May 2020

MONTHLY AGENDA - DISCONNECTED

Chief Investment Office

Disconnected

The outbreak of the corona crisis has left many of us feeling disconnected from friends, families, and work colleagues. Changes in the way we shop, work and play have occurred as a result. This is not the only disconnection that has occurred, however. Financial markets are also feeling disconnected – disconnected from the economy, disconnected from value, and disconnected in size. We consider each of these market disconnections and what implications there are for investors as a result.

Disconnect #1: Between the economy and the market

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There has been a lot of talk about a disconnect between the economy and the equity market. The US stock market has risen a staggering 32% from its low on March 23 in the past two months. It now sits just 13% below its record high. All of this while the unemployment que grows at an exponential rate!

We don't believe the disconnect is as stark as this picture suggests for two reasons.

First, price leads the fundamentals. The fact that the market is zigging while the economy zags isn't really strange or unjustified. In fact, if we cast our mind back to around the middle of February the apparent disconnect was working in the opposite direction. The market was collapsing while the economic data was blithely printing robust unemployment rates. As late as March 7th, the Bureau of Economic Analysis said the US had an unemployment rate of 3.5%. By then the market had already fallen almost 20% from its peak! Price was leading the fundamentals.

Secondly, this is truly a different situation we are in. We are seeing unemployment rates rise in the US from 4.4% to 14.5% in just one month not because there is a major imbalance in the economy but because the government told us to stop – stop working, stop spending, stop travelling, stop socialising. That is what we did and that is what is being reflected in these data releases. To look at these data as a gauge for where the stock market should be right now is misleading.

It would be like telling a runner to stop and then criticise her for not making her weekly distance target. It doesn't make sense and it is not useful. The more important question is how fast will she be able to run after having some time off? Several weeks shouldn't be a problem. Several months may be difficult, but doable. More time than that can be a problem given the loss in conditioning that results.

The economic data that will be released in the coming months will be far more useful in informing us on how much conditioning the economy has lost during the shutdown. Two facts point to a favourable outcome in this regard. First, the period of enforced hibernation has been far shorter than initially expected. That will help ease the pain when we start moving again.

Second, the condition of the global economy going into this crisis was better than it was going into say 2007 and the global financial crisis. Debt levels among US and European households were not as high; the banking system globally was healthier; and valuations in most housing markets were not as extreme.

So, if it is not the fundamentals, what has been driving stock markets?

Chart 1 shows a tight relationship between the US stock market and US financial conditions. In other words, the $20 trillion in fiscal and monetary support thrown at the global economy in response to the crisis has significantly eased financial market conditions in the market. Easier financial conditions are a necessary pre-condition for an economic recovery to take place.

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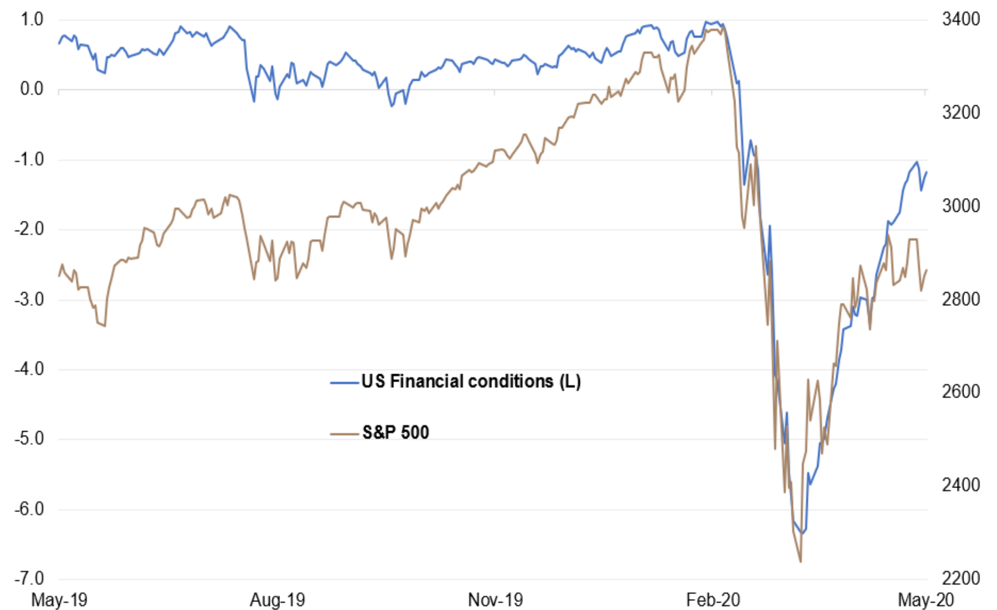
Chart 1. US Financial Conditions & S&P 500



Source: Bloomberg

Disconnect #2: Between value and growth

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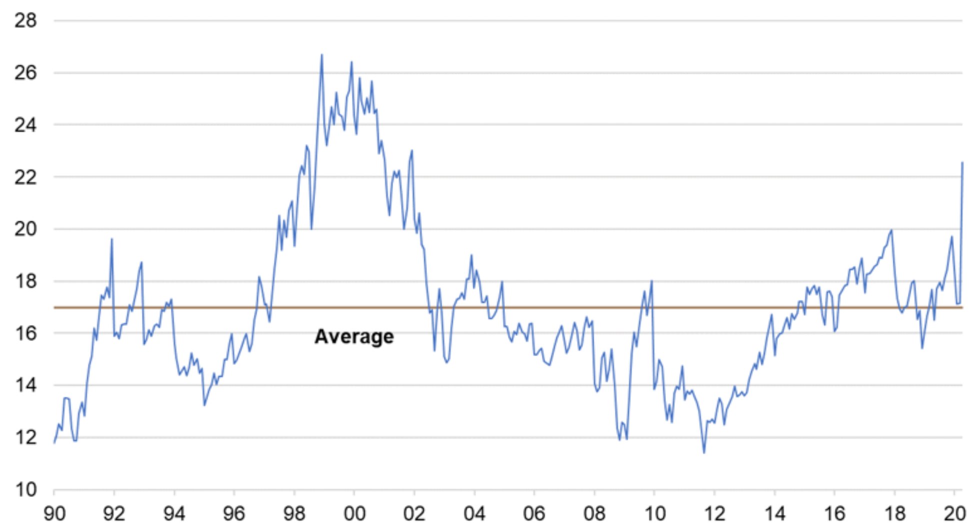
Another disconnect that become even more apparent over the past few months is the disconnect between growth stocks and value stocks.

This disconnect is not too surprising. In a low rate, low inflation world, growth stocks tend to perform better. Value stocks tend to do better when inflation is higher and when yield curves are steeper providing support to the banking sector. Investors, rightly in our opinion, are pricing in the view that inflation will remain low over the near to medium term. The latest Bank of America Fund Manager Survey confirms this. It shows a net 23% of respondents think value will lag growth going forward. That's the most bearish stance on value stocks taken since late 2007.

Chart 2. US S&P 500 PE



Source: Bloomberg

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Chart 2 shows the current price-earnings level of the US equity market in relation to its long-run average. Today's high PE level for the US equity market reflects the high weight in the index to growth sectors such as information technology. The more value-oriented financials sector makes up just 10% of the US S&P 500 Index.

Some caution is warranted when using valuation metrics like price-earnings. History is littered with examples of how bad market valuation is as a timing tool. In December 1996, then Federal Reserve Chairman Alan Greenspan warned of "irrational exuberance" in the market based on what he viewed at the time as excessive valuations. The following three years saw the S&P 500 almost double in value.

It is interesting to note that annual earnings growth has been negative 30 times since 1930. In 23 of those 30 years, the stock market rose. On eight occasions, when earnings growth was down double digits, the S&P 500 rose by double digits. The market thinks beyond the current years' earnings. The price of a stock today is the sum of its future cash flows many years into the future discounted by an interest rate. So, earnings will be bad this year, but they will bounce back over the coming years. And, the interest rate we use to discount those earnings will be much lower than at any other time in history and is likely to remain so for the next few years.

The surge in price-earnings valuations and the disconnect between growth and value has led many to suggest we are back to the dot com extremes of 2000. The data does not support this point. Chart 3 shows the difference between the PE of the Russell 1000 Growth Index and the Russell 1000 Value Index. As can be seen, we are a long way from the disconnect experienced during the tech bubble.

Chart 3. Disconnect between value and growth

Source: Bloomberg

Disconnect #3: Between large and small companies

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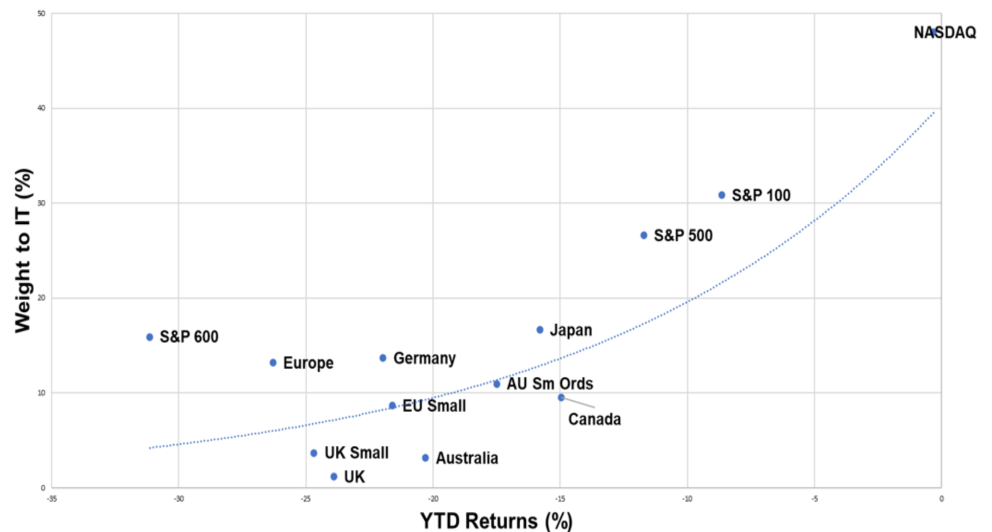
A final disconnect that has been very evident in the current environment is that between large and small companies.

The point to note here is large companies are benefiting from their ability to adapt to the radically different landscape. Large companies have more scope to move production, gain access to multiple sources of capital, and can more easily re-engineer systems, processes and supply chains. That is usually not available for small companies.

In addition, and unfortunately for the capitalists among us, we are also in an environment where the definition of too big to fail is being extended beyond the big banks – it now seems to include big auto companies, big cruise companies, big airlines. With the help of the Federal Reserve, the US Government is supporting big companies by buying their debt. Small companies don't tend to use the bond market as a source of funding. So those that do go bankrupt will likely be those that are too small to rescue.

Chart 4 shows an interesting relationship between market size, weight to technology and year-to-date returns. Using the weight to technology as a proxy for growth, we can see the better performing markets are those that are more growth oriented and are larger in size.

Chart 4. What if the market was small or didn't have tech?



Source: Bloomberg

Investment implications

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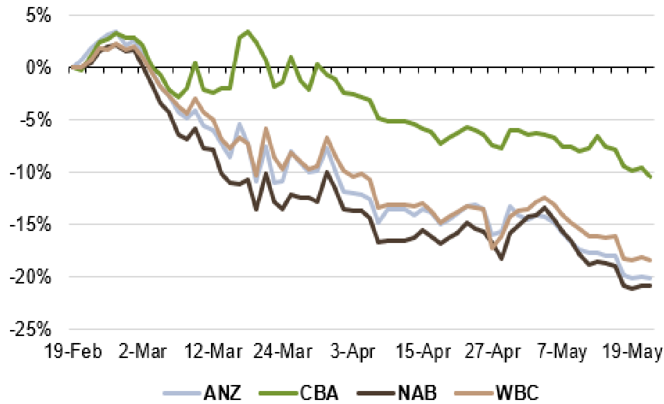
The key takeaway for investors in this environment is to go big and go growth. The low interest rate environment will continue to support valuations and will be more beneficial for growth style markets, sectors and companies. Value style markets, sectors and stocks have traditionally generated returns for investors by distributing income more than through capital gains. Generating an income from yield will be more of a challenge in this environment. This will be particularly apparent for banks who tend to profit from borrowing at short term interest rates and lending at long term rates.

For global investors, the markets that are likely to do better in this environment are the US, Japan and Canada. Europe and the UK will struggle given their defensive qualities (both have around 16% in financials). Australia is more a blended market and so sits somewhere in the middle.

We continue to believe small companies will find the current environment difficult. Smaller cap stocks are often seen as a barometer of investor sentiment and tend to be among the first to recover in an economic upturn. The level of dislocation this crisis has caused, however, is likely to weigh more heavily on those companies with the least flexibility to adapt.

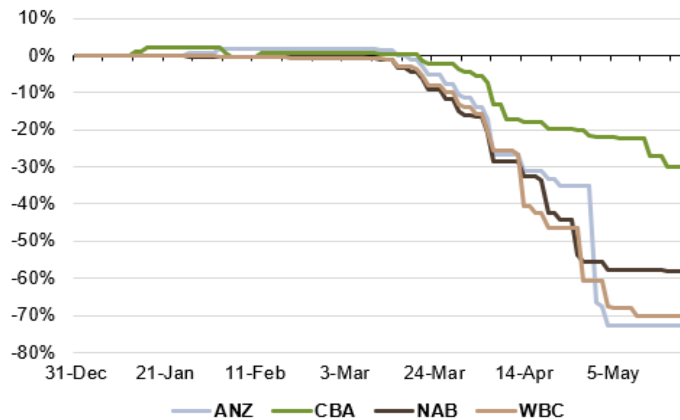
Chart 5: Banks: Relative Performance to ASX200



Source: Bloomberg

The recovery in global equity markets began in late March as a multitude of fiscal and monetary stimulus measures were announced around the world to support economies through the COVID-19 crisis. The recovery in the Australian market, however, has lagged that of most overseas markets. A key reason for this has been the weight in the ASX 200 of the major banks, which have been held back by lower earnings forecasts, primarily on higher bad debts charges.

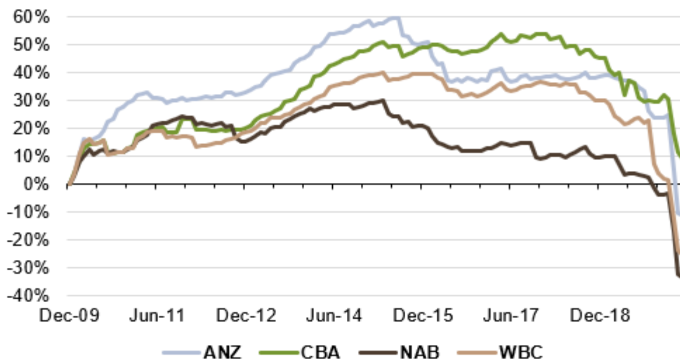
Chart 6: Banks' Dividend Revisions



Source: Bloomberg

Another key development which has contributed to the underperformance of the banks has been cuts to dividends. APRA issued guidance to the banking sector in early April, expecting that the banks will "limit discretionary capital distributions in the months ahead" including "prudent reductions in dividends" given the uncertain operating environment. Consequently, in the recent reporting period, NAB cut its dividend by more than 60%, while ANZ and Westpac opted to defer dividends until the outlook becomes clearer.

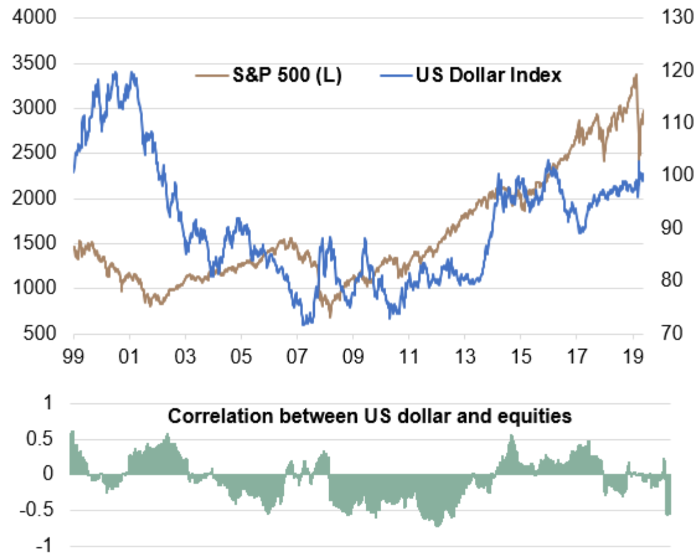
Chart 7: Banks' Longer Term Earnings Growth



Source: Bloomberg

While the current issues impacting the banking sector may be somewhat temporary in nature, over the last decade the sector has struggled to generate earnings growth. A combination of low credit growth, high cost growth from IT and compliance, recent client remediation costs and the impost of higher regulatory capital requirements have all contributed to a challenging decade. In fact, since 2010, Commonwealth Bank is the only major bank to generate positive earnings growth in this time.

Chart 8: QE has dollar weakness v equities strength again



Source: Bloomberg

The correlation between US equities and the US dollar is once again negative, as it was during the last time the US Federal Reserve undertook quantitative easing (QE). A stronger US dollar works against what the Fed is trying to achieve by tightening financial conditions. The willingness to do whatever it takes to sustain the recovery will necessarily involve the Fed targeting a weaker dollar – albeit without explicitly saying so.

Chart 9: Feeling unloved – European Banks

Source: Bloomberg

If banks are a proxy of risk-on sentiment in euro-area equities, this chart should leave no doubt about what lies ahead for Europe. Concern is rising over fiscal sustainability, given that debt levels are already stretched in several countries. This, despite the European Central Bank being on the verge of finally getting proper help from politicians to fight the region's economic battles with a 500 billion-euro coronavirus aid package.

Chart 10: US S&P 500 – Stuck in a range

Source: Bloomberg

There's been a lot of talk over why stocks have been so range-bound in recent weeks. Sure, there's been volatility within the range, but there hasn't really been a break-out in either direction. Investors it seems are trying to price the possibility of two binary outcomes. One outcome is a successful coronavirus vaccine is quickly developed and administered, setting much of the world on course for a V-shaped economic recovery. The other outcome is, no vaccine resulting in a series of rolling lockdowns that last for at least another year. Both scenarios are plausible, but hard to say which is more probable.

Chart 11: Leverage lives – Leveraged loans total return

Source: Bloomberg

One of the ironies of the current market is that investors appear to be rewarding the most indebted companies. In a classic 'credit crisis,' investors are so nervous they stop lending and the flow of money in the financial system comes to a halt. In today's coronavirus crisis, investors are buying more loans from the companies with the lowest credit ratings and the highest leverage.

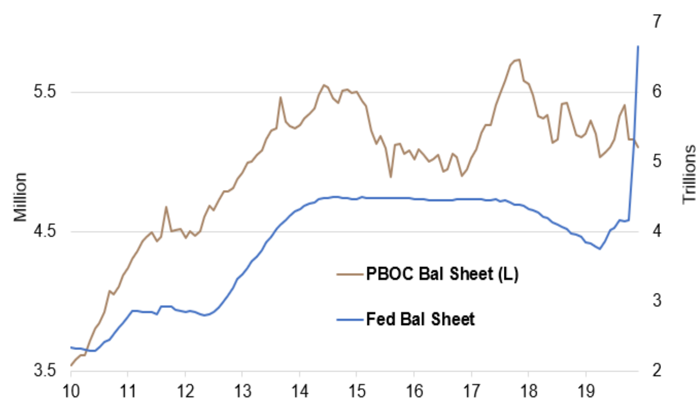
This likely means that this probably isn't the crisis that is going to flush out whatever excesses have been building up in the credit market.

Chart 12: Foreign ownership of the US Treasury market

Source: Bloomberg

One of the mainstays of the decades-long Treasury bond rally is fading. Foreigners hold just 37% of the marketable U.S. debt, the smallest amount since 2002. Central banks around the world have been selling their Treasury holdings to raise dollars. At the same time, the supply of Treasuries is rising in line with size of the U.S. debt. Concerns that China may reduce its stake might rise again as tensions with the U.S. grow. In the meantime, with the Federal Reserve such a large player in the market now, there doesn't seem to be any problem selling record amounts of debt to fund the stimulus programs.

Chart 13: China's PBOC balance shrinks as the US Fed expands

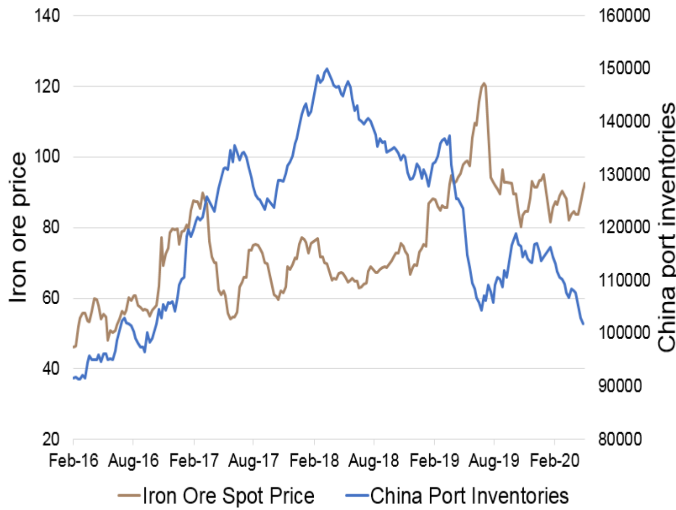


Source: Bloomberg

The most stark policy contrasts during this corona crisis is between the patient Chinese central bank (PBOC) and the extremely proactive US Federal Reserve. April saw China industrial output, retail sales and fixed asset investment shrink, even as the jobless rate soared to 6%. And yet, the PBOC shrank its balance sheet by quite a margin. The US is also seeing dire data, with the Fed responding by raising asset purchases at an exponential rate and highlighting a willingness to do more as needed.

Alternatives

Chart 14: Iron Ore Price & China Port Inventories



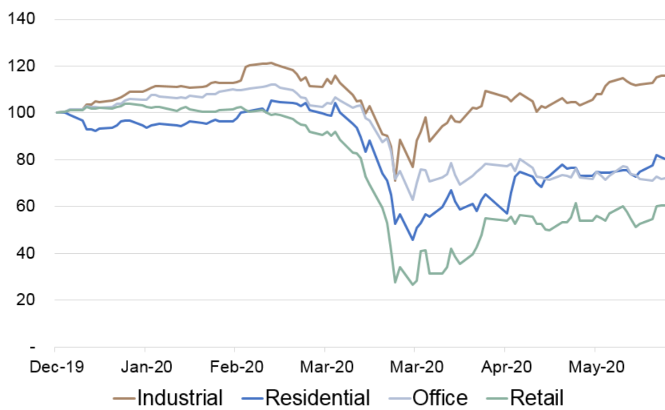
Source: Bloomberg

Iron ore prices have rallied strongly over the last month, up over 15% in May as stronger than expected demand from China coupled with disruptions to supply from the world's second largest producer of the metal, Brazil, have helped push prices higher.

Exports from Brazil have been greatly hampered in recent weeks as the South American nation struggles to deal with the spread of Covid-19 throughout the country. Vale, Brazil's largest producer of iron ore said it will struggle to meet expected production figures as a result.

Iron ore port inventories are at their lowest levels since 2016.

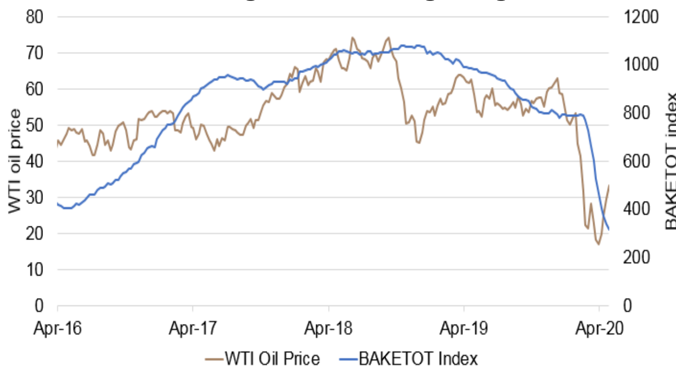
Chart 15: A-REITs Year to Date Performance



Source: Bloomberg

The underperformance of the property sector has been well flagged as A-REIT prices have fallen further than the broad index, industrial had been the outperformer coming into the crisis and remains the most resilient area within property. Reported collection rates in retail are ranging from as low as 20% to 65% for April with May expected to be much the same. Growth in net operating income had already begun to fall significantly pre Covid-19 and will likely come under further pressure as tenants struggle to generate revenue at this time.

Chart 16: Baker Hughes US oil & gas rig count



Source: Bloomberg

The number of oil and gas rigs operating in the US has dropped by more than 50% from its March peaks with analysts forecasting further declines. Although we observed a slight recovery in oil prices in recent times, the commodity remains volatile and well below the break-even price range of US $48 to $54 per barrel. The sector has already cut $53bn from planned spending of $130bn this year. The fall in oil prices below its breakeven level is leading to widespread job losses and bankruptcies in the US shale industry. According to the Federal Reserve Bank of Kansas City, nearly 40% of drillers would be insolvent before the year was out if WTI averaged $30 per barrel.

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