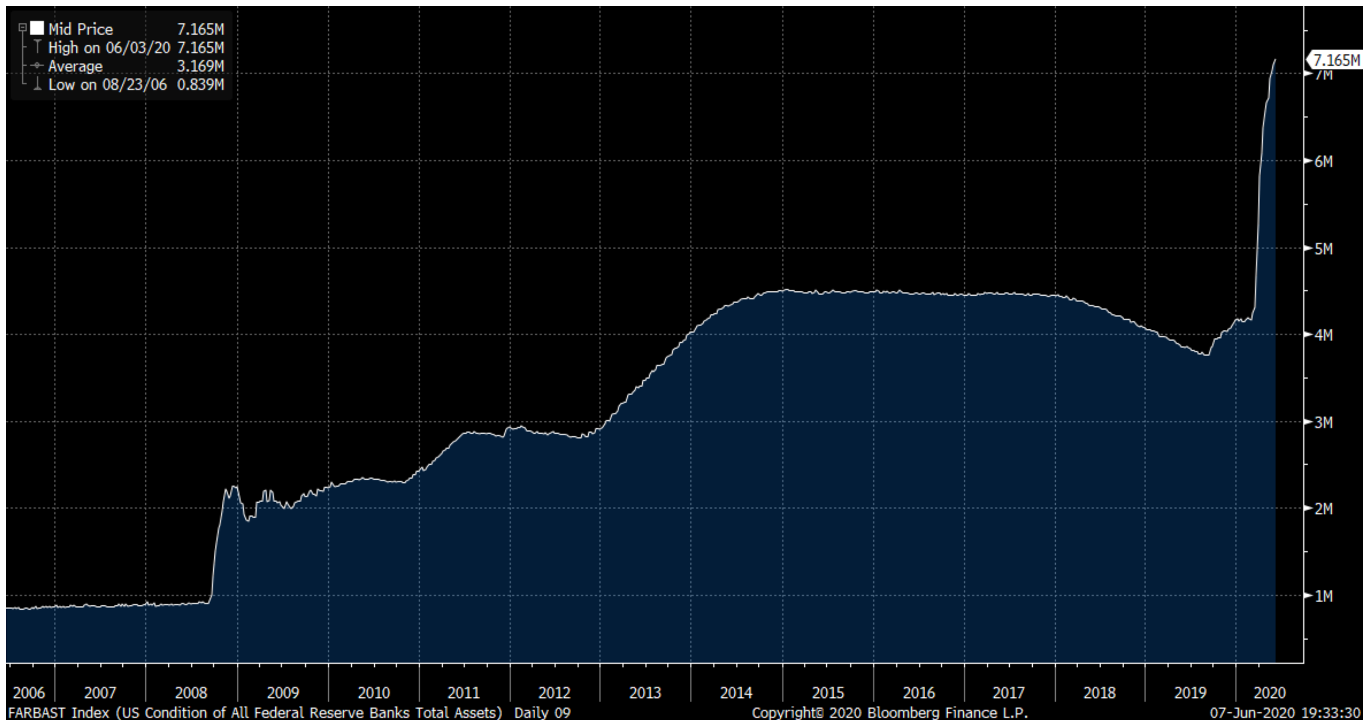
FROM THE DESK OF ERIK OROS

JUNE, 2020

Equities continued their unrelenting ascent in the month of May and into the first week of June as market participants cheered a global reopening and optimism around the recovery abounds. The uncertainty that plagued markets in the first quarter has been eschewed for a momentum driven market, firmed by a seemingly endless monetary and fiscal stimulus. We remain cautious on traditional equities and risk assets generally at this juncture. Markets underpinned by optimism, monetary support, and greed do not present the type of risk/reward that we seek even for our most long-term investors. While we have identified a number of compelling opportunities in the private market, whose prices have yet to reflect the zeal of those traded on national exchanges, our focus given the level of uncertainty that remains around the economic outlook will continue to be on capital preservation and risk first and foremost.

Following a surprise gain of 2.5M in May's non-farm payrolls report, markets pushed to post virus highs, with the NASDAQ composite hitting a new all-time high on June 5th 2020. These prices reflect an astounding level of optimism around earnings. Earnings for the S&P 500 are projected to decline by 12.8% in 2020 to $125.26 per share, compared to $143.70. Consensus projects a recovery to $161.57 in 2021, reflecting 29.0 % growth over 2020 and 12.5% over 2019. This would represent the fastest earnings growth since 1994, a year in which the Federal Reserve hiked interest rates 6 times, topping even 2018 (another year of monetary tightening) when the effects of the tax cut took effect. This optimism is largely a reflection of an unprecedented expansion of the Federal Reserve's balance sheet, driving investors back to the dangerous mantra of TINA ("There is no alternative"), and pressing investors toward risk assets.



Federal Reserve Balance Sheet

Multiples investors are willing to pay for such fast-growing earnings have continued to expand as well, rising to levels not seen since to dot-com bubble of the late 1990s. Despite lingering uncertainty around the ultimate effects of the national lock-down, a potential resurgence of the virus, and the pace of the recovery, investors have been willing to pay more for these highly volatile and indeterminate earnings.

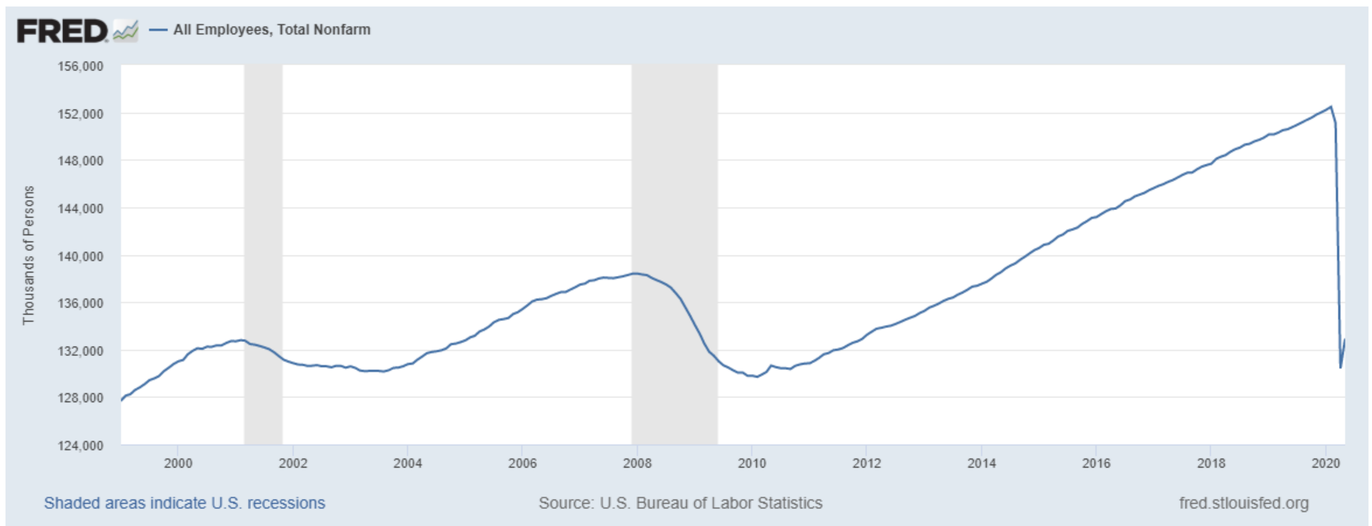
SPX Index - BEst P/E Ratio 25.4991

28.0000
26.0000
25.4991
24.0000
22.0000
20.0000
18.0000
16.0000
14.0000
12.0000

1995-1999 | 2000-2004 | 2005-2009 | 2010-2014 | 2015-2019

SPX Index (S&P 500 Index) Graph 8 Quarterly 31MAR1995-05JUN2020 Copyright© 2020 Bloomberg Finance L.P. 07-Jun-2020 19:40:41

Despite the marginal improvements we have seen in the economic data over the past month, we remind investors that the scope of the economic fallout we have witnessed is likely only beginning, and is historically immense. Joblessness has soared to levels not seen since the Great Depression. Q2 GDP is estimated to shrink by over 30%.



This type of setup in equities is reminiscent of February when we warned that investors faced the dangerous prospect of earnings downgrades paired with multiple contraction. It is during such episodes in which the swift declines in equity prices we witnessed in March can occur.

In April's letter we worried that "equity markets have trembled every instance monetary stimulus has been even remotely threatened." We fear that given the level of recovery in public markets and the dislocation between fundamentals and market pricing, the Fed will ultimately have no choice but to begin to remove its unprecedented accommodation. As was the case in 1994 and 2018, despite lofty earnings growth, the market trembled greatly as this stimulus was removed.

We also ended April's letter with a discussion around risks on the periphery as COVID-19 dominated headlines. Among the risks discussed was the prospect of geopolitical tensions and global trade policy. These risks intensified over the past month as China asserted its dominion over Hong-Kong and trade rhetoric heated up once again. While the market has seemed to shrug off this risk, along with social unrest and the potential for an extremely partisan election campaign, we continue to focus on the potential for these issues to make their way into the market's pricing mechanism.

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