PCM
PEAK CAPITAL MANAGEMENT

The Ultimate CONfidence

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Who can forget the picture of Frank Abagnale walking arm and arm with 6 flight attendants dressed to the nines as an airline pilot? The only problem was that Frank, played brilliantly by Leonardo DiCaprio, was not a pilot and had no idea how to fly a 747. "Catch Me if you Can" is a hilarious movie about Frank Abagnale, the most famous con man in U.S. history. Abagnale was able to convince people he was doctor, an attorney, as well as a pilot in carrying out some of the boldest cons ever witnessed.

Frank Abagnale understood that to really fool someone you had to act the part, you had to gain their confidence to avoid suspicion. As the markets soar to new heights amid the pandemic, where a large part of the economy remains locked down, I question where the confidence to buy risk assets is coming from. Is it possible that the Fed is playing the role of Frank Abagnale to unsuspecting but trusting investors?

The disconnect between the economic disruption caused by COVID-19 and stock prices is as significant as anything I have seen in my nearly 30 years of managing portfolios. Investors are betting that the Fed has both the ability and conviction to keep the markets from collapsing. The reality is that there are things the Fed can do to support the markets and the economy, but there are many things they are powerless to change. The Fed is able to keep interest rates at historically low levels to support home buying and real estate, but what they cannot do is make people consume at higher levels. The problem with the economy is weak demand, and regardless of how low rates are, some people are going to put off making purchases in order to decrease debt and build savings. The Fed can also reduce bank reserve requirements in an attempt to drive higher loan volumes, but they cannot make banks make more loans and credit conditions have tightened noticeably since the coronavirus became an issue.

Let's take a look at 3 specific risks the economy and markets face today that the Fed is incapable of addressing.

1. **Congressional oversight of Big Tech.** Not only are Apple, Amazon, Alphabet (Google), and Facebook among the largest companies in the world, they are also among the principal reasons why stocks are at an all time high. If you include Microsoft and Netflix in the equation, Big Tech is up around 45% this year and the S&P 500 would be down approximately 5% if you exclude those 6 stocks. The equal-weighted index is -4.5% for 2020 as of this writing. If Congress tries to move beyond hearings to actual sanctions, it could create a rush for the exits starting with the best performing stocks.

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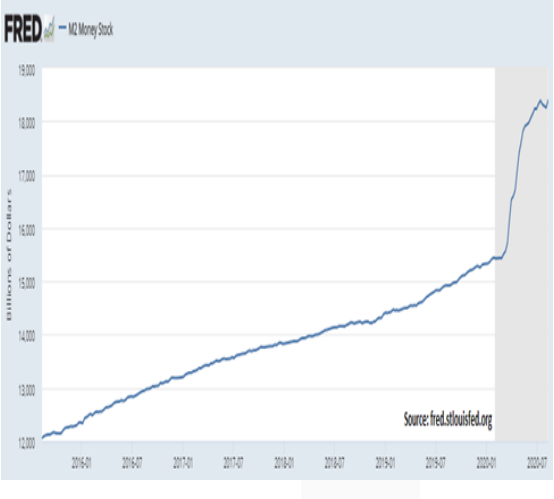
2. **Trade War with China.** Fed Chair Powell has referenced the risks to the economy of a prolonged trade war with the second largest economy in the world as reason to keep rates at historically low levels. The potential economic disruption caused by both sides assessing tariffs would result in a significant reduction in earnings and would likely cause a sell-off the Fed could do little about. China, being an authoritarian government, does not rely on election cycles or quarterly earnings — they are willing to be patient and endure short-term pain for long-term success.

3. **Supply Chain Interruptions.** This ties in with the potential of a trade war but is much bigger. Increasingly we see countries around the world adopting more protectionist policies intended to benefit their own citizens. The COVID-19 pandemic has led to different parts of manufacturing and supply chain capacity being negatively impacted. If a relatively inexpensive part made in Korea that is used to make a car cannot be sourced, auto production stops. There is also significant risk of inflation occurring from a supply chain interruption as companies spend to create new supply chains.

I believe the CONfidence in the Fed is irrational and may ultimately lead to catastrophic losses for investors who do not have any ability to hedge their equity market risk. Any of the three scenarios listed above, and dozens more that could be listed, could cause a rapid loss of confidence in the Fed and panic selling. However, never stray from the wisdom of Keynes who said, "The market can stay irrational longer than you can stay solvent."

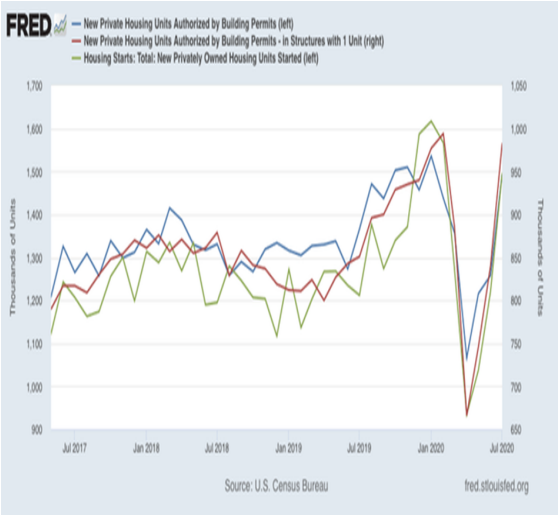
Show Me the Money (supply)



You do not have to possess the investigative skills of Sherlock Holmes to identify one of the compelling reasons why stocks are at all-time highs while the economy is mired in COVID-related lockdowns. The growth rate of the M2 money supply has spiked this year as both the Fed and Congress find new ways to try and keep the economy afloat. We are currently at 23% year-over-year growth in the M2 which includes all cash, checking deposits, savings deposits, and money market funds. The punch bowl has essentially been spiked to a level where it is mostly booze with a little punch. With bond yields so low, it is not surprising that much of this excess liquidity is finding its way into risk assets.

- Economists note that if the supply of money grows faster than the ability to produce, inflation is the natural consequence. I expect for the Fed to declare that inflation is not a concern right up to the day when it is.
- Another impact of the rapidly rising M2 is dollar weakness and gold at all-time highs. The USD is at the lowest level since mid-2018 and has fallen almost 10% against other major currencies year-to-date.
- Inflation has not dramatically risen because the velocity of money has declined at almost the same pace as the rise in M2. If cash is not spent on consumption and supply exceeds demand, there will not be inflation.

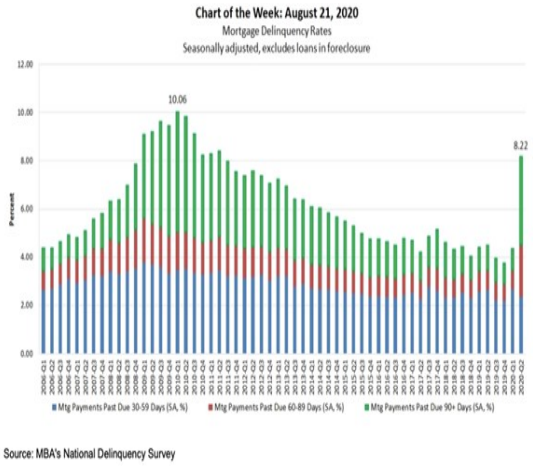
Housing Yin and Yang



The Federal Reserve Bank of St Louis reported in August that 12.5% of Americans are experiencing housing distress. Housing distress is defined as being late on rent or mortgage payments. The Census Bureau's Household Pulse Survey reveals that demographic, generational, and educational factors are strongly associated with distress. Housing, on the other hand, is rallying. The chart below shows an aggressive recovery in housing permits (blue), housing starts (green), and single family permits (red). Housing starts in July increased by 22.6% (Commerce Department). Economists polled by Reuters anticipated housing starts to increase by a rate of 1.24mm units versus the seasonally adjusted rate of 1.49mm units in July. Positive housing metrics provide encouraging news for the economy's recovery from Covid as they tend to be leading indicators.

- Education offers the most predictive contrast specific to housing distress with those without a bachelor's degree experiencing a distress rate roughly three times versus those with a bachelor's degree (St. Louis Federal Reserve Bank).
- Housing permits are within 3% of their high in January of 2020 (Seeking Alpha).
- Housing starts are lagging permits, within 8% of the January 2020 high (Seeking Alpha).

Mortgage Delinquencies

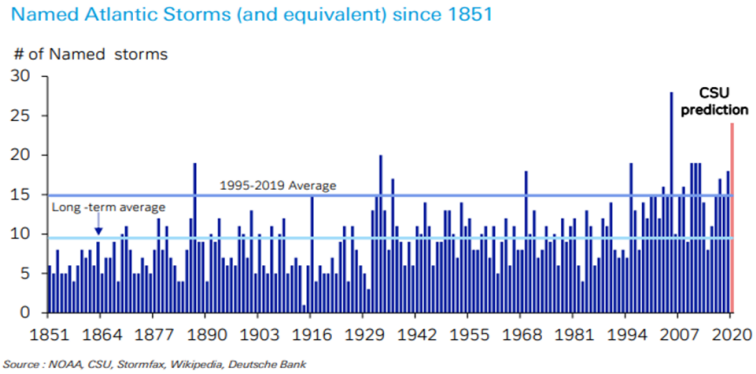


Based on data from the Mortgage Bankers Association (MBA), mortgage delinquencies reached a nine-year high in the second quarter of 2020. Furthermore, the quarterly jump in the delinquency rate of roughly 4% was the largest in the history of the MBA survey, which started back in 1979. An estimated 4.2 million homeowners are in forbearance as of the end of June 2020, and the number of homeowners who have missed three or more payments is at a 10-year high. Despite this, the overall housing market seems to be in decent shape, all things considered.

- It's no surprise that delinquencies are on the rise, given the spike in unemployment due to Covid-19. Many homeowners are finding it difficult to meet monthly mortgage payments. Without government assistance, such as the CARES Act, the rate of delinquencies would likely be much higher.
- The mortgage situation could be a ticking time bomb if government assistance expires. The situation is dire for mortgage servicers, who are responsible for paying the lenders. The servicers can only pay the lenders out-of-pocket for short time until defaults become a real issue.

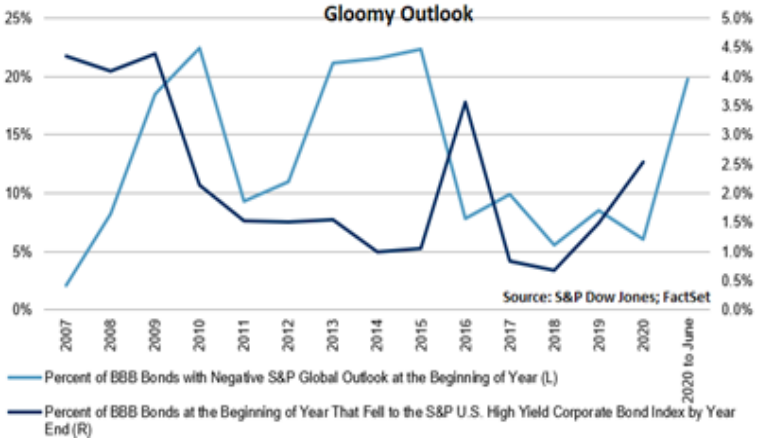
Macro View – Storm Surge

As we write this report, Hurricane Laura is ravaging Louisiana and Texas. Flooding, physical damage, and power outages drive negative economic ripples for weeks as the region seeks stabilization. Laura was the twelfth named storm in the U.S. in 2020 (Deutsch Bank). Colorado State University (CSU) hurricane researcher Phil Kotzbach provides data, below, on hurricanes dating back to 1851. CSU predicts 24 Named Atlantic storms in 2020. The average since 1995 is 15 and the long term average dating back to 1851 is 10. 2020 is stacking up to rival 2005 in terms of number of storms. Deutsche Bank reports that 2005, including Hurricane Katrina, experienced economic damage in reducing GDP by 1.2% that year. The impact to the market appears to be muted, though. LPL Financial points out that a month after the 15 most costly hurricanes occurring in the U.S., the S&P 500 was higher 9 times of the 15 occurrences while posting a median return of 1.2%.



Fixed Income - A Gloomy Outlook

We have documented in prior reports the surge of bond issuance that occurred in late 2019 and early 2020, particularly debt that was issued at the bottom end of the investment grade spectrum. The impact of the coronavirus on the global economy is creating concern that many companies with BBB bonds will be downgraded and result in a glut of high yield bonds. If the supply of high yield bonds exceeds demand for the bonds, you will see prices drop and the entire bond market will likely come under pressure. You can see that the light blue line indicates that just over 20% of all BBB-rated bonds have a negative outlook and potentially face a downgrade to junk status. Through the first half of 2020 2.5% of all BBB bonds were downgraded. That number may reach levels that occurred during the recession of 2008/2009.



Taking Stock – Health Tech Leading the Charge

The sentiment that Covid is creating a clear dividing line between "winners" and "losers," or the "haves" and "have nots," is driving analysts to dive deep in to where the winning opportunities will lie. Looking at global IPOs may be one indication of where supply is meeting demand and simply following the money trail. The FactSet table below shows the addition or subtraction of global IPOs across sectors. Health technology companies are clearly growing and expanding as indicated by IPOs. That appetite among investors and Covid created a open door for Health Tech. SK Biopharmaceuticals listed on the Korea Stock Exchange has returned approximately 40.5% (as of August 6, 2020) since listing in June. Similar performance for the sector was delivered by Samsung BioLogics and ZCelltrion Healthcare, returning 68.4% and 84.2% YTD as of August 6th (Factset).

Global IPO Activity — By Sector

Rank	Change in Rank	FactSet Sector	Market Share (2020)	Change In Market Share	Gross Proceeds (2020)	YoY %(Gross proceeds)	Transactions (2020)	YoY% (Transactions)
1	▲	Finance	28.30%	5.57%	18,253.04	2.12%	62	-43.12%
2	▲	Health Technology	18.10%	10.38%	11,671.97	92.39%	51	2.00%
3	▼	Technology Services	13.47%	-16.01%	8,688.88	-62.52%	40	-37.50%
4	▲	Retail Trade	9.48%	6.26%	6,111.61	141.54%	10	-28.57%
5	▼	Commercial Services	7.85%	2.87%	5,061.49	29.20%	14	-62.16%
6	▲	Producer Manufacturing	5.37%	1.10%	3,465.91	3.07%	30	30.43%
7	▲	Consumer Non-Durables	4.60%	1.99%	2,967.30	44.54%	6	-53.85%
8	▲	Electronic Technology	2.25%	0.44%	1,453.27	1.80%	21	5.00%
9	▼	Process Industries	2.09%	-3.99%	1,344.70	-71.85%	14	-41.67%
10	▲	Consumer Durables	1.94%	-0.09%	1,251.00	-21.72%	9	50.00%

Source: FactSet New Issues

Technical - Mega Caps Dominating

Mega stock companies like Apple, Amazon, Facebook, Netflix and Microsoft have been dominant this year, particularly after the March bottom caused by the pandemic. This handful of stocks is why the broad S&P index is not much lower on the year. You can see from the trendline of the S&P 500 ex-mega cap that it is essentially flat following the bounce in early April, while mega cap growth stocks have risen sharply. It will be interesting to see how long this trend can remain in place and what could derail these stocks. Because the mega cap names are mostly technology-driven companies, they have benefitted from the many shifts occurring like working from home and fewer entertainment options outside of the house. Time will tell if the stocks are being accurately priced for the future or are simply over priced waiting for a correction.

Market Performance Review

Clint Pekrul, CFA

We've highlighted this is previous PCM reports, but the fact that some major market indexes, like the S&P 500 and the NASDAQ, have reached all-time highs during such a turbulent economy is difficult to understand. There seems to be a disconnect between what the market is telling us in terms of valuations, and what we see happening in the real economy. Prior to the onset of COVID-19 in February, unemployment in the U.S. stood at roughly 3.5%. As millions lost their jobs and still remain unemployed, the markets have rallied to new highs.

To be fair, the markets are forward looking. That is, current valuations are based on what economic conditions might be a year or two years from now. Investors seem to be betting that COVID-19 will be in the rear-view mirror by then, thus allowing businesses to reopen and the economy to thrive. The reality today, however, is that roughly 30 million people are collecting unemployment. Furthermore, the stock market rally has been highly concentrated in just a handful of names. Some might argue that based on current valuations, the markets have run too far too fast, and are due for a pullback. But there is plenty of liquidity (thanks to the Fed) and we have record low interest rates (again, thanks to the Fed).

There's little competition for income from other asset classes. Bonds offer meager yields for investors looking for income. This narrative is nothing new, given the long-term secular decline in interest rates. The benchmark 10-year Treasury yield is currently 0.7%, which is little consolation to investors looking for safe income. For the year the BarCap Aggregate Bond Index is up roughly 6% on a total return basis due to declining rates (you can still make money in bonds). But investors generally hold bonds for the income stream they provide.

Another option for income is dividend-paying stocks. However, the risk profile for income producing stocks is much different than your typical bond portfolio. Year-to-date, the return for the S&P Select Dividend Index is roughly -17%, but the yield of roughly 4% is a full 3% above the benchmark 10-year Treasury. Dividend stocks as a group are not necessarily heavily weighted to technology, so the group's performance year-to-date is nowhere close to the broader S&P 500. However, from a valuation standpoint, dividend-paying stocks might now be attractive for long-term investors. Meanwhile, high-yield bonds are more-or-less flat for the year, as measured by the BarCap Corporate High-Yield Bond Index. The current yield is roughly 5% annualized.

International markets have lagged the U.S. so far this year. The MSCI EAFE Index, which measures international developed market performance, is lower by roughly -5% year-to-date, but is well above the lows reached in March. Meanwhile, emerging markets are slightly positive for the year, as measured by the MSCI Emerging Markets Index. Markets in China are higher by roughly 20% for the year.

If we look under the hood and evaluate the U.S. equity market by factors, we see quite a wide range of performance. To no surprise, momentum leads the way as the S&P 500 Momentum Index is higher by roughly 21%. The index maintains roughly 30% in the technology sector and trades at roughly a 35x price-to-earnings multiple. High-quality names have done reasonably well for the year. The S&P 500 High-Quality Index is higher by roughly 10% due mainly to sector weightings in technology and healthcare. The price-to-earnings ratio is currently 22x.

On the flip side, the S&P 500 Value index is lower by roughly -10% year-to-date. The index maintains a meaningful weight to financials, which have not performed well on a relative basis. However, the current price-to-earnings ratio is only roughly 15x. Likewise, low volatility stocks as a group are lower by roughly -5% for the year. The index maintains a large-cap value tilt with a price-to-earnings ratio of roughly 19x. Small-cap stocks are lower by roughly -10% year-to-date, based on the S&P 600 Small Cap Index. It's no surprise that small cap stocks have struggled, given the impact of the COVID-19 pandemic. The index maintains a price-to-earnings ratio of 16x.

If price-to-earnings ratios truly are mean reverting, we could argue that some slices of the market (e.g. sectors, factors, industries) seem expensive while others seem more reasonably priced. Keep in mind that the long-term mean price-to-earnings ratio on the S&P 500 Index is roughly 15x. Markets tend to get overbought and oversold all the time. The ride in technology has been an incredible one off the March lows, but are current valuations sustainable? As the economy recovers, will there be a rotation into other areas of the market? It's difficult to predict if and when these changes occur, which is why, in our view, it's important to maintain a diversified portfolio.

Q: How should portfolios be positioned leading up to the election?

The challenge in attempting to answer this question is whether "conventional wisdom" will prevail with whomever wins the election. Most of the "expert" commentators suggested that if Donald Trump won the Presidency in 2016 the stock market would correct. That forecast was accurate for about 4 hours after Trump had won and then the stock market went almost straight up for a couple of years. Markets are typically most comfortable with what is known and that would be a second term for Trump. The unknown if Biden were to beat Trump is whether his moderate views and positions would be pursued or if the Progressives in the Democratic party will prevail. If Biden does not move far enough to the left fast enough, he will likely lose his party's support and calls for his removal from office could begin.

With the level of uncertainty over what will happen politically I believe it makes sense to slightly reduce equity exposure and increase hedges against a spike in volatility. The worst-case scenario for investors is not knowing the winner of the election on November 2nd. Some states, including battleground states, may utilize mail in voting causing the state not to know who prevailed election night. Keep a close watch on the House and Senate as well. If Biden were to prevail, it is likely that will mean Democrats succeeded on turnout and the Senate could flip. If Dems control the White House and both houses of Congress, I expect an immediate double-digit drop in stock prices.

I wouldn't necessarily make large-scale changes to your asset allocation based on what might happen in the November election. It's basically impossible to know which way the markets might move based on the results ahead of time. The narrative historically has been that Republicans (i.e. a Trump administration) would be better for business and markets overall. Conversely, democrats (i.e. a Biden administration) would be more pro-regulation and big government, and less friendly to business. Reality doesn't really match the narrative though. Markets have done well (and poorly) under both Democrat and Republican administrations.

In the short- to intermediate-term, I don't see much changing in terms of the underlying economy, regardless of who is in the White House. Switching to a Biden administration won't change our frightening debt-to-GDP ratio, or necessarily stop the run up in technology stocks. Maintaining a Trump administration won't bring small businesses back, or necessarily prevent a vaccine for Covid-19. I'm not saying elections don't have consequences, but their outcomes typically aren't game changers for asset allocation decisions. I think the best you can do is to have a plan in place to maintain your risk profile, which might require only modest adjustments to the stock-bond mix and a marginal use of hedges.

Q: Are retail stocks dead forever?

For the traditional retailers like Nordstrom and Macy's, I fear the answer might be yes. The slew of bankruptcies since the COVID-19 pandemic forced the lock down of stores in all major U.S. cities has been dominated by large retailers. To some degree, the public health crisis likely just expedited what was inevitable anyway. The model of shopping in a mall or large shopping center was already suffering as foot traffic in malls collapsed over the last couple of years. According to Coresight Research, there were 6,000 store closings in just the first four months of 2019, long before the coronavirus became an issue. Even upscale malls that were able to add stores like Apple and Tesla did not see a bump in foot traffic according to their study.

It is not necessarily all bad news from a retailing standpoint. The Amazon model is being replicated by other large retailers such as Target, Walmart, and Costco. In 2019, according to Statistica, online shopping represented around 10% of all purchases and was forecasted to grow to 12.5% in 2020. Of this total Amazon captures around 15% of the e-commerce, but others are slowly catching up to Amazon's pricing, selection and delivery.

I expect most large shopping centers or malls to be repurposed in the coming decade and retailers who invest heavily in technology and expanded product lines will not only survive but will thrive.

Retail as a group has certainly taken a hit this year in terms of performance. The Covid-19 outbreak seems to have only accelerated the downward trend in the sector that's been developing in the age of Amazon. Consumers in general are now more accustomed to the comforts of stay-at-home e-commerce, rather than brick-and-mortar shopping. The Covid-19 pandemic has in many cases forced stay-at-home shopping. In addition, many retailers carry heavy debt loads and lease payments. In many cases, retailers face substantial operating expenses and burn through cash. So, the current environment isn't too conducive for business success.

However, there are some bright spots in the retail sector. Companies like Walmart, which has a substantial on-line presence, and Home Depot, which has actually benefited from the Covid-19 shutdown, have done reasonably well so far this year. I think that over time, you'll see some retailers adapt to the spending habits of consumers, while others will fail. It seems like a stock-picker's environment (i.e. there will be winners and losers). So, to say that retail stocks are dead is a bit of a stretch in my view.

All weights as of August 1, 2020

Income	
Mortgage Backed Bond	50.79%
Investment Grade Credit	13.24%
High Yield Bonds	7.33%
Preferred Stock	20.21%
US Dividend Equities	5.02%
US REITs	3.39%

Balanced Income	
US Dividend Equities	14.82%
International Dividend Equities	19.71%
US REITs	10.13%
High Yield Bonds	23.62%
Long Term Treasuries	31.72%

US Growth	
Low Volatility Factor	13.62%
High Quality Factor	12.88%
Small Cap Factor	9.94%
Value Factor	13.80%
Momentum Factor	10.23%
Long Term Treasuries	39.51%

Global Growth	
Low Volatility Factor	7.52%
High Quality Factor	6.08%
Small Cap Factor	4.41%
Value Factor	7.39%
Momentum Factor	5.19%
Developed Market Equity	15.00%
Emerging Market Equity	14.49%
Long Term Treasuries	39.92%

Weights are approximations only and are subject to change.

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