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Cadence clips

FOCUSED ON WHAT MATTERS MOST.

Facts Versus Narrative

The power of narrative can be incredibly strong. Its purpose is to shape, sway, and create an outcome different from what the facts likely would have otherwise created by accentuating and trumpeting particular ideas, observations, and data points, whether accurate or not. This is nothing new. Narratives have been spun up for as long as man has had an interest in controlling the outcome and they can absolutely change the course of events… for a little while anyway. So much of markets, and life for that matter, is a confidence game. If we're feeling good about the present and the future, then we're more likely to take the kind of positive action that keeps things going. Fear on the other hand leads us to retrench and pull back. Both of these reactions can happen regardless of the bigger picture reality, and it's precisely the type of game that's going on right now with respect to our economy and markets.

Facts

- The economy peaked and has been slowing since the fourth quarter of 2018.
- Covid-19 has accelerated this slowing and undoubtedly done lasting damage to the economy. Small businesses have been ravaged, consumers have changed their routines, and regardless of how quickly the virus leaves the scene, many of these adjustments will probably lead to semi-permanent changes in behavior.
- The economic impact by way of industrial production, retail sales, unemployment claims to name a few, is the worst we've seen since the Great Depression almost 100 years ago.
- Although there will be a point when economic activity starts to improve (probably sooner than later given the speed and depth of the decline), improvement will be from a very low base and will likely be slow. Getting back to where we were in Q4 2018 could take years. The disruption has been severe.
- Finally, financial markets usually track these economic cycles rather closely. Assets that carry risk tend to adjust in price as profits drop and defaults rise. It's really that simple.

- Oh, one more fact. The Federal Reserve can print money, but they can't print jobs for Americans or profligate corporations back into solvency. Thus, the Fed's role as fireman has its natural limits. With unemployment between 20% and 30% and hundreds of highly indebted corporations on the brink of failure, the gravity of the economic cycle will play out. Remember, the original purpose of the Fed was to be lender of last resort in the event of a financial crisis – to keep bad stuff (normal) from snowballing into worse stuff (counterproductive and harmful). The Fed was not established to create perpetual growth in economic activity, debt, and inflation. In fact, these goals, whether admitted to or not, have the effect of creating the very outcomes we're experiencing now and also experienced in 2000-2002 and 2007-2009. Cycles can't be abolished, nor should they.

Narratives

- The Fed has things under control and won't let anything bad happen – at least to "strategically important" corporations.
- The recovery will be "V-shaped", meaning we'll bounce back from this very quickly.
- The economy is re-opening and before long, we'll be back to normal.
- Corporate earnings will bounce back toward the end of this year, justifying the bounce in the stock market.
- Most corporations are beating their earnings estimates implying a better situation than most expected and a quicker return to profitability.
- Headlines announcing potential Covid-19 cures that tend to be very thin on detail and are released at times that seem designed to maximize market impact.
- Most of the lost jobs will come back as soon as we re-open the economy. This supports the "V-shaped" recovery narrative.

We'll spare you from our comments on what we've listed here, but suffice it to say that anyone with an interest in getting the stock market up quickly would probably support this messaging, regardless of how true or fact-based it is. On second thought, we'll comment on the one about companies beating their earnings estimates because that's a perfect example of controlling the narrative and it's been going on for decades. When a company beats earnings, it shouldn't be a surprise. An analyst may set their initial earnings estimate a year prior to a company reporting earnings. As time passes and visibility around those earnings improves, the analysts change their original estimate. This process often entails multiple revisions – often guided by the company itself – that continue until shortly prior to the company's earnings release. So, when a company "beats" earnings by 5 cents per share on that latest revision, it may have missed the original estimate by a country mile. The whole thing is a perception game designed to instill confidence in investors. Imagine if we talked about earnings in year-over-year terms? XYZ earnings down -20% versus last year has a different ring to it than XYZ earnings beat estimates by 5 cents! Reality versus narrative at work.

Narrative can be strong. Ben Hunt of Epsilon Theory writes beautifully about the power of narrative and its impact on just about everything under the sun. He describes it as a living, breathing creature that can take on a life of its own. In the end, narrative can re-shape reality for long periods of time, oftentimes against the better judgment of those who see the truth of the matter. How is it possible for some to believe that the economy over the last 10 years has been one of the best in history despite the fact that GDP has grown at ~2% annually over the period – one of the slowest stretches in history? Narrative. What about Covid? Is it possible for untrue messaging to become powerful enough to drive a particular outcome? Absolutely. Wall Street declaring stocks are reasonably priced in relative synchrony? Could that aid in the creation of a stock market bubble? You bet. And back to our cozy little arrangement between Wall Street stock analysts (not all) and publicly listed companies; Would it be possible for a company to lose money every single year until it finally declares bankruptcy without the average investor ever realizing there was an earnings problem? No doubt. With the narrative consistently being crafted around "earnings beats", every report can be viewed as good news regardless of the underlying issues.

It all boils down to this; for some period of time, the truth doesn't matter as much as one's perception of it. But every narrative has its half-life. Along the way, gravity (the truth) gets busy adding one brick at a time to narrative's back until finally, it cracks under the pressure. Ultimately the truth, the facts, gravity wins out and so we must stick to a process designed to push past the narrative, while being flexible enough to adapt to it.

With this framework laid out, let's discuss what we're viewing as the reality of the situation and its investment implications. We'll do it by following the steps within our investment process, since well, that's the way we arrive at investment decisions for our clients. The broad steps are:

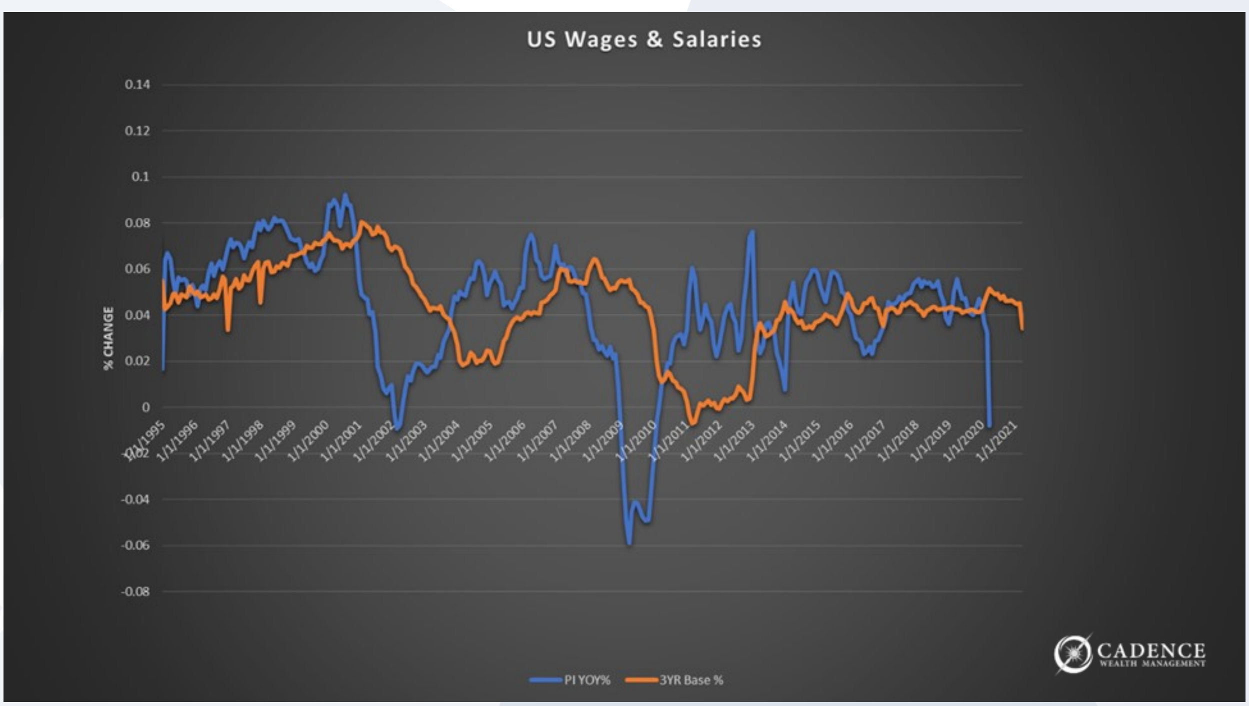
> **Economic, Credit, and Inflation Cycle** – Where are we across these varying cycles? Growing vs. slowing; Accelerating vs. decelerating.
>
> **Valuation** – Cheap or expensive? Although not very helpful in the short term, this provides an indication of both upside and downside risk when the cycle/sentiment shifts. Expensive, narrative-driven investments tend to lose value fast when the cycle begins slowing, whereas cheap, neglected assets have the potential to rise faster and further at the right stage of a cycle.
>
> **Market Internals** – What are broad measures of asset class performance and price action implying about where we are in the investment cycle? This could hint toward a trend change or cyclical turning point.
>
> **Technicals** – What is the short-term risk or opportunity within the longer-term trend? Nothing goes up or down in a straight line. Managing these swings in the short term can help keep risk in check.

With that in mind, let's look at where we are in the cycle…

Employment cycle

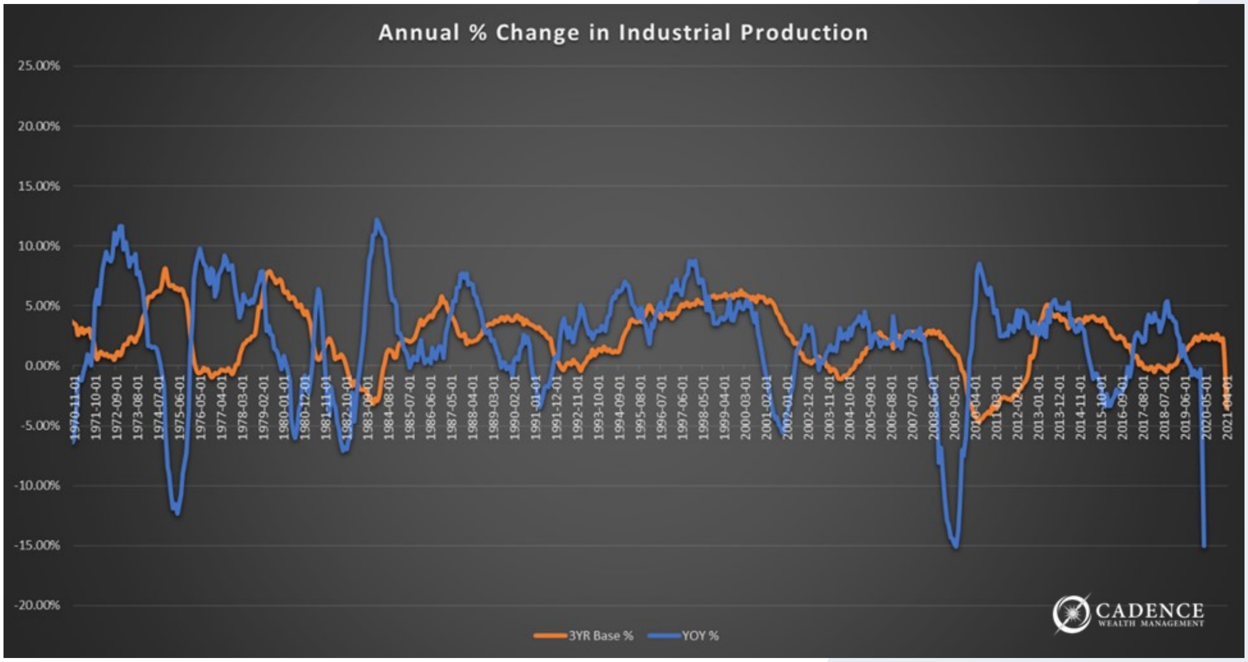
On the next page is a chart showing the stock market (red) along with the number of continued unemployment claims in the U.S. (blue and inverted). At the bottom of the chart in yellow we have the unemployment rate. What's very clear is that the employment picture, due to Covid-19 and our nations response to it, hasn't looked this bad in the last 50 years. What's also evident and highlighted with the yellow boxes, is that the stock market typically struggles greatly when unemployment increases. The market hasn't even begun to reckon with the situation at hand. There are two key narratives that are leading to this in our opinion. First, market participants "believe" that the unemployment problem will disappear along with Covid-19. The virus fizzles out, people get back to work, and this is all nothing more than a blip. Second, the Fed will print us out of this mess and everything that's showing up in the chart below will be magically undone. Here's the problem with that line of thinking: What if those assumptions turn out not to be true? If the reality is something different, more like what's been the case the last six times we've seen a meaningful shift in the employment cycle, then markets could well resume their trip downward to a fairer price.

Since the fourth quarter of 2018, the decline in the manufacturing cycle has been downplayed with the argument that the consumer is strong, and since consumption makes up roughly 70% of our economy, everything is fine. Below shows the annual change in the wages and salaries of U.S. workers. It’s gone negative after holding a below average growth rate for the duration of the economic recovery post-financial crisis. The consumer is clearly no longer strong, which is to say, the narrative around the strong consumer that has been used to justify a rising stock market is dead. Gravity won on this one.



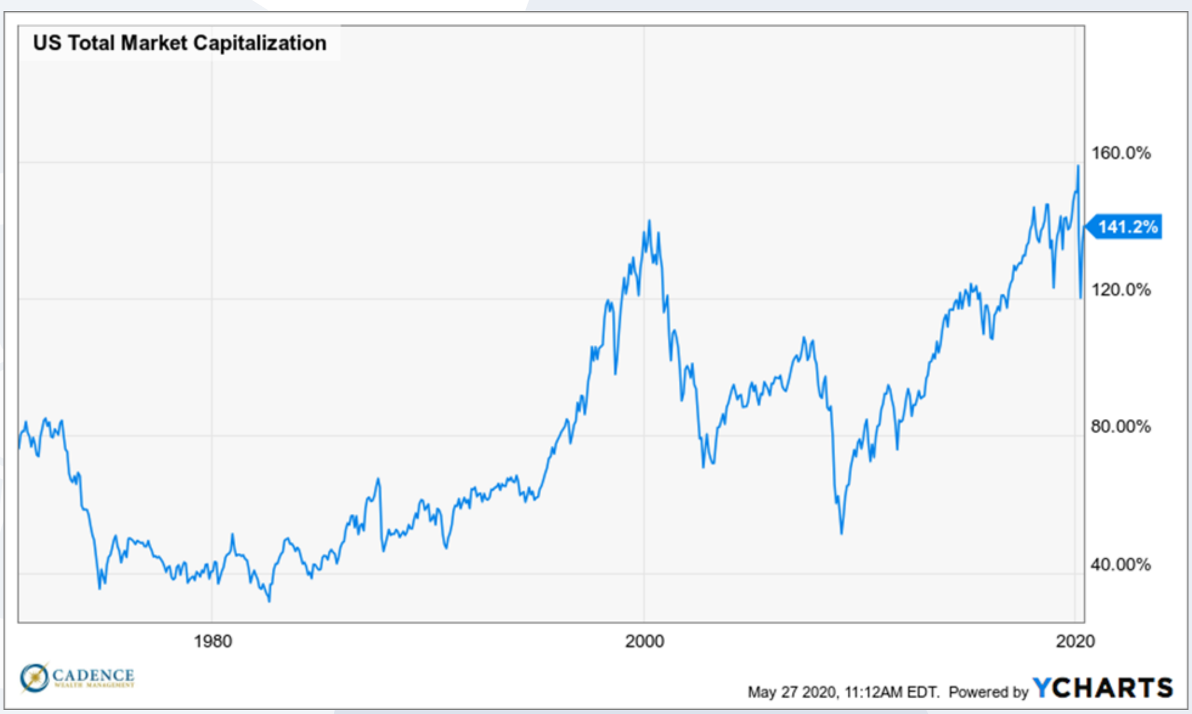
Economic Cycle

Here's the annual growth in industrial production, which is a reflection of the manufacturing cycle and broader economic cycle we mentioned had turned in late 2018. It was clearly decelerating toward 0% before Covid-19. It's now at a similar level of contraction to the worst seen in 2008 at -15% year-over-year.



Stock Market Valuations

There's a panoply of valuation metrics out there and we've cited many of them over the years. For simplicity, we'll look at total stock market capitalization as a percentage of GDP. At over 140% of GDP, the stock market is undeniably expensive. Other than the tech bubble in 2000, one would have to go all the way back to 1929 to find a similar valuation for U.S. stocks. Japan's market cap to GDP ratio at the height of its bubble back in 1989? 140%. The narrative around stocks being fairly priced is based on anything that would seem to make sense to the audience. Low interest rates, inflation, bonds being risky, the Fed. The accuracy of these claims doesn't matter as much as the goal, which is to keep money flowing into stocks. Narrative be damned. Stocks are expensive.



Market Internals

When one looks at the S&P 500 (below) or Nasdaq indexes, it's easy to get the impression that the stock market is either trending sideways or up. The problem is that these two indexes are not representative of the average stock in either the U.S. or the world.

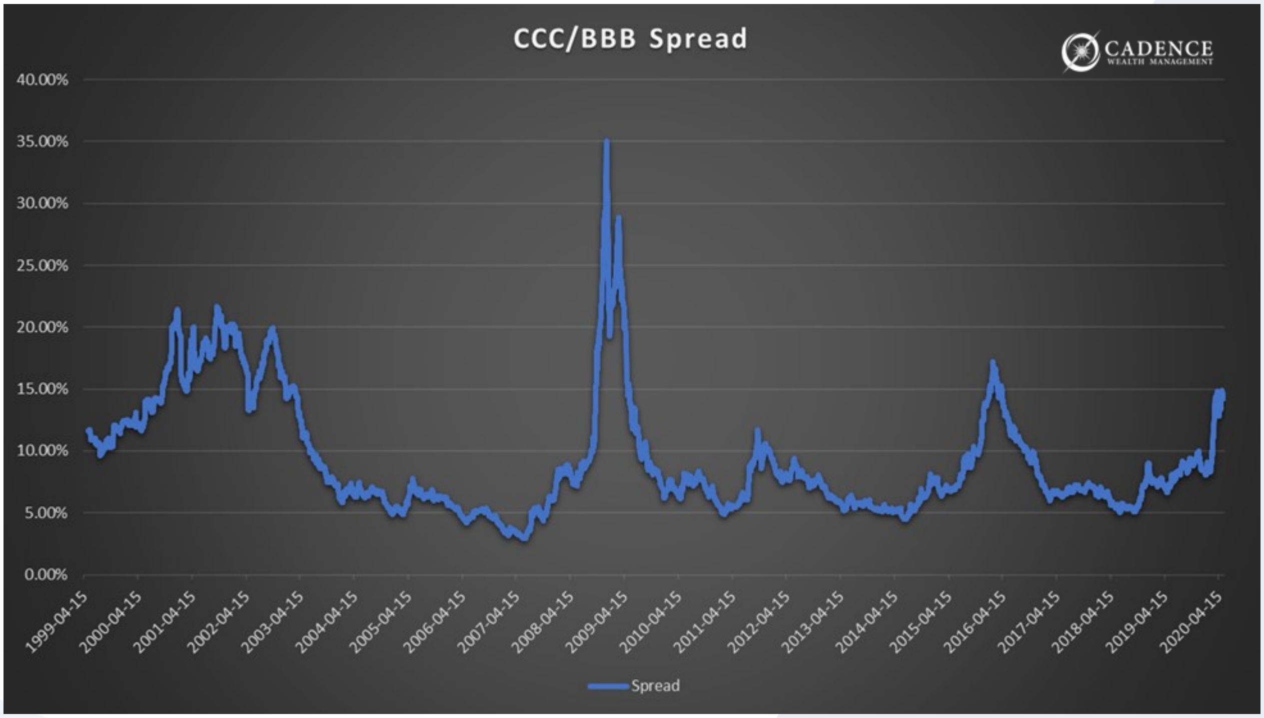
Here's a look at the Russell 2000 small cap index (orange) and the MSCI World ex-U.S. index (blue). They are both clearly trending lower and have been since the economic cycle in the U.S. peaked in the fourth quarter of 2018.

Traditionally Defensive Asset Categories

If the economy and stock market were in good shape, we'd expect to see defensive asset classes such as U.S. government bonds and gold underperform. Since the cycle peak in Q4 2018, this hasn't been the case. As our clients are becoming keenly aware, a portfolio of cyclically defensive asset classes – U.S. Treasuries, gold, silver, and gold miners – has outperformed the S&P 500 by a wide margin. Something we'd only expect to see in a decelerating growth/ recessionary environment.

The underperformance of the transportation sector is also something that is consistent with a transition from economic growth to contraction. As can be seen prior to the last two recessions and corresponding stock bear markets, transport performance dove relative to the S&P 500. It wasn't until the broad stock market began its decline that transports started outperforming. This dynamic hasn't happened as of yet in the current recession, which implies to us that it's possible the longer-term market decline hasn't yet begun.

And finally, the credit market (corporate bond market) isn't seeing things quite as positively as the stock market. If the worst is truly behind us as the narrative driving the stock market bounce is suggesting, then we'd expect to see spreads (the difference in interest rates between two bonds) between CCC junk debt and BBB low-end investment grade debt narrow. This hasn't happened as spreads still fluctuate between 14-15% - a range consistent with previous recessions and periods of market turmoil.



Inflation or Deflation?

One of the big questions out there now among investment professionals is whether we're more likely to see inflation or deflation in the months ahead. The reason this is a popular topic today is that the outcome has a big impact on which asset classes will perform the best and so we're also interested in getting the answer to this question right. From a big picture perspective, our thinking is that we're likely to see deflation first – as we are now – followed by inflation once the worst of economic and asset price declines are behind us. As for timing? We'll wait for the data to confirm when this shift might be taking place.

One of the most perplexing questions for many is why the record intervention we've seen by central banks over the years hasn't led to any meaningful spike in inflation? Surely printing money and giving it to the banks should cause prices to rise, right? No, it won't. Not unless that money is actually making its way into the hands of consumers and chasing a limited number of goods and services. This effect is measured by velocity of the money supply highlighted in red on the next page. You can see that although the money supply (M2 in yellow) has risen considerably over the years, the rate at which that new money moves around that economy has been steadily falling. In essence, falling velocity has been sterilizing the inflationary impact of new money. You can see how closely inflation (blue) tracks the velocity of money (red).

So, why hasn't this new money been moving around the economy at the same rate as it did 5,10, or 20 years ago? The simplest explanation to us is debt. Since the Fed can't spend the money it creates and can only give it to the banks to lend, it only ends up in the hands of consumers if it is in fact lent. When debt within the system rises, it's safe to assume that the desire to lend more money and the capacity for consumers to borrow it declines. As more and more of our discretionary income goes toward servicing existing debt, there's less available to consume with. Hence slowing velocity and lower inflation. Simplified for sure, but probably sufficient.

But what happens when all that debt gets defaulted on, paid back, or otherwise wiped out and spending accelerates? Velocity picks up and therefore inflation will too. Or, what if rather than giving money to the banks, the Fed in partnership with the Treasury finds a way to put a large amount of money directly in the hands of consumers? Velocity up, inflation up. Both of these scenarios have a decent chance of playing out going forward given the current set of circumstances. We'll keep an eye on the data and adjust accordingly.

Conclusion

In our opinion, the facts surrounding the economy and markets today suggest we are entering a deep recession, from which it could take years to recover, and stock markets are in the process of reflecting that. It would be very unusual for stocks and more speculative bonds to continue rising in price to new highs and beyond given the fundamentals we're facing and historical precedent against it. The rally over the last few weeks at this point still fits into the category of "bear market rally" complete with some of the largest daily percentage gains to be witnessed in a full cycle. A host of other markets including credit, foreign stocks, small cap stocks are still in clear downtrends while cyclically defensive sectors and asset classes are performing well and consistent with a "risk-off", decelerating growth environment. Will Fed intervention work? Only to the extent that it's perceived to work by market participants. Ultimately, the Fed can't do anything about 25 million people currently collecting unemployment benefits, nor can it clean up the balance sheets of highly indebted corporations. As the consequences of these two realities play out, our guess is that perception swings from Fed as savior to Fed as enabler.

Are we witnessing an unusually steep rally in the Nasdaq and S&P 500 given the dire economic circumstances? Yes, but why shouldn't we be. We're coming off the most expensive market in history, just witnessed one of the sharpest declines in history, and have the most overactive Federal Reserve and narrative-spinning financial community and media in history. We really shouldn't expect anything different.

Narrative is powerful and has its hand in just about everything these days. It's not always pernicious or destructive, but it can lead people down the wrong path if they're not able to discern the story and motives behind it from the facts. If only CNBC could find it within themselves to write the headline, "Markets shoot higher for no good reason at all", or to be fair, "Markets plummet for no good reason at all". This is probably truer and less harmful to investors than whatever narrative the story ends up getting wrapped in.

Getting bogged down wondering WHY things happen can keep us from pondering HOW they could. For example, knowing markets can bounce significantly during a bear market downtrend is more important than knowing why they do. Searching for answers can distract us from the very fact that they're normal and happen within every bear market. Surely, there can't be one correct explanation for a bear market rally since the circumstances present within every bear market are unique and different.

Why will stocks fall lower from here? Don't know exactly and it's really not important. How will they? Very easily. The gravity of the cycle, math, and excessive complacency and leverage. Assign whatever narrative you'd like. It's more important now than ever to stick to your process whatever that may be, think for yourself, and use common sense. For us this means sticking to our process which keeps us over-weighted in asset classes that tend to perform better through an economic slowdown. It means tuning out data sources and media outlets that are biased and harbingers of narrative. And finally, it means not over-complicating things. Markets near all-time most expensive levels, the sharpest economic contraction since the Great Depression, and more debt and leverage in the system than can be realistically paid back, all spells greater risk of loss in traditional investments than we'd care to be a part of. To us, this is as common as common sense can be. We'll change our tune when the facts change.