DORCHESTER
Wealth Management

Quarterly Economic and Market Comments
June 30, 2020

Whiplash. It turns out you can get it not only from a car accident, but from financial markets, too. On February 12th, the Dow Jones Industrial Average stood at 29,568. On March 23rd, it closed at 18,214, the steepest plunge in U.S. stock history. By early June, it was back to 27,580, representing the strongest 100-day run since 1933. When the dust settled on the second quarter, "the Dow" was ahead by almost 18%, its best quarterly effort since 1987 and, whereas in the first quarter virtually all asset classes except U.S. Treasuries and gold were down, in the second quarter all 38 of the 38 assets tracked by Deutsche Bank were up. So indiscriminate was the buying that, even though it was a great quarter for the riskiest assets, it was a good quarter for gold which outperformed non-North American stocks. Similarly, even though U.S. equities outperformed U.S. Treasuries by the most since 2009 in the second quarter, it was the best first half for Treasury bonds since the data began in 1926. As impressive as the second quarter was for risk assets, it is important to keep two things in mind. First, so far, despite the rally, stock markets in general around the world are still down between 5% and 15% year-to-date and only two of the world's fifty largest markets are within 5% of their record highs. Secondly, in a year of unprecedented volatility, big percentage moves need to be put in context, not just for financial markets, but for Covid statistics and economic data, too. For example, in the most recent week, the percentage increase in the number of Covid cases per ten million of population was more than twice as bad in Japan as in the United States. True, because Japan went from 7 to 15, whereas the U.S. went from 1030 to "only" 1480. Similarly, crude oil was the best performing asset class in the second quarter, registering its biggest quarterly return of the OPEC era. However, owing to its worst quarterly percentage loss (more than 50%) in the first quarter, oil remains the biggest loser year-to-year, down 35%.

Three months ago, we surmised that the world would transition from "the ugly" phase it was then in to "the good", but it is probably fair to say that, in terms of financial markets, "the good" has come on faster than many had anticipated and, arguably, faster than the economic and health data would warrant. So, the question is - have the markets gotten out ahead of their skis? One way of approaching this is to review the five reasons for optimism we listed three months ago.

The one factor that has clearly switched from a positive to a negative is valuation. When the Dow Jones Industrial Average fell from about 30,000 in February to less than 20,000 in March, this was a big change in a short time that could not be ignored. Now, however, with "the Dow" at 26,000 and the NASDAQ actually at a new high, valuation has ceased to be a plus, and investment sentiment has taken a decided turn for the worse. They say that history does not repeat, but more and more equity markets resemble the dot.com era. First, there is the obsession with technology in general and the big six "FANMAG" stocks in particular, which now have a combined market capitalization greater than that of all countries except Japan and the United States. The ratio of the technology-laden NASDAQ 100 to the S&P 500 recently surpassed its 2000 peak and the volume of trading on the NASDAQ has gone through the roof and is also now higher than at the dot.com peak. Of course, it is argued that the FANMAG stocks are behemoths, which is true, but it is nonetheless tough to grow at a rate sufficient to justify current valuations when you are a trillion-dollar company. Plus, a look back at the world's ten largest companies by market capitalization at the beginning of each decade reveals that the larger companies at the beginning of one decade are rarely on the list at the beginning of the next. In any case, it is not just FANMAG stocks investors love. Adobe, for instance, a "cloud" favourite, trading at nearly 60 times earnings and 18 times sales and with a market capitalization about equal to all U.S. listed gold mining stocks combined, reported mediocre results on June 11th yet proceeded to rise 15% over the next two weeks anyway. Not that even having earnings is critical. As one observer noted, the accelerated adoption of technology sparked by Covid-19 "has sidelined the question of profitability". So it is that Shopify has surged ahead of Royal Bank as Canada's largest company based on market capitalization. Meanwhile, a flood of money-losing companies are going public - for example, Vroom, an on-line seller of used vehicles, that raised half a billion dollars in June even though it lost $40 million in the first quarter of 2020. Last but not least, there is Tesla, which finally surpassed Toyota as the world's most highly-valued automobile manufacturer with a market capitalization equal to 26% of the total of all global auto manufacturers, despite having only 1.3% of the sales.

Infatuation with technology, a lack of sports on which to bet, millions of laid-off employees or people working from home, free government money, and new smartphone trading apps have led to another dot.com phenomenon - widespread retail stock trading. In June, TD Ameritrade said it was averaging 3.5 million client trades a day, more than four times as many as in the same month last year. Robinhood, a U.S.-based online trading platform had 13 million users in May of whom over half were first-time investors. It's not just in the U.S. either. The trading app, eToro, was founded in Israel and is headquartered in London. Retail investors in Japan have flocked to open on-line accounts as they have in South Korea which has roughly twice as many trading accounts per capita as the U.S. While these investors, not surprisingly, love FANMAG and similar mega capitalization technology stocks, they like to gamble on other items as well; for example, Hertz, the car rental company, whose stock fell 98% to 40 cents as it declared bankruptcy on May 22, was adopted by Robinhood traders who ramped the probably worthless stock up to over $6 a share on June 8th at which point it was held by 170,000 Robinhood users. The guru of the online retail army, David Portnoy, operating under the name Davey Day Trader, and a regular guest on CNBC, was, until recently, the founder and operator of the sports and pop-culture blog Barstool Sports. It's hard to know to what extent this gusher of retail money has helped push equity markets higher, although the Korean market has had one of the biggest rebounds of any major equity market and the most popular retail trading stocks in the U.S. have outperformed to the extent that Portnoy recently stated, "Warren Buffett is washed up. I'm the new breed. I'm better than he is." As one of his acolytes notes, "They (Buffett et al) just have a hard time understanding the new normal, the new business models." This is all eerily reminiscent of the atmosphere in 2000 represented by the Money Magazine cover "Jocks Know Stocks". As Davey Day Trader tweeted on June 12th, "Buy. Everyone makes money." As worrisome as this is, there is an upside for those who do not believe that Warren Buffett is senile or that his value-based approach is outdated. Financial and energy stocks in the U.S. are trading at or near record lows relative to the market. For patient investors, there is no doubt relative value to be found in these and other out-of-favour sectors.

If valuation and sentiment have switched from a positive to a negative factor over the past three months, two other factors have gone from positive to neutral. One is the price of oil. Probably one of the easiest calls three months ago was that the price of oil - which for a brief moment incredibly traded in negative territory - would rally. At $20 per barrel, for example, it is estimated that half the U.S. shale oil firms are technically insolvent. Chesapeake Energy, the best-known U.S. shale industry pioneer, recently filed for bankruptcy and more than 200 shale companies are at risk of joining them over the next twelve months. Nor is it just shale. Royal Dutch Shell cut its dividend for the first time since World War II and is writing off $20 billion of assets. B.P. has gone a similar route. These are the big boys which shows the pain reverberating through this industry. Now that oil is back to $40, however, whether the next $15 move will be up or down is less obvious. In the long run, prices substantially above $40 will be required to return the industry to the point of sustainable profitability. In the short run, however, Saudi Arabia pumped less oil in June than at any time since 2002 in an effort to support the market. They are not happy about it and are once again threatening a price war. The destruction of oil demand in 2020 is unprecedented as has been the volume of crude in floating storage. Net crude oil imports into the U.S. remain near multi-year lows and OPEC's surplus crude oil production capacity remains well above its 10-year average. How fast the world economy bounces back from its slump in the months ahead will presumably be the critical factor.

A second relatively easy call from three months ago was that "people would come out of their foxholes and there would be some sort of return to normalcy". This is no longer a case of if or when; it is already happening. Indeed, a sense of survivor's euphoria has already settled in (i.e. owing to our sacrifice and solidarity, we've passed through a traumatic experience and come out the other side). This positive feeling will be reinforced by the economic numbers in the months ahead as businesses continue to reopen and people go back to work. Then there's the development of a vaccine that seems inevitable given the resources that are being devoted to the task around the world. Having seen how excited the markets get when there is any hopeful news on this front, one can only imagine the reaction when a really effective vaccine is discovered.

However, as the generally upbeat economic numbers pour out in the weeks ahead, it will be easy to lose sight of the economic hole which has been created and, indeed, we will be encouraged to do so by Wall Street and the White House. Over the past 150 years, two global slumps stand out - the 1930s and the post-World War II rubble in Europe and Asia. Apart from those, the worst global slump was associated with World War I. The current Covid recession is likely of that magnitude. More countries will be in recession this year simultaneously than during the Great Depression or during the world wars. China recorded its first contraction in GDP since it began reporting quarterly figures in 1992. The Indian economy is facing its first annual contraction in forty years and the Bank of England is predicting that Britain will experience its sharpest annual contraction since 1706. In the U.S., the Federal Reserve Board, the Congressional Budget Office, and a variety of similar groups have taken a stab at likely economic outcomes over the next few years. It needs to be said they take into account the enormous fiscal and monetary stimulus and they are far from "worst case scenarios". Looking at the Congressional Budget Office projections, by the end of 2021, U.S. real GDP will still be 1.6% lower and the unemployment rate 5.1% higher than they were in the fourth quarter of 2019. What this forecast implies is that, over the intermediate term, the U.S. economy and the labour market in particular, will end up suffering worse than it did during and after the 2008-09 recession. The National Association of Business Economists anticipate the third quarter will be the best quarter of growth since 1978. They also anticipate a strong fourth quarter and a better year in 2021 than any year of the past decade. Yet, even extrapolating these optimistic growth rates, it will take the U.S. economy more than three years to get back to where it was in the fourth quarter of 2019. Most importantly from the point of view of equity markets, it typically takes quite some time for corporate earnings to get back to their previous peak after the end of a recession. In the case of the 2008-09 recession, it took two and a half years.

Barring a second wave of the coronavirus or some other unscheduled negative development, the economic news should continue to unfold in fits and starts in a positive direction, but the numbers must be kept in context. Two examples. First, much has been made of the number of jobs allegedly created in the U.S. in May and June. Even if we take the numbers at face value, however, the proportion of the U.S. population that is employed remains lower than any time since before World War II. Second, Mexico reported automobile production rose by 500% in May from April and production almost tripled again in June. Sounds impressive, until you realize actual production levels reman 80% below their peak in 2019.

There remain two positives from three months ago that are as positive as they were then; namely, unprecedented fiscal and monetary stimulus and the hunt for return on the part of investors in a zero-return world. If the hit to the world economy in 2020 has been huge, the policy response has been even bigger. The growth rate of the money supply in the U.S. adjusted for inflation of almost 25% is the highest in U.S. history except for World War II. Similarly, the surge in money relative to industrial production vastly exceeds anything seen since the War and indicates that far more liquidity has been injected into the economy than can be deployed. In 2008, when the Federal Reserve first started going off the quantitative easing deep-end, it boosted its balance sheet from $800 billion to $2 trillion. At the end of 2019, the number was $4 trillion. Today, it's $7 trillion and the former President of the New York Federal Reserve Bank says to expect $10 trillion by year-end or nearly 50% of U.S. GDP. This seems like a big number until one notes that the balance sheet of the Swiss National Bank is equivalent to more than 120% of GDP followed closely by the Bank of Japan. Indeed, these central banks have so much money they have become, in effect, hedge funds, buying equities or ETFs. There have been nearly 150 interest rate cuts by central bankers around the world, but, with interest rates at or near zero or even negative in many cases, major central banks have expanded their balance sheets by $5 trillion and counting.

Nor is the heavy lifting all been left to central banks. Coronavirus fiscal easing announcements exceed 7% of world GDP so far. Debt levels for OECD countries, which were 40% of GDP fifty years ago and 110% of GDP a few months ago, are expected to leap to 130% shortly. It's worth noting that the pre-War peak debt-to-GDP ratio in the U.S. under big spender FDR was 43% and the budget deficit never exceeded 7.5% of GDP. It's expected to exceed 20% in the U.S. this year. In April in the U.S., wages and salaries fell at a three-quarters of a trillion dollar annual rate, but the government doled out four times as much, with the result that, in the midst of the biggest economic downturn since the 1930s, total personal income in April grew at a $2 trillion annual rate. Some of this fiscal and monetary largesse has no doubt served to support individuals and businesses affected adversely by the recession. However, much of it remains within the banking system and the financial markets as the individuals and businesses to whom banks want to lend by and large do not want to borrow. So, the world is awash with excess liquidity. One result of this already mentioned is speculation in equity markets by retail investors and others. A second result is the crushing of yields. Britain's 30-year government bond yield of 0.6% dropped below Japan's equivalent borrowing cost for the first time ever despite a record expansion in the issuance of government bonds. Germany was recently able to raise its largest amount of 30-year debt at a negative yield. Three years ago, Austria issued a 100-year bond yielding 2.1%. Amazingly, the bond doubled in price and Austria recently re-offered the issue only this time the yield was 0.9% (for 97 years!). Of course, one reason some investors buy these bonds is that keeping cash on deposit means paying the European Central Bank 0.5% per year.

With government bonds yielding next to nothing, the attention of many investors turns to high-yield (i.e. junk) bonds of which there are plenty. Of the more than 2000 European non-financial companies rated by the three major rating services, only 5% are rated A or better, fewer than are rated CCC or worse (i.e. real junk). One outcome of central banks backstopping the financial markets is less incentive for firms to maintain pristine balance sheets and the percentage of so-called "zombie" firms whose debt service costs exceed their profits has risen from almost zero two decades ago to almost 20% today. Even as credit quality has deteriorated, the reward for buying junk has shrunk. Historically, the average junk coupon has been 5% above the prevailing default rate. Today, the current default rate in the U.S. is 6.4% and the yield is also 6.4%. The car rental company, Avis, a junk-rated company whose competitor, Hertz, as noted, recently declared bankruptcy, sold half a trillion dollars of 5-year notes in May which are now 13% above par. Similarly, Ford, cut to junk in March, floated a 10-year bond in

April which is trading 22% above par. As a Bloomberg headline writer with a poetic touch noted recently, “Fear Is All But Dead In Credit Markets Backed by Fed.”

Finally, if lack of fear has invaded the junk bond market, it has also invaded the equity market. With safe fixed-income securities yielding in the 1% range, many investors have come to realize they cannot meet their investment goals if they have 40%-50% of their portfolios in bonds. At the same time, they don’t want to increase their risk exposure. What to do? Simple. Redefine equities as less risky. This may sound facetious, but the legendary academic, Burton Malkiel, in the new edition of his iconic book, suggests that retired people reallocate from bonds into common and preferred shares. Another recent article was entitled, “Forget Bonds - Here are 5 safe (sic) tech stocks.” The world’s central bankers appear to have turned the financial markets into a casino. As the highly-regarded octogenarian (like Buffett) investor, Jeremy Grantham, recently told CNBC, “This is crazy stuff!” Three months ago, while things seemed scary, the right course of action was pretty simple - stay the course and do some buying or “nibbling”. Today, the world may seem less scary, but navigating the financial markets has become more complex.