Unprecedented, or Not?

Assessing the current market situation amid global pandemic.

Monday, March 30th, 2020

The month of March brought a global pandemic, and with it, levels of volatility in both equities and credit not seen very often in history. As investors, it is our job to navigate whatever scenario we encounter and to endeavor to create alpha no matter what the conditions. This month was no different.

A Little History

First, a bit of perspective. Is the current markt unprecedented, or not? I maintain that it is not unprecedented. The equity and credit markets have both crashed before, whether that be in October 1987, the Russian debt default and the unwinding of Long-Term Capital Management in 1998, the implosion of the .com bubble in 2000, or of course the GFC in 2008. All these markets experienced crashes followed by some retrenchment from lows, followed by a testing of those lows, and lastly in some cases, the creation of new lows. I don't know why this case will be any different.

I believe that the general psychology of all these crashes is basically the same. An event causes massive short-term uncertainty, impacting people's lives and companies' purchasing behavior. They also present challenges to existing government policy. When these forces combine, they force investors to question the basic precepts of current market conditions and a rapid repricing of assets ensues. The speed and depth of these crashes depends on the specific structure of the market at the time. Characteristics like the extent of leverage against credit and equity assets (e.g. hedge fund leverage in both quantitative and fundamental groups), the behavior of capital pools that utilize VAR management techniques to control risk, the capital available to intermediate between buyers and sellers, the health of banks and financial intermediaries, the actions of the global central banks (followed by the fiscal action which typically came after the initial crash), the extent of leverage against illiquid assets where the leverage has terms that are materially shorter than the underlying liquidity of the assets, mutual funds with daily liquidity holding less liquid assets, and any other levered structure where there is a maturity transformation present, to name a few. I think this crash had the speed of 1987 (it was actually faster, peak to trough) and the illiquidity of the credit markets in 1998. Additionally, large pools of assets had the experience of having managed risk in 2008 and moved quickly to reduce the impact, which had the effect of accelerating the market declines. This was exacerbated by the 2008 legislation that reduced banks' ability to provide market intermediation, fundamentally reducing the liquidity provided by market makers.

Offsetting these negative trends were the rapid responses of central bankers. They flooded markets with short-term liquidity, first announcing the purchase of government bonds and then by actually buying corporate investment grade credits, and finally, by providing term loan funding for less liquid assets. In the US however, there are still assets - high yield and mortgage assets - that are not being supported by these actions (including the recent reintroduction of Term Asset-Backed Securities Loan Facility, or TALF) and as such have suffered the largest and fastest declines.

Following the swift monetary response is a very large fiscal stimulus across the developed world, and, in particular, in the US. Atypically, this fiscal stimulus came much faster than in previous crises and is quite substantial in scale. Funds are heavily focused on the support of consumption and keeping businesses intact so that workers can return to their jobs. All of these are laudable actions.

Where Does This Leave Us?

To attempt an answer, we must first be dispassionate observers of the facts. We must assess these facts while recognizing what we still do not know, and we must use those unknowns to raise the risk that our assessments are not accurate. In effect, we must increase the discount rate required in order to hold assets.

So these are the facts: The disruption to our economy is driven by the governments around the world mandating social distance in an attempt to slow, and hopefully eradicate, the coronavirus. Enforced social distancing is disruptive to economic activity in almost all industries. But we do not know for how long this will continue. The length of our mandated isolation helps to determine the type of recovery we are likely to experience. A brief throttling of just a few months would enable most firms to remain in business and most people to keep their jobs. A longer, more protracted shutdown is much more challenging to model. Workers may get their jobs back, but their personal balance sheets will have been significantly impacted and therefore their marginal consumption patterns will change. This in turn will affect companies' willingness to invest. This is essentially what happens in "typical" recession.

China and South Korea are seemingly capable of returning to some sense of normalcy within two months. At present, their economies are not working at full capacity and are not interacting with the rest of the world as they normally would. Access and travel are restricted. On the other hand, European and US government actions, and most critically, weaker testing regimes are nowhere near as pervasive as they need to be.

Europe and the US Will Be Slower to Recover

It therefore stands to reason that the European and US populations will not return to normalcy any faster. Most likely, they will be slower. This means that we should not expect the large industrial nations to resume normal activities until the fall, at the earliest. It will then take three (for some industries, perhaps six) months for firms to adjust, for individuals to adjust purchasing activity, restart vacation planning, and for travel plans to return to normalcy.

Industrial manufacturers will have to assess how they bring back their labor forces and when to restart capital expenditures and investments. Transportation networks and logistics companies will be hard at work trying to determine how to reconnect the planet. To be sure, the world will return to normal, and it will surpass recent levels of activity as it has in any number of past recessionary events. But the timing is uncertain.

Interest Rates

What impact will global fiscal stimulus have on interest rates? It is critical to understand the level of long term interest rates to understand the retrenchment and then growth of asset levels. "Lower for longer" has been the mantra of the last few years, and it has led to high capitalization rates on real estate and high multiples on equity. If rates are to remain at those levels and not increase, well, that's one thing. If rates however move structurally higher, then that is quite another. If the latter happens, multiples for equities will decline and capitalization rates for real estate assets will rise, making assets cheaper at given earnings and cash flow levels. This is a risk that needs to be considered as markets recover from this crisis.

Finding the Bottom

Let's establish a baseline for how to think about the hit to earnings and how long will take for them to recover. Using the US as a proxy for the world (which is of course not perfect), the S&P 500 in 2020, was predicted to earn between $160 and

$170, so let’s say $165. If we assume that the second and third quarter will be lower than they otherwise would have been, by 25% in the second quarter and 15% in the third quarter, then we would need 10% growth in the fourth quarter to return to the general earnings trend, $183, the earnings level assumed for the following year, 2021. Most analyses have smaller reductions, and only in the first and second quarters. Assuming the third quarter is impacted as well, and the growth thereafter returns to normal (not the 10% mentioned above) then we would arrive at a 2021 number of $175, certainly more conservative than $183.

Of course, these are rough calculations, but let's proceed. To estimate where markets should trade we need to think about the prevailing equity risk premium (“ERP”). Before the crisis let's assume that the ERP was at its historical level of 375. With a ten year risk free rate of 1% (it is less today, 0.7%) then we would have an implied multiple of 21 (100 + 375 = 4.75; 100 / 4.75 = 21). That multiple would imply a market level of 3,675, about 8% above the high before the crash. I think this is a fairly reasonable estimate. In 2008, the ERP got to 900 at the low of the market in March of 2009. In my judgement, the global financial crisis was followed by a protracted return to normalcy.

In 2008, the economic hit to the economy was centered not only in financial institutions but also industrial and consumer businesses, and critically in the stability of important developed countries whose finances were generally believed to be tenuous.

I don't believe this episode will be that dramatic. Fiscal stimulus is coming faster and in substantially greater size. The demand interruption is likely to be limited by the duration of the viral infection curve, which we now know to be a matter of months, not a year or more. And coming into this crisis, the economy was operating at full speed. Of course, this is subject to debate - it is only my judgment. The financial system is awash in liquidity and, if and when demand returns it is prepared to lend, and lend aggressively. So, I would argue that the ERP necessary to test the bottom of this market would need to be only about two thirds to 75% of the historically observed number of 900. That implies a multiple of between 13 and 14 times or market levels between 2275 and 2500.

From this I conclude that the market is likely to test recent lows, and by the end of the year it will likely be focused on discounting 2021 earnings (and beyond) and the ERP will drift down further, allowing the market to move up towards 3000. This would imply an ERP of one half of the historically high ERP of 900.

Equities

In my opinion, all this math means that if you are an investor with cash, then now is the time to think about investing in equities. No one can even accurately choose the exact bottom of the market, so averaging in on a schedule that makes sense to each individual investor is the right thing to consider. Rebalancing portfolios is also a must. Those investors that rebalanced in late 2008 did so not at the bottom (the market fell another 20%), but at a level that provided handsome returns nonetheless.

This is a market in which investors should look for active managers who have outperformed the beta against which they are measured. In my opinion, managers who are actively reducing their beta exposure are not very likely to provide good risk-return profiles in a market that is as volatile as this one. In reduced-beta portfolios, leveraged positions require that risk be managed aggressively, and this comes at a cost that over the cycle doesn't provide a very attractive risk-return profile. Investors should look for managers who can produce alpha - that is the scarce source of premium returns and is truly valuable to investors over the cycle.

Credit

What happens in credit markets? Investment grade credit will be well bid, but there are going to be downgrades of businesses that are over-levered and/or can't survive the demand shutdown. So that's not where I would look at the moment. Furthermore, longer duration investment grade debt carries a great deal of risk should interest rates rise, which has a higher possibility given the size of the fiscal stimulus and the probability that this policy creates some inflation. High yield credit has seen and will continue to see substantial volatility as the dual impact of lower energy prices and a degraded economy take a toll on businesses. But the important question for credit investors is whether bond prices are reflective of these projected conditions. At the present time, prices have been battered and liquidity has been drained from the market. So there is reason to believe that active managers who have navigated this crisis well, have a demonstrated history of taking risk effectively, and who have liquidity are managers to whom it is worth allocating capital. Real estate finance is probably the weakest sector of the credit markets. For one, liquidity is low, and there is a relative scarcity of lenders who will finance security positions. Second, underlying assets are likely to suffer from lower occupancy and delayed interest and principal payments leading to restructurings and potential bankruptcies. Again, prices are quite stressed, so managers with liquidity and knowledge of the market are going to be able to acquire and manage assets with returns that are attractive. The market will be characterized by highly specific factors that are affecting specific assets owned by REITs or properties owned in security structures (Collateralized Mortgage Obligations and non-conforming mortgage securities). Hotels, for example, face a much less certain world, as do retail mall assets. Other property types such as industrial properties or office buildings will recover over different time lines and will have different return profiles. Therefore, differentiation among assets in the real estate complex will be critical, as it has always been. Choosing a manager that can differentiate effectively will be critical. Given the current state of the financing markets and liquidity for these securities and assets, returns will be volatile but for well-financed buyers who can hold them for longer time periods, some of these assets may provide very attractive returns.

Emerging Market Credit

Lastly I'd look at emerging market credits. This market has been hit with significant redemptions and outflows. Given the low level of liquidity generally this activity has led to far wider than expected spreads. While there are some countries that have become distressed, for example, Lebanon and Ecuador, many securities in the emerging markets credit complex are extremely attractive. EM exposure that takes advantage of current spreads but has shorter duration, would be attractive investments in the current environment. Let me explain. Global interest rates are likely to react to the fiscal stimulus. Rates in the long end of the curve are very low as a result of a combination of central bank activity and low inflation expectations. Therefore, longer duration bonds in the Emerging Markets ("EM") complex as well as in the developed world are expensive. While we have seen this condition prevail for the last five years, we now have a catalyst that could change the "lower for longer" mentality of the longer-term rate environment. I'm not saying there will be rampant inflation, but just a little bit will move US and other rates from 67 bps today to 100 - 200 bps higher and that will have a significant negative impact on performance of longer duration EM and other bonds as wide spreads begin to narrow significantly.

As we enter the all-important month of April and reflect on the market during the holidays of Easter, Ramadan and Passover, I encourage investors to think about how their portfolios can better serve the interests of their clients and their own families. We at Aperture will be focused on alpha production, and on the protection of capital where appropriate, in each of our investment services.

Thanks for your forbearance in allowing me the time to express my views.

Stay safe,
Peter Kraus
Chairman and CEO