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Broken Records
In a Year of Firsts, our View of the Most Promising and Most Troubling Milestones

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Introduction

In 1951, an executive named Hugh Beaver was at a shooting party in Ireland when he became embroiled in a trivial debate about whether the world's fastest game bird was the grouse or the golden plover. No one at the party was able to verify which bird was the record holder. Beaver surmised that other social gatherings must generate similar debates. He astutely saw a business opportunity given his firm was a major supplier to pubs throughout the United Kingdom. Beaver, in fact, worked for Guinness Breweries, and he went on to create the Guinness Book of Records, which became the de facto authority on world records in the decades before the Internet became widely available.

This year has been record-breaking in so many ways that extend well beyond financial markets. In this issue of Global Foresight, we review the milestones about which we are most constructive, those we believe pose no long-term issues to investors, as well as those with which we are most concerned.

Positive Impact

At first blush, it is hard to identify any beneficiaries of the Covid-19 pandemic besides the obvious ones - technology and other "stay home" plays. Perhaps the least discussed winner during this trying period has been the environment. The BBC estimates emissions of greenhouse gasses will decline 4% to 7% this year, reflecting the collapse in economic activity, especially driving and air travel. While such a decline may only make a dent in the pace of climate change, it represents an interesting proof point that technology can be deployed in a way that reduces the need for business interactions. A lasting positive from Covid-19 will likely be that it accelerated a shift in the way we work, that will help reduce demand for hydrocarbons today and in the years ahead.

The rapid shift of preferences to suburbs and rural areas has spurned a long overdue housing boom; a sector which had yet to fully recover to levels seen before the financial crisis. In fact, the pace of new home construction in the U.S. reached levels in 2020 that have not been seen since 2007. The sustainability of the housing boom remains to be seen. The rush to exit cities during the onset of Covid-19 will likely prove more fleeting for housing demand than will the impact of substantially lower mortgage rates than we had pre-pandemic.

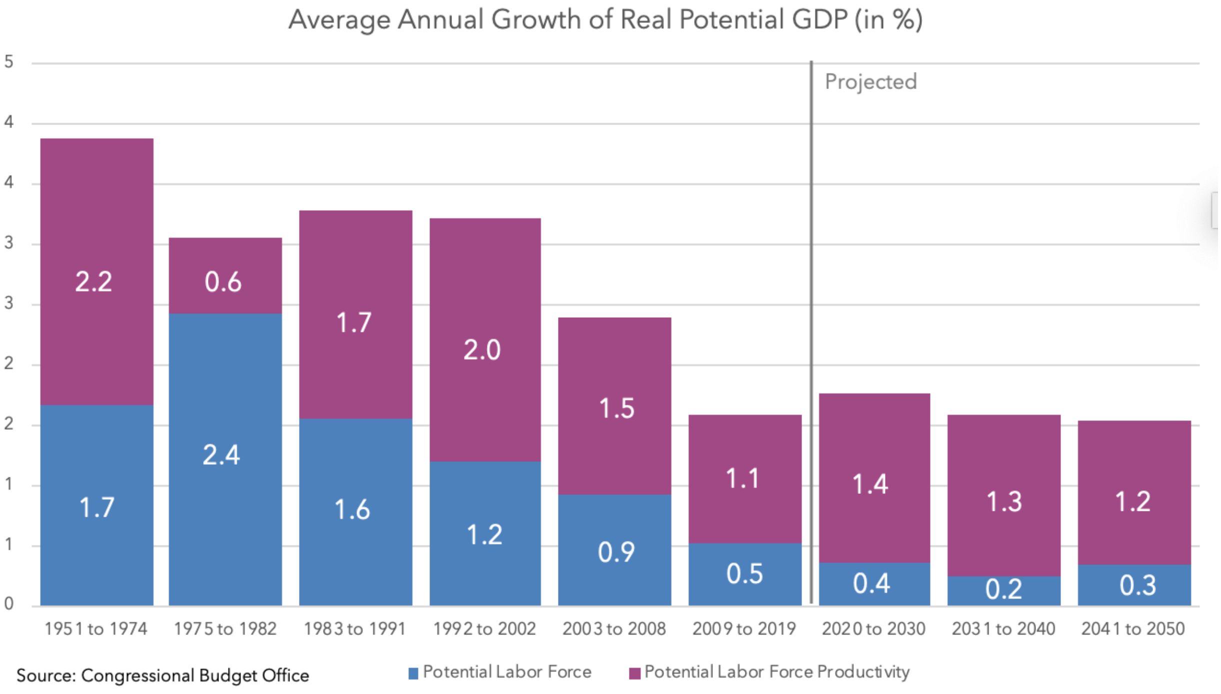
Limited Impact

This year has generated many new milestones which we expect will have only limited market implications. Perhaps the most remarkable record set in 2020, and one could argue the strangest in the history of capital markets, occurred back in April. Oil futures, as measured by West Texas Intermediate (WTI), closed at -$38 on April 20, when a glut of oil created an unthinkable first in commodities- a negative price for oil. Even with the subsequent recovery, oil prices remain low which we believe has a neutral impact for markets. It clearly helps consumers broadly, while creating economic hardship regionally in oil-producing states. Longer-term, we see the impact of Covid-19 as merely accelerating the move away from fossil fuels that has been underway for some time.

One of the outstanding questions about the impact of Covid-19 on society was whether lockdowns and quarantines would spur a new baby boom (and some have also speculated a surge in divorces). Fertility rates around the world have been setting record lows, reflecting a secular decline for decades. Early data in 2020 suggest no change from this trend.

The fertility rate is a key input to determining long-term economic growth projections since annual GDP growth is simply a function of the increase in labor force multiplied by the gain in productivity. This is arguably the single biggest factor for the secular slowdown in growth around the world and is an issue we have discussed from time to time in *Global Foresight*.

Between 2009 and 2019, U.S. GDP only grew 1.6%, according to analysis from the Congressional Budget Office (CBO), the economic forecasting unit for Congress. Productivity during this period was a bit lower than in past periods. But if the labor force had grown at an average rate of 1.6% as it had in past decades, GDP growth would have averaged 2.7%, a level that seems robust compared to what we have been experiencing in the 21st century. Since labor force growth will likely continue to grind lower through 2040, we can expect to see even more subdued economic growth in the future, unless we see a big reversal in productivity trends (Exhibit 1).



Source: https://www.cbo.gov/publication/56598

Exhibit 1: Average Annual Growth of Real Potential GDP (in %)

Negative Impact

Perhaps the most troubling record set this year is for fiscal spending, by far the highest since World War II, and a level that will create massive deficits for the foreseeable future, according to the CBO. Moreover, this year's spending is far in excess of the debt levels incurred to stabilize the economy during the global financial crisis (Exhibit 2).

As the national debt of the U.S. soars past 100% of GDP, the interest cost to service that debt will rival expenditures on Medicare, according to CBO projections in the chart on the following page (Exhibit 3).

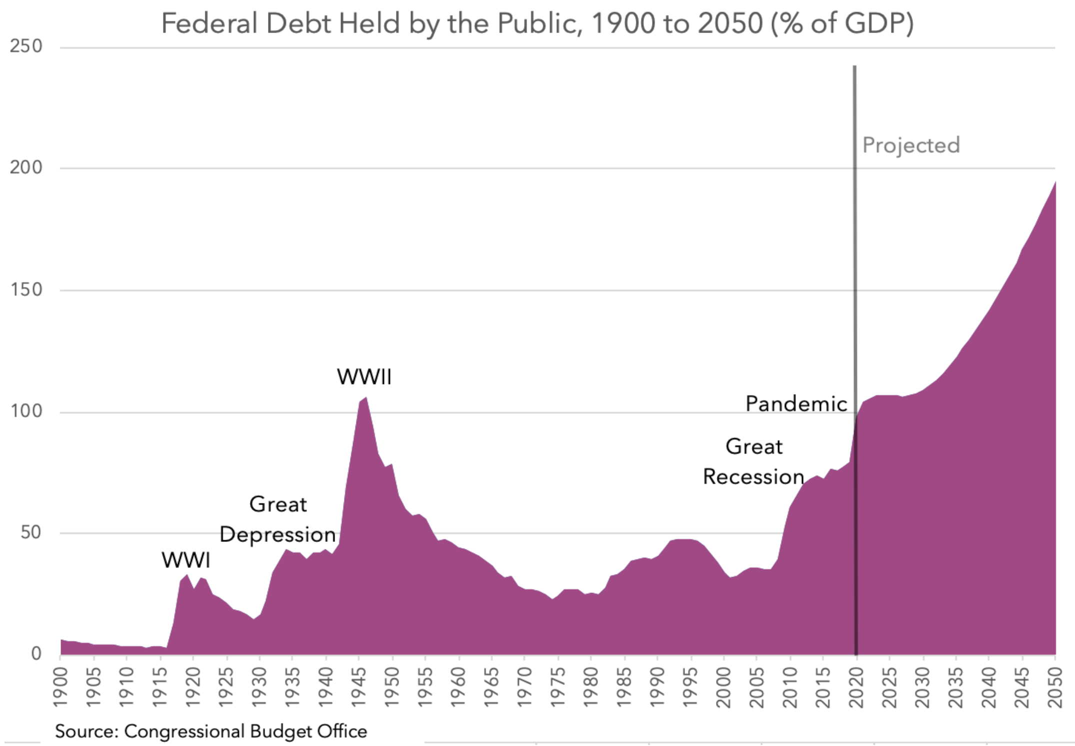


Exhibit 2: Federal Debt Held by the Public, 1990 to 2050 (% of GDP)

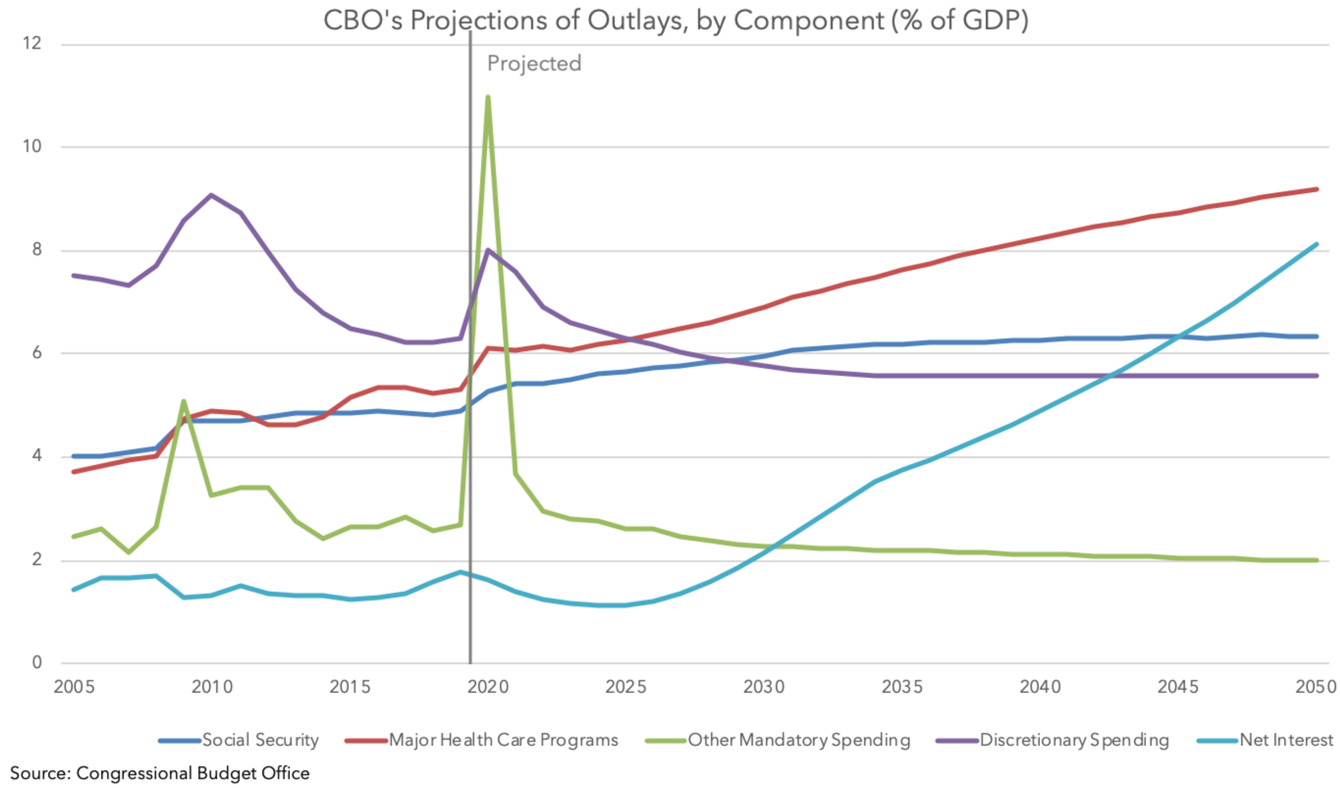


Exhibit 3: CBO's Projections of Outlays, by Component (% of GDP)

While virtually every major economy in the world is spending aggressively to combat the economic effects of Covid-19, the U.S. has spent far more than others and will have one of the highest levels of national debt of any major economy. In fact, the U.S. gross national debt, which includes Treasuries held by government agencies such as the Social Security Trust Fund, has soared from 108% of GDP pre-pandemic to over 135% at the end of April 2020. To put this figure into perspective, the prior peak was 119% in 1946, but quickly improved as the U.S. economy embarked on an expansionary period during the post-war baby boom. Today's population demographics, as discussed, present a more challenging fiscal path.

Valuation

This August, Apple became the first company to post a two trillion-dollar market valuation. This milestone can be viewed positively and negatively. On one hand, it shows the resilience of the U.S. technology sector to be able to power through the challenges the pandemic posed to the global supply chain. The success of American companies is clear from their dominance in size relative to global peers Alibaba, Tencent and Taiwan Semiconductor are the only companies outside of the U.S. that rank in the ten largest in the world. Nestle is the only European company to rank in the twenty largest.

However, this also reflects an unprecedented level of concentration within the U.S. market, as well as higher valuations, that suggests better opportunities for returns in the future from smaller companies and different geographies. Many companies and sectors have massively underperformed this year, but we feel are poised to snap back in the post-pandemic world.

We believe it is important to look for companies across the spectrum of market capitalizations and geographies to identify the most interesting opportunities, because portions of the markets are expensive driving up overall valuations. To provide a sense for how expensive equities are - the S&P 500 Index companies in aggregate are expected to earn roughly $130 in 2020, a massive 25% haircut from what was expected only 9 months ago, due to the pandemic. Even 2021 earnings will be affected, as current estimates are for approximately $157 per share; still below the $163 achieved in 2019. Current earnings estimates place the S&P 500 at 22x expected 2021 earnings.

Earnings estimates do not embed the prospect for higher corporate tax rates which we expect should there be a Democratic sweep in November. This would clip earnings by roughly 10% for 2021 and raise the PE multiple to roughly 24.

While market valuations have not broken the records set in 1999-2000, they are uncomfortably high and have been supported by the biggest record breaker of all in 2020: The U.S. Federal Reserve. Some of the key milestones from the Fed this year include: 1) growing its balance sheet even more aggressively than during the global financial crisis, 2) buying municipal bond debt, 3) buying corporate bonds, including high-yield and, 4) abandoning the practice of proactively lifting rates to ward off inflation.

The Fed's prescription fixed what ailed the equity market in March as it rallied sharply on the announcement of bond-buying and has sustained the momentum since. Going forward, our concern is that the proverbial medicine has been taken and we do not see much more the Fed can do. For example, the European Central Bank (ECB) has been buying corporate bonds for the last few years but has had limited impact driving sustained economic growth. Even Chairman Powell has recently stated the U.S. economy now needs more fiscal support.

The assistance from Washington has helped mitigate the worst effects of the pandemic, but there is a real cost that so many companies have had to bear, especially for small businesses in the hard-hit service sector. On the other hand, the Fed-induced rally in the junk bond market may have kept some so-called zombie companies alive.

Businesses close all the time as part of the creative destruction of capitalism. New and more efficient ones take their place. However, COVID-19 has mercilessly forced some to close as the impact of the pandemic has been far harsher and swifter than typical downturns, leaving less time for adjustment. As an example, the Roosevelt Hotel in midtown Manhattan just announced it was closing. Its ballroom was notably used in the film Wall Street as the setting for the "Teldar Paper" annual meeting, where Michael Douglas, as Gordon Gekko, gave his legendary "greed is good" speech, punctuating some of the excesses of a high-flying era in finance. Whenever we fully emerge from the pandemic, the world will look a bit different. But societies, individuals, and businesses have always evolved. The pandemic has just hastened changes that may have taken years to occur.

Conclusion

So many milestones have been achieved in markets and societies due to the impact of the pandemic. We suspect many of records set in 2020 will prove to have an ephemeral impact, at best. The ones most concerning to us are: 1) the levels of fiscal indebtedness that has been generated to manage much of the economic impact of Covid-19 and 2) valuations which seemed stretched even heading into 2020 and are now at their highest levels except for during the technology bubble in 1999-2000.

The trouble with concerns about national debt and valuations is they can both sustain high levels for an extended period before market forces correct excesses. Therefore, one can end up sounding like the proverbial broken record raising these issues. But sounding warnings is human nature – the concept is about as old as recorded history itself – consider that Aesop wrote The Boy Who Cried Wolf an astonishing 2,600 years ago; a lesson that still resonates today.

We suspect at some point investors will care about debt levels as well as market valuations. In the meanwhile, we will continue to focus on companies, sectors and regions that look attractively priced for their growth prospects. And in case you were still wondering, according to Guinness, the Golden Plover is the world's fastest game bird.

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