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Market Perspective
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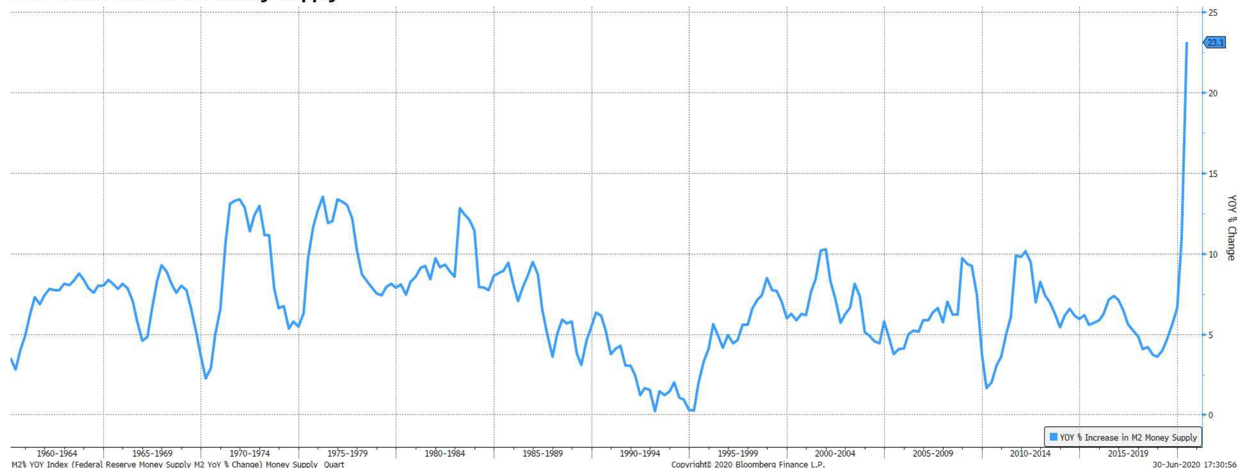
Let's start with a few quotes from last quarter's Market Perspective, written at the end of March:

- "Stock valuations have not fully returned to their average valuation based on a historical comparison to GDP."
- "GDP will clearly be materially reduced for some time by our actions to minimize the virus."
- "The attractiveness of today's market values is a function of one's views on the future direction of the challenged economy and corporate earnings."
- "I believe that after a couple of months of the economy being largely shut down and consumer/business cash reserves drawn down, it will be difficult for economic output to roar back to pre-virus heights."

You get the idea – I was focused on the fundamentals of the economy and the valuation of the stock market. Interestingly, each of these comments remain mostly true today, though there is arguably some disagreement by market strategists over how fast the economy will return to pre-virus levels.

So what happened from March 23 through June 8 to generate a total return on the S&P 500 of 45% and cause sharp rallies in other risk assets over this same period of time? How did so many big-name investors miss this move? Of course, no one will ever know for sure, but I have two thoughts. First, I think many did not appreciate the unprecedented level of asset support that was provided by the Federal Reserve, and the consumer stimulus that was provided by the Federal Government. The real-world effects are seen in the highest level of money supply expansion in more than 50 years.

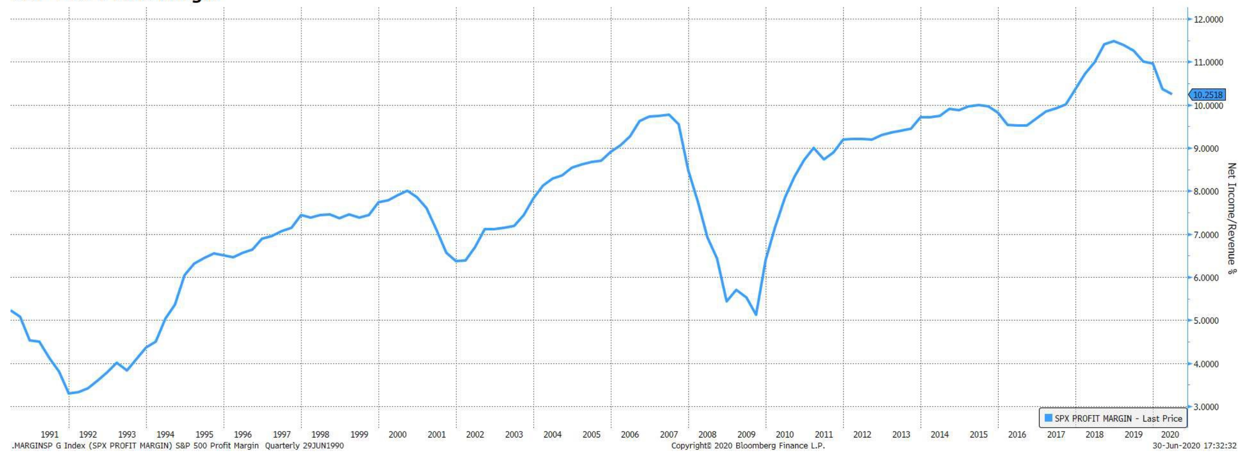
YOY % Increase in M2 Money Supply



At the same time as we respect what this liquidity did over the last three months, we must also begin to anticipate what will happen when the market is weaned from this unsustainable support.

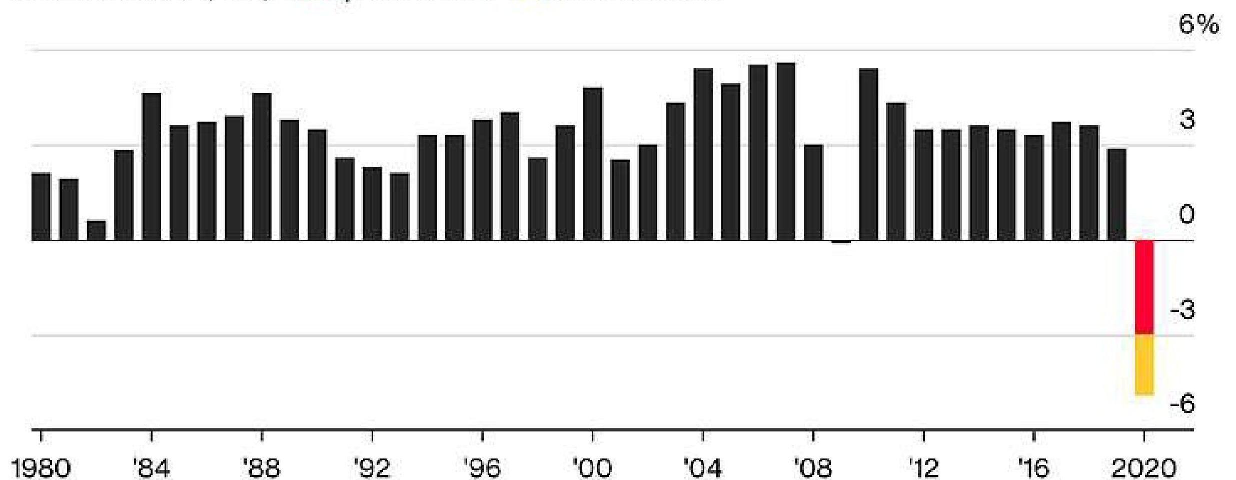
Second, I would contend that the final tallies on this market are not yet in. One classic connection that I think is critical to internalize is the relationship between the value of the market and the level of corporate earnings. Over long periods of time, equity market values are highly correlated with the earnings of the underlying companies. The euphoria that has accompanied the injection of liquidity since March has disconnected asset prices from this fundamental driver.

Some would say that asset prices are looking over the trough in near term earnings, anticipating a quick recovery and return in profitability. Rather than looking at S&P 500 earnings in 2020 (analysts' consensus estimates of $125), the optimists look forward to 2021 ($161) or 2022 ($188). Note that would put earnings in 2021 or 2022 at or above the level achieved by corporate America in 2019 – the all-time high in corporate profitability.



From my perspective, there are several challenges (accentuated by Covid-19) in assuming that corporate revenues and, more importantly, profit margins return to 2019 levels in the next couple of years:

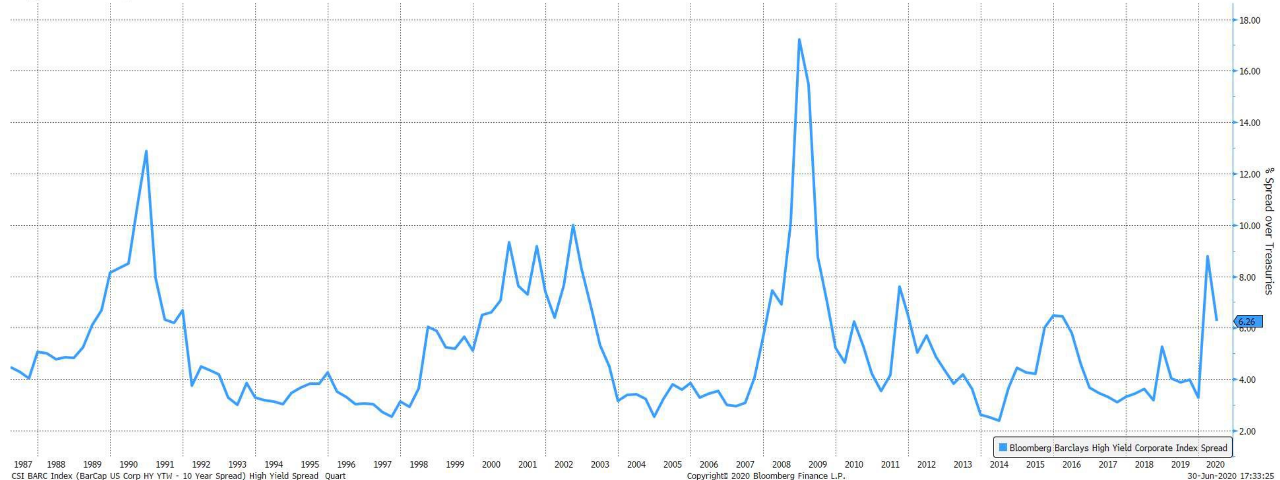
1. It appears the virus is going to be with us for some time. Perhaps there will be some type of vaccine by early 2021, but that is by no means certain. The very fact that our world must deal with the virus's presence seems to me to indicate less productive economic activity and profitability than a world without it. Last week, the IMF revised its forecast for 2020 Global GDP materially lower than their forecast just released in April.



2. There are several national and global forces that seem to portend a downward pressure on profit margins. Think of the likely (even intended) outcome of "Stakeholder Capitalism," where a corporation is managed for the benefit of more parties than just the shareholders. A closely related concept is the rise in values-based investing ("ESG"). The recent pushback against corporate stock buybacks is another.
3. Regardless of who wins the upcoming election, it seems likely that the next Administration will have to tackle both our out of balance budget deficit, as well as begin to address the debt that the country has built up. Corporate tax rates would seem to be one place they will look. It is easy to consider a reversal of that 2018 profit margin bump that came with the 2017 tax cuts (see Profit Margin graph, above).

While I have been focusing on the equity market, similar dynamics are at work in other risk asset markets. Consider High Yield Bond spreads. While today's 6% spread over Treasuries is by no means at the lowest levels of history, it is well-below the nearly 9% spread reached at the

end of March. We should question whether 6% is high enough to compensate for the increased level of bankruptcies and defaults we are already beginning to see in today's highly leveraged corporate world.



Many are struggling right now with whether it even makes sense to analyze companies or the markets for the purpose of making investment decisions. Certainly, for the period between March and June of this year, the answer to that question was no. All that mattered was the liquidity that was injected into risk markets by the government. Federal Reserve Chairman Powell has clearly said that he would wean the market from his "tools" when appropriate. It is worth asking what will happen to risk assets when the liquidity is tapered or when fundamentals regarding corporate earnings and asset valuation matter again.

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