PCM
Peak Capital Management

The Shape of Recovery: V, U, or L

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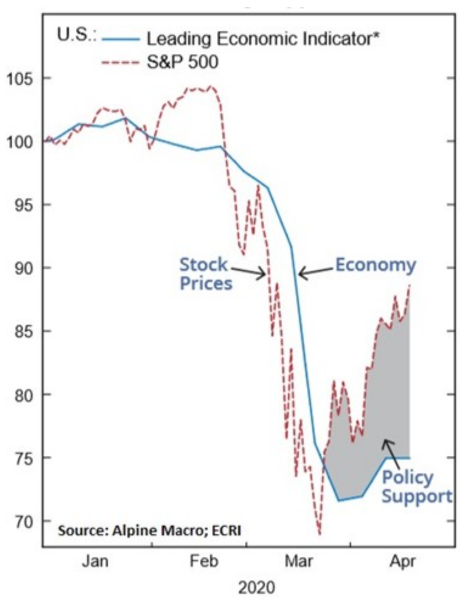
There is much debate on what the shape of recovery is going to look like following the unprecedented shuttering of the global economy. While some remain optimistic about the potential for future growth, some hopes have been dampened by economies in Asia that began opening up and experienced subsequent outbreaks of the coronavirus. What can be said definitively is that the greatest decoupling of the economy and equity markets in my lifetime has occurred in the last month. The S&P 500 fell 35% between February 19 and March 23, the fastest plunge into bear market territory in the history of the markets.

The uncertainty around the pandemic and corresponding impact on the economy justified the concern by stock investors, especially given that the markets were trading at all time highs. While the economy has remained essentially closed with shelter at home orders in almost every state, the S&P 500 has surged 20% off the market lows. While it appears the markets are pricing in V-shaped recovery, I think something else might be at play. The fiscal policy response exceeding $2 trillion, along with the monetary policy response by the Fed, signals to the markets that investment gains will be private but losses will be socialized. This assumption, right or wrong, has resulted in a V-shaped market response even while the economy is declining.



The chart demonstrates the decoupling of the economy and stock market and how much reliance on policy support exists today. The data I have analyzed suggests investors are overly optimistic in the efficacy of the actions taken by Congress and the Fed. The economic recovery is far more likely to be U-shaped as the economy re-opens in stages and people slowly begin to be rehired. Consumers will be impacted by damaged balance sheets even as the service sector opens at partial capacity. If restaurants are required to operate at 50% capacity, their rehiring will be impacted, causing unemployment to recover more slowly than many expect.

Consumer spending, which accounts for nearly two-thirds of GDP, is largely driven by confidence about the future and it is hard to imagine with all the talk of a "second wave" of COVID-19 that confidence returns to pre-virus levels within the next 12 months. Much is made of the potential for a vaccine, but that seems misplaced to me. Everything from common colds to the flu are virus-based and no one has been able to come up with a vaccine that keeps those from occurring. I do expect an effective therapeutic to be available before the end of the year that should help with

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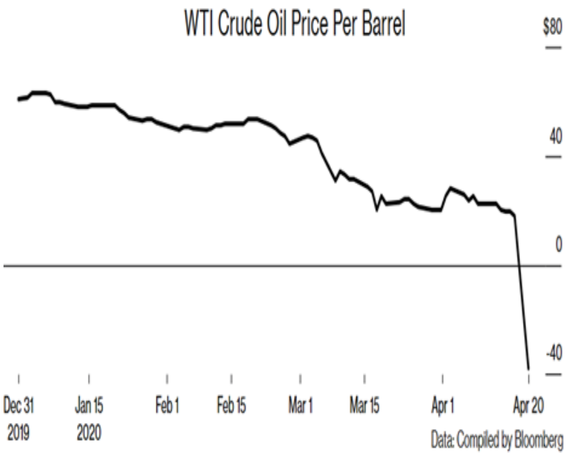
confidence. Additionally, there is some very exciting news about the ability to test for the virus and antibody that generates near instantaneous results. The ability to perform mass testing is probably the most important factor for a return to economic vitality.

The potential worst-case scenario involves an L-shaped recovery for the economy that would likely see the markets trade to new lows if it were to occur. In this scenario there would be a long-term behavioral change by consumers, starting with an effort to reduce debt and increase savings to be better prepared for a future crisis. As you read this you might be thinking, "wouldn't less debt and higher savings be a good thing?" The answer is yes if it is your household, but not when looking at the entire economy. Increased savings means less spending that results in lower corporate earnings, fewer employment opportunities, and less growth. The risk of an L-shaped recovery would be mitigated with an effective treatment for the virus.

What seems inevitable from this crisis is that the solution to the dislocation created by government interference will be yet more government interference. Knowingly or not, the government will be determining which industries and companies recover the fastest. The government's track record on these policies in the past have been dismal (Solyndra, A123, Fisker, etc.). The Wall Street adage, "Don't fight the Fed," has rewarded investors who have benefitted from the V-shaped recovery in equities but is unlikely to be sustainable. I expect a corresponding collapse in the velocity of money that will negate the impact of excess liquidity in the economy. Be prepared for a bumpy economic recovery and market volatility at levels not seen in years.

The Economics of Capacity



This month market gawkers witnessed something most never thought we could see: oil trading at -$37/barrel. The historic collapse in the May Nymex contract might also be a foreshadowing of what is still to come. The economic contraction caused by COVID-19 has driven demand for oil to the lowest point in decades at the same time we entered a supply war with Saudi Arabia, and Russia deciding to increase their production of oil. Oil is very short-term inelastic, meaning demand is not dramatically impacted by changes in prices. Gasoline may be the cheapest since we were teenagers, but nobody has anywhere to go. Storage capacity typically provides a buffer on price swings, but as storage neared capacity traders were faced with having to take physical delivery, something they have no ability to do.

- The energy sector is facing debt downgrades at a historic pace, creating Fallen Angels, or companies whose debt moves from investment grade to junk status. Occidental and Apache are two of the most recent victims.
- Even with recently announced production cuts of 10 million barrels per day, the supply of oil remains above the demand for oil by nearly 20 million bpd. With slower travel forecasted, the imbalance between supply and demand is likely to remain.
- The impact of negative capacity is being felt in shipping prices as tankers are being staged off the coast of California with no where to unload their cargo, in what amounts to very expensive storage.

Negative Yielding Sovereign Debt

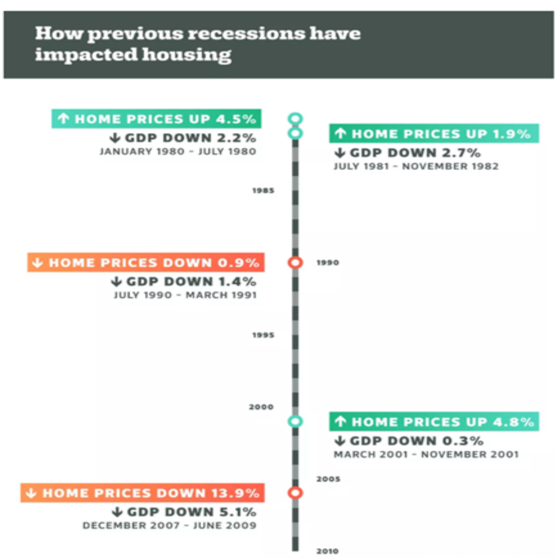
Value of Negative Yielding Bonds in the Global Market

Source: Bloomberg Barclays Global Aggregate Negative Yielding Debt Market Value USD. Monthly data as of 03/17/2020.

COVID 19 has pushed government bond yields lower, creating even greater numbers of countries dipping in to negative yielding territories. A negative bond yield is one in which the country is paid to borrow. Negative yields have become commonplace among European nations and Japan. In some cases, it was the market that drove rates below zero, rather than the central bank. Inflation can result from falling rates based on the quantity theory of money. Inflation has not taken hold in countries such as Japan and Germany, despite falling rates and negative yielding sovereign debt. The Bank of Japan is moving away from negative rates by purchasing riskier assets such as corporate bonds and equity ETFs. Negative yielding US treasury bonds could certainly be an unintended consequence of Federal Reserve and economic response to COVID 19.

- There is over $10 trillion in negative yielding bonds across the globe (Bloomberg)
- As of April 1, 2020, Switzerland led the charge on the negative rates with a rate of -.75% for a 3 month Libor.
- Investors typically purchase negative yielding sovereign debt for safety, deflationary fears, speculation, and for meeting regulatory requirements.
- Central banks are evaluating following the Bank of Japan's example and purchasing riskier assets than sovereign debt.
- Despite the additional liquidity and negative rates, inflation has not taken shape, giving way to fears of a deflationary recession.

Coronavirus Impact on Housing

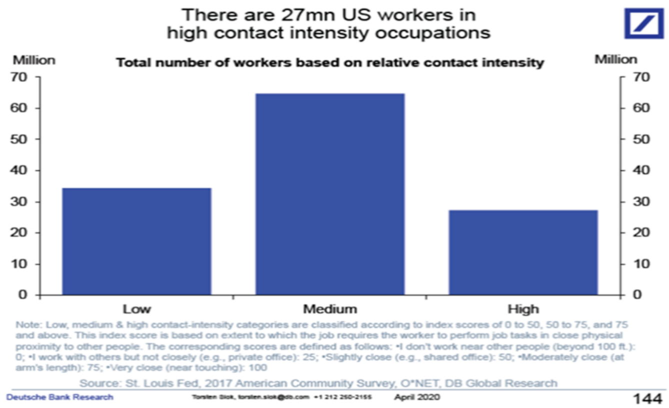


The coronavirus is certainly having an impact on the housing market. What is typically the busiest time of the year for buying a home, this spring will likely look much different than normal. The shutdown caused by the virus has disrupted everything from new listings to supply chains for home builders. Initially, the current shutdown was predicted to have a similar impact on the housing market that we experienced in the 2008 recession. However, the housing market has remained fairly resilient, due in part to a slowdown in overall transactions. In other words, prices overall haven't changed much because there are so few transactions.

- With a government moratorium on foreclosures, homeowners who've been hit financially by the economic shutdown can delay their mortgage payments. While this is good for homeowners, mortgage servicers could come under pressure to deliver missed payments to bondholders. At this point we simply don't know the potential longer-term damage this might cause.
- According to a Zillow study, in past pandemics home sales have dropped dramatically; however, overall home prices have remained fairly steady. Moreover, given the quarantine, existing homeowners might be more inclined to make renovations or additions, which could be a positive for homebuilders longer-term.

Macro View – Social Distancing and Employment

It is clear that skyrocketing unemployment is weighing on analysts, given the impact on GDP and sentiment. It is also clear that social distancing is critical to the success of reintroducing the economy and keeping the virus as contained as possible. Jobs that prevent social distancing may struggle further, compounding the pain the economy experiences. Deutsche Bank Research and the St. Louis Federal Reserve Bank note that there are approximately 27mm US workers in high contact intensity occupations. These jobs include teachers, motor vehicle operators, therapists, veterinarians, nurses, midwives, audiologists, other personal care specialists and health technologists. These groups make up approximately half of the high contact intensity occupations. This is further compounded for states that have the highest percentage of workers in these jobs.



Taking Stock – Flying the Not-So-Friendly Skies

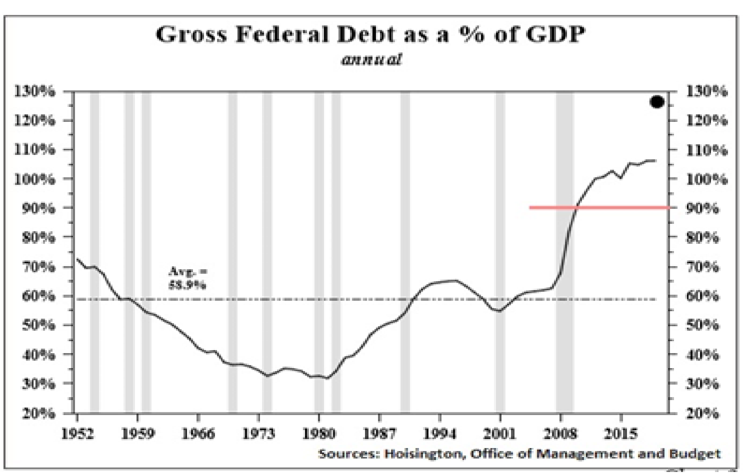
Airlines and cruise companies may be at the top of the list of industries most adversely impacted by COVID 19. As earnings are released, analysts are asking if and which airlines will survive and what the industry will look like in a post-virus world. Delta Airlines is reporting an expected 85% reduction in capacity, leading to quarterly revenue declining 90% year over year (Seeking Alpha). The government is also playing a role, with a total $50 billion package to support airlines. This portion of the CARES Act includes direct relief and a low interest, unsecured 10-year loan. The table below shows the breakout across major airlines. The short, medium, and long term recovery of airline companies is dependent in part on the shape of the economic recovery in terms of how effective cost savings and government support can be over a growing period of time, coupled with dramatically reduced revenue for the same period of time.

Airline	Distribution ($bn)	Loan Portion ($m)
American (NASDAQ:AAL)	$5.8	$1.7
Delta	$5.4	$1.6
United (NASDAQ:UAL)	$5.0	$1.5
Southwest (NYSE:LUV)	$3.3	$0.9

Source: Company Filings

Fixed Income - Buyer of Last Resort

The spike in U.S. Government debt is likely to be the biggest long-term impact of the pandemic crisis. While Congress and the Fed can be commended for how quickly they took action, it remains to be seen if their efforts are worth the long-term pain they may create. The deficit for this fiscal year could approach $2 trillion, an amount unconscionable just months ago as the national debt soars to over $25 trillion. As interest rates plummet, you might question who is going to buy all this debt? While demand does still exist from insurance companies, pension plans, and foreign investors, increasingly it will be the Fed stepping up as the buyer of last resort. Treasury Secretary Mnuchin announced the government was shelving plans to issue 50-year government bonds but will revisit that, along with potential 100-year bonds in the future.



Technical - Just Ask Homer

The COVID-19 pandemic and associated market crash has looked much different than prior crises, like the financial sector implosion in 2008. There has been an eerily similar path of this bear market to what occurred on Black Monday in 1987, although whether this trend continues is open to debate. Black Monday, where the stock market fell 20% in a day, was largely the result of an electronic trading strategy known as Portfolio Insurance that triggered electronic selling that overwhelmed buying. While the initial drop in the market mirrors that crash, the source of this crash is very different. The recovery of the current crisis will largely depend on how quickly an effective therapeutic can be developed that gives people confidence to reengage in the economy. In case you were wondering, the Simpsons (a show I admittedly have never watched) debuted in 1987.

PCM Report May 2020 | Volume 11, Issue 5

S&P Earnings and Potential Returns

Clint Pekrul, CFA

Given the economic shutdown from the coronavirus, future earnings for the S&P 500 are highly uncertain. Some projections are optimistic, but most paint a fairly bleak picture, at least over the near-term. Recently, several companies have disclosed that 2020 is going to be worse than expected in terms of earnings. It's expected that earnings for the aggregate S&P 500 will decline by roughly -16% for the first quarter. If that materializes, the drop in earnings will be the biggest since the second quarter of 2009.

As of this writing, just over 120 companies have reported quarterly earnings, according to Investors Business Daily. Of those companies reporting, only roughly 40% would comment on 2020 earnings, and of these companies, 60% indicated they would not give profit guidance for 2020, or withdrew previous guidance. Still, not all news is bad. There are some sectors of the economy that have held up reasonably well, such as consumer staples.

Ultimately, stock prices are based on underlying fundamentals, such as revenue and profitability. If those fundamentals are not well understood by the market, stock prices tend to become more volatile than normal. We've certainly seen this since the outbreak of the coronavirus and subsequent economic shutdown. The CBOE VIX Index, which measures the expected volatility of the S&P 500 Index based on options, reached as high as 80, surpassing the highest levels seen during the 2008-2009 financial crisis. A VIX of 80 suggests roughly a 5% daily shift, up or down, in the overall S&P 500 Index. This volatility is a direct result of extreme uncertainty about future earnings.

To quantify the potential volatility that we might see over the coming months, we can conduct a simple exercise. S&P provides earnings estimates for the composite S&P 500 Index (these figures are publicly available at https://us.spindices.com/indices/equity/sp-500). These estimates are based on "as reported" operating earnings per share and go out to the fourth quarter of 2021, and are provided in Table 1 below. S&P also provides historical (actual) quarterly price-to-earnings (P/E) going back to 1988. With this data, we can simulate potential returns by applying historical P/E ratios to the estimated operating earnings. To simulate the returns, we ran 5000 trials by randomly selecting historical P/E ratios and applying them to the earnings estimates. We assumed a base index value for the S&P 500 Index on the close as of April 27th, 2020 (2878). The results are below:

Table 1	Q2 20	Q3 20	Q4 20	Q1 21	Q2 21	Q3 21	Q4 21
As Reported Index Operating Earnings Per Share Estimates (S&P)	$140.29	$136.14	$136.08	$142.93	$154.87	$163.74	$170.87
Base Line S&P Index Value (19 P/E ratio)	2665	2586	2585	2715	2942	3111	3246
Simulated Cumulative Returns (base 2878; April 27th, 2020)							
75th Percentile	1.77%	-1.19%	-1.15%	3.82%	13.03%	18.94%	24.12%
50th Percentile	-11.13%	-13.76%	-13.80%	-9.52%	-1.89%	3.65%	8.17%
25th Percentile	-21.89%	-23.47%	-23.55%	-19.70%	-12.94%	-8.01%	-4.01%

Source: Standard and Poors, Peak Capital Management.

***Not Actual Results**

The point of the simulation is not to predict future returns (nobody we know has that magical crystal ball). What we want to illustrate is the potential variability of returns. For simplicity, let's assume that S&P's earnings forecast proves somewhat accurate. If we further assume that investors are willing to pay 19x those earnings (which is roughly what they are paying today), then the S&P 500 Index would trade somewhere close to 3246, which is roughly 13% higher than where the index trades today.

Historically, however, a P/E multiple of 19 is above average. Based on S&P quarterly data going back to 1988, the average P/E ratio is roughly 18, with a high of roughly 29 and a low of approximately 11. What the simulation suggests is the while the risk is to the downside in the near-term (i.e. potential losses far exceed potential gains), the opportunity is to the upside longer-term if S&P's forecasts prove somewhat accurate (i.e. potential gains exceed potential losses).

While the simulation above is useful for setting expectations, it illustrates just how variable returns can be, particularly during a pandemic and economic shutdown. We want to remind our clients that we don't attempt to forecast returns as part of our investment process. We seek to manage the variability of returns for potentially better longer-term outcomes.

Q: What political ramifications do you expect from the coronavirus?

I think it is too early to tell at this point. We saw Trump's favorability ratings hit new highs in the early days of the pandemic as he was out front in the public eye and his response was viewed in positive light by a majority of Americans. As the challenges of dealing with the virus have continued, there has been some reduction in the President's support. I tend to agree with the hypothesis that the election this November will be a referendum on Trump's handling of the crisis, which includes the reopening of the economy. There is also the issue of Trump's likely opponent, presumptive nominee Joe Biden. The former Vice-President has been relatively absent during the crisis and has done little to cast himself as a strong leader capable of making very difficult decisions.

In many respects, the coronavirus appears to have solidified the sharp divide that exists in the country today more than bringing the country together. Trump supporters have rallied behind their candidate, while the mainstream media and those on the political left find fault with every statement or decision Trump makes (some for obvious or comical reasons).

The most interesting recent development is the protests across the country of people demanding the quarantine end and the economy reopen. These protests are comprised of people across the political spectrum and are largely people that feel like the needs of small business people are not being listened to.

You have to assume that an event as impactful as the coronavirus outbreak will have political ramifications. Each party will use the disruption to jockey for power and try to push their agendas. That's politics. For example, Senate majority leader Mitch McConnell, a Republican from Kentucky, recently commented that he would be in favor of letting states simply declare bankruptcy. Is it a coincidence that the states that would be most deeply impacted by bankruptcy, namely New York, New Jersey, Illinois and California – are all blue? Money might run out for these states before the election, if the shutdown continues. Will president Trump side with McConnell and simply let states go bankrupt? The probability is greater than zero.

Make no mistake, there are numerous problems with the CAREs Act, despite the government's best intentions. There was little resistance when Congress decided to supply the struggling economy with $3 trillion. But after a month, there a several instances of small business not receiving funds, administrative breakdowns and delayed stimulus checks. Where did the $3 trillion go? That's the question many voters will ask themselves come November, and there will be plenty of finger pointing, particularly at the politicians. Given the enormity of the coronavirus situation, there is bound to be some fallout.

Q: How are you maintaining sanity during quarantine?

Ha, that assumes sanity is being maintained!

To be honest, I am among the most fortunate of people enduring this pandemic as my life has been disrupted far less than most people. I miss our favorite restaurants and activities, but eating at home with family has been a breath of fresh air as well. I travel extensively and in-person meetings are typically more effective than phone and Zoom calls, but we do the best we can until the restrictions are lifted. I am keenly aware that my ability to work and be with family, including our 3rd grandson born just a month ago, is a blessing I do not take for granted.

The pandemic has provided an opportunity for all of us to evaluate what is important, and could result in a type of resetting of priorities. I have taken advantage of utilizing technology to connect with family that do not live nearby. We do regular Zoom calls to play games together or "have lunch" together, even though we are in different states. We have done work Happy Hours where we connect over technology with adult beverages late on Friday afternoons.

The ability to work from home has allowed me to incorporate regular workouts since I am not on the road, and I enjoy my wine cellar more than I typically get to when traveling. After all, what is the purpose of collecting great wines if you do not take time to enjoy them with the people you love?

As I'm sure it has been for most people, maintaining some sense of normalcy during the shutdown has been a challenge. What I miss most is not being able to hang out with friends and do basic activities like going to dinner, happy hour, or a concert. It is particularly rough as we move into spring, when the weather is the best we have all year. Living in Denver, I take full advantage of going to several concerts a year at Red Rocks Amphitheater over the spring and summer, but I'm assuming most of the shows will ultimately be canceled. By the way, if you ever have a chance to see a concert at Red Rocks, it's well worth the time.

I think the best thing you can do is to stay as active as possible, while adhering to the quarantine guidelines. It's convenient to be able to work from home, but I have to make sure to leave the house and maintain some level of physical activity. With the gyms closed, I've resorted to taking several long walks a day. I live in the city but have a fairly big backyard, so I'm able to entertain my pet boxer, Switzer. Also, having a new smoker helps with ribs and brisket for dinner. Overall, the quarantine has been a necessary, but tolerable, inconvenience.

Model Weights

All weights as of April 1, 2020

Income	
Mortgage Backed Bond	23.55%
Investment Grade Credit	10.44%
High Yield Bonds	6.28%
Preferred Stock	4.76%
US Dividend Equities	5.11%
US REITs	4.46%
Cash	45.40%

Balanced Income	
US Dividend Equities	15.04%
International Dividend Equities	15.60%
US REITs	12.81%
High Yield Bonds	17.05%
Long Term Treasuries	14.50%
Cash	15.00%
Inverse S&P 500	10.00%

US Growth	
Low Volatility Factor	12.41%
High Quality Factor	13.71%
Small Cap Factor	7.60%
Value Factor	10.98%
Momentum Factor	12.86%
Long Term	17.44%
Cash	15.00%
Inverse S&P 500	10.00%

Global Growth	
Low Volatility Factor	5.84%
High Quality Factor	6.29%
Small Cap Factor	3.44%
Value Factor	5.00%
Momentum Factor	5.93%
Developed Market	15.33%
Emerging Market	15.73%
Long Term Treasuries	17.44%
Cash	15.00%
Inverse S&P 500	10.00%

Weights are approximations only and are subject to change.

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