STEWART CAPITAL

Market Commentary – Third Quarter 2020

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A Long Slog to the Finish...

Can this year get any stranger?

A once-in-a-century pandemic, a historic economic dislocation, a sharp sell-off in securities markets only to have them bounce back with a vengeance, an election process that saw a supposed front-runner nearly get eliminated only to make a stunning come-back to be the eventual party nominee, a debate that seemed more like an argument between school children, the death of a justice of the Supreme Court and contentious nomination of her replacement, and now the president and his wife becoming infected with COVID-19 just a month before the election. And that is just in the United States!

Yet, in the end, isn't it all just noise?

Magicians practice sleight of hand, making you focus on one thing so that you don't notice what he/she is really doing and making things seem to appear or disappear as if by magic. We are not suggesting that the problems of pandemic and the bluster of the presidential election aren't real, but don't they just distract from what is happening?

In our mind, while the pandemic has certainly had a negative impact on the health and well-being of many people, and while it certainly brought economic activity to a screeching halt in the United States and the world, in reality, many of the actions taken to get the economy going while not taking unnecessary risks simply fast-forwarded a number of trends that have been in place for a decade or more.

Tele-work, Retail Spending and Scale

While some businesses had begun using services like GoToMeeting and WebEx for certain sales calls, the pandemic really accelerated the need to find ways of communicating across space in real-time while sharing information. Businesses quickly adopted team communications tools like Zoom, Teams, Skype and G Suite to allow employees to both meet with clients and prospects and continue getting work done.

Many businesses saw a significant decline in travel and entertainment expense, which may have helped their bottom line, but hurt the bottom line of those hospitality and service businesses dependent on business travel. Hotels that cater to convention and business travel, for instance, have not come close to recovering. One of the more well-known casualties of this process was Chicago's Palmer House hotel, which was foreclosed upon by its lender, Wells Fargo. The Palmer House has seen its property value plunge by more than 45% to $305 million from its 2018 value of $560 million, well below its outstanding debt of $332 million (Source: *The Wall Street Journal,* "Grand Chicago Hotel in Foreclosure, a Symbol of Covid-19's Toll on Hospitality Industry," by Peter Grant, September 22, 2020).

According to the US Census Bureau, retail sales have certainly rebounded with a vengeance. Retail sales and food services, excluding motor vehicles and parts and gasoline stations (retail sales), declined approximately $62.5 billion from the end of February to the end of April of this year. Since then, retail sales have rebounded sharply to $389.8 billion, or nearly $10 billion higher than the February peak. People are spending. Unfortunately, spending is not uniform across the retail sector. Among the retail sub-sectors still below the February peak are furniture and home furnishings stores, electronics and appliance stores, clothing stores (accessories, men's, women's and shoes), department stores, miscellaneous retailers, fuel dealers, and food service and drinking places.

So far, 23 firms have declared bankruptcy since the beginning of the pandemic, including: Stein Mart, Ascena, Tailored Brands, Lord & Taylor, Brooks Brothers, GNC, J.C. Penny, Neiman Marcus, J. Crew and True Religion (Source: *Retail Dive,* "The running list of 2020 retail bankruptcies," September 14, 2020). We would expect others to follow suit and expect a plethora of small business retailers to exit as they can see no way forward – particularly with mall traffic down and limited Internet channels for smaller retailers.

Malls don't seem to be making the process any easier as many have cut hours in response to lighter traffic. This ends up creating a minor death spiral, as potential customers get to the mall near the end of the day during what had been normal mall hours only to be turned away because the mall (and store) was closing. The answer for many? I'm going to buy it on Amazon…

Which brings us to the issue of scale. Scale allows businesses to gain many advantages over their competition and allows one to operate in an environment that may not be hospitable to smaller players. Scale allows you to get better deals on shipping, and to cut better deals for products and services because you simply sell more than your competitors. You can also afford to spend more on brand building as the cost is spread over a greater sales volume and scale gives businesses advantages in R&D. Nowhere was this as evident as it was in the results for Amazon during the pandemic.

While retail sales declined by $52.85 billion or 3.87% from Q1 to Q2 of this year, Amazon saw its sales (online, physical stores and third-party sellers) rise more than $12 billion. No doubt, many of you ended up doing the same thing when faced with the inability to find something locally or not able to get out because of a shut-down— you just decided to buy it on Amazon. Indeed, with many companies struggling to figure out how to keep themselves afloat and pay fixed and employee costs through the pandemic, Amazon generated $13 billion in free cash flow during Q2 2020 (Source: Amazon Corporate filings).

The Economy

The economy has rebounded quite nicely, and even though the unemployment rate continues to be elevated, we are encouraged by what we have been seeing from the data.

As stated above, retail sales have rebounded sharply so that the retail sales of goods are now above their pre-pandemic levels. Food service and drinking places are really the only retail establishments meaningfully below pre-pandemic levels, and that is more a function of seating restrictions than the desire of people to go out to eat (or drink).

Purchasing Managers Indices (PMI) for manufacturing (whether Markit or ISM) are well above the 50-level, indicating continued expansion (ISM Manufacturing is at 55.4 and the Markit US Manufacturing PMI is at 53.2). The services sector also appears to be expanding, with their PMIs also well above 50 (ISM is at 57.8 and Markit is at 54.6).

In fact, the only real area of weakness appears to be jobs, with the unemployment rate sitting at an elevated 7.9% (down from 8.4% in August), with 12.5 million currently seeking work according to recent data from the Bureau of Labor Statistics. What keeps us encouraged, however, is the amazing (to us anyway) fact that even at the bottom of the pandemic-driven recession, the number of job openings never declined below the ***peak*** of job openings prior to the Great Recession of 2007–2009. Indeed, after bottoming at 4.996 million jobs in April of this year, the number of job openings has rebounded to 6.618 million as of July. If, as the market expects, the number of job openings stays relatively flat to the July data, then the net available labor pool (which we define as unemployed persons less available jobs) will sit at approximately 7 million people, or where we were roughly four years after the end of the Great

Recession. Put simply, the economy is rebounding as rapidly as it declined. We would not be surprised to see the National Bureau of Economic Research (NBER) date the end of the recession in April or the second quarter (depending on whether you are looking at the month or quarter of the trough).

Outlook

US markets had generally positive returns for the third quarter as nothing really served to push them much in either direction.

The one exception being technology, which had another exceptional quarter, and the tech-heavy NASDAQ rose by double-digits for the quarter, allowing it to far outpace any other standard index, domestic or international, equity or fixed income. Large-cap stocks continue to win the market capitalization battle as those indices are still dominated by the top five to ten names (see our comments on this issue in last quarter's comment).

We continue to be concerned that investors are mis-pricing risks, particularly in fixed-income securities, as current rates allow no room for error. If rates rise, fixed-income returns will turn negative, as even modestly higher interest rates will make current and future cash flows worth less in future periods on a relative basis. (If you buy a bond with a 1% coupon due in ten years at par today and interest rates rise even modestly, you will no longer be able to sell the bond for what you paid for it.) Not that you get much better in the stock market – particularly if you are buying an index fund tied to a market cap weighted index, as most index funds are.

As we write this commentary, domestic (US) equity indices trade between 21.78- and 84.89-times current earnings expectations. The earnings multiples don't get much better if you look forward one year (19.51–34.99X) or two years (17.25–22.68X), they still look elevated. Thought of another way, if you translate the PE (Price/Earnings) ratio to an EP (Earnings/Price) ratio, you can then compare them on a yield basis to corporate bonds. Looked at in this manor, EP ratios are still quite rich (expensive), as the indices trade on EP or earnings yield of between 1.12% and 4.59%. If we compare this to the Bloomberg Barclays Aggregate Baa index with a current Yield to Worst of 2.43%, we begin to get the sense that equities would seem to be, at best, fully valued.

What is an investor to do? With bond yields at all-time lows and equity prices at best fully valued, what does this mean for investors?

Put simply, particularly for those who follow indices, investment returns are likely to be sub-optimal for some time.

We do not see interest rates returning to more normal levels for quite some time. Indeed, Federal Reserve Chairman Powell has indicated as much in that he stated that the Fed would likely maintain its current easy money stance for longer to get inflation to an average of 2% (Source: Federal Reserve Press Release, September 16, 2020). This may prove difficult at best as demographics dampen their efforts to kick-start spending. This should mean bond returns in the low single-digits with occasional dips into negative returns for some time.

Equity returns could at least show better results than bonds, if not by much – particularly those that follow the market cap weighted indices. Lest you think we are being overly pessimistic, Vanguard recently came out with their projections for asset-class returns and they echo our sentiment. (US equity returns between 4.1 – 9.6% over the next ten years depending on market capitalization and style. US fixed returns between 0.4% and 2.8% for investment-grade bonds.)

Our suggestion is and has been to rethink your approach to investments. Fixed income can no longer be counted on as the portfolio anchor or income generator that it had been. If investors need cash flow, they should look to other cash-generating investments like dividend-paying equities and those that absolutely must invest in bonds should do so by staying relatively short-term to minimize value destruction as rates rise (even temporarily). Additionally, investors should look to alternative measures for risk mitigation purposes.

In a presidential election year, anything can happen. We would expect a rather bumpy ride through the election with the ride (potentially) getting a bit worse through to the inauguration.

Strategy Overview

Assuming volatility is on the upswing through at least year-end, we intend to use it to our advantage.

As we indicated last quarter, volatility causes mis-pricings, and mis-pricings lead to opportunities. The trick is to make sure that we, as analysts and investors, are pricing risks and opportunities correctly.

Risk can be your friend if you take it into account when assessing your opportunities. It has often been said that we should look at investing as if we have a partner (Mr. Market) who has manic/depressive mood swings. When he is high on the future he is willing to pay you nearly any amount no matter how ridiculous to buy your investments. On the flip side, when depressed, he is sure that the world is coming to an end and will unload his investments at ridiculously low prices. Our job is to try to determine whether he is overly optimistic or severely depressed and use that to our advantage.

In the end, we have time and patience on our side. Making sure that we are appropriately compensated for the risks that we take as investors is the most important decision we make. Ensuring that our valuation models encompass the risks that we as investors face every day is our primary duty. As risk gets elevated, it is our job to ensure that we adjust our return requirements upward in conjunction.

Importantly, by ratcheting up our return requirements in times of elevated risks, the opportunities end up being at levels that, were we to own the entire business outright, we should be more than pleased with the result.

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