PCM
PEAK CAPITAL MANAGEMENT

The Donald vs. Greta: Reflections from Davos

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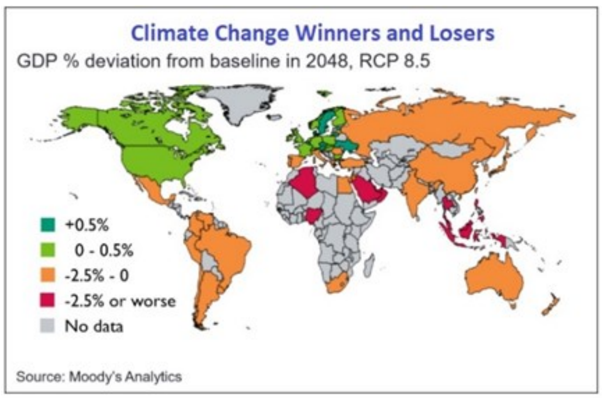
The World Economic Forum recently completed its 50th annual meeting in Davos as global business and political leaders gathered to discuss the challenges and opportunities they see in the coming year. Donald Trump and Greta Thunberg emerged as the two stars of the event. Trump drew massive crowds at each presentation while the 17-year old Swedish climate activist, and Time Magazine 2019 Person of the Year, commanded the attention of the media. Having participated in the WEF in the past, there are some key takeaways from this year's gathering, but before delving into those I want to touch briefly on what I see as the greatest risk to global economic expansion we have faced since the Great Recession.

In his book titled, "The Wealth of Nations" Adam Smith proffered a concept known as the Invisible Hand, an unobservable market force that helps supply and demand in a free market economy achieve equilibrium. This is widely accepted today but many do not understand how fragile this equilibrium is. Too much demand and the economy overheats (think of surge pricing from Uber) and Central Banks are forced to step on economic brakes to avoid devastating inflation. Too little demand and contraction occurs leading to recessions.



Source: Moody's Analytics

The coronavirus, originating from Wuhan, China, has the potential to unsettle the fragile equilibrium in the global economy with disastrous effects. The virus, originally spread from contact with snakes, is now being transmitted from human to human in a SARs-type fashion like the epidemic that happened in the early 2000's. While it appears world and national health organizations have been quick to address the risks and an astonishing 56 million people have already been quarantined, the economic damage may already be done.

> **Gone are the days where crowds overflow small venues in Davos to hear about cryptocurrency and ICOs (initial coin offerings), as "BigTech" is increasingly seen as the enemy of progress.**

As a very small example, I had planned to travel to Hong Kong in early March for a historic wine auction that business partners of mine are sponsoring, but have canceled that trip. The economic impact of lost travel for airlines, taxis, restaurants, hotels, etc. when multiplied by the number of people who will change plans because of the outbreak, can become an economic Tipping Point as brilliantly described by Malcolm Gladwell. Some people, out of fear or because of compromised health, will alter plans to go out to eat or go to a movie to avoid potentially being exposed. If not contained or a vaccine created soon, this could be the "off the radar" event that disrupts the global economy.

Getting back to Davos, there were 3 dominant themes that investors would be wise to be aware of:

- **Climate Change** – this was the dominant theme in 2020, leading some to refer to the meetings as the World Climate Forum. The media often portrays climate change as if an overwhelming majority of people view it as the existential threat to human survival; but in reality, the opinions are extremely varied. Angela Merkel referred to global warming as "matter of survival" while Trump refers to climate activists as "prophets of doom." Most participants at the WEF held positions somewhere in the middle, but recognize the impact climate discussions will have on the economy and markets. For example, it is likely that the EU proposes tariffs based on the carbon footprint that would lead to retaliatory tariffs by other countries. What seems clear is this debate will influence economic policy soon and the markets are going to have to account for the economic impact and ignore the hypocrisy of the world's elite who are willing to travel around the world on large private planes to have their picture taken with the 17-year old activist.
- **Global Trade** – the markets breathed a sigh of relief and surged to new highs when phase 1 of the trade deal with China was signed, but many at Davos believe the trade truce between the world's two largest economies will not last long. More concerning, however, was the likelihood that the US and EU are headed for a trade impasse. Trump was widely quoted as saying dealing with the EU was "frankly more difficult" than dealing with China and many saw that as becoming a self-fulfilling prophecy. The EU is going to push for a digital tax on American companies and the Trump administration will likely counter with tariffs on European steel, aluminum and cars. Stylistic differences will make finding agreement difficult. Trump, like President Xi, are

The Donald vs. Greta: Reflections from Davos, continued

seen as negotiating bullies, leveling threats for failure to adopt what they believe is "fair." Europeans negotiate very differently. They are focused on finding consensus and are more conciliatory. These differences are likely to lead to "lines in the sand" in 2020 negotiations between the trading blocks. Trump, coming off perceived wins with China and the USMCA, will feel he has the upper hand in negotiations. The US exported approximately $340 billion to Europe in 2019 or about 20% of total exports (compared to $100 billion to China), while we imported just over $500 billion from Europe. *(census.gov)* If retaliatory tariffs were introduced between the US and EU it would have an immediate impact on the economy and markets.

Antitrust investigations by:	GOOG	AMZN	FB
State attorneys general	√		√
US Dept. of Justice	√	√	√
Federal Trade Commission	√	√	√
House Judiciary Committee	√	√	√
European Union	√	√	√

Source: Mehlman Catagnetti

- **Techlash** – this word will increasingly appear in lexicon and was widely discussed at the WEF. Instead of being viewed as the darlings of the digital economy, Facebook, Google and Amazon are increasingly being viewed as threats to social and economic stability. Gone are the days where crowds overflow small venues in Davos to hear about cryptocurrency and ICOs (initial coin offerings), as "BigTech" is increasingly seen as the enemy of progress. George Soros, long time WEF participant, accused Facebook of secretly helping to reelect Donald Trump, something that would come as quite of a surprise to the left-leaning employees of Facebook. Everyone in Davos seems aware of the problems created by Facebook, Google and Amazon dominating our lives, but there are few solutions being offered at this point. All three companies are currently being investigated by State AG's, Department of Justice, FTC, and the EU, but there is no centralized authority on how to reign in BigTech's reach. The EU considers itself the leading global regulator of data privacy, but the issue today is more the deployment of AI (artificial intelligence) across social media platforms, something Europe vastly trails the US and China in. Political rhetoric draws cheers from crowds when announcing intentions to break up BigTech, but those same crowds instantly go to Twitter and Facebook to acknowledge their agreement while simultaneously ordering groceries from Amazon. Regulators often find themselves fighting the last war, and as long as that is the case I expect Techlash to be more bark than bite for the foreseeable future.

Politics are always front and center in Davos as business leaders understand the political climate often dictates how economies and markets will function. Trump is far more in his element and positively received than people might expect from news headlines emanating from the Forum. Leaders in Davos overwhelmingly expect Trump to be reelected with most taking a favorable view because of his pro-business and deregulation priorities. Geopolitical guru Ian Bremmer was quoted as saying, "Trump doesn't drive people crazy at Davos. They think he is going to win a second term and there was zero panic about the prospect that might happen."

The data today suggests they are likely to be right. Each side of the political divide has loyal followers, but elections are typically determined by the middle, often referred to as Independents. This group, more often than not, votes based on their economic outlook and if they are positive about the economy. Look at these data points:

- *The Misery Index (unemployment and inflation) is the lowest since the 1950's (Cato Institute)*
- *Highest Consumer Sentiment in the year before reelection since 1963 (University of Michigan)*
- *Homebuilder Optimism is the highest since 1999 (NAHB)*
- *Lowest average unemployment through first 3 years in US history (BLS)*
- *Wage growth for the lowest 25% of workers is the fastest since 2008 (BLS)*
- *Stock market is at an all-time high*

Not convinced? Much is made of Trump's job performance surveys (first President to fail to get to 50% approval in first 3 years) but the Economy Job approval tells a different story. The latest survey shows 52% approve of Trump's job with the economy, well ahead of the 3-year mark for Obama (40%), Bush (50%) and Clinton (42%), according to Real Clear Politics.

All signs suggest the global economy is poised to accelerate in 2020 as long as the economic impact of the coronavirus does not become contagion and politicians limit the damage from trade negotiations.

Macro View – GDP Innovation

GDP, a measure of the growth of an economy, will be a focal point throughout the presidential election. There is no shortage of ways to calculate GDP, supporting the saying that you can beat any statistic into telling you what you want to hear. For example, European nations include illegal goods such as prostitution and drugs in GDP calculations. Economists are constantly striving to create a more accurate depiction of GDP. MIT recently created a newer version of GDP called GDP-B that includes goods that are free, such as smart phone pictures, Google searches, and Facebook, attempting to quantify what consumers would pay for those free services if they were not free. Then, the team at MIT works to quantify the impact on GDP. The results below attempted to quantify, through research and experimentation, the economic benefit of free goods and services in the digital economy.

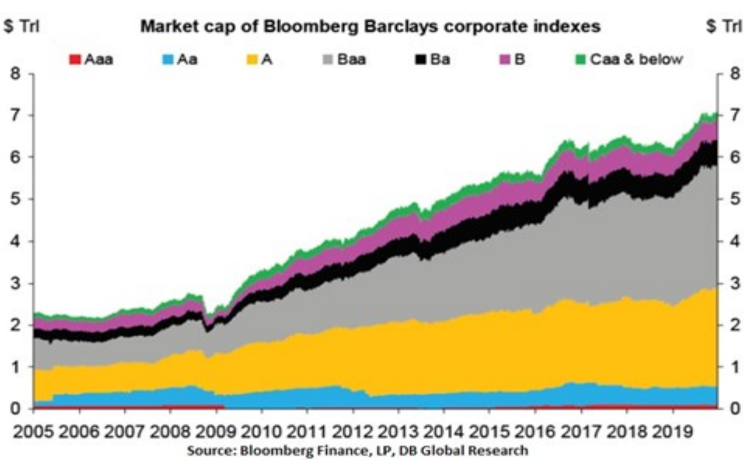
Table 3: Estimates of gross contributions of popular digital goods to real GDP-B growth in the Netherlands, percentage points, Total Income Method

Users	Average per year 10 million	Average per year 2 million
Service		
WhatsApp	4.10	0.82
Facebook	0.5	0.11
Maps	0.34	0.07
Instagram	0.07	0.01
Snapchat	0.02	0.00
LinkedIn	0.01	0.00
Skype	0.00	0.00
Twitter	0.00	0.00

Source: MIT

Fixed Income - Bad Credit Rules

The market cap of the Bloomberg Barclays corporate index has shifted in favor of risk over the last 15 years. The prevalence of A-rated bonds has stayed mostly constant, but Baa bonds, the lowest rating to qualify for "investment-grade," has surged over the last 6 years in absolute terms and as a percentage of market cap. In 2014, Baa-rated bonds were approximately 20% of the total bond market, representing $1 trillion of the $5 trillion market. Today Baa-rated bonds exceed $3 trillion and nearly 50% of the total bond market. Why does this matter? During the next recession there is likely to be a large number of downgrades as earnings fall. Baa bonds, if downgraded, become non-investment grade or "junk bonds," and will result in forced selling by institutions with mandates to avoid junk bonds. Look out below when that happens.

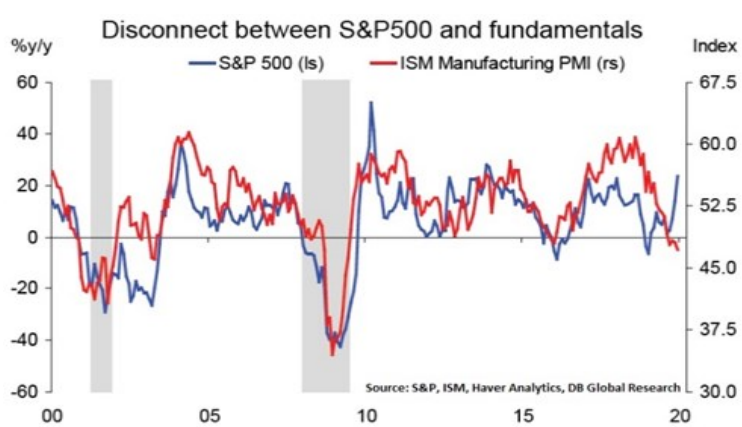


Taking Stock – Coronavirus Victory

The coronavirus is certainly threatening and tragic, but it is and will create opportunities for companies to stand in the gap and offer solutions. Johnson & Johnson is one of those companies. Janssen Pharmaceutical Companies, a unit of JNJ, is working toward a vaccine to fight 2019-nCoV, the coronavirus. Janssen is applying the same technology that provided vaccines for Ebola and Zika. The chart below shows 1 year performance for JNJ. The first incident of the coronavirus was on January 21, 2020. As of January 29th, 2020, the 1 year return for JNJ was approximately 16%. The appreciation over 8 days since the outbreak of the virus has been de minimis. The chief scientific officer at JNJ, Paul Stoffels, said, "At the moment we think we can make a vaccine and bring it to humans in the next eight to twelve months." Both history and the market will determine JNJ's success in providing solutions to a challenging problem.

Technical - Charting Fundamentals

The correlation between the S&P 500 and ISM Manufacturing PMI indices are unmistakable over the last 20 years. More than 90% of the movement of the S&P 500 could be traced to what was happening with the ISM index. Both accurately predicted that recessions were imminent when they fell below 50 and had negative year-over-year growth in 2000 and 2007. The data since early 2019 has had analysts scratching their collective heads as the formerly highly correlated indices move in opposite directions. The ISM data indicates a slowing of the economy breaching the lows hit in 2013 and 2015 that stopped short of a recession. The price of the S&P meanwhile has been able to climb to new highs over the last year. When correlated indicators diverge for this long of a period something must give, meaning the ISM recovers or stock prices tank.



Don't Give Up on Emerging Markets

Clint Pekrul, CFA

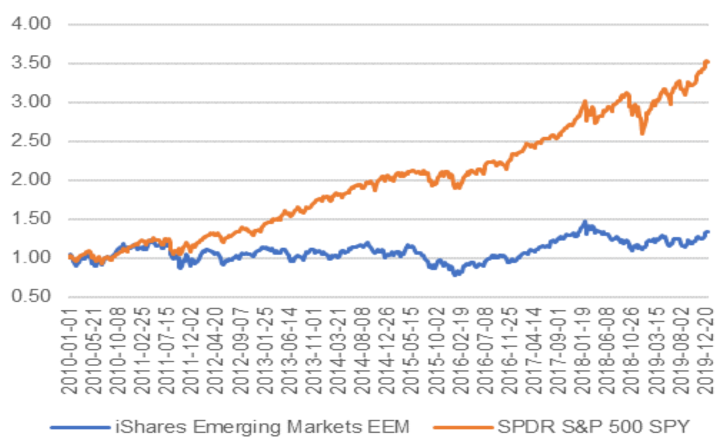
To say that emerging market equities have underperformed U.S. equities since the Great Recession of 2008-2009 is to state the obvious. Perhaps no other segment of the global equity universe has come under more pressure over the past ten years than those of developing countries. The underperformance has been substantial. But it's important to take a longer-term view and consider where emerging markets could go over the next ten years.

Prior to the Great Recession, emerging market equities provided attractive returns versus U.S. equities. On a cumulative basis from 2004 through 2007, emerging markets gained roughly 180% (as measured by the iShares MSCI Emerging Markets ETF) versus a corresponding gain of roughly 40% for large-cap U.S. equities (as measured by the SPDR S&P 500 ETF).

As pointed out by the IMF paper *The Impact of the Great Recession on Emerging Markets* (Llaudes, Salman and Chivakul 2010), the years prior to the Great Recession were marked by robust global trade and rising financial interconnectedness. Indeed, emerging markets reaped the benefits of a global economic expansion.

But as the authors point out, over the pre-crisis expansion, many emerging market countries developed external vulnerabilities, such as high current account deficits. Domestic demand was fueled by capital inflows. But when the music stopped, that is, when money center banks in developed countries imploded in 2008, financial interconnectedness was broken and capital inflows simply stopped. As shown in Chart 1 below, emerging markets as an asset class has been essentially "stuck" ever since. While the reasons for emerging market equity woes over the past ten years are myriad, the lesson seems to be that recessions after a financial crisis can be unusually long.

Chart 1: Emerging Market Equity vs. U.S. Equity (2010-2019; Source: YCharts)



So, what does the future hold for emerging markets? To be sure, the equity markets in developing countries have always been volatile. The geopolitical and currency risk adds to the uncertainty of future returns. In addition, thematic reasons for investing in the asset class itself seem to be changing.

As pointed out in the Financial Times (*Does Investing in Emerging Markets Still Make Sense?* Jonathan Wheatley, 2019), the "hyperglobalization" that began in the 1990s, in the form of a commodity supercycle and cross-boarder trade, drove emerging markets on a path of convergence with the developed world. But the landscape is different now. Commodity prices, in general, are lower today than where they were a decade ago, as measured by the GSCI Commodity Index. Today, we face trade wars in the form of tariffs, which is a far cry from the trade climate twenty years ago. In addition, direct foreign investment into emerging markets in aggregate is at its lowest level since the 1990s.

Despite the challenges, there are reasons, in our view, to hold an allocation to emerging economies if you have a long -term time horizon. Based on projections from the IMF, real GDP growth for developing economies in 2023 will be 4.8%. More specifically, India and Indonesia's real GDP growth are expected to be 7.4% and 5.3%, respectively. In contrast, projected real GDP growth for the U.S. by 2023 is expected to be 1.6%. For advanced economies in aggregate, projected real GDP growth is a mere 1.5%. Moreover, emerging markets have higher population and per-capita GDP growth rates. According to PwC Global, the size of the E7 economies (China, India, Indonesia, Brazil, Russia, Mexico and Turkey) could be double the size of the G7 economies by 2040.

One of the risks of investing in emerging markets is capital flows from wealthier, developed countries. In other words, local investors typically hold a smaller portion of the country's market capitalization, compared to foreign investors. But if demographics continue to shift, the impact of foreign capital flows on emerging market equity returns could diminish.

Despite current headwinds – tariffs, strong dollar, slower GDP growth from China – there is a rationale for holding a dedicated allocation to emerging markets within a global equity portfolio. The effects of the Great Recession hit emerging markets especially hard, and there are unique risks to consider. But the bottom line is that emerging markets will likely exceed developed markets in terms of population and GDP growth in the decades to come. As a consequence, they will likely represent a growing share of the world's market capitalization.

Q: Is gold a good equity hedge?

On the surface, gold is not a particularly effective hedge against equity market risk because there is no direct economic theory or compelling fundamentals that suggest gold and stocks are negatively correlated when stocks are correcting. There are certainly periods of time when gold did well when stocks were performing poorly but there simply is not sufficient data to suggest gold would consistently serve as an effective hedge against equity risk.

This may miss the point, however. Gold always has been considered a "safe haven" and that is unlikely to change in the foreseeable future. To the degree that stocks are retreating from a non-systemic risk event, the markets' assets often flow to a safe haven like gold. Gold tends to be very effective when safe haven assets surge in price, whether gold or Treasuries. The challenge is that many equity corrections do not involve a flight into safe havens, so hedging with gold in those periods would not be effective.

I would view gold as a currency hedge, particularly against the U.S. dollar, since it is the reserve currency of the world. There is compelling data that shows negative correlation to the greenback. Because inflation typically causes a currency to fall, gold is imputed as an effective hedge against inflation, although that relationship is known to break down. I would also be in the camp that gold is a good hedge against Central Bank policy errors.

Gold has been in the headlines recently, given its recent move higher. Currently, an ounce trades for roughly $1,570, which is roughly 16% higher than it was a year ago. I think some investors view gold as a safe haven in times of turmoil. It's a rare, precious metal that cannot be devalued like currencies. So, I can see how gold can be considered a store of value. Indeed, if you look at the recent history of gold price returns, they do exhibit a low to sometimes negative correlation to other asset classes, such as equities. In particular, when stocks fell almost -40% in 2008, gold prices rose roughly 9%. Likewise, when equity markets fell in 2000 through 2002, gold prices moved higher.

But the long-term history of gold is quite clear – its return is highly volatile and cyclical. Furthermore, gold has no intrinsic value. It does not pay a dividend or coupon. My take is that gold's primary purpose is a means for speculation, and not an investment. Gold's real, or inflation-adjusted, return over the past two centuries is essentially zero. To me, this means you have to actively trade gold and get the timing right if you want to use it as an effective equity hedge. Bonds, specifically Treasuries, can be quite volatile over the short-run, but at least we get paid to hold them as a dedicated part of an overall portfolio.

Q: Have markets overreacted to Coronavirus?

I think it is going to take more time to determine if the markets have overreacted or underreacted to 2019-nCoV, the technical name of the respiratory virus that began in Wuhan, China. Anytime an unsystematic risk like disease or war occurs, there tends to be the initial knee jerk reaction to the market of selling. The markets today are particularly vulnerable to unsystematic risk because valuations are stretched (extreme to some analysts) and many investors appear to be looking for a reason for profit taking after the tremendous run up in equity prices in 2019.

The 2003 SARS scare is the closest comparison to 2019-nCoV medically. To compare the market's response back them to today's environment is extremely difficult. SARS began in February 2003 and it took approximately 6 months to contain the virus. From the first case of SARS to the market bottom was only about 6% and six months later at full containment the market had actually gained 12%. However, February 2003 the markets had just tested the October 2002 low in the S&P 500 and were essentially at the bottom of the tech crash that began in late 1999. We are in an entirely different market environment today and it would be foolish, in my opinion, to try and draw too many conclusions. Time will tell what the proper response "should" be, but discretion may be the better part of valor.

We've certainly seen a pick up in volatility across the global equity markets, and much of it is due to the outbreak of the coronavirus in China. We've drawn comparisons to past outbreaks like H1N1 and SARS in 2003. The markets were somewhat shaken by these events, similar to what we are seeing today. I think what is different now, however, is that China's involvement in the global economy is much larger. Based on data from the IMF, China represents roughly 20% of the world's GDP, compared to roughly 7% in 2000. So, when a viral outbreak hits China, the economic impact could be substantial.

Chinese officials have already limited travel within the outbreak region, which coincides with the Lunar new year. Factories have been shut down, and travel restrictions will dampen holiday spending. But overall, for now, the outbreak doesn't seem to present a systemic risk to global markets. My guess is that we might see a few more moves to the downside as the extent of the outbreak becomes clearer. But eventually the outbreak will be contained and markets will move forward.

All weights as of January 31, 2020

Income	
Mortgage Backed	40.98%
Investment Grade	16.42%
High Yield Bonds	10.13%
Preferred Stock	13.08%
US Dividend	5.34%
US REITs	14.03%

Balanced Income	
US Dividend Equities	25.99%
International Dividend Equities	16.31%
US REITs	15.11%
High Yield Bonds	27.39%
Long Term Treasuries	15.20%

US Growth	
Low Volatility Factor	21.12%
High Quality Factor	15.31%
Small Cap Factor	12.85%
Value Factor	18.28%
Momentum Factor	12.61%
Long Term Treasuries	19.81%

Global Growth	
Low Volatility Factor	14.56%
High Quality Factor	7.44%
Small Cap Factor	6.92%
Value Factor	8.94%
Momentum Factor	7.02%
Developed Market Equity	17.73%
Emerging Market Equity	17.55%
Long Term Treasuries	19.84%

Weights are approximations only and subject to change.

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