PCM

PEAK CAPITAL MANAGEMENT

Into the Unknown

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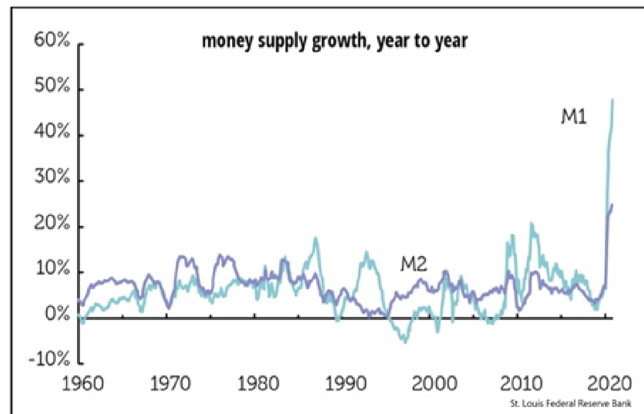
The phrase, "Happy New Year," is likely to be repeated more often than at the start of any other year of our lifetimes. Everyone will be glad to yell "adios" to 2020, but how confident can we be about what 2021 holds? We entered last year in pretty routine fashion before news of a virus originating in Wuhan, China sent the world into the largest pandemic since the Spanish Flu of 1918. The markets have traded in unprecedented fashion, losing over 30% in the shortest time in history, followed by the fastest stock market recovery in history.

Time will tell if the coming year has its own surprises in store, but there are some unknowns or risks that investors should be watching as trading in 2021 unfolds. Markets appear to be priced for a goldilocks scenario, where the economy opens up the first half of 2021 and corporate earnings surge. If there is one thing we have learned, it is whatever consensus suggests will take place, is far from guaranteed.

Risk #1 – Hiccup with vaccine rollout. It is astonishing that the market has traded at new highs when much of the global economy has been shuttered. The impact COVID-19 has had on the publicly traded companies has varied greatly. Big and emerging technology companies have seen windfall profits as companies scrambled to figure out 'work from home' scenarios, while travel and leisure companies and large retailers have filed bankruptcy at staggering rates. The ultimate impact of the virus, however, is going to be on small businesses, and that has been mostly ignored by the markets.



It has been estimated that more than 30% of small businesses closed over COVID concerns will never reopen. That represents a huge swath of jobs held by the most vulnerable, those with the lowest level of savings. There are still many unknowns about the vaccine adding to risks in the coming year. Side effects and allergic reactions are causing many to not be eligible or not desire the vaccine. The first approved vaccine needs be kept at minus 70 degrees Celsius, making logistics like transportation complicated. The best and brightest are working to solve this crisis, but the potential all does not go as planned is high and poses a significant risk to the impact of the first vaccine. Of course, the second approved vaccine requires storage at standard refrigeration temperatures, and other candidates may be viable at room temperatures, so the vaccination issue will not necessarily turn on the cold storage logistics alone.

Risk #2 – Balance of power in the Senate. Who controls the U.S. Senate will be determined following the January 5, 2021 runoff elections for 2 Senate seats in Georgia. If Democrats were to prevail in both races, they would control the House, Senate and White House, a potential panacea for Progressives who want to dramatically change the political landscape.

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Many of the promises made by candidate Biden could pose highly substantial headwinds for investors and the markets in general. According to some, U.S. corporate competitiveness surged following the drop in corporate tax rates from 35% to 21%. Because many corporate profits are distributed as taxable dividends to stockholders, it often resulted in a 60% net combined tax rate on profits. Lower taxes allowed U.S. companies to better compete and the surge in profits drove markets higher. Higher taxes on small businesses will significantly quell job growth at a time when as many as 20 million people find themselves unemployed.

Risk #3 – Fed blinks, impacting liquidity. Of all the reasons for the stock market's resiliency, excess liquidity provided by the Fed sits at the top of the list. Buyers of risk assets have benefitted from historically low rates in two ways: (1) low rates make borrowing for corporations very inexpensive, and (2) with little yield available from bonds, investors are almost forced into risk assets, driving prices higher. The chart in the middle showing the risk in the M1 and M2 money supply demonstrates how historic the Fed's response to COVID-19 has been.

The M1 money supply grew year-over-year by 48%, while the broader M2 grew at 25%. Personal savings has also skyrocketed, climbing YoY 302% in Q2 and 142% in Q3, representing more than $1.3T of new savings in just 6 months, according to the Bureau of Economic Analysis. Because of historically low velocity of money, there has not yet been any inflation associated with the surge in money supply, but if that starts to appear and the Fed tapers liquidity, I would expect a rush for the exits by investors.

Goldilocks scenarios rarely play out in real life and 2021 may prove that to be true. The markets appear priced for perfection and we live in anything but a perfect market environment. Don't be surprised if we see oxygen masks falling from the ceiling as the ride for investors gets bumpy in 2021.

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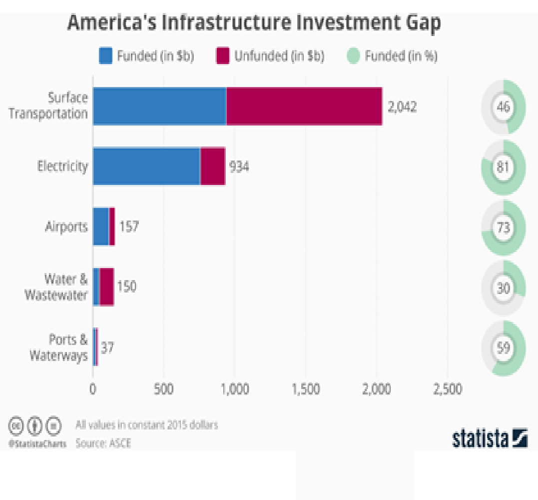
Time for Infrastructure?



The debate over infrastructure spending will heat up in the coming year as the new Administration figures out how it will navigate Congress to get spending bills passed. If the GOP holds on to at least one of the Georgia Senate seats, there will need to be more compromise than team Biden or the Progressives in Congress want. Just because it is widely believed that more spending on infrastructure is needed (considering a recent study showed 93% of roads in the District of Columbia are in disrepair), does not mean it is going to be easy to determine how to spend infrastructure dollars. Should dollars be allocated to traditional projects like roads, bridges, or water treatment plants, or should the focus be on technology infrastructure like 5G in order to remain competitive?

- Spending bills have typically been pork-laden, with dollars allocated on the basis of political power more than actual need. Remember the 'bridge to nowhere'? Only the most optimistic believe this year will be any different.
- There will be a lot of discussion of allocating money to the states, many of which have seen their budgets decimated by the COVID-19 lockdowns. Will allocated funds go to actual projects or to fund government employee pensions?
- Picking the winners who benefit from the spending is difficult. There will be significant pressure for "Green" initiatives to be included when funds are allocated.

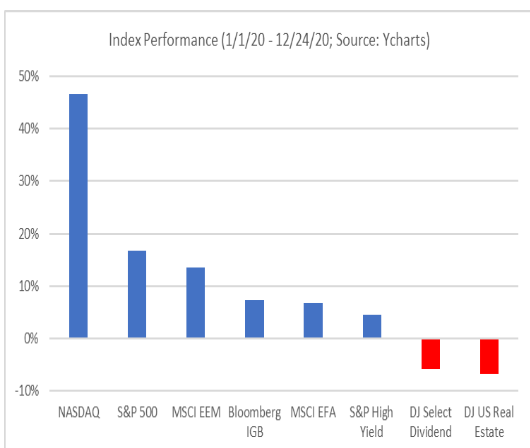
SPACs in Focus

Source: Peak Capital Management, LLC

A Special Purpose Acquisition Company (SPAC) offers an alternative to IPOs. SPACs serve as publicly traded shell companies with the objective of M&A. The shell company allows for the creation of a company without operational or assets typical of a traditional corporate structure. Furthermore, because of the structure of SPACs, capital raised is viewed as unlimited. Finally, the SPAC allows investors access to private equity without extended periods of illiquidity that can reach ten years or more for some private equity. SPACs have been around for over two decades, but 2020 has witnessed a flurry of activity, dwarfing activity in 2017, 2018, and 2019 combined. Bloomberg tracks The Indxx SPAC & NextGen IPO Index. The index gained 41% from April 30th until November 6th, 2020 (Bloomberg).

- As of November 6th, there were 152 SPAC offerings completed in 2020, raising $58mm (Bloomberg).
- Since the beginning of 2019, SPACs have accounted for over one third of all U.S. IPOs (Bloomberg).
- As of December 24th, there have been a total of 479 IPOs on US exchanges during the year 2020, versus 233 IPOs for the same time period in 2019 (stockanalysis.com).
- SPACs have been recognized as effective in capitalizing companies in the gig economy.
- One of the most notable products of a SPAC was the launch of Draft Kings.

Asset Class Performance



The year 2020 was extraordinary by any measure. We observed volatility at levels never experienced before, including during the Financial Crisis of 2008. As the coronavirus hit, broad swaths of the economy began to shut down. Many asset classes experienced drawdowns of -20% or more. The pace at which the drawdown occurred was not experienced since the market crash of 1987. Then, as we worked our way through the initial wave of the pandemic, market returns became highly bifurcated. Certain parts of the equity market began soaring to new highs, while others continued to languish as investors began to realize who was going to benefit from the current shutdown. As a result, we saw a large-scale asset rotation.

- The obvious winners this year were technology stocks as measured by the NASDAQ, which has advanced roughly 47% year-to-date. The index is on pace for its best year since 2009. Meanwhile, the large cap S&P 500, which is roughly 30% technology, is up approximately 17% for the year after delivering 31% in 2019. Likewise, both developed and emerging markets are higher year-to-date by roughly 7% and 14%, respectively.
- Much of the return from fixed income came during the height of the pandemic during March as yields plummeted. The Bloomberg Aggregate Bond index is higher by roughly 7% for the year. After Fed intervention to support liquidity, high-yield bonds have risen by roughly 4% for the year, but dividend paying stocks and real estate are lower this year by roughly -7% and -8%, respectively.

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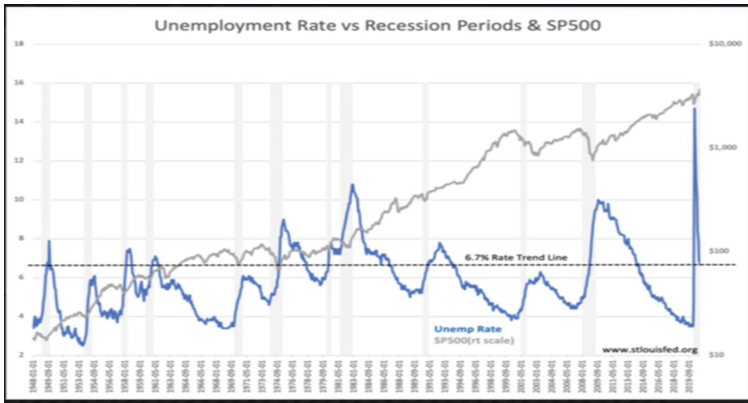
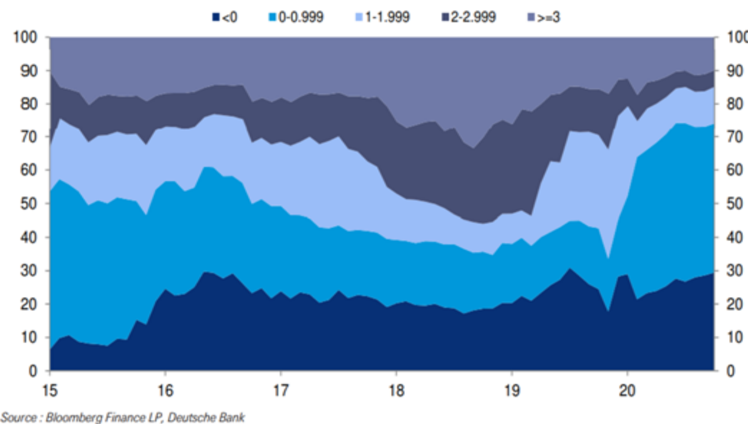
Macro View – Unemployment Tea Leaves

Unemployment can provide analysts a glimpse at where the economic cycle stands, potential for equity appreciation, and potential to forecast recovery from recessionary periods. The chart below shows economic growth reflected in S&P 500 appreciation, coupled with unemployment. It is evident that as unemployment falls following recession, equity prices appreciate. The chart shows unemployment currently rests at around 6.7%, peaking at about 14.7% in April (St. Louis Federal Reserve Bank). The peak reflected a rate not witnessed since the great depression. It is also worth noting that the current level of 6.7% surpasses unemployment levels going back to 2015. While unemployment is a lagging economic indicator, downward trends indicate rising equity prices. So, if it is believed that unemployment will continue to fall in 2021, the case can be made that equity prices will rise over the same time period.



Fixed Income - Picture Worth a Thousand Basis Points

Almost $1 trillion in bonds saw their yields turn negative in November 2020, meaning 29% of the total supply of investment -grade bonds trade at sub-zero yields, according to data from Bloomberg. As the chart indicates, only about 10% of global bonds, including all corporate high yield bonds, trade with a yield above 3%, and just 5% of global bonds have yields between 2% and 2.99%. The surge in the graphic of light blue (0%-.99%), moving from approximately 10% of the global bond market to more than 40% of the bond today, represents yields on U.S. Government bonds. Just 15 years ago, investors holding 5-year U.S. Government bonds earned yields of approximately 5%. You almost have to own a bond in default to get that high of a yield today, as witnessed by the benchmark BAML High Yield index showing average junk bond yields of 3.48%.



Taking Stock – The Best and Worst of the Year

2020 is littered with challenging circumstances. In a tough year, some companies have walked away as big winners in terms of stock price appreciation. As of the end of November 2020, the greatest gain was from Medtecs International Corporation, up about 2800%. The company produces personal protective equipment. The share price went from $.037 at the start of the year to $1.07 as of the end of November. At the bottom of the list, recognized as the worst performer, was Globus Maritime, down close to 94% as of December 16th. Globus owns and manages a fleet of around five dry bulk vessels that transport iron ore, coal, grain, steel, cement, and aluminum (Bloomberg). Total commercial construction spending declined over the course of 2020, contributing to the decline of Globus.

Technical - New Perspective on Bitcoin

Most investors are aware of the surge in Bitcoin that led many to speculate that it is simply a bubble that will burst and teach risk-taking millennials about investing. Those investors might be shocked to learn that the chart of the NYSE FANG index (Facebook, Amazon, Netflix, Google) looks strikingly similar to Bitcoin over the last year. In fact, only the latest rise that moved Bitcoin from $10,000 to over $20,000 allowed Bitcoin to catch up to what the FANG stocks have done. The meteoric rise in both indices suggests speculation that is unsustainable in my opinion. Part of this is the result of the excess liquidity created by the Fed that encourages risk taking. Interestingly, the rise in Bitcoin is likely correlated to many investors losing confidence in the U.S. dollar as the reserve currency, because of how much debt is being added to the government's balance sheet.

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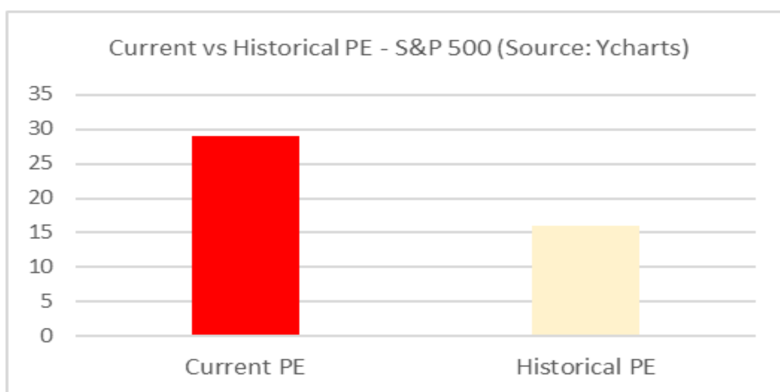
Are Equity Valuations too High?

Clint Pekrul, CFA

On December 21st, the S&P investment committee added Tesla to their benchmark S&P 500 Index. Shares of Tesla have risen roughly 700% year-to-date, and now represent roughly 2% of the total index. According to data from NASDAQ, Tesla trades at roughly 240 times 2021 estimated earnings. Meanwhile, the top two holdings in the S&P 500 – Apple and Microsoft – trade at roughly 30 times current earnings. The third largest holding in the index – Amazon – trades at roughly 90 times 2020 earnings estimates. Combined, the stocks mentioned above represent roughly 20% of the index's market capitalization.

The price-to-earnings ratio (PE) on the S&P 500 is roughly 29, according to Bloomberg. The historical long-run PE for the index is roughly 16. From a purely historical context, the S&P 500 is trading at roughly twice its long-run PE.



The Equity Risk Premium (ERP)

The ERP describes the excess return an investor can potentially earn from investing in equities over a risk-free investment, such as short-term Treasuries or a money market fund. In theory, as stocks become expensive, the ERP diminishes. In other words, relatively high valuations today are more difficult to support going forward, and the likelihood of achieving a return premium, if any, is diminished.

Conversely, if valuations are below historical norms, the ERP expands. Stocks are considered cheap relative to future earnings, and investors can be rewarded with a premium return over the risk-free rate. An expansion of the ERP typically occurs after a market correction, when stocks can trade at or below their long-run valuations.

As mentioned before, the current PE on the S&P 500 is almost twice its long-run average, which would suggest that the ERP has likely diminished somewhat, and that a return to more normal valuations could be in order over the intermediate term. That is, equity prices in general could likely fall more closely in line with earnings.

Historical Comparisons

When making historical comparisons to equity valuation metrics such as the PE ratio, it is important to consider the return premiums associated with other asset classes, namely bonds.

Historically, when stocks have become overvalued based on measures like the PE ratio, investors would swap the ERP for a duration or credit premium in the bond market. For example, back in the late 1990s towards the end of the dotcom bubble, when the PE on the S&P 500 hovered above 30, the yield on the 10-year U.S. Treasury bond was roughly 6.5%. Investors who were fortunate enough to rotate out of equities in 1999 earned handsome returns in bonds over the ensuing three years as equity values plummeted.

Today the 10-year yield is less than 1% - there is no meaningful duration premium offered in the bond market. As such, it is unclear where equity investors might turn if they think stocks are overvalued and the ERP is no longer attractive. Furthermore, with a zero-interest rate policy, the Federal Reserve has ensured that holding cash is not a viable option.

As a result, equity investors might be willing to hold stocks at higher valuations for a longer period. In other words, valuations could remain stretched for longer given the limited opportunities in bonds.

Domestic vs. International

It is noteworthy to mention how domestic equity markets have outperformed international developed and emerging markets. Over the past 3, 5, and 7 years, the S&P 500 Index has outperformed the MSCI EAFE Index on a cumulative basis by 47%, 59%, and 70%, respectively.

The PE ratio on the MSCI EAFE Index is 18 compared to a PE ratio of 29 for the S&P 500 Index. From a pure valuation standpoint, investors could begin to look for opportunities overseas. In other words, the ERP on international markets could begin to look more attractive compared to domestic equity markets.

It is a similar situation for emerging markets. Over the past 3, 5, and 7 years, the S&P 500 Index has outperformed the MSCI Emerging Markets Index on a cumulative basis by 27%, 57%, and 170%, respectively.

The PE ratio on the MSCI Emerging Markets is approximately 17, which is well below the corresponding PE ratio of 29 for the S&P 500. Emerging markets could provide a compelling ERP over the next five to ten years, given changing demographics and population trends.

Overall, a case could be made that equity valuations are too high, given expectations about future earnings and historical PE ratios. However, we should be cautious about making casual inferences from past market cycles. We have never had this degree of intervention in the financial markets by central banks and governments. This intervention, by design, effects valuations and, in turn, the ERP.

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Q: Will the latest stimulus be enough to keep a second recession from coming?

In short, no, I would have zero confidence that the latest passed stimulus plan will avert a second recession resulting from COVID-19 lockdowns of the economy. First, $600 of direct payments to about 80% of U.S. taxpayers is not enough to really move the needle. The bigger issue involves the forced closure of a large majority of businesses, particularly small businesses, in most states that deprives people from earning a livable wage.

In the same way the coronavirus has unequally impacted publicly traded stocks with some big winners and many losers, the same is true with the impact of individuals. High income earners have been mostly un-impacted by COVID because of their ability to work remotely in the work they do. The disproportionate impact has been on low-wage earners who often work in hospitality services that require direct customer interfacing. These workers are also at risk of losing enhanced unemployment benefits at year end 2020, of which the $600 stimulus is only a fraction of benefits being lost.

The depth of any recession I expect to occur this year would largely depend on the efficacy of the vaccine, testing, and a therapeutic. If by mid-year the virus is under control to a degree that allows all businesses to open and people are comfortable traveling and eating out, we will likely have a shallow recession, if not, 2021 could be dreary for the markets.

After days of pushing back on the proposed $900 billion stimulus proposal, President Trump finally relented and signed the bill into law. There is a proposal that the direct payments to recipients should be increased from $600 to $2000. The House voted overwhelmingly on the proposal and will be voted on in the Senate. It is likely that Senate democrats will support the change, but the $2000 direct payments will probably face opposition from Senate Republicans. At any rate, the package will deliver much needed relief to businesses and individuals and will avert a government shutdown. It also extends the eviction moratorium.

I am not sure why we call these bills “stimulus” packages, because they truly are emergency relief funds. My view is that the emergency relief proposal probably will probably not be enough to ward off another recession. President-elect Biden has suggested that another round of emergency funds might be needed once he is elected. Ultimately, the progress we make on eradicating COVID will dictate the terms of any future emergency relief proposals. If we fail to provide a uniform and effective front in the COVID battle, then I doubt the latest bill – in its current form – will provide enough relief.

Q: Does an equity risk premium still exist?

The equity risk premium is essentially hanging on by a thread at this point. Over the last 15 years the equity risk premium, the amount of excess return equity investors should receive over a perceived risk-free investment, has been around 5.50% per year. That means a perceived risk-free asset like a U.S. Treasury bond might provide 2.5% per year total return and owning the S&P 500 would average around 8%. The idea of the risk premium is that stock investors take on more risk and should be rewarded with higher expected long-term returns.

When market forces determine which investments win and which investments lose based on the relative merits of the investments, the risk premium can be identified. I am of the opinion that market forces have not determined winners from losers for some time, and Fed policy has been a much greater factor in determining investment success than actual results. This can be seen in how low quality stocks and zombie companies have performed this year. According to CNBC, low quality stocks, the 20% of companies with the worst balance sheet metrics, have outperformed the 20% of companies with the strongest balance sheets. Similarly, zombie companies, defined as a company whose earnings are insufficient to cover their interest payments on debt, continue to issue debt and thrive in many cases. Zombies added more than $1 trillion in debt in 2020, much of it at distinctly low interest rates.

To be clear, the equity risk premium (ERP) is the extra return you expect to receive by risking your money investing in the stock market. We start with a base-line investment in a risk-free portfolio, perhaps of short-term Treasuries or a money market fund. Your decision to make an investment in equities depends on the excess return you expect to receive from that investment over some time horizon. Based on history, equities have delivered a risk premium, which is why investors have bought stocks and held them for long periods of time. However, the ERP is not a constant and can vary quite significantly.

Much of what determines the ERP is valuations, such as current price-to-book or price-to-earnings ratios. In theory, higher valuations suggest a lower ERP. Since stocks are deemed too pricey, the potential for future returns shrinks (i.e. the premium is reduced). After market corrections like we had in March, the ERP expands. You’re likely to realize an attractive premium going forward since your entry point is at lower valuation (i.e. stocks are cheap). We’ve discussed the possibility that stock valuations are stretched based on historical measures, which would suggest a lower ERP today. However, don’t forget what intervention from the Fed can mean for stock prices and the ERP. While it still exists, the ERP is likely a bit compressed for now, given the incredible rally we’ve had in stocks this year.

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All weights as of December 1, 2020

Income	
Mortgage Backed Bond	56.34%
Investment Grade Credit	17.76%
High Yield Bonds	7.19%
Preferred Stock	11.13%
US Dividend Equities	4.64%
US REITs	2.92%

Balanced Income	
US Dividend Equities	13.96%
International Dividend Equities	15.24%
US REITs	9.59%
High Yield Bonds	27.26%
Long Term Treasuries	33.95%

US Growth	
Low Volatility Factor	15.92%
High Quality Factor	13.85%
Small Cap Factor	12.05%
Value Factor	16.59%
Momentum Factor	11.84%
Long Term Treasuries	29.75%

Global Growth	
Low Volatility Factor	8.31%
High Quality Factor	6.52%
Small Cap Factor	5.63%
Value Factor	7.90%
Momentum Factor	5.72%
Developed Market Equity	18.54%
Emerging Market Equity	17.73%
Long Term Treasuries	29.65%

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