NOTES FROM THE NORTH: MARKET OUTLOOK

October, 2020

Although the backdrop was election-fueled "2020" anxiety, the quarter just ended boiled down to a tug of war between the economic trends caused by Covid-19 and the amount of stimulus that the U.S. government was pumping into the economy. Job growth (recovery) in May and June averaged about 4% per month, but in July, August and September gains slowed to just 1% per month. The net result is that 7% more Americans are still without a job today than in February before the pandemic. In spite of the record size of the first stimulus package, more is probably needed. Plans for this have been entangled in politics, but there is still hope that another package of fiscal stimulus will be forthcoming before year end.

In the upcoming quarter, equity performance ought to be tied to earnings reports, Covid infections and/or vaccine surprises, and resolution (or not) of the Presidential election. Second quarter earnings exceeded expectations, and third quarter results are also likely to be strong for large U.S. firms. For 2021, it has been estimated that earnings would likely be shaved by 6%-10% if Biden wins the Presidency and implements his proposed tax increases. On the other hand, the market might approve if a change in administration were to bring more stimulus money, a better relationship with China and a reduction in tariffs. Assuming a vaccine is approved in the first half of 2021, the virus' effect on the stock market should be minimal by the end of 2021.

Looking out to that 12-month horizon, both BCA and JP Morgan expect the stock market to be moderately higher. BCA expects the dollar to weaken, contributing to an improved market performance for foreign stocks and U.S. value stocks. Except for these last 10 years, "value" has outperformed "growth" in virtually every decade. BCA points out that value is now cheaper than growth by the widest margin in recent history.

As a reminder of the danger of buying even great companies at extraordinarily high valuations, here are the comments of Scott McNeely, CEO of Sun Microsystems, in a 2002 Business Week interview (two years after the bursting of the 2000 Y2k/dot.com/technology bubble):

> **At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now having done that, would any of you like to buy my stock for $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. *What were you thinking*?**

(Emphasis ours. Note that Sun Micro stock was on its way from $64 to $6 and eventually, an acquisition by Oracle for $7.5 billion.)

Snowflake, a database application company, earned the title of the highest valued software IPO ever when it debuted in September. In its initial day of trading, it began at a level double its IPO price ($120/share) and traded as high as $310 before "settling" at $254. The CEO was sanguine about leaving over $3 billion in theoretical capital on the table. His goal, he said, was to gain long-term investors. "What you're seeing," (he said) "is the difference between the frothy, opportunistic retail side of the marketplace and the long-term shareholders… you can't get too distracted by what you're seeing on CNBC." At the IPO price for the long-term investors, Snowflake was valued at 97x sales (Revenues for the period ended 1/2020 were $1.24). The *opportunistic retail side of the marketplace* paid up to 250x sales during the very frothy day.

Notes From the North: Market Outlook, cont'd

Many seem to be getting distracted from valuation by *something*. Today there are more than 530 U.S. stocks trading at over 10 times their sales per share, and not all of them are new IPO companies that are actually doubling their revenues every year from a low base (as Snowflake has). Snowflake is joined by newcomers Moderna, DraftKings, and ZoomVideo but also by established companies Nvidia, Intuitive Surgical, Tesla, Illumina, Align Technologies (an orthodontic appliance manufacturer, not a technology stock), Lululemon, Twitter, Facebook, Netflix, and even Microsoft. The value of the Nasdaq 100 Index companies is now greater than the value of the entire European stock market.

This is not to say that the market must crash, therefore one shouldn't own stocks at all. With interest rates at record lows, equities provide a critical tool to ward off even mild inflation. It is a good time, however, to be mindful of the level of portfolio exposure to stocks with the type of valuation noted above. No matter how strong a company is, it is very difficult to produce competitive returns when you start from such a high valuation. The high valuation reflects investors' high expectations, and it's very difficult for any company to continue to meet or surpass those expectations year after year.

Looking out past 2021, Vanguard recently released their 10-year asset class return projections. The range of forecasts in the table below reflect the discussion above. Inflection points are difficult to identify, but Vanguard clearly anticipates there will be an inflection point on both the "U.S. vs Foreign" stock trend and the "value versus growth" style trend before the next ten years are over.

Asset Class	10-year annualized return estimate
U.S. Equities Overall	3.9%-5.9%
U.S. Equities: Value Style	5.0%-7.0%
U.S. Equities: Growth Style	1.6%-3.6%
U.S. REITS	3.4%-5.4%
Global Equities ex-U.S.	7.4%-9.4%
U.S. aggregate bonds	0.7%-1.7%
Global bond ex-U.S.	0.5%-1.5%
U.S. Cash	0.5%-1.5%
U.S. Inflation	0.5%-1.5%

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