Investment Update—January 2021

This is a quarterly update of economic conditions and investment strategy.

A Year of Surprises

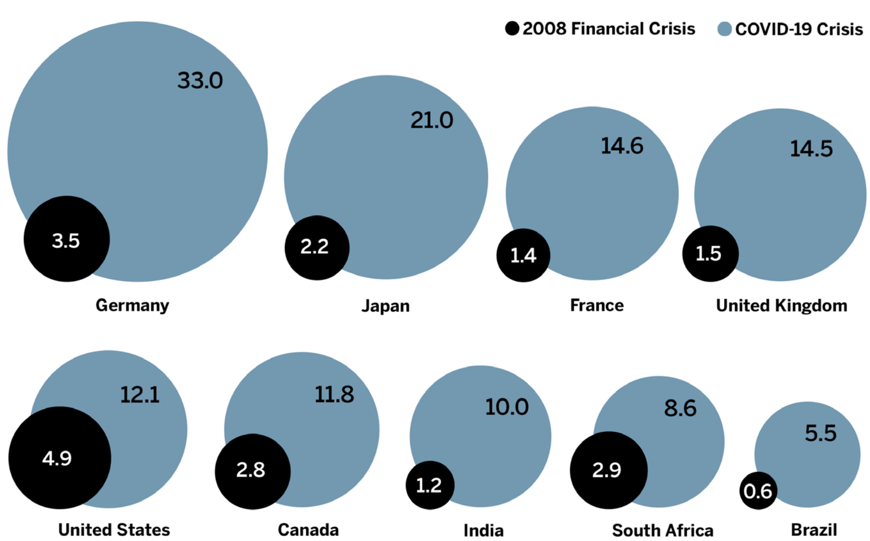
2020 was full of the unexpected. No one expected quarantines, rationing toilet paper, or virtual kindergarten. And we would have been hard-pressed to expect, despite widespread economic shutdowns, that markets would soar to new highs.

Stock markets around the world delivered robust returns in 2020. The S&P 500 generated a total return of 18.4%. The Nasdaq was even stronger with a total return of 45.1%. Most major non-U.S. markets also delivered impressive results. The total return for the MSCI All Country World Index in 2020 was 16.8%. At year end, the world's equity market capitalization was nearing a record $100 trillion.

These results are even more stunning since financial markets around the globe crashed in the first quarter. The S&P fell 33% in just 22 trading sessions. Japan's Nikkei Index fell 28%, and Germany's Dax fell 36%. At the same time, the U.S. 10-year Treasury yield fell from 1.88% to an intra-day low of 0.32%, and global short-term bond yields fell from 1.60% to a record low of 0.65%. Credit spreads widened as companies drew down credit lines to shore up balance sheets. The price of gold soared. Oil prices sank.

In response, governments and central banks stepped in with fiscal and monetary stimulus that dwarfed the huge measures implemented after the 2008 Global Financial Crisis.

Economic Stimulus Crisis Response, % of GDP



Source: Global economic policies and prospects, International Monetary Fund (IMF), March 2009, imf.org; government sources; IHS Market; IMF; press search; The state of public finances; Outlook and medium-term policies after the 2008 crisis; IMF, March 2009, imf.org.; CLSA

The U.S. Government issued over $12,000 of stimulus for every man, woman and child in the country (chart below). The Federal Reserve took unprecedented actions such as directly buying high-yield bonds. New regulations forestalled bankruptcies and foreclosures. After a decade of low inflation, governments were seemingly unconcerned that their actions could cause unwanted price increases that could drive inflation to dangerous levels.

Debt Levels and Changes in Leading Economies

	2020 gov't debt in US$ (bn)	2020 debt increase in US$ (bn)	Population (mn)	Debt increase per capita in US$	Total debt per capita in US$
USA	22,210	4,200	328	12,797	67,672
China	9,655	1,660	1,393	1,191	6,931
Japan	9,006	720	127	5,690	71,192
France	2,918	339	67	5,063	43,552
Italy	2,846	244	60	4,048	47,157
UK	2,678	464	67	6,961	40,176
Germany	2,123	439	83	5,286	25,571
Canada	763	308	38	8,202	20,300

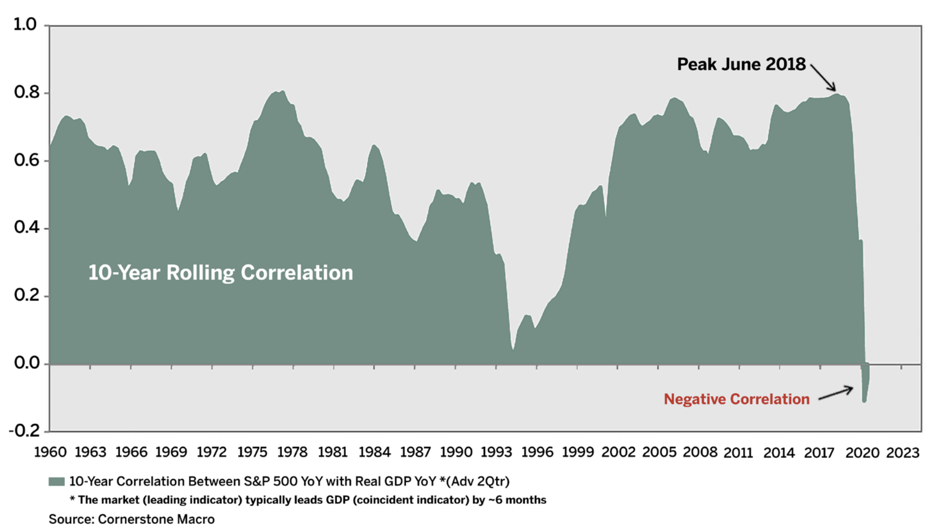
Source: GaveKal

Interventions of this scale were probably necessary in the moment, but they will likely have long-term consequences for financial markets. When fiscal and monetary decisions, rather than underlying economic conditions, are driving financial markets, investment decision-making must necessarily be different.

The Disconnect

For the first time ever, the long-term correlation between the S&P 500 and inflation-adjusted GDP growth has inverted. While the stock market and real economy sometimes move in opposite directions for short periods, they have almost always moved together over rolling 10-year periods, until now.

10-Year Correlation of The S&P 500 & U.S. GDP



Source: Cornerstone Macro

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Relationships between other economic data and financial markets have also become disconnected. Historically, the ISM New Orders Index, widely considered one of the most reliable leading indicators of economic activity, has been highly correlated with bond yields. When the ISM New Orders Index signals an improving economic outlook, bond yields rise; when it signals a weakening economy, bond yields fall. This tight historical correlation is now broken. While the ISM New Orders Index is near a high for this decade, indicating a sharp expected pick up in economic growth, yields have not risen significantly. In fact, the 10-year U.S. Treasury yield is negative on an inflation-adjusted basis. A negative real yield typically implies that investors are concerned about economic growth ahead.

The typical relationship between corporate earnings and equity markets is also broken. The consensus estimate for S&P 500 earnings per share for full-year 2020 is now about $136, down more than 20% from the $178 projected at the year's start. The consensus for 2021 is now $167, down more than 10% from the $196 estimate at 2020's start. Despite this drop in expectations, the S&P 500 delivered above-average returns in 2020.

With stock prices up and earnings down, the price-to-earnings multiple of the S&P 500 has ballooned to 22.5 times, helping to boost S&P 500 returns 56% over the past two years. Valuations have seldom been this high. The only other time the market was this expensive was in 1999/2000. The aftermath wasn't for the faint of heart.

Can Markets Be Too Big to Fail?

The combined market capitalization of all U.S. stocks is now 1.8 times total economic output, as measured by GDP. Never before—not even during the tech boom of the late 1990s—has the U.S. stock market been this large relative to the economy. Rather than economic growth driving equity market performance, it appears that equity market performance is driving economic growth, often characterized as a wealth effect. When people see their stock portfolios grow, they feel confident spending and investing more, which keeps the economy growing and the stock market rising, in a virtuous cycle. However, even virtuous cycles eventually come to an end.

We think the massive stimulus was the primary cause of rising global equity markets in 2020. In the U.S., the Federal Reserve cut interest rates to zero and expanded the money supply by buying up Treasury, mortgage and corporate debt. Lawmakers provided support to hard-hit industries and public companies that otherwise would have likely gone bankrupt. Interestingly, bankruptcy filings during 2020 have been unusually low, despite the worst economic downturn since the Great Depression.

We expect fiscal and monetary authorities to continue supporting financial markets. Ultimately, if this support continues anywhere near its current pace of over 25% annual growth in the money supply, and government, consumer, and corporate spending continue to increase, inflation will follow. The consensus calls for inflation to rise in 2021 from extremely low levels and then fade. We're skeptical. We already see early signs that the velocity of money, a critical aspect of inflation, is starting to accelerate. If this continues, we may be entering new investment territory after more than a decade of little to no inflation.

Bringing It Back to Our Themes

We think economic growth is likely to pick up in 2021, but counterintuitively, robust growth may not be conducive to financial market gains. Major economic indicators that underpinned the stock market's multiple expansion over the past two years have reversed course. At the beginning of 2019, 10-year U.S. Treasury yields were falling, oil prices were falling, and the U.S. dollar was rising. All three trends have now reversed. When the facts change, we adjust. Thus, our portfolios are now somewhat defensive and positioned to benefit from an uptick in inflation.

Last quarter we highlighted updates to our investment themes. Here, we highlight two industries that our thematic research suggests are now particularly attractive.

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Energy

One new theme, An End to Disinflation Tailwinds, led us to take a closer look at energy-related investments. In July 2008, the price of oil reached an all-time high above $160 per barrel and Goldman Sachs increased its price target to over $200. With peak oil theories predicting that the world would eventually run out of oil, investors poured money into private and public energy firms. ExxonMobil became one of the world's largest companies by market capitalization.

As is typical in the boom phase of a commodity cycle, massive capital flows funded excessive investment, which contributed to a sustained drop in oil prices. In April 2020, the price of oil briefly fell below zero as most storage facilities were at or near capacity. As a result, major U.S. and European energy companies slashed capital spending and wrote down asset valuations. Many private equity investors shut their energy funds and practices. Bank of America said it would no longer finance oil and gas exploration in the Arctic. Canada's BMO exited its U.S. oil and gas banking business. This is the bust phase of the commodity cycle.

Making matters worse for the sector, some investors concerned about climate-change are requiring fossil fuel-free portfolios. We share their climate concerns, but don't think ending investments in fossil fuels is the best solution from an Environmental, Social and Governance (ESG) perspective, or an economic perspective. Fleeing investments in fossil fuels will force energy prices higher, worsening income inequality—a key social problem for ESG investors. It will also create an economic problem since the world will need fossil fuels for the foreseeable future, even with rapid expansion of renewable energy sources. The world population is expected to increase by one billion over the next decade, and five new people are entering the middle class every second. Even with renewables, demand for oil is likely to grow.

To us, this spells opportunity. Long-term returns tend to be better in areas that capital has fled. That's particularly true for commodities. Oil stocks boomed in the 1970s, after hitting a low in 1972. Historically, the energy sector has become a larger portion of the Index's market capitalization when overall valuations are low and a smaller portion when valuations are high. Recently, the energy sector's weight in the S&P 500 fell below 2%, down from its 2008 peak above 13%. By comparison, the combined market capitalization of just two tech companies, Microsoft and Apple, represent over 11% of the Index.

After underweighting the energy sector for seven years, we began to move to an overweight in 2020. Commodities are arguably the most traditional inflation hedge and are likely to provide superior risk-adjusted returns when inflation expectations rise. We think factors are in place today that make the risk-reward trade off attractive at current levels.

Healthcare

While our Molecular Medicine theme performed particularly well last year, we think there are many reasons to continue to like healthcare stocks. Valuations are still reasonable, especially when compared to technology stocks. Profit growth, not multiple expansion, has driven healthcare stock prices higher. The pandemic has transformed investor attitudes toward the industry. Large pharmaceutical companies are no longer villains that politicians rail against. Instead, they've become saviors, discovering vaccines in record time and saving lives.

Perhaps most important from an investment perspective, the pandemic has improved the pace of drug discovery. The CARES Act alone gave $27 billion to the Department of Health and Human Services to fund development of vaccines, therapeutics and other activities, according to a Government Accountability Office report dated June 25, 2020. At least $3.5 billion of that funding was earmarked for BARDA, the Biomedical Advanced Research and Development Authority. Also, the infrastructure being set up in record time to distribute and store vaccines at extremely cold temperatures will benefit advanced gene therapies that require cold storage during development and distribution. That's just one of many barriers to commercialization of molecular medicine that's falling just as genomic science is devising new cell and gene therapies that can cure previously untreatable diseases.

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Another potential catalyst for the sector is a likely boom in mergers and acquisitions. M&A typically soars when free cash flow yields are high relative to funding costs, as they are today. Furthermore, deals struck when spreads are favorable have tended to add value to the acquirer's shareholders over the subsequent three years. Healthcare is the only sector where acquisitions have not, on average, destroyed value of acquirers.

The consensus of Wall Street forecasters calls for the median biotech stock to deliver top-line growth comparable to software stocks over the next four years but generate higher ending free-cash-flow margins. However, the average biotech stock is trading at less than half the earnings multiple of the average software stock. We think such valuations are too pessimistic since large-cap biotech stocks have, on average, delivered faster five-year earnings growth than software companies over every five-year period since 2003.

Not all healthcare companies will be winners. Some companies that generate disproportionately large profits from therapies for chronic diseases will be negatively impacted if and as new treatments are discovered. So far, valuations of individual healthcare companies have not diverged, increasing potential returns for investors who can identify those likely to be most successful.

Fixed Income

2020 was another positive year for bond investors. The 10-year U.S. Treasury yield began the year at 1.88% and fell 52% to end 2020 at 0.93%, materially lifting prices over the course of the year. However, the quarter-to-quarter progression tells a slightly different story. The all-time low closing yield for the 10-year U.S. Treasury of 0.52% occurred in the third quarter. Since then, yields have been slowly, but steadily rising. During the fourth quarter, the U.S. 10-year Treasury bond yield rose 35%.

The balance of probabilities points toward a steeper U.S. yield curve over the short- to medium-term, as U.S. short rates remain pinned near zero and long-dated U.S. Treasury yields continue to move higher as the economic recovery unfolds. Our emphasis is on individual high-quality bonds that are generally held to maturity, so principal can be preserved, and unrealized losses appear on statements but are never realized. We believe this is the prudent way to balance the higher inherent risks of equity investments.

During Trying Times

We wrote in our year-end 2019 update, "we continue to adhere to our structured thematic investment process." It served us particularly well in 2020, during difficult economic and market conditions. We are confident our thematic research can continue to identify investments likely to deliver strong performance. Our goal is to be ahead of the curve, sometimes too early, but always thoughtful and forward-looking.

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