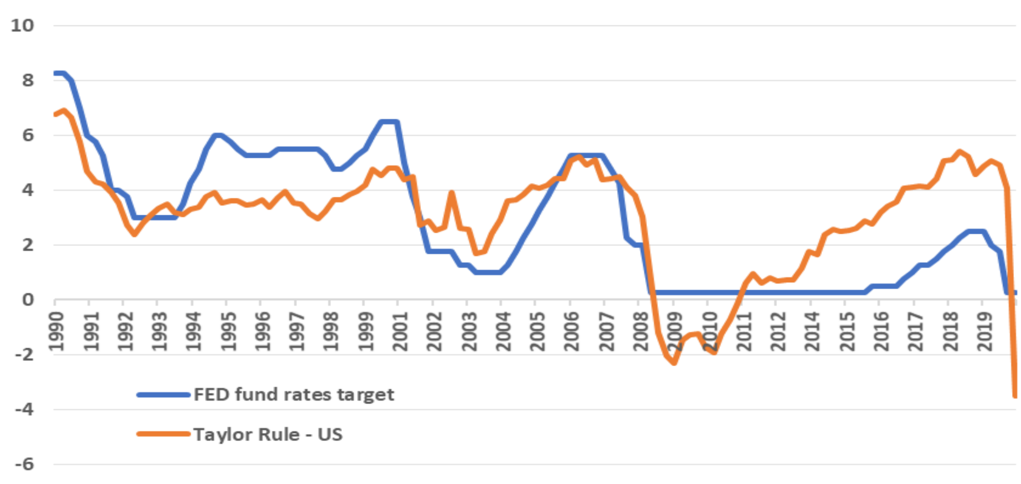
Creating Value through Innovative Financial Solutions

LC Monthly Investment Memo : September 2020

Concerns over a contested US election in November led to profits-taking in September. Risky assets such as equities and commodities fell, with the correction ranging between 7% and 20% depending on how speculative or crowded these trades were. For example, Nasdaq 100 index is down 10.15% from its peak on September 2nd while Silver is down 23.5% from its August peak. We anticipate markets to remain volatile and trade horizontally until the US election, after which investors are more likely to take a clearer direction.

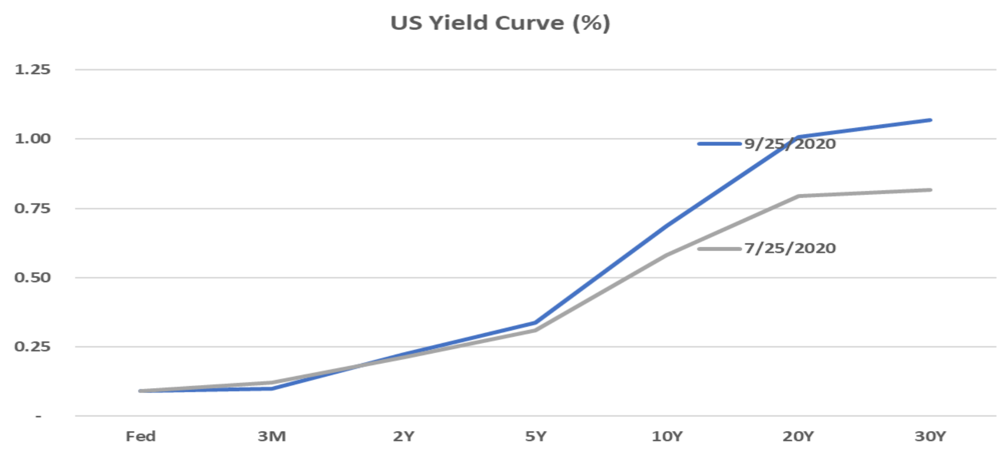
Fed Chair J. Powell called for more fiscal stimulus and has already announced that US interest rates are unlikely to increase until at least 2023. Since the Taylor Rule (a formula used to predict or guide how central banks should alter interest rates due to changes in the economy) is now deeply negative for the US economy (Graph 1), such an announcement should not come as a surprise to any investor. Interestingly, the 30-year maturity (long-term portion of the US yield curve) has increased by 30 bps over the last 2 months, indicating higher inflation expectations going forward (Graph 2). Lower short-term rates combined with higher long-term inflation is paving the way to financial repression and potential stagflation.

Graph 1: Fed Fund Rates vs Taylor Rule since 1990



Source: Bloomberg

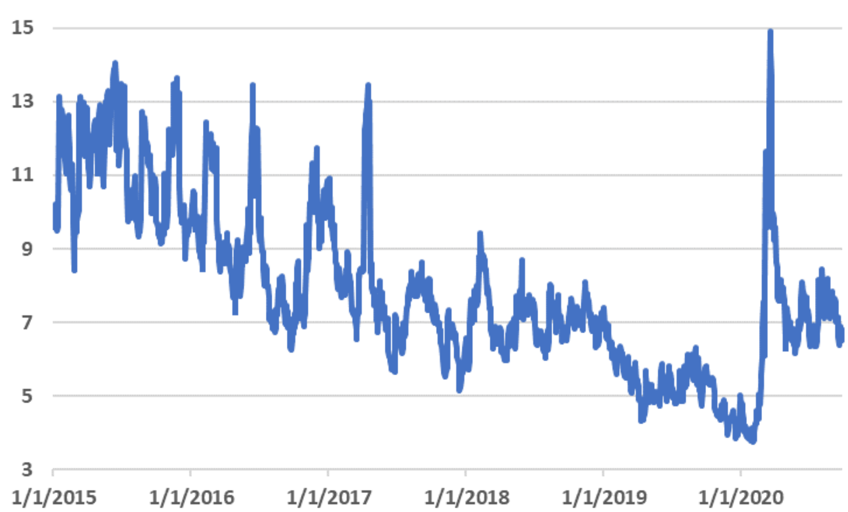
Graph 2: Long-term Portion of US Yield Curve Shifted Higher over the Last Two Months



Source: Bloomberg

Except for interest rates where "lower for longer" is widely expected, the next direction for equities, forex and commodities remains debatable. For instance, the VIX index is currently hovering around 30 (twice of January's level), which is suggesting that US equities could somehow remain volatile for the near future. The same feature can be observed on currencies, with the 1 month at-the-money (ATM) implied volatility currently hovering around 7% on the EUR/USD pair, much higher than the 3.8% reached on February 4th, 2020 as shown on Graph 3.

Graph 3: EUR/USD 1-Month ATM Implied Volatility since 2015



Source: Bloomberg

More interestingly, 4 out of the G10 currencies (SEK, NOK, GBP, AUD) had moves larger than 4% in September, which would be considered significant for such liquid pairs over such a short period of time. As an example, the Norwegian Krone, which was down 7.5% in September, has particularly been under pressure despite the country's strong economic fundamentals (and large FX reserves) – a weakness unfairly driven by investors' concerns over the impact of Brexit on Europe.

Graph 4: Norwegian Krone since 2019

Source: Bloomberg

Equities, and particularly the technology sector, give a sense of how speculative markets have become:

- Tesla shares jumped 83% between August 11th and August 31st, before collapsing by 35% (Sep 1st – 8th) followed by a 40% rebound (Sep 8th – 15th) and another slide of 24% (Sep 15th – 24th). Since Tesla's market capitalization is now equivalent to Volkswagen, Daimler, Ford, and Toyota combined, one would expect the share price to become less volatile, unless bulls/bears strongly disagree upon the level the share price should trade. (Graph 5)

- Snowflakes skyrocketed more than 120% the first day of its IPO and its market capitalization currently accounts for 242x its trailing 12m sales. This is remarkable as the company is yet to become profitable. While we agree that the company has a promising story, the notion that its "priced for perfection" offers no room for error and, in our opinion, could only lead to disappointment and losses for long term investors holding the stocks at current price.

Graph 5: Tesla Share Price since July 31st (Candle Chart – 30mns)

Source: Bloomberg

Although growth stocks appear to be overvalued, we still see few opportunities in the equities space. For example, many value stocks are trading at an attractive level from a Free-Cash-Flow yield perspective and could prove to be a good addition to a portfolio as we expect limited downside hereon. We continue to hold a long-term bullish view on Chinese equities – especially since they appear to be holding up much better than expected amid the impact of Covid-19. Institutional investors in US and Europe are generally underweight Chinese equities due to caution on the back of the US-China trade war fiasco, but we believe that it is just a matter of time before confidence creeps in and we see inflow into what will soon be the largest economy in the world. We reiterate our view that cyclical stocks do not present an attractive risk-reward yet, as demonstrated by the S&P Energy index where it was down 15% in September which is about 35% lower than its peak in June.

Stocks with negative EBITDA, limited barriers to entry with a single product line, especially those with market capitalization that are 15x their sales or above should be avoided - even if they offer a compelling growth story. A relevant example of such profile is Snowflake, where at 181x its revenue, its capitalization offers no upside even to long-term investors. In comparison, a market leader like Amazon, with huge barriers to entry, a strong brand, a diversified portfolio of activities and an improving profitability has a capitalization accounting for less than 6x its sales.

Considering the average index valuation, we believe the recent peak of 3600 points on the S&P 500 Index could act as a glass ceiling, at least in the short-term. Earnings growth will have to be stronger to propel valuations higher, especially if corporate defaults pick up in 2021, i.e. when governments' support starts tapering off.

Since policy rates around the world have plunged toward their effective lower bounds (0 in the US, negative in Europe and Japan), the ability of 10-year government bonds to appreciate during bouts of equity weakness appears to be limited. This creates an unprecedented situation where both equities and bonds will be vulnerable at the same time, especially for high yield and emerging markets issuers. While the longer-dated bonds still have a bit of runway when equities correct, the capital gains one can anticipate from their declining yields is limited. More concerning, these bonds are likely to be under pressure when or if inflation comes back over the coming years.

With uncertainties continuing to loom and the markets expected to remain volatile, investors should remain focused on downside management rather than be tempted by short-term gains – and that continues to be our approach amid the exceptional market environment since the start of Covid.

Yours Faithfully,

The Lighthouse Canton Team