TIFF INSIGHTS

CIO Quarterly Commentary

3Q2020

On Walls and Worries

As we prepare this quarterly piece, capital markets, especially U.S. equity markets, have fully recovered – and then some - from the disastrous 1Q & 2Q economic consequences of Covid-19. U.S. stock prices move up a little bit on most days despite continuing unsettling virus statistics, intense protests, and extreme political bickering over almost everything. With the polarizing 2020 presidential election now just 5 weeks away, Americans cannot seem to agree on much of anything, except that they should buy stocks, mostly U.S. growth stocks.

An old expression coined in the 1950's says that equity markets like to "climb a wall of worry." U.S. equity markets have recently been climbing a rather steep such wall indeed. We're cautious about that climb not so much because the "worries" are unprecedented - if you think living during Covid-19 is bad, read Erik Larson's *The Splendid and the Vile* and acquaint yourself with how U.K. citizens felt during the Nazi bombing campaigns of 1940 and 1941 – but rather because the institutions on which we rely to fashion solutions to the worries seem largely dysfunctional at present.

That said, we do not believe any investor with a long-term horizon should overreact (or underreact) to the problems and challenges of the here and now. Societal problems often seem insurmountable in the moment. Yet, human beings, wired as we are to overcome adversity, usually manage to find some acceptable path forward. So, if you serve on the Investment Committee or Staff of one of the many non-profit institutions for which TIFF stewards capital, we recommend that you pay careful attention to the important issues of the day and form beliefs around them. But, never conflate problematic current events with the drivers of long-term investment success.

Speaking of problematic current events, we have entered election season, when politics again assume center stage. Regardless of outcome, the results of the presidential election will influence each of us, our country, our world, and our capital markets. As was the case four years ago, this election is "the most important of our lives." We suspect each of the next few elections will be too. That said, elections indeed are important and we do believe that the differences between candidates this year seem wider than normal. The winners will get to try and set the direction of policies that can have meaningful impact on financial asset prices, as well as the world at large.

Whomever wins will oversee an economy trying to emerge from an extraordinarily difficult period. Without belaboring the point, the lockdown in 2Q produced some of the worst economic numbers since the Great Depression. Without the extremely fast and exceptionally large bipartisan relief programs, we might have seen a spiraling into our own depression. Fortunately, both monetary and fiscal relief arrived before that could occur. To give you a sense of the magnitude of the relief efforts, Ned Davis notes that in April 2020, government support accounted for 24.9% of personal income and three months later (July 2020) it was still 17.4%.

The good news is that over this same period, Americans' personal savings rate rose to 33.7%, before declining to 17.8%. With support programs beginning to expire in August, some of these savings should cushion the delay in a follow-on relief bill which most believe is needed to keep the economy going. During the 2008-09 Great Financial Crisis (the "GFC") when there was gridlock around getting bills passed, investors brought focus and discipline to the political process by pushing stock prices precipitously lower. This time, at least so far, the inability to pass CARES ACT 2.0 hasn't slowed the stock market rise. Investors either correctly believe a second relief bill is not needed or that it will get passed shortly. If investors are wrong, they may need to assume their historic role of vigilante enforcer.

The Good

We believe interest rates remain so low in large part because the Fed is aggressively intervening in markets to purchase debt. This intervention has kept rates low, a boon not only to debt holders but also to equity holders, as the low rate used to discount future cash flows pushes up the value of those cash flows. The low rate environment has significantly benefitted growth stock valuations because their expected cashflows generally come from further in the future. We noted in an earlier letter that it would be interesting to see which would dominate the direction of asset prices, massive quantities of money or a horrible pandemic. We have all again been reminded not to fight the Fed, particularly a creative and motivated Fed.

In addition to ample Fed liquidity, we have witnessed nearly $3T of fiscal spending so far appropriated during this pandemic. This is very different from anything we have ever experienced. Even in the GFC, fiscal spending did not come to the rescue at nearly this magnitude nor with nearly this immediacy. For the first time in several decades fiscal spending is a major part of the solution. Coupled with 2020 growth of the Fed balance sheet from $4T to $7T, fiscal stimulus has helped the economy bottom out and recover along with financial markets.

Fed chair Jay Powell recently announced that the Fed has adopted average inflation targeting. After a decade of not being able to get inflation up to its 2% target, the Fed no longer intends to tighten in anticipation of inflation reaching the target, but rather, intends to allow inflation to overshoot 2% to offset the undershooting of the last decade. Some herald this new Fed policy as signaling low rates for many years. We are concerned this benign sounding change could be more impactful than investors currently appreciate.

The Bad

While we have seen many positive developments since our last letter, not all of them have been positive (or at least not all in the long-term). For example, with a willing spender in the US government and the normal governor of inflation (the Fed) now absent, the odds of inflation coming back rise. If you were around in the early 1980's, you know that inflation can be hard to eradicate. Inflation destroys the value of the USD. Inflation at 1.7% per year (its average over the last decade) for 40 years cuts the dollar's value in half. If inflation averages 3% as it has over the last 40 years, the USD loses 70% of today's value. A weaker USD is certainly better for equities than for debt, but over the long run weaker dollars can help cause inflation and make achieving 5% real returns even harder. The next administration will play an important role in determining how this plays out.

The stock market has also shown some signs of frothiness. We see a new potential threat beyond the mundane economic and earnings fundamentals and even the ever-changing political landscape – namely new equity issuance. With an average of ~$500 billion per year of net stock retired in each of the last 5 years, a surge of equity issuance could dilute buying power otherwise intended for existing shares. Poor quality new issuance would be another indicator of market excess. In August, we had two "unicorns" (private companies valued at >$1 billion) file to go public via direct listings. In the past, few companies chose the direct listing path because they could not raise new funding at the same time, making it an impractical choice for companies looking for both liquidity and growth capital. The SEC recently approved regulations that enable companies to raise new capital by selling new shares of stock in direct listings on the NYSE. In addition to the two direct listers, we've also seen five other unicorns file to go public. That brings to $44 billion the total value of just these seven companies looking to tap into the public markets. Though we are probably a long way from this becoming a big burden, excessive, low-quality equity issuance during the latter part of the circa 2000 tech bubble played a role in the precipitous decline that followed.

Before touching on one last topic we would just note that there are many other differences between this year's candidates that will likely impact capital markets, including but not limited to their approaches to healthcare and Covid-19, climate change and renewable energy, China and global trade, the domestic economy and fairness, and finally regulation and taxes. In the long-term, many other trends and economic dynamics may overwhelm some of these policy differentials, but clearly these policies can have short- and intermediate-term impacts. For an interesting perspective on the potential modest impact on long-term trends, we invite you to read the recent Gavekal Research article entitled *Don't Waste Time Analyzing The US Election* that discusses their view of how best to think about the upcoming election – it is posted on our website under 3Q2020 CIO Quarterly Commentary. If history can be counted on as our guide, it may all work out just fine.

Potentially the Ugly

Our last meaningful concern as we write is the November elections themselves. In November, Americans will select a President, 35 Senators, 435 Congresspeople, 11 Governors and lots of other state and local leaders. We join the many civic minded voices who urge every citizen to vote. From a capital markets perspective, we'd like to see decisive margins of victory in each individual race (to minimize the likelihood of ugly post-election litigation), but a divided federal government that requires rational debate and compromise to get things done. Anybody remember Tip O'Neill and Ronald Reagan? We fear an increase in polarization and possibly even violence if either party "sweeps" our federal elections. We also fear the consequences a sweep might have on capital markets.

There is some chance that due to absentee ballots, the refusal of either side to accept defeat and expected legal challenges, this election will be fraught with uncertainty and an eventual winner could take days, weeks, or in the worst cast months to determine. Some examples of potential election uncertainty emanate from at least the following: a) potential lawsuits about voting processes and potential perceived irregularities; b) states having difficulty certifying their election results and returning them to the electoral college by December 14, 2020 (the date by which the electoral college is required by law to vote); c) some have warned of states sending multiple electoral slates to the electoral college if a state falls prey to b); and d) the actual mechanics of the 12th Amendment and the House selecting the President and the Senate selecting the Vice President in the event the circumstances of b) above preclude a candidate winning the majority of electoral voters (note: the 12th Amendment covers basic scenarios, but Constitutional scholars are able to envision many scenarios and conflicts not contemplated by that Amendment). This is a partial list of the complexities that could present themselves in this election and some scholars perceive that the uncertainty could persist even past January 20, 2021. The good news is that most of these uncertainties only present themselves in a very close election. Our bottom line here is that while it could get messy, this is part of a wall of worry the market is likely to climb by the end of January (or earlier) and then the uncertainty will be gone.

Long-Term Investing in Uncertain Times

Having now pontificated for a couple of pages on some ostensibly depressing subjects, we'll end on a brighter note. We remain long term optimists on the United States, democracy, capitalism, and human nature in general. We will find a cure for, or at least a means to survive and prosper while coping with, Covid-19. The planet will get greener and cleaner over time, even if not fast enough to satisfy everyone. Society will make real progress on lifting up and providing opportunity to those who have not been able to share and benefit fully in all our country has to offer. We are recognizing and addressing injustice even if that progress is not as straight line or as speedy as it ought to be. And, yes, America and democracy will both withstand whomever our next president turns out to be. The truly remarkable American non-profit sector, unparalleled anywhere else in the world, will play a vital role in helping to achieve all these things and in keeping America the greatest country on earth.

So, as we invest the portfolios of our non-profit members, we mostly "look across the valley" of the daunting problems facing society today. We keep most of your assets invested in equities which benefit disproportionately as the world solves current problems and advances to new heights. To be sure, we take careful account of, and form beliefs around near-term opportunities and risks. To that end, we have maintained equity exposure at about the 65% level and acquired a bit of downside portfolio protection as stock prices have relentlessly marched higher. Our diversifying investments remain spread across a broad group of hedge fund strategies and our fixed income exposure continues to be short duration government debt and cash. Our long-term view remains broadly constructive and, as Warren Buffet suggests, we won't be betting against America even with some obvious economic and political challenges ahead, because in America, over the long run, stocks move up and to the right. In the event that some of the risks, particularly those around the election, present attractive entry points, we could envision adding to our long-term equity exposure.

We hope your favorite candidates win in November and we look forward to our next opportunity to see you, ideally in person, but at least virtually. 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.

Your TIFF Investment Team

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