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Peak Capital Management

Brink of Destruction?

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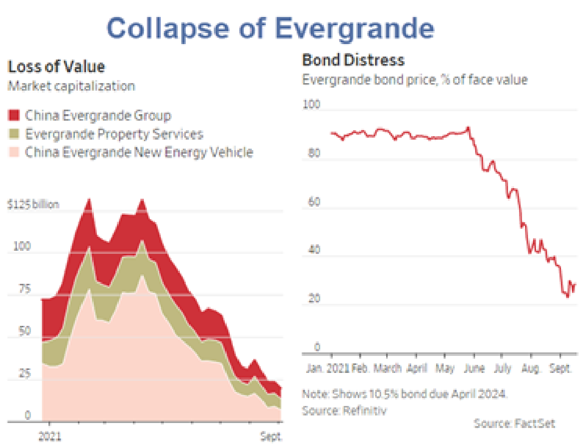
We live in a truly remarkable time.

Central Banks have progressed to the point where they not only are able to conquer the business cycle but eliminate the consequences of truly bad corporate behavior, regardless of the scale. The world was recently made aware of the pending bankruptcy of the largest property developer in China, Evergrande. Debts of the company exceed $300 billion, more than half of the size of Lehman that brought the global financial markets to a screeching halt in 2008, according to Bloomberg. According to Reuters, Evergrande also has $3.5 trillion of "unfinished" projects, which projects' value equals 25% of the entire Chinese GDP.

When global markets became aware of how dire the situation was, they sold off as expected, for about 2 days. That's right, the failure of the largest developer in what is soon to be the world's largest economy, potentially pricking the global real estate and housing bubble, was thus far a 48 hour event. This is remarkable.



China's real estate market has been described by many as a 'house of cards.' While Evergrande is the largest developer in China, it by no means is the only developer in trouble in Asia. The Chinese Communist Party and the People's Bank of China have indicated they are not going to bail out Evergrande or other developers who are massively over-leveraged. Many suspect this is because Chairman Xi has a plan to nationalize the housing markets in China to reduce speculation and ultimately try to reduce the income divide. Without a Beijing bailout, there will be a fire sale on the assets of Evergrande, creating a domino effect of highly leveraged developers and the banks who financed them. Much of the more than $300 billion in debt is owed to parties outside of China, making it as likely to be contained as a coronavirus in a wet market.

The stock of Evergrande has fallen over 90% and their bonds are trading at $.30 on the $1 as this is being written. There likely will be unintended consequences of allowing Evergrande to collapse that will impact markets for more than 48 hours in the future. Few institutions are coming clear with their exposure today, but in time full disclosure will come.

Unlike Las Vegas, what happens in China does not stay in China. While most investors had not heard of Evergrande before last week, their problems have been years in the making and rapidly approaching the surface like the Old Faithful geyser in Yellowstone. There are signs of distress in the US economy that the stock market is largely ignoring at the time of writing.

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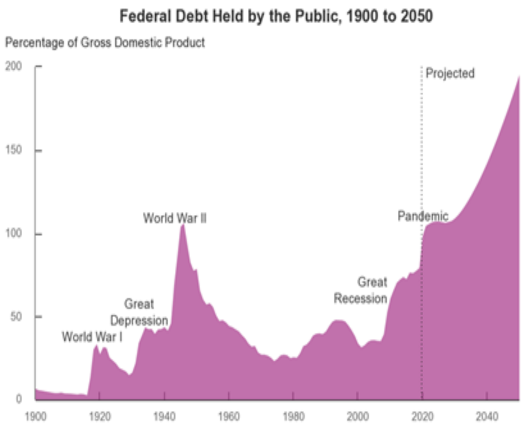
The National Association of Business Economics (NABE) released a report recently that was shockingly bearish compared to data in May of this year. Just three months ago, only 15% of NABE economists believed risks were skewed to the downside. That number has risen to 58% believing we are in the early stages of an economic decline. The most worrisome aspect remains the global pandemic with two out of three respondents fearing a vaccine-resistant strain of Covid leading to an economic contraction, according to NABE. If the US recovery from Covid lockdowns stumbles in the next 12 months, the timing for China could be catastrophic.

The markets reacted to the Evergrande news with just short of a rapid 5% pullback, but immediately recovered and sit just 2% below the all-time highs of August. Market bulls are apparently Teflon-coated as they shake off the 10-year US Treasury bond yield back near 1.50% off the mini-correction lows of 1.20%. Not even the Fed announcing their plans to "taper" could derail the equity markets. The best gauge of market fear, VIX, managed to rise above 20 for 5 trading days before falling back into the range it has maintained most of the year.

Investor complacency appears to be at alarming levels given the risks that exist today. Confidence is waning, the Fed is at least spiking the punch bowl less, and the real estate bubble is at risk of bursting, yet it remains fashionable to remain long this market. They may be right. The markets survived an unprecedented lockdown of the economy, the closing of nearly 30% of all small businesses, and more than 30 million Americans losing their jobs, so why fear the liquidation of the world's most indebted real estate developer?

History suggests now might be a good time to take some chips off the table and look for more attractive valuations for risk capital.

Raising the Roof (Ceiling)

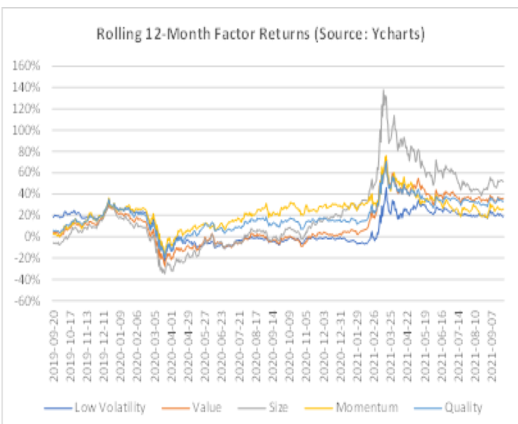


Source: CBO

Raising the government debt ceiling has become so commonplace over the last decades that even after the ceiling is reached there is little cause for concern. In the latest episode, the debt ceiling of $28.4 trillion was hit in July 2021 without hardly a mention by the media. Treasury Secretary Yellen has been using “extraordinary measures” to keep the government funded since then, but those measures are set to expire in mid-October. There is some political gamesmanship over how the US will avoid defaulting on its obligations, something no one expects to occur. The House recently passed, on a party-line vote, a bill to extend the limitation on borrowing until after the mid-term election to December 2022. All 50 Republican Senators are on the record opposing that legislation.

- To demonstrate the ‘non-issue’ of the debt ceiling, the longest government shut down of 35 days occurred in January 2019, and the S&P 500 was 10% higher at the end of the shutdown than when it began.
- The national debt appears to be a concern to about 52% of the electorate, according to polling from Hill-HarrisX in 2020, making a vote to increase the government’s debt politically risky for politicians.
- Those rooting for a government shut down might be ‘non-essential’ personnel who get furloughed during a shut down but always end up receiving any lost pay once the government reopens.

Becoming a Factor



We write extensively about factor investing as it is a cornerstone of many of our investment portfolios. Analyzing return patterns across factors can help reveal a market that is highly concentrated or a market that is diversified. The chart to the left plots the rolling 12-month returns for five U.S. equity factors going back two years. It’s interesting to observe the relative returns (i.e., periods of over and underperformance) across various segments of the market, particularly given the highly unusual performance patters from 2020, which saw a rapid -30% pullback followed by quick rally to new highs.

- After leading the way for much of 2020, momentum stocks have cooled off somewhat, while small-cap stocks, after shooting up 140%, have rolled back down in line with the other factors. Quality stocks have been more-or-less in the middle of the pack, while low volatility remains towards the bottom post pandemic.
- It appears that factor returns are beginning to converge into a narrower range today, which suggests some rotation is occurring in the broader market. For example, rolling returns for low volatility stocks have been fairly stable this year, while small caps and momentum stocks have trended lower.

Cold Winter

As winter soon approaches, soaring gas prices threaten to increase fuel bills across the globe. According to Reuters, the gas market chaos has driven prices 280% higher in Europe this year and has led to a 100%-plus surge in the United States. The surge in prices is largely being blamed on reduced gas supply and rising demand. Fortunately, the impact we will experience in the United States should be limited as we have not only reduced our reliance on other countries for energy, but also have a very diverse mix of energy production (natural gas, solar, coal, nuclear, etc.). However, as a result of rising gas prices, we still run the risk of stagflation (high inflation and low growth).

- According to the Farmer’s Almanac, the 2021-2022 winter is going to be a particularly cold one and has been dubbed the “season of shivers”. With rising energy prices and possibly one of the longest and coldest winters we have seen in some time, it is undoubtedly setting us up for the “perfect storm.”
- It is no surprise that the current administration is focused on transitioning the United States to more clean energy dependence. Just recently, as natural gas prices soar overseas, the administration announced it is targeting solar energy to power close to half of the electric grid by the year 2050, which now only accounts for about 3% of the power supply.

Macro View – Evergrande Fundamentals

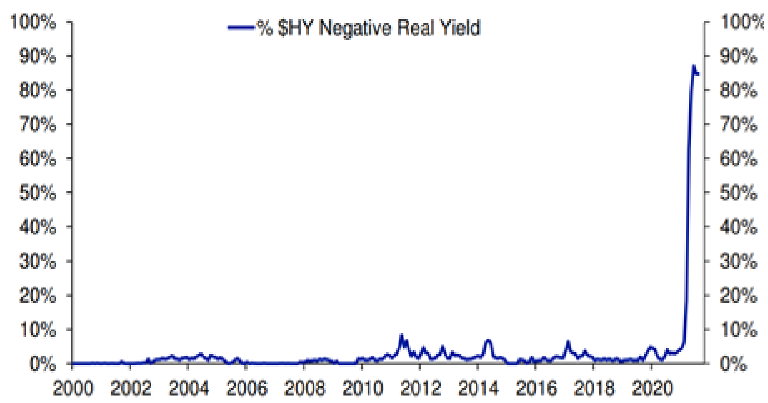
On Monday September 20th, the S&P 500 fell by more than 75 points or -1.69% after fears that the world's most indebted property developer, China Evergrande Group, was on the brink of defaulting on its loans. Some say that the financial fiasco China is facing with Evergrande will largely remain contained in China, which was reiterated by Federal Reserve Chair Jerome Powell, who expressed that the United States has limited exposure to Evergrande's debt and will likely not experience any spillover dangers. While the Evergrande situation in China is on every investor's mind, the reality is that stock market valuations are overstretched, and many believe the market is long overdue a decline. Yardeni Research's weekly look at stock-market fundamentals noted that the S&P 500's 20.8 forward price-to-earnings (P/E) multiple remained near levels last seen ahead of the dot-com crash. The index's price-to-sales (P/S) multiple of 2.8 is as high as it has been since data was first available in 2004. Adding Evergrande to the equation when investors are already concerned about proposed tax increases, the debt crisis, and inflation results in more uncertainty around market direction. And unfortunately, conventional wisdom says that uncertainty is detrimental for markets.

Taking Stock – Value Back in Favor?

Historically, the stock market has performed poorest during the month of September and is often dubbed the "September Effect." As treasury yields pushed higher after hawkish sentiment from the Federal Reserve, we saw several technology companies' stock prices drastically decline. As of 9/28/2021, iShares S&P 500 Growth ETF (IVW), which screens based on sales growth, earnings growth to price, and momentum, was down -5.19% MTD (YCharts). Not surprisingly, many of the largest holdings include some of the FANG names: Facebook, Amazon, Netflix, and Alphabet. Consequently, over that same period, the iShares S&P 500 Value ETF (IVE), which screens companies based on price to book value, price to earnings, and price to sales, was only down -2.49% (YCharts). If yields continue to rise, this could weigh heavily on growth companies, specifically those in the technology sector, and result in further declines. With interest rates and energy prices rising once again, value names may experience another phase of outperformance.

Fixed Income - Stupidity on Display

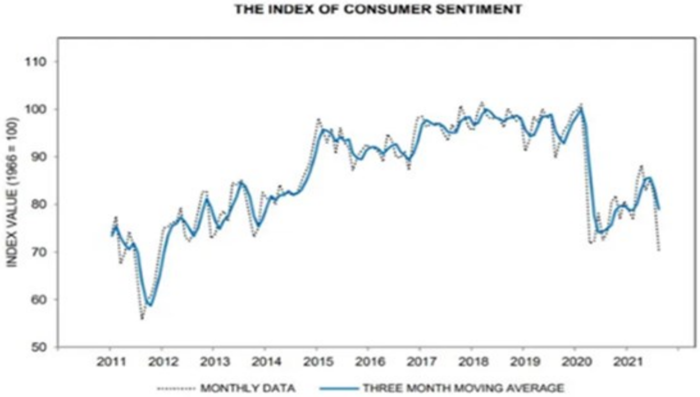
High yield data goes back more than 25 years and the average real yield has been just a tick below 4.50% per annum, motivating some investors to take on some credit risk. It may still make sense for tactical investors to own high yield, but buying it at a negative real yield seems crazy. Historically somewhere between 0% and 3% of non-investment grade bonds trade at a negative yield, but this is the "new era" of investing, boldly (and stupidly) going where no investors have dared to go before. Today a stunning 85% of US high yield is trading at a negative real yield. At the end of 2020, less than 4% of these bonds traded at a negative yield. Even if inflation went back to 50% above the Fed's target of 2% (3% for those in Rio Linda), an astonishing 35% of junk bonds would have negative real yields.



Source : Bloomberg Finance LP, Deutsche Bank

Technical - Sad Sentiments

While many talking heads continue to tout the current strength of the US economy, signs are appearing that suggest this is more wishful thinking than reality. The trends in Consumer Sentiment have a very strong correlation to changes in GDP over time. It will likely only take the threat of a contraction in GDP for markets to react from all-time highs in the wake of the ongoing pandemic. It is telling that confidence is waning at a time of peak corporate earnings, peak economic growth, and peak fiscal stimulus. Equity market cheerleaders are proclaiming we are in a goldilocks environment and investors have nothing to be concerned with. Intuitively, many investors are realizing the bears might not be that far off. With stimulus programs expiring and the Fed announcing they will taper bond purchases, caution makes sense.



Source: University of Michigan

A Dismal Forecast?

Clint Pekrul, CFA

Given the run up in equity returns over the past decade, and current valuations relative to historical averages, we have to wonder how much gas is left in the tank to keep sending the major indexes to new highs. Can future earnings support current equity market valuations? Likewise, can fixed income deliver positive real returns with the prospect of higher inflation?

It might not seem so in the short-run, but in the long-run, asset valuations must be linked to some fundamental metric, such as a company's earnings. Markets tend to become overheated occasionally, where investors might not be mindful of what they pay today for tomorrows earnings. As a consequence, markets tend to mean revert over time, swinging between periods of overvaluation to undervaluation.

If markets are indeed overvalued today, what might that mean for returns over the coming years? To tackle this question we've tapped into the research of GMO, a renowned investment advisory firm that periodically publishes forward-looking assumptions about asset class returns over the next seven years (GMO's forecast is publicly available at www.gmo.com).

While the forecasts rely on numerous assumptions and inherent errors, they can be useful for forming asset allocation decisions. The GMO framework is to evaluate current valuations, assume a long-term inflation rate and estimate a forward-looking real return for a set of asset classes. Below are the results of GMO's most recent forecast:

Equity Market Forecasts:

Stocks	Annual Real Return Over 7 Years
U.S. Large Cap	-8.0%
U.S. Small Cap	-8.5%
International Large Cap	-2.8%
International Small Cap	-1.8%
Emerging Markets	-1.3%
Emerging Value	3.3%

Source: GMO

GMO's grim outlook doesn't paint a pretty picture. Deviations from long-term trends seem to drive much of the negative sentiment in their forecast. For example, the current S&P 500 P/E multiple of roughly 33x is well above the long-term median of 16x. A reversion just back to the median P/E would suggest a significant pullback for the broad equity market.

Furthermore, the market capitalization of the Wilshire 5000, which tracks publicly traded stocks in the U.S., is almost twice our country's GDP – an all-time high.

The takeaway from GMO's analysis is that the equity markets seem increasingly ripe for a correction, and not the type we experienced in 2020, but a longer lasting pullback. Indeed, one particularly bad year (or two) could lead to a negative annualized return over a seven-year horizon. We most recently experienced this after the sharp pullback during the financial crisis of 2008.

Fixed Income Forecasts:

Bonds	Annual Real Return Over 7 Years
U.S. Bonds	-3.1%
International Bonds Hedged	-4.5%
Emerging Debt	-1.4%
U.S. Inflation Linked Bonds	-3.1%
U.S. Cash	-1.0%

Source: GMO

As with the equity markets, GMO is forecasting negative real returns for fixed income as well. Given the current level of interest rates, keeping up with inflation could be problematic. Furthermore, if interest rates increase substantially, investors could incur capital losses along with an erosion of purchasing power.

Based on GMO's estimates, cash will not suffice as a shorter-term hedge on a real return basis (i.e., cash will lose purchasing power as its value won't keep up with inflation). Furthermore, inflation-linked bonds are exposed to duration risk that would offset any adjustments to their coupons.

Of course, as we have seen in the past, GMO's forecasts could be considerably off the mark. Using historical data to support a view of over or undervaluation could downplay the role central banks have taken after the financial crisis to provide market liquidity. Central bank intervention in the markets is a dynamic without much in the way of precedent.

Furthermore, with low to negative interest rates around the world, there is little incentive for investors to rotate en masse out of equities into bonds as they have done in the past. This suggests that equity valuations could stay above trend longer than expected.

There are ways to navigate market uncertainty, such as adopting a strategy that seeks to mitigate the impact of sharp drawdowns that could lead to extended losses in your portfolio. A tactical strategy that allocates across various segments of the market could add value relative to the broader benchmarks.

These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward looking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

Q: What will the impact be of ending the eviction moratorium?

A better way of asking the same question might be: What will the impact be of restoring private property rights? The unprecedented restrictions placed on property owners during the Covid pandemic have had unintended consequences that many are ignorant of or simply choose to ignore. It was the Centers for Disease Control (CDC) that instituted the most visible ban on foreclosures and evictions. Yes, a group of doctors and scientists are setting policies impacting property owners. The need to help people who were displaced by Covid lockdowns is understandable, but putting the burden on landlords hardly seems reasonable. According to Pew Research data, more than 70% of rental properties in the US are owned by small, individual investors. For-profit companies own less than 20% of residential rentals. CDC policies have forced investor landlords to make mortgage payments, pay taxes, and maintain their properties, all while receiving no income in many cases. Because this policy is virtually impossible to deal with on a case-by-case scenario, many renters have simply taken advantage of landlords by refusing to pay rent even if their income was not impacted by the pandemic. So, the impact of ending the moratorium is to return to some level of sanity in how we make public policy. If we revert back into lockdowns from Covid, the government should direct any additional stimulus or enhanced unemployment benefits to landlords as needed.

One certain outcome will be political rumblings from both sides of the aisle. The Supreme Court made a ruling that the Center for Disease Control had overstepped its authority by imposing a nationwide moratorium on evictions. Now, for the moratorium to continue, it must go through Congress, which poses several challenges. On the one hand, there's a real concern for people who have been adversely impacted by the COVID pandemic and will now face the real possibility of homelessness if they cannot make the rent. By some estimates this would cover some 11 million households. On the other hand, landlords have become saddled with debt as they are unable to collect rent, but not allowed to evict tenants.

The political fallout from millions of evictions could be substantial. However, there are many opportunities for employment compared to a year ago. We simply can't allow homelessness to run rampant. Likewise, tenants can't live rent free indefinitely. I think the core of the issue is a lack of affordable housing, but, as history suggests, there's no easy solution to this supply issue. Unfortunately, I think we're going to see more homelessness, especially in the larger cities.

Q: Is Sports Betting in a bubble?

It would be easy to come to that conclusion if you bother to watch a professional sports event these days. Sports betting used to be taboo to professional sports going back to the Pete Rose days (he is still banished from the Hall of Fame for betting ON his team). It feels pathetic for announcers of games to be actively promoting betting, so clearly a lot of revenue must be generated for the recent changes in sport. Sports betting has gone from something that took place in Las Vegas to a worldwide phenomenon. Revenues are listed as GGR (gross gaming revenue) and some analysts have suggested the cumulative GGR will reach over $150 billion per year by 2025 (source: TRF). The popularity of podcasts like Barstool Sports and proliferation of startups that facilitate small-stake betting, similar to Robin Hood for stock investors, have made sports betting very mainstream. It is almost as if "bookies" are now doing IPOs and getting billion dollar valuations. The opportunity today may be with esports, however. Ever heard of Tyler "Ninja" Blevins? He is a professional gamer who averages over 70,000 watching when he competes (in a video game). He makes over $300,000 a month in revenue and has more than 12 million followers. We are likely 10-15 years from the time when more people will watch video game contests than live sports, not something those older than 40 today are likely looking forward to.

I guess when there's a pandemic, and people are confined to their homes, they look for new ways to entertain themselves. What used to be an activity relegated to Las Vegas is now mainstream with gambling apps at everyone's fingertips. The reality is that sports gambling is no longer taboo but rather mainstream. We see it with commercials during sporting events. The betting line is almost as prevalent as the score. We've seen networks like ESPN partner with the likes of Fanduel to attract viewers. I wonder how much of the government stimulus during the pandemic went straight to Fanduel and Draftkings? I'm not sure a sports betting bubble is actually possible, simply because the number of gambling opportunities is unlimited. In fact, the amount waged collectively on video games is greater than that of actual live sporting events. If there is indeed a bubble, the only way that it pops is when the gamblers start to go broke. It's not like speculating on a share of stock or a commodity. Over time, the odds are always stacked against you. Unfortunately gambling can become an easy addiction.

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