FROM THE DESK OF ERIK OROS

JULY, 2020

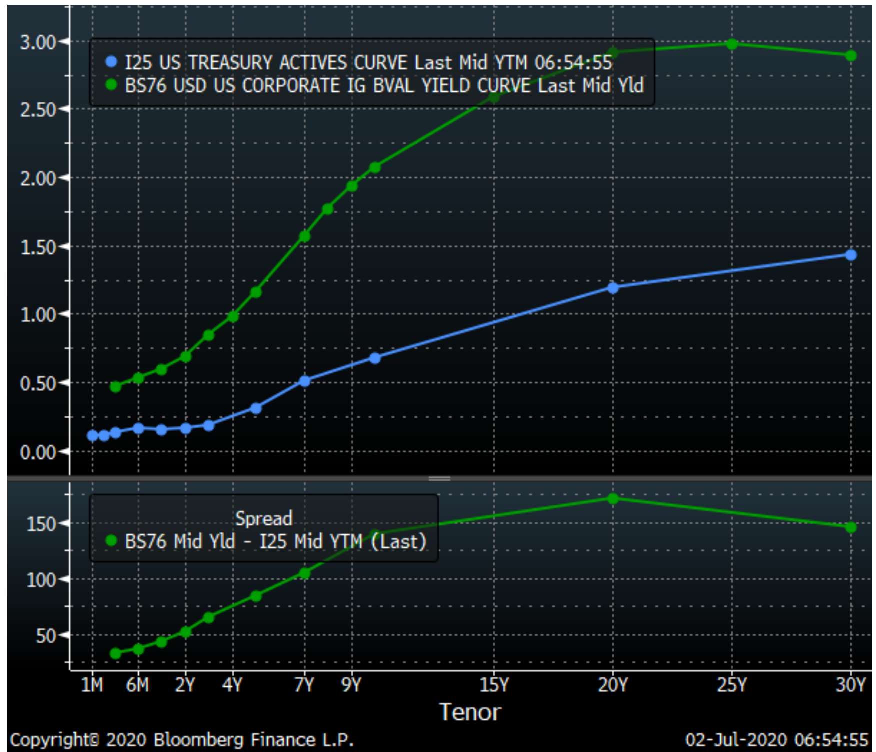
Global markets concluded the second quarter with exuberance and returns unmatched since the late 1990s as investors abounded with optimism around an uncertain economic recovery. Withstanding a surge in infections in the southern US, continued global trade tensions, and an intensified political backdrop, the S&P roared to its best quarterly performance since 1998. There were some fits and starts throughout the quarter yet seemingly every hurdle faced by markets was met with an equally impressive show of force by the Federal Reserve whose goal of restoring fully functioning markets might be better stated as elevating asset prices. Our assessment of risk and opportunity in public markets remains underpinned by an abundance of caution around tremendous uncertainty that has seemingly been priced out of public market assets.

US 10-year Treasury Yield

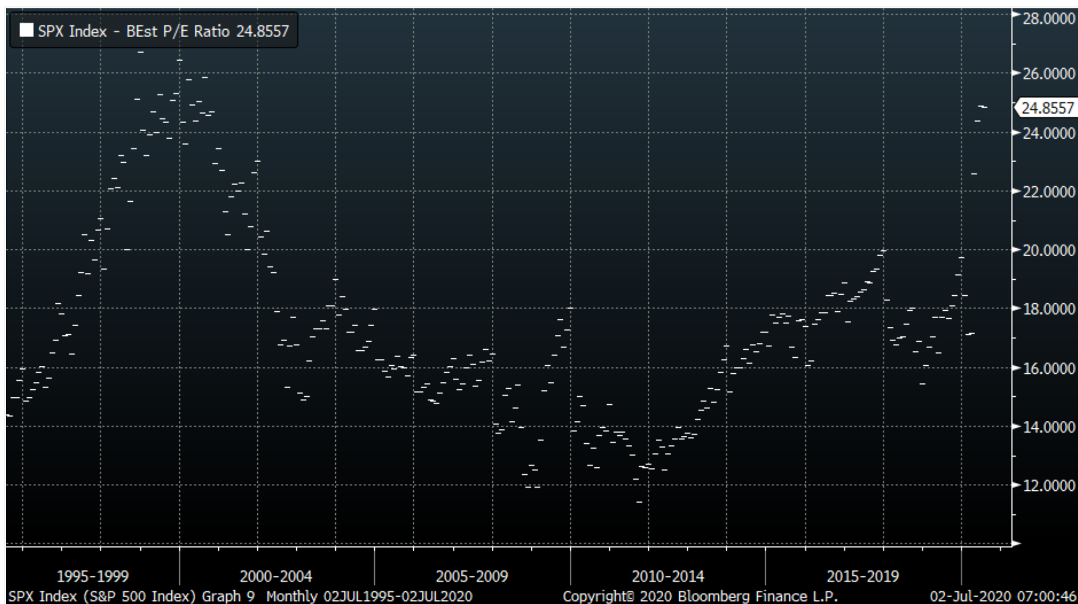
Our notes to clients this year have paid close attention to valuations and estimates across equity and fixed income markets. These metrics continued their ascent to levels not seen since the dot-com bubble of the late 90s, a reflection of the revival of the TINA ("There is no Alternative") mindset engrained in the investor psyche. In fact, as investors search for income and adjust their models in an environment deprived of any real yield on treasury instruments, long term and short-term investors alike have faced a difficult choice of either assuming more risk or hoarding cash. This dynamic has served to push equity valuations further into the stratosphere and has begun to compress spreads to levels seen prior to the outbreak of the virus.

As we enter the Q2 earnings season, we remain cognizant of risk that forward estimates imply an optimism around an economic recovery that in our view remains highly uncertain. During the Q1 earnings reporting, many companies either refused to guide all together or gave such wide estimates that Wall Street analysts seemed to have broadly given companies the benefit of the doubt and scantly adjusted numbers lower, particularly in the outer years of 2021 and 2022. As shown below, analysts not only view a robust sales recovery in 2021 of 8.5% growth but have projected that S&P companies will push to their highest levels of profitability in the last three decades. Whether this sort of optimism is warranted and can be reconciled with what we have seen in the economic numbers thus far is yet to be determined. Our view is that the risk to estimates is likely a downward revision as companies continue to grapple with fallout from the virus.

In May's letter we worried that "given the level of recovery in public markets and the dislocation between fundamentals and market pricing, the Fed will ultimately have no choice but to begin to remove its unprecedented accommodation." This concern played out in the halls of Congress in June. During Chairman Powell's testimony before the Senate Banking committee, Senator Toomey pressed the chairman on whether corporate bond purchases were indeed necessary at this juncture to restore market function, to which Powell reluctantly conceded there was certainly no stress in such markets currently and purchases were not needed. These comments were made June 16th, just one day following a surprise Fed announcement following the months worst decline in equity markets that these facilities would be expanded. Given that the details of such purchases have since been released to show the Fed has been purchasing bonds primarily from blue-chip companies at record low interest rates, our sense is that the public and political backlash to such accommodation has only just begun, especially if the paper gains in asset prices do not soon result in real improvements in employment. While the prospect of higher Fed-fund rates is certainly unlikely in short to medium term, a shift towards removing this accommodation would likely be a difficult blow to markets that are in no position to absorb such a shock.

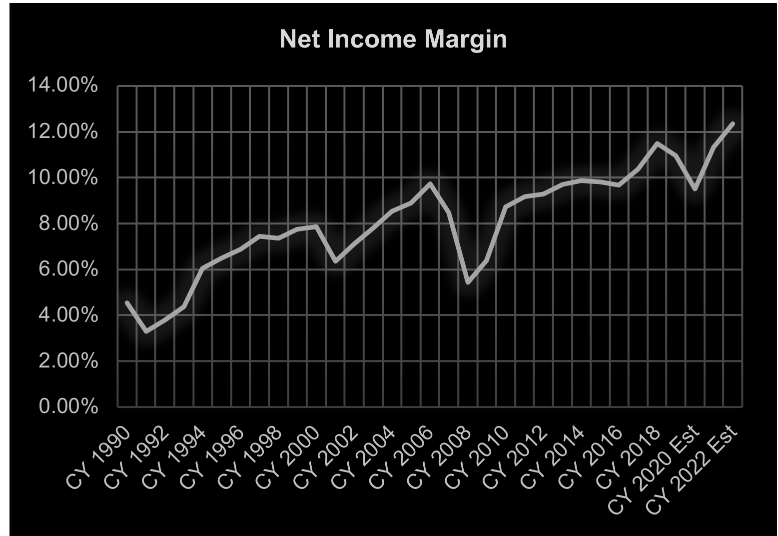


US Investment Grade Bond Curve



S&P 500 Forward P/E Ratio

We have traditionally concluded our letters with a discussion around risks on the periphery as COVID-19 continues to dominate headlines. These risks have continued to intensify almost uniformly. Political rhetoric between the US and China has continued to escalate as the US weighs sanctions tied to Xianjiang and Hong-Kong. The market now must also contend with the prospect of a so-called blue wave in November as democratic candidates rise in polls in races across the country and as such investors must prepare for the prospect of tighter fiscal policy, especially as it relates to taxation. Our focus will continue to be capital preservation in the face of such risk and elevated valuations.



S&P 500 Net Income Margin & Estimates

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