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BLOG POST

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10/5/2020

The past month has been one of the most interesting in a very long time. The markets have oscillated from bullish to bearish almost overnight and back again at a pace that has rarely been seen in my career. The prevailing narrative controlling the market direction appears to change more often than a teenager changes his . . . you get the idea.

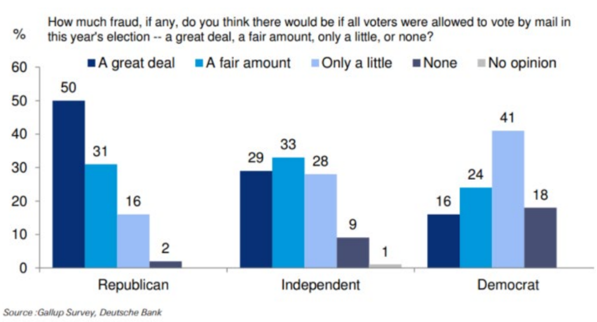
As a portfolio manager, the hardest question to answer right now is, "Do I even know the risks we are facing?" Risks can be factored into equity prices in a relatively efficient manner; it is the unknown risks that become very hard to determine if they are being priced in correctly. Looking at the landscape today I see a bevy of potential Black Swans that could derail investors (yes, a group of swans is called a bevy). What if the election results in a 269-269 division of electoral college votes? What if some states decide to allow votes for a week after the November 2nd and the winner changes daily as mailed in votes are counted? The potential for a legally contested election result lasting months and going to a Supreme Court with currently only 8 justices is a possibility that cannot be ignored.

Given the risks, the prudent course of action for many investors is to sit on the sidelines and wait for more clarity. Sadly, unless investors are willing to earn 0% on their portfolio, risks remain. In typical equity bear markets U.S. Treasuries are a great hiding place, but will that be the case when the 10-year Treasury bond is yielding 0.65%? There are also tax consequences that must be factored considering the recent gains in stocks over the last couple of years. Often selling means paying around one-third of your gains in taxes to go to cash and make nothing. In essence, there are no "Easy" buttons for investors today.

Many analysts are highlighting the upside potential of the markets long-term, but at what potential cost in the short-term? Making decisions even more difficult is uncertainty surrounding COVID-19 and the potential of a second wave of the virus. We are just beginning to understand the permanent impact of the forced lockdown of the economy across the U.S. A recent Harvard University study indicated that 100,000 small businesses have permanently closed but that is the tip of the iceberg. A total of 4.2 million small businesses have received assistance from the CARES Act and chief economist Mark Zander of Moody's Analytics believes that more than 1,000,000 of those businesses will close and all the associated jobs will be lost.

Right or wrong, many investors are undeterred by the challenging times we are in on the assumption that the Fed will be able to offset the economic impact of the lockdown and election results. That might ultimately be the right call but the risk of being on the wrong side of that trade could be disastrous given the current valuations in the markets. If the bevy of black swans dissipate and no scenario plays out that results in market panic, there may be 5-10% of upside potential over the next 6-12 months. If any of the alternative scenarios occur, it is entirely possible to see a correction along the lines of 2008/2009 where the S&P 500 fell more than 40% before bottoming out in March 2009.

Most concerning for me long term is how divided the country has become politically and the potential for that to spill over economically. The inability to pass a stimulus bill that both sides appear to agree is needed is a symptom of the larger problem. As the chart suggests, two people can look at the same circumstances and come to literally opposite conclusions. Will widespread mail-in voting/ballot harvesting result in election fraud? It might, depend on who you are asking that question. Given the "suspicion" on both sides of the political spectrum, if I could go "long" attorneys that seems to be the surest bet right now.



Whenever you determine that downside potential is roughly 4X upside potential, it is reasonable to make sure you have sufficient hedging in place. We are closely watching the correlation between equities and Treasuries, and if the relationship becomes positively correlated it will be necessary to have alternative hedges at the ready. The only certainty seems to be that volatility will remain elevated and the need to remain tactical to respond to the changing environment is as important as ever.