INVESTMENT PERSPECTIVE 2Q 2020

LIQUIDITY AND SOLVENCY

"The current P/E on the U.S. market is in the top 10% of its history.
The U.S. economy in contrast is in its worst 10%, perhaps even the worst 1%." [1]

The most frequent question we hear from clients is neatly summarized by Jeremy Grantham's conundrum above. How can we reconcile a highly valued stock market with the backdrop of distress and uncertainty? From late March until now, the answer was straightforward. Governments and central banks had issued a giant make-whole for any virus-related economic damage. They might have even thrown in a little extra for good measure. Despite the loss of 30 million jobs, household personal income in the U.S. was 8% higher in April versus February.[2] So it seemed reasonable to posit that the coronavirus might look like extended vacation. Sure, we would all have to ultimately pay back someone, someday. But, in the perpetual stream of corporate earnings, the COVID-19 quarters would end up looking like a fleeting data anomaly.

[1] *Jeremy Grantham. The Virus, The Economy and the Market. (1Q 2020). Retrieved from https://www.gmo.com/americas/research-library/1q-2020-gmo-quarterly-letter/*

[2] *Federal Reserve Bank of St. Louis, 'FRED Economic Data' (June 26, 2020). Retrieved from https://fred.stlouisfed.org/series/PI*

Liquidity and Solvency

(Continued)

The good townsfolk of Bedford Falls pool their resources to rescue the Bailey Building and Loan Society and...well, something like that. You can already see the internet meme mash-up where Jay Powell plays the angel. And, events could certainly still play out like the heart-warming finale of *It's a Wonderful Life*.

On first principles, providing unlimited liquidity was the advisable, least-bad recourse. Interest and rent forbearance and torrents of cash are the right solutions for temporary dislocations. The healthy rebound in activity that we saw across the board from mid-May seemed to validate the 'flood-the-system-with-cash' strategy. The only question was 'how fast' we were bouncing. As the virus drags on, however, we are incurring wounds that will take longer to heal. The salient question about the recovery is now 'to what?' On the other side of the health crisis, how much of the pre-COVID-19 economy will be viable? Briefly: not as much as we thought a few weeks ago.

According to Yelp, 140,000 small businesses closed from March 1 through June 15, of which 55% are permanent.[3] Among large businesses 111 have filed bankruptcy in the first half of 2020 - the highest since 2009.[4] And almost 400 corporate debt issuers are trading at levels that imply a high likelihood of impairment. So the crest of the bankruptcy wave is still ahead of us. The ones that emerge from bankruptcy will do so in reduced form. Many jobs and incomes have been lost for good. Reallocating those resources will entail costs. One quarter of renters either did not pay or made a partial payment in April.[5] As of April, 6.2% of U.S. home mortgages were delinquent more than 30 days.[6] Many commercial tenants are struggling to pay rent. The cumulative default rate for commercial property is currently estimated at 6.5%.[7] There is a pig-in-a-python of defaults working its way up through the system from tenants to landlords to property investors. In this quarter's earnings reports, almost all of corporate America managed to exceed reduced forecasts. You know who was not full of sweetness and light? The folks at the end of the default chain - commercial banks.

The point of this litany is to point out the limits of the policy of liquefaction. Ultimately, there are solvency problems that should not be addressed by - and surely cannot be fixed by - liquidity. The political process of socializing debt en masse will happen sooner or later. The longer we paper over the fundamentally insolvent with cash - the more drawn out the ultimate recovery.

Why even speculate on a perpetual government bail out? Because that scenario explains the conundrum where we started. Public deficits and debt ad infinitum that come with a socialization of private obligations will accrue exactly to equity owners. First, any bailout of the top of the capital structure ensures payments to equities continue. Second, equities provide an income stream that protects (over the long term) against any inflationary impulse. So, the stock market has upside in all scenarios. It may seem like we are in a kind of suspended animation waiting for the economy to break up or down depending on the virus. The crafty stock market speculators have thought a couple moves ahead and decided they hold the keys to the castle whoever the new King may be.

We started with the glaring apparent contradiction of a market at all time highs while real yields are at all time lows. Rather than dismiss that configuration as inconsistent, we have to understand which state of the world it implies. We cannot invest for the world that conforms to our ethical precepts; we have to apperceive the most likely future and invest accordingly. Of course, 'most likely' is not a certitude. Some policymakers might even have the audacity to suggest a bail-in or anti-trust scrutiny. Remember the 'bond vigilantes' that James Carville feared in the 1990s? High valuations suggest hubris. That alone counsels for some modest hedges. We remain slightly underweight global stocks in respect of the current valuation levels and attentive to any changes in the landscape.

—T. Brad Conger, CFA
Deputy Chief Investment Officer

[3] Yelp: Local Economic Impact Report. (June 25, 2020). Retrieved from https://www.yelpeconomicaverage.com/yelp-coronavirus-economic-impact-report.html

[4] Cromby, J. (June 16, 2020). U.S. Bankruptcy Surge is Worst Since the Great Financial Crisis. Retrieved from https://www.bloomberg.com/news/articles/2020-06-16/u-s-bankruptcy-tracker-the-storm-after-the-calm

[5] Popov, I., et al. (April 7, 2020). Nearly One-Quarter of Americans Couldn't Pay Their April Housing Bill. Retrieved from https://www.apartmentlist.com/research/many-americans-couldnt-pay-april-rent

[6] CoreLogic. Loan Performance Insights. (through April 2020). Retrieved from https://www.corelogic.com/insights-download/loan-performance-insights-report.aspx

[7] Trepp CRE Research. Analyzing CRE Loan Defaults & Loss Rates: Serious Challenges Ahead. (July 2020) Retrieved from https://info.trepp.com/hubfs/Trepp%20CRE%20Loan%20Defaults%20and%20Loss%20Report%20_%20July%202020-1.pdf