PCA Perspectives

Permit Capital Advisors' Thoughts on the Investing Landscape

February 2020

It has been said in the context of world affairs that "when America sneezes, the world catches a cold." Somehow that seems inadequate in the face of what's going on today, as seemingly overnight the path of the coronavirus outbreak, which started in China, has reached six continents. Leaving the epidemiological comparisons for others with proper training, we are comfortable opining on financial and economic projections, which have moved from an analysis rooted in lessons learned from the SARS outbreak to something much more impactful.

Markets trembled as the newly discovered form of the coronavirus family paralyzed the second largest economy in the world. But they shook as fears of an epidemic became fears of a pandemic, when the virus appeared to be on the verge of shutting down the world's third largest economy, Japan. If the virus spreads more widely in the U.S., leading to disruptive measures taken to limit its transmission such as closing shopping areas and cancelling public events, it is possible that the hit to consumer spending will topple the economy into a recession.

Of course, the global economy can adjust to many different varieties of shocks: war, energy crisis, earthquakes and any manner of natural disasters. The common denominator is that it takes time for companies, consumers, and governments to adapt to the new environment. We believe this episode will be no different, with perhaps a move by the corporate sector to revisit supply chain vulnerabilities, and the safety, resiliency, and sustainability of their business operations in the event of curtailments of travel and trade.

What is important to remember as long-term investors is that the correlation between global health conditions, economic conditions, and investment fortunes can be loose and it can be fleeting. In the world of modern monetary theory, weakness in the economy with a commensurate or even perceived impact on markets is often met with a Fed decision to lower interest rates and a Treasury step to monetize debt. Depending upon the speed of these actions, what we could be faced with is a floor underneath the market (fast and proactive Fed) or a V-shaped recovery from eventual lows (slow and reactive Fed). The chart below illustrates the recent tightness of the relationship between the Fed balance sheet and stocks.

Sources: Federal Reserve Bank of St. Louis. Standard & Poor's. As of January 13, 2020. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges.

What we focus on at Permit Capital Advisors is that while sources of market volatility can be impossible to predict, the impact of such volatility can be anticipated based upon the market conditions in which it appears. This recognition is why we look to maintain diversified portfolios across market cycles, in an effort to narrow the range of outcomes for any given risk profile. It is also why we focus so much attention on valuations. While valuations are a famously poor indicator of near-term performance, they historically have a much better track record of predicting longer-term performance. One of the reasons for this is that when faced with an exogenous shock (like a global pandemic), the markets tend to fall farther faster when their starting point is inflated valuations. As seen in the chart below, 2020 began with a U.S. market priced above its 25-year average on the heels of a particularly strong 2019, creating the fragile conditions that we are currently witnessing.

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	18.04x	16.28x	0.56
CAPE	Shiller's P/E	30.82	27.20	0.59
Div. Yield	Dividend yield	1.95%	2.09%	0.36
P/B	Price to book	3.31	2.96	0.47
P/CF	Price to cash flow	13.06	10.60	1.34
EY Spread	EY minus Baa yield	1.89%	-0.02%	-0.97

Sources: FactSet;FRB;RobertShiller;Standard&Poor's;ThomsonReuters;J.P.MorganAssetManagement

Putting all of this in context, while we will watch developments in the trajectory of the coronavirus keenly, as both investors and concerned citizens, we won't hit the panic button on our clients' portfolios because we don't believe that's a necessary reaction. Rather we put our faith in the proactive steps that we've taken over the course of the last several quarters. In other words, it is our belief that adjusting to longer-term market conditions precludes the need to adjust to shorter-term economic conditions.

Of course, we are happy at any time to speak on the phone or meet with our clients to discuss any of your thoughts or concerns.

Thank you.

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