PCM
PEAK CAPITAL MANAGEMENT

Earning on Up

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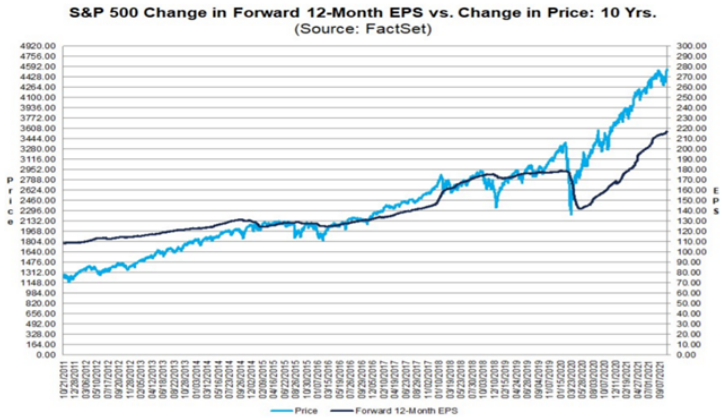
Sentiment may dictate short-term moves in equities, but most investors will agree that a companies' earnings ultimately determine the direction of a stock. We are about halfway through Q3 earnings reports, and some interesting trends have emerged. According to FactSet data, almost 75% of companies have reported higher revenues than forecast and just above 80% of companies reported a positive earning surprise. These initial results are primarily why markets are back near all-time highs, particularly among tech stocks.

Earnings growth is poised to come in above 32% year-over-year, making it the third highest growth rate in the last 48 quarters. But before we pop the bubbly and declare the markets safe, there are other signs that may be pointing to turbulence ahead. Forward guidance has been soft, with twice as many companies guiding lower than expectations than companies guiding higher. Valuations are also beyond stretched at this point. The forward P/E ratio sits at 21, well above the 5-year average of 18 and 10-year average of 16. Those claiming the market is 30% overvalued are simply solving a math equation at this point.



Another concerning data point comes from professional portfolio managers who manage publicly traded funds. As of October 15, according to BAML, cash levels at equity mutual funds are higher than at any other time in the last 12 months. With the recent lift in stock prices, it is clearly getting more difficult to find stocks that you feel good about the valuation.

It is somewhat baffling how earnings can be so strong given the supply chain disruptions evidenced by the ships unable to port and offload containers. Sectors like Consumer Cyclicals are bearing the brunt of supply chain issues, which at this time are only impacting goods shipped to the U.S. The most surprising data involves companies who rely heavily on exporting their products and services. S&P 500 companies that generate over 50% of revenues from sales outside the U.S. are reporting 44% earnings growth, versus only 26% growth for companies with a majority of sales in the U.S. Not surprisingly, it is tech companies (Apple and Alphabet) and energy companies (Exxon and Chevron) leading the way with these four companies alone accounting for almost 30% of foreign sales, according to FactSet.

Financials have clearly been helped by the trend toward higher yields, and as a group have reported Q3 earnings more than 19% above consensus. Healthcare had the next highest positive surprise at over 12%, which could be tracked to spending on battling COVID (Abbot Labs and Quest Diagnostics). Somewhat confounding given the media attention on inflation, the Materials sector was reporting both the lowest percentage of companies beating estimates and the lowest overall upside surprise.

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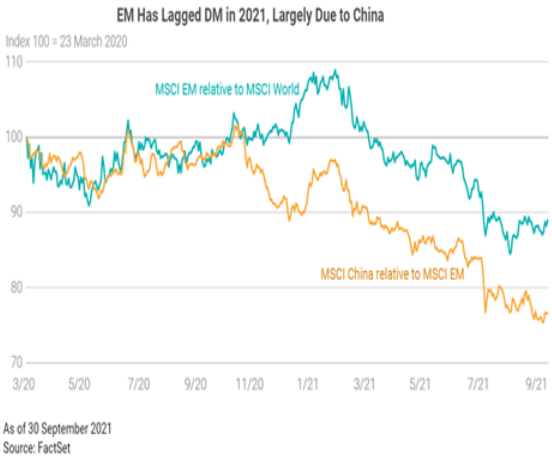
Before we forecast these strong earnings indefinitely into the future, there are a few factors we should consider. First, the year-over-year comparisons are against a weak backdrop as the economy was coming out of recession in 2020 following the onset of the pandemic. Many industries were still severely impacted 15 months prior as demonstrated by the Airlines contributing more toward earnings growth than any other group. Second, most industry insiders do not use the published consensus numbers, but rather the "whisper" number, when evaluating a company's performance. Companies try very hard to manage the expectation in a way that almost ensures they will beat consensus estimates. There is also a whisper estimate that is what analysts closely following the company expect the company to report. This explains why a company can beat consensus and see their stock drop if they do not exceed the whisper figure.

Of the companies reporting so far, only 37% have beat the higher whisper estimate (earningswhisper.com). This suggests that the number of companies actually producing higher earnings than experts forecast is much lower than the consensus numbers. It will be interesting to see how well companies are able to manage forward expectations given the lower guidance. As expectations rise, it clearly becomes more difficult to report positive surprises.

The biggest concern for investors should be valuations, as the chart clearly demonstrates. For the last 10 years, the correlation between EPS growth and Price growth has been remarkably strong until COVID hit. Stocks recovered from the price drop much faster than EPS recovered, and the gap between Prices and EPS is the highest it has been in decades. History is clear -- that gap will get closed either by stock prices plummeting or by EPS rising sharply. This suggests it might be a good time to consider increasing hedges in portfolios.

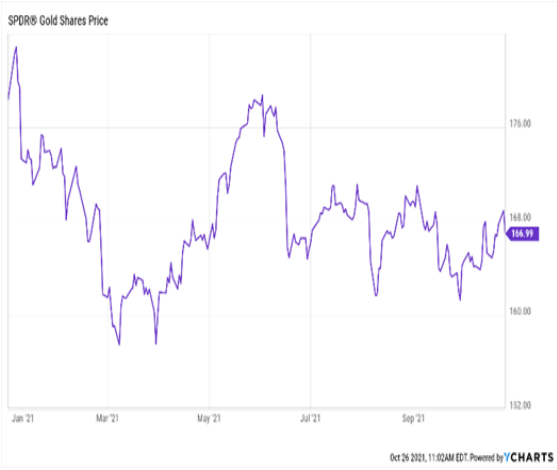
A Hidden Gem?



Many investors are avoiding Emerging Markets these days over fears that the type of excessive leverage in China that caused the collapse of Evergrande was systemic to the Chinese economy. China is almost 35% of the largest emerging market index (almost 50% if Taiwan is included) so it makes sense to steer clear of emerging markets if you share those concerns. That may be a mistake these days if you fail to realize that you can invest in emerging market ex-China. The chart below shows investors who are ex-China are 10% higher year-to-date than emerging market investors who own China in the index. As a group, emerging markets are trading at mid-single digit P/E ratios and have a yield higher than the S&P 500, making them a compelling value investment.

- The emerging market energy sector has been generating strong results and contributes most to the overall gains, followed by materials and industrials as exports continue to fuel these economies.
- Emerging markets in Europe, the Middle East, and Africa posted strong YTD results, while Asia and Latin America have lagged. India is the best performing country while Brazil has been the worst performer.
- Emerging markets are forecasted to grow real GDP at a rate of 5.2% in 2022, only slightly above the 4.9% estimate for the U.S. Growth might not be higher, but valuations are much lower today.

Has Gold Lost its Luster?



Gold and inflation tend to go hand-in-hand. Conventional wisdom holds that when inflation expectations rise, so does the price of gold. With its limited supply, gold can be a store of value when prices for goods and services rise. Historically, when indexes like the CPI edge higher, investors will allocate to gold to offset the loss of purchasing power. So far this year, we've seen headline inflation creep higher, but surprisingly, the price of gold has not followed suit. Based on the chart to the left, which measured the price of the SPDR Gold Trust ETF, gold is lower by roughly -6% year-to-date.

- Part of the reason gold is trading lower could be due to the opportunity costs of holding gold versus equities. Despite the increased inflation concerns, equities continue to hit new highs and earnings have been strong. Likewise, institutional investors might be of the mindset that inflation concerns are more transitory.
- Investors can also hedge inflation in other ways. Bitcoin, with its limited supply, could compete with gold. Likewise, companies that consistently increase their dividends can provide rising income over time to combat inflation. Gold might ultimately trend higher, but for now, investors are allocating assets elsewhere.

Bitcoin on Main Street?

Source: Coindesk

As of late, cryptocurrencies such as Bitcoin have been in the media spotlight once again. Many would argue that the most recent rally is largely due to news around the launch of an Exchange Traded Fund (ETF) that tracks bitcoin futures. On Oct. 19th, ProShares, a provider of specialized exchange-traded products, began trading of BITO: Bitcoin Strategy ETF, marking the first Bitcoin ETF to trade in the U.S. However, there has been some concern around BITO. According to ProShares, BITO seeks to provide capital appreciation primarily through managed exposure to Bitcoin futures contracts and does not invest directly in Bitcoin. While BITO does not track the spot price of Bitcoin, it allows investors who are more comfortable with traditional investment accounts to gain crypto exposure without having to hold or exchange the actual cryptocurrencies.

- On Oct. 20th, Bitcoin hit an all-time high of $66,974 and then fell back down into the lower $60,000 range.
- Despite BITO's flaws, Todd Rosenbluth from CFRA Research called BITO "a milestone for the ETF industry."
- Investing in crypto has historically been an expensive process due to high fees and transaction costs. Bitcoin futures ETFs like BITO potentially offer a relatively low-fee solution.
- Potential risk associated with futures-based ETF include, but are not limited to tracking errors, and a market condition called "contango", where the futures price could exceed the current price.

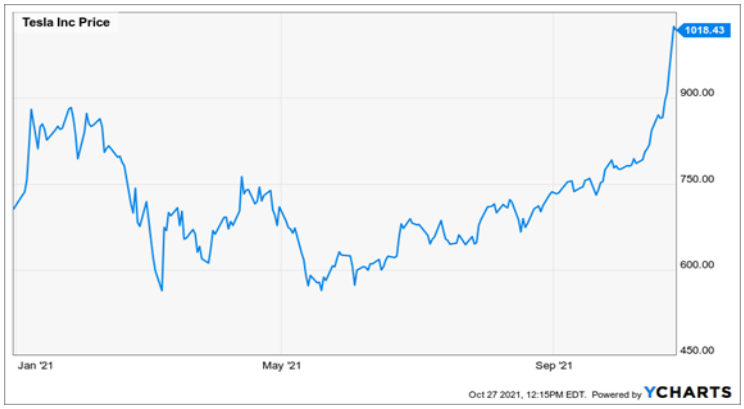
Macro View – Billionaire Tax

Democratic members in Washington have been looking for alternative ways to generate revenue after Senator Krysten Sinema's opposition to increasing marginal tax rates on corporations, capital gains, or individuals. Therefore, in an effort to pay for their vast social and climate change spending package, Democrats are now proposing an annual tax on billionaires' liquid asset unrealized capital gains. For example, if you own a stock that increases in value from $50 per share to $100 per share, but never sold, you will potentially have to pay a tax on the $50 "gain." Now, the proposed tax is expected to only affect people with $1 billion in assets or $100 million in income for three consecutive years, or likely fewer than 1,000 taxpayers, according to The Wall Street Journal. However, this bill, like many of Democrats' previous proposals, will face challenges from both Democrats and Republicans. Given the slim majorities in Congress, every Democratic vote would be needed to pass, something that is not clear at this time.

Source: Investopia

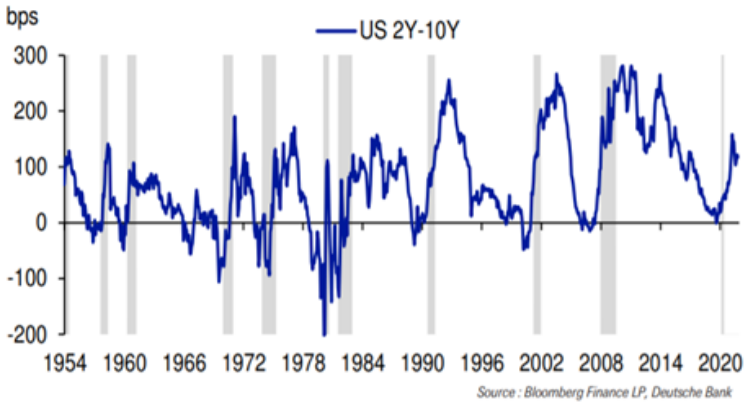
Taking Stock – Tesla

On Monday October 25, Tesla Inc (TSLA) hit a $1 trillion dollar market cap following the news that Hertz (HTZZ) is ordering 100,000 electric vehicles to build out its electric fleet of rentals by the end of 2022. This was after the company reported record profits and revenue for Q3 (EPS adjusted: $1.86 vs $1.59 expected and revenue: $13.76 billion vs $13.63 billion expected). According to Bloomberg, this deal with Hertz will reportedly bring in $4.2 billion for Tesla. Upon surpassing this milestone, Tesla joins the likes of Alphabet (GOOGL), Apple (APPL), Amazon (AMZN), Microsoft (MSFT), and Facebook (FB) as companies with over a $1 trillion market cap. At the time of this writing, Tesla is up about 45% YTD and 60% over the last three months. However, automakers like Tesla still face challenges with semi-conductor shortages and ongoing supply chain struggles weighing on the industry.



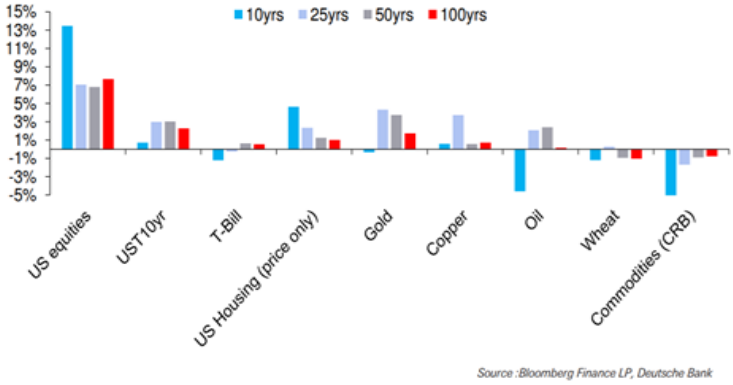
Fixed Income - Hitting the Curve

The yield curve is getting a lot of attention in the current environment of high inflation at both the consumer and producer levels. Short-term interest rates have historically tracked inflation expectations with the CPI and 3-month Treasury demonstrating high correlations. It is assumed that if inflation remains high, it will force short-term interest rates like the 2-year Treasury significantly higher than current levels. Given the fact that the 10-year Treasury bond is currently only about 50% of CPI (1.6% vs 3.5%), many are concerned that the 2-year Treasury yield could soon surpass the 10-year Treasury yield, causing an inverted yield curve. One of the more accurate predictors of recessions for more than 70 years is an inverted yield curve. The chart shows that the yield curve inverted in virtually all recessions and the spread between the 2/10's is about 115 basis points today, but worth watching as it narrows.



Technical - Investing for Generations

One of the greatest challenges for investors is determining what time frame they should use when evaluating investment trends for technical strength or weakness. Because reversion to the mean is considered a given over a long period of time, recent outperformance of certain asset classes may portend underperformance in the future. Take U.S. equities as an example -- the performance over the last 10 years has been at least double the average performance over 25, 50, or even 100 years, suggesting it is highly unlikely that they will continue their outperformance long-term. Commodities are at the opposite end of the spectrum, having underperformed during the prior 10 years at nearly 3 times the average over 25, 50, or 100 years. This data is factored into the GMO 7-year Asset Class Return forecast and why they believe most equities will have negative returns over the next 7 years.



Inflation and Commodity Prices

Clint Pekrul, CFA

With supply chain issues causing disruptions across the global economy, we've seen inflation rise over the course of 2021. Consumer demand is quite strong, but bottlenecks at the ports and labor shortages have led to empty shelves and higher prices for most items that consumers buy every day. Inflation expectations, as measured by the breakeven rate of 10-year Treasuries, is at levels not seen since 2006. However, long-term Treasury yields remain relatively subdued.

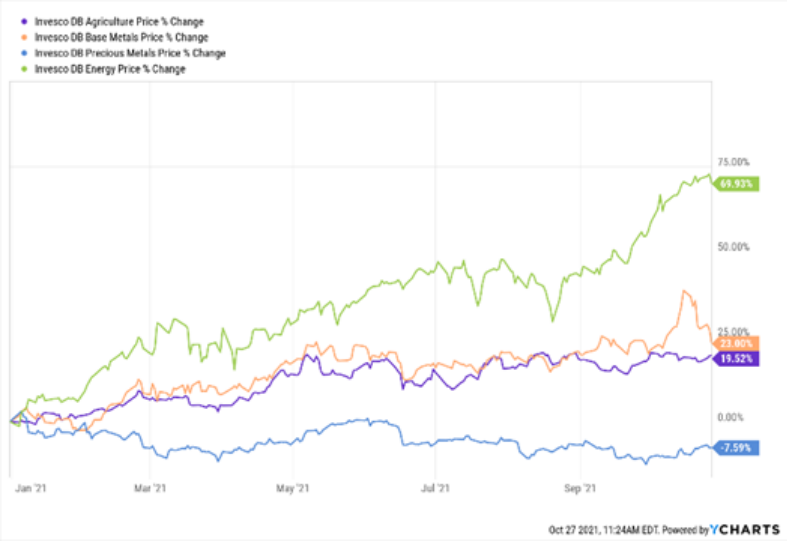
Inflation Breakeven Rate

The chart below illustrates inflation expectations based on the 10-year nominal and TIPS yield. The current reading is 2.69%, which is above the Federal Reserve's long-term target of 2%.

According to the chart above, investors would be better off holding TIPs over the next ten years if inflation exceeds 2.69% (approximately), given that the coupons on TIPS would be adjusted upward based on the Consumer Price Index (CPI).

Commodity Prices

The chart below illustrates the year-to-date returns for four primary commodity groups – energy, precious and base metals, and agriculture.



Energy prices (i.e., crude oil, natural gas, gasoline, etc.) collectively are higher for the year by roughly 70%, but this comes after a decline of roughly -25% in 2020. Higher energy prices reflect a combination of higher demand and tighter supply. Likewise, agricultural prices (i.e., coffee, sugar, corn, etc.) are higher for the year by roughly 20%.

10-Year Treasury Yield

The chart below illustrates the 10-Year U.S. Treasury Yield Index (current yield x 100). The index currently sits at 15.7 (or 1.57%).

The 10-year index reveals an interesting pattern, particularly over the past year. After the plunge in yields in 2020 due to COVID, rates accelerated higher. After starting from such a low base of 0.5%, the 10-year yield peaked at roughly 1.75% around the end of March. But then the yield rolled back down below 1.2% despite inflation concerns. The current yield is still below levels just before the pandemic began last year.

Velocity of Money

The chart below illustrates the velocity of the domestic money supply. The velocity multiple currently stands at 1.12.

The chart above is telling and can provide some insight as to why the 10-year Treasury yield is not trading at a higher level. The velocity of money describes the number of times one dollar is spent to buy goods and services over a given period of time.

The velocity of money is important as it relates directly to inflation. While we have seen headline inflation creep higher due to supply chain issues and higher commodity prices, the velocity of the money supply is rather stagnate. This suggests that there are fewer transactions occurring between individuals in the economy than before, which does not suggest inflation.

Perhaps the bond market is playing a game of tug-of-war between the headline inflation number and what is occurring in the underlying economy.

Q: Will Cathie Wood or Jack Dorsey be correct on inflation?

It is always interesting when you see people from different disciplines engage in debate on topics that are currently relevant. Jack Dorsey, co-founder of Twitter and Square, strayed a bit outside his typical lane when making economic comments about inflation, suggesting the US was going to experience hyperinflation in the near future. Dorsey leads a social media platform with over 206 million active daily users, so his statements are meaningful, even if they become just a self-fulfilling prophecy. Cathie Wood, famed investor and manager of Ark Investments known for investing in innovation and cryptocurrency, was quick to respond to Dorsey's predictions. Not only did she suggest hyperinflation was not going to occur, she said the real issue we will be dealing with is deflation. You could not get further apart in your analysis than the two publicly shared.

I would suggest the overwhelming odds are that Cathie Wood will be proven correct. She correctly points out that many of the price increases have resulted from supply chain disruption that is likely to be resolved by early 2022. While the government has spent obnoxious amounts over the last 18 months in response to the pandemic, the velocity of money continues to fall as it has done for the last decade. Ultimately, higher debt levels become deflationary as they serve as a barrier to growth. Wood points out that training cost for AI and machine learning are falling between 40%-70% per year and that companies will increasingly use robotics to reduce costs of products.

That's the million-dollar question. Cathie Wood, who runs Ark Invest, suggests that in the long-run, deflationary forces will overcome the current supply chain issues. Her stance is not too surprising, given her focus on innovation technologies. Jack Dorsey, who founded Twitter, is claiming that hyperinflation is around the corner, which means 50% price increases per month. So, Cathie's and Jack's forecasts are diametrically opposed. In the end, I think Cathie's take on inflation will likely be closer to reality than Jack's.

There are secular trends at play that I think will lead to downward pressure on prices in the long-term. The first is demographics. An aging population in the developed world and slowing population rates don't push aggregate demand higher, but lower. Second, technological innovation doesn't tend to lead to higher prices (it's a deflationary force). Lastly, globalization puts downward pressure on wages, and ultimately prices. I think what we are seeing today is simply the combination of extraordinary fiscal stimulus in the face of COVID, coupled with supply chain disruption. These are likely temporary forces, however. It would not be surprising to see inflation run modestly above the Fed's long-term target of 2%, but this is a far cry from Jack's hyperinflation scenario.

Q: Who is to blame for the supply chain issues?

As is the case with most crises in the world, there is plenty of blame to go around. Also true is that with more than 100 container ships off the coast of California waiting to port, it will create an opportunity for the future that others will take advantage of. There have been changes in consumer spending patterns since the pandemic began, largely driven by government stimulus payments and lockdowns altering people's lifestyles. Certain products were more difficult to source because of raw materials or manufacturing that were impacted by COVID. The current problem, however, is more of a broad transportation problem caused by a lack of truckers to haul freight coming in from overseas. The American Trucking Association has stated that the industry is short 80,000 truck drivers, the highest in history. The shortage is caused by closing schools during lockdowns and regulatory actions taken by states like California and AB5. Originally thought to impact just the 'gig' economy like Uber drivers, the restrictions on classifying Independent Contractors have very much impacted trucking in California. There are also regulations stipulating zero emission trucks over the next decade, making it difficult for some companies to justify spending on equipment that may not be compliant during its expected lifespan. Throw in poor planning and reliance on just-in-time inventory, and you end up with a mess that only complicates the current inflation challenges.

There seems to be plenty of blame to go around, but it seems that the supply chain issues are due to a confluence of many factors. On the one hand, consumer demand can increase quite meaningfully in a fairly short period, especially when you have a global shutdown (more-or-less) due to a pandemic followed by a "grand reopening." Demand soars, but it takes more time to increase capacity at the ports, hire workers and build warehouses. What we're seeing with the supply chain now is a perfect storm of sorts.

Truckers, ports, warehouses, etc., are processing record amounts of goods, but they face shortages of workers. According to the Labor Department, the warehouse industry had a record 490,000 job openings, and the trucking industry had a shortage of over 80,000 drivers. As far as who is to blame, it depends on who you ask. Truckers say that the longshoreman aren't working at full capacity and blame the ILWU for not allowing the ports to operate on a 24/7 basis. Still, others say there is not sufficient automation at the ports to allow for quicker processing times. At any rate, it doesn't seem that the current supply chain issues will be resolved any time soon, especially with the holiday season approaching.

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