North American Management

Q2 2020 INVESTMENT LETTER

Aftershocks

While the first quarter of 2020 was one of the worst in history for equities, the second quarter was one of the best. It was a remarkable rebound in global stock prices amid a not-atypical episode of extreme volatility, with gains as sudden and violent as the losses that preceded them (see our April 19, 2019 Perspective on market volatility). The two far right columns in the table below show how dramatic the sell-off and subsequent recovery have been. As markets rallied globally, investors rotated away from lower risk stocks and toward those with higher volatility, such as stocks of smaller companies and those with high momentum. Smaller companies have historically outperformed large companies in recoveries and, perhaps in anticipation of this, investors changed their positioning from defensive, lower risk stocks to equities that would benefit if the economy and market continued to rebound. By June 30, the average gain among the equity indexes in the far right column below was more than 36%.

Stocks and bonds rallied in the second quarter, one of the best on record for equity investors.

In retrospect, two offsetting Covid-19 "bombs" have been dropped on investors this year: 1) a massive demand shock that decimated employment and consumption (70% of the U.S. economy is consumer-driven), and 2) an unprecedented government response, both fiscal and monetary. To put the scale of various government actions in context, stimulus announced to date is about twenty times the size of the Marshall Plan and at least five times larger than FDR's New Deal, when measured in today's dollars.[1] The U.S. economy is awash with liquidity and will eventually recover, but once it does, future return-drivers within client portfolios may be different.

Index Total Returns as of June 30, 2020	2nd Quarter	1st Quarter	Year to Date	Feb 19–March 23 2020	March 23–June 30 2020
Barclays Bloomberg U.S. Agg	2.9%	3.2%	6.1%	-0.9%	5.1%
MSCI USA Quality	19.8%	-15.0%	1.8%	-30.7%	38.3%
S&P 500®	20.5%	-19.6%	-3.1%	-33.8%	39.3%
MSCI USA Minimum Volatility	12.7%	-17.3%	-6.8%	-33.1%	31.5%
MSCI USA Low Size	23.2%	-26.3%	-9.1%	-39.1%	44.2%
MSCI All Country World ex-USA	16.3%	-23.3%	-10.8%	-32.9%	33.8%
MSCI USA Value	13.0%	-25.7%	-16.1%	-36.7%	31.8%

Shifting Sands

Considerable human suffering and painful adjustments in the U.S. economy have been dominating the headlines since February. In many cases the economic conditions, while worthy of focus, are not permanent. Today's horrendous unemployment levels will eventually recede, bad debts will be restructured, and corporate profits will recover. We do think course changes in the following three areas, however, may have longer-term impacts on expected returns:

The U.S. Dollar — We have been somewhat bearish on the dollar since last fall, though a clear catalyst for dollar depreciation was lacking until Covid-19 opened the monetary and fiscal floodgates in the U.S. Interest rates have since plummeted, the dollar's advances have leveled off, gold has rallied further, and foreign equities have started to perform better. For the time being, savings rates are dramatically elevated as consumers and companies hoard record amounts of cash and banks curtail new lending. However, spending and lending patterns could return to normal well before it is possible to restart enough production to meet demand. If today's gargantuan stimulus programs are not withdrawn quickly enough, short-term deflationary pressures may reverse in a meaningful way.

"Total deposits at U.S. banks are up more than $2 trillion this year, according to weekly data from the Fed. That is by several multiples the biggest six-month increase on record."

The Wall Street Journal
July 12, 2020

Inflation and the Concept of Scarcity — Inflation arises from scarcity: too much money chasing too few goods. When that happens, commodities and other manufacturing inputs become precious as investors wishing to hedge inflation risk decide to buy "jewels instead of tools."[2] Companies that are unable to raise their prices fast enough to cover rising input costs fall out of favor. While this certainly isn't the case today (the dollar is still strong, growth rates are depressed, and unemployment is sky-high) readers might be interested to see which assets have dramatically outperformed the S&P 500® Index over the past three years (see chart at right). What has really become scarce, and consequently a lot more expensive? 1) Disruptive quasi-monopolies (FAANG stocks, and now Tesla), 2) Large-cap, top-line growth in general (NASDAQ 100), 3) Fiscal and monetary restraint (Bitcoin and physical gold are a hedge), and to some extent 4) Housing (lumber). Broken supply chains and spot shortages in a pandemic are one thing, but the persistence of these longer-term price indicators is worth thinking about. To us, the kind of inflation that comes from currency debasement and continuing trade conflicts looks plausible, and could lead to better performance among foreign and value stocks. On the other hand, fixed income returns may be subdued compared to previous years.

Cumulative Price Returns as of 7/20/20	***3 Year***
FAANGs	*136%*
Bitcoin	*129%*
Semi-Conductors	*90%*
Cloud Computing	*88%*
Nasdaq 100 Index	*84%*
Physical Gold	*46%*
Lumber	*38%*
S&P 500 Index	*32%*

Price return only, no dividends included.

Real Estate, Public Infrastructure and the Environment — As we wrote last quarter, some important commercial trends already in place before Covid-19, such as working from home and online shopping, have accelerated. Knock-on effects among retail and commercial property markets, public transportation and the environment could be significant. Residential and commercial rents in major metropolitan areas may continue to deflate, for example, while suburbs attract new tenants and buyers. This migration may not be enough to save retail malls, however. While mall traffic has been declining for years, today some mall operators are actually trying to buy tenant businesses in order to make them "captive renters." This could be a good business decision, or it could be desperation. Finally, as commuting habits in place since WWII are reset, urban infrastructure and the environment are less stressed. Decaying bridges, roadways, and airports have been characterized as national embarrassments in recent years. Now, their useful lives may be partially extended. The International Energy Agency estimates that the lockdown will lead to an 8% decline of global CO2 emissions (back to 2010 levels). While this has come at an immense economic and social cost, the images of canals running clear in Venice and the Los Angeles skyline without smog are inspiring.

Our Perspective

While deep recessions and their aftershocks can rattle investors, sap confidence, and reduce risk appetite, we often come out of them on firmer economic footing. It is not unusual to see dramatic rises in worker productivity after a recession — an important driver of corporate profits and a natural governor on inflation expectations. One of the mysteries of the post Great Recession recovery is persistent low levels of productivity growth during the 2010s. One theory is that most of the technological advances since the advent of the iPhone in 2007 have been rather frivolous, and may actually detract from productive activity — that video games, social media, and texting have been, on balance, costly diversions.

We take a more constructive view. While it took a pandemic to force changes in behavior and office culture (previously, people who worked from home were sometimes viewed as unambitious), many of the valuable technologies that support remote workplaces were already in place but simply underutilized. For example, cloud-based computing and storage are much more than business interruption insurance or cheap data storage — they are the backbone of a relatively seamless transition to a WFH (work from home) environment. We might actually see a welcome jump in worker productivity as the following irritants are diminished: draining commutes, large expensive real estate footprints, office politics, and inefficient meetings, to name a few. If that happens, even at the margin, it could be a tremendous boost for the economy and a much needed offset to our inflation concerns.

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Endnotes

1 GaveKal Research and MacroBond, June 29, 2020.

2 GaveKal Research, June 18, 2020.

Sources of graphs and data not specifically cited: FactSet, Strategas Research, MSCI and BlackRock. Referenced indexes in U.S. Dollars, unless otherwise stated. All equity returns include reinvestment of dividends, except where stated to be price returns. The MSCI Factor Indexes are rules-based indexes that capture the returns of systematic factors such as low volatility. All return data through June 30, 2020, unless otherwise stated. All data is in U.S. Dollars (USD), and Total Return represents the sum of the dividend, changes in earnings and multiple estimates for each ETF. Investors cannot invest directly in an index, nor is an index subject to fees and expenses associated with investment funds or accounts.

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