

The Economy and Today's Markets

July 1, 2020

The market's whiplash-inducing performance over the last four months has been astonishing. Now, as the economy begins to open up again, the financial market has been on a tear. Is the bad news all behind us? What's in store for the future?

Today's discussion will focus on what has propelled the market to today's levels, whether these near all-time high valuations are justified, and how investor expectations seem to be shaping up.

Moderator and Speaker



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Executive Chairman and Treasurer of Fiduciary Real Estate Development, Inc.

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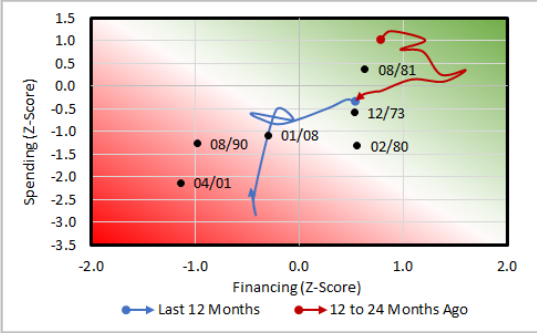
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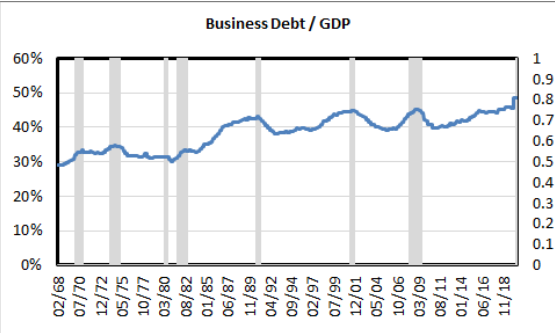
Late Cycle Dynamics *Before* Coronavirus, but Markets Were Not Worried

Many late cycle indicators

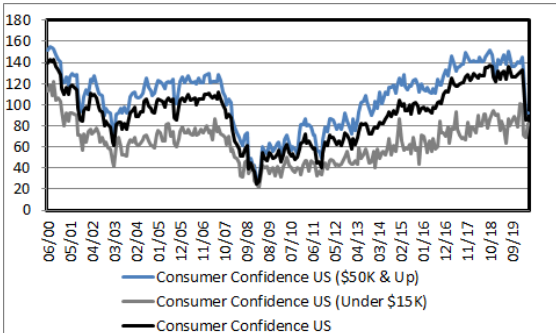
Economy deteriorating for two years



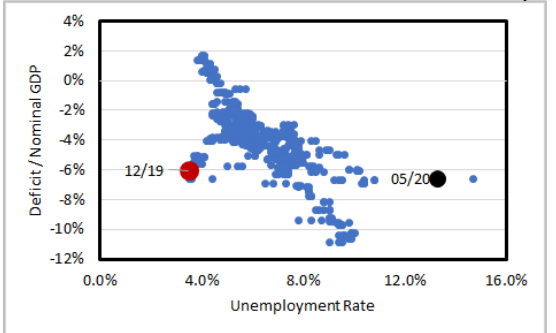
Business debt was high



Consumer confidence was high



Government started in bad financial shape



Model Variables →

Fed Financing:

- M2-GDP Growth
- Fed Funds-Inflation

Bank Financing:

- 6 Mo Ave Senior Loan Officer Survey Cons
- Business Debt/GDP
- Consumer Debt Outstanding
- Commercial Bank Loans/Leases Growth

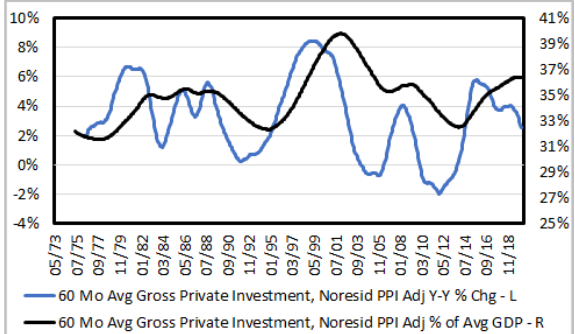
Business Spending:

- Industrial Production Growth
- ISM PMI Survey
- Capacity Utilization
- Private Inv, Fixed, Nonresid, Equip Growth

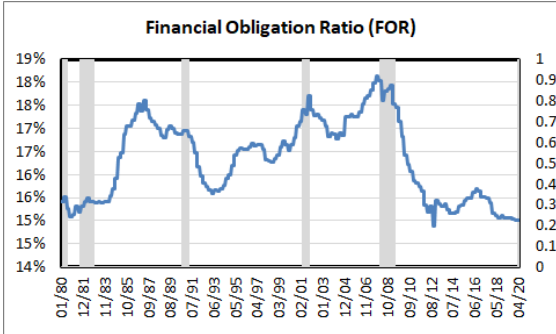
Consumer Spending:

- 2 Consumer Confidence Indicators
- Sales of Retail Stores Growth
- 3 Mo Avg Annual Growth Housing Starts
- 3 DPI Indicators
- Unemployment Rate Growth

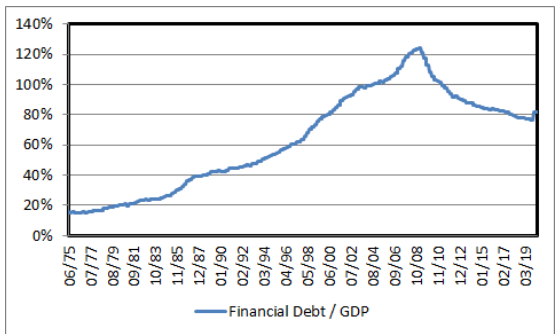
Contrary to popular opinion, business spending was not low



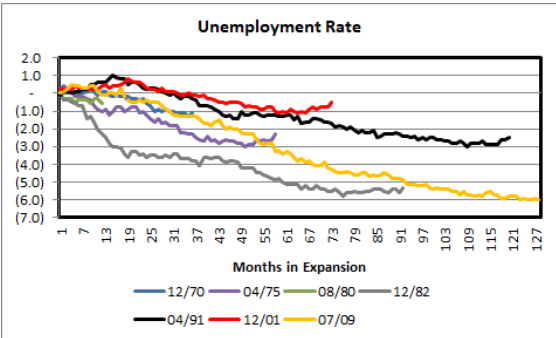
Consumer was better off, but low rates and higher income help



But bank balance sheets started much better in this recession



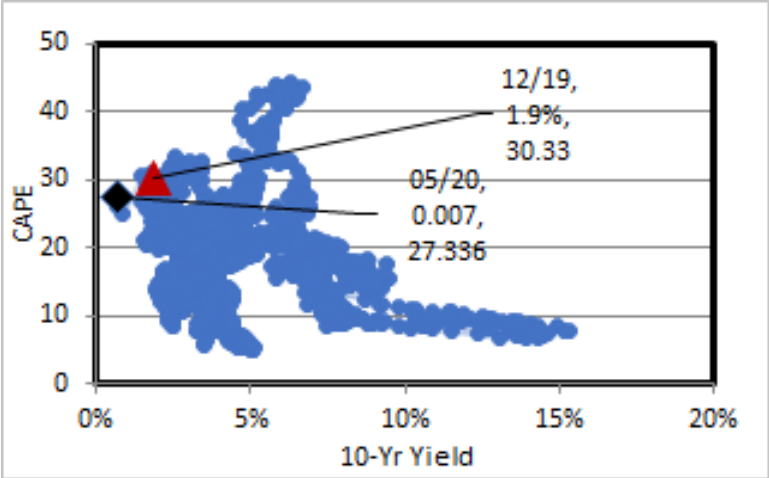
Unemployment rate was down substantially and low



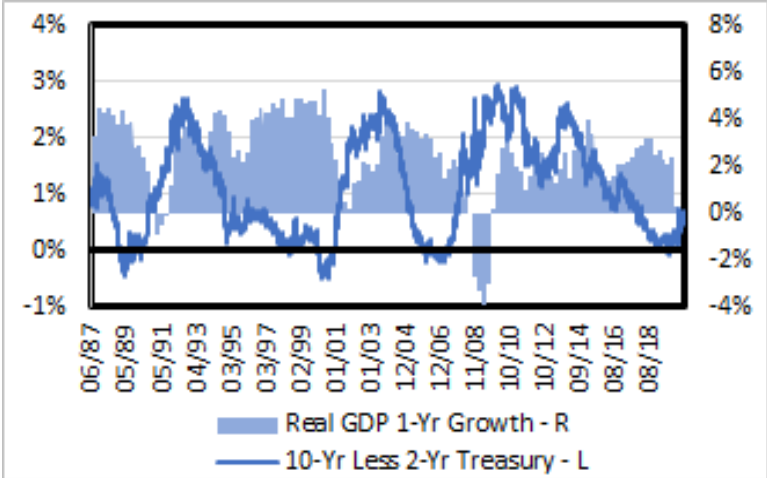
Source: Spellman, BEA, Conference Board, FactSet, Federal Reserve System, and US Department of Labor.

The stock market and credit market were, for the most part, not worried

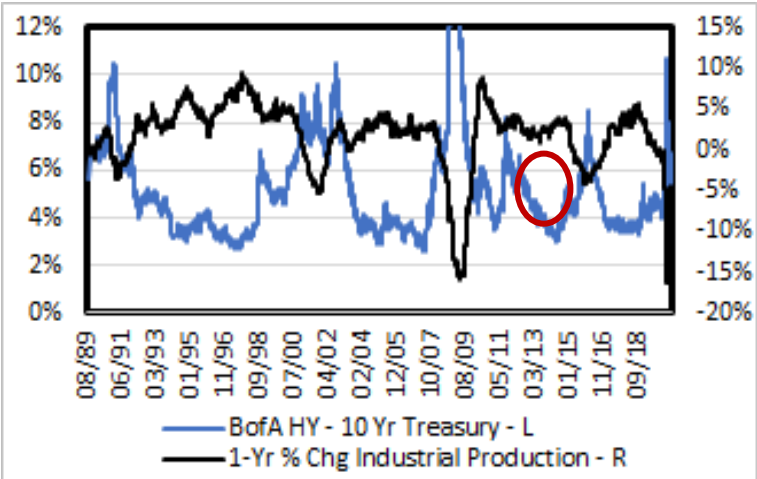
P/E extremely high versus interest rates



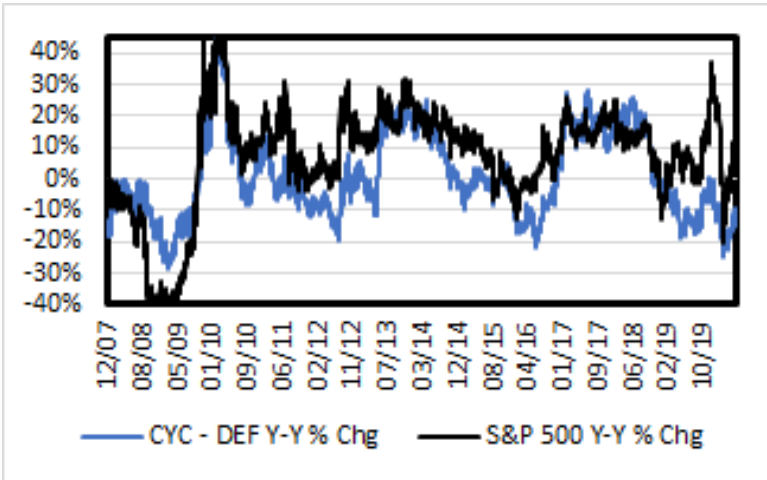
Yield curve did suggest worries



Credit spreads low to Treasuries which were moderate to expensive



And cyclicals were underperforming, which is odd as market was making highs



Source: Spellman, BEA, FactSet, Federal Reserve System, ICE B of A, Shiller, and S&P.

Market Overview

Stock market within 11% from all-time high, but internals are still risk-off YTD

S&P Index	Total Return							EPS Growth		
	1W	1M	3M	6M	YTD	1Y	2Y	2019	2020	2021
1500	-2.93%	-0.9%	18.5%	-8.1%	-7.9%	0.9%	8.2%	0.7%	-24.2%	31.5%
500	-2.86%	-0.7%	18.4%	-7.1%	-6.9%	2.3%	10.8%	1.5%	-22.4%	29.4%
400	-3.66%	-3.0%	20.8%	-16.7%	-16.7%	-11.6%	-11.8%	-6.0%	-34.9%	48.5%
600	-3.67%	-2.8%	17.7%	-22.6%	-22.8%	-17.3%	-22.7%	-5.5%	-57.7%	91.0%
500V	-3.87%	-3.9%	10.3%	-19.2%	-19.1%	-9.7%	-4.4%	1.0%	-30.9%	32.5%
500G	-2.16%	1.7%	24.7%	3.6%	4.0%	12.6%	24.5%	1.2%	-10.3%	24.1%
400V	-4.96%	-4.4%	16.8%	-25.1%	-25.2%	-20.1%	-21.1%	-5.3%	-42.7%	62.9%
400G	-2.61%	-1.9%	24.1%	-8.9%	-8.7%	-3.9%	-3.2%	-6.4%	-18.0%	27.6%
600V	-4.14%	-3.5%	15.9%	-29.1%	-29.4%	-23.5%	-30.6%	-2.5%	-72.9%	184.6%
600G	-3.28%	-2.2%	19.3%	-16.4%	16.4%	-11.5%	-14.6%	1.8%	-37.0%	49.6%

Value underperforming growth
Small underperforming large

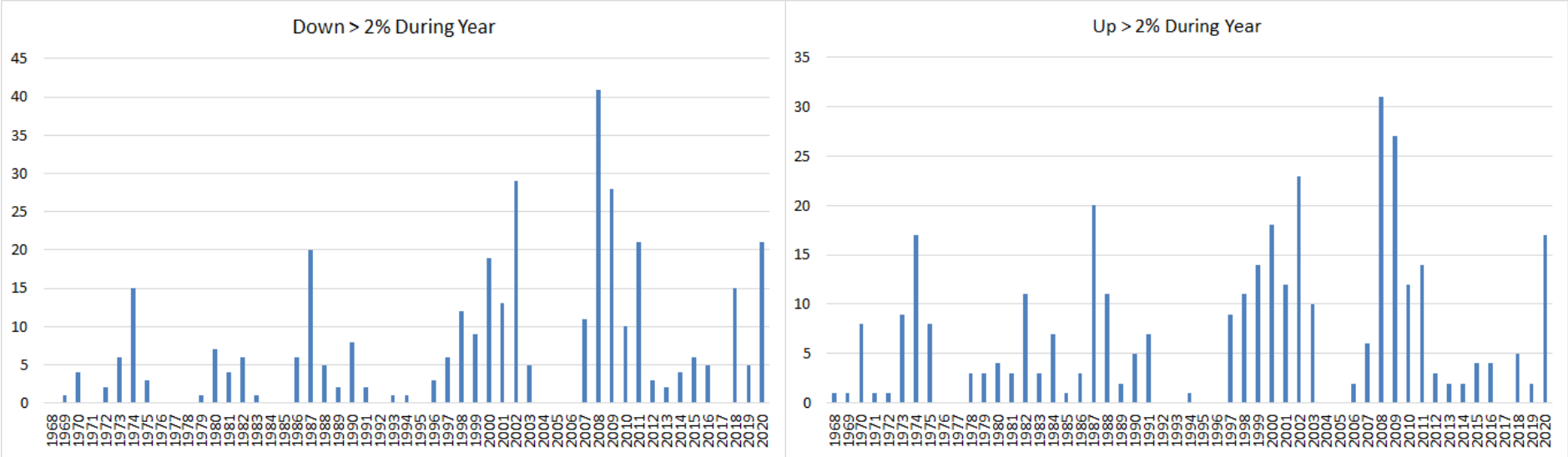
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COMM	-5.22%	-3.1%	19.2%	-5.0%	-4.2%	5.9%	16.7%	4.2%	-16.0%	22.8%
CD	-1.90%	2.5%	29.1%	2.8%	3.4%	7.9%	17.4%	1.4%	-58.4%	119.0%
CS	-3.35%	-3.2%	6.5%	-9.9%	-9.5%	-1.9%	10.5%	1.3%	-2.8%	7.8%
E	-6.45%	-5.0%	27.5%	-39.0%	-39.3%	-41.2%	-50.3%	-30.0%	-106.5%	-735.3%
F	-5.25%	-4.2%	7.5%	-26.6%	-26.5%	-18.1%	-14.9%	7.4%	-36.7%	38.2%
HC	-2.78%	-3.9%	14.8%	-4.6%	-4.3%	6.1%	17.9%	10.7%	-1.5%	15.9%
I	-4.02%	-2.5%	12.3%	-19.1%	-18.6%	-14.2%	-6.9%	-3.8%	-48.8%	81.2%
IT	-0.45%	5.1%	29.1%	10.6%	10.8%	30.1%	46.5%	3.0%	1.2%	15.2%
M	-2.46%	-1.4%	23.3%	-10.7%	-11.0%	-6.5%	-5.4%	-15.5%	-21.2%	28.5%
REIT	-3.88%	-3.0%	8.0%	-12.0%	-12.4%	-7.9%	4.2%	1.4%	-7.3%	8.4%
U	-2.89%	-6.4%	-0.9%	-14.2%	-14.6%	-7.4%	6.6%	6.8%	1.0%	6.1%

Cyclicals underperforming
(financials (F), energy (E), industrials (I), materials (M))
Mix of growth and discretionary doing well
Health care (H), technology (IT), and consumer discretionary (CD) doing well

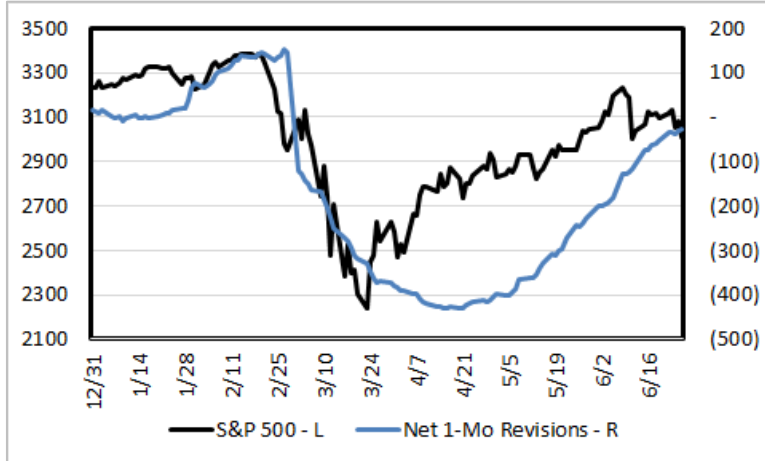
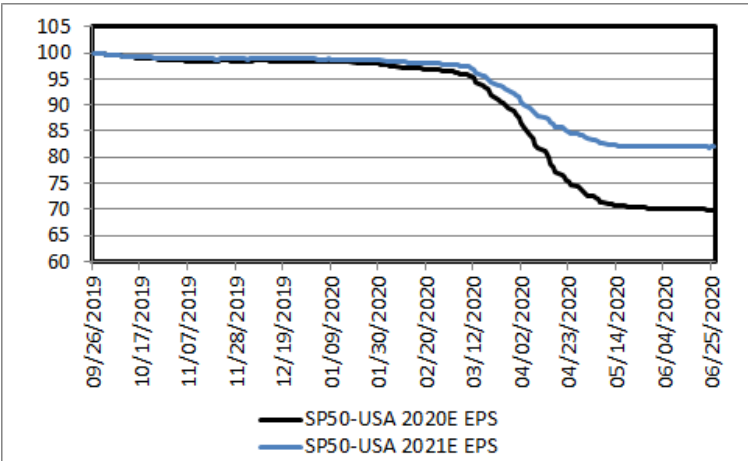
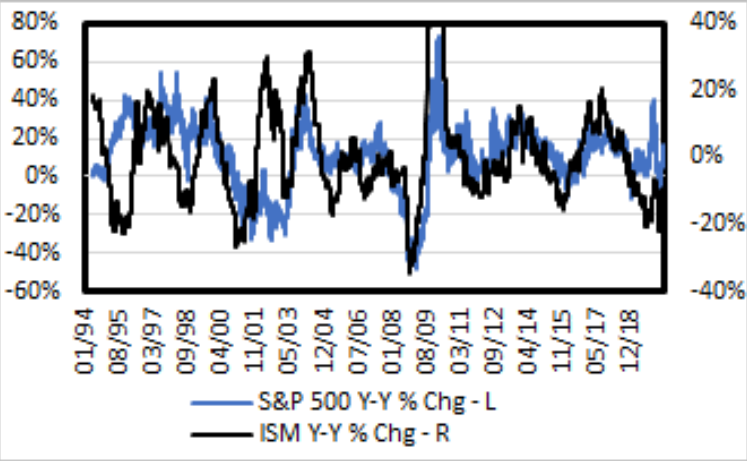
Source: Spellman, FactSet, and S&P.

Normal volatility during recession and market bottoming "ahead" is normal

Market volatility high, but normal during times of turmoil



Recovery at hand, which is normal as conditions bottom (PMI bottoming and earnings estimates may be bottoming)



Source: Spellman, FactSet, and ISM.

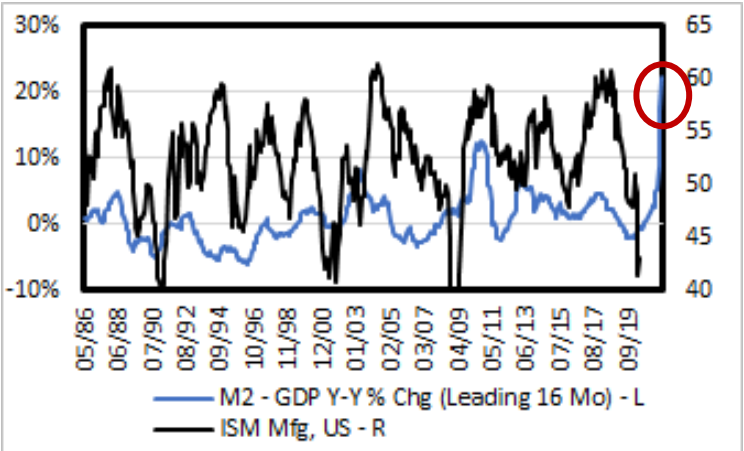
Government Stimulus Propelling Market

The money must go somewhere, and it made it to the market

Federal Reserve and fiscal spending may be 40% of GDP

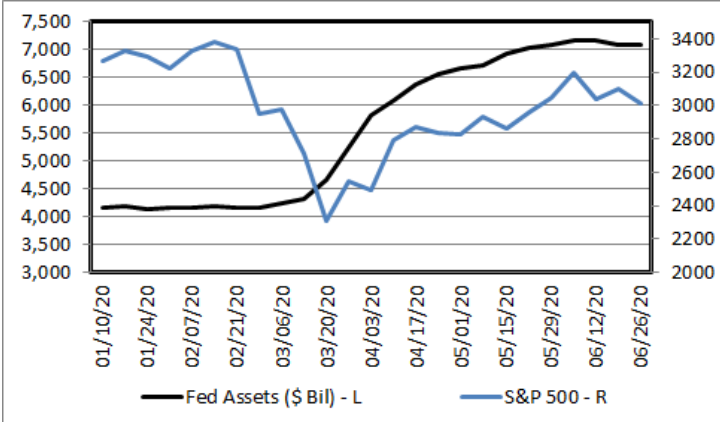
- Fed balance sheet grows \$3 trillion
- \$3 trillion fiscal stimulus (maybe another package in July or August)

Money supply up 24% over the last year and leads ISM PMI (highly correlated with the S&P 500)

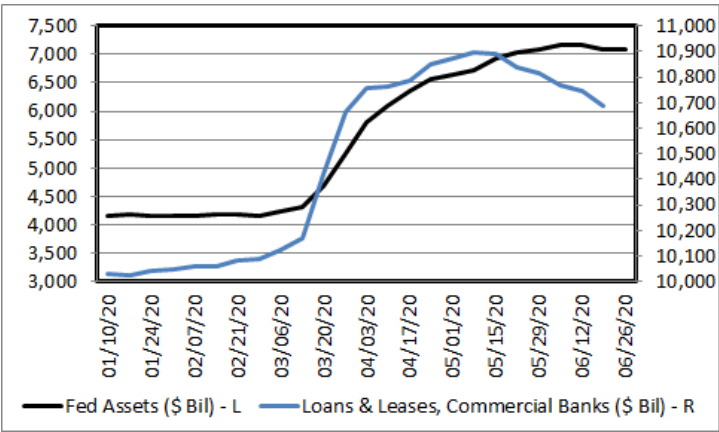


But much is now spent (\$1.5 trillion), Fed balance sheet growth is slowing, and bank lending coming down

Fed balance sheet growth slowing as market peaks



Loans & leases spiked \$600 billion (PPP was over \$500 billion and corporations borrowed through credit lines) and now coming down

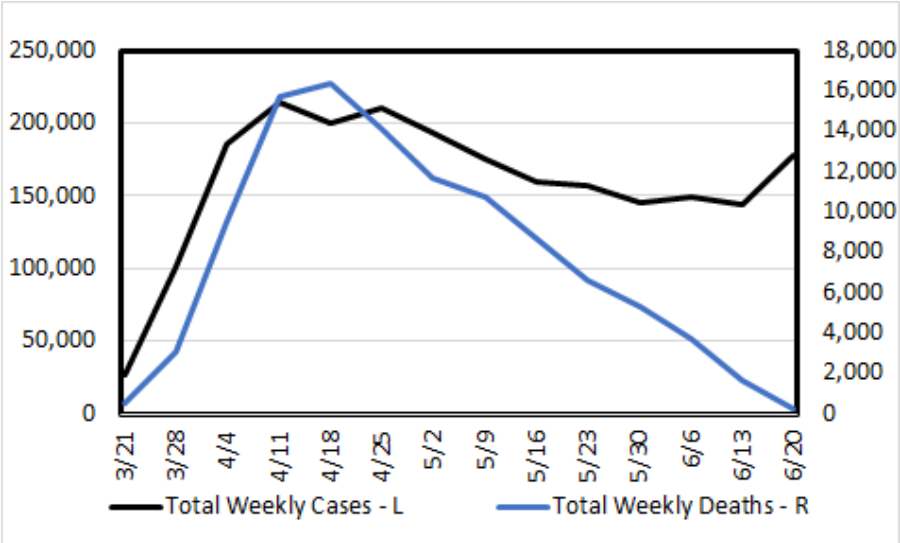


Corporate debt issuance at all time high this year, but small companies don't have access to market and rely on banks

Source: Spellman, BEA, FactSet, Federal Reserve System, ISM, and S&P.

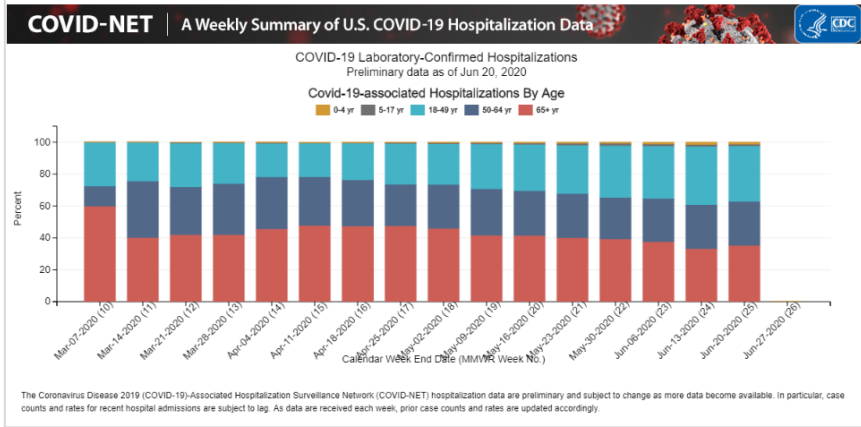
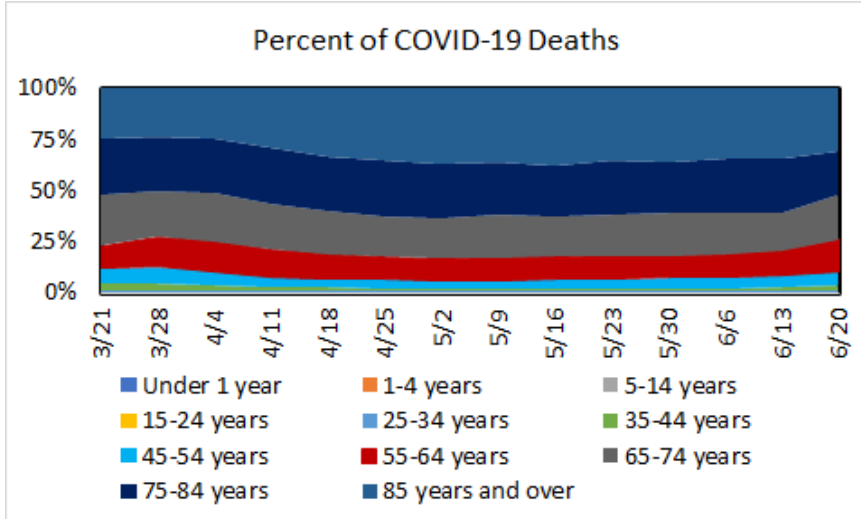
Coronavirus Trends

Five reasons coronavirus deaths are not (yet?) on rise despite rising cases



Maybe...

1. Treatments are improving (remdesivir and others)
2. The most vulnerable are staying home
3. The mobile young are catching it and have less severe cases
 - But they will eventually get the older sick ...
4. Testing more, so more people with less severe cases are positive
 - Now 600,000/day, up from 150,000 mid-April
 - Positive rate peaked above 20% and bottomed below 5%, but now above 5% and rising
5. **Hospitalizations and deaths lag cases so they are about to rise**

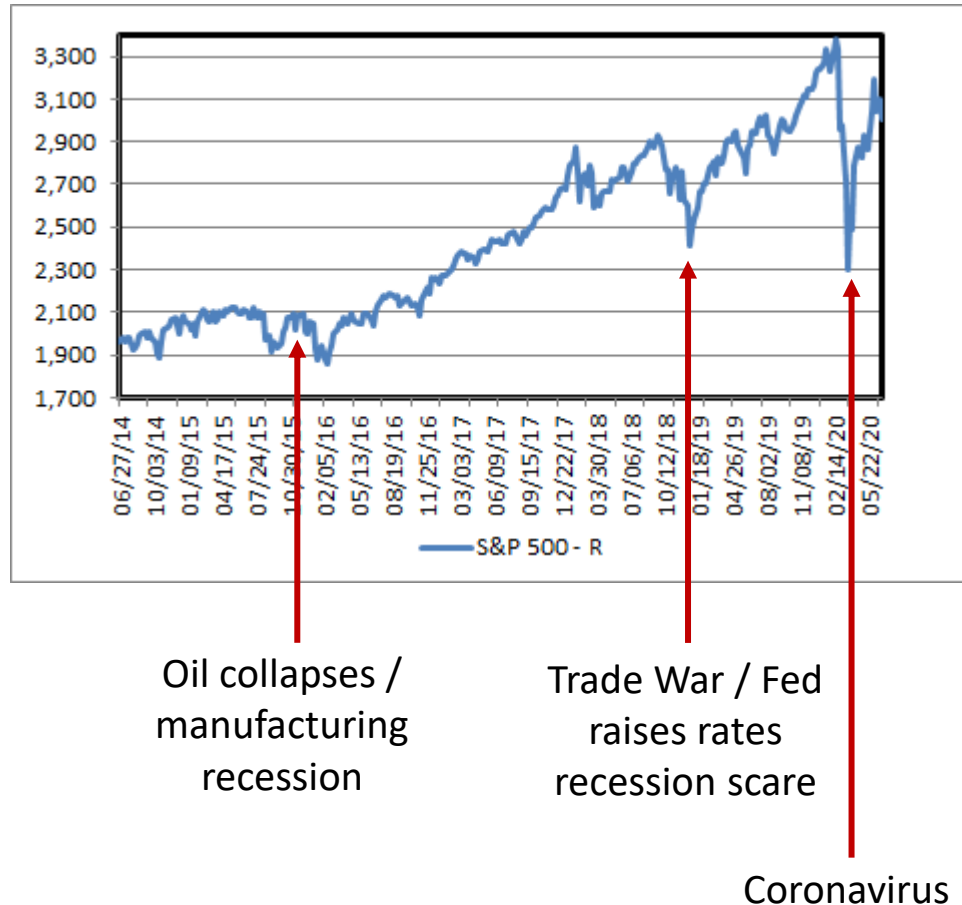


Source: Spellman, covidtracking.com/api, cdc.gov/nchs/nvss/vsrr/covid_weekly/index.htm, and coronavirus.jhu.edu/testing/individual-states.

Is the Market Overvalued?

Magnitude of recovery is crazy

Stock market about to all-time high

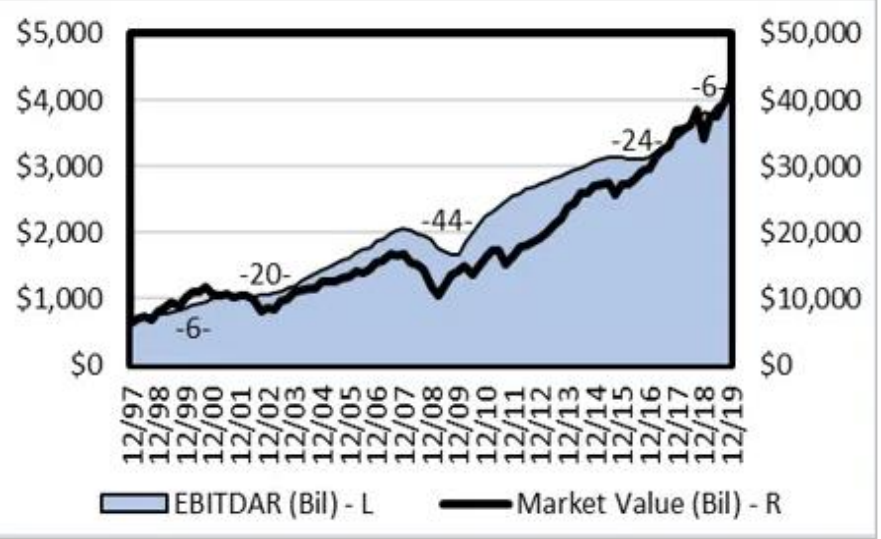
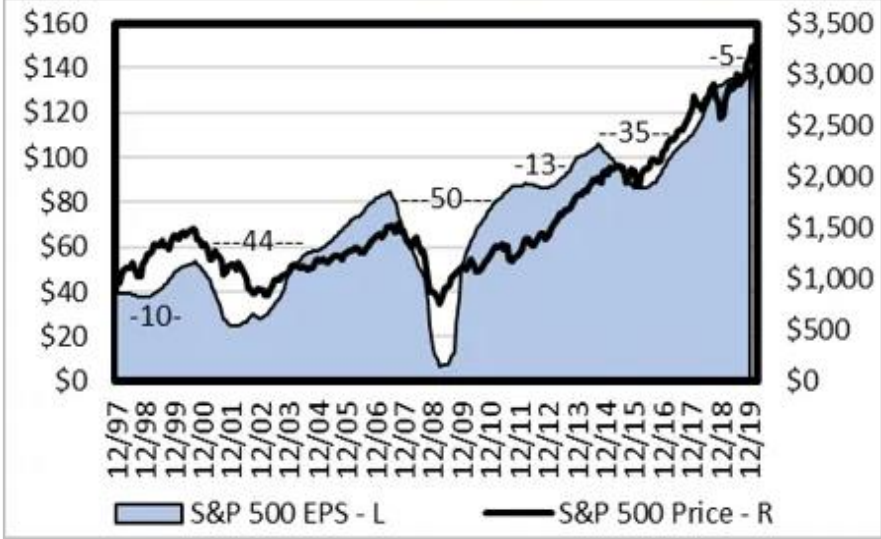
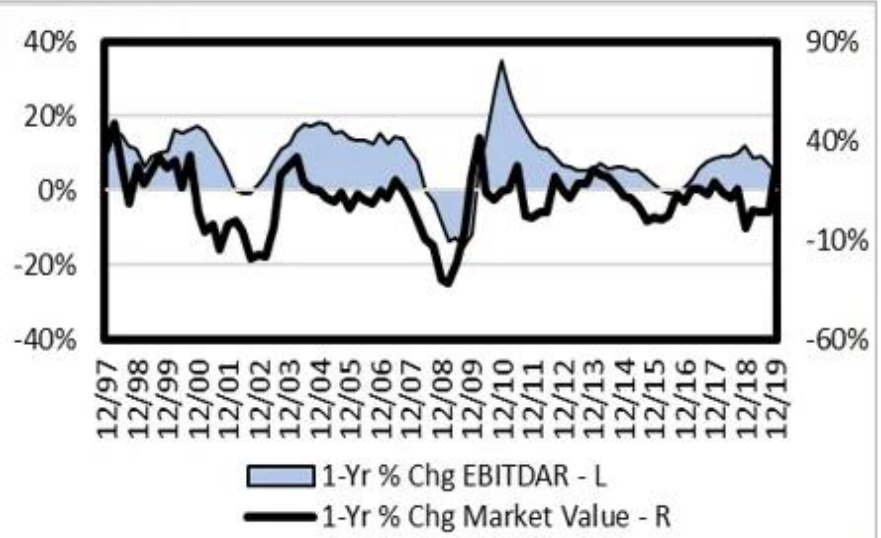
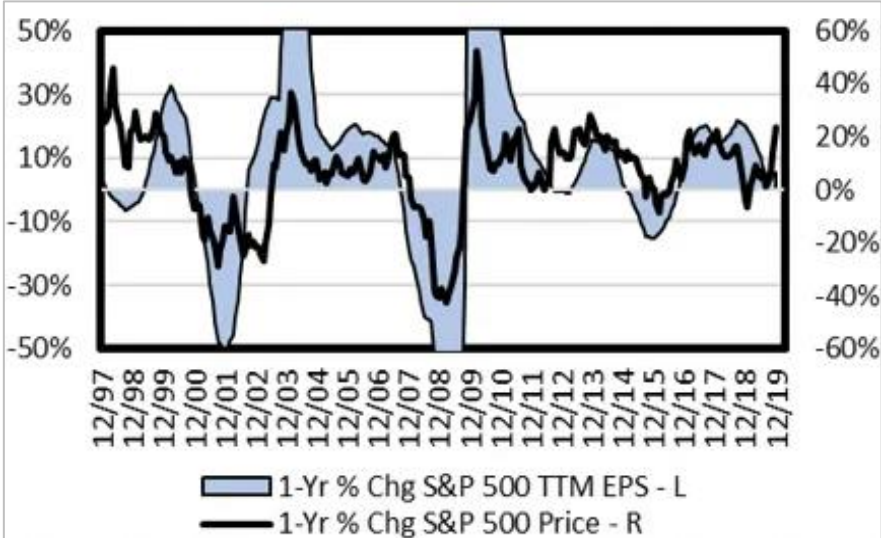


Many arguments for lower valuation

1. Corporate debt build borrows from future consumption/growth expenditures
2. Corporate debt raises financial risk
3. Government debt could result in higher taxes and lower earnings
4. Trump may ramp up Trade War ahead of elections if it looks like he is losing
5. Good jobs report and retail sales numbers getting *temporary* boost from PPP, unemployment checks, and stimulus checks
6. At end of July, unemployment checks run out
7. Coronavirus cases are growing, and what if it mutates?
8. Coronavirus disproportionately impacted people with lower income and rising stock market helps wealthy – fuels populism
9. George Floyd protests create uncertain outlook
10. Vaccine not certain (markets acting like it is) and only perhaps 6% of US population has had coronavirus (long way to go)
11. Diversifying supply chains and de-globalization raises costs
12. Fed was a savior, but this big buyer does not care about valuation – how will this \$7 trillion and growing experiment end? Fed could be politicized. Fed is punishing good actors and rewarding the irresponsible (with high debt/risky growth projects) which can lead to misallocation of capital
13. The Fed and market is not worried about inflation, but it is possible
14. Some firms cannot operate at 50% capacity and will go bankrupt
15. No visibility and withdrawn guidance from management raises risks
16. Election → poor economy may result in power transition and uncertainty
17. Since 1997, earnings/EBITDAR recoveries take 5-50 months, and forecasts call for GDP to not rise above 2019 until 2022 (see coachinvesting.com/2020/04/30/the-markets-hopeful-thinking/)

Source: Spellman, FactSet, and S&P.

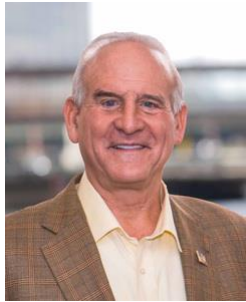
Since 1997, earnings/EBITDAR recoveries take 5-50 months



Notes: ISS EVA EBITDAR is earnings before interest, taxes, depreciation, amortization, and return. It is an operating cash flow figure before unusual items. Since EBITDAR is tracked quarterly, the months re estimated based on a lead of two to 11 quarters.

Source: Spellman, ISS EVA (Investor Express), FactSet, and Shiller.

Discussions



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Participants Questions & Answers

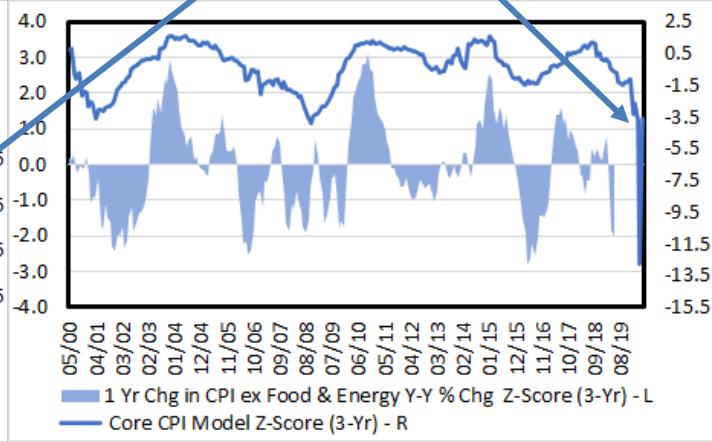
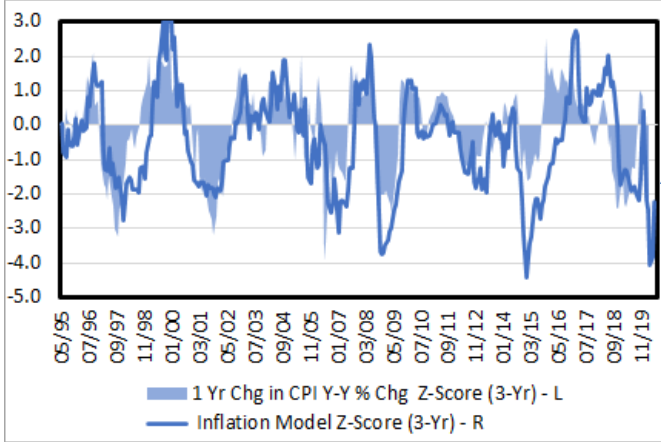
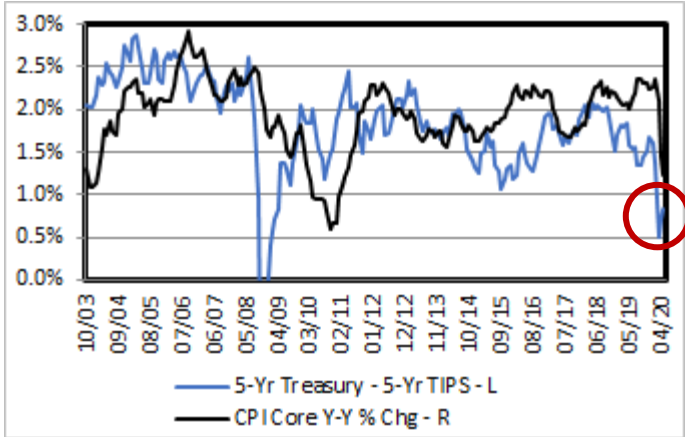
Appendix

Could stimulus drive up inflation and really scare markets?

CPI All Items (Coincident)	Core CPI (CPI ex Food and Energy) (12-Month Leading)
Real GDP Growth (positive correlation)	Real GDP Growth (positive correlation)
Change in Oil Prices (positive correlation)	Wage Growth (positive correlation)
Change in Dollar (negative correlation)	Unemployment Rate (negative correlation)
	Change in Capacity Utilization (positive correlation)

Inflation model hooking up

Fed not worried & market Implied inflation low



Drivers of Lower Inflation

- Technology
- High unemployment
- Low capacity utilization
- Debt-constrained spending



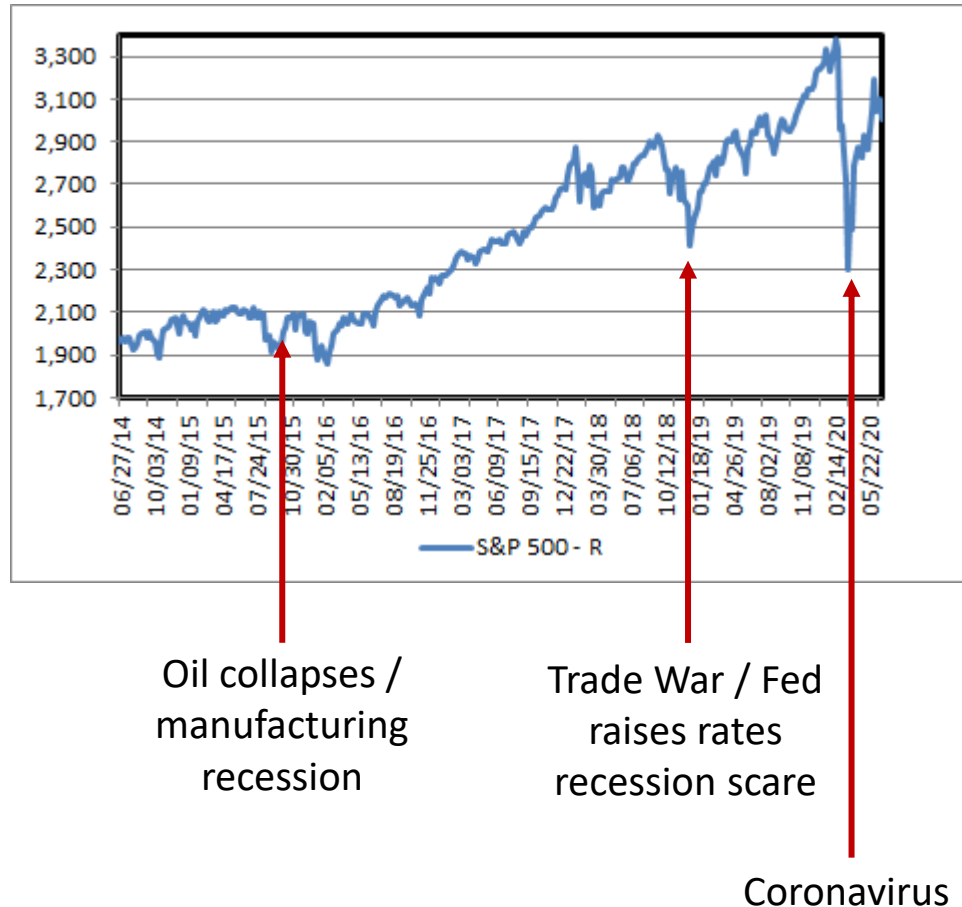
Drivers of Higher Inflation

- $M * V = P * Q$, and M2 growing like crazy and what if V (lending) rises as economy recovers?
- Populism fueled by coronavirus (wage growth)
- Diversifying supply chains, de-globalization
- Declining dollar (low rates and improving economy) → imports/commodities prices rise
- Demographics (older people don't demand higher wages (younger do) and are retiring)
- Trade War raises costs
- Fiscal stimulus geared to lower income who are more likely to spend

Source: Spellman, FactSet, Conference Board, Federal Reserve System, and US Department of Labor.

Or, is the rally justified?

Stock market about to all-time high



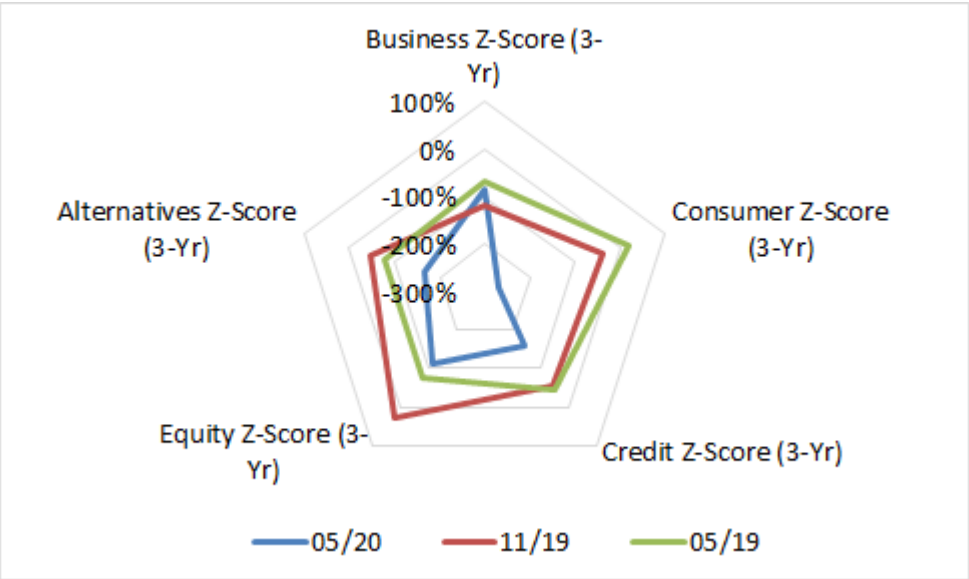
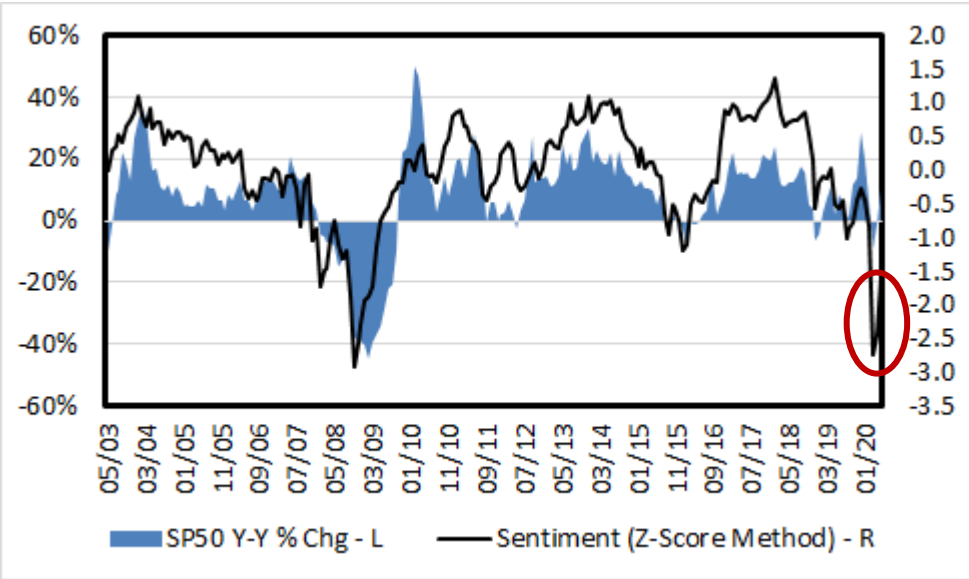
Arguments for the run up

- Conditions appear to be bottoming
 - So a rebound is reasonable (but the magnitude seems out of line)
- What are your options (0% interest rate debt)?
 - However, maybe sitting out is best
- The money must go someplace
 - Much money on sidelines in money market funds, Fed says it has much it can do, and government is eager to spend (4th package coming soon?)
 - However, does it make sense to invest in a fundamentally overvalued market?
- No solvency risk if Fed provides liquidity
 - However, banks cutting back so small firms may not survive with low capacity utilization
- Many firms are working on a vaccine, and with this many shots on goal, won't one work?
- Consumer balance sheets much better before crisis
 - However, that was before loss of income, but rates still low
 - Savings rate high
 - Wealth high (housing not declining and market near highs)
 - Will there be much pent up demand?
- Rates low keep housing up, as is potential move away from cities, and housing is much of consumer net worth and provides a boost to GDP (housing is a volatile component and contributes much to *change* in GDP)
- New growth trends may emerge (technology) and de-globalization could lead to investments and growth and hiring in the US
- Coronavirus deaths are down
 - At least for now...
- Wearing a mask could really help and it would be sure nice if we could adequately traced people
- Investors are, on average, bearish, which means there is buying potential

Source: Spellman, FactSet, and S&P.

Sentiment indicator off historically low levels

Fundamentals		
Business	Consumer	
Business Surveys	Consumer Confidence Surveys	
Fixed Investment	AAll Surveys	
Commercial Loan Growth	Stock-Bond Flows	
Financial Markets		
Credit	Equity	Alternatives
Real risk free rate	Valuation (Multiples)	Currency
Inflation expectations	Revisions	Commodities
Yield curve	Advance-Decline	Volatility Index
Credit spreads	Price Bands	Safety/Risk Ratios

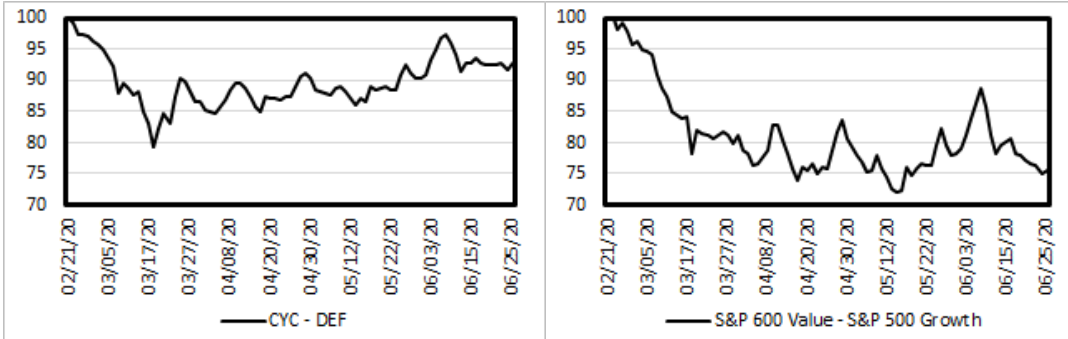


Source: Spellman, AAll, Conference Board, CBOE, CRB, FactSet, Federal Reserve System, Goldman Sachs, ICI, ISM, Merrill Lynch Fixed Income, S&P, University of Michigan, and US Department of Labor.

Sentiment is mixed

Cyclicals and small value bouts of out-/under-performance

Mostly risk-on for June, but paired back in last few days (as of 6/26)



FAANG doing great and getting more expensive

Area	EPS Growth				
	2017	2018	2019	2020	2021
S&P 500	11%	21%	1%	-22%	29%
FAANG	86%	60%	112%	8%	44%
FB	86%	75%	-13%	13%	33%
AMZN	292%	-7%	405%	-19%	100%
AAPL	-10%	11%	29%	4%	20%
NFLX	44%	188%	101%	56%	35%
GOOGL	18%	33%	37%	-15%	32%
Information Technology	21%	17%	3%	1%	15%
FAANG Rel S&P 500	75%	39%	110%	30%	14%
IT Rel S&P 500	10%	-5%	2%	24%	-14%

Area	Return Since 12/31/2019	P/E	
		12/31	6/26
S&P 500	-6.9%	21.6	21.7
FAANG	22.0%	54.3	60.7
FB	5.3%	32.8	29.6
AMZN	45.7%	81.8	128.7
AAPL	20.4%	24.8	27.7
NFLX	37.0%	103.4	89.8
GOOGL	1.7%	28.7	27.5
Information Technology	10.8%	26.3	28.1
FAANG Rel S&P 500	28.9%	2.5	2.8
IT Rel S&P 500	17.7%	1.2	1.3

Returns			Returns		
Risk-on asset	Risk-off asset	Difference	Risk-on asset	Risk-off asset	Difference
Cyclical Stocks	Defensive Stocks		Russell 3000	BB US Agg Gov	
12 Mo -17.63%	12 Mo 0.78%	-18.41%	12 Mo 11.46%	12 Mo 11.24%	0.22%
3 Mo -17.25%	3 Mo -10.16%	-7.08%	3 Mo 2.89%	3 Mo 3.24%	-0.34%
1 Mo 16.70%	1 Mo 7.87%	8.83%	1 Mo 5.35%	1 Mo -0.24%	5.59%
MTD 4.03%	MTD 3.80%	0.24%	MTD 2.77%	MTD -0.26%	3.02%
Russell 3000	FTSE NAREIT		Russell 3000 Value	Russell 3000 Growth	
12 Mo 11.46%	12 Mo -9.35%	20.81%	12 Mo -2.52%	12 Mo 24.99%	-27.50%
3 Mo 2.89%	3 Mo -12.20%	15.10%	3 Mo -5.14%	3 Mo 9.91%	-15.06%
1 Mo 5.35%	1 Mo 1.71%	3.64%	1 Mo 3.39%	1 Mo 6.87%	-3.48%
MTD 2.77%	MTD 3.56%	-0.79%	MTD 0.61%	MTD 4.38%	-3.77%
MSCI EM	MSCI AC World		Russell 2000	Russell 200	
12 Mo -0.17%	12 Mo 6.54%	-6.71%	12 Mo -3.44%	12 Mo 16.33%	-19.77%
3 Mo -4.64%	3 Mo 0.38%	-5.02%	3 Mo -5.18%	3 Mo 5.20%	-10.38%
1 Mo 0.66%	1 Mo 4.30%	-3.64%	1 Mo 6.51%	1 Mo 4.69%	1.82%
MTD 6.90%	MTD 3.42%	3.48%	MTD 2.92%	MTD 2.81%	0.11%
GSCI	Gold		BB US Agg HY	BB US Agg Gov	
12 Mo -24.69%	12 Mo 33.01%	-57.71%	12 Mo 1.32%	12 Mo 11.24%	-9.92%
3 Mo -14.33%	3 Mo 11.05%	-25.38%	3 Mo -3.39%	3 Mo 3.24%	-6.63%
1 Mo 19.46%	1 Mo 3.13%	16.33%	1 Mo 4.41%	1 Mo -0.24%	4.64%
MTD 7.67%	MTD 1.14%	6.53%	MTD 2.53%	MTD -0.26%	2.79%

Bullish

- Market near high
- NASDAQ/NYSE volume high
- Growth in brokerage accounts
- Credit spreads narrowed
- Percent of market in largest stocks very high

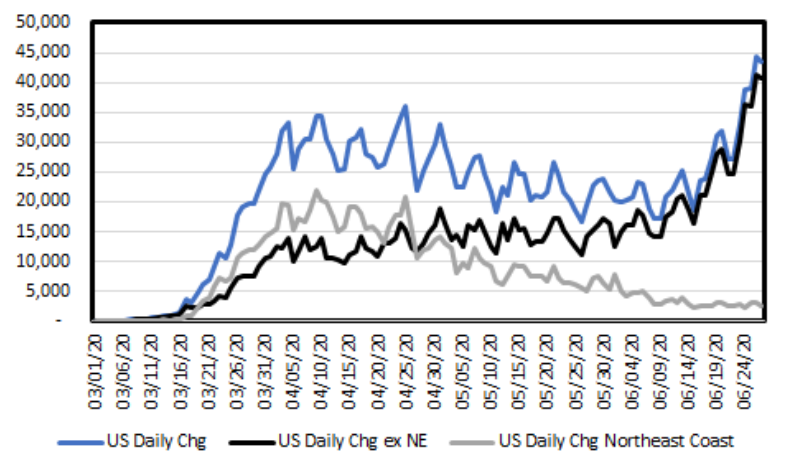
Bearish

- Small/value/cyclicals still underperforming
- Hedge fund net positions
- Surveys of professional investors
- AII still bearish (less so)
- Debit balances broker accounts low
- S&P future positions (non-comm) low
- VIX and actual volatility high
- 10-year bond low
- High money market account balances

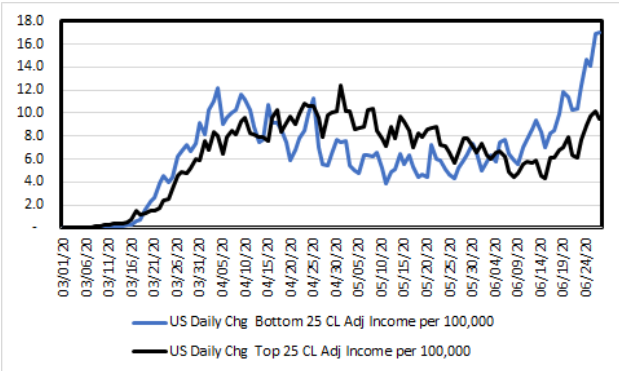
Source: Spellman, Barclays, Bloomberg, FactSet, FTSE, Goldman Sachs, MSCI, Russell, and S&P.

The coronavirus surge has been going on since mid-May, but it is uneven

Improvement in large northeast numbers masked growth of COVID-19 in rest of country until recently

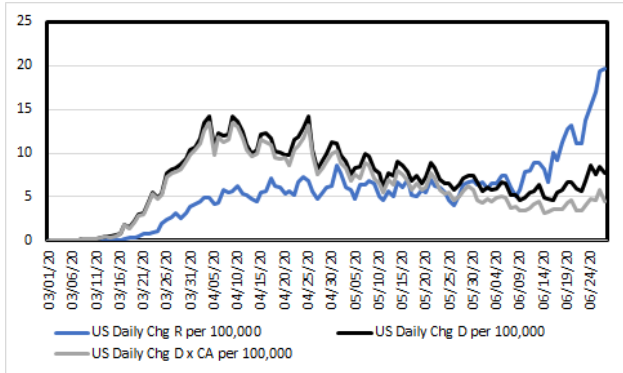


Lower income (adj for cost of living) states better until recently

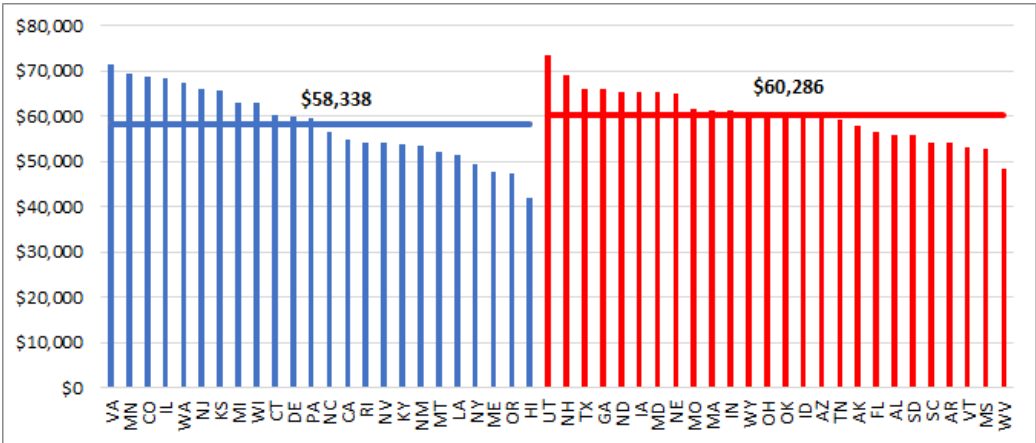


Lower income more impacted by shutdowns and reopening

Democratic governor states performing much better than Republican



Democratic governor states lower income adj for cost of living than Republican



Source: Spellman, covidtracking.com/api, en.wikipedia.org/wiki/List_of_U.S._states_and_territories_by_income, and simple.wikipedia.org/wiki/List_of_U.S._states_by_population.