PCM
PEAK CAPITAL MANAGEMENT

The Great Disconnect

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Breath-taking, staggering, astounding, inconceivable. These are a few of the adjectives used to describe the markets in 2020. The stock market began 2020 in positive but pedestrian fashion gaining a little over 4% through mid-February. That is when COVID-19 became a household name, and government, and economies, around the world began to shut down.

It is not difficult to predict the economic damage when economies shudder; more than 35 million Americans lost jobs in the first 6 weeks, driving the unemployment rates higher than at the peak of the Great Financial Crisis. The official unemployment rate, called the U-3 rate, is not the only calculation the BLS provides. The more comprehensive U-6, that includes full-time working only working part-time, was at 22.80% at the end of April. Based on BLS figures for average earnings, the lost jobs equate to nearly $1 trillion in reduced consumer spending after factoring in government benefits.

Economist David Rosenburg believes 20% of the jobs lost due to the shut down will be permanent, and that double-digit unemployment will last into 2023 (unemployment peaked at 10.0% in the last recession). It is not just jobs being lost — thousands of companies have filed for bankruptcy, including high profile names like Pier 1, JC Penney, Nieman Marcus, Gold's Gym, J Crew, and Dean and Deluca, and we are no where near the economy fully functioning.

The collaborative efforts of the Fed and Congress to address the economic pain has been admirable, and costly. More than $3 trillion has been allocated and estimates are for at least that amount in future stimulus. Baring a revocation of the Laws of Economics, this additional debt will result in slower future growth as there is no free lunch. Markets priced economic calamity at breakneck speed with the S&P 500 falling 35.5% in just 23 trading days, the fastest onset of a bear market in history.

If the story ended here, you could make the argument the markets are efficient and priced in the uncertainty risk of halting the global economy. What causes many to scratch their head is the recovery off the March 23 lows when the full economic impact is still largely unknown. The S&P 500 has bounced back 22% in the 41 trading days since the March bottom.

Many have posited theories on the recovery in equities while the economic carnage deepens based on growth in the money supply and the Fed's intervention. No doubt, the Fed publicly stating they will buy junk-rated fixed income ETF's suggests a strong backstop for investors. Fed action and Congressional stimulus helped with confidence but have done little to impact corporate earnings. The data, however, provides a clear explanation of the sharp rebound in stocks.

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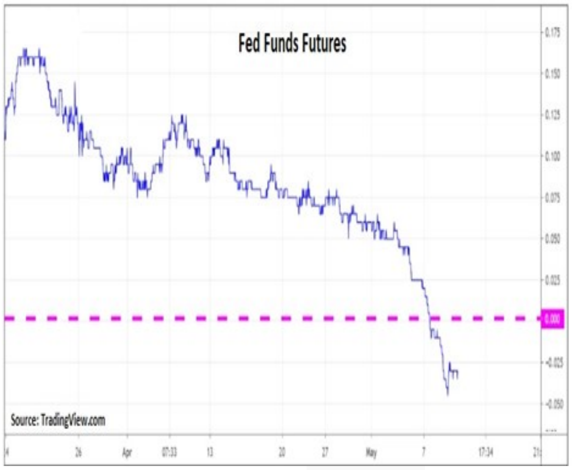
The chart shows the concentration in the S&P 500 of just the five largest market caps: Microsoft, Apple, Amazon, Google and Facebook. Before the Tech Crash, this concentration rose to 18% and many thought that would never be repeated. Today we are above 21% and the chart looks like a Space-X liftoff. The S&P 500 is down only 9% YTD when heading into a Depression because of the performance of those five stocks. All five are positive, ranging from +5% (Google) to +32% (Amazon). The median price gain is +15% YTD, but they have risen a cumulative 170% from the March bottom.

I have been in the camp that the recent rally is a powerful bear market rally as has occurred in every bear market since 1929, so equity investors are clearly not out of the woods. The question is how long can the top five companies maintain earnings to sustain current levels? This contraction is very unique being self-imposed and forcing significant changes as a result of social distancing and work from home. Not surprising, companies like Amazon, Microsoft, and Apple are benefitting from some of the changes, with the jury out on what will happen with ad revenue from Facebook and Google. More than any time in the past, there seems to be clearly delineated winners and losers from this period.

COVID-19 is not just an economic catastrophe, it has taken a massive human toll as well. Sadly, the human toll is greatest in the developing world where my friend David Beasley of the World Food Programme has said the economic shutdown has put 260 million people at risk of starvation. U.S. leaders like Oregon Governor Kate Brown pledging to keep the economy in shutdown into July, even though fewer than 150 deaths from COVID at this writing, seem oblivious to the physical harm their actions are having.

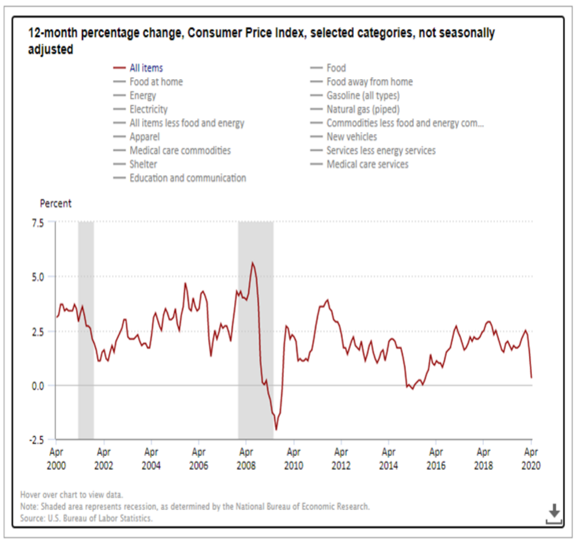
Saved by Zero



Many will remember the classic hit by The Fixx by the title above. Fed Chair Powell has stated on many occasions that he does not think it would be helpful to price Fed Funds below zero, as the Fed has other policy tools he believes would be more effective at accomplishing their targets. Traders evidently do not find Mr. Powell's words reliable as the futures markets began pricing a negative Fed Funds rate beginning in April 2021 for the first time in history. The willingness of the Fed, and other Central Banks around the world, to adopt "non-traditional" policy is likely the reason the market is pricing in negative rates. The Fed recently began buying non-investment grade bonds, junk bonds, through ETF purchases in the open market so there is a wide range of possibilities.

- The thought behind negative rates is to punish banks for holding excess reserves at the Fed. By forcing banks to pay to hold reserves the Fed hopes banks make a greater commitment to lending to spur economic activity.
- Negative short-term rates are becoming commonplace with more than $15 trillion in sovereign debt, 25% of the government bond market, currently trading at negative rates out past 20 years on the German bund.
- The ECB was the first Central Bank to push rates into negative territory in June 2014 followed by the Bank of Japan going negative in January 2016. The benefits, other than lower debt servicing costs, are questionable.

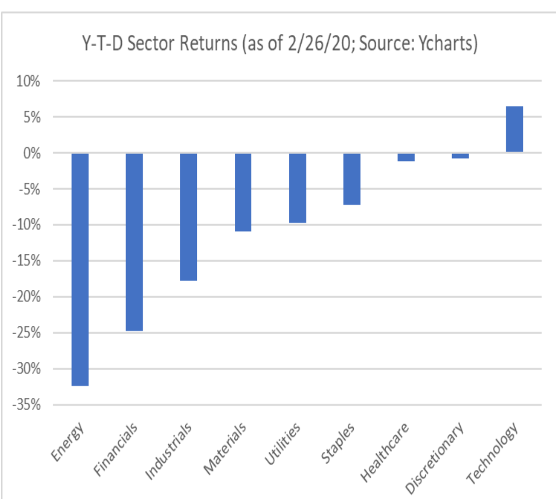
Deflation to Stagflation



Central bankers have confidence in their ability to manage inflation, yet deflation and stagflation can be a thorn in their side. Deflation is noted by a fall in overall prices and total demand, while stagflation is persistent high inflation, unemployment, and stagnant demand. Economists at the recent Strategic Investment Conference postulated that the U.S. is likely to face deflation followed by stagflation. Deflation is a vicious cycle of consumers not purchasing products, producers lowering prices, profits decreasing, wages decreasing, unemployment increasing, etc. Furthermore, fixed debt for households, companies, and the government carries a greater burden as a result of wages and prices falling. This is likely to persist until rates begin to go up. Inflation can become difficult to take shape when growth is muted, as the vicious cycle continues to repeat itself.

- The Federal Reserve is likely to keep rates low, if not implement a zero rate policy or negative rates to inspire economic growth.
- The BLS chart of Consumer Price Index, an indication of deflation and inflation, show falling prices.
- The chart shows prices approaching negative territory in April 2020.
- The only other time CPI turned negative the past 20 years was during the Global Financial Crisis of 2008 (Bureau of Labor Statistics).

Sector Returns

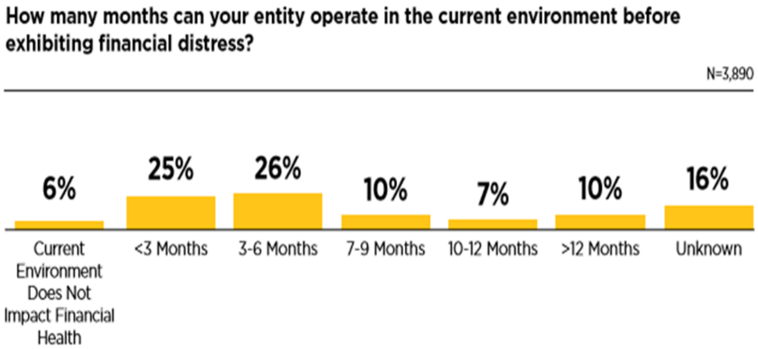


Despite markets being down overall for the year, there are a few bright spots. When breaking down the markets by sector, those companies that aren't deeply impacted by the economic cycle (i.e. expansions and contractions) have held up reasonably well. It's not surprising that technology and healthcare have led the way. The top holdings in the technology sector are Microsoft and Apple, both of which are up roughly 17% and 10% year-to-date, respectively (combined, they represent approximately 40% of the sector). The reason the consumer discretionary sector has outperformed on a relative basis is due to the weighting of Amazon, which is up roughly 32% for the year.

- Energy and financials have taken the brunt of the downturn. With depressed interest rates, banks are having a tough time. Likewise, with weak overall demand, energy companies have seen a wave of downgrades. Year-to-date, the energy and financials sectors are lower by roughly -32% and -24%, respectively.
- The outperformance of the technology sector might be a bit stretched. When looking at the sector overall, the price-to-earnings ratio is roughly 28, compared to a corresponding ratio of 21 for the total S&P 500 Index. Still, consumer demand for technology services is robust.

Macro View – Surveying Main Street

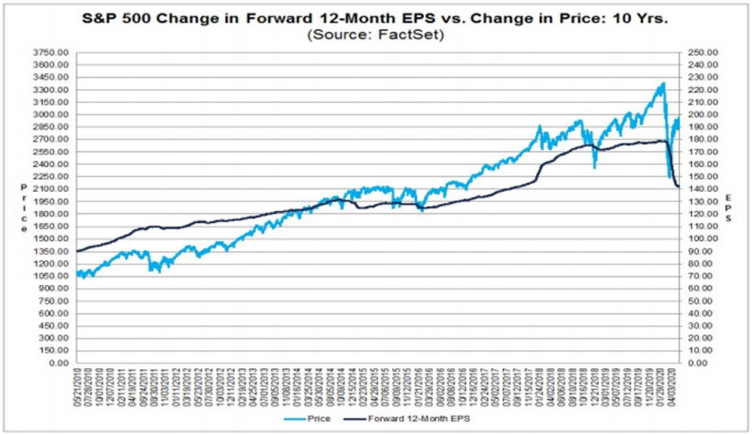
The Federal Reserve produced a report surveying communities across the country and the impact COVID-19 has had on Main Street USA. Nearly 70% of respondents indicated a "significant disruption" to the communities they serve, making recovery "expected to be difficult." 35% said that it would take more than 12 months for their respective communities to return to the conditions experienced pre-pandemic. The impact of the pandemic was characterized in the survey as income loss, health concerns, changes in food and housing, impact on homeless and vulnerable populations, non profit impact, and business impacts including closure, revenue loss, and supply chain disruption. Over half responded that their entity could operate up to six months in the existing pandemic economic environment before exhibiting financial distress. The bar chart below shows the results for entities' ability to maintain sustainability.



Source: Federal Reserve

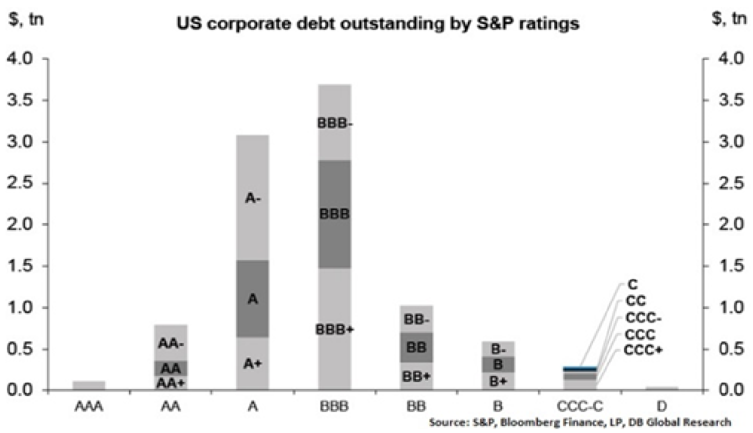
Taking Stock – An Extreme Dislocation

Factset has offered tremendous insight into forward earnings. When overlaid with the S&P 500 price, there is a clear dislocation. The forward 12 month P/E ratio for the S&P 500 is 21.0 (Factset). The 12 month forward EPS is just above 140.00 with a precipitous drop at the end of Q1. At the same time, the S&P 500 produced a significant rise. In Q1 2020, the approximate earnings decline was 14.6%. Earnings were revised even further by 6.9%. Furthermore, one-third of S&P 500 companies withdrew EPS guidance for 2020 as a result of uncertainty given the pandemic. For 2020, analysts anticipate a year over year decline in earnings of 42.9% for Q2, 24.8% for Q3 and 12.4% for Q4. Earnings surprise, be it less bad news, may be difficult to navigate if companies are not providing earnings guidance.



Fixed Income - Junk Bond Tsunami

The chart below shows the dollar value of outstanding corporate debt in the U.S. categorized by S&P ratings on the debt. The most important classification is the BBB category that distinguishes between "Investment Grade" debt and "Non-Investment Grade" debt, also known as junk bonds. The Fed's financial repression of keeping interest rates near zero forces many yield investors, including large institutions, to overweight BBB bonds in their portfolio to receive higher yields. As we stare into the abyss of an unprecedented economic contraction, there are likely to be many debt downgrades as companies lose cash flow and earnings to service their debt. The smallest downgrade from BBB- will put those bonds into the junk category and result in forced selling for funds and pensions that are required to only hold investment-grade bonds and why the Fed is proactively stating they will buy junk bonds.



Technical - At a Tipping Point

Effective technical analysis requires looking at different time periods to see where indicators demonstrate a convergence of guidance. When multiple time periods are sending the same signal, confidence grows in the accuracy of the indicator. The red line shows the 65-week moving average on the S&P 500. This is a widely followed long-term technical indicator that signals secular bull or bear trends as opposed to shorter-term cyclical moves. You can see that in 2019 there were multiple occasions where the S&P pulled back to the 65-week moving average only to bounce higher, maintaining the bullish outlook. The recent recovery from the March lows has the S&P right at the 65-week moving average once again. If stocks can move above the trend line, and remain, it would signal a new bull market. A retreat from the trend line suggests the bear is not yet in hibernation.

The Future of Commercial Real Estate

Clint Pekrul, CFA

It's no surprise that the COVID shutdown has posed an enormous challenge for the commercial real estate industry. With people increasingly staying and working from home, it's highly likely that the commercial real estate industry will undergo substantial changes in the not-too-distant future. Furthermore, simply reopening the economy doesn't ensure people will return to previous behavior. This will impact the profitability of the industry over the short- to intermediate-term.

Based on data from the National Association of Real Estate Investment Trusts (NAREIT), some sectors of the real estate market have taken a substantial hit this year. Based on the table below, retail as a group is lower by roughly -41% through April, with regional malls lower by -52% (see table below).

Likewise, lodging and resort properties are lower by roughly -45% as people have avoided travel since the pandemic hit. Other sectors, however, have held up relatively well, such as data centers and infrastructure. These sectors are not as sensitive to the effects of the coronavirus.

The fact that retail REITs are in decline isn't surprising. Investors have been calling for the so-called death of brick and mortar stores and shopping malls for some time, as consumers turn increasingly to making online purchases. However, the current situation with the COVID 19 shutdown has brought into question the future for office space and resort properties in particular.

According to a Gartner survey of 317 CFOs conducted in April, 74% of respondents indicated that they will move at least 5% of their previously on-site workforce to permanently remote positions. Furthermore, 25% of respondents said they would move 20% of their on-site workforce to permanently remote positions.

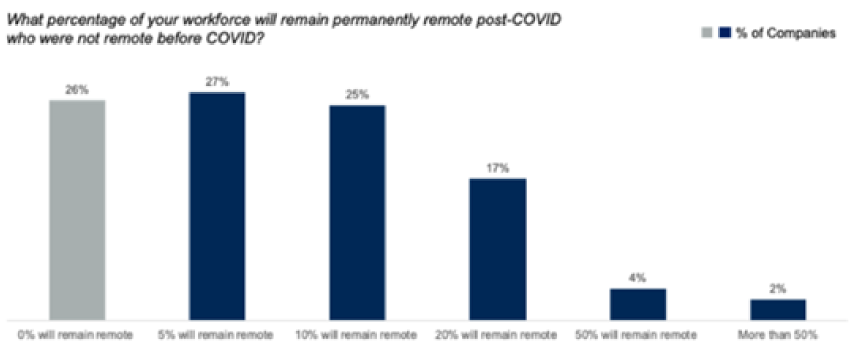
Investment Performance by Property Sector and Subsector

April 30, 2020

Sector	Number of Constituents	Total Return (%) 2019	Total Return (%) April	Total Return (%) 2020: YTD	Dividend Yield (%)	Market Capitalization ($)[1] Equity	Market Capitalization ($)[1] Implied
FTSE Nareit All Equity REITs	162	28.66	8.83	-16.68	4.32	1,030,111,822	1,058,115,627
FTSE Nareit Equity REITs	153	26.00	8.30	-21.27	4.87	802,104,527	830,078,935
Industrial	13	48.71	7.98	-3.17	2.82	114,286,444	117,530,601
Office	18	31.42	7.52	-22.63	3.84	79,569,848	84,285,089
Retail	32	10.65	14.78	-41.16	8.51	97,903,513	103,237,198
Shopping Centers	18	25.03	16.61	-41.16	8.25	34,626,191	35,319,936
Regional Malls	6	-9.13	20.03	-52.49	13.06	25,201,959	29,507,278
Free Standing	8	24.76	10.04	-29.94	5.70	38,075,362	38,409,984
Residential	21	30.89	8.60	-18.05	3.43	153,201,342	158,990,770
Apartments	15	26.32	9.15	-19.53	3.90	108,685,807	112,311,186
Manufactured Homes	3	49.09	6.61	-11.80	2.38	23,967,619	24,679,182
Single Family Homes	3	44.30	7.98	-16.59	2.07	20,547,916	22,000,402
Diversified	16	24.10	13.06	-31.15	6.68	42,930,403	45,009,179
Lodging/Resorts	15	15.65	11.29	-45.81	8.26	24,386,694	24,567,329
Health Care	17	21.20	10.03	-30.42	7.05	85,618,086	86,283,516
Self Storage	5	13.70	-6.72	-14.15	4.41	54,416,144	56,409,160
Timber	4	42.00	22.13	-25.82	5.81	22,162,424	22,162,424
Infrastructure	5	41.95	9.58	8.82	2.05	205,844,871	205,874,268
Data Centers	5	44.21	8.14	17.66	2.30	112,936,784	116,173,102
Specialty	11	27.39	6.83	-31.89	9.32	36,855,270	37,592,991
FTSE Nareit Mortgage REITs	37	21.33	19.41	-47.61	15.55	43,170,662	43,454,395
Home Financing	23	17.20	16.84	-49.10	16.52	27,849,146	27,864,230
Commercial Financing	14	32.10	24.97	-44.30	13.61	15,321,516	15,590,165

Source: FTSE™, Nareit®.

Lodging and resort properties will likely see a return to more normal conditions as the virus eventually runs its course. Hotel REITs have struggled considerably, but as people begin to travel again, hotel properties can begin re-pricing rooms. Hopefully, there will not be significant cash flow issues for many commercial REITs. As vacancy rates are likely to go up, and leases are renegotiated, the ability for some REITs to continue to pay a dividend to shareholders could come under pressure. In all likelihood, some REITs might delay or cancel some dividend payments (this has already happened in the hotel sector). As a result, the volatility of the asset class might remain elevated for some time.



Source: Gartner (April 2020)

Overall, office lease transactions have declined considerably so far this year. If work-from-home becomes more common, or permanent, lease demand will weaken at least in the short- to intermediate-term. This shift will likely impact densely populated, urban areas, such as New York City. Businesses will likely trim costs by leasing smaller spaces. Over time, however, the industry will adapt. Only time will tell to what degree workers go back to the office when, working remotely becomes more accepted.

Q: How do we know if this is a bear market bounce, or the bear market is over?

Typically, you answer that question by studying history and looking for indications of what defines a bear market bounce from a new bull market. There are a couple of problems with this approach. First, we are in unprecedented times in the economy and there really is no period to look upon to get guidance on how the economy will respond when we reopen. In the early days of the lockdown, I argued for a sharp rebound because there were no structural issues that led to the recession/ depression. In the late 1990's, when the markets valued companies based on "eyeballs" on websites, there was tremendous speculation in technology that created a large dislocation when it became evident many of those companies would never turn a profit. In 2007-2008 the speculation in housing created unsustainable mortgage issuance, where defaults would soar on the first sign of a slowdown and financial engineering of mortgage-backed products meant no one knew who owned bad debt. There were no structural problems leading to the contraction, so the hope was for a quick recovery. The length of the lockdown has surprised me and risks more permanent damage to the economy and corporate earnings. China, ground zero for the virus, remained in lockdown for less than 3 weeks, while many parts of the U.S. are approaching 3 months. Second is the Fed's historic intervention in the markets that we can only guess as to the ultimate impact it will have.

That's the million-dollar question. It's always easy to look back in hindsight and pinpoint where a bear market officially ended. It's another thing to identify the bottom in real time. My point of view is that the worst of the pandemic is likely over. As the country begins to reopen and business activity picks up, we'll get a clearer picture of what businesses will survive and what businesses will never come back. How the economy gets back on track will be interesting to watch. Given the pandemic and social distancing over the past months, consumer spending habits have likely permanently changed. Some parts of the economy will benefit, such as technology, while others might not get back on track for some time, such as travel and airlines.

My guess is that we might have some additional selling pressure once it is better understood how deeply the shutdown has impacted the economy. Now might prove to be an opportune time to wade into some sectors that have been beaten down considerably. We might not retest the lows we experienced in March, but a 10% pullback from current levels wouldn't surprise me. One thing is for certain, though — we can't time the bottoms and I wouldn't want to be completely out of equities.

Q: Where are opportunities to deploy capital in a world of high risk and zero interest rates?

That depends on your outlook for the future. Many of the analysts I follow believe we have not seen a low in the equity markets and when the realization of the permanent or long-term damage to the economy is known, markets will retreat below the March lows. They expect a flight to safety when this occurs, and yields on U.S. Treasury bonds will approach levels seen in Germany and Japan (who are negative to around 20 years). If Treasury yields do fall to new lows the prices will shoot higher, causing some to want to own 30-year zero coupon bonds as their prices are most sensitive to changes in interest rates. This is highly speculative, but if their outlook turns out to be correct, they stand to make very large gains. There is another camp who believes the rapid response by the Fed and Congress will keep the economy afloat long enough for sentiment and consumer spending to return to pre-crisis levels. This camp is also betting that either a vaccine or effective therapeutic will be developed soon that allows confidence for crowds to gather whether at entertainment events or mass transport. This group is buying stocks on dips believing markets will return to pre-virus levels soon. I view technology and healthcare as the most attractive places to deploy capital as spending is very likely to increase in both sectors and the strong companies with reasonable valuations should benefit greatly.

Finding places to deploy capital is becoming more challenging. From a current yield perspective, bonds don't seem all that attractive right now, although we tend to compare yields to historical levels. If rates do actually go lower, bonds could provide an attractive total return (current yield plus price appreciation). It's hard to argue against the return potential from the technology sector, especially since its performance isn't quite as sensitive to the overall business cycle. If you don't mind the volatility, I think there's potential in the energy sector, particularly for companies that have clean balance sheets and aren't highly leveraged. Currently, the dividend yield on the S&P Aristocrats index about 3.5%. Compared to bonds, the income from a basket of dividend-paying stocks seems relatively attractive, albeit with greater volatility.

We've mentioned emerging markets in the past. It's been particularly rough for the asset class this year, with declines of roughly 20% year-to-date. But if you maintain a long-term time horizon, I think there's upside potential for the asset class overall. For those that are able, there is also potential in private equity. Ultimately, a basket of equities such as the S&P 500 will likely deliver the best returns of any investible asset class over the next 20 years.

All weights as of June 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	16.28%
International Dividend Equities	16.89%
US REITs	13.87%
High Yield Bonds	18.46%
Long Term Treasuries	14.50%
Cash	10.00%
Inverse S&P 500	10.00%

US Growth

Low Volatility	13.49%
High Quality Factor	14.90%
Small Cap Factor	8.26%
Value Factor	11.93%
Momentum Factor	13.98%
Long Term	17.44%
Cash	10.00%
Inverse S&P 500	10.00%

Global Growth

Low Volatility Factor	6.35%
High Quality Factor	6.84%
Small Cap Factor	3.74%
Value Factor	5.43%
Momentum Factor	6.45%
Developed Market	16.66%
Emerging Market	17.09%
Long Term Treasuries	17.44%
Cash	10.00%
Inverse S&P 500	10.00%

Weights are approximations only and are subject to change.

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