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"The Big Money Is Not In The Buying Or In The Selling, But In The Waiting"

Charlie Munger

In the early months of the novel COVID-19 pandemic and the related shutdown of the economy, the pace of economic and health developments was frenetic. Nowadays the slower pace of developments allows for more rumination, and this note reflects some thoughts about our present circumstances.

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A BIT OF A RECAP OF WHERE WE WERE AND WHERE WE ARE

In the absence of a vaccine, the only way to deal with the outbreak was to shut down economies via lockdowns, in order to minimise interpersonal contact. This caused millions of people to file for unemployment benefits and Q2 GDP to shrink dramatically (in US alone, GDP fell by an annualised 33%, 3x the greatest quarterly decline in 70 years).

The economy required life-support, and the Central Banks/Governments supplied it: payments to individuals and households; grants to distressed industries; guarantees for money market funds and commercial paper....

When the number of new cases, hospitalisations and deaths declined, it was time to resuscitate. Economies began to reopen in May, helped by ultra-low interest rates and Central Banks' provision of liquidity.

Initially, the response was positive, retail sales jumped and unemployment moved down from the peak.

The trickier issue was where the world economy would end up once the initial rebound was complete. Would the recovery totally wipe out the loss? If not, how long would it take to eliminate the remaining shortfall? Looking at past recessions was not particularly helpful, as this downturn had nothing to do with "normal" cyclical fluctuations.

We are now starting to get some answers to these questions. Activity in most economies is patchier than it was before the pandemic, in part a reflection of how consumers are choosing to spend their money. In aggregate, this has left a significant shortfall in demand.

- COVID-19 has not gone away. While full national lockdowns are unlikely, local lockdowns and continued social-distancing restrictions will have a material impact on economic activity and confidence.
- Consumers have cut spending in 2020, even as government policy supported disposable incomes. So far most additional saving comes from wealthiest households: many lower-income households are not currently saving enough (especially if fiscal support fades and they face a lengthy period out of work).
- Persistent weak activity in some sectors will create a shortfall in demand, leading to stubbornly high unemployment. The H1 decline in employment will probably become more permanent.
- Uncertainty and a prolonged downturn will also have implications for business investment.
- As all crises tend to do, COVID-19 is accelerating digital disruption, which could trigger a powerful reallocation of resources. Job automation threatens to undermine prospects of the low-skilled.

For the moment, Central Banks are embracing fiscal dominance, adopting "average inflation targets", which rule out monetary tightening and provide an open invitation for fiscal largesse. However, they have no real control over whether they can meet these new objectives.

Indeed, all the action is now on the fiscal side. Governments seem to have started to become slightly more uncomfortable with the huge deficits of 2020 as economic damage from COVID-19 looks set to persist for longer than they imagined when they first launched their rescue programmes. This raises the dangerous prospect of (attempted) fiscal consolidation in 2021-22, which would undermine the recovery and repeat the mistakes of the past (e.g. 1933, 2010).

WHERE ARE WE IN THE BUSINESS CYCLE?

The current downturn did not result from excessively optimistic business decisions or too-high growth expectations that were disappointed, but rather from an exogenous event that brought a sudden end to the expansion. Cycles will continue to occur over time, highlighted by excessive movements away from "normal" and toward extremes (high and low) that are later followed by corrections back toward normalcy and through it, to excesses in the opposite direction. But that does not mean that every event in the economy or markets is cyclical. The pandemic is not.

Additionally, there will probably be permanent changes to our way of life (in travel, in businesses moving away from old constructs around what offices should be, and activities involving crowds) that affect the path of recovery.

WHAT SHAPE WILL THE ECONOMIC RECOVERY TAKE?

Everyone has his or her favourite candidate: a W, an L, a U or maybe a Nike Swoosh (which is what I predicted back in April).

The one we hear the most about is a V. In principle a "V" has to satisfy two important requirements:

- The pattern has to be down-and-up (i.e. not much time skating along the bottom)
- The two sides should be basically symmetrical (i.e. recovery rate similar to the rate at which it went down)

That second criterion makes me doubt that the current recovery will be V-shaped. The US deteriorated in Q2 at an annualised rate of 33%, and it is extremely unlikely that it will come back at the same rate (leaving aside the fact that it takes a 49% gain to offset a 33% decline).

In fact, only China has seen activity returning to anything close to a V-type recovery (more on this later).

Because of these reasons:

- Reopening of economies will, in some areas, be delayed as inevitable spikes in cases take place.
- It is unlikely that future support payments by governments will be as generous as the early rounds.
- Many people with the choice may not return to the office, holding back the recovery of businesses that exist to serve office populations.
- Industries whose business models have been affected (like airlines, resorts and entertainment) may take years to recover to their prior levels.
- Many restaurants and other small businesses may never reopen.
- With industries evolving, more being done digitally and business owners having had an opportunity to watch their companies function with fewer people, some jobs may never return.
- Pandemic has accelerated trends such as job automation.

....it is back to the Swoosh sign: fast down and slow up.

HAVE RETAIL SALES NOT RECOVERED A LOT? WHAT NOW FOR CONSUMERS?

Consumer spending was responsible for much of the H1 contraction: households cut spending as they were worried about the virus and because governments restricted their ability to move around.

Since May onwards, there has been a very uneven recovery in consumer demand.

On one side, we have seen a strong rebound in retail sales. In the US, UK and parts of the EU (including Germany), retail spending is back to pre-pandemic levels. Part of the explanation is that consumer goods are more likely to benefit from "pent-up" demand, especially where the authorities have supported disposable income through tax cuts and government transfers.

On the other side, spending on services remains in deep recession, with levels much weaker than before the pandemic.

Overall, consumer demand is likely to be slow to return to levels of the past as saving rates (i.e. amount saved as % of household disposable income) are expected to be higher than in recent years. Also, higher unemployment rates will hold back labour incomes.

YOU MENTIONED CHINA RECOVERING FASTER. WHY HAS THIS HAPPENED?

For two main reasons:

- China's COVID-19 shock was mostly confined to Q1, and they seem to have been pretty good at imposing restrictions that have prevented virus spread.
- Government ownership of the major Chinese banks meant forbearance toward clients whose loans might otherwise be called. In the West privately owned banks cannot be 'ordered' to forbear from calling in loans. This means that fiscal policy in advanced countries has had to pick up the burden of financial support for stressed firms that in China is being borne by banks' balance sheets.

WHAT ABOUT OTHER EMERGING MARKETS (EM)?

Within EM, differences are emerging between countries based on the evidence of their lockdown success and testing capacity, while expectations of the scale and delivery of stimulus measures point to differences in the outlook for sustainable economic recovery and for markets.

Let's quickly compare how the main EM countries are doing:

CHINA
- Effective testing and tracing plus targeted regional lockdowns
- Impactful monetary and fiscal stimulus

INDIA
- Containment success in urban areas as testing capacity ramped up amid new regional lockdowns
- Stimulus indecision hampers recovery

RUSSIA
- Strong testing capacity and vaccine hope with regional lockdowns
- Fiscal capacity limited by oil price

BRAZIL
- Mixed success in containing the spread in urban areas as testing capacity is improving
- Stimulus is backed by hope of reform

INDONESIA
- Easing of urban restrictions as lack of testing casts doubt on COVID-19 statistics
- Implementation of stimulus measures has been slow

SOUTH AFRICA
- Strong testing capacity, but severe lockdown proved ineffective
- Plans to revive growth not in place

TURKEY
- Strong testing capacity, deaths limited despite seemingly weak lockdown
- No plan to revive growth

MEXICO
- Very weak testing and ineffective lockdown
- Fiscal stimulus unlikely to be large enough

WHAT IS THE ROLE OF CENTRAL BANKS IN THE RECOVERY?

Post COVID-19, Central Banks around the world were quick to provide unprecedented stimulus through the provision of support payments designed to replace cash that normally would have circulated throughout the economy.

As an example, The Fed's balance sheet has increased by $3tr and the Treasury has added $3tr to the expected deficit, for a total increase of liquidity in the economy of $6tr!

There is deep interest in what Central Banks will do next. Neither The Fed nor the BoE seem prepared to introduce negative rates yet, and those banks that are already using them (ECB and BoJ) are reluctant to reduce them further because they (rightly) fear the damage this will cause to banking sectors.

Formal yield-caps remain a possibility in some jurisdictions, but seeing as there is no tendency for yields to rise, the authorities do not believe this policy is really necessary.

Instead, Central Banks appear to think they can influence their economies through indirect measures, such as tinkering with inflation targets and trying to manipulate expectations.

CAN'T CENTRAL BANKS KEEP IT UP FOREVER?

This is the Trillion Dollar question. Are there any limits on its ability to create bank reserves, buy assets and expand its balance sheet? Are there limits on Governments' willingness to run deficits?

In theory, there is no limit on the ability of a Central Bank to create reserves, as long as someone is willing to take them. The key question is the impact of that reserve creation on money supply and the demand for money.

THE FED HAS ANNOUNCED "A NEW APPROACH TO INFLATION TARGETING". WHAT DOES THIS MEAN?

Recently, Fed Chairman Powell highlighted that today's US economy has two main features: slowing real trend growth and falling real interest rates. At the same time, he noted that the record long expansion that just ended greatly increased minority employment, and that record low unemployment did not create higher inflation.

Subsequently, he said that The Fed is “moving towards flexible average inflation targeting”. In practical terms, this means that after “periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time.”

TRANSLATION:
The Fed will have to “make up” for past periods where they undershot their targets. In the current context, this means that there is a firm commitment to zero interest rates for years to come.

IS THIS ANNOUNCEMENT A BIG GAME CHANGER?

The Fed was already unofficially in average inflation targeting mode, having chosen in 2018 to emphasise a “symmetric” inflation target of 2%, meaning it aimed for an overshoot of the 2% target after a period of undershoots. Persistently low inflation, alongside rising US-China tensions, was a crucial justification, for the three rate cuts last year.

Overall, the shift in The Fed’s policy approach shows that, with interest rates effectively at the zero lower bound, worries of “Japanification” in the US are very much alive.

Yet the fact remains that despite its extremely accommodative monetary policy over the years, The Fed has not managed to lift inflation back to 2% (and average inflation expectations have actually tended to decline). So, The Fed might find it tough to reach 2.5%, which could be an acceptable target. Also, some critics think that the Fed’s persistent dovishness translates mostly into higher asset prices rather than higher consumer prices.

CONCLUSION:
In itself, raising inflation targets is not necessarily a game changer. In fact, they are actually passing the buck to fiscal policy, which is where all the action must be.

Central Banks will only to meet their new enhanced objectives if governments are willing to provide more stimulus.

WHAT’S THE OUTLOOK FOR INFLATION?

Whether it is Japan (where the BoJ’s balance sheet exceeds 100% of GDP and growing) or the ECB (50% of GDP and growing), or The Fed (30% of GDP and growing), as long as there continues to be a very large demand for super liquid, safe assets like bank reserves and cash, the Central Banks can maintain large balance sheets – and even increase them – without a sharp increase in money supply that ignites inflation. The ongoing uncertainty over the course of the virus and the policy responses will undoubtedly keep the demand for safe liquid assets high for some time.

We see inflation evolving across three phases:

– Phase 1: Consumer-price data is noisy and unreliable, subject to large temporary moves. There are huge distortions in the data, thanks to changing spending patterns and supply disruptions. We are now in this phase.
– Phase 2: Deflationary pressures take over. Global economy will be operating with significant spare capacity and high levels of unemployment, and the risks are skewed towards inflation becoming too low rather than spiralling higher. We could be in this phase for a few years.
– Phase 3: More radical policy responses might end up producing an inflationary era of ‘fiscal dominance’.

For us as investors, the trickiest issue is how to time the transition from Phase 2 to Phase 3.

THERE IS TALK ABOUT MMT. WHAT IS THAT?

Modern Monetary Theory (MMT) argues that the size of the public deficit is meaningless, and that the public sector should provide whatever spending is needed to operate continuously at full capacity, with inflation becoming the ultimate constraint on fiscal policy. Governments, as long as they have their own currencies, can always rely on their Central Banks to finance their spending.

The "less modern" monetary theory (or LMMT, an acronym I just made up) still applies, at least in places like Argentina or Zimbabwe. Markets certainly allow credible governments like Japan and the US to borrow enormous amounts without much concern, but the key issue is what could undermine that credibility?

For the moment there is reluctance to embrace MMT fully after the massive deficits recorded in the first half of this year.

LET'S TURN TO EQUITY MARKETS. CAN YOU SUMMARISE THE LAST MONTHS?

Just five months after the onset of the pandemic, and just a few months after the bottom was reached in risk markets and the economy, investor optimism has been largely restored and prices of many assets have regained a big part of prior losses.

A big driver of such moves has been the influence of Central Banks and Governments. Indeed, the reduction of interest rates to near zero has increased the value of investment assets and spurred a global bidding war that has raised their prices.

If the prices of some risk assets have been reached, not by working through fundamental reasons (such as current earnings and the outlook for future gains), but rather in large part because of The Fed's buying and its injection of liquidity, there is the risk that those actions will have to continue for asset prices to remain high. In other words, if/when Central Banks take the foot off the pedal, those prices could fall.

WHAT DO YOU MAKE OF THE RECOVERY IN US STOCKS?

Outside the US, Equities still have quite a bit to go before making up for the losses in February/March. UK equities, for instance, have struggled and are still substantially down year to date.

Meanwhile, US equity indices have recovered much more.

Before we go into any detail, it is important to highlight that the breadth of the recovery is nowhere near as large as one might think:

- While US stock indexes hit record levels, less than 6% of companies have reached a 52-week high.
- Apple Inc's market-cap early last week (before falling 10% at the end of the week) equalled the market-cap of the entire Russell 2000 Index.
- The five largest stocks in the SPX have reached a market-cap that equals the smallest 390 stocks in the SPX.
- The five largest stocks in the SPX represent 25% of the index.
- One out of five stocks are down more than 50% from their all-time highs.

US equity bulls argue that because of how low Treasury yields are, one has to buy stocks which have a higher yield (the earnings yield is the inverse of the P/E ratio). While lower Treasury yields make equities more attractive, this argument fails to take into account the relative risk of stocks vs. bonds.

Comparing the earnings yield of equities to the credit yield (as opposed to government bond yields) is more appropriate. Currently, the gap between the earnings and credit yield is on average close to the tightest it has been since the Global Financial Crisis brought about zero interest rates in 2008. So, if anything, this is an argument against buying stocks, as the compensation for risk relative to corporate bonds is historically low.

Another measure of equity risk premium (earnings yield + GDP growth – real US yield) has recovered a bit from the near-historical lows of the couple of months ago, but it remains very low.

CONCLUSION:
Lower rates alone cannot explain current equity valuations.

SO THEN, WHAT ELSE HAS DRIVEN UP EQUITY PRICES?

Central Bank liquidity-driven euphoria.

Indeed, there is evidence that speculation levels in the US equity market is at high levels:

- Investors' Intelligence Advisor Sentiment is at a new 2020 high and at highest since September 2018 (we all know what happened then: https://www.cnbc.com/2018/12/31/stock-market-wall-street-stocks-eye-us-china-trade-talks.html).
- Citigroup's panic/euphoria model has soared above 1.00, the highest reading since reaching 1.50 at the early 2000 top for US stocks.
- Call option "open buys" have skyrocketed to a multi-decade high.
- Volume for single-stock options expiring in less than two weeks, now comprise 75% of total option volume (a multi-decade extreme).
- US corporate insiders sold $6.7 billion of stock in their own companies last month (highest selling in 5 years), and the number of insiders selling was the highest since August 2018.

On balance, the best way to describe US equity valuations is "stretched":

- Forward price-to-earnings (P/E) multiple on the SPX of 23x do not appear to be "baseline" (i.e. with symmetrical risk around them) but rather a number that is at the top end of any reasonable range: in the last 70 years it has occurred only 0.1% of time.
- The trailing price-to-earnings (P/E) multiple on the SPX of 27x has occurred only 0.4% of the time in the past 70 years.

In other words, there are scenarios under which US equities are fairly priced, but these are only the "best-case" ones (i.e. 'V-shaped' recovery in earnings).

WHAT ABOUT TECH STOCKS? ARE THEY NOT BENEFICIARIES OF STRONG TRENDS?

Yes. We are witnessing the acceleration of many exciting trends. As Satya Nadella (Microsoft CEO) has recently noted, we witnessed years of digital transformation in 2 months (March and April).

In general, tech names have the following benefits:

- They tend to grow faster than other sectors, and in some cases the growth is more secular than cyclical
- COVID crisis has accelerated their growth
- They have scale and network effects
- They can grow without much additional capital (all 5 top tech firms in SPX have cash holdings that exceed their debt)

Some of the overarching themes that will persist into the decade include:

- The ongoing growth of ecommerce and digital payments
- The shift towards remote work and learning
- The shift towards online advertising spend, the fusion of healthcare and technology
- The creation of digital content
- The growth in connected devices and Internet 3.0

Indeed, 90% of all the data in the world has been created in the last two years.

However, even great companies can become overpriced, and in fact they are often the stocks most likely to do so. My first boss at JPM always mentioned how, in the 70s when he joined the industry, the companies of the Nifty Fifty (IBM, Xerox and the like) were expected to outgrow the rest and prove impervious to competition and economic cycles, and thus were awarded unprecedented multiples. In the next five years, their stockholders lost almost all their money.

Also, speculation levels on tech stocks are, as mentioned before, at record high levels.

WHAT IS LONDON & CAPITAL'S VIEW?

In April we launched our Growth Plus theme, which invested in Structural Growth Compounders (mostly in Technology and Consumer discretionary sectors):

FREE CASH FLOW GENERATORS
- Utilities
- Telecoms

CYCLICALS
- Industrial
- Materials
- Energy
- Consumer discretionary
- Cyclical Tech

DEFENSIVE COMPOUNDERS
- Healthcare
- Consumer staples

STRUCTURAL GROWTH COMPOUNDERS
- Consumer discretionary
- Technology

Our traditional STAR screen tends to emphasise the first three buckets very well but as an outcome of the screening process creates an underweight in the last bucket. Growth Plus basket was designed to help resolve that Growth "factor" imbalance.

I believe that a core of STAR stocks (which have continued to participate well in this environment with the rising market but is careful not to invest now into overly exuberant areas) and selective exposure to Growth Plus portfolio is the best recipe of long term success in equities.

WHAT ABOUT FIXED INCOME? WHAT TO DO?

Our Fixed Income portfolio returns continue to build on the strong recovery since the sharp fall in March.

Central Banks continue to extend asset purchase programmes and other emergency measure continuing to underpin both risk and flight to quality assets.

Credit spreads continue to contract and still have further to fall, supporting our strategy of favouring corporates vs. sovereign exposure. Investor demand for corporate debt remains strong, and our strategies continued to participate in this spread contraction through adding new credits to capture additional yield and potential capital gains.

Most of our risk budget remains positioned in the following areas:

- G-SIFI Financials: Key conduit for governments and Central Banks
- Utilities (inc. hybrids): Key part of the global economic infrastructure
- Major telecom and tech companies (inc. hybrids): Key short and long-term beneficiaries of the new normal
- Major global corporates (inc. hybrids and prefs): Key global employers and wealth creators

WHAT IS THE OUTLOOK FOR USD?

Big Mac Index indicates that the USD is overvalued by 16% against EUR, by 25% against GBP and by 36% against JPY.

Moreover, the prospect of major fiscal stimulus in the EU has helped narrow the rate differential between 10 Yr US and German sovereign bonds by 0.10% since the beginning of May.

The major unknown right now is how quickly non-US Institutional investors will sell USD-denominated assets if they suspect that the USD weakness is likely to persist. This would raise the risk of large losses on US Treasuries for non-USD-denominated investors.

According to IMF data, the EUR share of allocated foreign reserves is only 20%, while the US is at 62.0%.

CONCLUSION:
There is considerably more room for the EUR share to move higher off a relatively low base that is less than one-third of the USD.

This reversal of capital flows, which had favoured the USD since 2011, would also result in greater availability of investment capital for the EU, while driving the value of the currency higher (vast amounts of capital shifted from the EU to the US since 2011, as questions about the long-term viability of the Euro intensified). This contributed to nearly $10tr of global capital concentration into U.S. assets in less than a decade. This capital concentration is now in danger of going into reverse.

CONCLUSION:
We expect the USD to remain under downward pressure as the currency's growth and interest rate advantages have been deteriorating. By contrast, the EUR prospects have improved, thanks in part to advances on mutualising euro area debt (which I covered in a previous CIO Note).

STILL CONSTRUCTIVE ON GOLD?

In previous notes I highlighted its improving prospects based on the potential decline in US long-term real rates. However, the appreciation in the price of gold has proved much faster than anticipated (the decline in US 10 Yr real rates beyond -1% and the recent significant depreciation of the USD dollar compared to major currencies, acted as a catalyst for the recent surge in gold price).

There are signs of some exuberance in the behaviour of the gold price, so there is risk of a short-term correction.

Over the longer term, though, the global low-yield environment means the opportunity cost of holding gold will remain low. Besides, large increases in public debts and massive injections of liquidity by Central Banks make Gold particularly attractive as a store of value and hedge against any potential rise in inflation in the (distant) future.

CONCLUSION:
Still bullish on Gold, though it will be a bumpy ride upwards.

CONCLUSIONS AND ASSET ALLOCATION IMPLICATIONS

- We have had a surprisingly rapid recovery of the stock and credit markets, despite the fact that the spread of COVID-19 has not been halted, and that it will take a long time for the economy to merely return to its 2019 level (and even longer for it to give rise to the earnings that were anticipated at the time those market highs were first reached).
- The evolution of Central Bank's monetary stimulus and governments' fiscal support remains key.
- Average P/E ratios are unusually high currently and debt yields are at unprecedented lows, so caution is warranted: valuations like these are usually justified with protests that "this time it's different," four words that tend to get investors into trouble.
- We remain underweight equities overall at these demanding valuations and in the face of considerable uncertainty.
- We remain constructive on the credit of systemically important financial institutions.
- A deal to expand common debt issuance and a relatively disciplined approach to the coronavirus pandemic are all casting a more positive light on the EUR vs. USD.
- We continue to like Gold as a store of wealth.

SOURCES: GOLDMAN SACHS, OXFORD ECONOMICS, LOMBARD STREET, OAKTREE CAPITAL

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