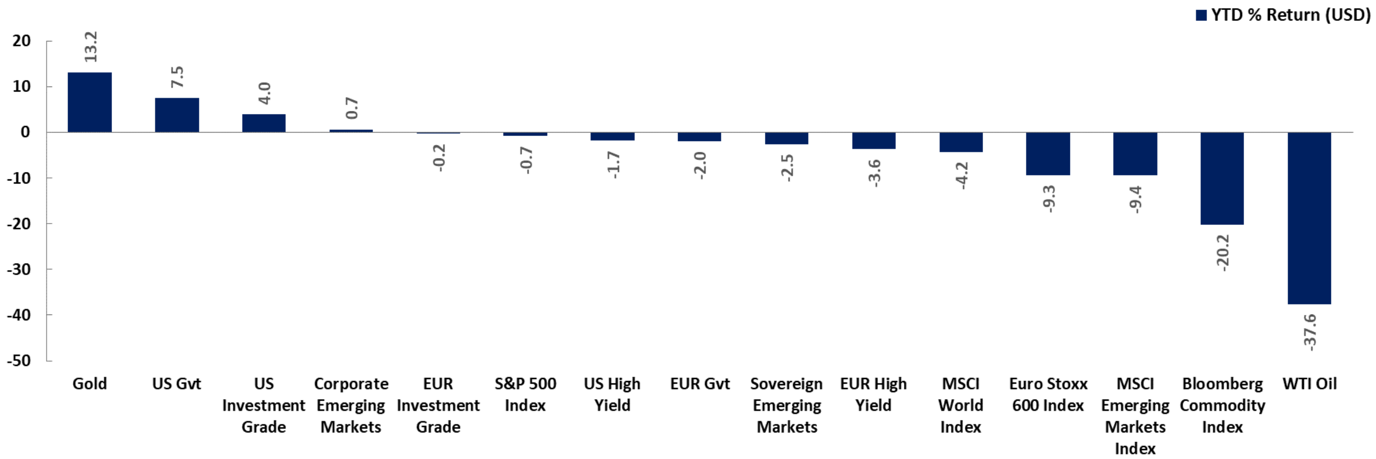
Flash Market Outlook

Risk assets continue to ignore the dire state of the economy. Despite the sustained collapse in economic activity, global equities remain resilient with the S&P 500 Index erasing 2020 losses bolstered by the actions of the Fed, the US government, and the generous stimulus packages in other major economies. After undergoing the fastest market sell-off in history (-35% in 33 days), we are now in the midst of the fastest liquidity-driven recovery in history (+47% in 77 days). Defying fundamentals, this market has many veteran investors throwing in the towel (Buffet, Druckenmiller, Tepper, and Grantham) on what is emerging as the most furiously ridiculous rally in history. While we managed to pick the bottom at the end of March and sell put options to capitalize on heightened volatility at a time of excessive fear, we admittedly did not expect the strength of recent rally. We believe financial markets are the most disconnected to the real economic activity than they have ever been in recent history.

Chart 1. Asset Class return YTD (USD Base)



Economics

GDP Recession. We continue to see a growing divergence between the economy and risk assets. US Real GDP was down -5.0% (QoQ) in Q1'20, consensus now has US GDP contracting -34.4% (QoQ) and -9.7% (YoY) in Q2'20 **(Chart 2)**. US Composite PMI crumbled below 30 in April and barely recovered to 37 in May. The headline US unemployment rate is set to reach 16.2% in Q2'20 after March and April recorded the highest initial jobless claims in history. The drop in GDP and rise in unemployment in four weeks equaled what took one to four years to reach in the Great Depression and were never reached in other events (i.e. 1989 Japan, 2000 Tech US).

The shape of the recovery (V, U, W, L, and "Swoosh") **(Chart 3)** is one of the hot topics today with many interesting articles with diverging views that can be found on the subject and surely cases can be made for all of these possibilities. Historically, economic recovery from most recessions tended to be V-Shaped. The experience of the Great Depression (1929) suggests recoveries after such severe downturns should be shaped more like an L or W. The recovery following the Great Recession (2008) was widely perceived as a U. Rogoff & Reinhard, Harvard Professors who wrote the definitive analysis of the 2008 burst, agree this event is indeed completely different and suggest it will take at least 5 years to regain 2019 output levels (e.g. L-Shaped: the economy never fully recovers). We humbly disagree. Today, we think there is a case to be made for either a U or Swoosh recovery. We expect the large drop in economic activity to be followed by a painfully slow recovery with many western economies (incl. US and Europe) not back to pre-Covid output before mid-2022, fairly in-line with consensus.

Chart 2. US GDP Growth

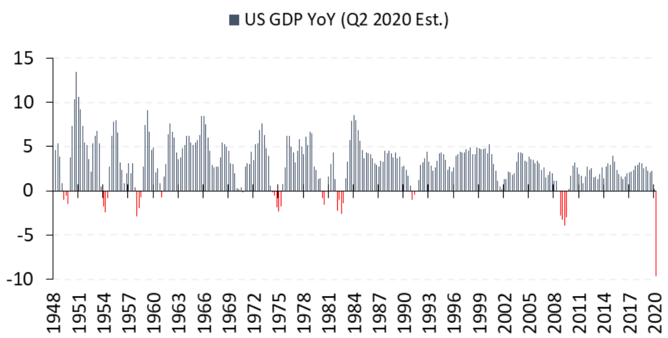
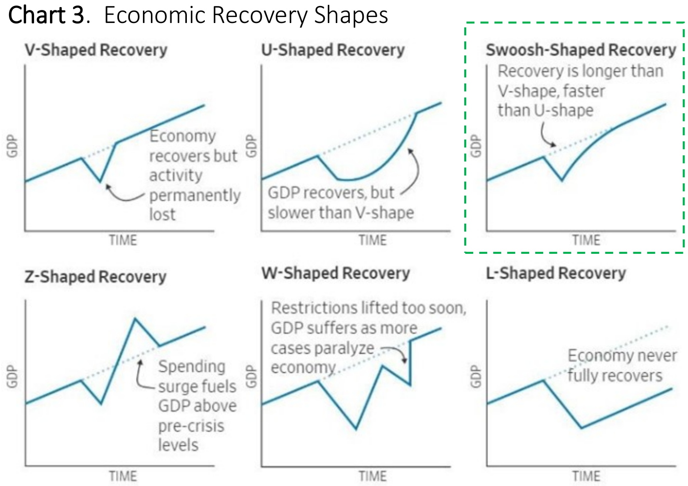


Chart 3. Economic Recovery Shapes



US Unemployment. The Department of Labor announced last week that with a “limited resumption of economic activity” 13.3% of Americans were unemployed in May. Although still high relative to historical standard, it was pleasantly accepted by economists who were expecting a figure closer to 20%. However, this statistic does not depict the whole story. If we were to include more workers who have been hurt during the pandemic, numbers show a much more contrasted picture. Headline unemployment rate is based on the number of unemployed adults divided by the total number of people in the labor force, employed and unemployed. This rate includes workers expecting to be recalled back to their jobs as well as those on permanent layoff, job leavers, new and re-entrants in the labor force. Yet, there are millions of people who are not working and want a job that the aforementioned rate leaves out of the equation. To be counted as unemployed ones not on temporary layoff must indicate they have looked for work in the past four weeks. Now, if we expand to those who looked for a job in the past year, the rate rises to 14%. Suppose we now include people who say they want a job, the rate increases to 17.9%. The rate increases even further, to 24.1%, if you include those working part time because their hours were cut or they could not find a job. Finally, the Labor Department said an additional 2.9% of workers counted as employed were absent from work for “other reasons” and were most likely miscategorised because they were on temporary layoff. While they are still technically being paid, their absence contributes to the drop in economic activity. In turn, when we account for these individuals the unemployment rate expands to 27% **(Chart 4)**. In our view, this is more reflective of the share of the workforce that has been negatively impacted by the pandemic and resulting lockdown measures.

US Fiscal and Monetary Stimulus. Over the course of 8 weeks, the Fed and US government introduced a set of unprecedented measures in response to the economic impact of the virus. Together, they injected over $6.3Tn into the US economy alone. The Fed expanded its balance sheet by $3.1Tn while the US government signed a $3.2Tn stimulus. Now, the Trump administration is planning to introduce another $1Tn package before congress in the coming weeks. This would bring the total amount of money injected into the economy above $7.3Tn. In comparison, the S&P 500 Index total market capitalization grew by $8.3Tn from March lows, or 115% of the total stimulus package (current and expected). Although we are far from arguing a direct causality here, it does remind investors of the famous “Don’t fight the Fed” motto. In the first half of 2020, the amount of new public debt outstanding covers more than 170% of the expected drop in nominal GDP **(Chart 6)**. However, as the last two decades taught us, debt issuance and fiscal deficits have become increasingly less effective at stimulating the economy. Each time around, a substantially greater percentage of fiscal deficit **(Chart 5)** is needed to yield the same impact on the economy while the time between the increase in money supply and economic recovery elongated. As a result, while these numbers seem high, we expect more alike to be needed to revitalize the global economy and bring output back to pre-pandemic levels while taking longer than a V-Shaped recovery would imply.

Chart 4. Restating the US Unemployment Rate

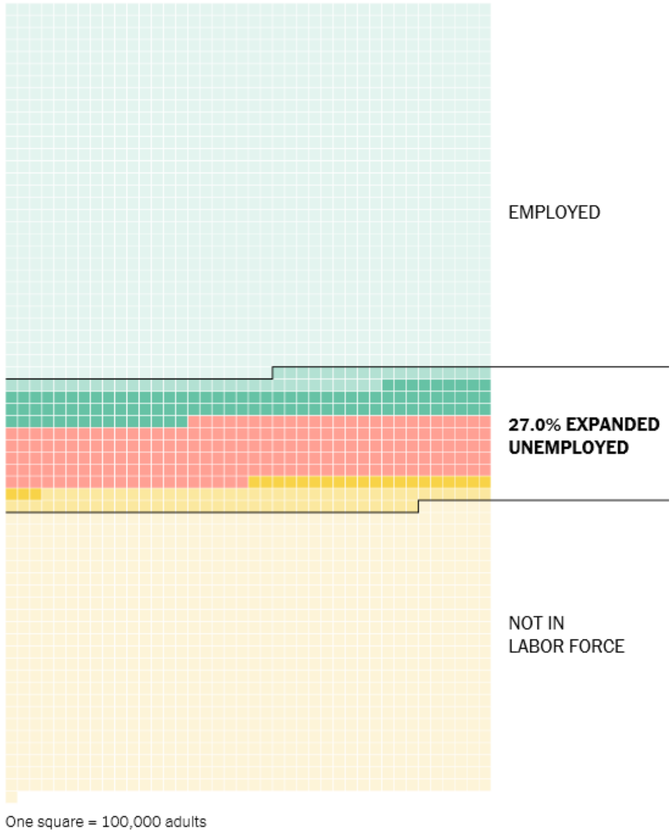


Chart 5. US Budget Deficit (% GDP) & Unemployment Rate

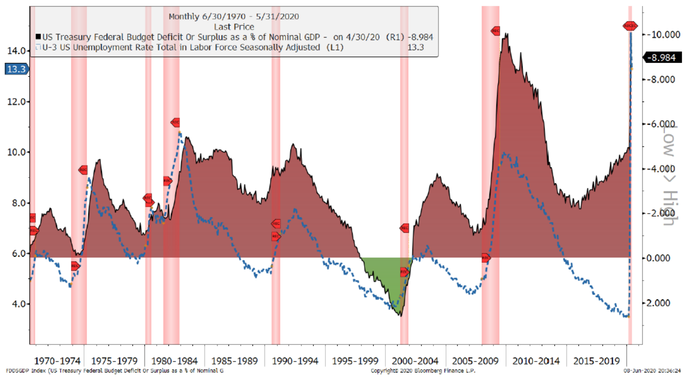
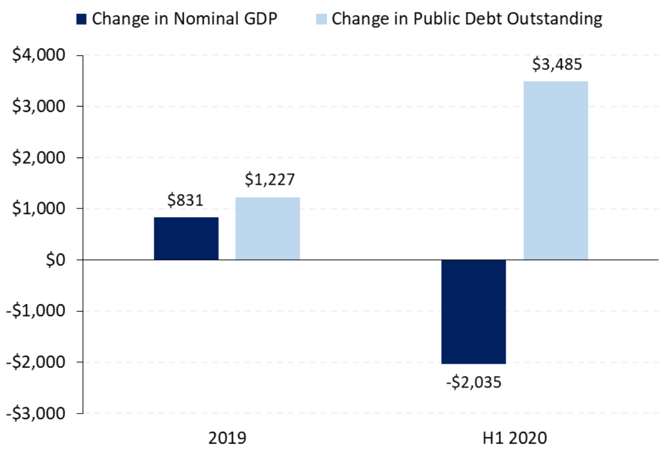


Chart 6. Change in Nominal GDP and Public Debt Outstanding



Exploding Monetary Supply. Money growth around the world is accelerating in response to the unprecedented set of easing conducted by central banks. US M2 is expanding at its fastest rate since WWII, Japanese M2 at its quickest rate since 1991, and the Euro Area at its strongest level since the Great Financial Crisis **(Chart 7)**. Yet, money supply dynamics today differ quite extensively to those prevailing in the aftermath of the GFC. Beyond the base money increase linked to QE programs, private sector deposits are also growing rapidly highlighting how both banks and the private sector are more robust than they were prior to entering the 2008 crisis. This also reflects the large injection of cash in the economy by governments, and indirectly central banks. However, this money has yet to make its way into spending. Globally, household savings have surged while companies slashed both their workforce and CAPEX. With governments and central banks unlikely to suddenly withdraw their stimulus, the expansion in monetary supply is here for some time. With time, as economies reopen and confidence increases, the additional money should begin to finance spending which is likely going to be concentrated in durable goods purchases. The deep cyclical companies will be the primary beneficiaries of this phenomenon. In turn, less savings will drive yields higher through (in part) inflation breakeven rates. On the backdrop, this could prove negative for growth stocks.

Consumer Spending. Remember how a few months ago there was record high consumer confidence, 50-year low unemployment, record low interest rates, and 20-year high household income? Were things truly as strong as they seemed underneath the surface? During this historic economic expansion, there was a hidden pain missed by many, including us. Studies have shown Americans are far from being wonderful savers. In fact, 45% of Americans have no savings and another 24% have less than $1,000 saved up. In 2019, the Fed reported that nearly 40% of the population does not have enough cash on hand to cover an unexpected expense of $400. Clearly, Americans were not ready for a rainy day, and even less for something like this. The University of Chicago shows nearly half of Americans surveyed cannot afford to miss more than 1 pay check. This should not be the solid footing on which record high stock markets are built upon. It also is far from being an environment capable of easily powering through a crisis. Today, the economy is far from being in a better shape than it was then. Economies have been on idle mode for weeks. We now have record high jobless claims, double digit unemployment, slowing household income, and crumbling consumer confidence **(Chart 8)**. This should neither be the environment upon which risk assets revert back to pre-crisis levels in less than 15 weeks. Consumer spending is going to take time to come back. Despite lockdown easing, early data supports the case of a U or Swoosh recovery with a progressive yet timely pick up in demand. Seated diners **(Chart 9)** and hotel occupancy rates **(Chart 10)** are only some of the indicators showing that individuals have not reverted back to their former habits. Small business optimism dropped significantly, and the longer consumers fail to come back the most likely it will remain low, and he most recent wave of social unrests is unfortunately the latest factor to impair the road to recovery.

Chart 7. Money Supply Growth Across Major Central Banks

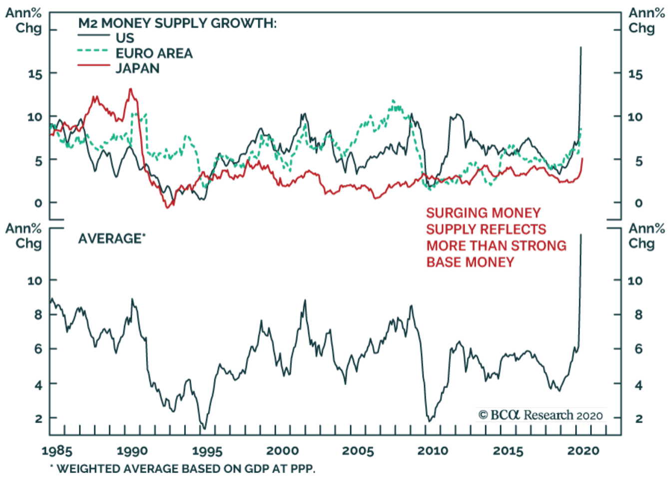


Chart 8. Consumer Confidence Index

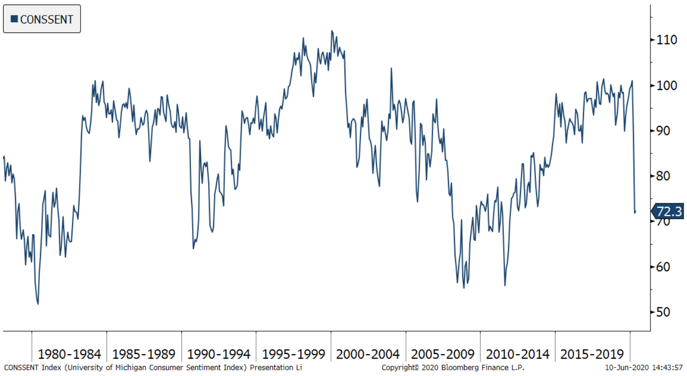


Chart 9. Seated Diners YoY (by State)

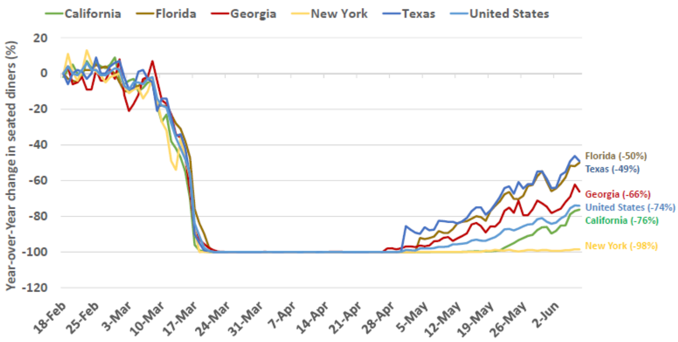
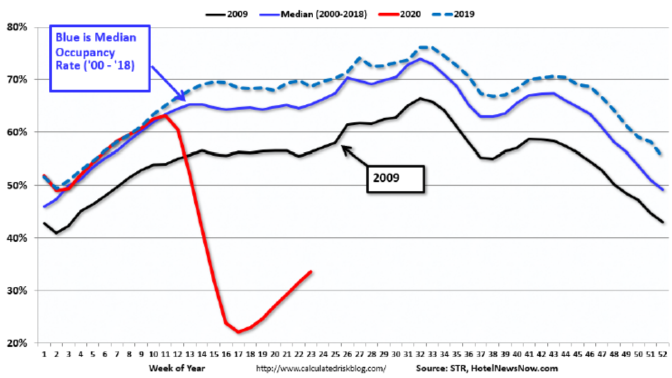


Chart 10. Hotel Occupancy Rate by Week of Year (4W SMA)



We don't expect what consensus see as a V shaped recovery. Instead we believe the US economy will take at least two years to recover from the impact of the Covid-19.

Equities

Corporate Earnings, A Bleak Outlook. Earnings expectations are an important factor in equity market valuations and overall equity market performance. The consensus is very eager to expect a "V-shaped" recovery in earnings. As can be seen from the table below, the consensus expects S&P 500 earnings to drop -17.7% in 2020 and recover earnings to pre-Covid19 levels by mid-2021; i.e. within less than a year. Based on our assessment of the economic outlook, this seems wishful thinking. Especially as we have seen year after year that consensus is typically too "bullish" and keeps revising its expectations lower over time. At MAM, we believe that the 2020 earnings impact will be conservatively closer to -20% **(Table 1)**. We then anticipate, barred any negative growth shock, for earnings to match economic recovery by taking two years to recover to pre-Covid19 levels. This means a return to 2019 earnings by the end of 2022. Knowing that 2019 displayed very meagre earnings growth (1.1%), this would mean that the US equity market would have had no earnings growth for a period as long as 4 years.

According to consensus, the US seems "immune" to the global economic slowdown. The devil is in the detail. What most market participants fail to see is that the current earnings landscape in the S&P 500 Index is extremely misleading. It is entirely driven by earnings expectations of 6 stocks, the "FAAANM" (Facebook, Apple, Amazon, Alphabet, Netflix and Microsoft). As per the chart on the right **(Chart 11)**, should we exclude FAANM stocks, S&P 500 Index earnings would be closer to the rest of the world. While most see them as "recession proof" stocks, one can argue that all of them require a certain level of consumer spending to grow. Lower business confidence should lead to lower ad spend on Google and capex spend on Microsoft products. Lower disposable income should lead to lower Apple and Amazon sales. There is inherent cyclicality in these stocks that the market fails to consider. So far, most of the S&P 500 Index companies have cancelled 2020 earnings guidance. Consensus is navigating blind. Q2 earnings due to start in July/August 2020 will provide some clarity into whether this V-shaped earnings recovery is viable or not. We side with the view that expectations will be re-set lower. As such, we see a potential period of downward earnings revisions ahead which could act as a headwind to the equity market.

Table 1. Consensus vs. MAM S&P 500 EPS Expectations

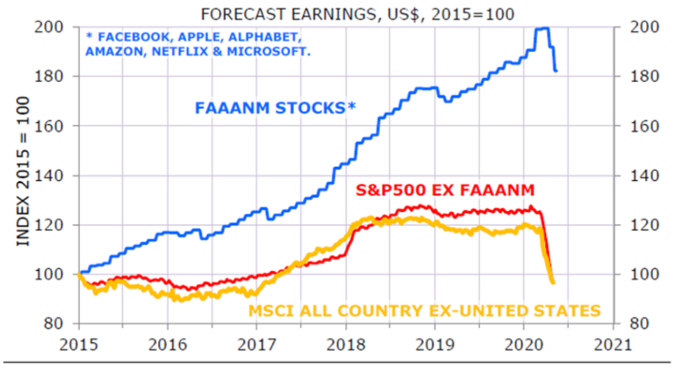
Consensus EPS Expectations for S&P 500 Index

Year	2015	2016	2017	2018	2019	2020E	2021E	2022E
S&P EPS ($)	108.86	109.16	124.12	150.61	**152.29**	125.32	161.55	**187.74**
YoY EPS Growth (%)	-3.01%	0.28%	13.70%	21.34%	1.12%	-17.71%	28.91%	16.21%

MAM EPS Expectations for S&P 500 Index

Year	2015	2016	2017	2018	2019	2020E	2021E	2022E
S&P EPS ($)	108.86	109.16	124.12	150.61	**152.29**	121.83	146.20	**152.05**
YoY EPS Growth (%)	-3.01%	0.28%	13.70%	21.34%	1.12%	-20.00%	20.00%	4.00%

Chart 11. S&P 500 Earnings Forecasts ex. "FAAANM" Stocks

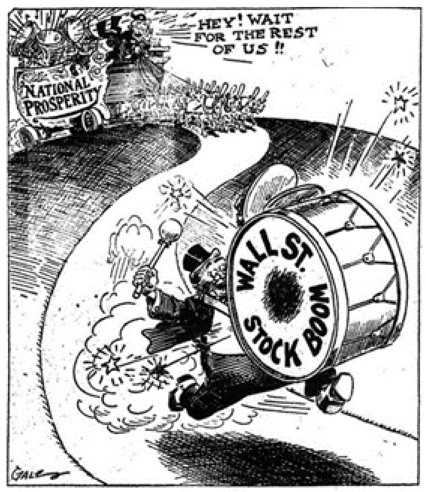


Source: MSCI, IBES/DataStream, Bloomberg; Minack Advisors

Considering the dismal earnings outlook, it is fair to say that 100% of the market fluctuations we have seen in 2019 (+28.9%) and in 2020 (-0.7%) are due to valuation re-rating. Meaning that depending on the prevailing macro trend, the market ascribes a valuation multiple irrespective of the underlying condition of corporate earnings. This seems extremely short-sighted.

Valuations, S&P 500 Index PE Multiple in the top 10% of History while US economy in its worst 10%. The Price-to-Earnings valuation multiple is the most widely used metric for its simplicity of analysis across cycles. Using the level of the S&P 500 Index at 3,207 (as of 09/06/20) and consensus expectations of earnings per share of $125.32, we get a PE multiple of 25.5x. Should we take MAM's expected 2020 earnings expectations of $121.83, we get a multiple of 26.3x. In any way one would look at this, it is expensive. In fact, looking back 30 years **(Chart 12)**, this is as high as it has ever been. The S&P 500 Index only reached this level of valuation before the tech-bubble crash in 1999-2000. As per the cartoon of 1928 on the right hand side, equity markets seem highly disconnected to the economic reality.

Did risk assets move too fast too quickly?



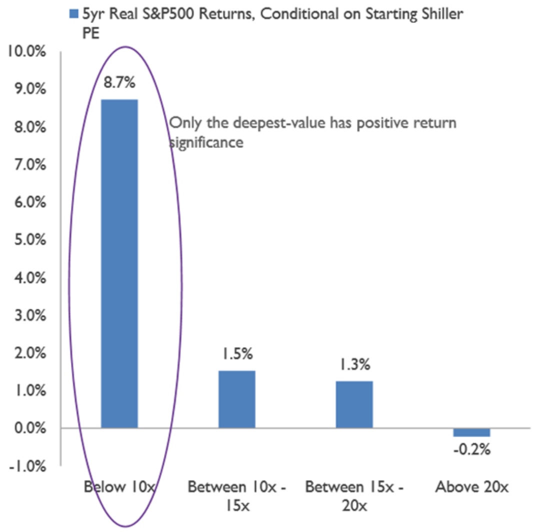
"Getting Ahead of the Band Wagon!"
Los Angeles Times, November 24, 1928

Some market participants will justify this level of valuation based on low interest rates for longer. There is some truth to that. Lower interest rates means lower discount rates and higher cash-flow based valuations for stocks. Mind you, record low interest rates in Japan and Europe has never led to record PE multiples in their respective equity markets. Even assuming the lower interest rates argument stands, we see some flaws in it. The Fed's yield curve control should lead to higher inflation expectations; which we are starting to see across different metrics. Higher inflation expectations leads to negative real interest rates. This is typically not good for equity market valuations.

One of our favourite quotes from Warren Buffet (increasingly in the news for missing the recent market rally) is: "Price is what you pay; value is what you get". Buying equities today at over 25x earnings is probably the worst value proposition in recent history. When we studied market history ahead of the launch of the "All Weather Certificate", centre to our research was the fact that S&P 500 Index future returns are dependent upon the starting valuation level. As per **Chart 13**, with a PE multiple over 20x earnings the S&P 500 Index 5-year real annual return is expected to be negative -0.2%. This is based on 100-year of data. This means that one should expect markets to fall after adjusting for inflation. While nothing prevents the equity market to display short-term market rallies from here, the risk/reward is definitely skewed to falling equity markets from current levels of valuations.

Chart 12. S&P 500 P/E Ratio (Monthly)

Chart 13. S&P 500 Earnings Forecasts ex. "FAAANM" Stocks

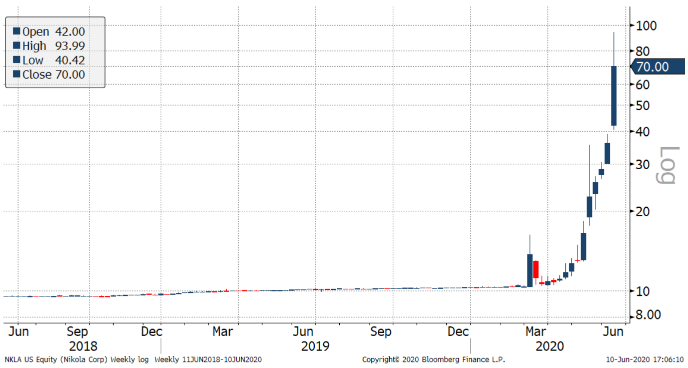


Strong Signs of Market Greed. Sentiment is as extended as in February or during previous S&P 500 Index tops in the past few years. Some of the short-term indicators we look at such RSI, put/call ratio, advances/declines line are all flashing "red". Equity markets are over-extended. Greed is slowly showing up on our radar screens as investors that have missed out on the rally are chasing performance. Additionally, the market action has an element of a short squeeze. Here are some events that only happen during extreme investor complacency, usually at market tops:

- Hertz, filed for bankruptcy on May 25th. The stock has rallied +680% since then.
- Chesapeake Energy rallied +181% the day before it announced its filing for bankruptcy.
- Luckin Coffee, under investigation for severe accounting fraud, has rallied +185% from the lows in May.
- Tesla, has rallied +160% from the March lows and is about to break-up through the psychological level of $1,000/share.
- Nikola (**Chart 14**), dubbed "the next Tesla" designs and manufactures electric trucks. The company has 0 revenues. Yet it has a market cap of US$28bn. The stock has rallied +182% since the beginning of June.

This type of market action is concerning. Lack of sports betting (due to Covid-19 sports lockdown) pushes millennials to "try out" equity market speculation. The number of new trading accounts being opened is exploding. Charles Schwab, Etrade and Robinhood accounts, which offer low-fee trading are seeing the greatest surge. Without discrediting people's ability to invest appropriately in the stock market, the current environment feels like fast-money betting rather than "real" investing. The more seasoned investors such as Jeremy Grantham or Stanley Druckenmiller are staying on the side-line. We would rather be on their side rather than investing alongside day traders.

Chart 14. Nikola Corp (Weekly)



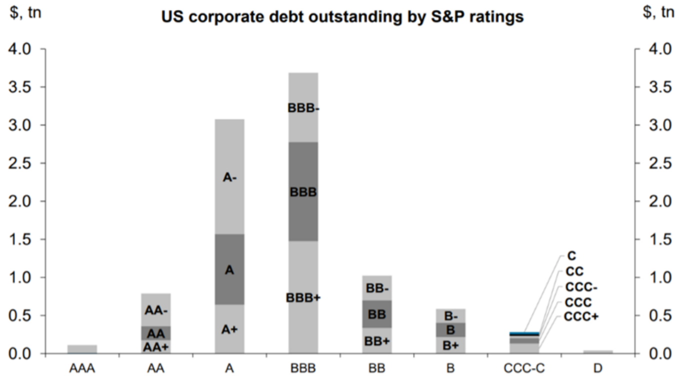
Portfolio Implications. The uncertainty surrounding the current economic recovery makes any "fair value" calculation somewhat irrelevant. No-one can say with confidence whether the S&P 500 Index PE multiple should be 20x or 14x. From our perspective, based on the arguments put forth above, we are happy to keep a very low allocation to equities in portfolios of c. 20-25%. Real value will only emerge once we have a significant downward adjustment in PE valuations either through 1) evidence of higher than expected earnings growth or 2) a reasonable correction in equity market prices. We keep an open-mind to all possibilities but for now side with the view that equity markets can correct 10-15% over the coming months. Only when this happen will we be entailed to change equity allocations in portfolios to materially higher levels.

Fixed Income

Corporate Bonds, Only Value Left is in Emerging Markets. US High Yield spreads have managed to tighten from a high of 850bps to 440bps currently. That said, they are still far from the start of the year level of 280bps. This shows that the bond market is more concerned about the economic outlook and the raft of recent bankruptcy filings than the equity markets. The number of credit downgrades far outpaces the number of upgrades, similarly to previous recessions as 2008 **(Chart 16)**. There is a significant risk that part of the $3.7tn of US corporate debt outstanding gets downgraded to junk **(Chart 15)**. This can have ripple effects on bond portfolios and equity markets as corporate borrowing costs will naturally rise.

In a yield-deprived investment landscape, with declining real interest rates and a falling USD, we find better value in emerging market local currency debt.

Chart 15. US Corporate Debt Outstanding by S&P Ratings



Source: S&P, Bloomberg Finance LP, DB Global Research

Chart 16. Last 12-Months Upgrade - Downgrade Ratio

Source: J.P. Morgan; Moody's Investors Service; S&P

Currencies

USD, Bear Market in Sight. USD has almost universally weakened over the past two weeks, consistent with the improvement in risk sentiment. A key factor supporting both positive risk and a weaker USD has been the Fed's aggressive liquidity injections, which have shifted the supply/demand balance away from excess demand toward excess supply. Another key driver of our bearish USD thesis is the widening twin deficit in the US. The US twin deficit currently at -7% of GDP **(Chart 17)** could reach close to -10% of GDP over the coming 2-3 years. Trump's ambition to get re-elected should surely contribute to a worsening of this ratio as he looks to enable further economic stimulus. Historically, a widening deficit has been a leading indicator of USD weakness by up to two years. We have been early on our call for a weaker USD but feel we are close to a turning point.

EUR (Chart 18). The EUR remains cheap relative to its major trading partner's currencies. The crisis has motivated the European Union to link arms more tightly through a symbolic step toward fiscal solidarity and transfers. This is positive for the common currency. Technically, the EUR/USD exchange rate looks ripe for further upside. The exchange rate found support on the 20-year uptrend. Monthly stochastic and momentum indicators are turning up. Market positioning is gradually moving in favour of the EUR. A break above the March highs of 1.156 should lead to a rally towards 1.20 vs. the USD.

Chart 17. US Trade Weighted Dollar (Blue) vs. Twin Deficit (Red)

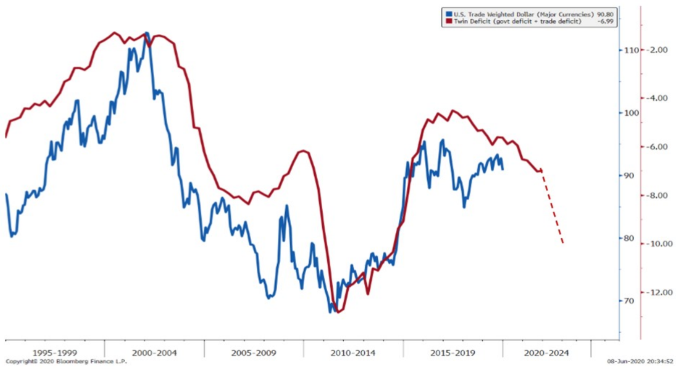
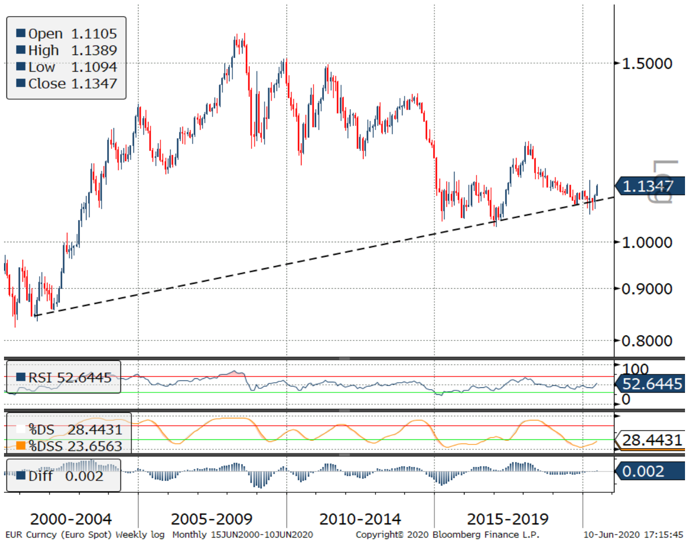


Chart 18. EUR/USD Exchange Rate (Monthly)

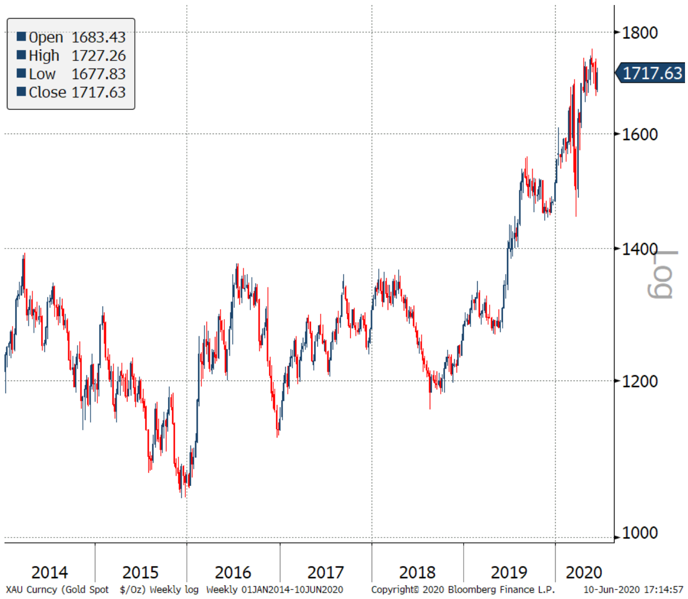


Commodities

Gold's Time to Shine. USD weakness, economic recovery uncertainty, rising inflation expectations and declining real rates is a perfect recipe for continued outperformance of Gold. Gold prices have rallied +40% since we turned bullish in Q4 2018. We continue to believe that pull-backs due to heightened correlation to equity markets should be bought. Our year-end gold price target of $1,800/oz is still in place. A successful break of the 2010 highs ($1,900/oz) would suggest a potential rally towards $2,750 (+60%) longer-term. However, silver is likely to prove the real winner here as it remains much cheaper than gold and will benefit from demand linked to solar panels and data centres.

Investment Implications. We continue to recommend lower than 10% allocation to the USD in EUR accounts and over 10% allocation to EUR in USD accounts. We continue to recommend a 3-5% allocation to gold and silver across all portfolios with a "buy the dip" strategy. We still recommend limited exposure to US and European high yield markets. Should we look for exposure in high yield, we would favour shorter maturity debt which is the target of ECB and Fed purchase programs.

Chart 19. Gold Spot Prices (Weekly)



As always, please let us know should you have any questions,

Kind regards,

MAM Investment Team