U.S. MARKET REPORT

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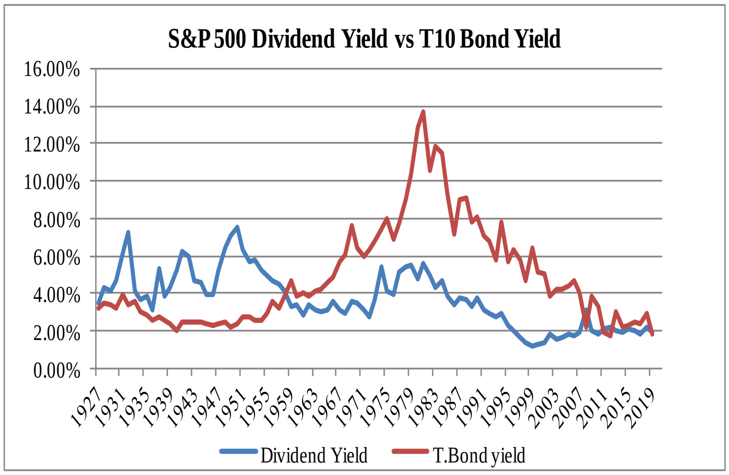
Historic Shift Underway: Stocks Yield More Than Bonds

We are holding higher than normal levels of cash and U.S. Treasuries because of a heightened risk of recession. However, fixed income has become even more unattractive and we expect equities to significantly outperform in the years ahead. For as long as most people can remember, the yield on the ten year bond has been higher than the S&P 500's dividend yield. This made sense because the coupon payments on bonds are fixed. Since dividends grow over time, investors have been willing to take a lower current yield on stocks. However, notice that in the 1930s and 1940s, stocks had a higher current yield because stocks were perceived as more risky (see Chart 1). As growth was sustained in the post war years, investors became less fearful and bid up the price of stocks and caused dividend yields to decline relative to bonds. The crossover occurred in 1959. Interestingly, 60 years later another crossover has occurred and the S&P 500 now has a dividend yield of 1.9%, above the 1.7% yield on the 10-year U.S. Treasury bond. If you can buy a security with a current yield of 1.9%, and those dividend payments will rise, why buy a security with a 1.7% yield with fixed payments? Some may say the answer to that question is to gain diversification into an asset class that is uncorrelated with stocks. But that is changing too.

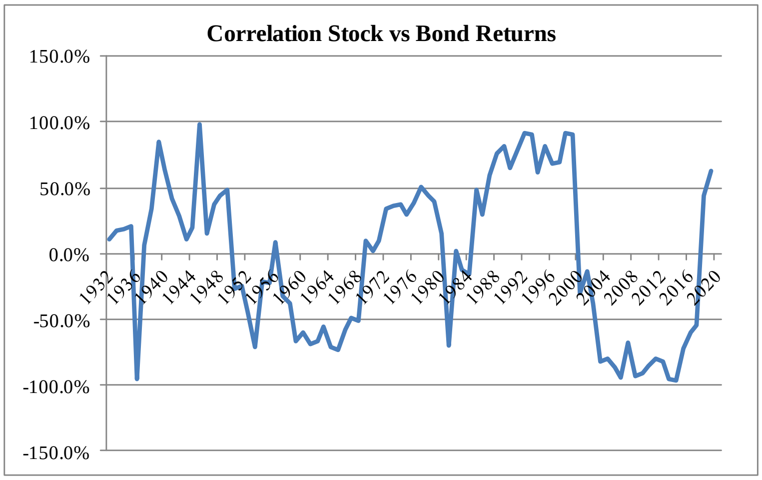
From 1999 until last year, the returns on stocks and bonds were negatively correlated (see Chart 2). That is no longer the case. From today's perspective, we can look back and things make some sense. In the mid-1970s, stocks and bonds had a positive correlation of up to 50% because they both suffered from the great inflation. From the early 1980s until 1999 stocks and bond returns had a positive correlation as much as 90% as they both had strong positive performance thanks to disinflation, lower taxes and faster growth, and the "peace dividend" following the fall of the Soviet Union. Now, again, the correlation has turned sharply higher. Unfortunately, those earlier periods were unique and tell us little about what is happening now. What we can say, is that if stock and bond returns are positively correlated, there is little diversification benefit to owning bonds. And since bonds don't even have a current yield as high as stocks, there seems little reason to own them.

Chart 1



Source: Prof. Damodaran, New York University, FVCM

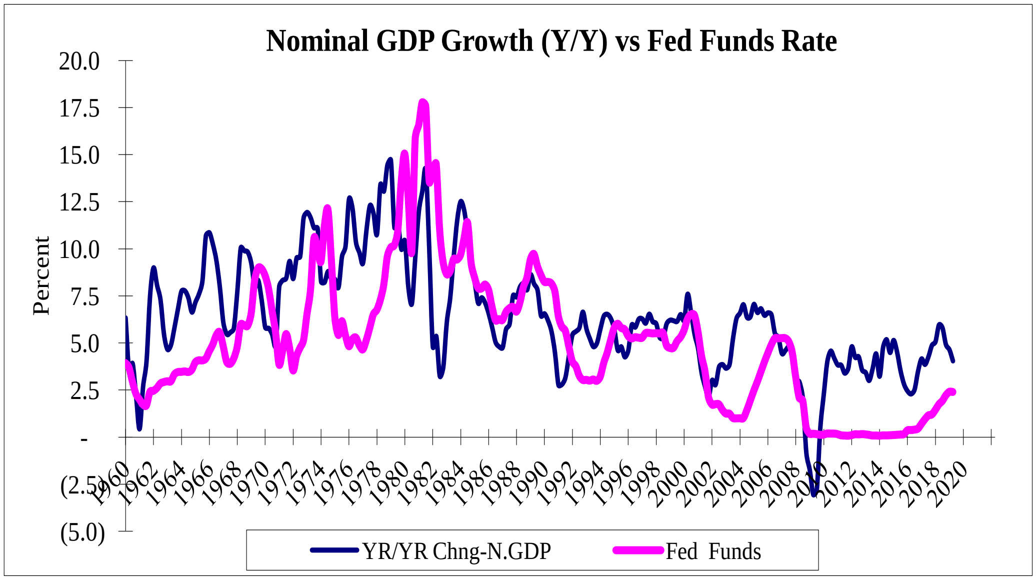
Chart 2



Source: Prof. Damodaran, New York University, FVCM

There has never been a period, to our knowledge, when both stock and bond yields have been so low. As we have written in previous reports, we seem to have gotten to the current circumstance because of the rise in global debt over the past several decades. Central banks are not causing interest rates to be low, interest rates are low because people who spend money are already in too much debt, and people who have lots of money spend very little of what they have. There is a gusher of loanable funds available and few good creditors to borrow. Evidence that central banks do not precipitate events, but rather react to events, is seen in Chart 3. Notice in almost every cycle, the Federal Reserve was increasing the Fed Funds rate *after* GDP growth began to accelerate, and it was cutting rates *after* GDP growth began to slow. The one exception was in 1979-1981 when Paul Volker pushed interest rates up to the sky with the express purpose of choking inflation out of the economy.

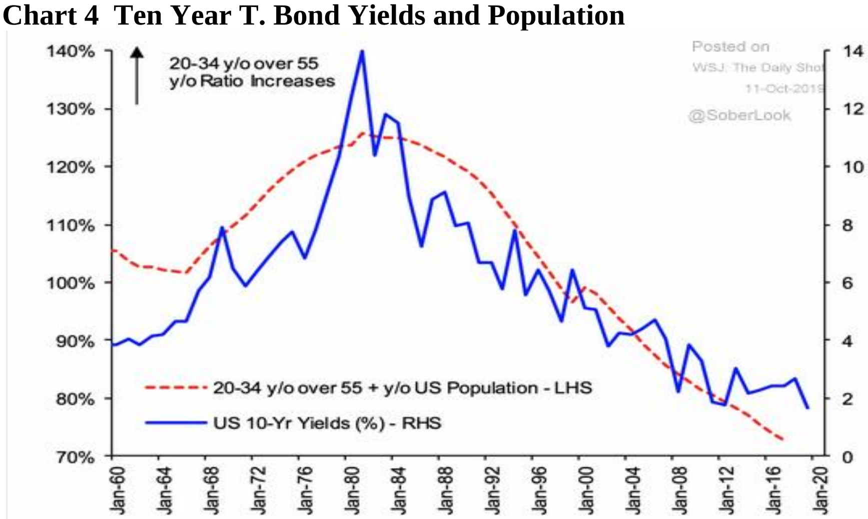
Chart 3



Source: Federal Reserve, FVCM

Another reason that bond yields will likely stay low for long is demographics: The share of the population in the prime work—and spending—years is shrinking relative to more conservative older folks. As seen in Chart 4, there does seem to be a relationship between the group of young adults entering the labor force and 10-year Treasury bonds. Young people need to buy homes, furniture, automobiles and all other types of material items and many use debt to do so. The shrinking portion of this younger group does not bode well for spending. It's also noteworthy that the low-spending, low-growth, low-interest rate environment first began in Japan in the 1990s. Japan's demographic implosion was among the first to begin.

Chart 4 Ten Year T. Bond Yields and Population



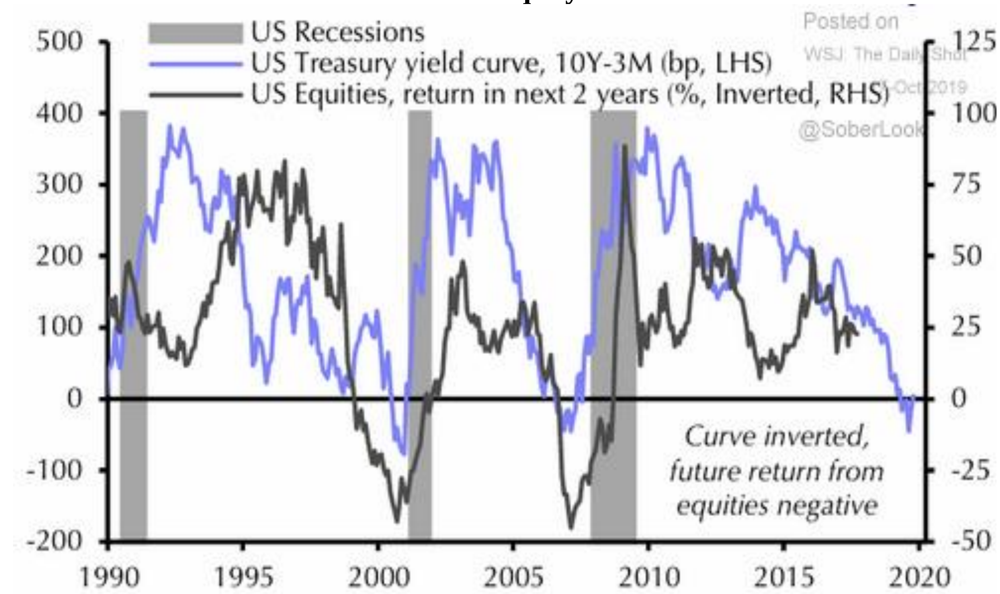
Source: Wall Street Journal, Institute of International Finance

The obvious implication of low yields is that investors are unlikely to achieve the returns experienced in the past. Clearly both nominal and real returns in bonds will be minimal. As for stocks, we expect long-term equity returns to approximate 7% annualized, down from the 10% annualized returns during the past 100 years or so, largely because inflation is running lower than it has historically. In real terms, a 7% nominal return on equities would equate to a 5% real return (annualized) if inflation runs at 2%, which appears realistic at this juncture.

Near Term Outlook for Stocks Still Risky

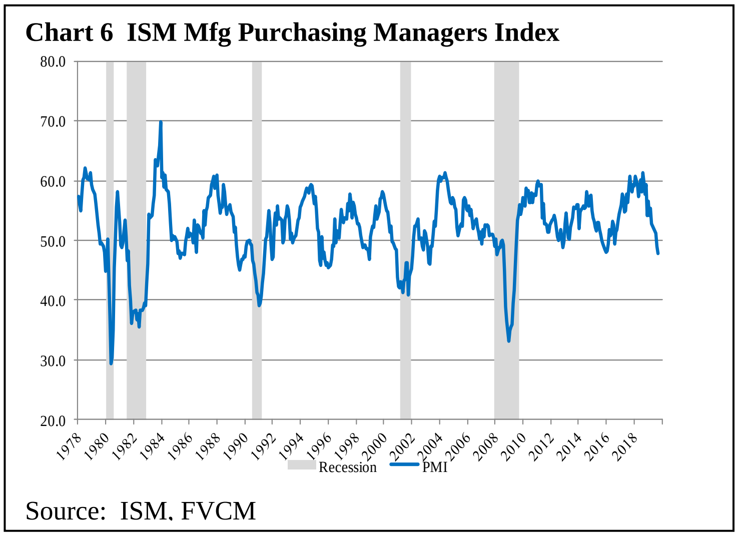
While equities remain the best option for long-term investors, and the yield curve recently turned positive again, there remains heightened risk in the near term. An inverted yield curve is one of the best indicators of a coming recession. The yield curve had recently been negative by about 0.50%. Motivated by that signal, the Federal Reserve cut the Fed Funds rate by 0.25% at both the July 31st and September 18th meetings. At this time, the 3-month Treasury is yielding 1.66%, below the 1.77% yield on the 10-year bond, and the yield curve is positive again. The problem is that this is a common occurrence. As shown in Chart 5, the yield curve (violet line) went negative before the last two recessions, but then went back to positive just before the start of the recession. Stock prices (black line, inverted), started downward movement at about the same time the yield curve turned positive again. Here is the possible explanation: The Fed raises short-term rates during an expansion only to then realize they went too far and the economy is experiencing a slowdown. So the Fed starts to reduce interest rates, as they did in July and September 2019, but the easing typically comes too late.

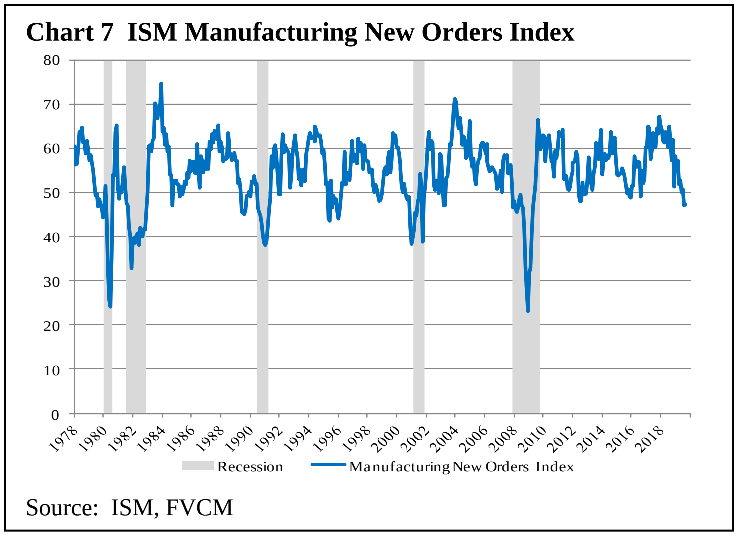
Chart 5 U.S. Yield Curve and Future Equity Returns



Source: Wall Street Journal, Capital Economics

In addition to the action in the U.S. Treasury yield curve, our concern about a recession has only increased as other indicators have turned south. For example, the Institute of Supply Management's (ISM) Purchasing Managers Index (PMI) for manufacturers had been solidly in growth territory when the yield curve inverted. But that is no longer the case. Both the PMI index and the new orders index fell below 50, signaling contraction, as of the August reading. This is still not conclusive because the PMI index for non-manufacturing, which covers the biggest part of the economy, remains positive today. However, one must wonder whether that will still be the case in a few months. It is because of these concerning signals that we think prudent investing justifies holding above average cash levels, including funds parked in U.S. Treasury securities.





Investors Chasing Growth and Yield

The big tech oriented stocks have dominated the performance of the S&P 500 this year, and with interest rates falling, bond proxies have also done very well. Just 30 out of the 500 companies in the S&P 500 produced 10.1% of the 19.9% year-to-date gain for the S&P 500. The biggest contributors were Apple (Info Technology sector, up 54%), Microsoft (Info Technology, up 35%), Facebook (Communications Services, up 42%), Alphabet/Google (Communications Services, up 21%) and Amazon (Consumer Discretionary, up 17%). And yet, such discrete, rather arbitrary periods of time, i.e., year-to-date, don't always tell the full complexity of the markets. For example, Amazon is up 17.3% year-to-date and is one of the biggest contributors to the S&P 500 because of its large size but, for the past 12 months, Amazon is actually down 1.5%. There has been constant churn in terms of the individual stocks and best performance. But what has been apparent, is that the markets have been largely ignoring "value factors" like P/E and Price/Book and Value ratios. Perceived safety and sustainability of growth have been most rewarded in this era of slow economic growth. But even that does not come close to providing full color to the markets. Apple, looks spectacular with its 53% gain this year, but it only came after a 32% plunge during the fourth quarter of 2018. From its peak, Apple's shareholders have had a wild ride and are up a much more modest 6%. Stocks are trading on confidence, which seems to come and go very quickly.

The Real Estate and Utilities sectors have performed very well thanks to their perceived safety and relatively high dividend yields. Fear and uncertainty, as is often the case, are major factors in investor behavior. Real Estate Investment Trusts, which pay nearly all of their earnings out in dividends, as well as utilities, tend to perform well when interest rates are falling, as they have this year. As we discussed earlier in this report, stocks that have growing and high dividends are more attractive than bonds, with their fixed coupon payments. Nonetheless, there are risks in this sector as well. As everyone knows, real estate cash flows and asset values can swing wildly with the business cycle. And, as we recently saw with the bankruptcy of Pacific Gas & Electric, the heavily regulated utility sector is not without risk. Looking ahead, there certainly appears to be more downside than upside in most of these stocks.

Markets move in long cycles, and the dominance of Value stocks should return. There have been recent signs that growth investing is losing some momentum. The recent collapse of the proposed WeWork initial public offering (IPO), as well as the negative performance of Uber and other "unicorn companies" is reminiscent of the last time a boom in growth stocks came to an end. By the beginning of the year 2000, discussion in the financial press turned to "cash burn" among some tech and other growth stocks, especially those that had recently gone public. Interestingly, WeWork has ignited new emphasis on profitability and cash burn. Even Masayoshi Son, CEO of Softbank in Japan, has now instructed his people to push their investment companies for profitability rather than unlimited spending for growth. The tech sector is by no means as overvalued as it was in 2000, but there clearly are excesses. This change in zeitgeist towards current profits could be a leading indicator of the return of value investing.

Table 1 S&P 500 Sector Data, as of 23 October 2019

S&P 500 Sector	% of Portfolio	Price % Chg YTD	Tot Ret % 12 Months	Market Cap ($ Mil)	EPS GR% 3 Year LS	EPS GR% 5 Year LS	P/E FY1	P/E FY2	Div Yld %	P/Book TTM	P/CF TTM	EV/Sales TTM
INFO TECHNOLOGY	21.8%	33.0%	18.3%	493,506	25.9%	20.2%	22.2	19.7	1.4%	7.7	16.0	4.7
REAL ESTATE	3.3%	31.7%	35.1%	40,749	20.0%	16.1%	21.9	20.6	3.0%	3.8	18.6	9.9
COMMUNICATION SVC	10.5%	25.0%	14.6%	445,739	30.2%	27.3%	18.9	17.4	1.3%	3.5	10.4	3.6
UTILITIES	3.5%	24.8%	27.2%	48,173	5.7%	5.8%	20.9	19.7	3.1%	2.3	9.9	4.4
CONSUMER DISCRETIO	10.1%	24.0%	16.7%	315,875	46.9%	44.2%	23.5	20.9	1.3%	7.9	13.4	2.1
INDUSTRIALS	9.3%	23.3%	12.0%	69,997	18.0%	10.5%	18.2	15.7	1.9%	4.8	12.0	2.1
CONSUMER STAPLES	7.5%	22.8%	20.4%	163,630	9.0%	5.3%	20.7	19.4	2.8%	5.8	15.7	1.7
FINANCIALS	13.0%	20.9%	13.0%	186,740	17.9%	12.3%	12.9	12.3	2.2%	1.5	10.1	1.0
MATERIALS	2.7%	16.4%	20.0%	42,298	11.2%	7.1%	19.4	16.9	1.9%	2.0	9.9	1.9
HEALTH CARE	13.8%	9.8%	6.3%	128,601	18.9%	12.6%	16.0	14.7	1.8%	4.3	11.9	1.9
ENERGY	4.5%	4.4%	-10.3%	141,596	92.2%	4.4%	20.6	17.1	4.0%	1.4	6.7	1.3
Portfolio Avg/Total	**100.0%**	**19.9%**	**11.1%**	**257,633**	**25.7%**	**17.7%**	**18.5**	**16.9**	**1.9%**	**3.4**	**12.1**	**2.3**

Source: Zacks

As first noted, we are holding higher than normal levels of cash and U.S. Treasuries because of a heightened risk of recession. Nonetheless, we have no plans to reduce equities further since stocks remain the most attractive long-term asset class. Should there be a decline in stock prices in the months ahead, we would be very pleased to use our U.S. Treasury holdings and cash positions to increase equity exposure to the limit while de-emphasizing fixed income. The one exception to this scenario would occur if an extreme candidate from the Democratic party appears to be heading towards winning the November 2020 election for the U.S. presidency. A policy of high taxation, sharp increases in government spending and greater regulation of business, would result in sharply lower economic growth. In such a scenario, interest rates in the U.S. would likely turn negative and long bonds would be the most attractive asset class. This seems not likely to happen, but we do need to keep a watchful eye.
