Economic & Market Outlook

Executive Summary

~ In 2020, financial markets looked past the economic damage brought about by COVID-19, delivering attractive returns for risk assets.

~ Equity valuations continue to climb, and relative to history, are elevated. That said, the range of valuations is as wide as it has been in decades, leaving ample opportunity.

~ Newer startups, particularly within the electric vehicle space, trade at valuations that are almost impossible to justify.

~ A heavier emphasis on fiscal policy, rather than monetary policy, appears to be in the works as Democrats take control of Washington D.C. This, among other matters, has many investors wondering if inflation is around the corner.

Introduction

2020 was a year of hardships for our country and the world. Over 400,000 Americans have died along with many multiples of that outside of the US. Daily lives have been upended, and severe economic damage has been imparted. At the trough, over 22 million Americans lost their jobs, 14.8% of the US labor force. To make matters worse, the job losses disproportionately impacted already low wage earners; think maids who clean hotels and offices or line cooks and waiters at your local restaurant.

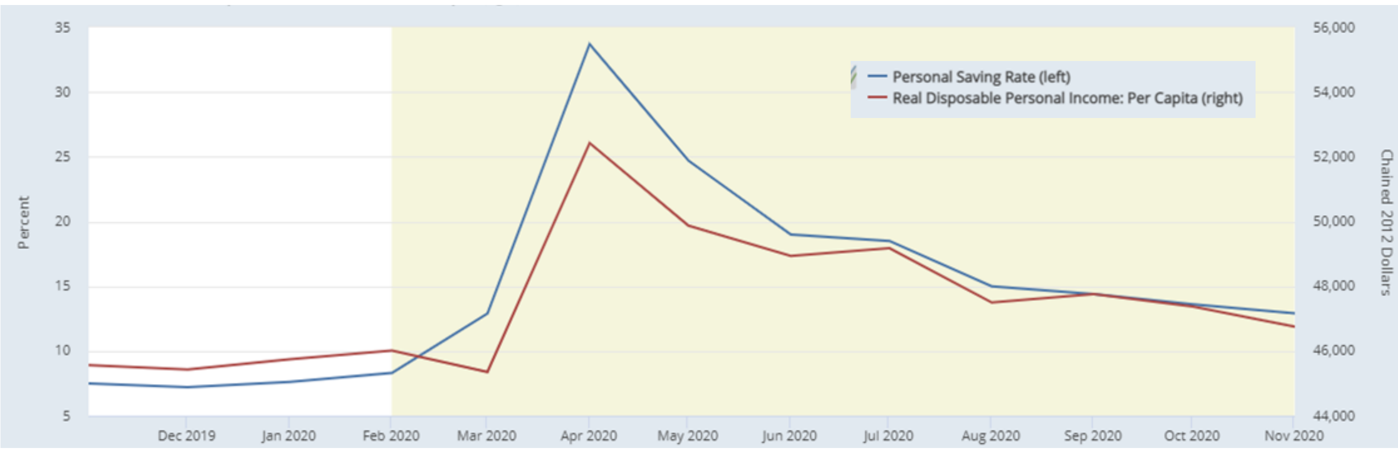
Job Losses Have Disproportionately Hit Lower Wage Earners

Source: Opportunity Insights, BLS, CNBC

The good news is many of the pains and hardships created by COVID-19 will pass. Our economy has already begun the process of recovering. Of the +22 million jobs lost, over 12 million jobs have been recovered. Strategists across Wall Street are optimistic economic growth will accelerate in the back half of 2021 as vaccines become widely available.

There is ample, pent-up demand in our economy, and to boot, consumer balance sheets are healthy. We still find this hard to believe, but real per capita, disposable income has increased 1.6% since February. Said differently, thanks to stimulus checks and enhanced unemployment subsidies, average income levels in the US grew during the pandemic. With businesses closed, individuals had few places to spend that money, which led to a massive jump in personal savings rates. Recently, Congress authorized another round of stimulus, totaling $908 billion (not yet reflected in the following chart). When our economy reopens, the excess savings created by two rounds of stimulus checks and unemployment subsidies should translate into even greater levels of spending.

Per Capita Income and Savings Increased During the Pandemic



Source: Federal Reserve

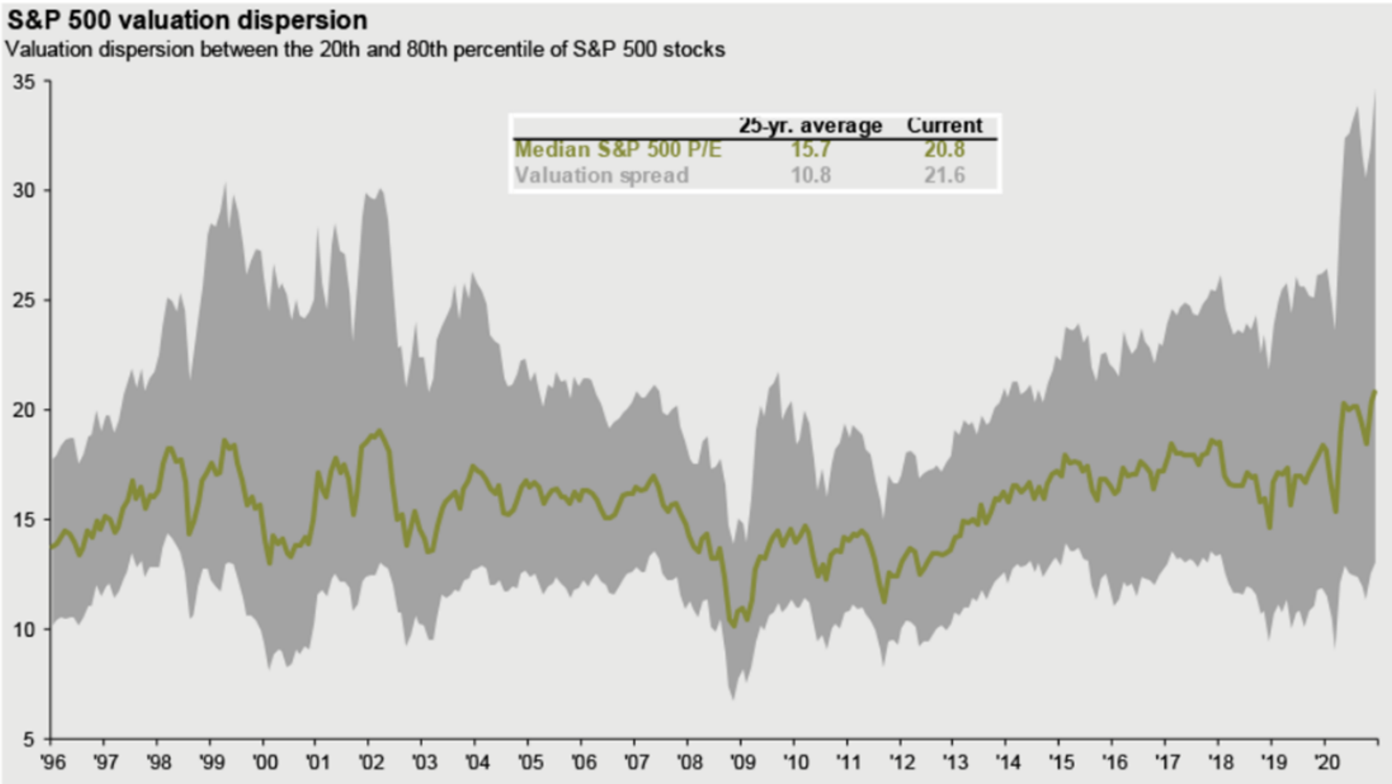
Correspondingly, consensus earnings expectations for the S&P 500 have steadily improved. Analysts now forecast the S&P 500 will generate $164 per share of operating earnings in 2021 and $192 per share in 2022. For perspective, S&P earnings stood at $157 per share in 2019. If analysts are right and we achieve their 2022 estimates, earnings will have grown at a 6.9% annual rate over the past three years despite a global pandemic. Pretty impressive.

The Catch

Here's the rub. Market prices reflect a lot of the good news we just discussed. It took a mere 99 days for the market to recoup its COVID-19 induced losses. By year end, global equity markets had posted 16.8% returns. Think about that for a second. In the same year as a global pandemic, stocks went gangbusters.

As a result, the average US stock is more expensive today than it was before the pandemic. Imagine the earnings picture had COVID-19 never existed. Before COVID, the S&P 500 was projected to earn $171 in 2020 operating earnings. Had that forecast played out, the S&P 500 would still be trading at 22.0x operating earnings, 6.8% higher than its prior-year valuation. That said, confining our discussion of the equity market to a single multiple can be misleading. It is best to think of stocks along a spectrum. At any given time, some stocks are overpriced and some underpriced relative to their intrinsic value, which is the present value of their future free cash flows. It is also important to note this spectrum changes with time. Valuations for the distribution can skew rich (1999) or inexpensive (2009), and the distribution itself could be wide (1999) or it could be clustered (2009). The shorter way of saying all of this is, it is a market of stocks more than it is a stock market.

Stock Valuations Skew Expensive, but Dispersion is High

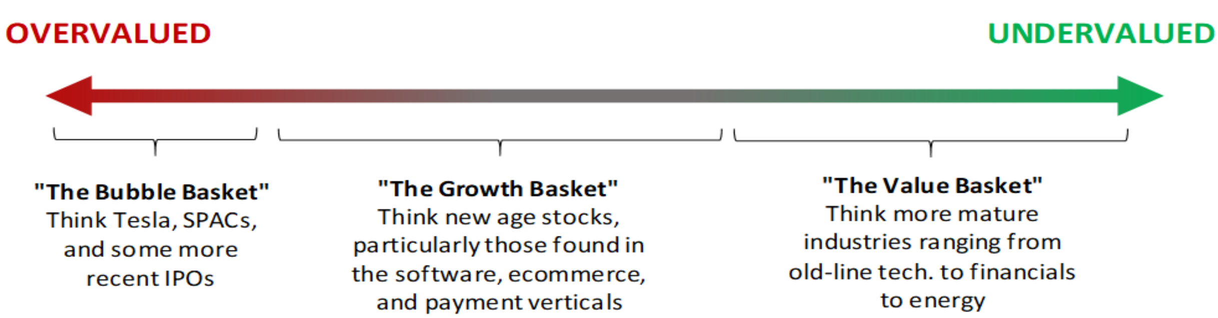


Source: JP Morgan

Today's valuation spectrum carries many similarities to what we witnessed in the late 1990s (see the chart above). First, the median stock skews expensive relative to history. As we previously mentioned, had we hit pre-pandemic earnings estimates, the S&P would have traded at 22.0x 2020 estimates. Per JP Morgan, the median stock in the S&P 500 trades at 20.8x forward earnings estimates, a historical record. Whether or not these headline statistics are justified we will save for another conversation, but we do think it is reasonable to say – valuations skew expensive. The other similarity to 1999 is the dispersion in valuations is large. Again, using JP Morgan's forward earnings estimates we can see that the difference between the most expensive 20% of stocks and the cheapest 20% of stocks is rarely this wide.

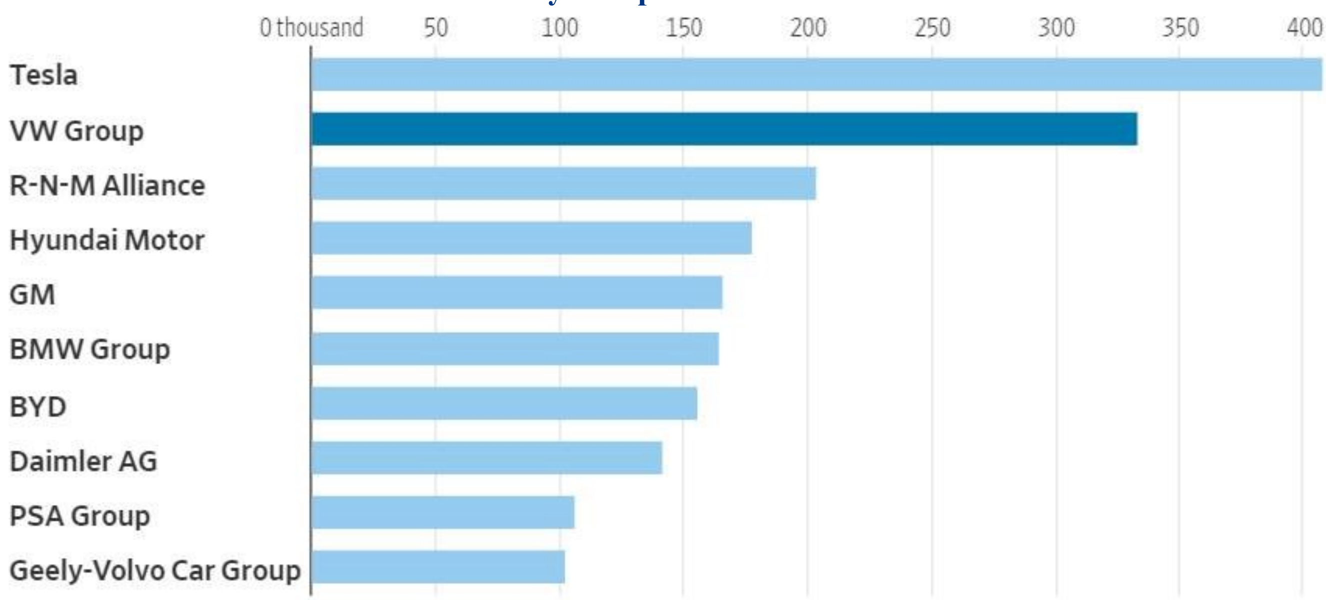
Contextualizing the Stock Market

To better help you understand the dispersion in market valuations, we grouped the market into three baskets and plotted them along a valuation continuum, below. This exercise grossly oversimplifies matters, but the anecdotes that follow will hopefully give you more context for where various equities trade and what Wall Street expects of them.



The first grouping is the bubble basket, and it is analogous to the truly outrageous events of the late 90s, think pets.com. The underlying investor base is mostly retail, cares little about valuing cash flows, and is simply betting on continued price momentum. The poster child for this segment is Tesla, whose capitalization began 2019 at $76 billion and today sits over $800 billion, making it the 5th largest company in the US. We cite Tesla as an example of a bubble stock because no matter how hard you try, it is virtually impossible to justify its valuation on the basis of future cash flows. In the last 12-months, Tesla has generated $556 million in net income, implying the company trades at 1,438x trailing earnings. If you back out the impact of tax credits, Tesla's income would fall to approximately negative $750 million. We cannot help but notice the lengths investment banks are going to justify Tesla's ever-growing stock price. Credit Suisse recently published a report in which they assumed Tesla had a negative cost of equity. In other words, Credit Suisse assumed equity investors expected a negative return on their investment, which in turn gave Tesla a financing advantage in their model. Morgan Stanley recently published a report where they argued Tesla's insurance segment is worth more than Allstate even though Tesla insurance barely exists. To be clear, the bubble basket extends beyond Tesla, but for us, it is the poster child for the speculative mania that exists today.

Tesla's Key Competition is Close Behind

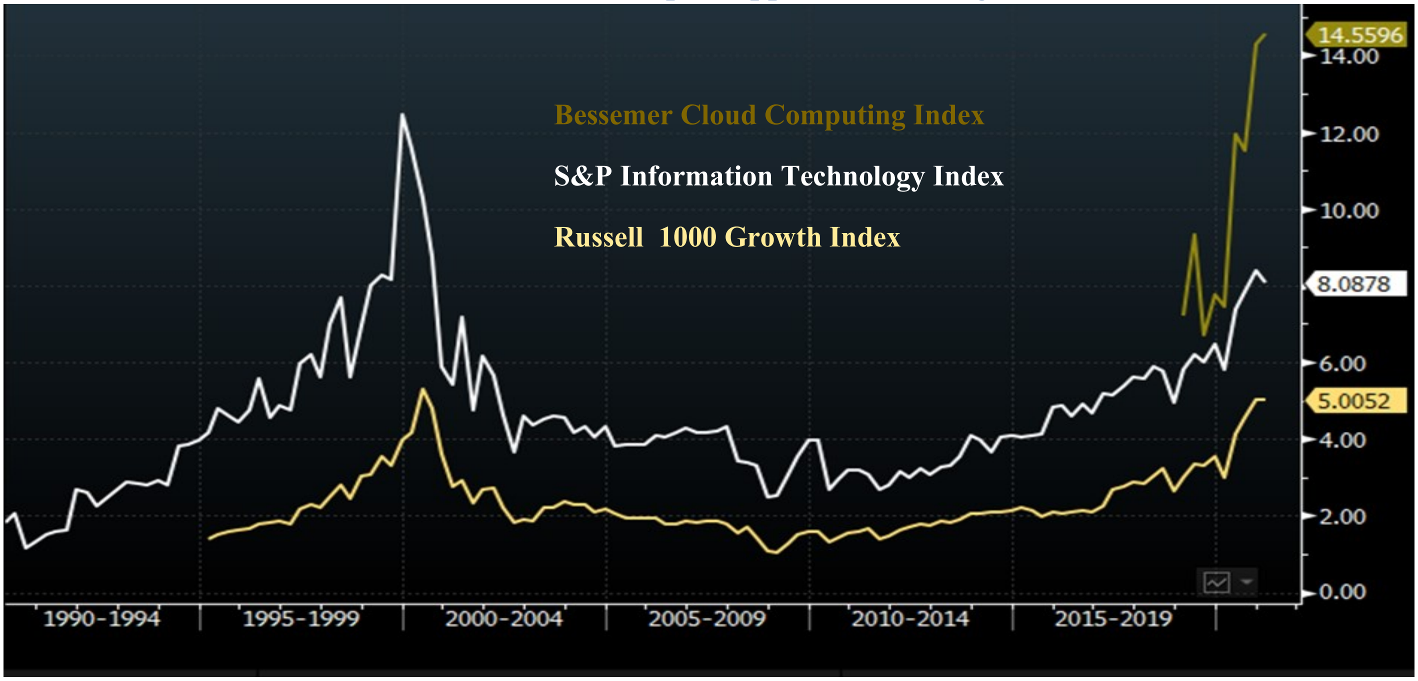


Source: Wall Street Journal

The second grouping we have termed as the growth basket. The underlying businesses within this segment have the potential to become market leaders (think emerging cloud companies) or already are (think Amazon, Microsoft, and Apple). This basket is far more defensible than Tesla or other bubble constituents, but justifying their valuations still requires optimistic thinking and distant projections. Statistically, the more egregious valuations within this basket can be found amongst various software upstarts. For instance, the Bessemer Cloud Computing Index trades at an eye-popping 14.6x sales. In aggregate, the constituents of the index do not generate a profit, but that is partially by design. Large portions of their revenues are funneled into research and sales to fuel future revenue growth. Last year, the index saw its members grow aggregate revenues by 25.6%. Furthermore, we have examples of what the economics of mature software businesses can look like if successful. Ansys, a mature software company that dominates the market for engineering simulation software, regularly generates net profit margins above 30.0%. Adobe, a company you surely have heard of, is forecasted to post net profit margins in the ballpark of 35.0%. We say this to point out that when these businesses scale, they can be wildly profitable. The problem is the market is valuing every software business as the next Adobe or Ansys, but not all these companies will achieve that level of scale and success.

Put it this way, the Bessemer Cloud Index trades at 23.4x 2025 earnings if it can maintain 25.6% annual growth for the next five years straight and hit a 20.0% profit margin at the same time. Some of its constituents will crush these hurdles, but most will not. We highlight this example because it is emblematic of the pricing we see in the higher quality and higher growth segments of the market.

Price-to-Sales Multiples Approach New Highs

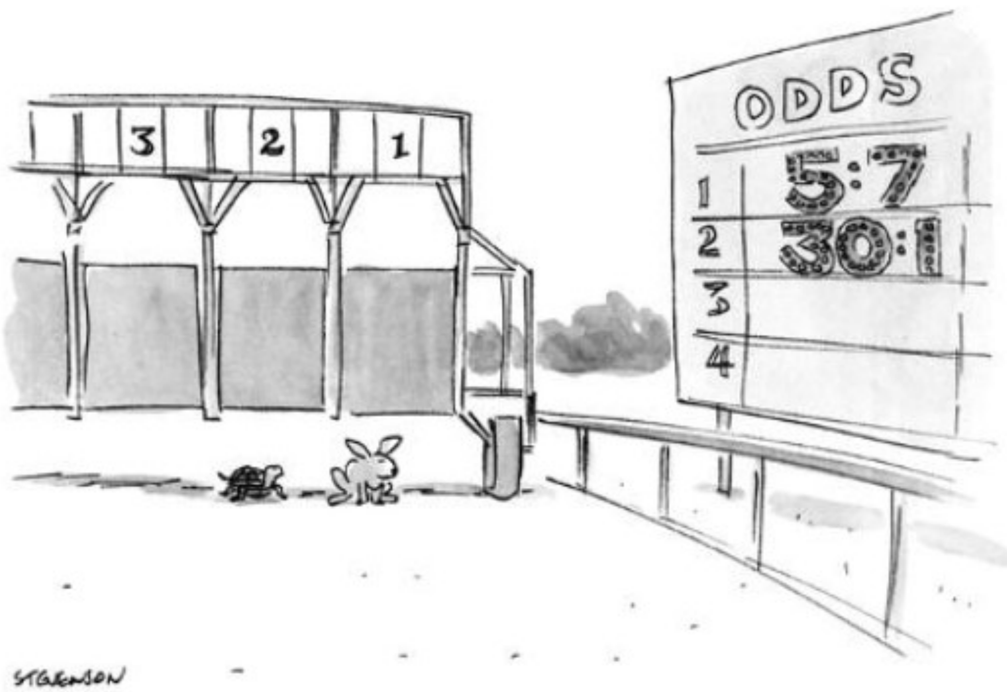


Source: Bloomberg

The final group we have termed as the value basket. Within this basket, you are unlikely to find the next Amazon. You are most likely to find cyclical stocks within the banking, insurance, industrial, and energy sector. On average, these stocks have lower long-term revenue growth prospects than the previous bucket, and they are of slightly lesser quality. That said, the valuations within this bucket reflect a gloomy future. Consider the banking sector, investors are reluctant to hold banks, because the interest rate environment has hampered profitability and they fear COVID will lead to large markdowns in bank loan portfolios. We agree that these concerns are valid but would argue these concerns are already reflected in security prices. At roughly 1.0x book value and 13.8x 2021 earnings, banks are pricing in a bleak future. Regarding their loan portfolios, banks were very aggressive in reserving for bad loans in the first half of 2020. In fact their loan loss provisions were on par with those made during the global financial crisis. There is even an outside chance banks were too aggressive in reserving for future losses, and regulators will allow them to release a portion of their reserves. We would also note that in the past few months the yield curve has steepened, which is good for bank profitability. Despite these positive tailwinds, banks are priced as if they will generate low, single-digit returns on equity into perpetuity, a hurdle they surpassed as recently as 2017 and 2018. A similar argument can be made for the midstream industry. One of the pipeline indices we follow trades at roughly 5.0x operating cash flow. If you assume one-fifth of this cash flow must be reinvested to maintain pipeline infrastructure you are left with an asset trading at 6.0x free cash flow. Said differently, after reinvesting back into the business, pipeline companies are trading at a 16.7% free cash flow yield. These are unencumbered dollars management could potentially return to shareholders in the form of a buyback or dividend. To be clear, we expect these cash flows will decline over time, but at this entry valuation, the market has left the sector for dead.

Horse Racing

Before wrapping up our discussion of the three baskets we need to digress into the topic of horse racing. The betting that occurs at horse races is known as pari-mutuel betting, meaning that the wagers go into a pot and are shared equally among the winners. What makes this form of betting unique is the actions of other gamblers influence everyone else's odds. The stock market is very similar in this respect. That is, the more individuals pile into an asset (bidding up prices), the lower its prospective return. If there are 101 betters at the racetrack, each wagering one dollar, and 100 of them bet on the same horse, then their prospective profit is only a penny. However, the lone individual who went against the consensus stands to profit one hundred dollars per dollar wagered. At present, it feels like most of the market has put their wagers on bubble and growth stocks. We understand and sympathize with the market's wager on growth stocks, because the fundamental business metrics are outstanding. That said, the current fundamentals for value stocks aren't too shabby and nobody is wagering on them. As Michael Maubossin once wrote, "perhaps the single greatest error in the investment business is the failure to distinguish between the knowledge of a company's fundamentals and the expectations implied by the market price."



Soothsayer vs. the Investor

The hardest part of our business is timing. When will the Tesla bubble pop? Our answer, no one knows. When will interest rates rise? Same answer. When will the market fall? We don't know. I know it is difficult to hear this, but such market soothsayers do not exist. If you find one, we can assure you their track record is either statistically insignificant or they are a huckster (most likely selling a newsletter). This begs the question, then what do you pay Annandale for? Going back to the horse analogy, our job is to carefully build a portfolio of investments given an uncertain future. We cannot predict the future, but we can estimate the market's expectations for differing assets, and by doing so, create informed opinions about an investment's prospective risk and reward. Rather than predict what the market might offer, we react to what it does offer.

Our recent history within the fixed income market serves as a great case study. To be a perfect fixed income investor you need to know two variables, that is where interest rates and credit spreads are going. Unfortunately, forecasting the direction of interest rates or credit spreads is virtually impossible, so we don't try. Rather, we constantly survey the fixed income markets and ask, where is the market compensating us for risk?

Entering 2020, our fixed income portfolio was positioned very defensively, because the market was not paying us adequate compensation to take either credit or interest rate risk. On the credit side, corporate bonds paid approximately 1.0% over Treasuries, and even less relative to safe, mortgage-backed securities. On the interest rate side of the equation, the yield curve was flat, meaning longer-dated bonds offered the same yields as shorter-dated bonds. For this reason, we also made the conscious decision to shorten the duration of our portfolio and minimize interest rate risk. When COVID-19 hit, the 10-year Treasury plummeted from roughly 1.6% to 0.5%, rewarding investors who had taken on interest rate risk, which we had not. The other impact of COVID was credit spreads blew out. Corporate bonds went from paying 1.0% over Treasuries to 3.0% by March 31st. Our decision to avoid credit risk has proven beneficial, but it was not enough to compensate for being on the wrong side of the move in interest rates. As we always do after big market moves, we revaluated the fixed income markets looking for where we might be compensated for taking risk. We concluded the market still was not paying fair compensation for interest rate risk, but the opportunity to take on credit risk had improved, leading us to add more corporate bond exposure. By year-end, our fixed income portfolios had delivered roughly the same return as the aggregate bond index but had done so with far less risk. All we had to do was respond to the opportunities the markets offered.

Fixed Income Markets at Present

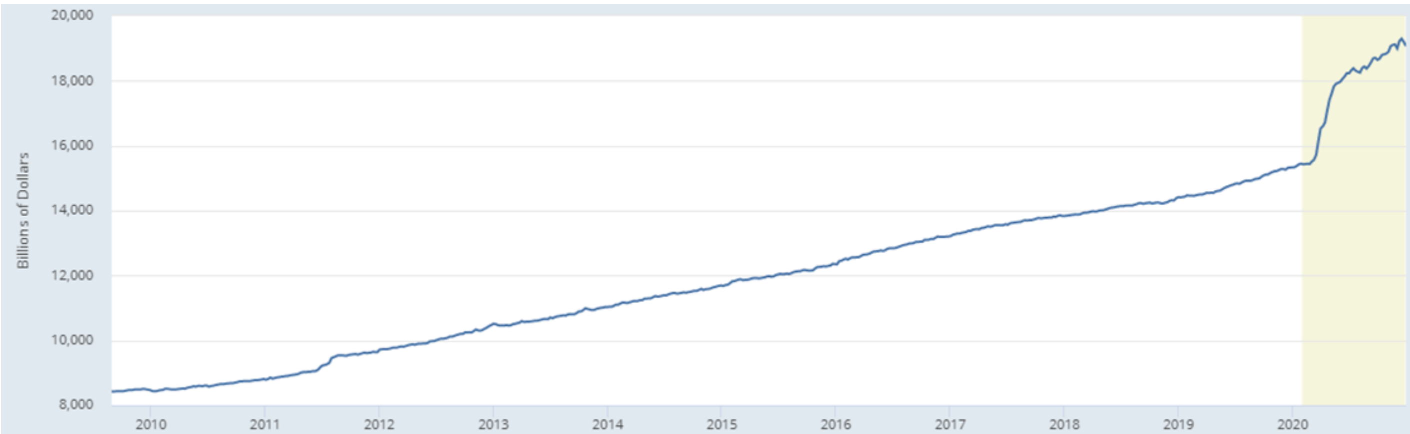
Surveying the fixed income markets today is illuminating. Corporate bonds are once again paying a mere 1.0% over equivalent Treasuries, which speaks to the ebullience in the market. As a result, there is a decent probability we cut back our corporate exposure even though it was added less than a year ago. Short-term bond yields are anchored near zero, while longer-term bond yields continue their march to pre-COVID levels. This is causing the yield curve to steepen, which we welcome. That said, we would need to see an increase in the absolute level of rates across the curve, in addition, to further steepening before we would feel adequately compensated for taking on incremental interest rate risk.

Fed Chair Powell Warns Of 'Exuberant' Spending And Price Spikes After Pandemic But Isn't Worried About Long-Term Inflation

Source: Bloomberg as of 1/4/21

There is also a growing body of investors who believe inflation is around the corner, and it is beginning to show up in market data. An inflationary shock, of any size, would change the market's attitude towards compensating interest rate risk. The emergence of inflation indicators is also interesting because their arrival might represent a regime change for the markets. For over a decade, central banks have tried to stoke inflation, but despite their best efforts have had zero success. So, what might have changed the market's attitude? We can only speculate, but would argue it's twofold. First, we are hopefully in the back half of the recession and pandemic. Expectations for increased consumer spending once the economy reopens are high, and businesses are will need to replenish inventories. The stimulus checks that have aided savings will hopefully turbocharge matters. Second, policymakers at the Federal Reserve and in Congress are quickly warming up to the idea of using fiscal policy as their primary tool. We would point you to our previous commentary for a deeper discussion of the topic, but the combination of greater money supply and velocity leads to monetary inflation. Central banks are dependent on bank lending to grow the money supply, one of the critical ingredients for inflation. Fiscal policy, however, can inject money directly into the bank accounts of individuals and corporations, see the two most recent stimulus packages, bypassing a critical step. The million-dollar question remains though, can we successfully stimulate money velocity?

M2 Money Supply Explodes



Source: Federal Reserve

Conclusion

At Annandale, we have lots of opinions about the future. We likely share the consensus view that economic growth should be strong in the back half of 2021, assuming mass vaccination can take place. We would argue that said growth bump, should disproportionately benefit cyclical sectors of our economy, like the refinery who is suffering because too few cars are on the streets. We also think many businesses who benefited from COVID will see a temporary reduction or deceleration in revenues. For example, how many individuals tackled home improvement projects during the quarantine and shopped at Home Depot or Lowes for materials? We expect the boost in Home Depot's sales to be transitory, and matters will normalize once the virus has passed. We believe the shift to fiscal policy is a big change and given our new government, its use may become a mainstay. We have lots of forward-looking views, and these views undoubtedly influence our portfolios. That said, we are far more sensitive to the market's expectations than to our forecasts. Simply put, you do not get paid for being right if the market shares your view. Instead, we are constantly asking what risks are we being compensated to take and why? It is also worth adding that identifying great risk-reward tradeoffs is difficult but acting on them is even harder. Adding credit risk during the pandemic did not feel right, nor did our decision to rebalance equity portfolios in March. Sometimes our decisions don't pay off, like avoiding interest rate risk in 2020, but as the famed poker player, Annie Duke wrote, "what makes a decision great is not that it has a great outcome. A great decision is the result of a good process, and that process must include an attempt to accurately represent our own state of knowledge."

Thanks for the trust you have placed in us. We look forward to 2021 and hope is a fruitful year for you and your family.