Economic & Market Outlook

Executive Summary

~ 2019 was one of the better years on record for stocks, and it also marked the end to a decade of strong returns for investors

~ Investor complacency appears to be on the rise, as evidenced by falling lending standards in the $1.2 trillion market for leveraged loans

~ Valuations for the majority of financial assets remain elevated

~ The prolonged outperformance of domestic equity markets, and more specifically US growth stocks, has led many investors to question the long-held role of portfolio diversification

Introduction

What a year it has been. In 2019, global bonds returned 6.8%. Bonds of the riskier variety, like high-yield corporates (credit risk) and long-dated zero-coupon Treasuries (interest rate risk), fared even better. But the good news doesn't stop there. Global equity markets returned 27.1%, placing 2019 in the top decile of all calendar years on record.

Writing the Market's Narrative

Entering 2019, some investors feared the US and global economies were on the verge of recession. US and Chinese trade negotiations appeared to be making little progress. Global trade activity had plummeted, and the US/global manufacturing sectors were already contracting. Likewise, the outlook for US earnings was decidedly weak.

Global stocks fell 17.4% from their peak in 2018, but have since rallied 29.7%

Source: Annandale, Bloomberg

Fortunately, the deterioration in economic activity never expanded past the industrial sectors of our economy. Unemployment levels, a backward-looking measure, remained at historic lows, and there were no signs the slowdown had hit consumer spending (a disproportionate contributor to US GDP). The Federal Reserve, fearing trade-policy and other matters posed a risk to the current economic expansion, began adopting a more accommodative policy stance. By year-end, the Federal Reserve had made three "insurance" cuts to the target Federal Funds rate, significantly easing financial conditions. Additionally, investors' fears that US/China trade negotiations would spiral out of control were alleviated in the second half of the year, when the Trump administration announced a "phase one" trade deal. Fears of a looming recession vanished, and investors across the globe witnessed a strong rally in risk assets.

A Word of Caution

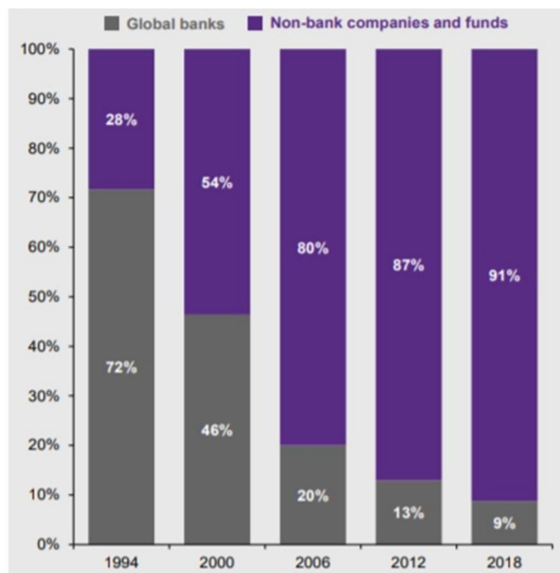
Before we proceed further, we must pass on a word of caution. The famed economist Hyman Minsky observed, *"success breeds a disregard of the possibility of failure,"* or in our more colloquial terms, everyone thinks they are a genius in a bull market. For US investors, stocks have had an incredible 10-year run, compounding at 13.5% per annum. It has also been a period of relative economic and financial tranquility. We are amid the longest expansion on record at 127 months, and as of year-end 2019, the unemployment rate sat at 3.5%, its lowest recorded level. Perhaps most importantly, the US economy has been awash in liquidity with interest rates at historically-low levels and the Federal Reserve pivoting to an accommodative stance. Our point is simple, the backdrop of the last year, and decade, has likely safeguarded investors from a multitude of blunders and provided investors with a false sense of security.

A Growing Sense of Complacency

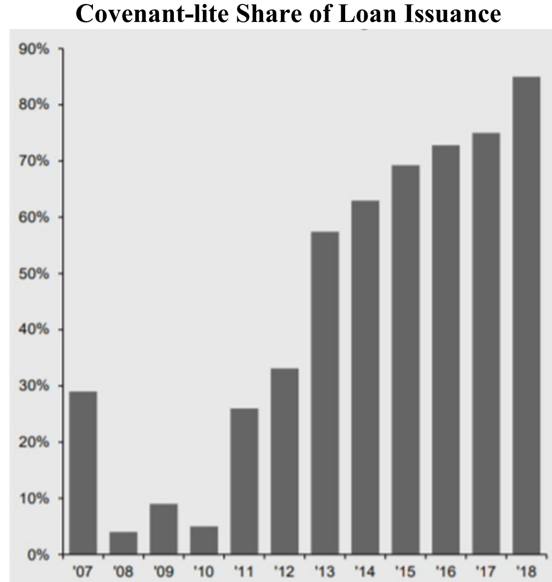
One of our worries is a growing sense of complacency in the markets, or worse yet, investors simply letting their guard down. A prime example can be found in the $1.2 trillion market for levered loans. Historically, banks dominated this lending market, providing loans to their customers secured by the company's underlying assets. All but the bank's best customers would have strict covenants, dictating a set of restrictions and obligations the borrower must heed. For example, a borrower would have to maintain a certain level of cash flow (EBITDA) relative to their overall borrowings (debt). Failure to comply with such a covenant would give power to the lender and might even result in the lender taking control of the borrower's assets. The covenants would outline other matters, like how much additional debt, a company may take on, and/or what collateral could be pledged to whom.

Fast forward to today, mostly due to regulatory reasons, banks have exited the levered loan market. Stepping in to fill that void has been alternative sources of capital, like BDCs and direct-lending funds. With global interest rates so low, direct lending funds (in particular), have found it easy to raise capital from yield-starved investors. Unfortunately, the ever-growing number of well-capitalized direct-lending funds means a disproportionate amount of negotiating power resides with the borrower. As a result, the covenants of the past have largely disappeared. Last year, 87% of all levered loans issued were covenant-lite, meaning they lacked basic lender protections. When protections do exist, the language is typically very weak. For example, many lenders are allowing borrowers to include cost savings the borrower "expects" to achieve in the future in their calculations of cash flow. The list of anecdotes is too long to cover in this commentary, but suffice it to say, lending standards are far worse than in past cycles.

Non-bank Share of Loan Market



Covenant-lite Share of Loan Issuance



Source: JP Morgan

Most investors are naïve to this reality. They haven't had to think about matters like credit covenants, because it has been over a decade since the last default cycle. Instead, they are blinded by the above-market yields direct lending provides (roughly 10.0% per JP Morgan data). When the next credit cycle does occur, we wouldn't be surprised if the average direct-lending fund exhibited equity-like risk or greater, with significant impairment of capital.

Valuations: Another Cause for Concern

Another reason we would caution investors is we believe individuals are being conditioned to overpay for assets. At Annandale, we have always said that forecasting future investment returns is difficult, but if there is one variable that has long-term explanatory power, it would be valuations. This should be common sense, but let's run through the basic principles. Any investment's value is a function of its future cash flows. This is a fact.

Let's consider the value of a money tree that lives for five years. In year one, that tree will grow ten $1 bills. Each year thereafter, it will sprout an additional dollar, such that it generates $11 in year two, $12 in year three… and $14 in its final year. How much would you pay for such a tree. The answer to that question depends on your required rate of return. If you wanted to earn 5.0% you would pay $51.5, but if you wanted to earn 10.0% you would only pay $44.8. We are just trying to stress the simple truth, that the less you pay for a series of cash flows, the greater your prospective return. The opposite is also true, the more you pay, the lower your return.

One difficulty in our industry is that except for safer bonds, it is difficult to estimate what future cash flows will look like. Going back to our previous example, assume we had paid $51.5 for that tree, so that we could generate a 5% rate-of-return. Unfortunately, the tree became diseased and in year five it didn't produce a harvest of dollar bills. Due to this unfortunate event, your rate-of-return fell to negative 4.2%. In the real world, we must account for this uncertainty, and the best way to do so is to pay less for an asset. Conversely, when assets are richly valued, investors are afforded very little margin of error in their calculations.

We won't harp on this too much, but today it is more difficult to find assets trading at discounted valuations. The safest assets, Treasuries, mortgage bonds, and higher-quality corporates offer yields ranging from 1.5% to 2.9%. Riskier bonds, such as high-yield corporates and/or levered loans, yield 5.1% and 6.1% respectively. Private equity is paying the highest valuations on record for buyouts. Quality Class A real estate assets are in a similar position. Per CBRE, Class A apartments within the Dallas city limits are transacting, on average, at a 4.75% capitalization rate. As you can see in the table below, US equities look expensive relative to history on almost every metric, unless you compare them to the historically-depressed interest rates that exist today. We aren't in the bubble territory of the late 1990's, but asset classes whose valuations offer a margin of safety are few and far between. Simply put, investors can't afford to be wrong about their explicit or implicit forecasts of future cash flows.

Various Measures of US Equity Valuations

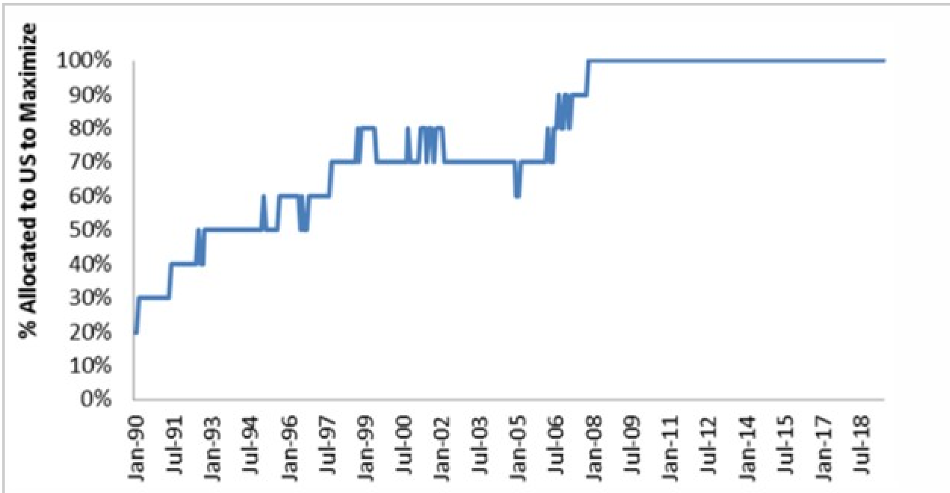
Valuation metric	Current reading	Analysis
Fed Model	-64.8%	Inexpensive
Equity risk premium (10-year Treasury yield)	3.4%	Inexpensive
Equity risk premium (Baa corporate bond yield)	1.0%	Inexpensive
Rule of 20	20.2	Fairly valued
Tobin's Q	1.27	Mildly expensive
S&P 500 trailing P/E	20.7	Expensive
S&P 500 forward P/E	18.3	Expensive
S&P 500 price/book value ratio	3.61	Expensive
S&P 500 5-year normalized P/E	26.7	Expensive
S&P 500 dividend yield	1.8%	Expensive
Shiller's CAPE (cyclically-adjusted P/E)	31.4	Expensive
S&P 500 price/cash flow	15.1	Very expensive
Market cap/GNP	138.4%	Very expensive

Source: Charles Schwab

The Death of Diversification

Another side effect of this bull market is it has called into question many investing norms, some of ours included. Two months ago, we were startled to find an article on the CFA Institute's website claiming international diversification had lost its efficacy. In his essay, the author published the following chart showing the percentage of US stocks an investor should hold to optimize a portfolio's risk-adjusted returns (i.e. returns divided by volatility).

Percent of Global Equity Portfolio Allocated to US Equities to Maximize Risk-Adjusted Returns, Rolling 20-Year Data

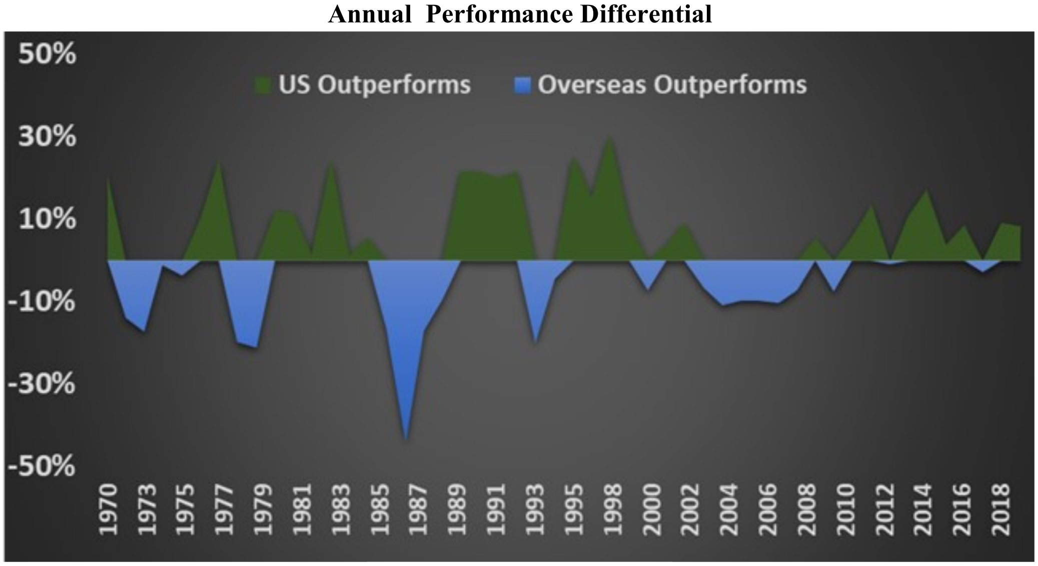


Source: CFA Institute, Ford Donohue

The author pointed out that since the financial crisis, overseas diversification had failed to add any value, and to be fair that is mostly true. He then made the very bold conclusion that this trend will continue, but provided no rationale as to why other than our recent experience. As we began to think about his paper more critically, we discovered it was a product of recency bias coupled with sampling error.

The graphic advocating 100% US equities is mostly just a reflection of strong US outperformance in the late 90's and this past decade. By utilizing a 20-year lookback window, the author ensures roughly 80% of his observations overlap with the very best period for US stocks relative to overseas equities. Had he used a shorter lookback window, like rolling 3 or 5-years instead of 20-years, you would find the percentage allocated to US stocks would fluctuate more wildly. In the chart below, we illustrate the annual return differential between US and overseas stocks. As you can see, there is no clear pattern to the data. Sometimes US stocks outperform, as has been the case for much of the past decade, and sometimes overseas stocks outperform.

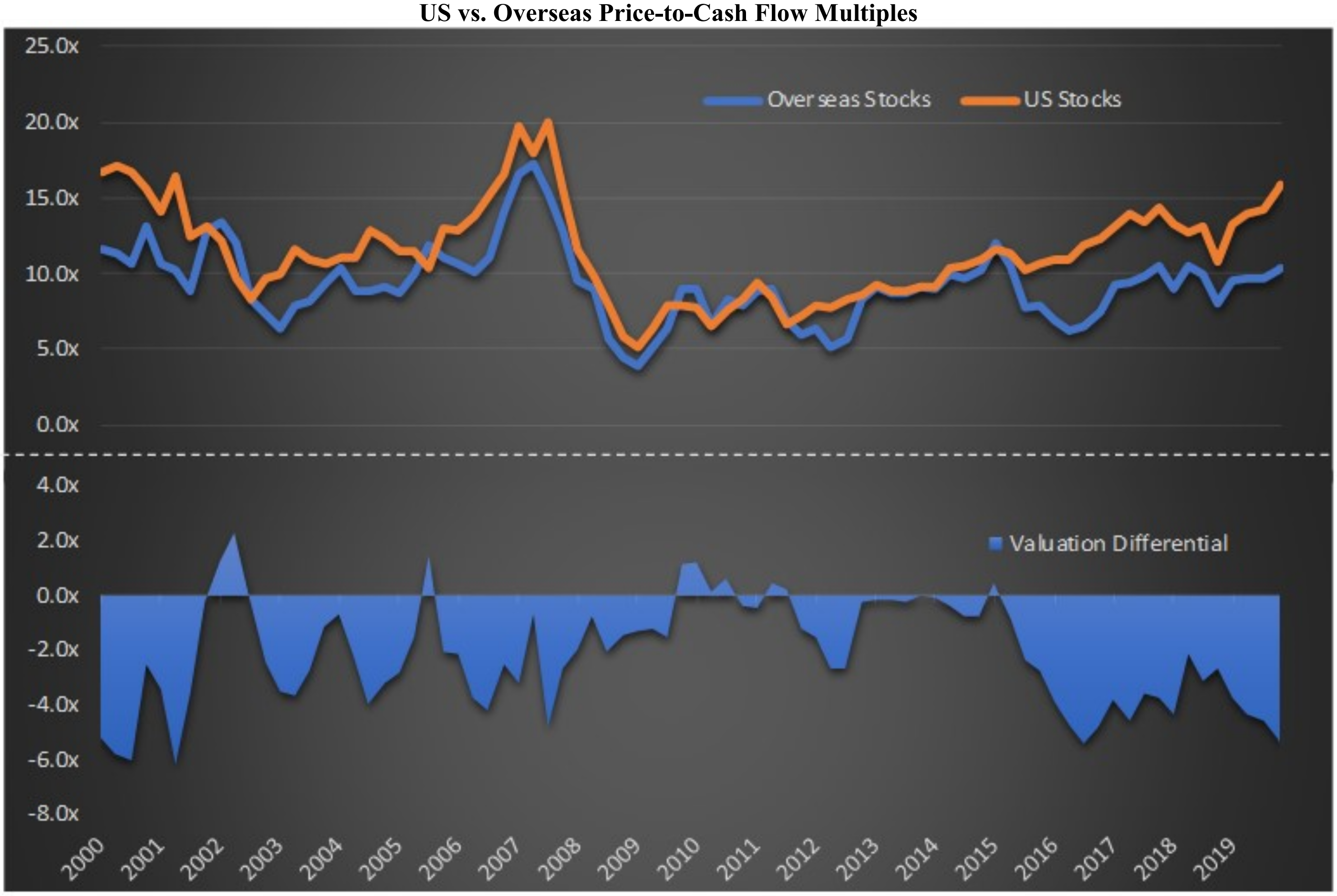
Annual Performance Differential



Source: Annandale, Bloomberg

As a matter of principle, we always strive to maintain global diversification within our equity portfolios. For us to break that rule would require extreme circumstances, and even then, it is unlikely we would eliminate overseas stocks from our investment mix. We certainly aren't advocating change now, given overseas stocks carry the largest valuation disconnect since the turn of the century.

US vs. Overseas Price-to-Cash Flow Multiples



Source: Annandale, Bloomberg

The Death of Value

An even more widely-discussed topic has been the death of so called "value" stocks. Stock indices are commonly split into two groupings: value and growth. In general, value stocks represent the less expensive half of an index and growth stocks represent the more expensive half. Historically, value stocks have outperformed growth stocks. In fact, the relationship is so well documented that many investors, Annandale included, believe in the existence of a value premium. We share a view that over time, value stocks will outperform growth stocks for systematic reasons.

Unfortunately, this has not been the case for several years. Within the US, value stocks have returned a healthy 11.7% per annum, but that pales in comparison to growth stocks at 15.1% a year over the last decade. What's more is the underperformance of value has occurred not just within US markets, but also across European and Asian equity markets.

Trailing Returns as of 2019

	Value	Growth	+/-
1-year	26.2%	36.2%	-10.0%
3-year	9.6%	20.4%	-10.8%
7-year	12.1%	16.8%	-4.7%
10-year	11.7%	15.1%	-3.5%
15-year	11.5%	16.0%	-4.5%

Source: Annandale, Bloomberg

Given this backdrop, we can understand why some investors have lost faith in value stocks. We even think the anti-value camp makes some fair points, calling the index-based measures of value (like price-to-book) dated. That said, our dominant view is the value premium still exists, and we take issue with how critics have framed this debate. Since 1928, value stocks have outperformed growth stocks by an average of 4.7% in any given calendar year. Furthermore, they have outperformed in 56 of the 91 calendar years on record.

We should also add the narrative that value is dead has been heard many times in the past. There are many documented instances of value stocks underperforming growth stocks, such as the late 30s, early 70s, late 80s, and late 90s. In each instance, the value premium subsequently reemerged. Anecdotally, we would point out that value's underperformance in the late 90's was far worse than what we are experiencing today, but had you abandoned value stocks, your portfolio would have drastically underperformed on a go forward basis.

Trailing Returns as of 2000

	Value	Growth	+/-
1-year	7.3%	33.0%	-25.7%
3-year	18.6%	33.9%	-15.3%
7-year	17.0%	22.3%	-5.3%
10-year	13.2%	18.9%	-5.7%
15-year	20.8%	28.4%	-7.6%

Future Returns as of 2000

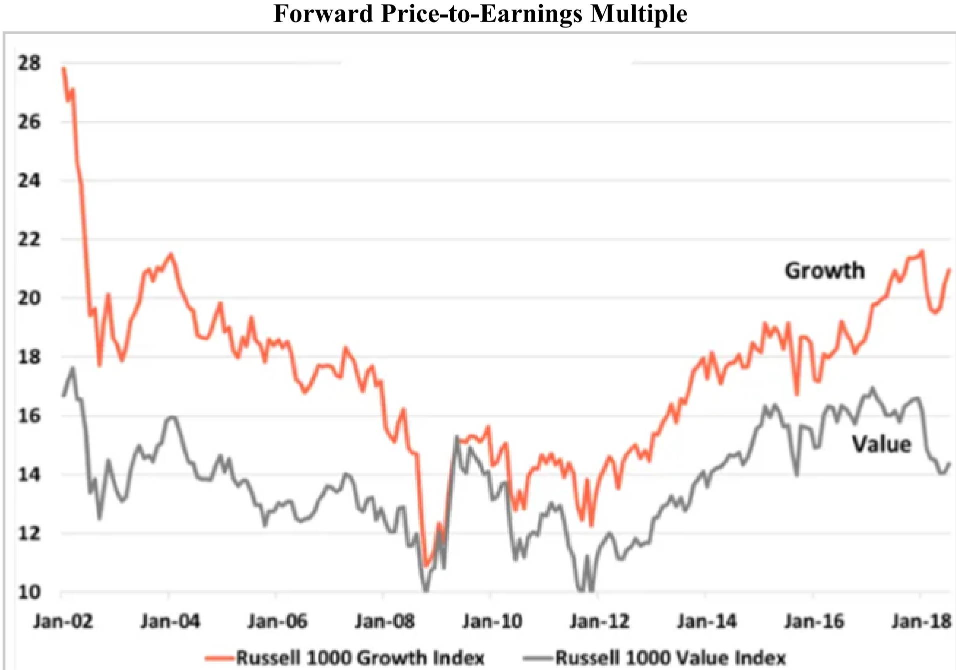
	Value	Growth	+/-
1-year	7.2%	-22.3%	29.6%
3-year	-5.0%	-23.6%	18.6%
7-year	7.7%	-4.9%	12.6%
10-year	2.4%	-4.0%	6.4%
15-year	6.5%	2.2%	4.4%

Source: Annandale, Bloomberg

More important than statistics, is the reason for the value premium's existence. One would think that, on average, growth stocks exhibit faster profit growth than value stocks, but this isn't entirely true. Multiple academic studies have found there is no discernable difference in the long-term economic profile of growth and value stocks. It is only over very short time horizons that growth stocks achieve a higher growth rate. Additionally, investors tend to pay a premium for companies who have performed well in the past (i.e. have a history of above-average growth). As a result, the cohort of growth stocks tends to by systematically overvalued, and the cohort of value stocks systematically undervalued.

On a side note, growth's most recent run began in 2009, coming out of the financial crisis. It is worth noting that 2009 is one of the few periods on record where the two groupings carried similar valuations. In other words, growth stocks were not systematically overvalued in 2009, which in part explains the recent past. Today, value stocks trade at a sizeable and growing discount to their growth peers, like they did in the late 90's.

Forward Price-to-Earnings Multiple



Source: CFA Institute, Gautam Dhingra

Conclusion

Only time will tell what 2020 and the decade ahead brings, but rest assured, the next ten years will look different than the past ten. During this period, our commitment to you is to remain steadfast in our investment process. When complacency is high, we will tighten, not loosen, our underwriting standards. When overvaluation is pervasive, we will look longer and harder for acceptable investments. Basic tenants of investing, like portfolio diversification, will always remain part of our process no matter how uncomfortable the present circumstances feel.

We remain grateful for the opportunity to protect and grow your capital. Please reach out to us should you have any questions or concerns.