

*2020 started with investors' appetite for risk still healthy*

## Introduction

We entered 2020 with some deep concerns that investors were oblivious to the lurking risks stemming not only from the then developing Coronavirus in China but also from slowing economic growth in parts of Asia (particularly Japan) and Europe. In our **Q1 VRS Global Markets Report (07/02/20)** equity section we reiterated the obvious that very few investors seemed to pay attention to: most of the stellar performance in global indices/shares during 2019 came from P/E multiple expansion amid steady or even lower earnings. More Central Bank liquidity in the US to combat a REPO market freeze was interpreted by investors as “another” free lunch QE type of program enacting animal spirits. In our late September/early October 2019 analysis we clearly stated that the Fed’s intervention WAS NOT a QE. Analysts and participants continued to ironically call the program “not-QE” for months being lulled into complacency.

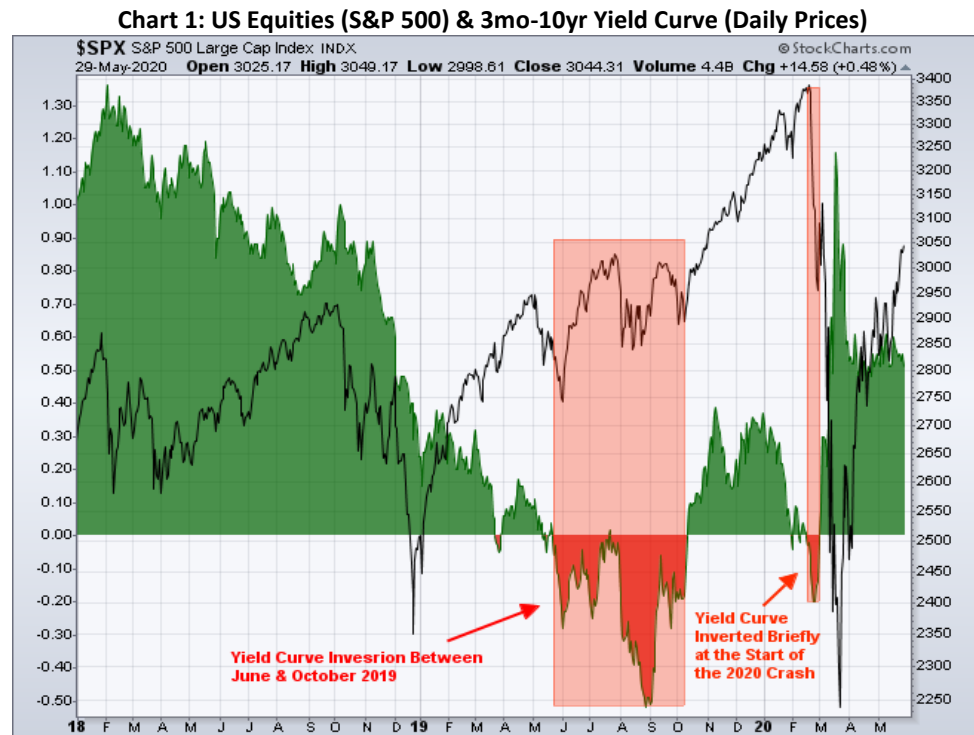
In our equities section (page 8) we stressed among other things the below:

*As we look into Q1 of 2020 and further beyond for equities we see a rather potentially dangerous market. It is very likely that the upside momentum will not subside easily as we have witnessed so many times in the past. The “buy-the-dip” mentality is too far entrenched into investors’ and traders’ mind that they will not give up easily buying any dip. **This momentum in markets will stop ONLY AFTER a corrective dip will not reward the buyers.** When people who pile into equities after a pullback are punished with losses only then will start to change their attitude. At the moment it is a bit early to see such a change after a minor corrective blip. The coronavirus event is a potential destabilizer and a wild card but unless it spreads around the world indiscriminately killing thousands of people it will not be the real force behind the equity indices.*

*As the COVID-19 related crash proved once again, this time WAS NOT different*

It was rather worrisome to watch equity markets march higher without having the tailwind help of earnings and advance non-stop for months. Every time we have had multiple expansion of this sort markets are thought to be priced for perfection. **It WAS NOT different this time around.** Momentum investing was still in full force. In said environments the accumulating risks under the hood need one fine catalyst to just tip prices over. Capital flows out of Europe/Asia and into the US bonds for a few months during 2019 led to yield curve inversion (3mo-to-10yrs). Investors initially interpreted the inversion as a precursor to a recession and spent August/September in a risk-off mood. The US Fed’s official REPO announcement in early October was a game changer igniting investors’ appetite. Risk-on again despite the warnings from the bond market. There is no doubt the US Fed had to intervene. No question about it. But investors/traders extrapolated into the future once again what worked in the past. As **Chart 1** on page 2 presents, the **3m0-10yr US Treasury Yield Curve** inverted briefly again just as the 2020

crash in global equities was starting. In just a few weeks, and after the US Fed's actions to slash overnight interest to almost zero and initiate aggressive QEs and other lending programs, the curve went back to steepening (110 bps). It has backed off a bit since late March (55 bps) but remains positive. We need to remember that a positive yield curve is an absolute minimum in order for banks and other lending institutions to have a healthy environment from which to operate and profit. During yield curve inversions profits margins tend to get eroded as tighter spreads squeeze the lenders.



*A few US stocks (mainly tech) were masking the underlying weakness in broad indices*

Perhaps one of the harbingers to future trouble was the quality of the equities advance in many countries. In the US markets, in particular, a handful of large-cap stocks mainly from the technology sector rallied breathlessly higher to the very price market peak in mid-February. Small-cap stocks lagged by a huge margin having peaked in early 2018. The New York Stock Exchange Composite Index topped in mid-January. In other words, we had risk-on behavior in parts of the market with the biggest weight on the main indices (S&P 500, Nasdaq Composite, NDX, Dow Jones, etc.) thereby masking the weakness under the hood. A few tech stocks (Apple, Facebook, Netflix, Google, Microsoft, Amazon) accounted for almost **30%** of the S&P 500 gains during the rally since the late December 2018 lows. In such narrow market rallies a good catalyst is usually needed to make things fall apart. Once the late leaders start to sell off, the market has little support underneath. Late stage market sponsorship can last for only so long.

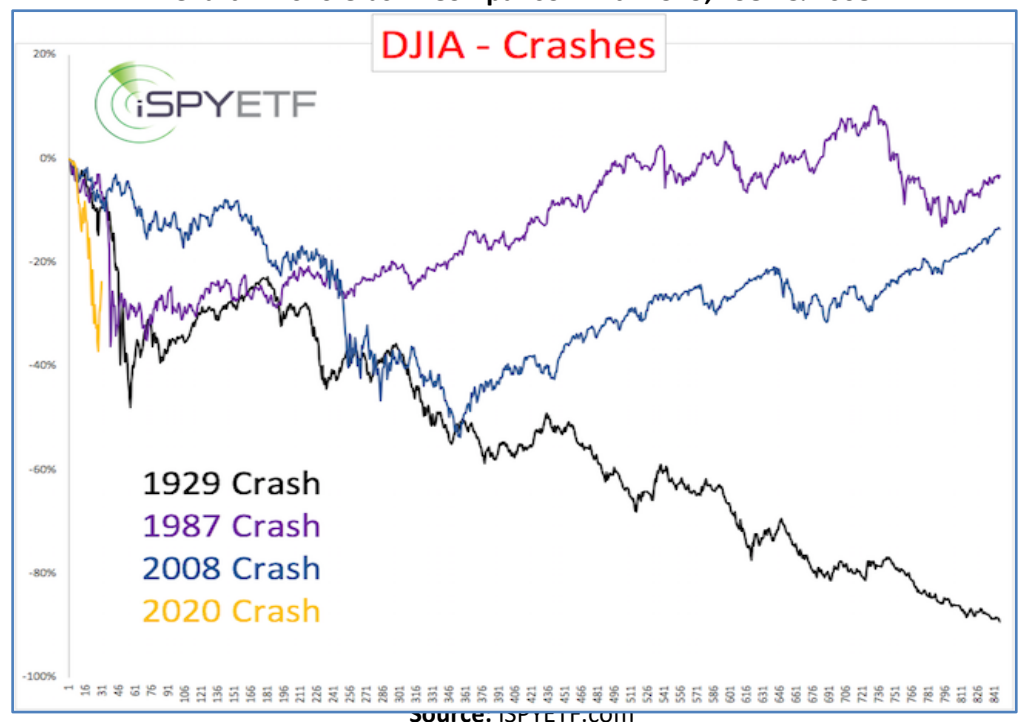
Even before Coronavirus rattled investors' sentiment towards the second half of February signs of weak demand were already apparent from China. We first saw it in slowing crude oil imports and a subsequent price decline for the commodity. As mentioned earlier slow economic figures had manifested themselves in Europe, Asia and Japan. In Q4 of 2019 GDP turned negative in Japan. And that was weeks before the virus even made its "official" appearance in China. The Saudi Aramco IPO in January perhaps delayed and/or postponed the crude oil collapse. The worrying signs were there but many investors choose to ignore them.

## Historical Comparisons & The Recent Crash

*The Feb-Mar 2020 crash was for the history books and one fastest declines in the past 100 years*

The crash between February 24<sup>th</sup> and March 23<sup>rd</sup> was indeed for the history books. As market students we have studied all previous crashes, and especially for the US where ample data are available. Up to the recent really frightening decline we had been using the 1987 one-day stock market crash (-22.6% in the Dow Jones Industrials) as the worst comparison followed by the October of 1929 Wall Street experience. The below **Chart 1** shows the 1929 as being a bit worse but is a bit confusing as it took more time to unfold. In 1929 it took the Dow Jones two months to decline to its initial bear market low. Not to be easily misled, but those previous events were not of the same nature. We also examined the global bear market of 1973-1974 during which the UK stock market was particularly hit, but still no good comparison. Finally, we analyzed bit by bit the last two bear phases, that of the dot.com bubble (2000-2002) and the most recent credit/subprime crisis (2007-2008). Again, we found some similarities but also quite a few differences. Therefore, not very useful for the analysis of our current market behavior. Simply put, the 2020 crash was one to behold resembling no other of the previous crashes despite some glaring similarities on the % declines.

Chart 2: 2020 Crash - Comparison with 1929, 1987 & 2008



*Very few analysts had predicted the extend and speed of the decline*

When comparing only the % of market declines without noting the context of each event is really comparing apple with oranges. The 1987 Wall Street crash culminated with a 22.6% decline on “Black Monday” October 19<sup>th</sup> and despite the fact that the total decline from peak (early September) to trough (early December) was approximately 35%+ it did not result in further economic hardship. No recession in the US or globally ensued.

What is really interesting to note is that very few analysts/investors had predicted the extend, and above all, the speed of the recent collapse. The price declines of most equity indices globally witnessed since late February were the worst ever recorded even surpassing the 1929 Wall Street collapse. The US Fed responded by

**Most Central Banks lined up with additional liquidity and QE programs as expected**

initially lowering its overnight interest rate target by 50 bps in early March only to see its intervention being “ridiculed” by market participants by an aggressive wave of selling. Did investors think that a panicky Fed was foretelling a grimmer picture? You bet they did. The ECB intervened with a **EUR 750 billion** monetary package stating it will do more if needed<sup>1</sup>. The Bank of Japan as well. Governments lined up all sorts of fiscal responses pledging trillions to combat the economic consequences of the COVID-19 fallout. Markets did not find a more solid interim bottom until the US Fed came out with its “unlimited-QE” bazooka on March 23<sup>rd</sup>. It was the end of a drama that kept unfolding day after day with intense selling begetting even more selling. Whether the selling came from short-term investors trapped at higher levels or from long-term equity holders shifting vast portfolios into a more underweighted allocation it did not matter. Equity markets were washed out in the short- to intermediate-term.

In sum, we have witnessed the fastest equity market decline ever in such a brief time span and the culprit was not even a financial event or a by-product of a purely economic event. Of course, many have tagged to COVID-19 sell-off a Black Swan etiquette, although we believe this is not proper. It did not pop-out of nowhere. We had the Chinese lockdown response in January but most markets chose to ignore the signs. What was also interesting in a sense, at least for some time during the month-long liquidation of equities, was the behavior of bonds. They were bid-up initially as investors started to flee equities but when the panic stage of the selling hit during the 2<sup>nd</sup> and 3<sup>rd</sup> week of March, bonds sold off along with gold. It was rather obvious that margin calls were causing liquidation of other trades/positions. Gold lost nearly **\$200/oz.** from its early March top.

### The Crude Oil Factor

**Saudi Arabia and Russia confronted each other on production cuts. The disagreement sparked a furious selloff in crude oil**

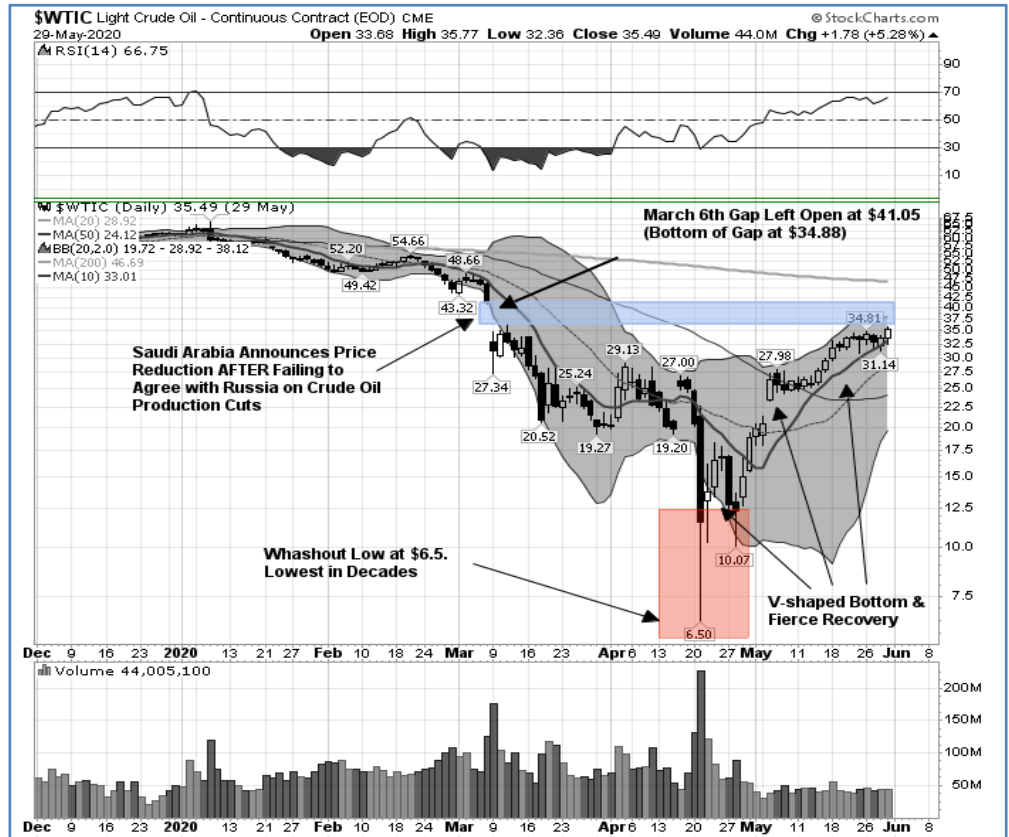
As the selling in global equities accelerated in late February/early March, the US Fed responded with an initial 50 bps overnight (Fed Funds) interest rate cut on March 3<sup>rd</sup>. Markets saw it as a panic measure and sold off harshly yet again. But the dispute between Saudi Arabia and non-Opec member Russia over crude oil production cuts on March 5<sup>th</sup> led to a surprising action by the Saudis. Over the next weekend they announced price reductions to oil shipments out of Saudi Arabia for Asian and US buyers. As electronic markets opened late Sunday on March 8<sup>th</sup> crude oil prices tumbled more than **-30%** trading to as low as **\$27.34/barel**. Initial attempts to support the decline failed in the next couple of days as selling pressures mounted. Oil prices fell towards **\$19-\$20** and remained in a broad range between **\$19** and **\$29** for the following 4 weeks. As the time for the May futures WTI contract roll into June approached by the last week of April, and having filled all possible storage options, prices collapsed as the glut from the continued lockdown in most US states was led many holders of May contracts to “abandon” their contracts even at negative prices as they could not take delivery of said quantities. Storage was non-existent. **Chart 2** on page 5 presents the Continuous WTI futures contract showing a price low of **\$6.5** on April 21<sup>st</sup>! The May contract had reached a low of negative **-\$37.40** that very day. Another price decline for the history books.

In a similar event during the culmination of the 2007-08 credit crisis (Oct-Dec 2008)

<sup>1</sup> As May drew into a close the EU via its Commission gave more details on its proposed **EUR 750** relief/recovery package. The biggest chunk of it will be via subsidies and the remaining balance via cheap loans. The hardest hit countries are expected to benefit a bit more from this program. The proposal is up for EU official approval sometime later in June.

crude oil prices approached the \$32-\$35 area just before Christmas. Many speculators including some prominent energy hedge funds taking advantage of the also low tanker freight rates used the tanker floating storage space in order to profit from the steep contango in crude oil prices.

**Chart 3: WTI Light Sweet Crude Oil since Dec 2<sup>nd</sup> 2019 (Daily Prices)**



Source: Stockcharts.com, Price Data as of May 29<sup>th</sup>, 2020

*The historic lows of WTI crude oil prices at \$6.50 were the lowest in decades*

**Chart 4: Floating Storage Glut During the COVID-19 Lockdowns**

**Floating Glut**

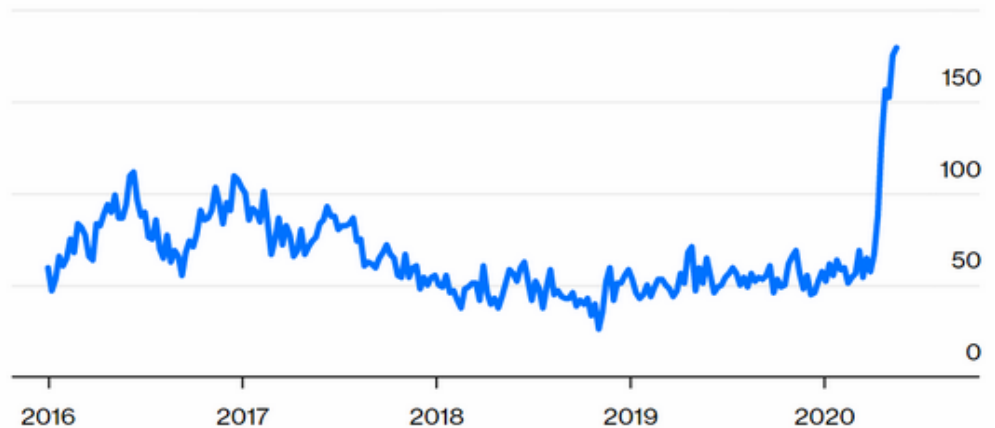
The volume of crude in floating storage soared as the world went into lockdown

Global crude oil in floating storage

WSJ: The Daily Shot  
27-May-2020

@SoberLook

200 million barrels



Source: Vortexa

Source: Vortexa, Data as of May 27<sup>th</sup> 2020

*During the COVID crisis global crude oil floating storage demand soared*

During the early 2020 collapse leading to the April massacre even the available floating storage was depleted so fast that there was virtually no place to hide and place to store oil. The cheapest storage place for crude oil was the ground. In other words, it was better NOT to drill oil from the ground. As markets begun to price some type of return to normalcy after April crude oil rallied sharply amid optimism that we have seen the worst and better than expected crude oil inventory reductions in Cushing, Oklahoma (delivery point/port for WTI).

*Crude oil producers hit the SELL button in search of the much needed revenues*

Even though official data cannot be possibly found, it is highly likely that the collapse of crude oil prices and subsequent selling in global equities (and other asset classes) were interrelated. Many crude oil producers found themselves trapped with huge revenue shortfalls from the spiraling down of prices. Their sovereign wealth funds have been holding enormous allocations in global/US equities and during the oil glut some selling must have been the preferred option. Only that in an illiquid environment like the one we witnessed during March, when many market liquidity providers were absent, prices had to fall further down in order to attract buyers. It looks like many oil producers sold aggressively other assets to obtain the necessary liquidity for their budgets. That is why we have been writing often that a well behaved crude oil market is a pre-requisite for calmness in other markets.

As prices attempt to re-enter the gap left open from the March 6<sup>th</sup> close at **\$41.05** they have covered a long way from the multi-decade lows at **\$6.50**. A retracement back below **\$30** cannot be unexpected if the gap brings in selling. The **\$35-\$41** price area will likely be the battleground for the next few weeks as supply and demand clash once again. It would take a sustained recovery and trading above **\$41** to lead towards further gains.

### The Challenges & The Rally Off the Lows

The early 2020 Coronavirus/COVID market collapse will be remembered for many decades to come as the decline that not only caught by surprise many analysts and investors but also as the event that humbled even the famous ones. Many market mavens and gurus were easily beaten by the market as we all contemplated from front row sits the show of a life time. How can someone having witnessed the recent three-four bear markets, even in his/her 80s – as the famous Warren Buffet – be prepared for an event that proved worse than the first phase of the 1929-1932 decline? It simply cannot be done easily. Apart from the very few who were quite bearish coming into this decline – and were bearish for many months likely being burned – the vast majority of participants could not ever imagine that they would navigate a market fall at a faster speed than that of October of 1929. We did not expect such a drubbing either but at least from early December we were stressing reduction of over-weighted long portfolios and/or hedging the exposure either naturally (by increasing cash levels) or outright.

*Despite the harsh sell-off of early 2020 equity valuations did not approach levels of undervaluation*

As the markets crashed, not only the weak hands were shaken out of position but the fundamental shift forced out of long positions even the long-term holders of equities. Many quantitative strategies (mechanical quant trading, risk-parity, arbitrage, etc.) added to market selling as prices cascaded lower. For many trading days equity markets around the globe looked like bottomless pits. Without a credible compass to navigate many participants sold in disgust. Truth to be told, however, and despite the **35%+** decline from their early 2020 peak, equity valuations around the globe hardly approached levels of undervaluation. As we entered 2020 most of the developed equity markets around the globe were at very

lofty valuation levels whether looking at P/E, P/Sales, P/Book or Price-to-Cash Flow multiples. A few Emerging Markets were showing quite some undervaluation with Russia being the cheapest one. Still it was hit hard the most as the collapsing crude oil price led to a huge **51%** decline as the following tables shows.

**Table 1: Equity Indices Around the Globe (% Declines from 2020 Peaks & Rallies Off Lows)**

Index	Peak	Peak Date	Trough	Trough Date	Peak-to-Trough	Recent Peak	Peak Date	% Gain
<b>S&amp;P 500</b> (United States)	3394	19/2	2192	23/3/20	-35.4%	2968	18/5	35.41%
<b>FTSE-100</b> (U.K.)	7690	17/1	4899	16/3/20	-36.3%	6152	30/4	25.57%
<b>DAX-30</b> (Germany)	13795	17/2	8240	16/3/20	-40.3%	11233	30/4	36.33%
<b>CAC-40</b> (France)	6111	19/2	3632	16/3/20	-40.6%	4720	30/4	29.95%
<b>SMI</b> (Switzerland)	11270	20/2	7650	16/3/20	-32.1%	9950	28/4	30.06%
<b>IBEX-35</b> (Spain)	10100	19/2	5803	16/3/20	-42.6%	7210	14/4	24.24%
<b>MIB</b> (Italy)	25483	19/2	14153	16/3/20	-44.5%	18303	30/4	29.32%
<b>NIKKEI-225</b> (Japan)	24116	17/1	16358	19/3/20	-32.2%	20535	5/5	25.53%
<b>Shanghai Comp</b> (China)	3127	14/1	2647	19/3/20	-15.4%	2914	11/5	10.11%
<b>Hang Seng</b> (HK/China)	29140	20/1	21139	19/3/20	-27.5%	24855	29/4	17.58%
<b>KOSPI Index</b> (S. Korea)	2277	20/1	1439	19/3/20	-36.8%	1960	11/5	36.20%
<b>All-Ord</b> (Australia)	7290	20/2	4429	23/3/20	-39.2%	5623	30/4	26.96%
<b>TSX Comp.</b> (Canada)	17971	20/2	11173	23/3/20	-37.8%	15298	29/4	36.92%
<b>RTS Index</b> (Russia)	1652	20/1	809	19/3/20	-51.1%	1168	29/4	44.41%
<b>Bovespa Index</b> (Brazil)	119593	24/1	61691	19/3/20	-48.4%	83598	29/4	35.51%
<b>BSE Sensex-30</b> (India)	42274	20/1	25639	24/3/20	-39.3%	33887	30/4	32.17%
<b>Mexican Bolsa</b> (Mexico)	45955	20/1	32503	3/4/20	-29.3%	38014	12/5	16.95%

Source: Bloomberg, VRS Research, Data as of May 29<sup>th</sup>, 2020

**Table 1** above needs no further discussion. It is so much self-explanatory and concerning at the same time. If a liquid stock market like the US can plunge **-35%** in a few weeks, then we must be alarmed how the fleeing liquidity and a serious catalyst can inflict so much damage in a “blink of an eye.” Imagine those investors trapped in hedge funds strategies with monthly liquidity. Private equity investors as well.

### Markets hate uncertainty

The snap back rally from severely oversold (not undervalued) levels was somewhat expected to happen. The only unknown was the exact price levels to start from and how far up will it retrace of the previous decline. The COVID-19 economic decline has triggered a synchronous global recession that the world has not faced in decades. Even if stocks rebounded from deeply oversold conditions earnings

visibility would NOT be easily restored. If there is one thing a market CANNOT value/discount is extreme uncertainty. A market can discount quite far into the future events that can be somehow be quantified. If we face a recessionary incident with some known characteristics from previous cases the market can approximate a company's stock value. COVID-19 has introduced a rather different market uncertainty where a mix of demand loss and supply chain interruptions could not be priced easily. How can the market price its stocks if it did not hear a concrete plan on how to re-open the economies? How to react when it cannot be sure if and when lockdowns will be repeated and subsequently lifted? Will a likely vaccine be on its way sooner or later? How effective will the drug protocols used to combat COVID-19 patients be as we wait for a vaccine?

*Why the "wise" equity market could not foresee the danger in early February?*

Couple all the above questions with a few trillions of liquidity thrown by Central Banks and the mix becomes very explosive. Are stocks being bought during the recent rally because there is faith on Central Bank actions of even more QE or because the "wise" market has already discounted the worse outcome at its March lows? Why should we trust this "wise" market discounting the *bad* outcomes when it could not foresee at its February peak the danger coming? Which *good* outcomes was the market discounting at the all-time-highs of early 2020?

### Stock Market vs. the Economy

One of the cardinal mistakes investors make many a times is overlooking the NOT so obvious distinction between the stock market and the economy. A positive economic backdrop that translates into robust corporate profit growth drives market prices higher. But that is in general and in the long-run. The stock market is a long-term discounting mechanism of corporate cash flows. Whether an analyst/investor uses DCF models (Discounted Cash Flow) or dividends to value a future value stream is less important. Of course, price targets may vary but the process is the same. Short- to intermediate-term this valuation process is less important. We clearly saw during 2019 that US equities (and other markets in general) went considerably higher amid zero corporate earnings growth. Investors bid stocks higher based on liquidity factors (see US Fed liquidity) when at the same time there were substantial capital flows into the US. Part of the flows went into bonds sending yields lower and the rest into stocks mainly large-cap technology.

*The equity markets continue to be in rally mode in anticipation of the re-opening*

As the US Central Bank intervened massively again during the March market malaise it was pretty obvious that a temporary backstop was placed below those price lows/levels. There is no denying that the global equity market washout did create some bargains but in the grand scheme of things even at those short-term depressed levels equities did not present valuation bargains seen at important market bottoms. As the stocks marched quickly higher from the March lows economic data started to come out bleak. Employment, manufacturing, services and other economic figures collapsed reaching levels NOT seen in decades. Even the Great Depression of 1929-32 looks mild so to speak when compared to the current economic freeze. It took three years to register unemployment of **25%** in the US. This time around we got almost **15%** in April with questionable data adjustments to show less damage. More conservative sources put the figure above **15%** already. The GDP haircut globally will be one for the history books for sure. We just need to wait and see what the actual numbers will be. However, based on the markets' initial reaction we will perhaps have double digit GDP declines for Q2 with some carry over into Q3 depending on how the re-opening of the economies will fare. The full GDP growth for 2020 is anyone's guess. We would not put real weight on any estimate as anybody's figure could be as good as a

monkey's dart throw.

*Equities defy  
"logic" as Wall  
Street focuses well  
into the future*

The strong snapback rally in equities globally seems to forecast an almost V-shaped recovery in many countries and that, at least with all the data available until late May, does not add up as of yet. Have expectations run ahead of fundamentals? Perhaps, but that is almost always the case. The markets usually will not "wait" the economic data to play catch-up until they trade higher. But the current rally feels quite weird to many participants as the divorce of market prices from the economic reality is wide enough to question its validity. The dichotomy between the main street (real economy) and Wall Street (stock markets) could persist for a lot longer defying any logic. Short-term factors such as US Fed induced liquidity, investors' positioning, market sentiment or seasonal factors can influence trading which is above and beyond logic. The real question, therefore, is for how long a market can defy logic/fundamental data and trade at valuations that do not make sense? For a lot longer than many people even expect. This is not our forecast. We are simply stating that amid this very unique set of parameters logic may not be the best guide. Liquidity induced rallies can defy logic and gravity for a very long time before succumbing to reality. Watching/following the price is many times a better barometer than doing guesswork based on false narratives waiting for fundamentals to play catch up.

We firmly believe that today's market environment is the most unique we have faced not only in our lifetimes but perhaps in many decades. Some people would go a step further stating that this has never happened before. Ever. And yes, watching some set of economic data they would be correct. Our main thesis for approaching today's environment is to be way more flexible when using past events for comparison. We are writing history plain and simple. Hence, we CANNOT use the same old yardsticks to measure a market performance during this cloudy environment. In other words, until we gain some substantial clarity over many economic variables all efforts to correctly value future cash flow streams may be futile. This is not to say one should completely shy away from equities, bonds or other asset classes. We are simply saying that this unique economic environment affected by the COVID-19 event has altered the investing landscape in such a way that we must accept altered principles or re-think the way we decide to commit into an investing position.

*In times of  
uncertainty being  
underweighted/un  
der allocated is not  
too bad, unless  
career risk is the  
issue*

Unless we gain more clarity over the intermediate-term being somewhat underweighted in some or all of the asset classes is a valid option. Having more cash in portfolios, i.e. being naturally hedged, is also an option. The main issue many professional money managers face, however, is career risk. If one is less exposed and the market runs away, especially to the upside, underperformance is a career killer. Perhaps, after many years of subdued returns some Hedge Fund strategies can get some traction as the absolute return style becomes trendy again. Passive investing via ETFs of indexed funds could have a tough time if we do face another leg lower in this economic contraction. We advocate a more balanced approach where less is more in many aspects. Having some powder dry for any emerging opportunistic allocations is always welcome.

## **Was the COVID-19 Event Just a Harsh Correction or a New Bear Market?**

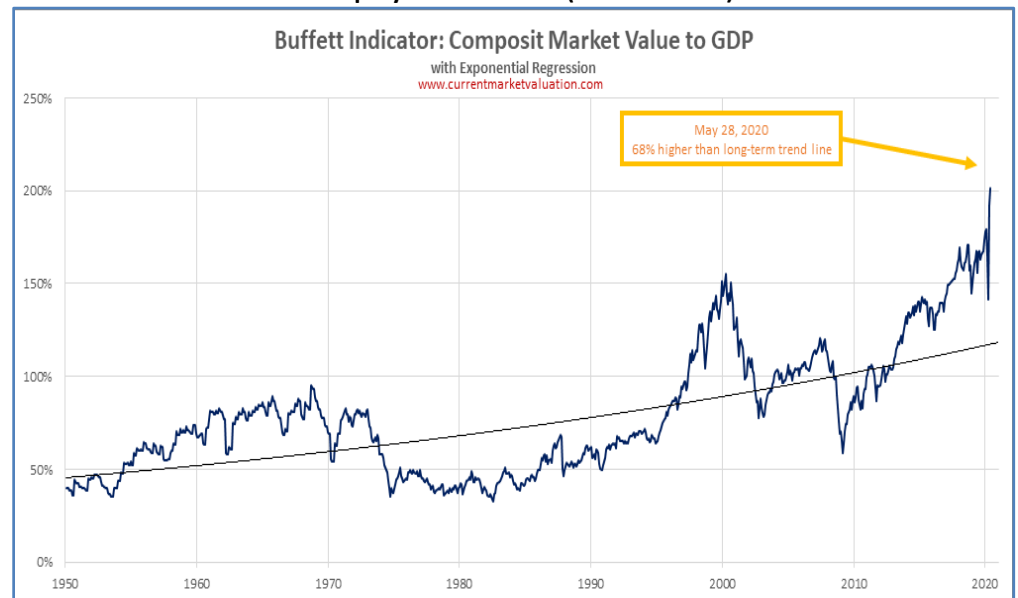
Perhaps the most important question that hangs on most investors' mind is the following: was the February-March 2020 harsh decline a one-time event, pretty

**The Buffet Indicator indicates US stocks as being very overvalued currently**

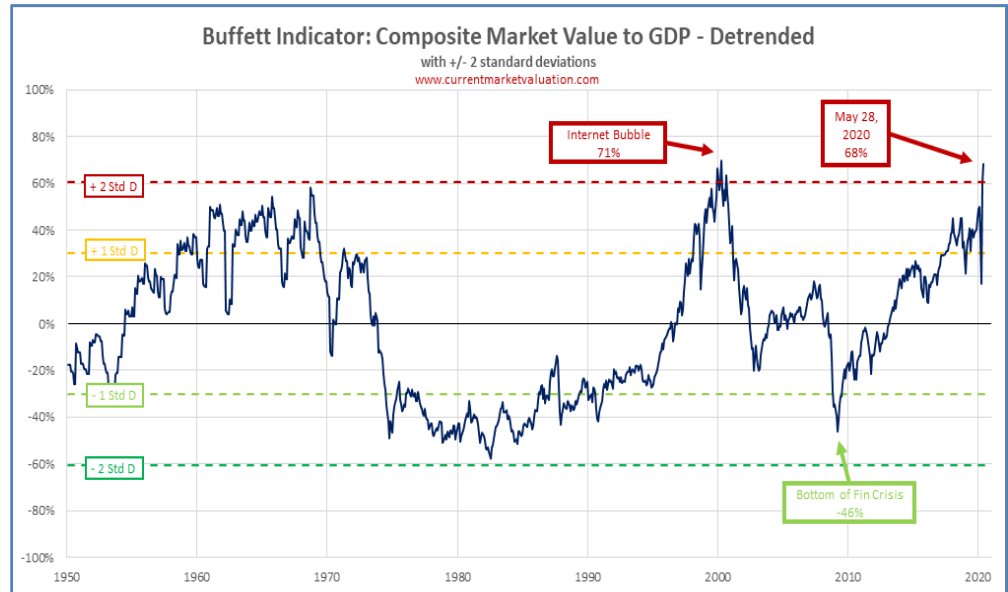
much like the October 19<sup>th</sup> 1987 Wall Street collapse, or the first leg of a longer-term decline/bear market that will unfold in the months/years ahead? We will not have the answer to the above anytime soon, or at least for another few months. And of course we do not prescribe to the **-20%** defining line as the onset of a bear market in equities. Why a **-19%** decline is still a serious correction but a **-20.1%** fall is considered a bear market? Pure nonsensical approach.

The most widely known value investor of all times is perhaps Warren Buffet of Berkshire Hathaway. Along with Charlie Munger have dominated the value investing headlines for many decades. Apart from his investing style over the last five decades he is the author of the **Buffet Indicator**, a composite market valuation calculation. The Buffet Indicator is the ratio of the total US stock market valuation to GDP. The US market is represented by the widest index of all, the Wilshire 500. The GDP represents the total production of the US economy. This is measured quarterly by the US Government's Bureau of Economic Analysis. The GDP data is all **nominal** and not adjusted for inflation. The next two charts depict the US market valuation per the Buffet indicator. **Chart 4** below presents the Buffet Indicator since 1950.

**Chart 5: Total Equity Market Value (Wilshire 5000) to GDP**



Source: [www.currentmarketvaluation.com](http://www.currentmarketvaluation.com), Data as of May 28<sup>th</sup>, 2020

**Chart 6: Total Equity Market Value to GDP – Detrended w/Standard Deviation**

Source: www.currentmarketvaluation.com, Data as of May 28<sup>th</sup>, 2020

*US equities trade 2 standard deviations ABOVE their long-term valuation trend*

There is no denying that the current stock market valuation despite the February-March 2020 decline, and subsequent rally, stands way above trend. The rising black line is the exponential regression line, i.e. the natural growth rate of the indicator. This shows the upward historical trend that expectations for future growth have risen faster over time than actual economic output. But in order to make the context of our current position more clear, we can draw the regression line horizontally and remap the data as the percentage above or below that historical average. This is shown on **Chart 5** of page 10, along with band lines showing +/- a standard deviation or two.

From the extreme overvaluation of US stocks in 2000 it took two bear phases (2000-2002 and 2007-2009) for most of the froth to clear. And it did clear almost entirely. The late 2002/early 2003 lows were **20%** below fair value while early March 2009 was **45%** below the zero line. That was relatively close to the previous generational lows of August 1982 at nearly **-60%** and **-2** standard deviations from trend. The March 6<sup>th</sup> of 2009 low in the US market was even below the correction lows of 1987. In other words, valuation-wise stocks were priced even lower than they were when compared to GDP of 22 years before.

*Central Bank liquidity has helped equities achieve a V-shaped recovery*

In late May 2020 US equities still trade in a theoretical vacuum so to speak. With so much uncertainty dead ahead amid collapsing GDP values, double digit unemployment that rivals that of 1929-32 and no credible corporate profit estimates, valuations appear as expensive as they were at the late March lows. That is of course a simple mathematical calculation as the downward revisions of earnings (the “E” of the P/E variable) have left the multiple valuation ratio at higher levels than the March 23<sup>rd</sup> low. This is, of course, on a trailing earnings basis. However, we do not buy this argument as the market is NOT supposed to value a company and its stock taking into account current and the next few quarters of earnings only. Today’s stock price is supposedly reflecting the discounting of many years ahead as the surviving entities are going concerns with no finite life-span. Until this assumption changes and a company goes out of business or is acquired by another entity, we must assume that today’s market valuation is valuing a publicly traded entity looking many years into the future. Therefore, the only way to perhaps accept today’s higher valuation levels, despite the extremes registered in

so many economic variables, is to assume that the market is looking way into the future and has swept aside all the negative economic data since March.

We firmly believe that this approach may lead to negative performance results if the world finds itself into a more protracted bear phase and not serious correction like 1987. But for now, Central Bank induced liquidity has found its way into equities sparking a V-shaped recovery in many global indices. The best example of an index recouping almost ALL of its early 2020 decline is NDX, the NASDAQ large-cap technology benchmark in the US. A strong recovery in the leading technology names along with the perception that many of them not only are immune to the COVID-19 effects but have also benefited during the lockdowns, has led to a test of the February all-time highs. It also true, however, that many technology firms have really benefited from the shift to remote work. Data centers, cloud based services, remote video conferencing and other similar products have soared during the lockdowns. Demand for these products will perhaps stay elevated for some time to come as the business world connects more and more remotely.

*Central Bank QE programs help the markets but do not create unemployment as fast*

### What Now?

As we head into the latter part of Q2 and more incoming data from all over the world are becoming available it is pretty obvious that most countries are facing perhaps the steepest and fastest GDP decline during a peacetime. The destruction of capital formation during a recessionary event is not similar to the permanent loss incurred in wars. Therefore, the resilience of consumption should be a positive enough factor to drive demand back up sooner than expected as soon as some normalcy returns. The positive in today's COVID-19 crisis is that the consumer is a lot less leveraged than the previous global recession of 2008. And that is a notable deviation from the corporate sector. This time around the corporate coffers appear emptier as most cash and credit "power," mostly from low interest borrowing, was spent in share buybacks to enhance earnings growth/share prices.

As we navigate through this unforeseen situation with quite some different characteristics from previous events we need to be a bit more careful in assuming the same outcomes. **What is apparently different this time around is the arrival of Central Bank QE bazookas as soon as the fallout began.** This is not to say that most of the structural damage inflicted will be healed with Central Bank liquidity or asset purchases. But the necessary bridge to link the broken pieces of the economic machine will make things a bit less severe. Asset purchases in fixed markets will not bring back jobs in the real economies and especially the small businesses until the recovery gains traction. And that may be weeks/months away. But the equity markets will not wait for the economy to recover. They have already been powering up. The question is: are they more optimistic than what reality demands? Again, the disconnect between the stock market and the real economy is real. But at turning points the stock market usually leads the economy. We expect them to move in unison ONLY during the middle phase of a cycle (either up or down). So, the current divorce between stock market valuations and economic reality may persist for a while.

*The month-long equities consolidation/digestion phase has ended with an upside breakout in late May*

What is NOT known as of yet is the speed of recovery as many economies attempt to reopen. If the economic recovery gains traction and we do not have to experience widespread lockdowns again in coming months, then most likely the price lows seen in March may not be violated. They may be re-tested or undercut marginally but not violated meaningfully. The clash between the "eternal QE liquidity" and real economic fundamentals will be a pull-push battle that could last

for months. In all likelihood, and if we do not take off to the upside amid more positive outcomes on COVID-19 medical treatments/vaccines, we could spend a couple of quarters - if not more - in a wide trading range as markets digest the upcoming information. Valuations did appear somewhat fair, on a forward price/earnings basis (not using the Buffet Indicator we posted earlier), but who can trust analysts' estimates for the coming quarters.

After the initial buying climax lasting three-to-four weeks off the lows, markets have gyrated for another few weeks digesting the first lift off the March lows. At the end of May most equity markets have broken out again in an attempt to trade convincingly higher than the April highs. The range-bound lateral trading since mid-to late-April was likely a digestion/resting period before rallying anew. As we enter the month of June the rally seems to get traction and in many areas looks frothy yet again. Therefore we need to monitor the May break-out levels (in most equity indices) for any clues that the rally is tiring and may need somerest... for now.

*Negative interest rates are a tax on deposits*

We see the coming weeks/months as a "Clash of Warriors" type of market, especially in equities. Deflationary forces, on one hand, will be trying to bring prices down to earth while market friendly Central Bank liquidity, on the other, will be an up lifter. It will mainly be decided on the economic front, we believe. If despite an additional coronavirus wave next fall/winter the US and other main economies DO NOT go to a full lockdown we will not expect another destructive leg lower to meaningful new lows below those of March. Perhaps the unknown card is the outcome of the US Presidential election but this is a separate matter. The current situation requires either a lower exposure to risk until some more clarity appears (with the danger to miss out the upside if markets continue to advance above the early 2020 peaks) or have a more short-term opportunistic approach with timely allocation changes in small steps to not fall way behind the curve. It is indeed a very tough environment as conditions appear liquid enough to warrant extreme caution and flexibility.

*Stability in the oil complex is a plus for the overall health of the markets*

In a separate note we will discuss interest rates and bonds as current proximity to the zero bound even in the US leaves less space for maneuvers. The US Fed chairman Jerome Powell has, for now at least, repelled any idea of negative interest rates. Our opinion on the matter is firm and clear: **negative interest rates not only distort market pricing as they destroy discovery of fair levels in fixed income but also pose a huge "tax" on deposits.** At the same time banks and other financial lending institutions cannot benefit as much from a regular functioning yield curve. The failed experiment of Japan since the 1990s and of Europe since mid-2010s should not only spark grave concern but also be an example to avoid. Let's hope the US Fed will not commit the same mistake.

It is rather obvious that even if the equity markets head higher still, the structural damage inflicted in many economies will take some time to heal. Volatility should be at lower levels in order to feel a bit more upbeat and also stability in the energy sector should be an additional positive. If we recall, the selling accelerated aggressively in equities once crude oil broke below **\$40-\$42/barrel** after Saudi Arabia and Russia could not "agree" on some production output cuts. Many Gulf Sovereign Wealth Funds were net and aggressive sellers of liquid assets to make up for the lost revenues from the collapsing oil prices. After the current deflationary COVID-19 induced event massive Central Bank "printing" and a likely declining US dollar (after the deflation shock ends) we should be expecting an inflationary environment in the years ahead. At least this is what the current environment heralds. As most economic variables are in constant motion having a fixed stance is

nearly utopia. If the facts change we will have to change our tune as well adapting to the new reality. We will elaborate more on this in due time, of course, when long-term interest rates *finally* bottom. For now, it is still an uphill battle to deal with the consequences of the COVID-10 economic fallout before stabilizing resuming a more stable positive path.

Hands down 2020 has been so far a year to behold ... and we are not still half way through!

## Notes

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