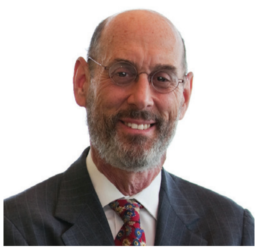
SEGALL BRYANT & HAMILL

4TH QUARTER 2020

SBH NEWSLETTER

Thoughts on the Current Environment



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"The more tasks you give to central banks, the more they're dealing with trade-offs associated with political choices."

-Stephen King, Senior Economic Adviser at HSBC Holdings plc

This Halloween, Fear Zombies and FAANGs

The summer of 2020 was hot in a variety of ways, but all the heat did not slow the recovery of the financial markets in the third quarter. Social unrest, the struggles of a global economy fighting to recover from a pandemic, great wildfires in the western part of the U.S., and an election season were pretty much shrugged off by a bull market with the bit in its teeth and the need to run.

Some suggest that the market has its "seeing eye" in place and can peer into the future and foresee a global recovery ahead. Some suggest that investors are being forced further and further out the risk curve due to the determined efforts of the global central banks to stimulate their economies—and inflation—no matter what the cost. As a result, investors may find they have no choice but to buy equities as it is the only asset class capable of producing sufficient returns that can allow stewards of capital, be they the trustees of an endowment or pension fund or a couple living on retirement savings, to cover their future spending. We enter the fourth quarter, confronting both a strange election season and a very unusual set of financial market metrics.

To find some guideposts, we can revert to the old adage: some things you know, some things you have a strong hunch about, and some things are just guesses.

Forecasting a global economic recovery and all that goes into that—forecasts of gross domestic product (GDP), inflation, interest rates, stock market valuations, to name a few—turns, just as it has since Day 1 of the pandemic, on knowing when global health is restored and it's safe to creep back into the lives we once knew as herd immunity levels are reached.

The most likely path to herd immunity is with the approval of a vaccine or vaccines. How soon that happens and how effective (and safe) they prove to be, and global adoption of said vaccines, will define the timing and scope of a resumption of "normal" life. Forecasting without a good estimate of when that will occur is akin to tossing a coin.

In their efforts to rescue the economy, the monetary authorities of the world (central banks) and the fiscal authorities (the legislatures) have pulled out all the stops, incurring vast amounts of debt, both in absolute terms and relative to the size of their economies. It has worked, but it remains to be seen whether the cure will prove worse than the disease.

Massive borrowings are likely to provide economic stimulus, and have paradoxically driven interest rates down to zero (and below) even as levels of debt soar. Interest rates have not been this low in the recorded history of finance.

Without the signaling power that interest rates provide their economies, it is next to impossible to know whether financial assets are expensive or cheap. The remote work environment has created an additional unexpected variable on real estate valuations, whether residential or commercial.

By traditional metrics of valuation, financial markets are expensive. The Cyclically Adjusted Price to Earnings Ratio, also known as CAPE or the Shiller P/E Ratio, adjusts past company earnings by inflation to present a snapshot of stock market affordability at a given point in time. This ratio has reached levels it has seen only in 1999 and 2008.

Equity markets—or, at least, the major market indices—are being driven higher by a small group of stocks. The so-called FAANG stocks (generally thought to be Facebook, Apple, Amazon, Netflix, and Google, usually with Microsoft added in) have come to represent approximately 24% of the total value of the S&P 500® Index. Since the S&P 500 is a capitalization-weighted index, the returns of the largest holdings have a disproportionate effect on the return of the whole index. For the third quarter, the S&P 500 returned +8.9% on a total return basis but only +6.8% on an equal weighted basis. For the year, the S&P 500 returned +5.6% on a total return basis but the S&P 500 is down 1.8% when excluding the five largest holdings.

Such concentration has historically marked a peak for the equity markets. Bulls contend that lofty valuations are warranted, due to the strength of the business franchise each of these companies has shown in recent years and especially in the time of the pandemic. The fact remains that when allocations of a group or a sector grow to levels such as we see for the FAANGs now, the stocks have reached the end of their run. That happens right about the time the justifications for the ultra-high valuations become the most erudite.

The strength of the FAANG stocks has masked significantly poorer operating results for the rest of the market. Over the 12 months (LTM), profits for the popular FAANG group have increased 5% while the remaining 495 companies have declined 21%. Most companies in the S&P 500 have been negatively impacted by the current environment, which may be more reflective of the state of the economy than the experience of the FAANGs.

One of the by-products of a zero-interest rate regime is that low rates may be keeping alive many companies that, in the normal course of events, would be merged out of existence or should have gone bankrupt. Instead, they are able to stay in business and are referred to as "zombies" as they price only to stay alive, day-to-day, sucking profitability out of the system.

The stated policy of the Federal Reserve Board has been modified of late to include a 2% target for inflation. The study of the economy and markets in Japan may shed light on current conditions, as for almost 30 years, despite the best efforts of the Japanese Central Bank, Japan has experienced stable to falling prices during this entire period.

The Nobel Economics Laureate Milton Friedman was surely correct when he observed that inflation was forever and always a monetary phenomenon. What he may have appended onto that statement was the observation that how inflation would manifest itself was open to the vagaries of human emotion. For instance, in the '70s, inflation was fueled by excessive growth in the money supply. In the '80s, the Boomers came of age and demanded housing, schools, offices, shopping centers, and the like, creating inflation in goods and services. The inflation we have seen since 2009, when money supply grew well in excess of needs, has played out solely in the financial markets. (We call this kind of inflation a "bull market.") The price of shoes doesn't go up in this kind of inflation. Rather, the prices of the shares of the shoe manufacturer rise.

The cost of servicing the global debt burden is at risk of getting out of control if either the global economy falters or interest rates rise due to a return of goods and service inflation.

For this among other reasons, a major concern of thoughtful people is that the traditional kind of inflation returns in force. For several reasons, we do not think this is likely. One primary reason is the rise in the degree of technological innovation in the global economy. Technology is a powerful deflationary force, which drives prices of goods lower and lower. It allows service companies to substitute self-service kiosks and the like for labor. Second, the massive debt overhang is a deflationary force. Debt is in and of itself deflationary as it pulls demand forward, thereby reducing future demand. And lastly, slowing population growth will slow the demand for goods than services.

Beyond this list, we can offer you one stone-cold certainty: Your portfolio at SBH will be managed with all the skill and care we possess, always with a mind on the objectives of your portfolio and the risks being taken as we work to meet those goals, through the idiosyncrasies of 2020, the upcoming election, and beyond.

Stay safe.

MARKET BAROMETERS
AS OF 9/30/20

	Oct. 1, 2019	4Q19	1Q20	2Q20	3Q20	Sep. 30, 2020	Low	High
Dow Jones Industrial Index	26,573.04					27,781.70	18,591.93	29,551.42
S&P 500 Index	2,940.25					3,363.00	2,237.40	3,580.84
Russell 3000 Stock Index	1,720.12					1,968.09	1,288.04	2,089.83
Russell 2000 Stock Index	1,493.43					1,507.69	991.16	1,705.22
Russell Midcap Growth Index	1,125.32					1,393.33	844.03	1,453.14
Bloomberg Barclays Aggregate Index	2,224.72					2,376.13	2,204.91	2,400.81
Barclays Muni Bond Index	1,263.08					1,313.92	1,174.65	1,318.95
Gold (Price/Oz) London AM Fix	1,466.10					1,883.40	1,455.00	2,061.50
Goldman Commodity Index	2,385.52					1,726.81	1,249.25	2,642.50

Source: Bloomberg.

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