NOTES FROM THE NORTH: MARKET OUTLOOK

May, 2020

During the Great Financial Crisis of 2008-2009, the Federal Reserve invented a new playbook to help repair the damage to the capital markets. The intervention then was deemed “unprecedented,” and much hand-wringing was spent during the ensuing decade on unpacking and anticipating the possibility of negative fallout from the Fed’s expansion of its tool box. One of the biggest concerns was that the Fed would be out of tools if we had another crisis before monetary policy had normalized. We’ve found out in the last months that the Federal Reserve had a surprising number of tools still in its toolbox, and Jay Powell and his crew have been busy redefining the notion of “unprecedented” monetary policy.

The market’s reversal of the first quarter downward slide is timed almost exactly to the Federal Reserve’s announcement of a program of “shock and awe” that included cutting interest rates to 0%, at least $700 billion of quantitative easing, and a broad assortment of programs designed to grease the gears of the financial system, including programs for commercial paper, primary dealers, and money market funds, a coordinated central back effort to provide liquidity for the dollar swap markets (there was a run on the dollar as a safe haven, which stressed global dollar liquidity), the announcement of additional supportive programs to begin in early May (the “Primary Market Corporate Credit Facility”, the “Secondary Market Corporate Credit Facility,” and the “Paycheck Protection Program Liquidity Fund,”) and others announced for a time still to be determined (including the “Term Asset-Backed Securities Loan Facility,” the “Main Street Business Lending Program,” and the “Muncipal Liquidity Facility.”) There is a reason for the Wall Street adage, “Don’t fight the Fed!” Once the reversal established itself, enthusiasm grew to “buy what the Federal Reserve will be buying,” with speculation bubbling that the Fed was even getting ready to buy stocks.

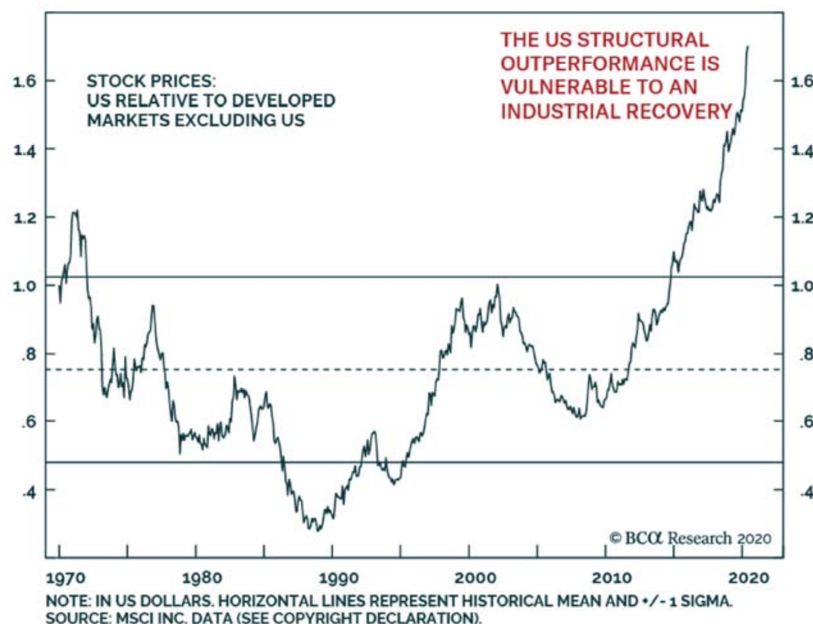
After recouping more than one-half of its dramatic first quarter decline, the market (as measured by the S&P 500 Index) appeared to be running out of steam by mid-May. For a trader, it’s not a surprise that the market would pause and digest at these levels. Major moves in individual stocks and the broader markets are often followed by about a 50% retracement (in either direction) and then “consolidation.” Of more significance to an investor, the consolidation process entails time to respond to the change in circumstances and reevaluate future earnings power. Visibility has not improved yet. In fact, many firms simply withdrew earnings guidance for the balance of 2020 during this reporting season. Companies generally said they expect sales and earnings to eventually recover, but the magnitude and timing of that recovery is very uncertain.

Of note, as well, is that although the broad market rebounded, renewed enthusiasm did not lift all stocks. It lifted mostly technology and healthcare stocks. In fact, the five largest firms in the S&P 500 (Facebook, Amazon, Apple, Microsoft and Alphabet) now account for more than 20% of that index. These five firms are clearly among those that have benefited from the stay-at-home orders and there’s good reason to suspect they will continue to benefit from long-term cultural shifts. However, technology now accounts for 25% of the S&P 500. If you include Facebook and Alphabet, which have been recategorized as part of the Communications sector, and Amazon, moved to the Consumer Cyclical sector, technology stocks as you know them account for ~34% of the S&P 500.

Twenty years ago, at the top of the dot.com boom early in 2000, technology stocks set a record high of 34.8% of the S&P 500 index. Is it possible for technology to prosper when virtually every other type of business in the country (or world) is languishing? The market’s response to the question *then* was “No.” The S&P 500 Index experienced a “lost decade.” When the tide turned on the economy and technology stocks, anyone who had bought the Index at the top of the dot.com boom did not break even again until 2007. The weighting of the technology sector shrank from 35% to 18% of the Index over the next ten years or so. In contrast, the stocks that hadn’t led the charge to the top of the tech boom fared reasonably well.

The divergence in returns between growth and value styles in the U.S. has lately returned with a vengeance, driven

largely by the differences in industry exposures within the two styles. Growth is heavy in technology and health care, value is heavy in financial services and energy. The non-US developed economies do not have nearly as many large technology stocks as the United States, and this lack explains in part the sharp outperformance of U.S. stocks versus other developed markets. This divergence is approaching a two standard deviation level from normal this year (see chart, below). BCA reminds us that valuation alone is not a catalyst. One possible catalyst they're monitoring is the value of the dollar. A shift in the upward trend for the dollar would signal an improvement in global economic prospects relative to the U.S., and a relative recovery in the industrial world compared to the digital world. An uptick in global economies would soften the dollar and give room for value stocks like industrials, materials, energy, and financials to outperform growth stocks. This would benefit non-U.S. stocks overall, and value strategies in the U.S.



A chorus of historically successful investors (including Warren Buffett, David Tepper, Sam Zell, Paul Singer, Stanley Druckenmiller, Jeffrey Gundlach, Mohammed El-Erian, and Ray Dalio) have begun to sound alarms that the market may be ahead of itself. Charles Gave, co-founder of Evergreen Gavekal, has joined in the cautionary chorus. (Gave's opinion is that U.S. stocks were 40% overvalued in February, and now they are 30% overvalued.) He points out that the last time the idea of buying what the central bank was buying became popular, it rationalized stock prices in Japan in 1990. That did not end well: Japanese stocks went down suddenly when profits collapsed, and that market has not fully-recovered to this day. Gave reiterates that stock prices should equal the future earnings stream discounted by an appropriate interest rate. Monetary policy can influence earnings and the appropriate interest rate to use for discounting, but it is not a direct, straightforward relationship. It's never a good plan to "Fight the Fed," but it would also be prudent to keep in mind that the current crisis has been caused by a virus that cannot be cured by an increase in the money supply.

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