EPIC INVESTMENT MANAGEMENT

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# Disconnected

As has long been noted, the stock market is not the economy, and vice versa. Nevertheless, there should be a connection between the two. Indeed, in the past century, the worst decades for economic progress were the 1930s depression era and the 2000s post-boom period. And the two worst decades for equity returns were… you guessed it, the 1930s and 2000s.

In the post-World War II era, the 1950s saw the first full-decade recovery from the Great Depression. It was boom time in America. The 1980s and 1990s produced an economic renaissance following the malaise of the 1970s. All three decades, the 50s, 80s, and 90s, were rewarding times for equity investors. So, the stock market is not the economy, but it certainly is related to, and reflects the overall health of, our nation.

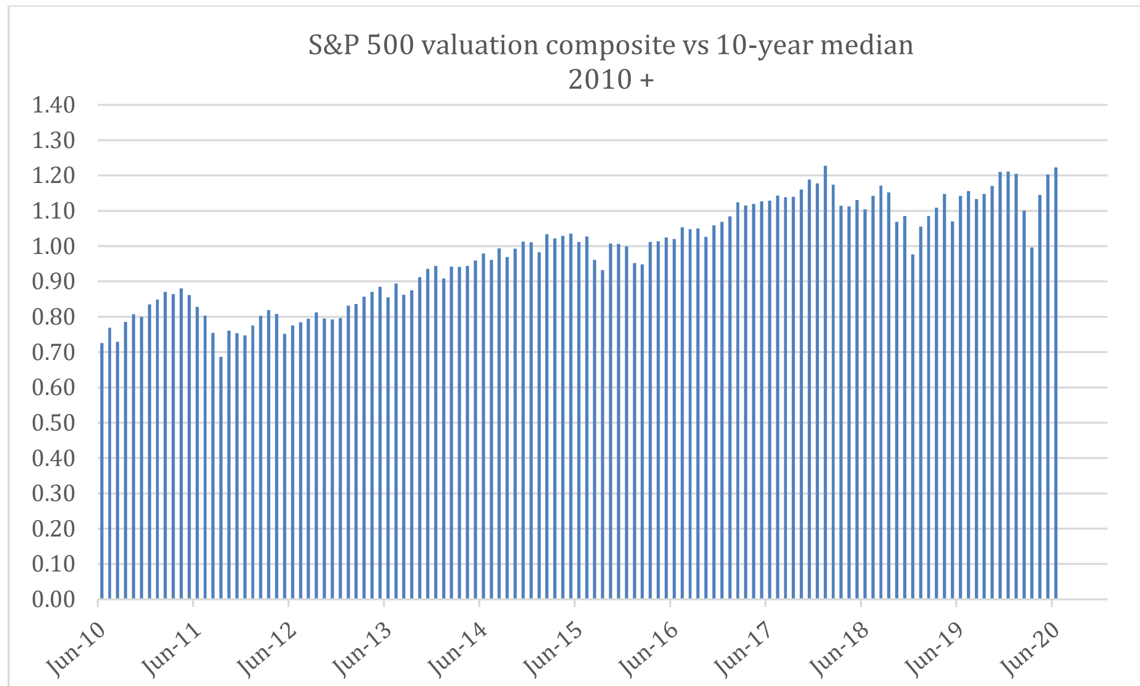
Even through February of this year, the connection held true; as it did in March, as the stock market cratered in the face of the coronavirus pandemic and its ravages on our physical and economic health. That a subsequent rally might ensue, especially given the speed and force of Washington's rescue response, might be understandable, but the magnitude and resilience of this rally is truly remarkable. In short order, the US equity market has experienced its fastest, deepest decline, immediately followed by its quickest, strongest recovery since the early 1930s.

Something seems out of sync.

The common explanation -- or is it rationalization? -- is that the Federal Reserve trumps everything, or as the old adage says, "Don't Fight The Fed". Clearly our central bank's easy money policy, at what would have previously been considered an unfathomable level, is the best and perhaps only reason for the market's resurgence. Still, explanations differ from predictions, and no one we know saw this rally coming; not to the speed and not to the extent it has progressed.

Presenting a cogent, balanced assessment of implied market foresight in light of economic reality seems futile. There are so many contradictions, other than the aforementioned Fed, it doesn't make much sense. Instead we offer a medley of musings, developments and observations taking place over the past three months. And if in total they seem cautionary, perplexed, even dis-believing in tone, that's good; you grasp the message. Wishy-washy will have to wait for another day.

**Valuations Getting Stretched**



blend of ltm pe, fwd pe, p/ book, p/ sales, dividend yield, p/ cash flow

Using a blended valuation measure and comparing it to the market's pricing over the past decade, stocks look expensive. The only time in the past 30 years when equities were more richly priced was the tech bubble of the late 1990s to early 2000s. Then again, those valuations reached another 30 percent higher.

**Strange Goings On**

Equity market activity has gone from perplexing to euphoric to some type of frothy frenzy. The former two are acceptable, while the latter is a bit scary.

Case in point, stock in American Airlines rose 41 percent in one day last month. Days later a profit estimate was provided for the global airline industry, projecting an annual loss of 84 billion dollars, more than twice the loss in the recession of the global financial crisis. No telling how American avoids its share of these losses.

Case number two, the stock of Nikola Corporation doubled in a day, for no apparent reason. Nikola is a hydrogen fuel cell-electric truck company that months ago nobody had ever heard of, and yet at one point it boasted a market value of 29 billion dollars. For reference, Ford Motor, more than a century old and publicly traded since 1956, carries a lower market value. One difference is that Ford's revenues exceed 100 billion dollars, whereas Nikola's revenues do not exceed zero. We might describe Nikola as a modern-day truck manufacturer, except the company does not manufacture anything. It does have a website, some cool designs, and is willing to take a deposit for your truck order. Delivery date uncertain.

Case three, Hertz Global Holdings, the rental car company. Hertz recently filed for bankruptcy and as expected was trading for less than one dollar per share, but not for long. Again, with little explanation, the stock rose to six dollars, perhaps reflecting hope of some residual value for shareholders after its bankruptcy restructuring, but more likely reflecting pure speculation. The stock made a quick round trip and is once again trading near one dollar per share.

Case four, Chesapeake Energy, once a leading energy exploration company but now a fallen angel with little hope of surviving in its present form. This stock rose 180 percent in a day's trading before a news story repeated what almost everyone already knew... the company was heading for bankruptcy, and shareholders would likely be wiped out.

Case five... well, you get the picture. The most common explanation is that small investors trading their Robinhood accounts for zero commission have hijacked a speculative corner of the market, and are out-smarting the professionals.

As an anecdote, a publicity-seeking day trader recently proclaimed himself a better investor than famed billionaire Warren Buffett, saying day trading "is the easiest game I've ever played".

Another story declares, "young investors, like (name), appeared to have a prescient understanding of the market, unlike the billionaire hedge fund managers... " The person named in the prior sentence gained his fleeting fame by profiting 1,500 dollars on a trade.

We have seen this movie and it does not end well.

**Zero Sum, Disproven**

There is no silver lining to this pandemic, the combined health and financial toll is too high to even think in those terms. Yet there may be an economic lesson to the recession the virus induced. It disproves the misguided belief that economics is a zero-sum game. If Bill Gates and Warren Buffet are super rich, it must have come at the expense of everyone else, no? No.

It seems a fair thought experiment to play the story backward, to test its validity.
If economics is a zero-sum game, how is society finding its balance during this pandemic to offset the obvious hardship? What large groups benefit from this recession? Corporations? Their customers and suppliers? The labor force? Pension plans? Savers? Investors? Does big government win by spending more while taking in less? Municipalities? Universities? The sports world?

The answer is nobody wins. Okay, perhaps bankruptcy lawyers and subsets of the economy benefit, including e-commerce. Televisions win while movie theaters lose. Bicycles are booming while mass transit is shunned. But we would never say commerce as a whole is a beneficiary. Indeed, almost everyone loses. That is because economics is not a zero-sum game, and never will be.

And if people thought society was troubled while the economy was strong, wait and see the strife when the economy is weak. Well, we don't have to wait any longer, it is already upon us.

**V is for fantasy**

There are still a few people holding out hope for a V-shaped economic recovery, mostly Wall Street pundits with nothing to lose. One strategist claimed all recoveries are V-shaped, but this is deceiving.

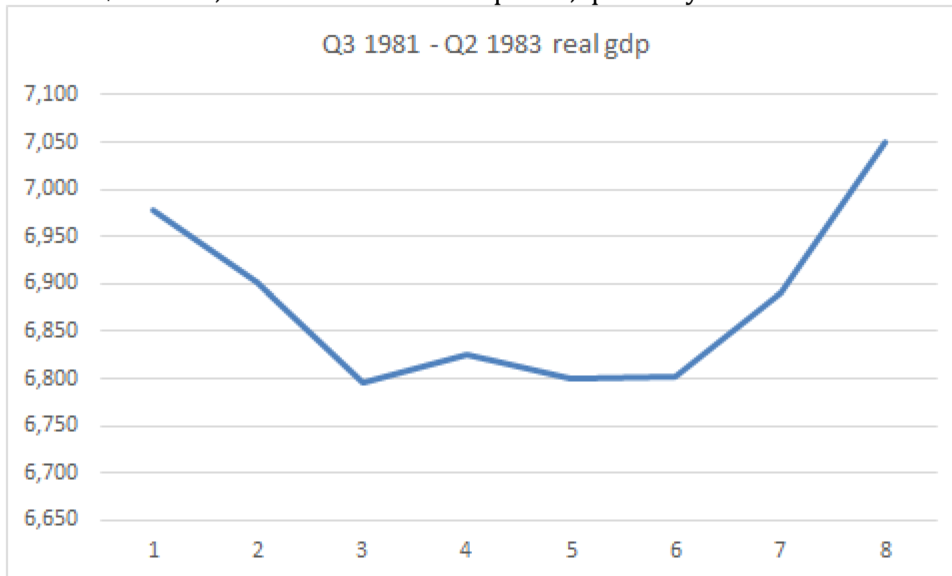
Imagine two economic cycles. In the first, activity rises by two percent, drops by two percent, then rises by two percent again. If we plot this, the graph will be V-shaped. Now imagine a far worse economy, growing by one percent, then declining by ten percent, before rising by four percent. This too will look like a V, only deeper into the trough and higher into the recovery. In the first scenario, the economy ends up two percent larger, whereas in the latter case, the economy is still five percent smaller. And the latter case is close to what we will experience in the first three quarters of this year.

Call it V-shaped if you want, then take it up with billionaire hedge fund legend Stan Druckenmiller, who called the idea "a fantasy".

Better to consider the recovery fast or slow. To illustrate, here are the quarterly progressions of real gross domestic product (GDP) in two severe recessions -- 1981-82, and 2007-09. The measurement periods begin at each expansion peak and continue beyond the trough, until a new high in economic output is reached.

While the 1981-82 recession was severe, once the recovery started, it regained lost ground rapidly. This has been more common, 1930s Great Depression excluded. In the global financial crisis of 2007-09, it was a different story. It was not until 2011 that a new high in real GDP was attained... the ordeal took 3 1/2 years to resolve. This go-round? Guess slow, sadly.

GDP in $ billions, chain-linked to 2012 prices, quarterly



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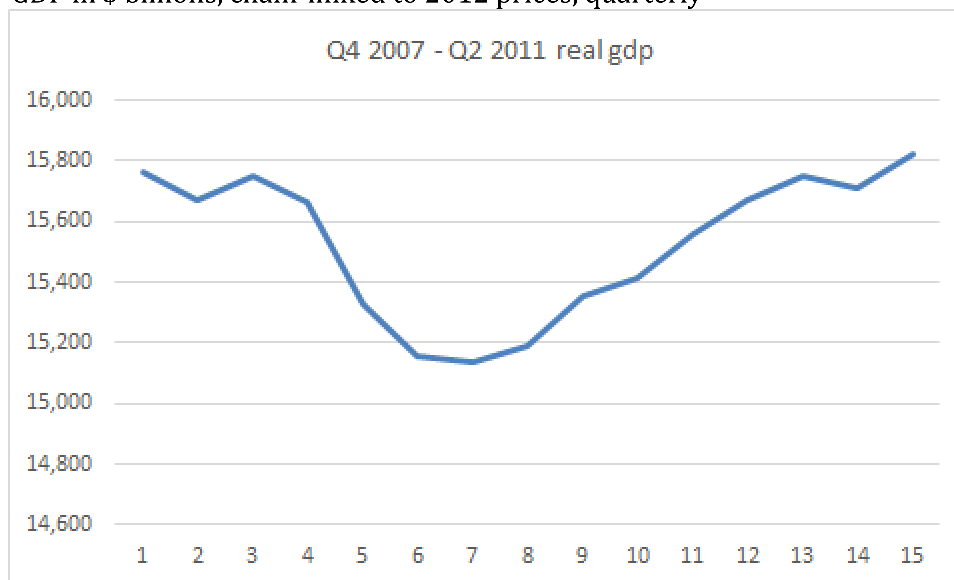


**The Promise of Free Money**

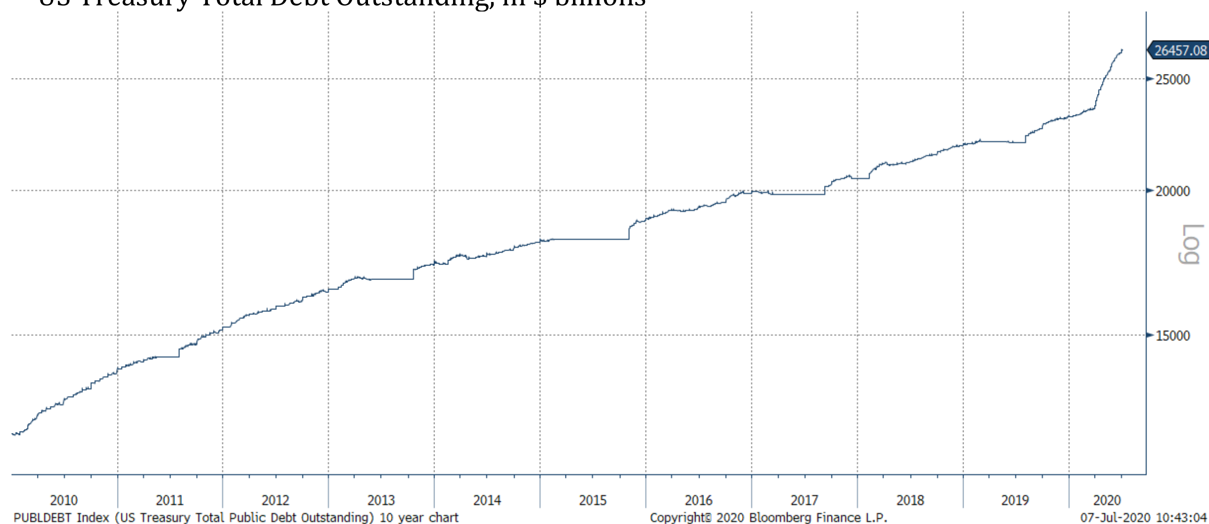
As it ends up, it's good to be king, at least economically and especially amidst a pandemic. The US is in a rare position as the world's largest economy, able to borrow money around the globe in our own currency, and with a central bank still considered a responsible party.

Here is how it plays out:

Every month or two, Congress and the White House devise a new spending plan to rescue our economy. The most recent bill totaled three trillion dollars, and we will probably need that much again in the coming months. At some point, members of Congress will declare "enough is enough", but until that group reaches a majority, it is "spend now, pay for it later".

In 2002 it took 72 months for the federal debt to rise by one trillion dollars, to a total of six trillion. By 2011, the timeline to add a trillion dollars in debt was shortened to 11 months. In 2019, it was down to nine months. By early this May, we were down to 28 days, with a total federal debt of 26 trillion dollars. Let's face it, a trillion dollars just isn't what it used to be.

US Treasury Total Debt Outstanding, in $ billions




The deficit spending in response to the pandemic is so extraordinary, it is running out of adjectives. 'Unprecedented' seems to be the default term these days, and for now we will leave it at that. This is where our global borrowing capacity and central bank come in. There is no sign of the global bond market pushing back against our emergency spending, as yields around the world remain near historic lows. And just in case, the Federal Reserve decided it has unlimited capacity to purchase our debt. It's a neat trick, one arm of the government issues debt, the other arm buys it. Rescue funds are raised, yields remain subdued, and most everyone is happy.

Financial purists can kick and scream all they want, but the truth is these are dire circumstances, requiring extraordinary remedies. If we have to play king, so be it.

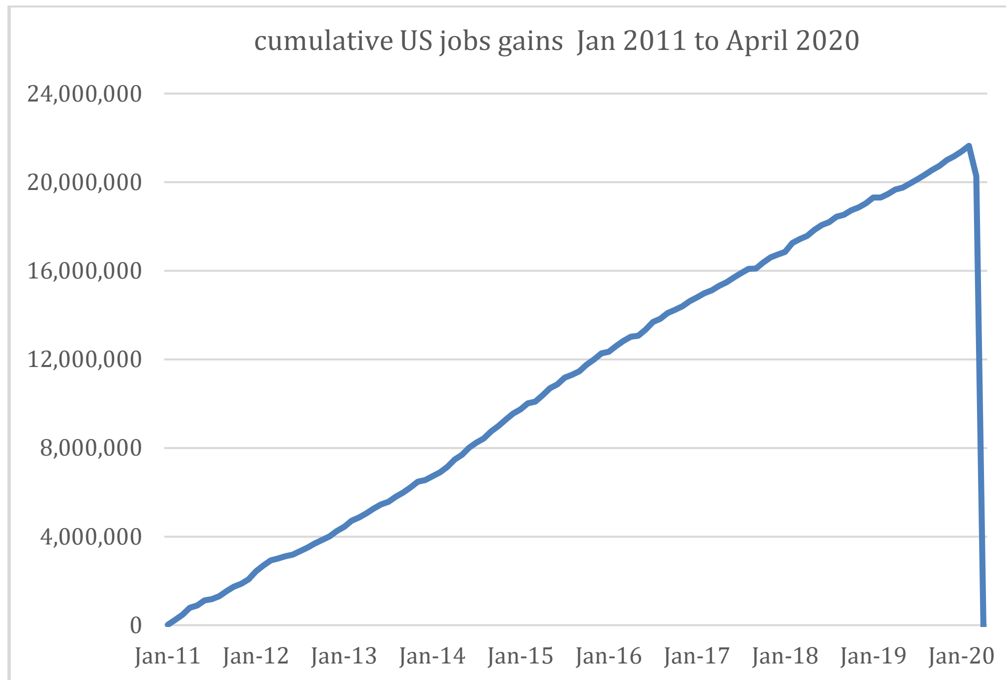
One secondary effect of the pandemic will be the economic drag of this excessive debt, both at the government and corporate level, leading to slower long-term growth.  Paying interest on debt is not a fruitful exercise, unless the debt is used to fund productive endeavors.  This drag will last for years, maybe the entire decade.  The rescue plan may be the best alternative, but it is not a free lunch.

We went through this in the prior cycle.  At the end of the global financial crisis the phrase "new normal" was coined.  It suggested higher debt levels, a larger role for government, and slower growth.  In this case the predictions came true -- it happens once in a while -- but there was a twist.  We experienced a decade of slow but for the most part steady growth, with low inflation and declining interest rates.  Housing and other real estate recovered, the job market boomed, corporate profits soared, and stocks enjoyed a prosperous decade.

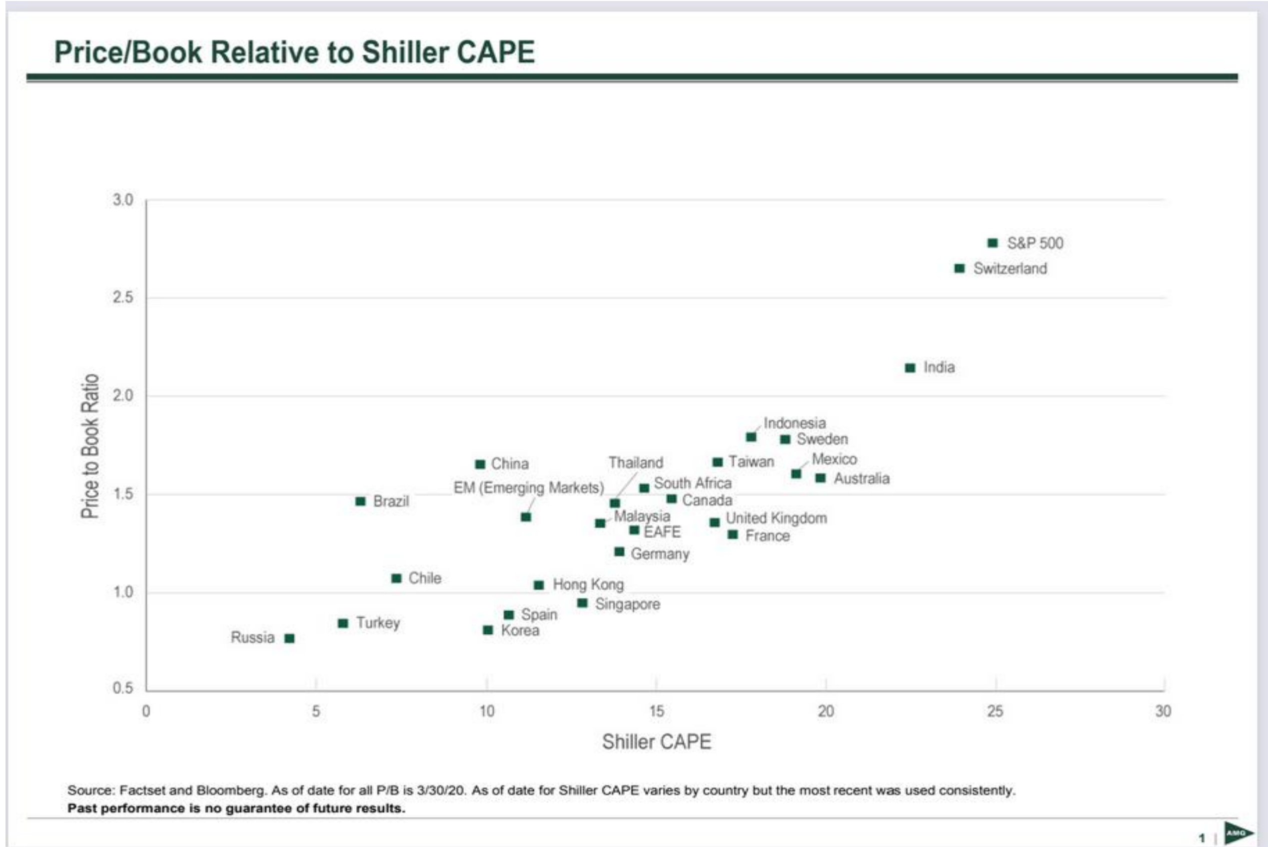
This was quite fortunate, as it could have turned out differently.  Today we face a similar proposition, and "double-or-nothing" seems an uninviting wager.  Plus, valuations stand much higher, leaving less room for error.  Anyone expecting a repeat performance is either eternally optimistic, or delusional.  Then again, that may be a distinction without a difference.

**Jobs machine goes haywire**

From January 2011 through February 2020 the US economy generated 21.6 million new jobs.
In March and April, 22.2 million jobs were lost. It took two months to destroy nine years of progress.



**Valuations Stretched, part 2**



source: AMG
CAPE = cyclically-adjusted price-earnings ratio

Find the outliers.

**Follow the smart money?**

What do these ten men have in common?

Warren Buffett
Sam Zell
Larry Fink
Stan Druckenmiller
David Tepper
Carl Icahn
Jeffrey Gundlach
Leon Cooperman
Jeremy Grantham
Ray Dalio

They are all Wall Street titans, famed investors and chief executives. And they are all billionaires, or close to it.

There's something else. All have been publicly cautious, or outright bearish, about the prospects for our economy and financial markets in the face of the coronavirus pandemic.

It's a fair assessment that each of them is wrong once in a while, but if taking an optimistic view, do we really want to bet against them all, at the same time?

**Tidbits…**

US economy contracts by five percent in first quarter as recession begins.
China's economy shrinks in first quarter, only contraction in 28 years of quarterly data.
Australia's economy enters downturn after record-setting 29 years of growth.
World Bank forecasts global economic contraction of 5.2 percent in 2020, worst results since World War II.

Federal Reserve expects to retain zero-interest-rate policy through 2022.
Federal Reserve begins buying exchange-traded funds investing in corporate debt, and corporate debt directly, including junk bonds. Junk bond issuance reaches record volumes in June.
Municipal bond defaults rise to highest level since 2012 as local tax revenues shrink.

OPEC, other oil-producing nations agree to cut production by nearly 10 million barrels per day as oil demand plummets. Crude oil briefly trades below zero as buyers are paid to move supplies.

Boeing chief executive warns air traffic may take two to three years to bounce back from recession.
Global airline industry projected to suffer record-setting 84 billion dollars in losses in 2020.

Sign of things to come? Twitter extends work-at-home policy to 'forever'. Facebook follows suit.

*Office properties at risk, along with worker productivity.*

Argentina defaults on its sovereign debt for ninth time in history, less than three years after issuing 100-year bond.

*P. T. Barnum was right.*

US chooses five pharma companies to participate in "Operation Warp Speed" trials, hoping to accelerate development of covid-19 vaccine from years, to two-to-three quarters.

100 million loan payments go unpaid by US individuals, including student loans, auto loans and other debts.

*Unpaid, not extinguished.*

Germany's Bayer reaches preliminary 12 billion-dollar settlement with plaintiffs over Roundup herbicide cancer claims, while still denying the health risk.

US-Mexico-Canada Agreement (USMCA), tri-lateral trade deal becomes effective, replacing 26-year old NAFTA.

Background checks for firearm purchases reach record level in June.

*Can't be a good sign.*

Retail store closings over next five years estimated at 100,000, represents 11 percent of existing store count, as coronavirus accelerates move to e-commerce.

Retail and other bankruptcy filings:
Neiman Marcus
J. Crew
J. C. Penney
Stage Stores, owner of Gordmans and Beall chains
Pier 1 Imports, changes plan from restructuring to liquidating
Tuesday Morning
CEC Entertainment, parent of Chuck E. Cheese
Gold's Gym International, private company with 700 fitness centers
24 Hour Fitness Worldwide, private company with over 400 fitness centers
Brooks Brothers Group
Ascena Retail Group, with 3,000 US stores, including Ann Taylor and Lane Bryant
Hertz Global Holdings
Advantage Rent A Car
Chesapeake Energy, one-time king of fracking
Cirque du Soleil, world-renowned circus troupe

Source:
Bloomberg
The Wall Street Journal