almost 1.5 billion citizens support the expectation that China will become the largest economy in the world, displacing the U.S., over the next 10 years or so[16].

When the number 2 economy overtakes the #1 economy, the "Cold War" has turned into a "Hot War" in 12 of the last 16 occurrences over the last 500 years[17]. *This is cause for caution*. China's aggressive economic goals involving several countries in Africa, its planned "One-Belt-One-Road" initiative to link Eastern Europe with Asia, combined with its aggressive stance on the Indian border[18], and in the South China Sea vs Japan, deserve more research and awareness.

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[14] See Presentation "Market Returns During Election Years 1928 – 2016. Market Returns During Election Years

[15] *"Report for Selected Countries and Subjects". International Monetary Fund. 16 April 2013. Archived from the original on 2 November 2013. Retrieved 16 April 2013.*

[16] https://en.wikipedia.org/wiki/Economy_of_China

[17] https://www.belfercenter.org/thucydides-trap/case-file

[18] https://www.usnews.com/news/world/articles/2020-09-06/experts-warn-china-india-standoff-risks-unintentional-war

This global relationship may become an event with far greater implications than the current healthcare crisis over the next several years. We do not believe a "Hot-War" is currently priced into the market.

In short, this is another low probability event, with high uncertainty, and may become an accident waiting to happen, with incredibly significant outcomes on a global scale.

The Economic Downturn in the U.S. Economy

As said previously, the combination of viral spread, with lack of knowledge about how to contain and fight the virus, led our government to shut down a significant portion of our U.S. economy.

Public Sector: The stress on our state, city, municipal, and public service finances has been significant (think airports, highways and bridges).

Record-breaking unemployment created significant losses in tax revenue. It will be difficult to recover from this deficit. This may require the U.S. government to come to the rescue and bail out cities/states unable to repay the debt. *We do believe the U.S. government will do what is necessary to ensure the public services meet their debt obligations*.

Private Sector: In the private sector, the stress has been incredibly uneven. Some industries have thrived by experiencing several years of growth in less than 6 months. In other industries, catastrophic declines in revenue and subsequent profits will make it more difficult to rebuild than the financial markets believe (think restaurants, retail, transportation, hospitality).

The negative impact of this downturn on private sector companies will materialize in the fourth quarter of 2020 and beyond. Bankruptcies will be significant. While the timing is impossible to predict, the longer it takes to approve a vaccine the public trusts, the more damage to the private sector.

Asset Allocation Amid Extreme Uncertainty

When making decisions, it is important to embrace both positive and negative data and facts. After aggregating all positive and negative facts, and an opinion is formulated, it is important to find and embrace the counterfactual. It is only after studying both sides of the argument, and weighing the probabilities and the outcomes, are you capable of making a well-informed decision.

I have tried to summarize the data collected over the last 24+ weeks into an easy to understand visual series of charts and graphs that outline both the positives and the negatives of our U.S. economy and the state/valuation of our U.S. capital markets.

The goal of this exercise is to help each of us embrace an expectation for the future, despite incredible uncertainty, based on relevant historical evidence.

As you will see, some of the damage to our U.S. economy started well before the virus. As is often the case, *a leveraged economy is more fragile and takes just one negative event to trigger a downturn*. The degree of downturn and subsequent economic damage depends upon the length and severity of the downturn.

When a leveraged economic system's center becomes imbalanced, the slightest gyration may easily cause an amount of damage far greater than what might typically be expected. One has to look no farther than 10 years ago with the 2007 – 2009 Great Financial Crisis (GFC), where housing market debt threatened to sink the *global* economy[19].

The GFC, had a higher risk of creating a global catastrophe, it was easier to solve. Since the GFC was a financial crisis, lowering interest rates, combined with government guarantees, allowed our U.S. and Global economies to recover.

Today's crisis is different. This is a healthcare crisis. It will take a medical solution, not a financial solution to fix our U.S. economy. This crisis is affecting many different industries in many ways. Some industries have benefited, as this crisis has created 5-7 years of progress in less than 6 months. Other industries are severely damaged and will take years to recover, if they ever recover.

Chart 1: The chart below outlines the increase in U.S. corporate profitability vs revenues, from 1994 – 2019.

It is important to remember that *current and future profits determine the value of a financial asset*.

The chart below shows that profit margins have increased from approximately 6% to 11% over the last 25 years. While this is great, profit margins expand and contract over time, most often, reverting to the mean of 5 – 8% after-taxes, for the best companies.

The takeaway: *Corporate profitability is likely to revert to a MUCH lower percentage of revenue*. While this reversion is NOT guaranteed, corporate profitability is typically a "mean-reverting" characteristic, as high levels of profit in a capitalistic economy tend to breed competition, which tends to create price wars, thus reducing profitability.

[19] We have yet to see the damage done to the core of the U.S. economy – as many of the government aid supplements have recently run out. We believe it will take 3-6 months or longer, to determine which industries and which companies within those industries, will remain, and which will have to reorganize in bankruptcy. It is quite possible for the bankrupt companies to cause a much more significant downturn. Japan embraced an economic downturn 30 years ago. Japan reacted with lower interest rates and money printing. Today, its economy is worth approximately 50% of its value, 30+ years ago.

*If corporate profitability is reduced to more normal levels of 5 – 8%, it will lower earnings, thus lowering stock values.

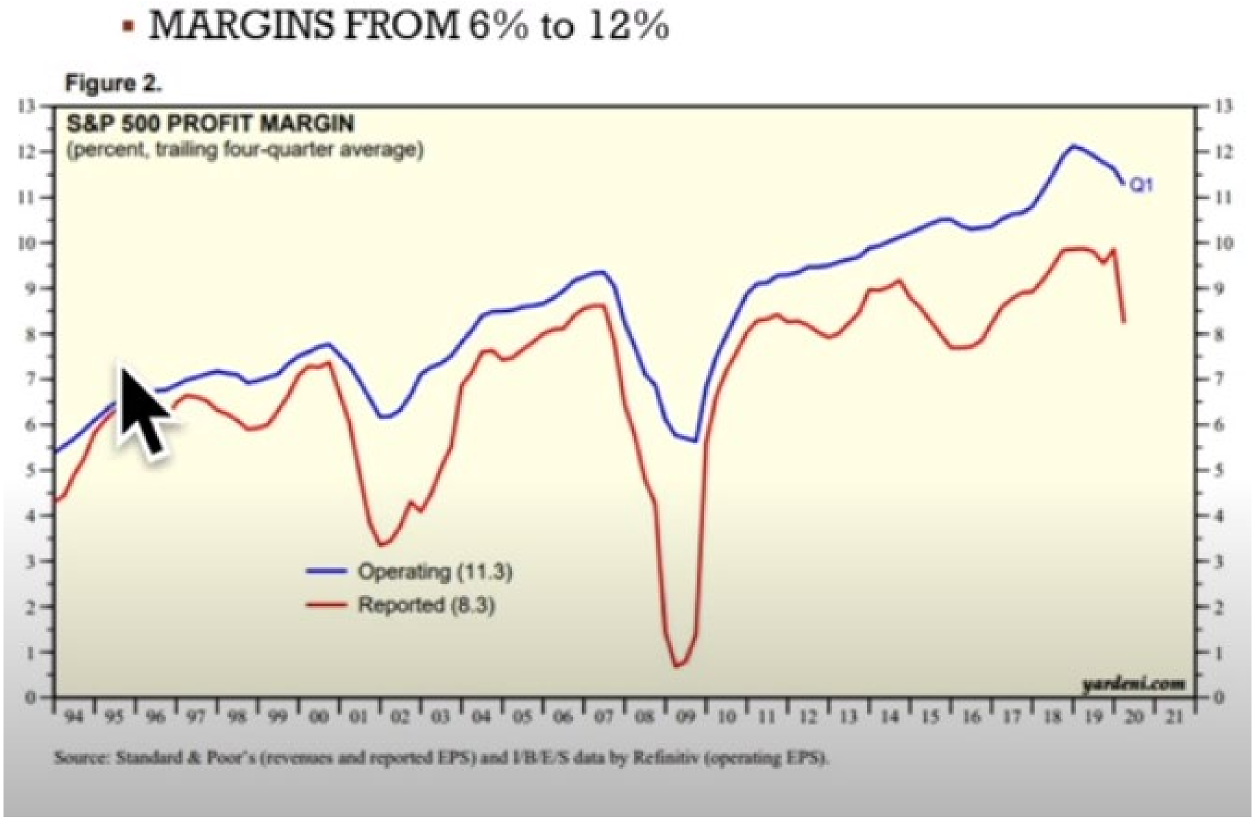

Chart 2: The second chart outlines our corporate Income tax rate from 1918-2019. Corporate taxes directly reduce corporate profits, as *taxes reduce earnings dollar for dollar*. As you will see, current tax rates are at the lower end of historical rates (1918 – 2020).

The only period which was lower, preceded the Great Depression in 1928 and was followed by significantly higher rates.

The Takeaway: Corporate income tax rates are more likely to increase than to decrease. Increased corporate taxes will lower after tax earnings, thus lower financial asset prices.

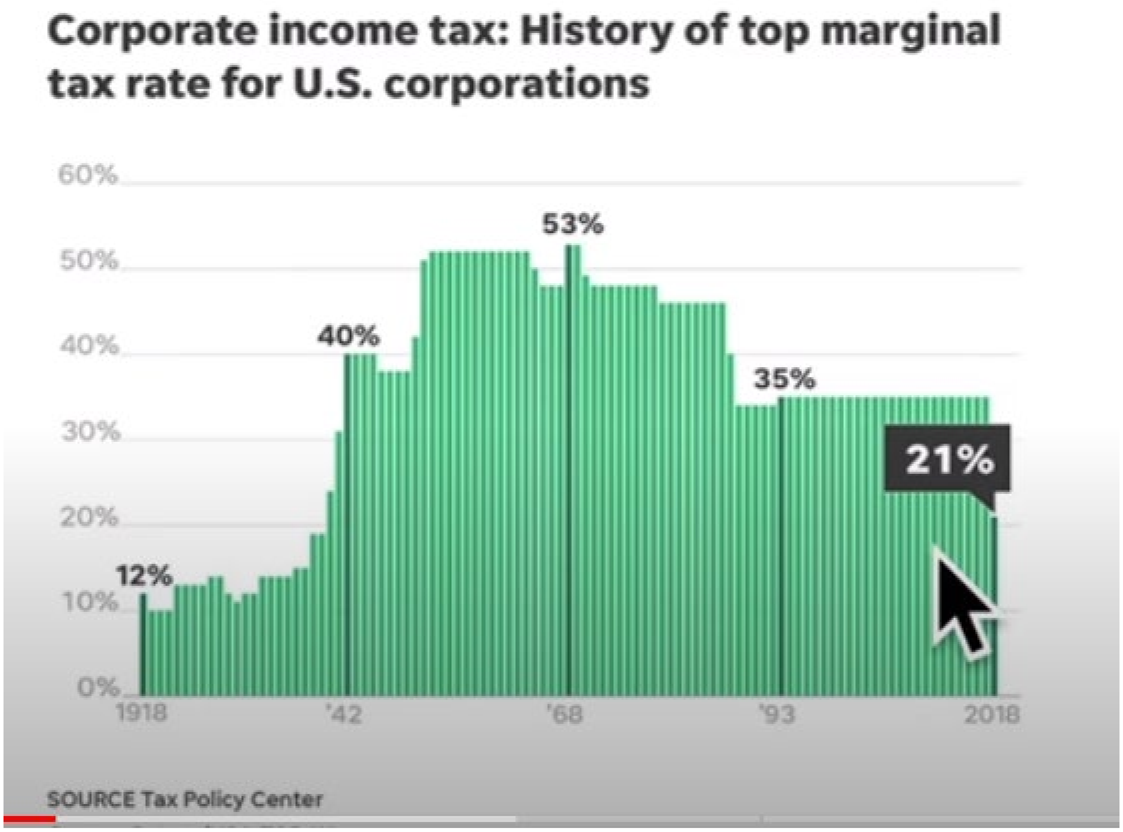

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Chart 3: This chart is a bit shocking.

It took our country a bit more than 200 years to accumulate its first $1 trillion in U.S. Federal Reserve debt. *It took it less than 20 years to triple that amount ($3 Trillion). It took less than 10 years to more than double that amount ($6 Trillion + today).*

At the end of 2019, the U.S. bond market had more than $45 *trillion* in outstanding debt securities[20],[21]. Why is this important? Significant bodies of research posit that as debt increases, growth slows[22]. This is true for corporations and for governments. **Reason:** the income available for growth initiatives is directly reduced by the debt and interest payments due. As debt increases, less funding is available for productive/growth initiatives.

As our governmental and corporate indebtedness has increased, the interest rates decreased from approximately 5-6%+ in the 1990's to 0.7% as of this writing (see the chart in the upper left hand

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[20] This Time *IS* Different, but it will end the same way: Unrecognized Secular Changes in the Bond Market since the 2008 Crisis That May Precipitate the Next Crisis by Daniel Zwirn, Jim Kyung-Soo Liew, and Ahmad Ajakh. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3379979

[21] SIFMA U.S. Fixed Income Markets Quarterly https://www.sifma.org/wp-content/uploads/2020/03/US-Research-Quarterly-Fixed-Income-2020-03-27-SIFMA-1.pdf

[22] Seminal Book by Reinhardt and Rogoff: Eight Centuries of Financial Folly. https://www.amazon.com/This-Time-Different-Centuries-Financial/dp/0691152640

quadrant of the larger chart). *<u>This is a significant positive</u>* as it has helped our government and our corporations increase the amount of debt they can handle without defaulting. However, these debts MUST be repaid. That is the bad news.

The Takeaway: the U.S. economy entered this downturn with high levels of debt. High levels of debt are responsible for the U.S.'s slowing growth over the last 5 years. We believe *<u>U.S. government and U.S. corporate debt will reduce growth over the next economic cycle.</u>* Slower growth, most often means lower financial asset values. *Most other developed nations around the world are in similar - or worse shape.

All investors should expect much slower growth as their base-case assumption for future returns.

*Note - Economic fragility increases when debt increases, as corporations and governments are less able to handle negative events. Consequently, it is more likely that future financial disruptions are either A) more frequent, or, B) more severe, or, C) or both.

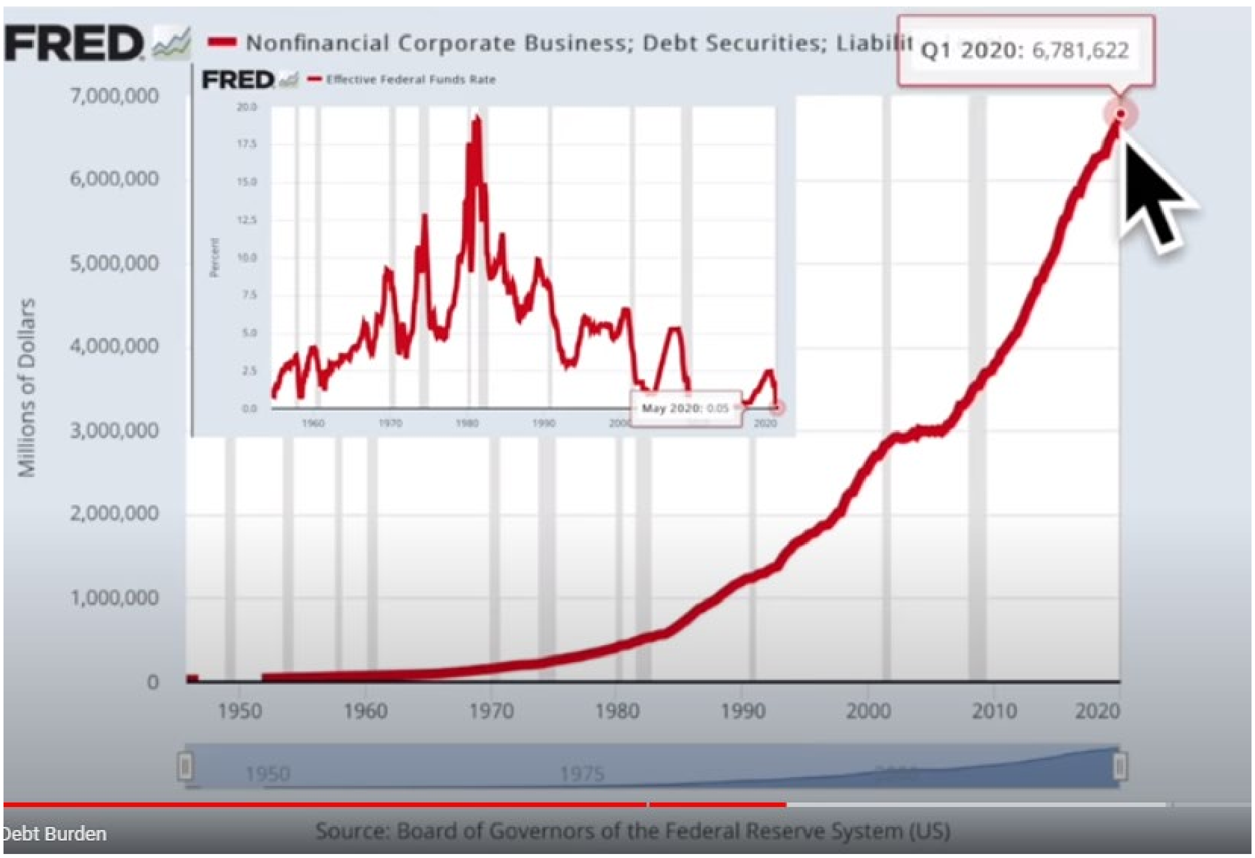

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Chart 4: compares the amount of government debt to total assets owned by the major U.S. Banks. **The U.S. Banking system is the largest buyer of U.S. debt securities.** As the U.S. Federal debt continues to rise, the U.S. Banking system's ability to buy the U.S. government debt will *<u>diminish</u>*. This means, the

U.S. government will have to depend on the rest of the world to buy their bonds – rather than having the U.S. banks buy their bonds.

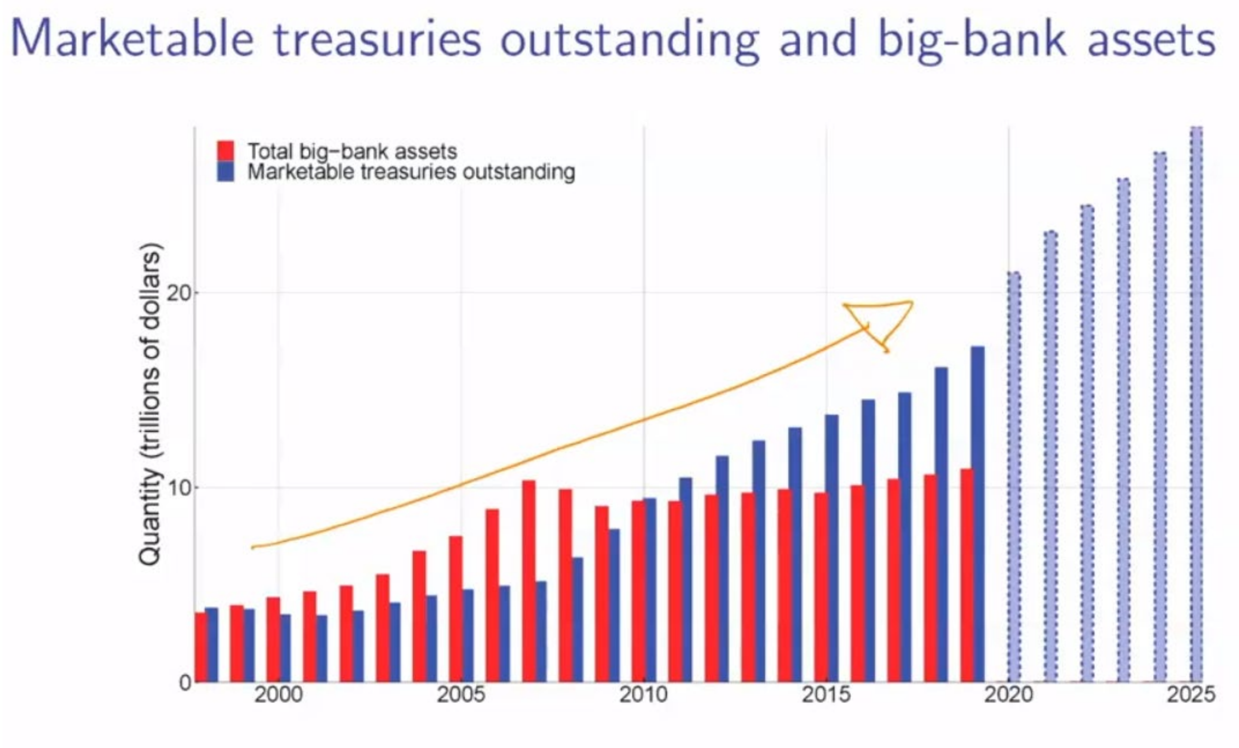

Figure: Marketable treasuries outstanding, including projections from 2020 from deficit of Committee for a Responsible Federal Budget, April 13, 2020. Total assets of

When the U.S. Banking system is buying U.S. government bonds, the U.S. government is largely in control of the rates it pays when issuing the debt. When the U.S. government has to depend upon entities outside of the U.S. to buy their bonds, another dimension of risk enters the equation, as those governments are <u>NOT required</u> to buy the U.S. government bonds. Non-U.S. buyers *must be incented to buy U.S. bonds*. Over recent history, that has not been a significant challenge. Yet recent history does not diminish the possibility that at some "tipping-point" the U.S. may NOT be able to sell the bonds required to fund the U.S. operating deficit. If (or when) this happens, interest rates will rise, and may rise significantly. (This would be incredibly negative for financial assets.)

The Takeaway: The U.S. government controls its debt issuance *and* the interest rates it pays for the bonds it is selling. However, the U.S. banking system is pushing its upper limits. This could create unintended consequences for the U.S. Federal Reserve and the global financial system as well.

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Charts 5-8: The following three charts act as a compass. They offer clues about how the U.S. markets are currently valued, relative to historical valuations. ***These charts are NOT market-timing devices.** However, they may be helpful in determining future investment returns.

Chart 5: The **Buffett Indicator**. It compares the market capitalization of the S&P 500 (the total value of the S&P stock market) to the U.S. Gross Domestic Product. If the S&P 500's market capitalization **is below U.S. GDP**, *investors might expect higher than historic returns*. If the S&P's value is **above U.S. GDP**, *investors might expect lower than historic returns*.

The takeaway: U.S. capital markets are richly valued. Future returns are likely to be lower than average.

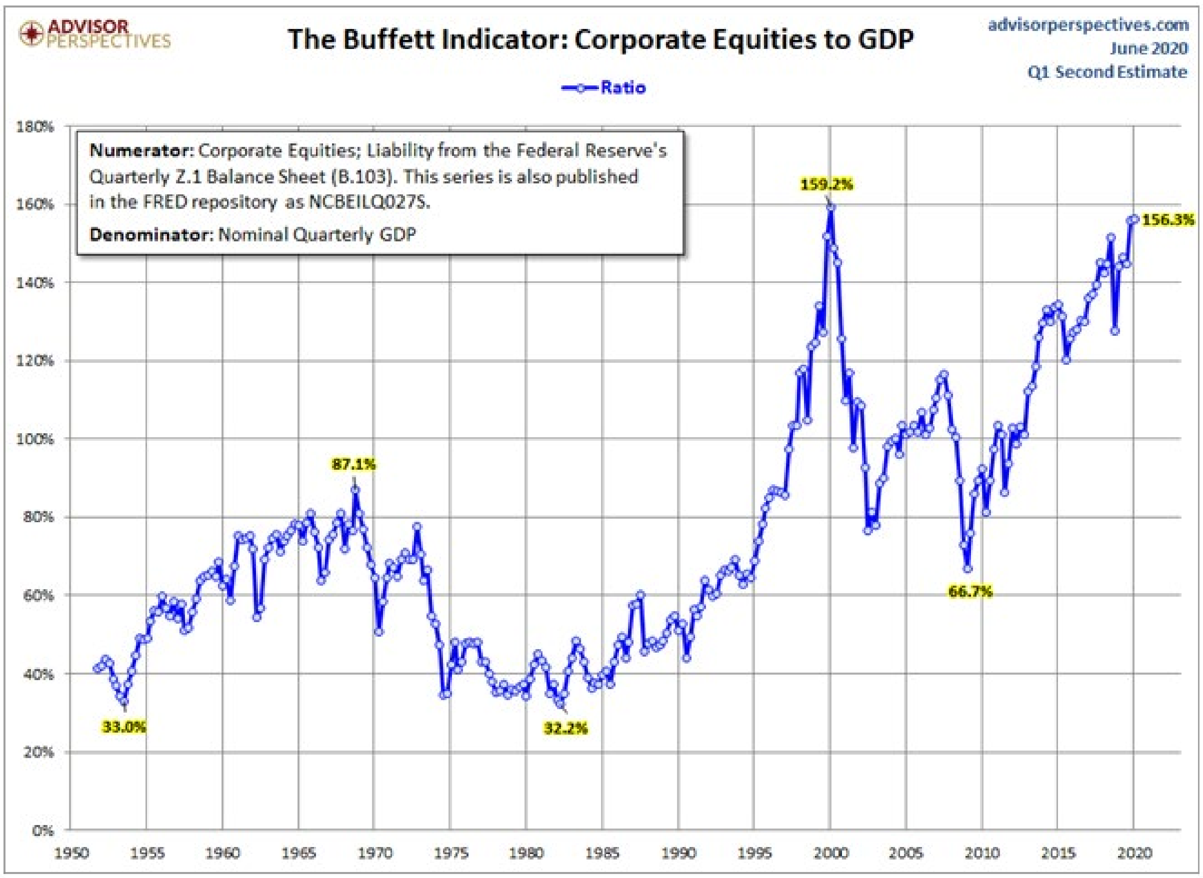

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Chart 6: The chart below, is similar to the chart above. **One change:** the chart below uses the **Wilshire 5000 market value**, in place of the S&P 500. Different data points which lead to the same conclusion create a more confident expectation.

The Takeaway: U.S. capital markets are richly valued. Future returns are likely to be lower than average.

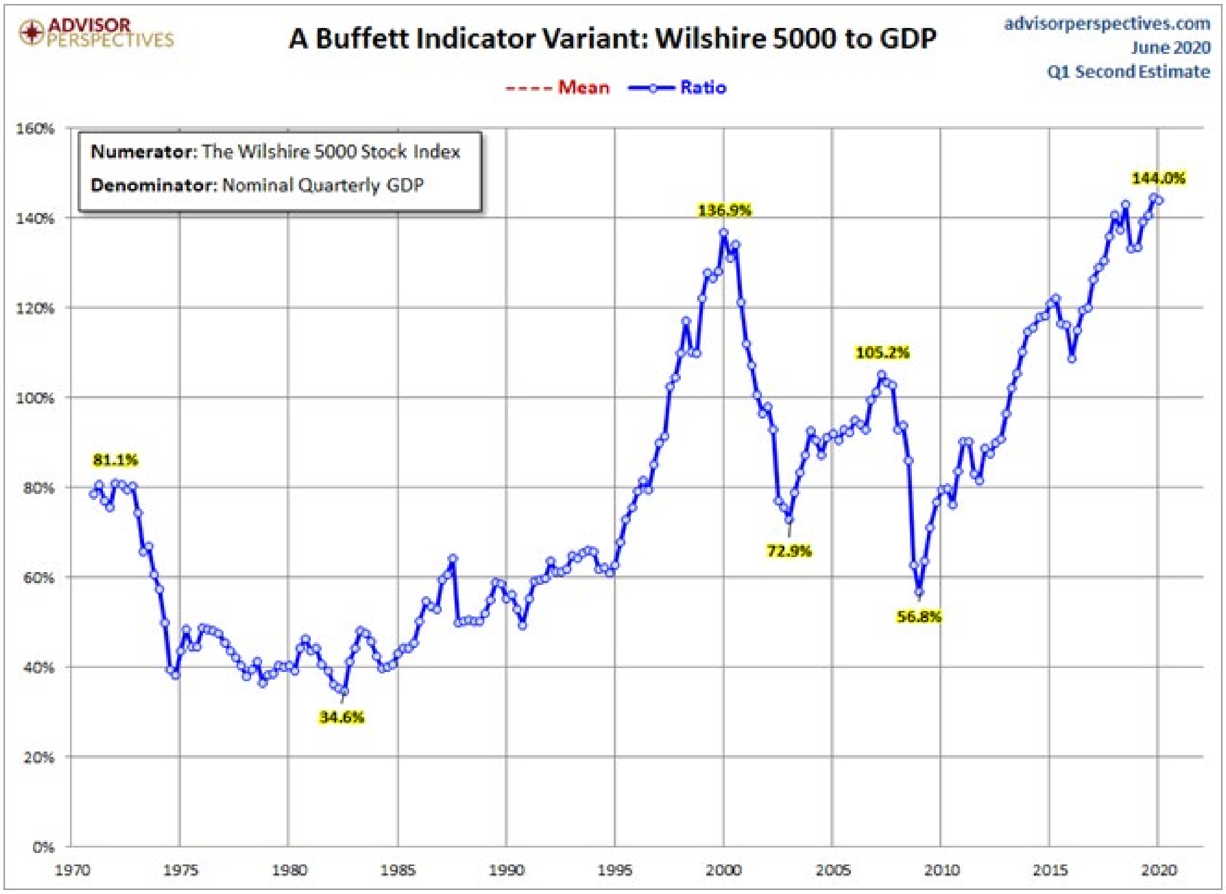

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Chart 7: The chart below offers a more granular compass setting, as it encompasses a much longer time-line of data.

The "**Crestmont PE Relative to the Geometric Mean"** compares "profits" generated, to the "current value" of those companies generating those profits.

This chart will help investors understand the prices of securities relative to the profits those securities have produced over the last 100+ years. T**his chart is NOT a market-timing device**. It is designed to tell the investor how much Mr. Market is currently paying for $1.00 of profits relative to the last 100 years of market history.

The Takeaway: Mr. Market is about as euphoric as he has been throughout history. Expect lower future returns.

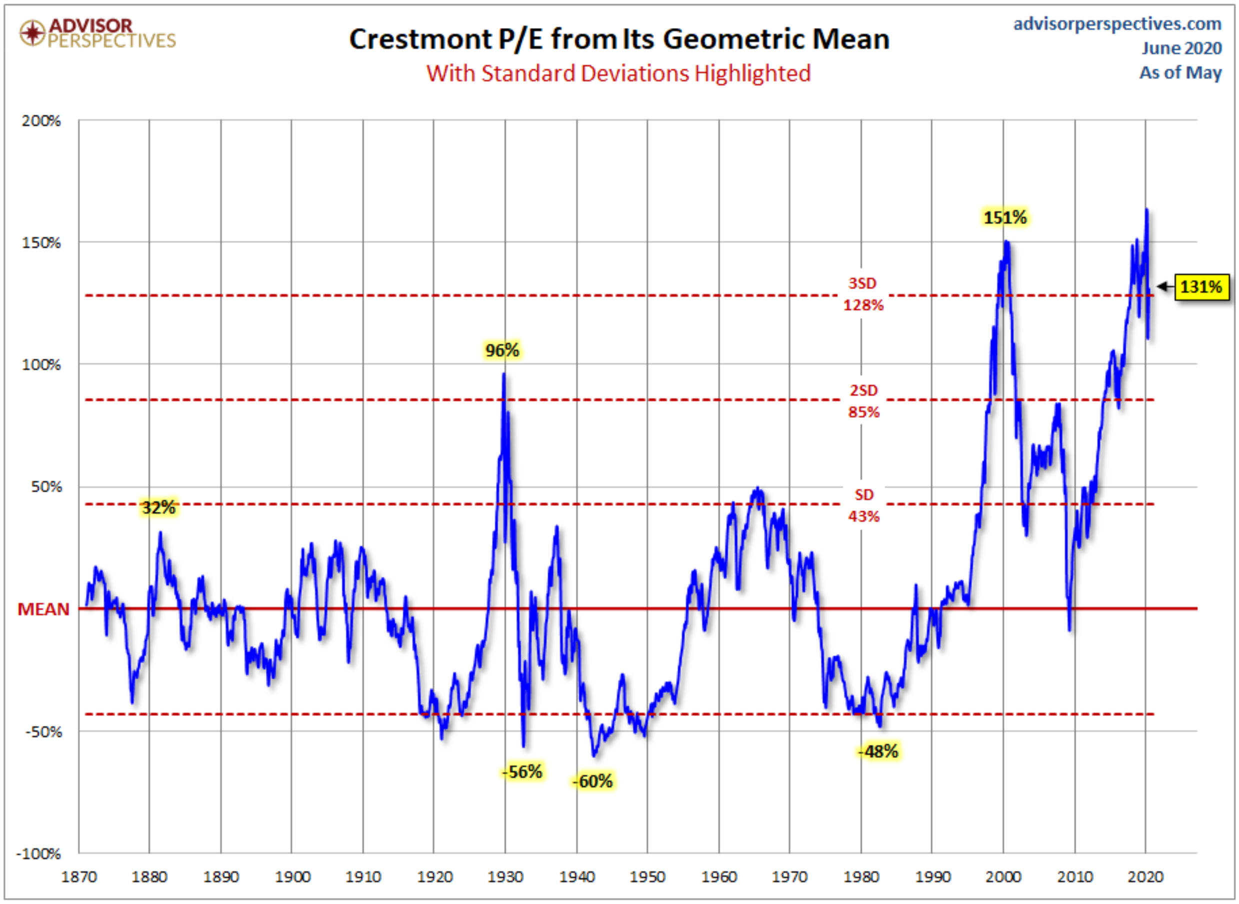
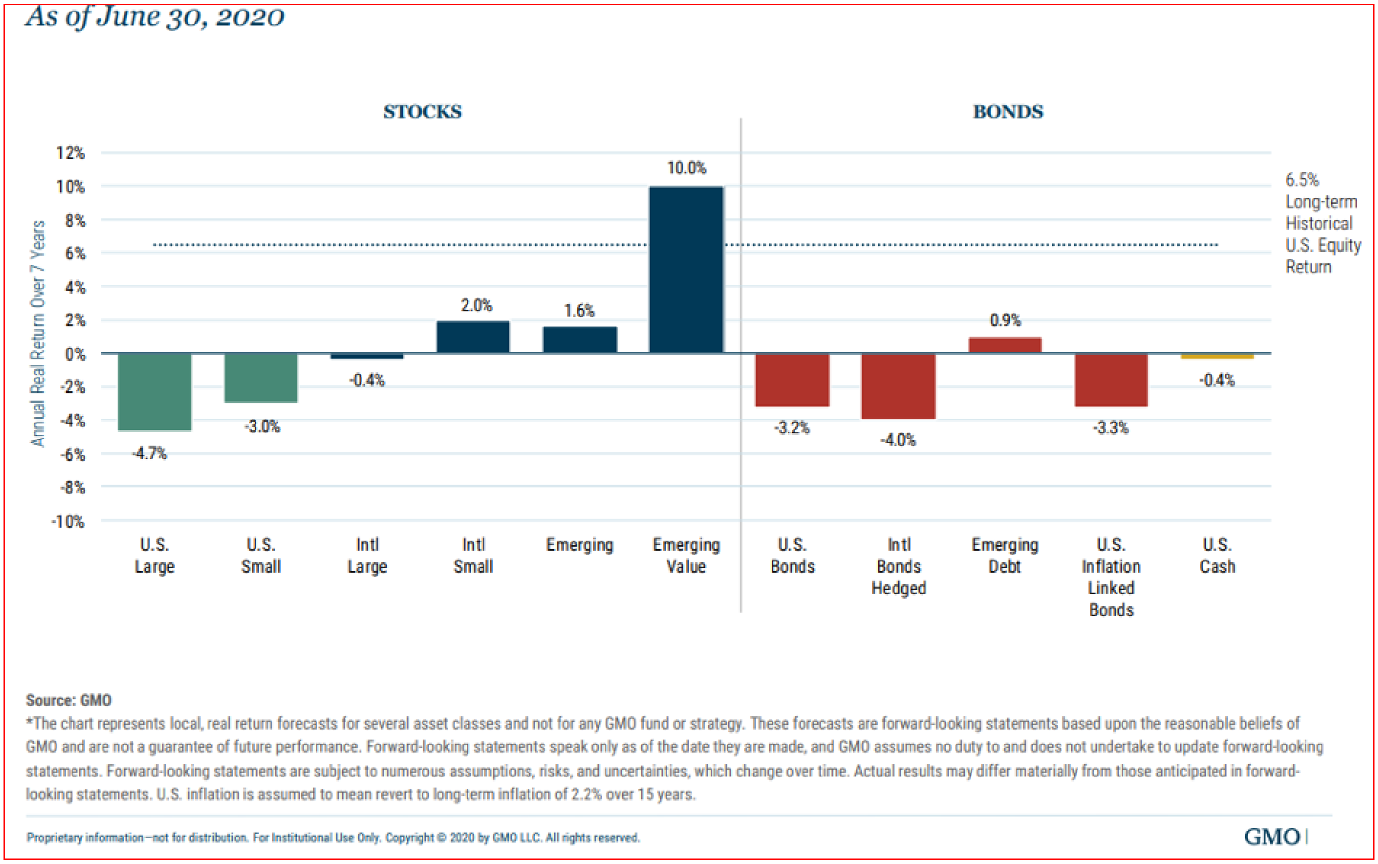


Chart 8: Below, you will find a chart from Grantham, Mayo and van Otterloo (GMO). It plots current prices against expected earnings. This chart describes GMO's "return" expectation for each asset class over the next 7 years.

The goal of this chart is to help investors develop an expectation as to the next 7 years of asset class returns based on *current prices*. **This is NOT a market-timing mechanism**.

The Takeaway: *U.S. capital markets* are overvalued. Expect lower than average returns. *Emerging Markets* are undervalued. Investors may expect higher than average returns. Bonds are overvalued. Investors should expect the coupon rate of return only (which is likely to be less than the inflation, thus bond investments are likely to reduce an investor's purchasing power).



The Federal Reserve's Response to the Economic Shutdown

One picture may help us describe the U.S. Federal Reserve's reaction to the economic shutdown:

In short, the U.S. Federal Reserve came to the rescue. Again.

After numerous economic rescue actions since the 2007-2009 GFC, totaling trillions of dollars, The U.S. Federal Reserve (Fed) is at it again.

In March 2020 the Fed cut rates from 1.5% to almost 0%.

Again, in March, the Fed offered to buy $500 billion in U.S. treasuries, and $200 billion in mortgage backed securities.

In June 2020, the Fed agreed to buy $80 billion *per month* in additional treasuries and $40 billion *per month* in mortgage backed securities.

In total from March 2020 to June 2020, the U.S. Federal Reserve added over 2 trillion U.S. dollars to our economy by purchasing securities on the open market. Consequently, the U.S. Federal Reserve's portfolio of "securities purchased" (the Fed's balance sheet) grew from $3.9 trillion to $6.1 trillion[23].

Additionally the Fed backstopped the a) primary dealer market, b) the U.S. money markets, c) the U.S. repurchasing market (REPO), d) the U.S. Primary Lending market, and the list goes on and on.

In short, the Fed promised to do "whatever it takes" to ensure the U.S. economy did not fail. The U.S. Federal Reserve safety net continues today.

How long will it last? We are uncertain, yet the capital markets are pricing this status as if it will continue forever.

One thing is ***certain***. *The U.S. Federal Reserve's guarantee is NOT going to continue forever.* At some point the U.S. Federal Reserve will have to stop pushing money into our economy, and eventually the Fed will have to start increasing interest rates, as a 0.7% interest on *10 year* U.S. treasuries, guarantees investors will lose purchasing power, as inflation acts as a 2% per year tax (and maybe more as inflation kicks in).

Until then Mr. Market is not confused. Mr. Market is absolutely euphoric.

Personal Note: This is a time for discipline and not risk taking. Until we find a solution to the healthcare challenge before us, it is unreasonable to have a firm view on what our future holds. The longer a solution takes to gain approval, adequate distributional capability, and adequate acceptance by the public, the more likely corporate failures increase. (So Far we have counted over 140 large corporate failures and that was before the PPP loans and unemployment checks to the public ended).

[23] https://www.brookings.edu/research/fed-response-to-covid19/;

We believe healthcare professionals know more today, and are better prepared to treat additional flare-ups in virus outbreaks. We also believe we will NOT have a nationwide shut-down, yet geographic shut-downs are expected. Consequently, we DO NOT believe a particularly negative outcome is likely for long-term investors.

At the same time, the equity market has become increasingly fragile. It is dependent upon the U.S. Federal Reserve continuing its support of the financial markets, and a few highly priced technology stocks continuing to remain highly priced.

While anything is possible, it is unreasonable to expect this support from the U.S. Federal Reserve. It is also unreasonable to expect a few highly priced companies to continue propelling the indexes to new highs. This investment environment is unlikely to reward increased risk taking and significantly leveraged companies.

Below, you will find our anticipated outlooks for:

- **Interest Rates;**
- **Bond Market;**
- **Stock Market;**
- **Commodities Markets,**

The cumulative understanding of each sector below will help investors' gage risk, and guide us to our ideal risk vs reward asset allocation.

Interest rates:

We expect the U.S. Federal Reserve will manage interest rates at current levels, until data signal a *sustainable* U.S. economic recovery.

The U.S. Federal Reserve will let inflation expand, well past its 2% stated limit before raising interest rates.

Implications for Intelligent Investors: Interest rates will remain largely unchanged during 2021. Remember, *changes in the interest rate structure take 12 – 18 months to affect our U.S. economy*.

Increasing interest rates have historically caused *temporary* indigestion in the U.S. marketplace. We expect this to continue, yet, as said, no changes between today and 2021.

Our country is in a difficult position. We are near the end of the U.S. Federal Reserve's ability to a) repair, and b) stimulate our economy. We will need new strategies to generate growth. Infrastructure repair and technology infrastructure build-out, strike us as likely initiatives to add jobs and create a better America. Repaying our debt (and the interest on that debt), will allow less latitude for infrastructure initiatives.

Bond market:

Investors should expect to earn the interest rate on the bonds purchased, and no more over the next 5-10 years.

In short, bonds are egregiously overvalued. Many U.S. bonds will deliver a negative "real" return over the next 5 – 10 years, as the coupon is lower than the inflation rate.

However, if a negative global economic event takes place, U.S. bonds will likely outperform stocks to a significant degree *over the short-term*. Reason: investors historically have flocked to U.S. government bonds for safety, and the U.S. bond market is the largest, liquid market in the world.

Implications for Intelligent Investors: Bond investors should expect to earn the coupon on their bonds as their return objective, no more.

Stock market:

Today's Investors are living through one of the most aggressive monetary policy experiments the world has ever seen. This policy has increased U.S. economic fragility and *financial* asset prices to above average levels.

We believe U.S. stocks will provide lower than average returns over the next 5+ years and approximately 2% in dividends (before taxes and inflation). Investors should consider owning stocks, which pay dividends and have the ability - and history - of *increasing* their dividends. **Reason:** dividend payments are more certain and consistent than stock price appreciation, which will be lumpy, and prone to unpredictable, event-related setbacks.

Between now and the time a solution to the virus is approved, investors should consider moving up in quality and up in the size of the company they own. Reason: higher quality companies and larger companies usually pay dividends and have less debt. This makes them more able to withstand a difficult economy. It is possible the U.S. will have a difficult economy between now and the time a healthcare solution is approved, and accepted by the public.

NOTE: Both non-U.S. "developed", and "emerging market" international stocks are less expensive than the U.S. stocks. For this reason, it is likely that international investments will deliver higher returns, *yet with more risk*, over the next 5+ years. Keep in mind that less-developed, emerging markets, are growing much faster than the developed markets, and have younger population demographics, yet are more volatile.

Implications for Intelligent Investors: Value based companies have *underperformed* growth-based companies for almost 10 years, and smaller companies have underperformed large companies for the last 12 months by more than 15%. Despite this fact, *cautious investors* should move up in a) quality and move up in b) size, until we have an acceptable healthcare solution.

When a healthcare solution is approved and available, investors should maintain their equity investments with a higher allocation to *value* vs growth, *small companies'* over large companies, and international markets relative to U.S. markets. In the U.S. markets, investments should include dividend-paying equities, as they are likely to deliver competitive and more reliable returns with less risk.

<u>**Commodity Market:**</u>

There is still more capacity than demand in the commodity sector. The availability of cheap financing from each successive QE program since 2009 by the U.S. Fed, the Japanese government, and the EU, created overcapacity in many commodities. (The overcapacity is concentrated in metals and mining mostly. Agriculture is better balanced.)

Inflation is unlikely to increase significantly during 2020.

We believe investments in the commodity market will help guard against inflation over time. However, <u>*it is too early to start adding to our broad commodity holdings*</u>.

Implications for Intelligent Investors: when inflation starts its ascent, it may become painful. We believe it will take a long time for the developed economies to deal with it – thus we would rather witness confirmed evidence of inflation taking hold <u>*before*</u> adding to our commodity position.

The energy sector has underperformed for the last 5 years. However, global supply and demand became balanced before the viral pandemic. Capital expenditures in the energy sector have been constrained for the last 4+ years. This creates less supply, and a more fertile profile for "energy" investments.

We do not have confidence in our ability to predict *energy demand* until our U.S. and global economy find a solution to the virus. However, the U.S. has implemented policies, which encourage *U.S. producers to increase production and distribution of its energy assets*. *Dividend paying pipelines and refineries are likely to offer above average return* with lessened risks over the next few years.

We continue to own Real Estate Investment Trusts (REITs) as they produce increasing levels of income, and real estate tends to keep pace with inflation. Current income of 3% – 6% in the real estate market is attractive with 10-year U.S. government bonds yielding less than 1%.

The historical combination of real estate's appreciation in-step with inflation, and the income it generates, makes it a potentially preferable to other commodities currently.

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As always, we will look forward to speaking with each of you over the coming weeks.

In the meantime, please feel free to call with questions about the letter above, and any of our conclusions as they relate to your family's investment portfolio and future.

Warmest regards,

Steven Abernathy – The Abernathy Group Family Office