Unsustainable Disconnect

The stock market is not the economy. The former is recovering while the latter remains in critical condition. The question on many investors' minds is how has the S&P 500 recovered so dramatically from its March implosion while economic data both in the U.S. and the rest of the world keeps getting worse? The simple answer is that the market is forward looking whereas economic data reflects the past. Unprecedented levels of fiscal stimulus and monetary intervention (see below chart) along with expectations for an improving economic outlook have largely fueled the 28% recovery in the S&P 500 from its March 23rd lows, leaving the Index down 15% from its February highs.[1,2] The main risk for the stock market is that the market sells off to match the grim condition of the economy rather than the economic data catching up with investors' optimism about the future. We do not have a strong opinion on how this disconnect will resolve itself; only that the disconnect itself is unsustainable.

As the market reaction shows, the tools at the government's and Federal Reserve's disposal to support the economy and markets are immense and should not be underestimated. In theory, Congress could do away with taxes, the Treasury could issue unlimited amounts of debt to be purchased by the Federal Reserve and the Fed could keep interest rates at 0% forever, or even set them at a negative rate (as the futures market is pricing in for 2021). The Fed could even move from buying corporate debt to directly purchasing U.S. equities. The major risk of these

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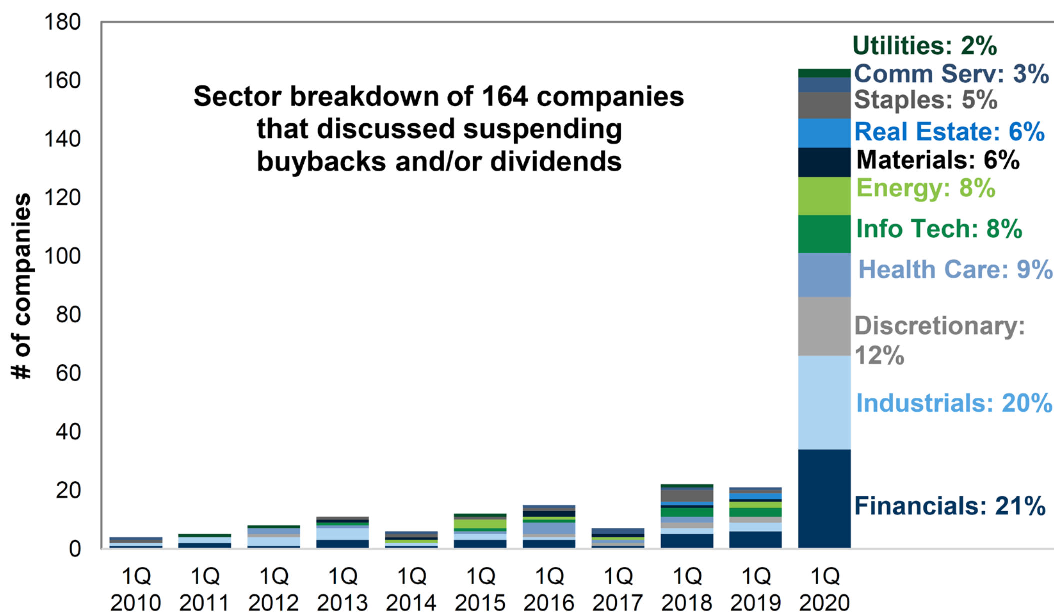
tactics is that they cause interest rates and inflation to jump – requiring major tax increases and rate hikes to prevent runaway deficits and inflation. For now, that is an outcome many investors would welcome. We should note that the Japanese (aside from cancelling taxes) have embarked on this low interest rate, high government debt-to-GDP-ratio experiment for decades without major market shocks. The result has been lackluster growth as individuals save more (since they can't earn any interest income on cash) and as poorly run companies stay in business and remain a drag on the economy (since they have access to cheap capital). Such companies are called "Zombies."

In the short-term, markets are prone to outsized moves up or down based on changing investor sentiment. In the long-term, markets tend to track economic and company fundamentals. The challenge at the moment is that the potential range of future outcomes for the economy and companies is so varied that it is difficult to speak about fundamentals other than saying they are currently bad. Management teams of public companies seem to agree and thus have broadly withdrawn future sales and earnings guidance. Further illustrating the current level of uncertainty, there has been a huge jump in the number of companies discussing stock buyback and/or dividend suspensions (see below chart).[3] So while we usually would like to have a discussion about the market's valuation to inform our advice on investing, the reality is that such a discussion is meaningless when sales and earnings could either be down 50% next year or back to 2019 levels.

Exhibit 5: 164 companies discussed suspending buybacks and/or dividends this 1Q earnings season compared to 21 firms in 2019
as of May 11, 2020



Of the total 429 released earnings transcripts, 164 S&P 500 companies mentioned "withdr", "suspend", "pause", or "pull" as well as "buyback", "share repurchase", or "dividend" within one paragraph in their earnings transcripts.

Source: Thomson Reuters, Goldman Sachs Global Investment Research

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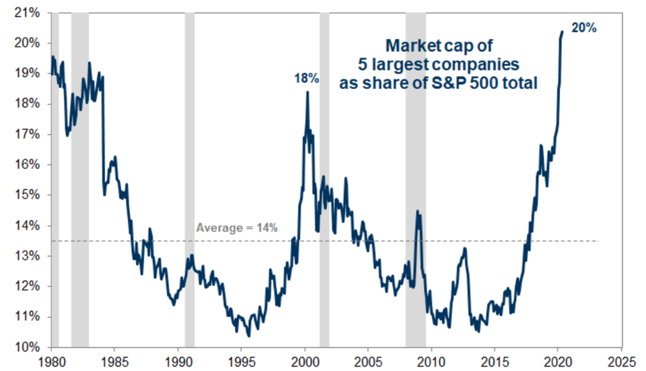
One has to wonder how consumer and business behavior will change and their implications. As state lockdowns are lifted, businesses might open their doors; but will foot traffic be anywhere close to what it was last year? Anecdotal evidence thus far in places like Texas and Georgia suggest the answer is no. Until there is an effective vaccine (and perhaps for some time after), it is hard to imagine people being as comfortable dining at restaurants, traveling for business or leisure, commuting on public transport, etc. And given the scale of job losses, we think the personal savings rate will eventually increase – hurting consumer spending – as households seek to build more robust "rainy day" funds. In the face of weaker consumer demand, businesses are unlikely to ramp up investment spending. Unfortunately, the reluctance of consumers and businesses to increase spending is not a problem that the government or Federal Reserve can easily solve for. Economic confidence will only return once people are confident that they can resume their normal lives.

It is fair to say that we think the balance of risk for stocks leaves more room to the downside than upside, but that doesn't mean that we think the market is uninvestable. The current downturn has caused investors to reassess the valuations for "essential" companies. Firms that provide vital business and consumer services – especially those with resilient business models and strong balance sheets – have recouped much of their stock market losses over the last month and in some cases are trading close to all-time highs. There are only a few companies that provide key services, have stable business models, strong balance sheets and a steady or growing end-market. Accordingly, investors are rewarding such firms with valuations that price in a scarcity value premium.

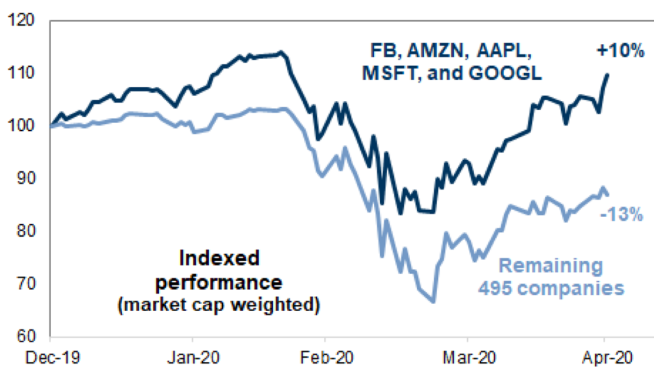
Whereas the median stock in the S&P 500 trades 23% below its record high, many technology, healthcare and consumer staples firms have recouped their losses.[4] In fact, just five companies – Facebook, Apple, Amazon, Microsoft and Alphabet (Google) – colloquially known as "FAAMG" – now constitute over 20% of the S&P 500 Index (and are all are up for the year). As illustrated in the below charts, these companies have carried the market and together account for the greatest top-5 company market cap concentration since the 1980s.[5] Certainly there are more than five stocks that will survive this crisis and perform well in the future, but their strong performance demonstrates the degree to which investors are rewarding perceived long-term business stability despite significant medium-term uncertainty over profits and cash flows.

Exhibit 1: Concentration of market cap in the largest stocks has surged
as of April 30, 2020



Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 2: FAAMG has outperformed YTD; the rest of the index has stagnated
as of April 30, 2020



Source: FactSet, Goldman Sachs Global Investment Research

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The market performance since the March lows could also be telling us that there really is no alternative to equities. With interest rates at or close to 0%, investors cannot achieve meaningful returns unless they own stocks. Owning bonds at today's yields is more of a bet that yields are going negative; thus, buying Treasuries is now for capital appreciation rather than income. Another possibility is that the stock market is anticipating a future benign inflationary environment that benefits asset prices – in which case cyclical companies will eventually outperform along with gold and inflation-linked Treasuries (or TIPs).

As we noted last month, if you need cash in the next 6-12 months you should still consider de-risking your portfolio. For those with a longer-term horizon, we largely recommend maintaining your current positioning. To the extent you want to increase your stock exposure or reallocate your capital, we recommend companies in the technology, health care, consumer staples and even utilities sectors (the latter especially for dividend-seeking investors). If you are going to put new capital to work, you should invest in the most resilient firms during a time like this. Many investors already have this mindset, but the investment thought process right now must change from trying to maximize upside potential to minimizing downside risk. While large cap technology or health care firms have some degree of valuation risk, they largely do not have solvency risk; rather their main risk is regulatory – from antitrust to a higher tax regime. Smaller and more cyclical firms have more upside if the economy recovers faster than we anticipate, but generally (with perhaps the caveat of some emerging biotechnology firms) we do not think the extra risk is worth it in this environment.

To be clear, we think that the disconnect between markets and the economy is unsustainable and that markets may follow the path of the economy lower. We are **not** suggesting that now is the best time to purchase large-cap stocks with resilient business models. We do not think they would escape further market weakness – only that they might relatively outperform the broader market on the way down and continue doing well if markets recover. Our recommendation for those who want to increase stock market exposure or reallocate currently invested capital is to invest in best of breed companies or to invest in what might be referred to as "anti-fragile" assets. These are asset classes or stocks that should do comparatively well if the market sells off once again. These assets could also perform well in a new investing environment which may be upon us. If you would like to learn more about what we consider "anti-fragile assets", please let us know.

While we dislike spending so much time highlighting risks, the reality is that this is still a much riskier than normal market environment whose performance hinges on two unknowns over the next year: (1) whether the federal intervention to stimulate the economy will prove effective and (2) whether an effective therapeutic or vaccine will allow people to return to normal lives. Let's also remember the upcoming November election and the potential eight combinations for the White House, Senate and House which could ultimately change fiscal and tax policies. Certainly, a Democratic president (presumably Joe Biden) in combination with a Democratic House and Senate might reverse previous tax policies.

All we can confidently say is that if you know you will need cash over the next year, raise it and de-risk your portfolio. If have a long-term outlook, we advise staying the course. And if you want to increase your stock market exposure stick to the essential firms in the economy – particularly those with the operational resilience and financial wherewithal to get through this current downturn.

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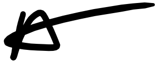
We hope you are all staying healthy and look forward to meeting again in person hopefully soon. Please let us know if you would like to discuss your portfolios or specific investment opportunities.

Sincerely,



Peter Karmin
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Citations and Disclosures

[1] Bloomberg (May 12, 2020). All data citations herein are sourced from Bloomberg unless otherwise noted.
[2] Bianco Research (May 8, 2020).
[3] Goldman Sachs, *Four key themes from 1Q 2020 conference calls* (May 12, 2020).
[4] Goldman Sachs, *US Weekly Kickstart* (May 1, 2020).
[5] Goldman Sachs, *US Weekly Kickstart* (May 1, 2020).

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