Market Commentary

In 2008 there had still been a note of hesitancy about central-bank interventions. In 2020, that was gone. The full implications of the opening of the monetary floodgates would become clear over the weeks that followed, as fiscal policy caught up. This was emergency action of the most radical kind. But what now was normality? – Adam Tooze from Shutdown: How COVID Shook the World's Economy

After a 0.6% third quarter return – the weakest showing since the initial pandemic selloff in March of last year - the S&P 500 returned 15.9% year-to-date. Value stocks still lead in 2021, but a second quarter growth stock rally narrowed the gap. Value regained its momentum over the past several weeks as technology stocks came under pressure. China, driven by government crackdowns on its big tech firms and worries over the solvency of property developer China Evergrande Group, was the worst performing major market, down nearly 18% year-to-date. In emerging markets outside of China, smaller companies, large value stocks and India were strong performers.

Expect further volatility as the economy transitions from the pandemic. At the beginning of the year, expectations for a broad, global economic recovery remained strong. China and supply shortages now threaten this view. A reasonable historical analogy might be the 2010-2012 period following the 2008 Global Financial Crisis, where after an initial rebound, the collateral damage from the crisis emerged. This included the near collapse of the European Monetary Union and two declines in the S&P 500 of over 15%.

Cheap debt fueled China's economic growth over the past decade, leading to justifiable concerns of a financial crisis, similar to Japan's downturn in the early 1990s or the 2008 implosion of the US banking system. Pundits have predicted a collapse for years, but the country continues to defy expectations. The real estate sector, as the famous YouTube videos of empty cities attest, does appear vulnerable. Real estate accounts for around 20% of China's GDP and nearly a third of household wealth. The CCCP recognizes the risk and presumably will take every possible step to avoid a disorderly collapse of the sector. While they will likely succeed at preventing a disorderly Lehman-type meltdown, they may fail at preventing the sector's troubles from spilling over to the broad economy.

Global shortages, particularly in natural gas, risk reaching crisis levels this winter, with European countries struggling to provide heat to their citizens. The lack of investment in oil & gas, driven perhaps equally by ESG concerns and the long history of miserable stewardship of investor capital by energy companies, means that supply responses may be inadequate. Natural gas faces significant transportation problems – it must be liquefaction at temperatures of -260F to be loaded on a tanker. While the US and Middle East retain plentiful resources, they lack the liquefaction capacity to solve Europe's problem. These supply issues raise the specter of stagflation – the nasty combination of low growth and inflation that stymied the global economy during the 1970s.

While these are likely temporary issues that will not have a long-term impact on company fundamentals, **the response of equity investors, who currently hold record high allocations to stocks, remains uncertain**. A recent paper[1] by Harvard professor Xavier Gabaix and Ralph Koijen from the, University of Chicago, attempts to quantify how stock prices react over the long term to investor inflows or outflows. Traditional economic theory posits stocks do not react to flows other than perhaps short term (1-3 day) liquidity effects. Stock prices, according to conventional economics, fluctuate more or less solely due to changes in company fundamentals and discount rates. However, most investors pursue more or less fixed asset allocation strategies. While plentiful capital exists within the equity market to take advantage of relative valuations between different stocks - selling the stock of a company who announces disappointing sales and buying one announcing a promising new product launch, for example- very little capital sits on the sidelines waiting for the market to drop to buy in. Hedge funds might be expected to serve this role, but in reality these funds tend to sell stocks when they are declining, either to meet redemption requests or to reduce risk. With few pools of capital ready to step in, this means that flows from stocks to cash or bonds will negatively impact the price. Their research shows a multiplier of 5-7x to flows – meaning that if everyone reduces their equity allocation by one percentage point, the market will experience a long-term decline of 5-7%. During the last two major bear markets (ignoring the short-lived decline of 2020), the S&P 500 declined by about 50%. The corresponding reduction of equities by US households (net of price declines – so % of shares sold) was about 4.5% over the June 2000 to September 2002 downturn and around 3.6% during the 2007-2008 Global Financial Crisis. Applying their simple '5-7x' rule does not account for the full decline.

Corporate bankruptcies, elimination of buybacks, and liquidity factors also contributed. Some investors, such as pensions, became net buyers of stocks. The key takeaway from this research is the market is more micro-efficient than macro-efficient. Stock prices can remain high or low relative to other asset classes without a good fundamental explanation. It also makes market timing more difficult – if one could trade profitably in and out of the equity markets based upon some analysis of stock valuations relative to other asset classes, then perhaps one could create a good strategy based on that information. It is somewhat disconcerting to think that stock valuations over long periods of time depend to a considerable amount solely on investor sentiment.

Stock valuations, while stretched, still offer a return spread to high quality bonds comparable to historical averages. Importantly, unlike bonds, stocks possess the ability to pass through inflation by increasing prices. Companies with longer term debt also benefit from inflation, as it reduces the value of their liabilities. US growth stocks are historically expensive, with valuations comparable to the peak of the 1999-2000 tech bubble. Price / Earnings ratios for US value stocks, and foreign companies trade within one standard deviation of their 15-year average.

Technology disrupted commercial real estate over the past decade, a trend accelerated by the pandemic. Ecommerce destroyed the retail sector and work-from-home cast doubt on office properties once viewed as trophy assets. Apartments and warehouses/distribution centers became most desirable assets. Retail remains a disaster, with most markets oversupplied with space, as ecommerce permanently altered consumer buying habits. Office viability varies by market, with select high-growth 'red-state' cities like Austin or Miami enjoying a boom while New York and San Francisco languish. Institutional investors, fleeing office and retail, are embracing formerly niche sectors such as medical office, life science facilities, student housing, for-rent senior housing and data centers.

Another strategy that overlaps multiple sectors is single-tenant, triple-net lease. This typically involves a company selling its essential industrial properties or corporate headquarters to a real estate investor and then signing a long-term (10-20 year) lease. A triple-net lease gives nearly all maintenance responsibilities to the tenant. This transaction is similar to a loan to the company, with the ability of the tenant to make lease payments the primary concern of the property owner. As these assets are essential to the operation of the business, if the company does go into financial distress and restructure its debt in a Chapter 11 Bankruptcy, the lease will typically be honored and the real estate owner will suffer no loss and may actually benefit from having a more creditworthy tenant after its other debt is restructured by the court. Generally an investor in these properties will only suffer a loss if the tenant goes out of business and liquidates its assets. In that event, the real estate owner will need to locate a new tenant, which takes time and money. This risk can be managed by diversification of tenants, industries and geographic locations. Private credit - making direct loans to smaller companies- has been a very popular and strong performing investment strategy over the past ten years. However, for taxable investors, it generates income taxable at the highest rates and often they cannot deduct fund expenses against this income. Triple-net real estate targets similar companies – typically below investment grade and with a private equity sponsor. A portfolio of single tenant, triple-net real estate provides all the benefits of private credit, but with growing income stream, inflation protection and tax-efficient income.

As new risks to the global economy develop against the backdrop of near fully-recovered equity markets, investors should maintain discipline, adhering to diversified strategic allocation targets and opportunistically rebalancing. Potential changes to the US income tax code do not necessitate dramatic changes in investment strategy. Portfolios need to remain diversified and focused on high quality real assets that can withstand the risk of potential inflation or deflation. Outside of a few speculative niches, valuations still offer modest, but acceptable rates of return.

Owning quality companies and real assets purchased at reasonable valuations is the only way to deal with an uncertain world. We continue to believe our diversified, high quality asset strategy can add substantial value over the coming years regardless of the near-term market concerns.

[1] Source: Xavier Gabaix and Ralph S.J. Koijen:"In Search of the Origins of Financial Fluctuations:The Inelastic Markets Hypothesis" https://www.nber.org/system/files/working_papers/w28967/w28967.pdf

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Chief Compliance Officer

Smart Investing Webinar:

Tuesday, October 12, 2021 at 11:30 Central on Zoom

We invite you to join Steve Browne, CFA, CIO and Alison Moss, CEO, for our Smart Investing Webinar.

Link to join the webinar:

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