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B + V ADVISORS

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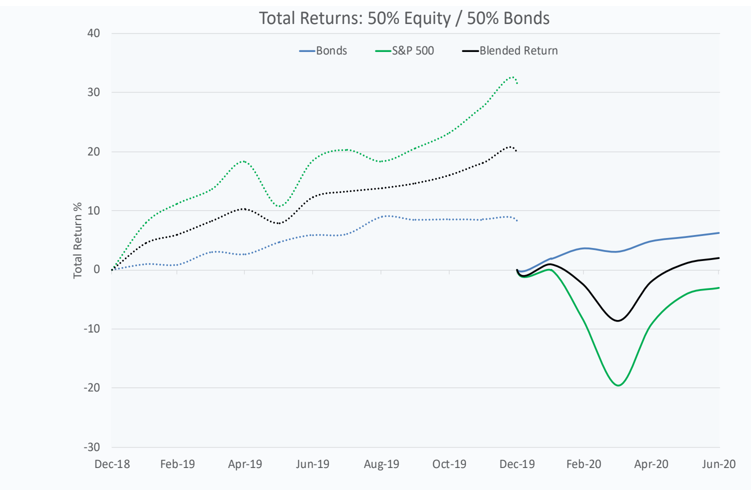
RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

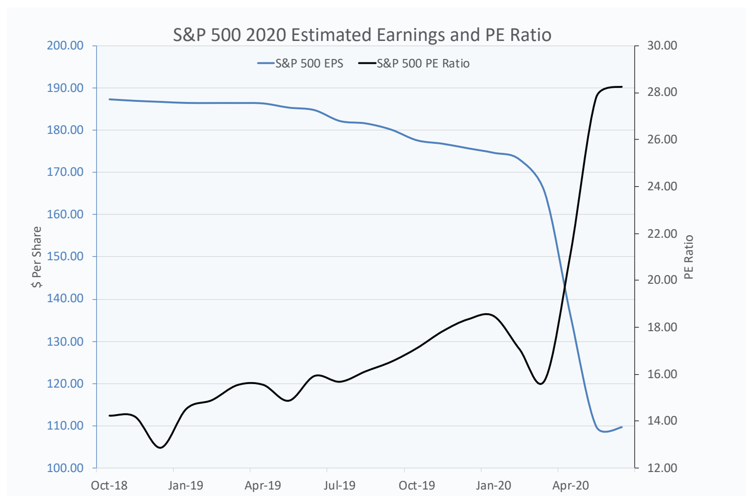
WHERE WE STAND – Q2 2020

The S&P 500 Total Return Index was up 20.5% (including dividends) in Q2 2020. See the solid green line to the right in the chart below. The Aggregate Investment Grade Bond Index (including interest) was up 3.1% for the quarter (blue line). If your portfolio comprised 50% S&P 500 and 50% Bonds, your YTD return would be 2.0% (black line). Data for 2019 is shown, broken lines, to the left.



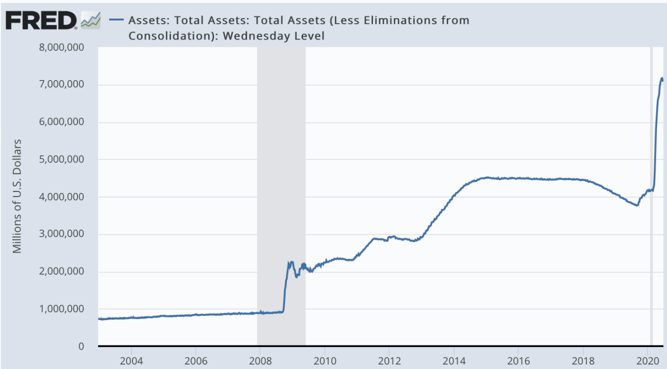
Overview

The S&P 500 index rocketed by 20% in the 2nd quarter, recovering a substantial portion of the previous quarter's losses. As the US officially entered recession in February 2020, earnings forecasts for the broader US equity market have collapsed from around $175 per share to, now, around $110 per share for the current year, as shown by the blue line in the chart below. The black line shows how, given the concomitant rise in equity prices, the PE ratio has risen to 28x earnings. Implicit in this extremely high valuation, is an expectation by investors, that earnings will have a very sharp recovery in the coming year/s, thereby justifying today's lofty valuations.

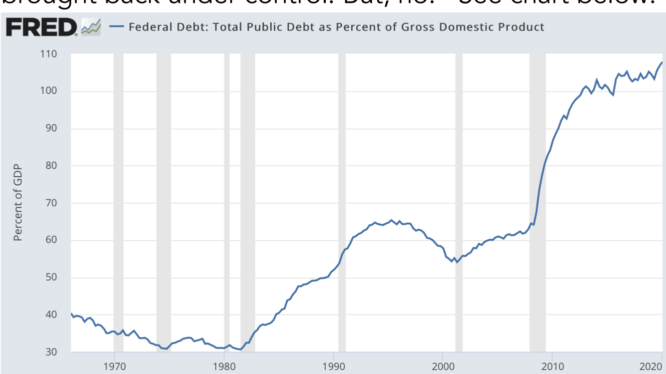


As we all know, the Federal Reserve and the Federal Government have flooded the financial system with liquidity and with massive fiscal spending programs, in response to the devastating economic impact of the coronavirus pandemic, where the unemployment rate has risen to around 14% as of now.

In the process, the Federal Reserve's balance sheet has exploded by ~$3trn since January to unprecedented historic levels as shown in the chart below, far eclipsing their actions in the last recession. (Recessions are shown in gray). For the US, this is a moment of economic triage, but we really aren't sure what the long-term ramifications are of such a drastic monetary experiment.



On the fiscal side, the early projections for the budget deficit (the amount the US government has to borrow after subtracting its spending from its income tax receipts) is expected to approach $4trillion in 2020 alone! (During the great recession, the highest annual budget deficit was ~$1.6trillion.) This, on top of a burdensome level of US Government Debt to GDP that had already passed the significant 100% level in recent years, in economic growth times, when it really should have been brought back under control. But, no! See chart below.



What does this all mean?

1. Owing to the Fed's actions, interest rates have collapsed, forcing investors who evaluate their investments based on dividend or interest income only (as opposed to total return) to move into riskier assets to garner some kind of income on their investible assets. I'm really uncertain as to what the long-term implications of this action is. Some argue it will lead to inflation, but others say no as they look to say, the Japanese experiment with central bank balance sheet expansion, arguing that deflationary pressures will persist. What is apparent is that a constant Federal Reserve backstop to financial markets works against some of the basic precepts that have made capitalism successful: first, free financial markets with true price discovery and second, creative destruction in order to create long term investment to foster productivity and economic growth. For financial markets as of now, these seem to be concerns for another day in the future.
2. Owing to the fiscal spending (including increased unemployment benefits and loans/grant to stressed corporations) by the US Government, economic activity has stabilized somewhat at lower year-on-year levels, but the jury is still out until the coronavirus situation and other issues are resolved. Even though interest rates are low, and therefore debt in general remains somewhat manageable, having so much debt on the corporate and government balance sheet is really not a good situation as we enter a recession of indeterminable length.

Where We Stand

The extent of the rebound in financial assets in the second quarter hasn't surprised us, but it has exceeded our expectations.

As a result, because valuation matters when making investment decisions, we have reduced our exposure to risk assets that were acquired in Q1 and locked in our gains for the year, in anticipation of opportunities that we are sure will present themselves in the future. All of our portfolios have again exceeded their high-water mark.

We have had to manage our cash positions because interest rate returns on money market assets have collapsed this year. But we don't underestimate the value of the optionality of cash: the ability to react when high quality value propositions present themselves.

As we enter the second half of 2020 it is apparent we are living in a unique historic moment and outcomes for investors are extremely uncertain.

We are now again defensively positioned and keen to take advantage of opportunities that should present themselves as the resolution of various market moving issues unfold:

- How will the socio and economic effects of a global health pandemic fully manifest?
- How will policy makers respond in an extremely divided political environment?
- How deep/long will this recession be and what will the effects be on corporate profits including capital allocation strategies like dividend policy and stock buybacks?
- What will happen to inflationary/deflationary pressures?
- What geopolitical issues will unfold relating to a global recession and increasingly precarious international relations?
- How will the political landscape in the US change heading into and exiting the November presidential election? What are the implications for distribution of wealth policy issues? How will this impinge upon corporate and personal tax rates in an attempt to address the huge fiscal imbalance mentioned above?

Our internal work shows that as was the case towards the end of 2019, forward projected returns from US equities have fallen dramatically. And given the collapse in US bond yields, expected future returns from bonds (unless interest rates in the US go negative as in Europe, which we don't expect for now) are very low too.

Weighing up this uncertainty with projected future returns, we have again reverted to wait and see and will react aggressively when the opportunity arises.

"When the facts change, I change my mind. What do you do, Sir?"

John Maynard Keynes