PCA Perspectives

Permit Capital Advisors' Thoughts on the Investing Landscape

August 2017

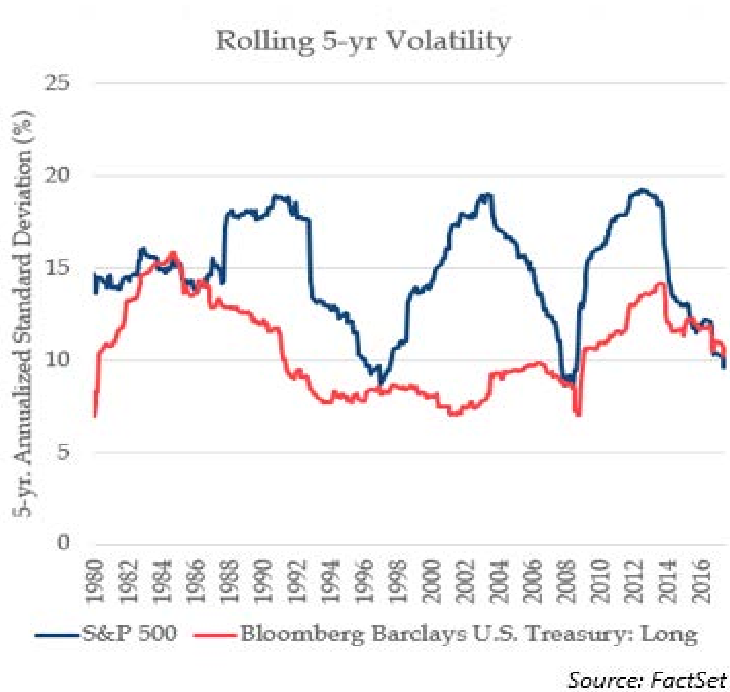
The Path of (Un)Totality

Doubt is not a pleasant condition, but certainty is an absurd one.

-- Voltaire

For most of the past eight years we've seen an investment landscape with very little equity market volatility. In fact, on a rolling 5-year basis, bonds have exhibited more volatility than stocks (Exhibit 1). This seems to indicate a sense of certainty amongst investors about market and economic conditions that may not be prudent. While we'd all like to believe that we have a certain totality of information about a new paradigm in investing from which we can make successful allocation decisions, the reality is that none of us do. Conditions change and reversions to the mean occur, regardless of attestations that "this time it's different". In some periods the pathway to that eventuality may seem new, and this may be one of those qualifying periods. Even the world's leading central bankers who are gathered this week in Jackson Hole, Wyoming, are whitewater rafting in unchartered waters.

Exhibit 1: Volatility Of Stocks Dips Below Volatility Of Bonds



Source: Martello Investments, "Monthly Market Reviews," May 2017

Technology and Education

One of the factors that drives the rate of change in the world is technology. In some arenas, like education, the change has been slow and unsteady. In others, like retail and the US consumer, the change has been transformational. We follow the rate of change in education not simply out of humanitarian concern, but based upon the link between education and economic growth. As far back as Adam Smith in the 18th century, economists noted that productivity was linked not just to equipment and land, but also to peoples' abilities. And in 1992, Gary Becker received the Nobel Prize in Economic Science for his work in Human Capital, which compared investment in an individual's education and training to business investments in equipment. For various reasons, developments in educational technology (EdTech) have so far impacted the field in a way that could best be described as fair to middling. Among them, concerns about the role of teachers in the face of technological integration, and the dogmatic belief by technologists that teaching had to look a certain way. Today, that's beginning to change, specifically because the focus has been on the value of an individualized approach to learning.

Ever since Philip II of Macedon hired Aristotle to prepare his son Alexander for Greatness, wealthy parents have paid for tutors. Unfortunately, in much of the world that sort of discretionary outlay isn't an option, resulting in only a quarter of students in poor countries acquiring at least basic level knowledge of math, reading, and science. In a world with nearly 1.5 billion schoolchildren, that's a significant underinvestment in future global growth potential.[i] One of the goals of EdTech should be to narrow inequalities in education, and with a renewed focus on bespoke education, that now seems to be possible.

One high-profile manifestation of this effort is the case of Summit Public Schools, a 2,500 student charter school network in California and Washington, serving mostly poor students in underserved districts. Summit impressed none other than Mark Zuckerberg on a tour of their facilities in January 2014. Inspired by the potential of digital tools such as Khan Academy, Summit embraced technology and data as a means of providing more customized instruction and helping students take more control of their own learning.[ii] However, with only one engineer on staff their ability to implement this vision was limited. Until Facebook lent their considerable capabilities.

Technology, Pricing Power, and Inflation Targeting

While long-term, the investment implications of the effect technology has on education may be significant, in the short-term the effect it has already had on the pricing power of businesses will be far more impactful on markets. When those aforementioned central bankers gather at the annual conference hosted by the Kansas City Fed, one of the primary topics of conversation will presumably be what they see as stubbornly tepid inflation. It is on the basis of this viewpoint that they seem determined to keep monetary policy exceedingly easy, even as the Federal Reserve is likely to announce next month that they will begin to normalize (shrink) the size of their balance sheet as early as September.

Our concern is that they don't mistake structurally lower inflation in certain pockets of the economy for something that can be fixed by throwing money at the problem, thereby needlessly creating inflation in other pockets. As Rick Rieder, CIO for Global Fixed Income at BlackRock, recently (and repeatedly) has pointed out, technology has driven a stake into the US consumption story, which now lies beholden to a totally new model. He explains how it has evolved from a small number of monopolistic brands selling their products via a network of thousands of small "mom-and-pop distributors", to now, a small number of monopolistic distributors (Amazon, eBay, Alibaba, Tencent) selling the products of thousands of "mom-and-pop brands".[iii]

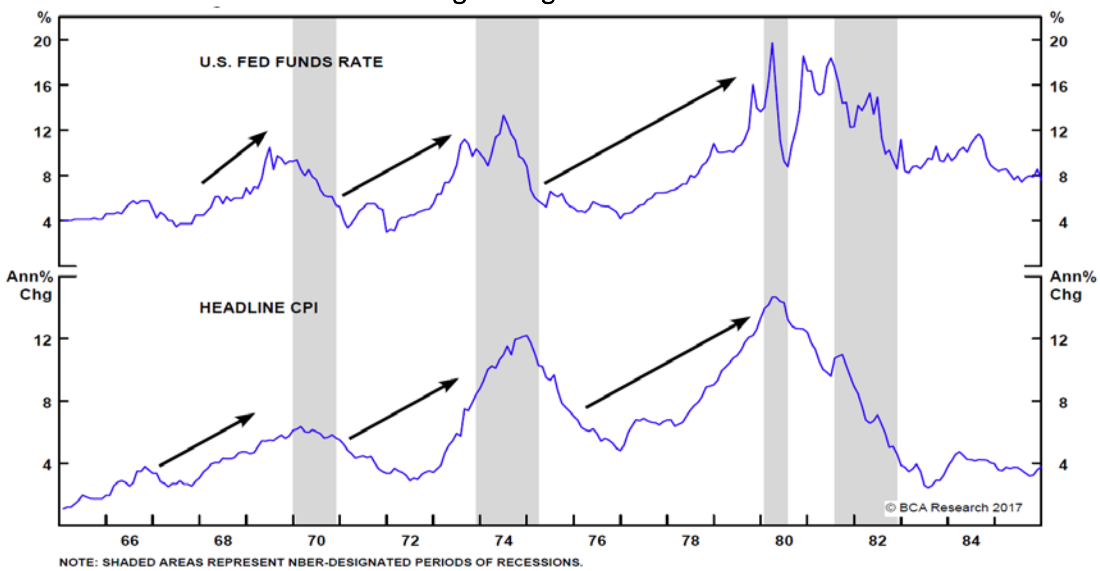
Further, these brands are able to match quality with a much lower cost of goods sold due to cheaper distribution and overhead based upon their smaller physical footprints, and social media and crowdsourcing have leveled a chunk of the previously coveted brand-name value. As a result, producer surplus, which is an economic measure of the difference between the amount a producer of a good receives and the minimum amount the producer is willing to accept for the good, will continue to be suppressed.

Is the Fed Leading or Following?

If the Fed drags its feet in raising interest rates and further reducing the size of its balance sheet, it risks starving the world of cash flow that demographics continue to drive a need for, and falling behind the curve in the delicate balancing act involving growth, inflation, and unemployment. If it allows unemployment to fall too low, not only will it face inflationary pressures in non-consumer segments of the economy, but the unemployment rate will naturally start to gravitate higher. And once that rate starts rising it generally keeps rising because of various negative feedback loops, which is why the odds of a recession actually rise when economies approach full employment.

Therein lies a risk worth watching: that the Fed puts itself in a position where it has to aggressively hike rates in the future due to its failure to gradually lift them today. There was a time not too long ago when a typical recession was brought about by this sort of Fed action. Unlike more recent recessions that were caused by asset bubbles and financial sector disruption (2008, housing; 2001, dotcom stocks; 1990-1991, savings and loan crisis), in the 70s and 80s it was Fed missteps that led the economy into recession (Exhibit 2). Given how rare it is to see a sustained fall in stocks outside of a recession, this is clearly something to keep an eye on.

Exhibit 2: Could Fed Tightening Result In A "Retro-Recession"?

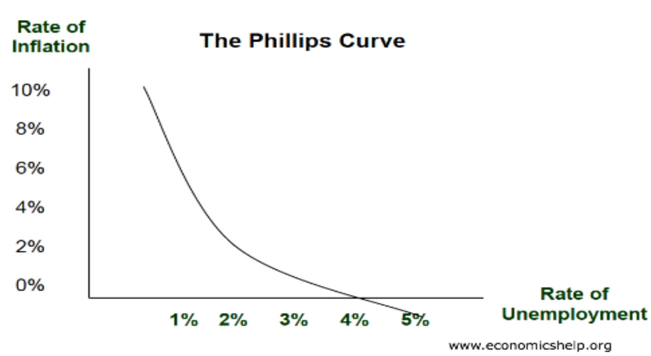


Source: BCA Research, "Global Investment Strategy Weekly Report: What's the Matter with Wages?" on August 11, 2017

As referenced earlier, there is a contingent of market participants who do believe that "this time it's different," and who doubt that inflation will rise even if the unemployment rate continues to trend downwards. They argue that the relationship between economic slack and price levels – epitomized by the Phillips curve – has completely broken down. If they're wrong, and there's a price to pay, they will have either their inexperience or their impatience to blame. It wouldn't be the first time that a perspective borne from experience was derided by those who disagreed with it. As iconoclastic economist, John Kenneth Galbraith remarked, "in euphoric times, past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present."

Impatience would be a failure to recognize that the Phillips curve tends to steepen once an economy reaches full employment (Exhibit 3). If the unemployment rate falls from 7% to 6%, this is unlikely to have a huge effect on wages and ultimately, inflation. But if it falls from 4.5% to 3.5%, the territory we're now approaching, the effect could be substantial.[iv] The implication is that there is a non-linear effect, and once inflation does start rising, it could rise more quickly than investors (or the Fed) expect.

Exhibit 3: Inflation May Be A Further Dip In The Unemployment Rate Away



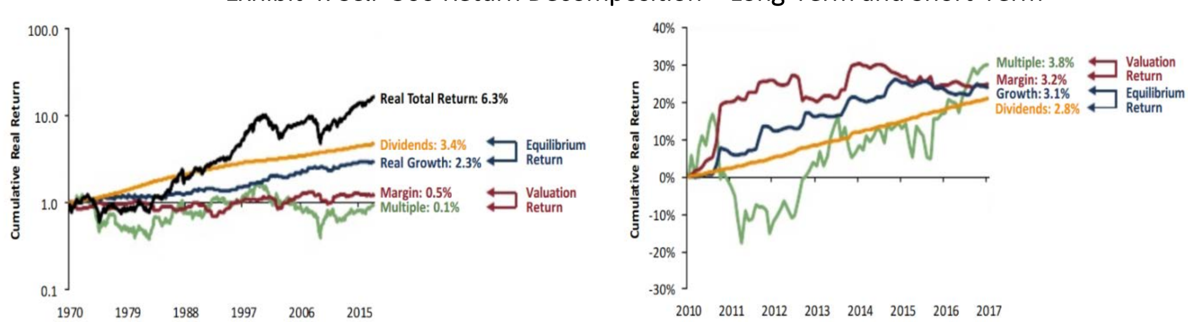
We must also be mindful of the somewhat dueling realities that financial crises can take a long time to develop, but once they erupt they tend to spread rapidly, widely, and (seemingly) indiscriminately. As famed investor Howard Marks commented in his recent memo, “The key strategic decision for anyone shaping investment strategy is whether to apply aggressiveness or defensiveness at a given point in time. In other words, should we worry more today about losing money or missing opportunity? The answer at all times depends on what’s available in the investment environment.” Recognition of this challenge leads us to a belief that a prudent secular asset allocation outlook starts with assessing long-term valuations across major asset classes – rates, equities, and credit. Combining valuations with macroeconomic assessments will set the stage for portfolio construction decisions.

Valuations and an Asset Allocation Framework

This evaluation of equity valuations can’t take place in a vacuum; it’s important to evaluate in the context of the current low-rate environment by looking at the real equity risk premium. This measures the long-term return expectations of equities normalized for yields. Even through that prism, stocks are expensive. Metrics like the median price/revenue ratio and Shiller P/E reflect the market at a historically expensive level, with the former showing the market more expensive than it was at the 2000 and 2007 peaks, and the latter only surpassed in 1929 and 1999.[v]

If you break equity valuations into components it becomes clear where these stretched valuations are coming from. The four components are dividends, earnings growth, margin, and multiple. Dividends and earnings growth are considered to be more stable, sustainable, and reliable, and thus are referred to as equilibrium return. They account for the majority of returns over a long time period. Margins and multiple are basically flat over the long-term, and are referred to as valuation return. Over the last seven years, while dividends and earnings growth have grown steadily, the outsized returns in US equities have really come from the valuation return drivers, with multiple expansion providing the biggest boost (Exhibit 4).[vi] If investors think that returns will continue at this pace they’re making a bet that multiples and margins will continue to do so as well, and the historical support for this assumption is not strong.

Exhibit 4: S&P 500 Return Decomposition – Long-Term and Short-Term



As of 6/30/17
Source: GMO, Worldscope, Compustat, MSCI
Note: The “Multiple” driver includes a rebalancing effect (essentially the impact of more expensive companies entering the index and cheaper companies exiting).

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Source: GMO Whitepaper, “The S&P 500: Just Say No” by Matt Kadnar and James Montier, August 2017

Market history has shown us that bear markets can begin at a wide range of valuations, both below and above current levels. While currently lofty valuations will prove to be a drag on the long-run performance of US equities, they do not provide a good guide for market direction in the short-to-intermediate term. Short-term outcomes are dependent on the psychological inclination of investors towards either speculation or risk-aversion. Risk-on or risk-off. If the market does continue to move higher on the back of valuation return drivers, the negative full-cycle implication would only magnify eventual losses.

As noted by Marks in the same memo, "I have no doubt that the ascent to the apex from which the Global Financial Crisis took place was powered by willing acceptance of risk in the low-return world of 2004-07. In other words, excessive risk tolerance and the resulting incautious behavior provided the foundation for the vast losses experienced in the move from peak to trough." The reverse is true as well, as the excessive risk aversion that followed kept some on the sidelines and created the opportunity for the huge returns enjoyed by others.

Taking Advantage of Relative Cheapness

Over the last seven years, diversifying outside the US has been wholly unsatisfying. While the S&P 500 is up 15% annualized over that period, MSCI EAFE (Europe Australasia and Far East) in USD terms is up 8% annualized while MSCI Emerging Markets by the same measure is up 4%. Going back a bit further and on a country-specific basis, the S&P 500 has now surpassed its 2007 peak by nearly 60%. Amongst its developed market brethren only the UK and Germany have surpassed their 2007 peaks, and by much smaller amounts.[vii] Simply based on the catch-up potential of non-US equities, and the benefits of historically low cross-regional equity correlations, an investor should look to shift around allocations. Other considerations, such as valuations, demographics, and central bank policy only reinforce this perspective.

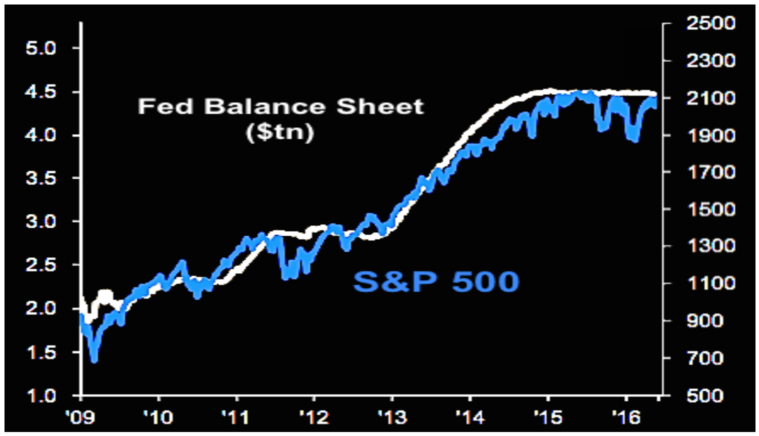
While EAFE has some similarities in valuations, as evidenced by elevated P/Es and profit margins, in relative terms it is significantly cheaper than the US. In fact, the only times since the early-80s that EAFE has been this cheap relative to the US was in the late 90s and during the European crisis of several years ago. These markets also have higher dividend yields, better earnings growth prospects (expected 12.6% EPS growth this year for the Euro STOXX 600, 14.8% EPS growth for the Japanese TOPIX), and more room for improvement with respect to economic growth (9.1% unemployment and falling versus 4.3% in the US and plumbing decade lows).[viii]

The story is similar in Emerging Markets, which have seen the strongest positive earnings revisions this year relative to the rest of the world. From a demographics standpoint, Asia is well positioned, as 88% of the next 1 billion members of the middle class will live there according to the Brookings Institute. This growth is largely taking place in China, which is leaving Japan looking like it is standing still. According to the IMF, in 1995 China was a $700 billion economy, and it has grown to $12 trillion today. Japan, on the other hand, was a $5 trillion economy in 1995, and it is a $5 trillion economy today.[ix]

The case for non-US equities taking some of the portfolio space currently occupied by US equities may be strongest as it pertains to central bank policy differentials. While as discussed above, the Fed is in danger of falling behind the curve in the face of tight labor market conditions, this does not appear to be the case for the

Bank of Japan or the European Central Bank. In fact, labor market slack across the euro area as a whole is still 3.2 percentage points higher than in 2008, and 6.7 points higher if you exclude Germany.[x] Sustained rate hikes in Europe are still several years away. Mario Draghi explicitly said recently that "the last thing that the governing council may want is actually an unwanted tightening of the financing conditions." Contrast that to the Fed, which is reducing the size of its balance sheet, and the investing consequences come into focus (Exhibit 5).

Exhibit 5: Possible Correlation Between Fed Balance Sheet and Equity Returns?



Managing Risk and Tail Risks

Of course, investing is not purely a relative exercise, as goals and expectations for an investment program are grounded by absolute parameters as well. The need for diversifiers and alternative sources of return becomes particularly acute against a backdrop of buoyant markets. It appears clear that there is an insufficient margin of safety to adopt an unequivocal risk-on posture, which makes striking an appropriate balance within a portfolio particularly critical.

On the defensive side, US duration may not be a source of significant return potential, but it remains a viable diversifier. Even in the midst of a hiking cycle, downside risks are likely to keep rates range bound, and they still have room to rally amid a significant negative event. This is in large part due to the fact that the Janet Yellen-led Fed has expressed a belief that by virtue of debt overhang and modest global growth, the neutral rate today is lower than it has been historically, with an expected neutral real policy rate of around 0% rather than the historical standard of 1.5%.[xi]

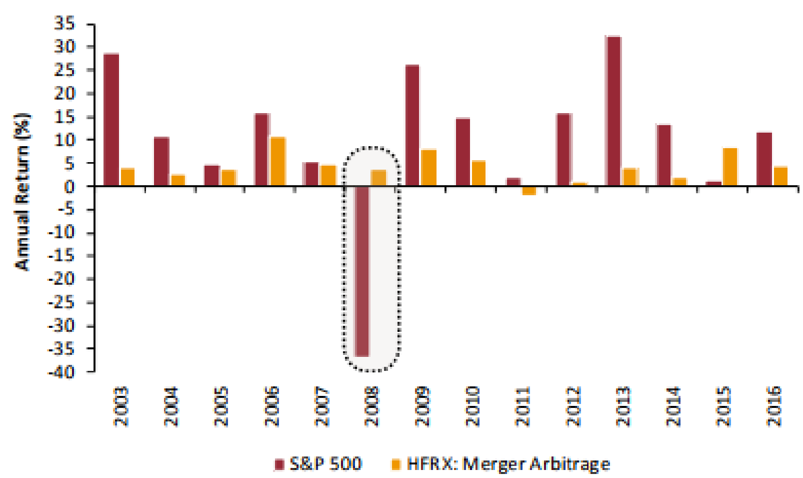
The neutral rate is the federal funds rate at which the economy is thought to be in equilibrium. If the Fed were to strike this ethereal balance, monetary policy would not be seen as loose nor tight, and the economy neither too hot nor too cold, but rather just chugging along at its long-term optimal trajectory. In this framework, US rates are still an attractive portfolio hedge against both persistent deflation and various tail risks.

We caught a glimpse of what a geopolitical tail risk looks like last week, when sabre rattling between the US and North Korea shook markets briefly. Experts in the region identified the benign, yet still scary, nature of developments fairly quickly and this helped restore market order. Going forward, the canaries in the Korean coal mine are personnel related, and will include, 1) a move to evacuate American military families and diplomats, 2) civil war defense exercises by North Korea, 3) South Korea ordering the mobilization of army reserves, and/or 4) China ordering the evacuation of Chinese nationals from South Korea (estimated to be one million).[xii]

Delivering on outcomes in a low return environment requires access to more exposures. Gaining access to the right exposures at the right time requires skill, and an ongoing effort to source opportunities across a wide swath of the investment landscape. Many niche markets – private lending, royalties, real estate, and infrastructure – lend themselves to opportunistic allocations if stewarded by appropriate active managers that are positioned to deliver alpha. One strategy that depends more upon the prevailing market environment is merger arbitrage.

When merger spreads are attractive, it offers a positive expected return, little to no equity beta (Exhibit 6), and little to no interest rate duration. The strategy seeks to generate positive absolute returns by profiting from the deal-spread of publicly announced merger and acquisition transactions. It is only looking to harvest the remaining appreciation between the price an acquisition candidate moves to after an announcement and the price it will reach upon closing. Its low beta nature stems from the fact that once a deal is announced, the target stops behaving like a traditional equity. It swaps its market beta for an idiosyncratic correlation to the outcome of the deal, and that, not the broader market, will drive price movement. The low duration profile is a result of the fact that deals tend to either close or break in a very short time frame – most often six to nine months.

Exhibit 6: Merger arb returns vs. S&P 500



Source: HFRX index, GMO

Source: Advisor Perspectives, "Merger Arb and Unicorns" by Peter Chiappinelli of GMO, August 10, 2017

Investment Strategy

In a world with an elevated valuation backdrop and macro pivot points that call for reduced risk, there is more to be done than simply waiting for clarity on risks or better valuations. Dynamic allocation is required to manage exposures, take advantage of tactical upside opportunities, and importantly, manage a portfolios liquidity profile. A focus on quality sources of yield to increase portfolio carry while keeping some dry powder will allow us to take advantage of an eventual dislocation.

There are a number of explanations for the market's resilience, and lack of equity volatility, over recent years. Globally coordinated easing across central banks has pushed investors into riskier assets, and Wall Street has willingly accommodated these efforts with an array of easy-to-access investment vehicles. Perhaps these forces can continue to support the market indefinitely, leading investors into a sublime post-volatility world. Perhaps this time "it really is different", but we're not willing to bet on it.

One doesn't need to forecast a 2000-2002, or 2007-2009, scenario to call for heightened vigilance. Being mindful of the dangers that arise from persistently low volatility, coupled with record leverage, and their impact on investor behavior, and expectations, is a good idea. Whether or not this is the calm before the storm remains to be seen, but we do think there is sufficient evidence to take the portfolio off of cruise control, and to pause and scan the horizon for new directions that the market may take.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

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[i] The Economist, Brain gains, July 22, 2017
[ii] Education Week, Inside Facebook's Partnership to Develop Software for K-12 Schools, March 7, 2016
[iii] BlackRock/Rick Rieder, Chatter Fills the Room, But…, July 27, 2017
[iv] BCA Research, What's the Matter With Wages?, August 11, 2017
[v] Hussman Strategic Advisors, Estimating Market Losses at a Speculative Extreme, August 7, 2017
[vi] GMO, The S&P 500: Just Say No, August 15, 2017
[vii] JP Morgan, Are risk premia too tight?, August 11, 2017
[viii] Barron's, The Curse of 2017, August 14, 2017
[ix] BlackRock/Rick Rieder, Chatter Fills the Room, But…, July 27, 2017
[x] BCA Research, Are Central Banks Behind The Curve Or Ahead Of It?, July 21, 2017
[xi] PIMCO, Preparing for Pivot Points, August 10, 2017
[xii] Keefe, Bruyette & Woods (Walter Wong), August, 13, 2017