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VIEWPOINTS

While the phenomenon of stock prices uncoupled from reality is far from novel in the zero-interest rate world we've operated in since the Great Financial Crisis, the gap between US stock prices and the health of the global economy has become so wide in recent months that it begs the question of whether traditional security analysis has been rendered altogether obsolete. We sure hope not, but we nonetheless must accept that the gargantuan asset purchases by the Federal Reserve have, and will likely continue to destroy price discovery and reduce the art of investing to a game of speculating on the direction of central planning.

We accept that the Fed's unprecedented backstopping of risk could continue to push US stock indices to new highs, but this process, in our view, will greatly increase the likelihood of another "Minsky Moment," a term coined in 2008 during the collapse of the subprime mortgage market. The expression derived from the late economist Hyman Minsky, who spent his academic career in relative obscurity developing a theory that describes how private credit-driven booms sow the seeds of later busts, and his work has since become extremely relevant in our understanding of the GFC. Minsky categorized credit into three varieties: 1) hedge financing (relatively safe): firms rely on future cash flow to repay borrowings; 2) speculative financing (risky): firms rely on their cash flow to repay the interest on their borrowings, but must roll over their debt to repay principal; and 3) Ponzi financing (very risky): cashflow covers

neither principal nor interest; firms depend on appreciation of their underlying assets in order to cover their liabilities.

Speculative debt has been alarmingly prevalent in the leveraged loan market for the better part of the past decade and is now endemic to the corporate bond market. Motivated by a guaranteed buyer in the Fed, US investment grade and high-yield issuers looking to pad their balance sheets to ride out the crisis have raised over $1 trillion and (a comparatively modest) $100+ billion of new debt, respectively, so far this year. Roughly 56% of the investment grade bond universe is now rated BBB, just one notch above junk. Outside of corporates, the Fed also declared it'll be purchasing municipal bonds, commercial real estate loans, assets backed by student loans, auto loans, and credit card debt.

It doesn't stop there! Since early February the central bank has also purchased $1.7 trillion of federal debt, equivalent to 163% of the Treasury's total net issuance in 2019. Remarkably, the Fed now owns 40% of long-dated Treasury bonds, and it announced on June 10th it'll be buying $80 billion in Treasuries per month going forward. In aggregate, the Fed's financial market support since March already exceeds the multi-year quantitative easing programs established in the wake of the GFC. We think it's now fair to say that the Fed is no longer the lender of last resort, but the lender of *all* resorts. This activity has blatantly undermined the notion of "free markets" and in our view will lead to significant price distortions and increasing fragility in the financial system.

Dynamics in equity markets have also been largely driven by the Fed's intervention, yet they have been far from uniform. US indices have significantly outperformed international benchmarks, and within the US the larger, more expensive stocks, particularly the FAANGs, have significantly outperformed stocks of smaller companies with weaker balance sheets. Within the S&P 500, the largest five stocks in S&P 500 are up 33% YTD while both the broader index & Russell 2000 remain in negative territory. The ten

best-performing stocks in the NASDAQ have accounted for 90% of overall index's 16% YTD gains.

With the concentration of equity performance as high as it is, some analysts are now claiming to have identified a new symptom of the coronavirus: an irresistible urge to buy popular technology stocks! While we say this in jest, it is in fact true that retail investors armed with "house money" in the form of stimulus checks, and in many cases unemployment benefits in excess of their prior incomes, have in part driven the massive rally not only in the FAANGs, but also in highly speculative stocks like Hertz and Chesapeake Energy, which have been teetering on the edge of bankruptcy. The number of Robin Hood brokerage accounts has exploded higher, and advertisements on CNBC, Bloomberg, and the like are now dominated with investment products in lower and lower denominations in an effort to attract naive retail investors. Charles Schwab, also trying to take advantage of the fact that casinos and racetracks have been closed, now offers a product called Slices that allows individuals to buy fractions of company shares for $5. We fear this speculative frenzy will not end well for millions of Americans trying their hand in the market for the first time.

That said, we're clearly in a period where market outcomes are largely dependent on the extent to which the government expands or rolls back its support schemes. Though we don't pretend to have a crystal ball for how the November elections will turn out - political outcomes are among the least predictable things of all - we can't ignore the implications of various scenarios, in particular the potential of a Democratic sweep in November and the tax reform that would likely ensue. This could come in many forms that could have an immediate impact on risk-asset valuations: a reversal of the 2019 corporate tax cut, an increase in the capital gains tax, higher marginal tax rates for earned income, a removal of the cap on Social Security taxes, etc. In addition to the threat of higher taxes, across the political spectrum we expect candidates will rely heavily on economic populism and the use of China as the whipping boy for our domestic problems. History shows that rhetoric rarely leads to action in the political arena, but we don't think either theme will play well in what is an increasingly sentiment-driven stock market.

With respect to Covid, we continue to see the market underestimating the implications of mass unemployment, changes in consumer behavior and business activity, and the possibility of widespread insolvency among municipalities. What the Fed has provided to the market is *liquidity*, as distinct from *solvency*, which is defined by access to cash flows, or income. Very few in their right mind are inclined to take on more debt when their outlook for future income has soured. As various economic entities are faced with balance sheet impairments, we expect to see a growing preference for saving and paying down debts.

Slowing consumption, a massive debt overhang, and aging demographics are deflationary forces the Fed will continue to combat with

its inflationary zero-interest rate policy and asset purchase programs. The tension between these two has presented the critical question in global finance today: what is the fate of the US dollar? The March crisis demonstrated once again that the dollar is what the world demands when uncertainty grows. While this has largely been the case for most of our lifetimes, the longer-term outlook for the greenback's global leadership is looking increasingly questionable. Senior officials from the Bank of England, European Central Bank, and Bank of Japan have all publicly declared that the dollar standard is no longer working for the world, and the rise of cryptocurrencies and demand for gold also present longer-term threats to the dollar's strength that are not to be ignored.

With 2-year and 5-year Treasury yields at or near all-time lows, the bond market is signaling that investors should settle in for continued deflation and slow growth, an environment our portfolios have been constructed to thrive in for some time. We're not ones to argue with the bond market's signals, but in light of the facts that the US has just raised debt levels from 80% to 110% of GDP, the Fed has declared it will use yield-curve control to maintain near-zero yields, global supply chains are in shambles, and pro-labor policies look to be on the horizon, we do not want to be caught off guard by a sudden increase in prices for commodities and consumer goods. We've taken advantage of muted inflationary expectations and begun to add inflation-protection to our portfolios. As we've said before, we think it's better to show up early to a party than to miss it altogether.

Before the coronavirus the world had already been slowing by almost every measure: the US had been through a rate tightening cycle, margins were rolling over, trade wars were escalating, global trade had gone negative, and ISM and PMI surveys had crossed below 50. Equities were the only asset class suggesting things are rosy, and this continues to be the case. We believe our focus on Treasuries and high-quality US equities has us prepared for whatever is waiting around the corner.

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