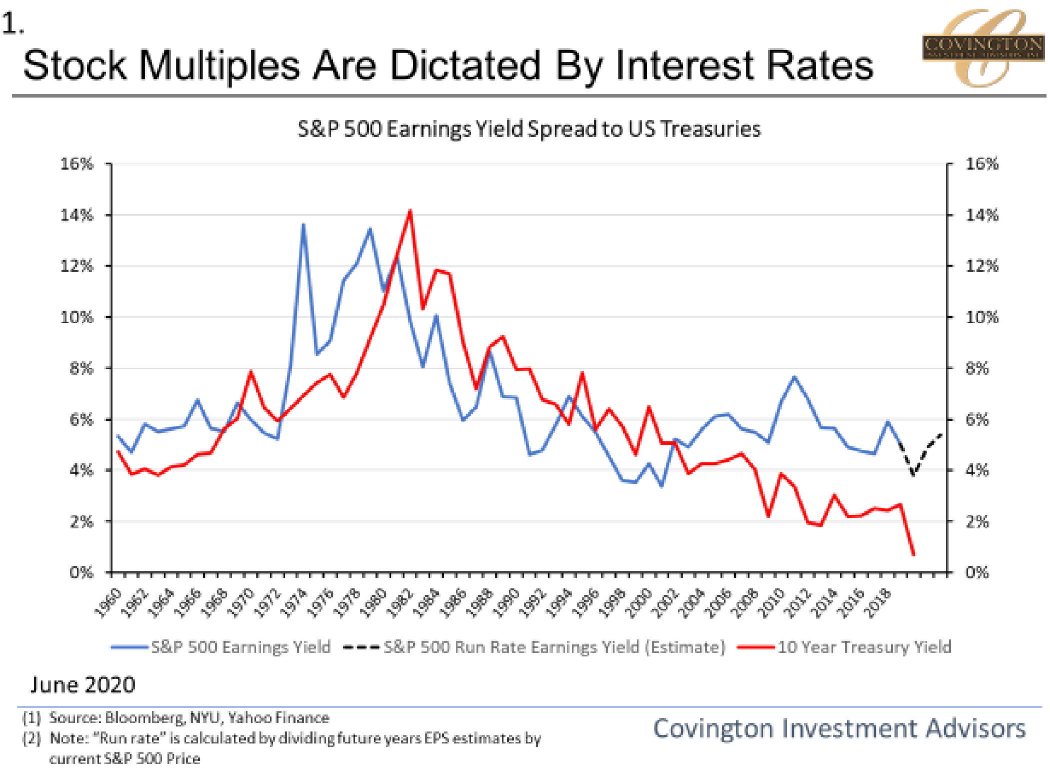
June Market Positioning

Although the market is not trading entirely on fundamental metrics right now, it is still important to keep valuations in mind. For now, investors have been surprisingly willing to “look past” 2020 earnings with the hope of a V-Shaped recovery in late 2020-2021 aided by the most accommodative monetary and fiscal policy ever implemented around the world. An important part of this stimulus is the backstopping of investment grade companies (90% of S&P 500) through the new credit facilities set up by the fed which prevented a default wave from occurring in large cap companies.

1.



The value of virtually all investments is dictated by the risk-free rate of return (See Chart 1), which is determined by the yield on US Treasuries. Lower yields mean lower required return, which means higher multiples paid for cash flow streams. Fama & French determined that the historical equity risk premium dating back to the early 1900s for large cap stocks (premium that investors require over treasury yields due to increased risk being taken on as equity holder) is roughly 4.5%. So, if an investor believes that earnings will quickly recover, current market multiples do not look unreasonable given where interest rates currently are. The volatility will arise in the coming quarters as we begin to see if a quick snap back in earnings will truly occur.

Of course, it is more nuanced than that. The S&P 500 has undergone a significant mix shift in the last 6 months with the index becoming very top heavy in large cap tech companies. As seen in charts two and three, the market is also pricing this in fairly efficiently given how much cash flow they produce as a percentage of the S&P 500. These companies convert more of their earnings to free cash flow compared to market leaders in former decades that required more capital to grow or operate (AT&T, Exxon Mobil, GE). Current companies (Amazon, Google, Microsoft, Facebook) can grow very quickly without the need of debt or additional capital to finance themselves. Those companies would command a higher multiple meaning the overall market multiple would be higher.

2. Top 5 Companies Make Up 21% of S&P 500 Market Capitalization

(1) Source: Bloomberg, BofA Global Investment Strategy
(2) Note: April 2020

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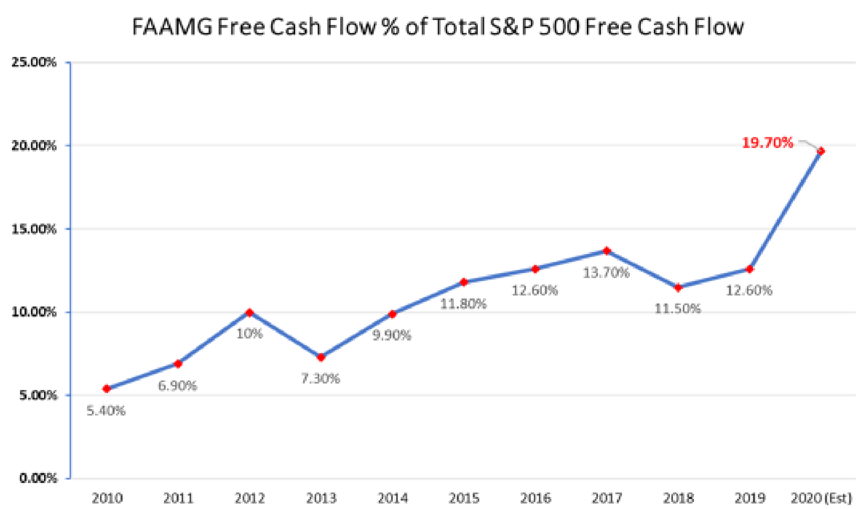
3. Top 5 Companies Make Up Almost 20% of S&P 500 Free Cash Flow



(1) Source: BofA, Bloomberg | May 2020
(2) Note: "FAAMG" = Facebook, Apple, Amazon, Microsoft, Google

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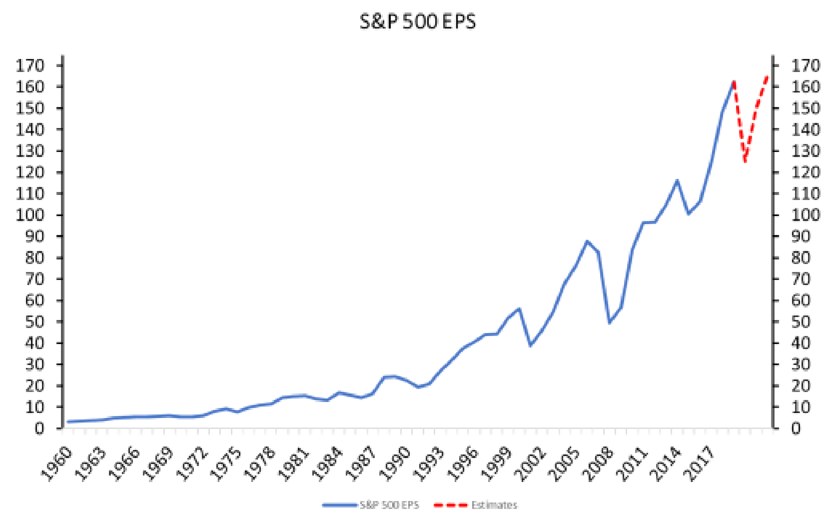
FAAMG:
Facebook
Apple
Amazon
Microsoft
Alphabet (Google)

MARKET POSITIONING

The two questions now going forward are:

1. Will the long-term earnings of S&P 500 companies be permanently impaired and rerate lower because of the current crisis or will it be a true "V" shape recovery in earnings? (See charts 4-6)
2. Will the US & Europe continue on their current path of "Japanification" to negative rates due to deflation, demographic, and growth headwinds? Or will inflation and growth pick up resulting in interest rates moving up?

4. Consensus Estimate is a "V" Shaped Recovery in S&P 500 Earnings



June 2020

(1) Source: Bloomberg, Yardeni Research
(2) Note: "Estimates" are consensus estimates sourced from Bloomberg

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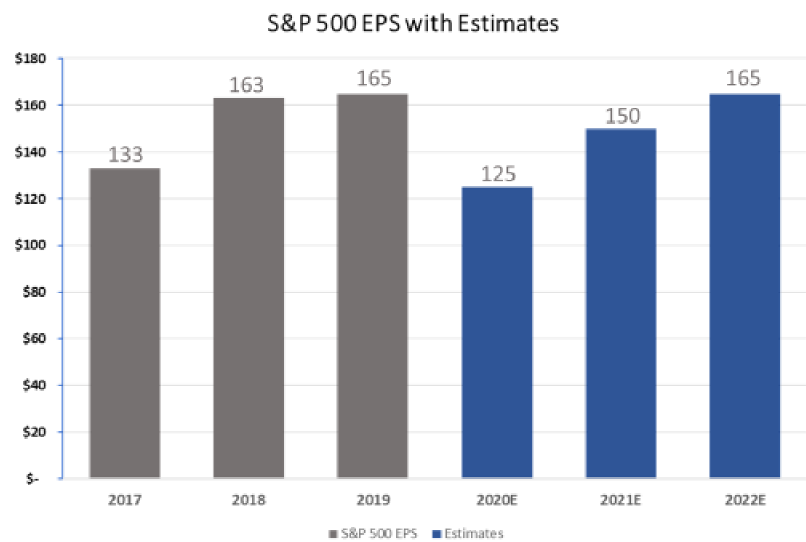
5. Expectations Are It Will Take 3 Years For Earnings to Fully Recover



(1) Source: S&P, FactSet, Credit Suisse
(2) Note: June 2020

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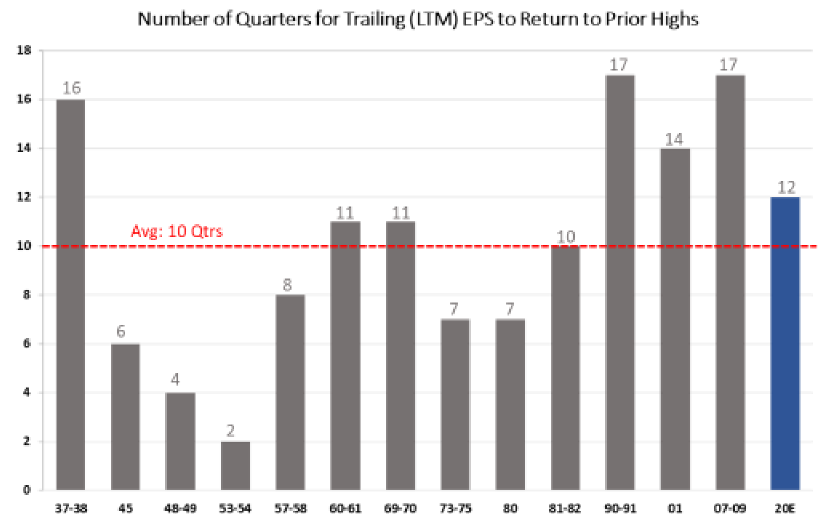
6. The Prior 3 Recessions Have Taken 3 ½+ Years to Regain Peak EPS



(1) Source: S&P, FactSet, Credit Suisse | June 2020
(2) Note: Trailing 12-month EPS. '20 is estimate

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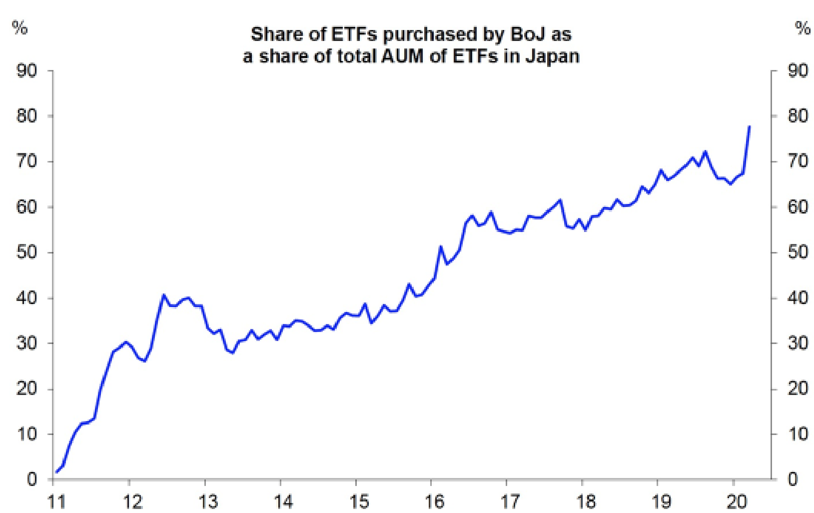
The most likely outcome of the huge stimulus will be the "Japanification" of the US economy. The template for a developed country facing aging demographics, low growth, deflation, and huge monetary stimulus is Japan. The Bank of Japan really pioneered both negative interest rates and aggressive quantitative easing going so far as purchasing equity ETFs (See chart 7). The BoJ owns roughly 5% of the Japanese stock market and almost 50% of the Japanese government bond market as of 2019. Chairman Powell has mentioned several times in recent weeks that the Fed "is not out of ammo" which many investors assume means either equity ETF purchases, negative rates, or both. With the US enacting huge QE measures and already expanding the Feds purchase ability, we appear to be on the same path as Japan.

7. Bank of Japan Owns Almost 80% of All ETFs Domiciled in Japan



(1) Source: BoJ, Haver Analytics
(2) Note: June 2020

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MARKET POSITIONING

So, what does this mean for the economy and markets?

Slower and slower economic growth as the debt anchor weighs us down (deflationary not inflationary). Monetary velocity might even fall even further as many companies have rushed to issue debt but most of this debt is being used to secure financial positions rather than being spent on goods and services. So large amounts of new money are being lent out to corporations in the system but not much of it is being spent.

Will this be inflationary after the economy gets completely back on its feet in a year or two? Possibly. But in the near term the US will be fighting deflation which for a debtor nation is worse than mild inflation.

This also puts the bond market in a precarious situation. While credit spreads and liquidity have returned to a more reasonable level due to Federal Reserve actions, returns going forward will most likely be suppressed. With interest rates already being so close to zero, even a move into negative territory would put a ceiling on the capital appreciation potential for bonds that was experienced in 2019/first half of 2020.