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Finding Realities Beyond the Visible

Mindfulness as an Investment Strategy in Times of Turbulence

Perhaps at no other period in recent decades have so many large and consequential events merged to create turbulence and cross-currents for investors as they have in 2020. The corona virus pandemic has now claimed half a million lives around the world, and shuttered economies across the continents. Centuries'-old racial and social conflicts in America and elsewhere have boiled over onto streets and into communities. Political divisions in every corner of the world have pitted opposing ideologues against each other. The trade wars preceding these outbreaks have brought disruption, damage, and uncertainty to millions. And power struggles between global superpowers have made the world less secure and more unsettled for all.

For conservative investors, these events have worked in concert to make investing a sometimes halting process. They have raised profound questions about the future and injected greater than normal uncertainty into the investing picture. It would be easy to shrug off these circumstances and the challenges they pose by saying "only time will tell", but nonchalance and inattention are luxuries that we cannot afford. Investing is an active endeavor, not a passive one, and it requires us to make forecasts and decisions about the future, even in difficult times. It requires us to take a stand one way or another.

Practicing mindfulness during times of turbulence may be as important an investment strategy as asset allocation or stock selection. Mindfulness is a state in which we are consciously and unemotionally aware of the things taking place around us, including things taking place in the economy and our investments. Mindfulness works to focus our senses, calm our minds, and to help us envision the likeliest scenarios we might face ahead.

Since my last investment letter in April, much has changed. Some of it has been a surprise, like the speed with which the pandemic has slowed economic growth. Others, such as the onset of a recession, have been less of a surprise, and were anticipated.

Mindfully reviewing where we have been may help us to understand where we are heading.

The Treasury's Inverted Yield Curve Accurately Predicted the Current Recession

Throughout 2019, my investment letters highlighted the value of the inverted yield curve as a time-tested predictor of recessions. Whenever this relatively rare phenomenon has occurred in previous periods, a recession has ensued in as little as six months.

An inverted yield curve is a situation in which interest rates on short-term treasury securities, such as 3-month T-Bills, are higher than interest rates on longer-term issues, such as 10-year T-Notes. This is the precise opposite of a normal yield curve and it signals that investors have little confidence in the immediate future of the economy and would instead prefer to lock in the higher rates that longer maturity bonds normally offer.

Fixed income securities such as treasuries have an inverse relationship between prices and yields. Consequently, as investors gravitate to longer-dated treasuries, such as the 10-year, the price of those securities moves higher while their yields move lower. Simultaneously, the opposite happens with short-dated treasury securities, driving their prices lower and their yields higher. The inverted yield curve, therefore, reflects the collective sentiment of millions of domestic and international investors about the future of the U.S. economy. It does it in a completely unbiased way. This is its value as a recession signal.

A recession is defined as two or more quarters of economic contraction. According to the National Bureau of Economic Research (NBER), the official voice that signals both the start and the end of recessions, the U.S. economy entered a recession in February of 2020. That means it did so before the corona virus pandemic hit the nation with its severe human and economic tolls.

In other words, the U.S. probably did not enter the recession because of the pandemic itself as is popularly believed, but because of economic factors that had been deteriorating over the previous two years. These factors would have included the trade war and tariffs with China; the cutting of global supply chains; the nullification of international treaties; and the overall economic policy uncertainties emanating from Washington.

Popular opinion may, however, be correct in that the depth of the recession will be great. This view is supported by the U6 unemployment statistics that mark the broadest measure of unemployment in the U.S. The U6 measure covers those who are unemployed, plus those who are employed part-time but who wish to be employed full-time, plus those who normally work part time, plus those who wish to work but who are too discouraged to look for work. In this recession so far, the U6 figure has spiked to 21% of the working population. By comparison, during the 2007-2009 Great Recession U6 spiked to roughly 16%. Unemployment is only one significant measure of economic health, but it is a dramatic and telling one in this case.

The buzz in the investment world is that the recession may already be over. If true, this would be consistent with what is known as the "V" scenario in the "alphabet soup" of economic recovery scenarios: V-shaped, U-shaped, W-shaped, or L-shaped.

If we are in fact experiencing a V-shaped recovery, then all should be back to normal in short order – and we are in fact seeing some evidence of that in the economic figures. The May head-

line unemployment registered at 13.3%, down from 14.7%, whereas economists were expecting it to spike to 20%. Retail sales in May also rose by 17.7%, surprising economists. Yet, these results may not necessarily be proof of a recovery. In fact they could be expected as a normal bounce back from extreme levels. The NBER has not yet pronounced the end of the recession.

The Fed Has Spoken, But Their Words Are Not Reassuring

The pandemic's slowing effect on U.S. economic activity has alarmed the Federal Reserve so much that the Fed's decision-makers have pledged not to raise interest rates through at least 2022, a full two-and-a-half years from now, if not longer. That is both good news and bad news.

It is certainly good news for borrowers, both individuals and companies, since it allows them to borrow at historically low interest rates to fund personal and business activities. For many, low rates may be a lifeline that allows them to stay financially afloat during the current recession.

Alternatively, the Fed's action can be viewed as bad news since the Fed is essentially signaling that the U.S. economy is in sufficiently poor condition to warrant prolonged life support in order to avoid a full-on depression. The central bank is using a combination of ultra-low interest rates and massive cash infusions to urgently support the economy. Simultaneously, Congress is injecting trillions more from the fiscal side via deficit spending in the form of stimulus checks to individuals and families, as well as grants and loans to businesses.

From an investment risk-taking standpoint, the Fed's move is counterproductive in that low interest rates often encourage risky behavior by investors. To make up for a lack of yield from conservative assets like bonds and high quality stocks, investors may feel forced to take on more speculative selections, thereby increasing their risk of actual loss. If they speculate with money borrowed at low interest rates, that will only compound the danger. In the U.S., interest rates are currently at the lowest levels they have been in the past 100 years (please see the chart below).

Expect The Stock Market Correction to Continue

The recent 45%+ rise in share prices from their lows in March of 2020 has led many to ask why the stock market has risen so much in such a short period of time if the economy is in a recession. The U6 unemployment figures alone are enough to highlight the weakness of the economy, along with the seeming irrationality of the stock market in the face of those figures.

One explanation for the stock market's powerful rise is that the Fed's enthusiasm for keeping rates low and its efforts to expand the money supply are perceived by investors as helpful to the economy and to corporate profits. That may well be true. Low interest rates provide individuals and companies with an opportunity to tap into capital at minimal cost. For corporations, lower costs may mean higher profits, and profits are the fuel that run the stock market in the long-run.

This scenario may in part be why stock market valuations remain stubbornly high as they have since early 2018. From Factset Research: "The forward 12-month P/E ratio for the S&P 500 is 21.2. This P/E is above the 5-year average (16.8) and above the 10-year average (15.1)." (Factset, Earnings Insight, June 12, 2020). High valuations are a clear indication that investors

are still overly hopeful about corporate earnings growth even as corporate earnings continue to decline and fewer CEOs offer future earnings guidance to their investors. These high valuations may also be a sign that a V-shaped recovery is the consensus expectation in the market at this moment.

According to Factset Research corporate profits are anticipated to drop by -43.5% in the second quarter of this year once all S&P 500 companies have reported their results in July and August. Factset also notes that "Fewer S&P 500 companies have issued EPS guidance for Q2 2020 than average. At this point in time, 48 companies in the index have issued EPS guidance for Q2 2020, which is well below the 5-year average for the quarter of 107." (Factset, Earnings Insight, June 12, 2020). The future is foggy and many CEOs have little visibility into the future - they are not sufficiently confident to offer their expectations for sales and profit trends in the months ahead.

Considering how eager CEOs of publicly traded companies generally tend to be in offering a glimpse of things to come, this speaks volumes about the condition of the economy and of corporate earnings. Both remain unpredictable and murky. For the full calendar year 2020, Wall Street analysts are projecting that S&P 500 corporate profits will decline by -21.4%, and corporate revenues will fall by -3.8%. By comparison, at this same time last year they were projecting that corporate sales for 2019 would grow by 4.4%, while profits would rise by 2.6%. The differences are dramatic.

For conservative investors, overvaluation makes it difficult to find attractive stocks for the long-term. The combination of declining corporate profits and high stock market valuations is an unattractive mixture for sustained returns. The prospect of overpaying for an asset where the risk/reward balance is skewed to the downside is unappealing.

We will continue to see volatility in stocks and other asset classes as the pandemic continues. We should expect the stock market correction that began in early 2018 to continue for now. This will mean volatility up and down. It will also mean periods of market activity that make little rational sense as investors and traders incorporate new information into their models and as the world seeks direction and balance in the midst of turbulent events. In the short-term, especially in periods of macro-economic or geopolitical turbulence, emotions tend to upstage rationality.

Realities Beyond the Visible

At no other time in history have we had so much information, news, ideas, and commentary immediately available to us from millions of people and thousands of sources around the world. On its surface investing has become much more democratized and accessible than ever before, thanks to the Internet. The smallest investor now has access to nearly the same information that the large investment houses used to have just a few years ago. The advantage gap has been substantially narrowed between institutional and individual investors.

But access to all of that information should come with a caveat. Information is not necessarily wisdom, and not all knowledge and opinions are useful for investing.

Take the current situation in the economy versus the stock market. The first is telling us that things are not going so well in the real world - the economic numbers, especially the unemployment figures are saying as much. Yet the stock market is giving us the opposite message and has been cheering “the recovery”. The question is, which one is right? What is the market seeing that the economy isn’t? The answer makes a difference to how we invest.

The key is to remain mindful, to look beyond the visible, and to spot below-the-radar trends that are often more telling than splashy marquee headlines or political pronouncements.

For example, last year, while some financial commentators were predicting a strong economy into 2020 and beyond, I noted that the trucking industry was in dire straits. Companies were going bankrupt, and truckers by the thousands were losing their jobs. Long-haul was suffering due to a lack of international trade and domestic demand. The headlines in the media said almost nothing of this, yet this one fact was a harbinger of the current recession.

Simultaneously, the number of states moving slowly into recession was increasing to the point that by year-end 2019 a little more than half of the states were either in recession or very close to the tipping point. The media made almost no mention of this either. To their credit, the financial media did talk about the inverted yield curve as a possible indicator of recession, but often qualified it with an “it may be different this time” remark. From experience, I would say that the same time-tested causes rarely produce different effects “this time” - that would be true for the inverted yield curve as well.

Now, the marquee headlines are hinting that an economic recovery is in progress and are offering as proof the stock market’s strong rise toward all-time highs. While the stock market is often a harbinger of future economic trends, the realities beyond the visible may once again tell us a different story. Staying mindful in these turbulent times will serve us well.

V. Henry Astarjian

U.S. 10 Year Treasury Note Yield

Source: Trading Economics (tradingeconomics.com)

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