December 2020

It's A Wonderful Life – 2020 Version

Imagine if you will… as we come to the end of what has felt like an endless and apocalyptic year, a look at the landscape around us which reveals the following:

- A stock market that collapsed under the weight of a global pandemic, resulting in a 34% drop through March that was just the beginning of the wealth destruction to come;
- An economy that saw a 31% fall in GDP in the second quarter, and hasn't yet begun its upturn;
- Unemployment that soared to 14.7% in April and continued to climb throughout the year;
- Faint indications of a vaccine approval, but nothing on the horizon in the immediate future due to intractable regulatory constraints.

Fortunately, the circumstances above do not represent current conditions, but rather what we would likely be facing without the presence of the protagonist in this quasi-science fiction movie we've all been living through. In the parlance of the 1946 holiday classic, *It's A Wonderful Life*, this is what you would call a "glimpse" – a gift given to George Bailey in the form of a chance to see what the world would be like without him. In the 2020 version of the movie, the protagonist is not George Bailey, but rather the supportive forces of stimulus and innovation.

In April of this year, we as a population were staring into an abyss of destruction that seemed poised to deliver a blow from which a generation may not recover. As the effects of COVID swept across the globe – taking lives, shutting down societal movement, and paralyzing the engines of economic growth – projections regarding the eventual impact were impossible to ascertain based upon the unprecedented nature of the circumstances faced. As we get ready to turn the calendar on a year that won't be missed by many, the "glimpse" scenario has been avoided (for the moment) by a collective triage of intervention performed by monetary, fiscal, and healthcare regulatory authorities.

A look at the key policy responses taken includes:

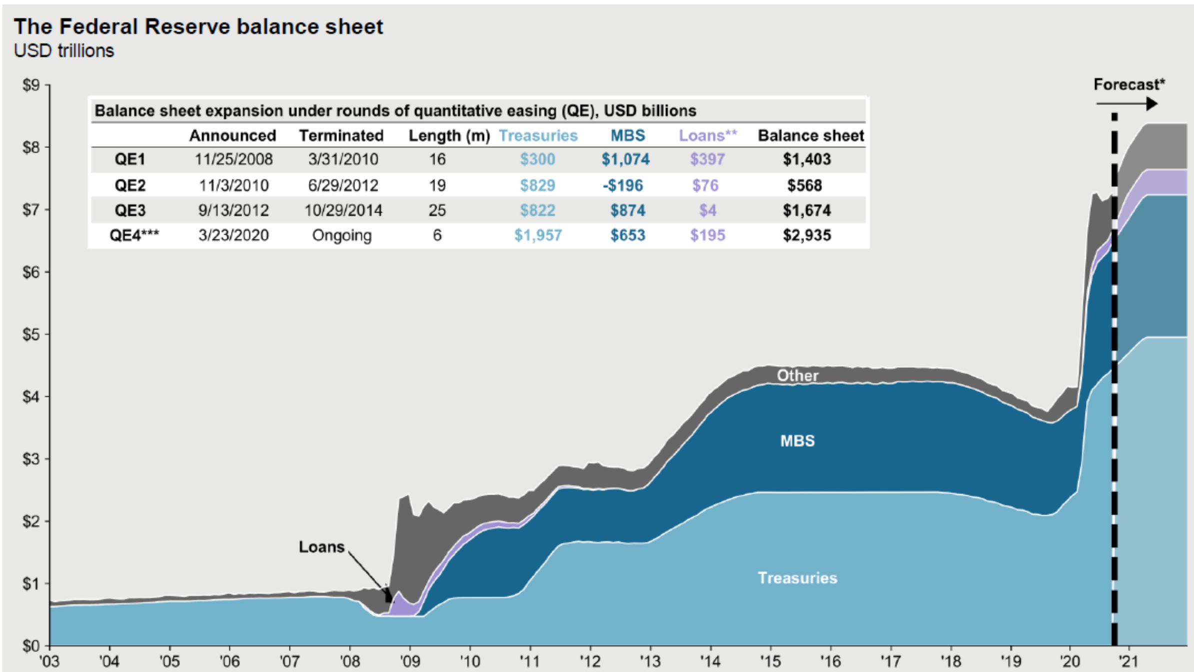
Monetary and Banking

- In March the federal funds rate was lowered by 150 basis points to 0-25 basis points.
- Treasuries and agency securities were purchased in significant volumes to add liquidity to the system.
- The existing cost of swap lines with major central banks was reduced.
- Facilities were introduced to support the flow of credit, backed by the Treasury using funds appropriated under the Coronavirus Aid, Relief and Economy Security (CARES) Act, including the Commercial Paper Funding Facility, Primary

Dealer Credit Facility, Money Market Mutual Fund Liquidity Facility, Paycheck Protection Program (PPP) Lending Facility, and the Primary and Secondary Market Corporate Credit Facilities.

- Federal banking supervisors encouraged depository institutions to use their capital and liquidity buffers to lend and to work constructively with borrowers affected by COVID, and indicated that COVID-related loan modifications would not be classified as troubled debt restructurings.
- Regulators lowered the community bank leverage ratio to eight percent, provided that PPP covered loans would receive a zero percent risk weight, and that assets acquired and subsequently pledged as collateral to the MMLF and PPPLF facilities would not lead to additional capital requirements.

Monetary Expansion



	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$397	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$76	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$4	$1,674
QE4***	3/23/2020	Ongoing	6	$1,957	$653	$195	$2,935

Sources: FactSet; Federal Reserve; J.P. Morgan Asset Management; J.P. Morgan Investment Bank

Fiscal

- $483 billion for the PPP and Healthcare Enhancement Act, including funding for forgivable Small Business Administration (SBA) loans and grants, as well as for hospitals and expanded virus testing.
- $2.3 trillion (11% of GDP) for the CARES Act, providing one-time tax rebates to individuals, an expansion of unemployment benefits, a food safety net for the most vulnerable, loans and guarantees to prevent corporate bankruptcies, additional SBA funding, transfers to state and local governments, and funding for hospitals.
- An extension of Coronavirus reliefs provided by previous legislations including additional unemployment benefits, continuing student loan payment relief, deferred collections of social security payroll taxes, and options to help renters and homeowners avoid evictions and foreclosures.
- Over $200 billion for the Coronavirus Preparedness and Response Supplemental Appropriations Act and the Families First Coronavirus Response Act, providing funds for virus testing, transfers to states for Medicaid funding, paid sick leave and emergency leave for those infected, support for the Centers for Disease Control and Prevention responses, and importantly, funding for the development of vaccines, therapeutics, and diagnostics.

Healthcare Regulation

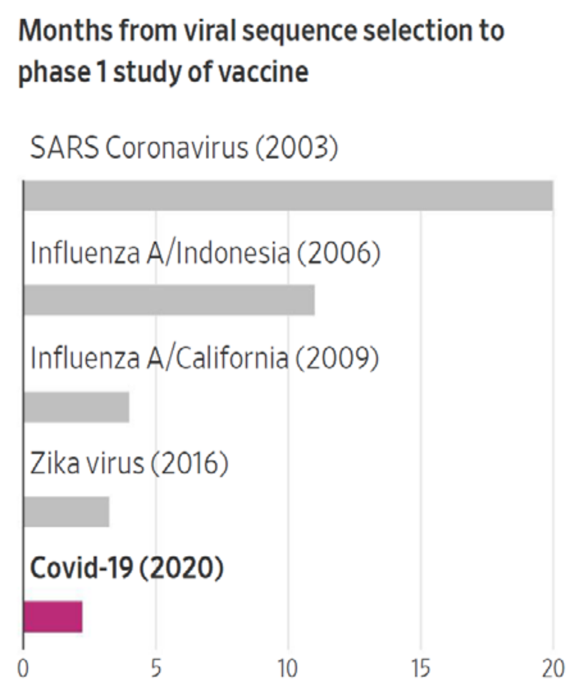
- Operation Warp Speed (OWS) was established with a goal to produce and deliver 300 million doses of safe and effective vaccines with the initial doses available in January 2021, record speed.
- OWS is a partnership of components of the Department of Health and Human Services, including the Center for Disease Control and Prevention, the National Institutes of Health, and the Biomedical Advanced Research and Development Authority, and the Department of Defense.
- In July OWS announced up to $1.95 billion in funds to Pfizer for the large-scale manufacturing and nationwide distribution of its vaccine candidate.
- And earlier this month, the FDA's Vaccines and Related Biological Products Advisory Committee quickly and overwhelmingly voted to recommend the Pfizer-BioNTech vaccine for emergency use.

The logical question in the aftermath of such an onslaught of rarely implemented measures is, "What comes next?" While the deluge of liquidity has staved off worsening conditions, in fairly remarkable fashion, we are far from out of the woods, as we sit in anticipation of a virus spike that could make it a dark winter in Pottersville. However, with a keen awareness of what a massive injection of liquidity can mean to a flailing economy facing self-imposed shutdown, we can hold out hope that round two of a recovery from a standstill position is possible.

Despite the huge economic damage caused by the pandemic, fiscal and monetary stimuli eased financial market conditions and indeed have driven up the prices of risk assets to almost uncomfortably lofty levels. This may in fact leave stocks vulnerable to a short-term correction, but on balance investors should favor equities over bonds given the likelihood of earnings acceleration behind accommodative monetary policy, and the likely resultant boost in economic growth. As the charts below indicate, we're already back to pre-COVID levels of corporate profits and unemployment claims continue to trend lower, providing a solid base for such growth to emerge.

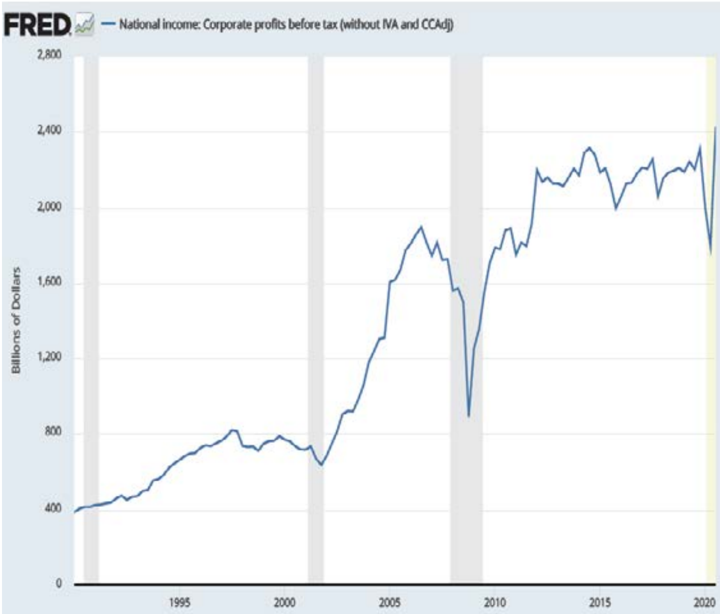
Valuations also favor stocks, as the global equity risk premium, arrived at by subtracting bond yields from the cyclically-adjusted earnings yield, remains quite high. Further, dividend yields are generally above bond yields. Estimates indicate that if nominal dividend payments stay flat for the next 10 years (likely an exceedingly pessimistic assumption), then real equity prices would have to fall by 24% in the U.S. for stocks to underperform bonds.[i]

Accelerated Regulatory Process



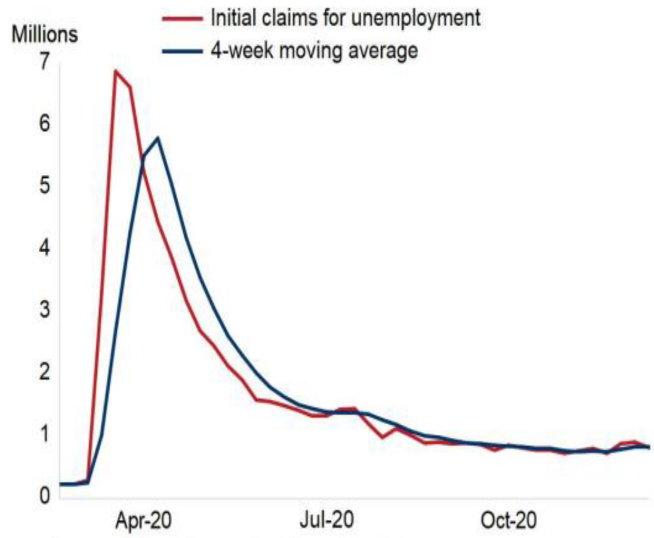
Source: National Institute of Allergy and Infectious Diseases

Corporate Sector Recovery



Source: U.S. Bureau of Economic Analysis

U.S. Unemployment Claims



Sources: Oxford Economics; Haver Analytics

U.S. Dollar

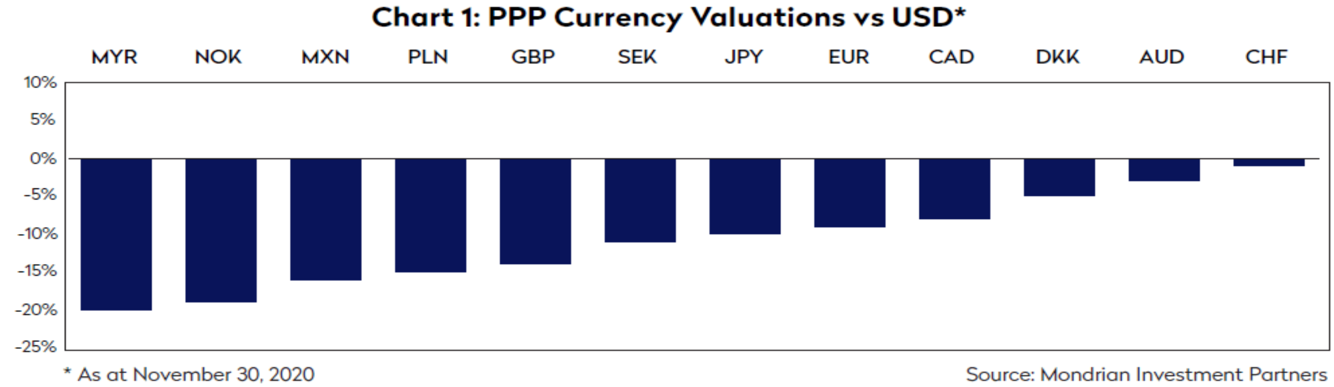
Of course, the magnitude of stimulus we're experiencing represents a form of financial Faustian bargain, as we are staring down the barrel at growing twin deficits. This means that our government is spending more money than it is taking in (fiscal deficit), and as a country we are sending more money overseas for goods and services than we are receiving (current account deficit). As a result, we should expect a weakening U.S. dollar, perhaps significantly so and for a prolonged period.

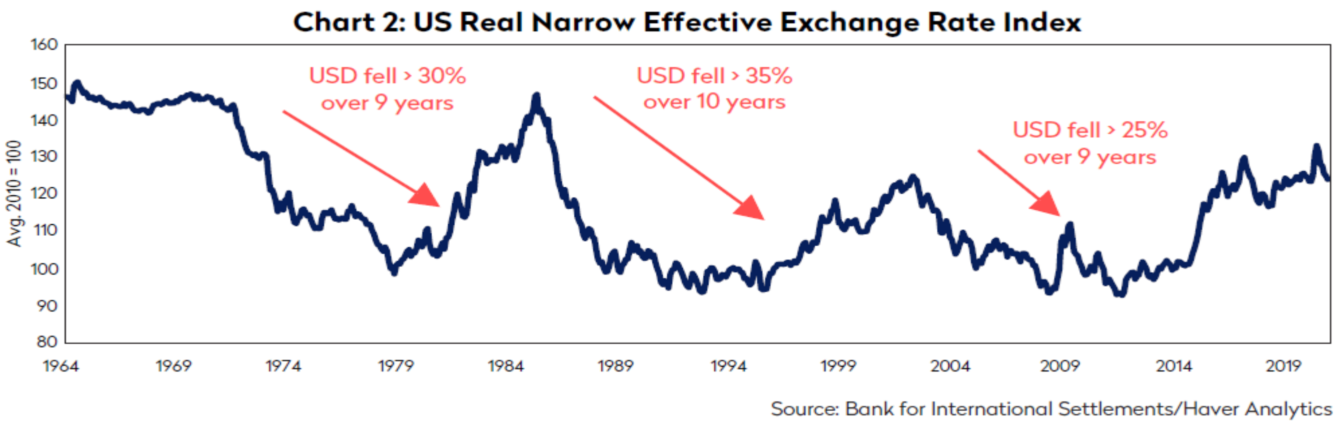
It is not just these widening deficits that are likely to contribute to dollar depreciation, there are other headwinds as well. These include a collapse in interest rate differentials, stronger global growth, overvaluation relative to other currencies, and recent trading trends. In other words, both fundamental and technical factors point to dollar weakness.

With respect to interest rate differentials, at the start of 2019, U.S. real 2-year rates were around 190 basis points above those of other developed economies. Today, U.S. real rates are around 60 basis points lower than those abroad. Still, the trade-weighted dollar has not moved in commensurate fashion, indicating a likelihood that there will be "catch-up" weakness for the dollar sometime in the not-too-distant future. Also, the dollar tends to be a counter-cyclical currency, meaning it tends to weaken when the global business cycle is gaining steam. If vaccine distribution and efficacy are as anticipated, this would pull down dollar demand.

From a pricing perspective, we favor a theory called Purchasing Power Parity to compare the value of various exchange rates. By this measure the U.S. dollar is about 13% overvalued[ii], and it sits in that territory against every major currency in the world. Furthermore, from a technical perspective the dollar tends to be a high-momentum currency. When it comes to trading patterns, it is historically profitable to go long the dollar when it is trading above its moving average and to short when the opposite occurs. Today, the trade-weighted dollar is trading below its 3-month, 6-month, 1-year, and 2-year moving averages.

Looming Dollar Weakness





Since the end of World War II, there have been only three previous instances of dollar overvaluation this extreme: the late-1960s, caused by high inflation within a fixed exchange rate regime ("Bretton Woods"); the mid-1980s, caused by Fed policy under Chair Paul Volcker that saw rates rise to double digits in an attempt to squeeze inflation out of the system; and the early-2000s, driven by the tech boom pulling capital into the U.S. In each instance the dollar then experienced a period of extended and deep depreciation, lasting at least nine years and seeing at least a 25% fall in value.

The focus on the future path of the dollar relative to its fiat currency counterparts is not primarily a means to a trade, but rather a mechanism to help set important asset allocation decisions for the cycle ahead. For reasons tied both to the cause of a depreciating dollar as well as its effect, there is a tendency for cyclically sensitive stocks to outperform during these intervals. This has consequences for the balance of leadership across distinctions of style (favors value), capitalization (favors small cap), and geography (favors non-U.S.).

Growth vs. Value, U.S. vs. Non-U.S.

When matters of investment style category are at hand, it is generally a byproduct of sector distinctions. The most acute implications of potential sector rotation involve Financials, representing value, and Technology, representing growth. Regarding Financials, they should be the beneficiary of anticipated stronger growth in 2021 post-vaccine rollout, as that dynamic will likely put upward pressure on long-term bond yields. Since short-term rates will likely stay low, yield curves will steepen, boosting banks' net interest margins. This would also serve to improve credit conditions banks are faced with and help to tamp down defaults. Since banks have set aside considerable capital for anticipated loan losses that haven't (yet) materialized, this could be a boost to earnings. To that point, according to the American Bankruptcy Institute, commercial bankruptcies are lower now than they were this time last year.

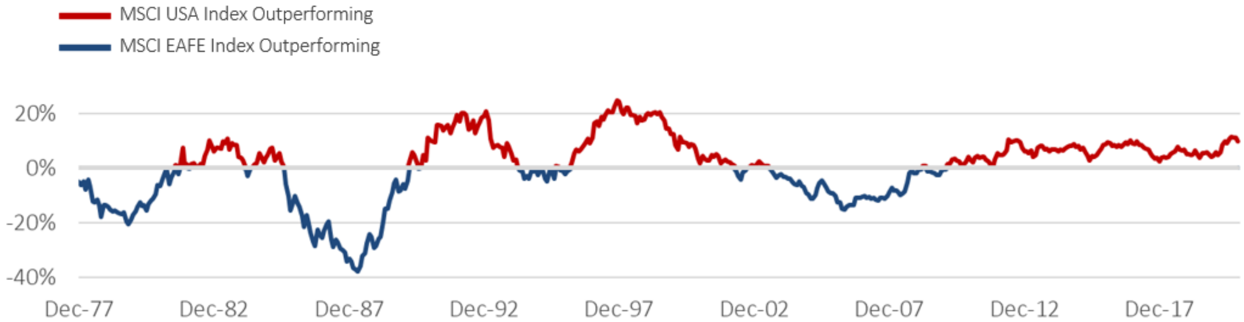
On the growth side of the ledger, it is easy to stand behind the notion that since profit growth is a key driver of stock performance, then companies will perform in line with their growth projections. However, what matters typically is more about profit growth relative to expectations than absolute profit growth. Looking back in time at Technology outperformance since 1996, a decomposition of factors points primarily towards two: multiple expansion and margin expansion. The former is a result of investors' willingness to pay for the aforementioned earnings growth, while the latter has been driven by the monopolistic powers that these companies possess.

This comes in part from the dependence of consumer tech companies on the network effect. The more people who use a particular platform, the more attractive it becomes for others to follow suit (think social media). These same companies also benefit disproportionately from economies of scale. Once a piece of software has been written or a chip has been designed, the incremental cost of replication goes down significantly. However, two forces are likely to put a crimp in future earnings growth. First, many of the giants have already gathered such significant market share that future growth is going to be dependent on growth of the market itself. For instance, nearly 75% of U.S. households already have an Amazon Prime account, slightly more than 50% have a Netflix account, close to 70% have a Facebook account, and Google commands 92% of the internet search market.[iii]

Second, the power they wield makes them vulnerable to governmental action. This could take the form of higher taxes, increased regulation, and strong anti-trust enforcement. According to a recent Pew Research study, this is a bi-partisan stance, as a majority of both liberal Democrats and conservative Republicans favor increased government involvement in the affairs of the sector. There is not necessarily a siren sounding for an absolute decline in the share of tech stocks, but we believe that there is likely to be a secular shift towards outperformance by traditional value stocks that could last for quite some time.

Where the fact patterns line up are in both cross exposures (Financials represent 18% of the MSCI non-U.S. Index and 10% of its U.S. Index, Technology represents 12% of the non-U.S. Index and 28% of the U.S. Index) and in fundamentals. Stocks outside of the U.S. on average are meaningfully cheaper than their U.S. counterparts on the basis of trailing price-to-earnings, price-to-book, and price-to-sales, as well as dividend yields. Further, relative 12-month forward earnings estimates between U.S./non-U.S., large cap/small cap, and tech/overall market, have all turned to the previously unloved. As indicated in the relative performance charts below, a reversion towards the mean would result in significant outperformance across these strategic allocations.

Difference in Rolling 3-Year Annualized Returns
(MSCI USA Index – MSCI EAFE Index)



Data are since each index's inception (January 1, 1970) and through November 30, 2020. MSCI USA Index is MSCI USA Net Total Return USD Index. MSCI EAFE Index is MSCI EAFE Gross Total Return USD Index.

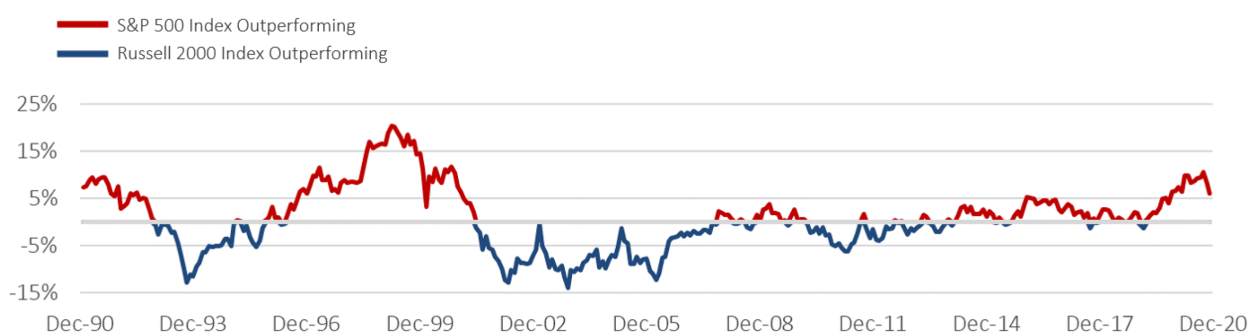
Source: Bloomberg; Morningstar Direct; Permit Capital Advisors, LLC

Difference in Rolling 3-Year Annualized Returns
(MSCI World Growth Index – MSCI World Value Index)

Data are since each index's inception (January 1, 1975) and through November 30, 2020. MSCI World Growth Index is MSCI World Growth Net Total Return USD Index. MSCI World Value Index is MSCI World Value Net Total Return USD Index.

Source: Bloomberg; Morningstar Direct; Permit Capital Advisors, LLC

Difference in Rolling 3-Year Annualized Returns
(S&P 500 Index – Russell 2000 Index)



Data are since February 1, 1988 and through November 30, 2020. S&P 500 Index is S&P 500 Total Return Index. Russel 2000 Index is Russell 2000 Total Return Index.

Source: Bloomberg; Morningstar Direct; Permit Capital Advisors, LLC

Fixed Income

While a tilt towards equities, and within equities, can provide significant value in a portfolio construction exercise, an analysis of fixed income as overvalued, or even unattractive, does not mean it would be prudent to substantially eliminate the broad asset class. There are various reasons why an investor diversifies into these strategies, with the most typical objectives being a desire for yield and a measure of principal protection afforded a security with low historical default rates. As discussed previously, interest rates that are anchored near zero on the short-end of the yield curve, and likely to drift higher on the long-end of the yield curve do not provide much in the way of support for either objective. However, there are other important drivers behind a decision to allocate to fixed income, including a reduction in correlations across a portfolio and a reduction in portfolio level volatility.

We often discuss with our clients that fixed income allocations provide ballast to a portfolio in an attempt to narrow the range of outcomes around any desired risk profile. In the current rate environment this requires a broadening of the traditional opportunity set coupled with an understanding of how to balance various considerations related to diversification. With respect to added tools, we are always looking for strategies that take advantage of structural inefficiencies in capital markets, and have often found reliable solutions within the realm of less traditional fixed income strategies, or fixed income substitutes. This covers a range of options including bridge lending, ultra-short duration high yield, private lending, unrated municipal bonds offerings, and even absolute return hedge funds. The common thread across these investments is that we believe there is a replicable process in place to deliver attractive risk-adjusted results despite the headwinds faced by investors searching for yield, or even equity-like returns, without an over-dependence on equity markets, which are likely to be faced with ongoing and unpredictable exogenous risk factors.

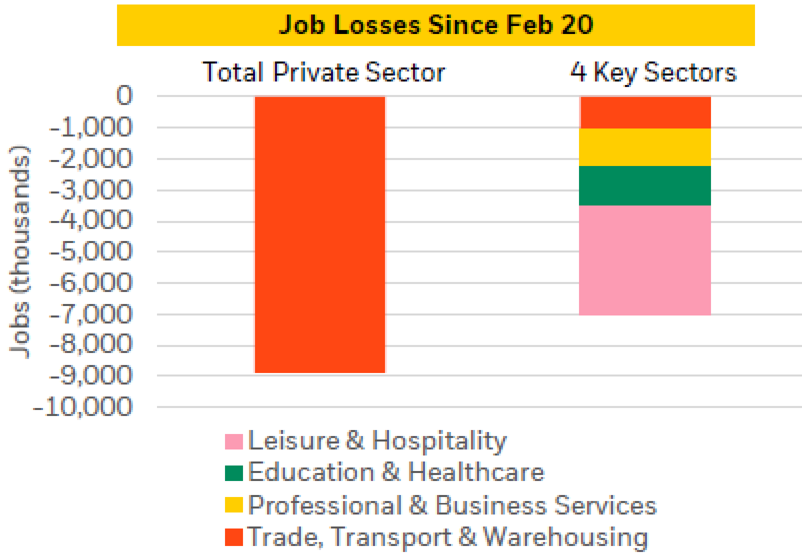
Risk vs. Uncertainty

The presence of such hard-to-predict risk factors is, of course, an inherent aspect to any return-seeking investment program. Interestingly, there is an important distinction to be made between the existence of risk versus uncertainty. The concept of uncertainty in economics was introduced in the early part of the 20th century by John Maynard Keynes and Frank Knight. They offered that, in cases where risks are analyzed, the range of future events or consequences of a decision are known, but the eventual outcome is unknown beforehand. This makes a probability calculus applicable and provides a sound basis for risk management, cost/benefit analysis, budget planning, and other decision-making mechanisms.

In the case of uncertainty, the range of future developments cannot be foreseen. Therefore, the same probability calculus has no sound foundation, leaving no objective basis for the various decision-making mechanisms described above. Our role as an investment advisor is to manage risk and mitigate uncertainty – COVID represents an uncertainty. The key in periods of uncertainty is to respond to events as they unfold, separate signal from noise, and attempt to at least identify the factors that will shape what comes next.

Part of navigating uncertainty in a period of COVID-driven economic turmoil is understanding the flip from a “lockdown” economy to a “return” economy, recognizing the industries most acutely affected, and understanding a proper price (or valuation) to pay for the relevant assets. As a result of the widespread shutdowns faced by cities and states across the U.S., four sectors have accounted for 66% of the jobs that still need to be recovered – Leisure & Hospitality, Education & Healthcare, Professional & Business Services, and Trade, Transport & Warehousing.

Industries Most Impacted by COVID



Source: BlackRock

The light at the end of the tunnel from vaccine distribution is certainly relevant here, but the recovery has been a steady one since additional unemployment benefits rolled off at the end of June, as the four sectors have continued to recoup about 750,000 jobs per month.[iv] This could be an opportunity for timely investment into distressed sectors, industries, or companies, and we are working through our relevant due diligence accordingly.

Conclusion

Any attempt to try to make sense of what we have seen in 2020 is probably farcical to begin with. However, we do believe that it has been a year to remind us of certain investment principles that have proven to be durable in their application. This includes the importance of rebalancing, both when the environment feels most precarious and when it appears to be at its most sanguine. It also reflects a recognition that during periods of heightened stress, the communication and relationships that are built with our clients over time are the bedrock we must rely upon to properly work together towards the steady attainment of long-term goals.

We describe this year through the prism of the classic movie, *It's A Wonderful Life*, because we think it is a valuable exercise to recognize the forces that impact our fortunes, and to be mindful of the consequences involved in having them withdrawn. This informs our thoughts about investing, but also our appreciation for the opportunity to work with all of you.

Thank you as always for your confidence, and please feel free to reach out to us with any thoughts or questions.

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[i] BCA Research, "2021 Key Views: Navigating A Post-Pandemic World," December 10, 2020

[ii] Mondrian Investment Partners, "US Dollar Could Have a Lot Further to Fall," December 9, 2020

[iii] BCA Research, "Inflation, Innovation, and the Value/Growth Debate," November 27, 2020

[iv] BlackRock, "Taking Stock (More of It) of Where We Are," December 3, 2020