CIO Quarterly Commentary

2Q2020

What a Precarious World We Live In, and $13,990.99

First things first. We have often encouraged a long-term view from those responsible for investing long-term assets. We still do. Despite significant ups and downs along the way, over longer periods the U.S. and most other stock markets seem to move up and to the right. Stock markets weather civil unrest, bad politics, inflation, economic slowdowns and even wars, always in the end recovering to new highs and beyond. As a result, a long-term view enables most investors to achieve much better results than those who trade these wiggles in fundamentals, always trying to sell interim peaks and buy back at modestly lower levels. Those folks who don't take the long view but also who don't really have the stomach for buying when markets decline precipitously often get hurt the worst. We all read about one or two savants who seem to time things exactly right, yet we rarely hear about those who take their capital out at bottoms and then miss the bulk of the market move back up. Funny how these folks seem to be much less talkative about their experience.

Occasionally, however, there are times when an added dose of caution proves warranted. Nobody knows for sure when one of those times is upon us, so at TIFF we do not often try to anticipate such periods. Rather, we generally stay focused on the long-term. That said, we may now be in one of those rare times when it pays to acknowledge the unique risks currently facing equity markets across the globe, including here in the U.S. We haven't yet seen the Time Magazine cover proclaiming that now is the time to own U.S. stocks, but there are other signals that make us more nervous than normal.

Given our acknowledgment that markets are probably better at discounting the future than we are and our assertion that markets tend to go up over time, should you care that we are "more nervous than normal?" Perhaps. Investing is a difficult and humbling business. The market's job is to discount the future, which is a very tough task even in the calmest of times. For the most part, the market does a pretty good job. You have probably heard the old saw: "The market climbs a wall of worry." Our job is to understand that "wall of worry" and rationalize how and why the market will avoid slamming into and sliding back down that wall. When the U.S. and China get into a tariff battle, we must decide whether to trim or eliminate our Chinese equities in favor of something else. When a new president gets elected and brings new policies to the White House, and the market then drops, we must discern what the silver lining might be. When the economy begins to slow too much, we must anticipate what the Fed and government might do to help get the economy back on track. Obviously, we don't do this work alone, but in conjunction with our manager partners who give us a larger window into the world and what is or might soon be happening. Our job is filled with uncertainty, questions, and the never-ending search for the silver lining. Because, in the long run, markets move up and to the right.

Why are we currently more nervous than normal? Because we have never seen an environment anything like what we are going through now. As we have previously written, what started as a global health crisis quickly became an economic crisis, briefly added a dash of a liquidity crisis, and then was joined by a solvency crisis. Globally, governments locked down their people and their economies to slow the COVID-19 spread and forestall a much worse health crisis. These actions led to a sharp and immediate contraction and the worst global economy in at least 75 years. The roughly 30% drop in global oil demand then led to oil prices going negative for a short period, putting enormous pressure on producers globally, and creating a solvency question for many producers and even some governments. All these factors contributed to a 34% decline in the S&P 500 (and the ACWI All Country World Index) in the shortest ever time from all-time highs to a bear market. Unprecedented, and worrisome, stuff.

What also makes us more nervous than normal is the extraordinary recovery the market has since experienced. As of June 5, the S&P 500 had risen 41% from its March lows. This recovery is the steepest ever, from the shortest bear market in history. The market is certainly discounting the future, in this case a much brighter future. Part of the brighter future the market sees may be a result of the Federal Reserve stepping up monetary stimulus as never before to the tune of about 20% of GDP. Part of the brighter future the market sees may be the U.S. government enacting unprecedented fiscal policies (handing out money) in a very compressed time designed to stabilize the economy until it can restart. As we have said before, we think both of these policy moves were needed and appropriate. We applaud them. Other governments around the world have enacted similar policies in an effort to help their economies recover as quickly as possible. At present the U.S. and the world are in the process of re-opening their economies. If we are lucky, we won't see the 25% unemployment rate in the U.S. predicted by some or the 50% decline in Q2 GDP forecast by others. Other countries will fare similarly to the U.S., some perhaps a little better and some probably a little worse. This pandemic is global.

The market seems to be discounting a fairly certain outcome to the pandemic situation, about which we are optimistic though admittedly less sure. How and when will the pandemic end? Many smart and dedicated researchers from across the globe are working on a vaccine or other cure. Most experts project it will be at least 12-24 months before a reliable vaccine emerges. As economies re-open will we see a relapse, or will social distancing and the wearing of face masks preclude such an outcome? We generally remain optimistic about these topics, appreciating that mankind is wired to overcome adversity. We will find a vaccine and probably also develop a platform to create future vaccines in a fraction of the time this one will take. Unfortunately, optimism does not equal certainty.

Another cause for our nervousness: the current U.S. monetary stimulus has overwhelmed the economy's immediate need for capital. So, where has the stimulus money gone? Some of it most certainly has gone into stocks and bonds. The monetary policy expansion of purchasing investment grade corporate bonds, fallen angels (former investment grade bonds that have been de-rated to junk bonds) and ETFs, in addition to the traditional government bonds and mortgages, has directly pushed huge sums of money into capital markets. Retail investors have joined in the buying spree. Reports of new individual brokerage accounts opened in Q1 2020 are prodigious. The big three online brokers saw new accounts rise by over 800,000 in the first quarter, only to be overshadowed by the stock trading app Robinhood, favored by millennials, which added three million new accounts in the quarter. Over 1% of Americans opened a new brokerage account in Q1 2020 as equities were entering and then starting to rebound from a bear market. Maybe all these new stock traders know something the rest of us don't?

Finally, we are nervous because current equity valuations seem generous to us. In 2019, S&P earnings were about $165 per share. This current consensus for 2020 is that we'll see about $125 in earnings, recovering further in 2021 to perhaps $162. From our perspective, the deep uncertainty of the economic path forward, the near certainty that earnings won't be back to 2019 levels until 2022 (at the earliest), and the fact that valuations are up nearly 40% from March lows suggest that equity valuations are at least fulsome today.

Reflecting on matters such as these, Jeremy Grantham of GMO recently acknowledged in the *Financial Times* that his firm (GMO) has reduced exposure to U.S. equities to a net short position in its "Benchmark-Free Allocation Fund." He noted that the current P/E on the U.S. market is in the top 10% of its history, with the highest debt level ever in the U.S. both for corporations and for peacetime government. The U.S. economy in contrast is currently in its worst 10%, perhaps even its worst 1%, condition ever. This mismatch is one of the most impressive in history. Other renowned investors have also walked away from equities including two of the best hedge fund investors ever, David Tepper and Stan Druckenmiller. Tepper calls today the second most overvalued stock market he's ever seen, behind only 1999; while Druckenmiller says the risk-reward of investing in stocks has never been worse (Mr. Druckenmiller has more recently stated, essentially, that he was wrong and that one should not fight the Fed). In the category of "watch what they do and not what they say," at the Berkshire annual meeting this year Warren Buffet said to "Never bet against America." But he then disclosed that he had not made any meaningful stock purchases recently because the prices never reflected the sort of value that he found interesting. All these comments were made in the first part of May, since which time the S&P 500 has risen another 7% or so to rest within 5% of where it began the year.

Processing all the above, we have two powerful yet competing thoughts. On one hand, all the factors we describe here and the fundamentals are making us more nervous than normal. The cone of potential outcomes seems wider to us this year than at any time in our experience. We don't know if we will find a COVID-19 vaccine or cure or if we actually will even need one. Maybe we won't have a relapse in the fall or spring, but maybe we will. Maybe the economy can recover without more stimulus, but we might need a lot more. Maybe all the spending the US is doing will keep the economy going long enough to find a vaccine, but that outcome is far from certain. With MMT in full force, we've even heard talk of inflation returning. Inflation would certainly raise the U.S. budget deficit by pushing interest costs up. Rising federal deficits, combined with the increasing shortfalls in state and local government budgets, might also lead to higher taxes for individuals and corporations and pinch forward P/E ratios.

On the other hand, we know that markets generally move upwards and to the right and the cost of missing market rallies can be high. We are optimistic about the amount of stimulus in the market. We are optimistic about the scientific community. We are optimistic about the resiliency and dynamism of the human spirit, and in particular we are optimistic about the long-term prospects for the U.S. economy. We know that the market is the world's greatest discounting machine and the market clearly sees light at the end of the tunnel.

We currently balance these two competing thoughts by staying pretty close to our risk benchmarks versus our usual modest equity overweight, as we perceive uncertainty to be higher than normal. We are willing to modestly trim equities when we see exuberant spikes and we are willing to buy equities when we think the asymmetry of the markets favors equities. However, we are not currently making large moves to underweight equities as we know markets generally move upward and to the right.

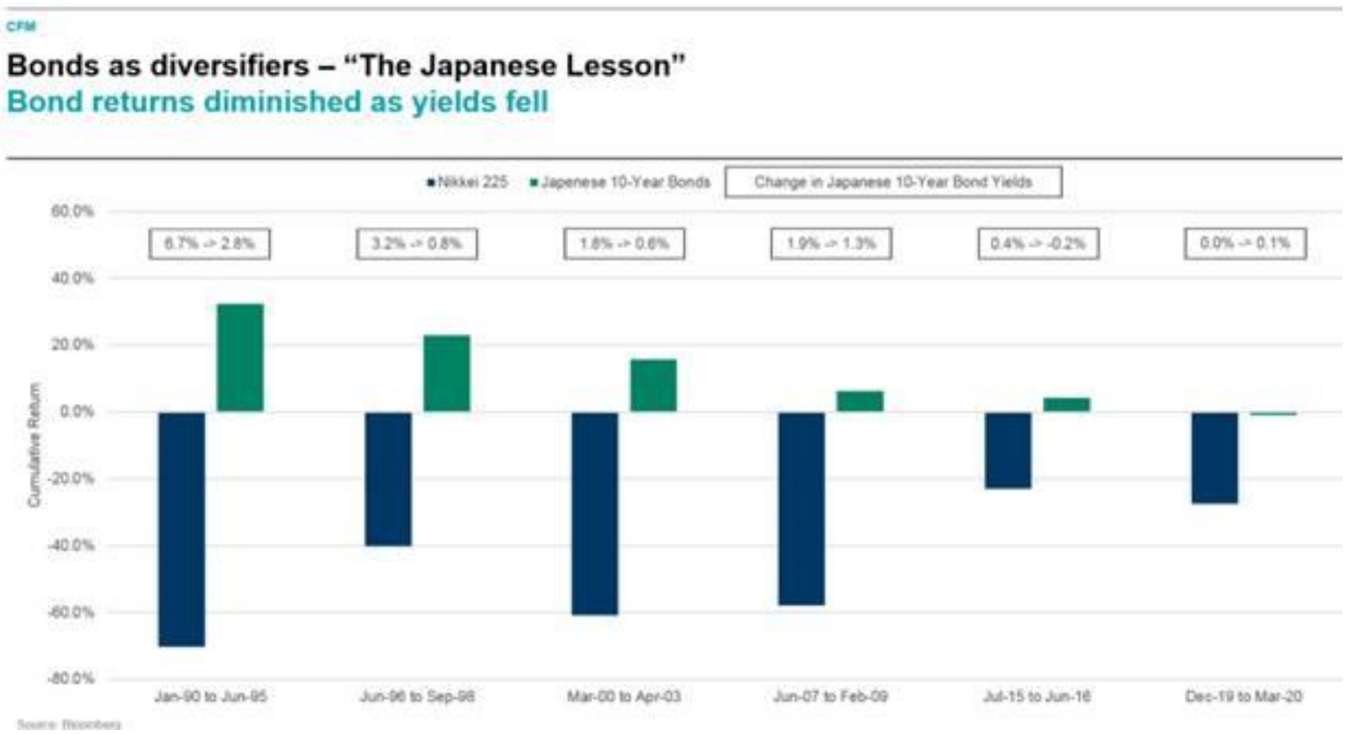
$13,990.99

We are beginning to question the traditional role of fixed income in a core portfolio. In 1Q 2020, when equities fell 34%, high yield bonds (as measured by the ETF "JNK") dropped by 23%. No surprise you might say, but what about the 22% fall in investment grade corporate bonds (measured by the ETF "LQD") in the same period? Only U.S. government bonds held up, with the 10-year Treasury gaining about 8% as rates fell from 1.92% to 0.67% and the 30-year Treasury gaining about 16% as long rates fell from 2.39% to 1.32%. Any investment the price of which moves in the same direction as equities is not a good diversifier. It doesn't provide you the full value of your money to rebalance into equities when the opportunity presents itself. For this reason, holding credit is today much less desirable than it has been in the past. Ten-year maturity investment grade corporate bonds provide you about 1.75% more yield than treasuries as we write this (and junk bonds about 6.3% more), but we think the diminished portfolio diversification these securities currently offer materially reduces their value in a core portfolio.

Treasuries, as noted, did provide great diversification, especially those with long maturities in the recent equity sell-off. When investors get nervous, they traditionally gravitate to the safest investments, focusing particularly on treasuries. This approach worked again in the latest sell-off as rates in the U.S. set new record lows. The question with treasuries is whether they will continue to provide this portfolio ballast. Do you take the risk that rates in the U.S. continue to move lower as they have in Japan and Europe if we have another equity market sell-off? Our answer to that is a resounding "maybe."

$13,990.99 is how much interest you make today per year for investing $1 million in a 30-year U.S. Treasury bond. That figure is less than ever before, save a few different times over the last few months, and is nowhere near a 5% real rate of return. It may not even be a positive real return. The Fed has stated its intention not to take rates negative, though its position could change. The Fed has also reaffirmed its goal to get inflation up to 2%, an inflation level that would presumably be good for business but not so high as to impair the future value of the U.S. currency and bonds. If the old saw "Don't fight the Fed" is still true, then one should be selling U.S. Treasury bonds now. With current yields well below target inflation, these bonds will not maintain your purchasing power over the next 10 or 30 years. Further complicating the investment decision-making process, if 30-year Treasury rates were to move back up to historic levels of 3% above inflation, and inflation was 2%, the value of your current bond would fall by about 53% ($530,000) from today's prices. You would receive less interest over the next 30 years from your bond than the capital loss you would incur. Betting against the Fed, earning very little while risking a lot as MMT (QE, helicopter money, whatever you want to call it) powers ahead is an investment combination we find unappealing. The only reason to own long Treasuries today is to hedge against a deflationary world, in which someone will pay you more for those bonds during the next equity market downturn. We find that scenario plausible but unlikely. We'll explain why next.

In developed market economies over the last 50 years, the singular case study for prolonged deflation is Japan. Since its great stock market bubble burst in 1989, Japan has struggled to gain economic traction, with its stock market lagging the world and inflation remaining very low. The following chart shows how the Japanese Treasury equivalent bond has provided successively less portfolio protection (green bars) against equity market declines (blue bars) as time has passed and the starting rate of the Japanese bond has declined. In fact, during the 2020 equity market sell-off, the Japanese Treasury bond provided no positive return.



Data from Bloomberg. Based on Capital Fund Management's Food for Systematic Thought webinar on May 7, 2020

The chart above covers Japan's six equity bear markets over the last 30 years. The boxes across the top show the change in rates for ten-year JGB yields.

Should such a scenario play out in the U.S., we would need to find some other asset that could help provide protection in downturns as well as some reasonable return in normal times. We stand fast in our conviction that hedge funds are a better option over forward market cycles than treasuries (or corporate bonds). If bonds can't provide portfolio ballast in an equity sell-off, then our conviction becomes greater, even to the point of questioning whether the optimal core portfolio should contain any bonds at all. We admit that figuring out what might take the place of treasuries in today's core portfolio is very tricky. Our current list of possible ideas includes gold, bitcoin, cash, foreign sovereign bonds paying a higher positive yield, commodities and equity puts. Of course, none of these ideas is the sure thing that treasuries have been for the last 35 years. They may not provide the ballast when stocks fall, nor the attractive long-term returns over a cycle. Then again bonds might not either. Ours is a tough business.

We hope this letter doesn't sound too negative. We feel duty bound to share with you the issues with which we are wrestling on your behalf. But, we are optimistic people by nature and given the uncertain outlook, we are pleased to have done relatively well during the 1Q decline and to have recouped most of those losses in 2Q so that we are generally positive on a year-to-date basis. Our slightly more conservative posture reflects the concerns we have noted here and is designed to continue to participate meaningfully in any upside while giving us a little extra dry powder in case one of the less favorable environments develops. We continue to expect markets to move higher in the future and to recommend a long-term approach to investing long-term capital. But, here for a bit we agree with some of the best investors who have a somewhat less constructive view on equities than they usually do. We won't ever "bet against America," but we will try and prudently wait for equity valuations to become more attractive before we prepare for the inevitable move, up and to the right.

We very much appreciate the opportunity to manage your capital and to help you achieve your organization's financial goals. We are here to assist you in any way possible, so please reach out and let us know how we can help.

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