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"Cleopatra's Nose" and the Search for Clarity

Relating News to Stock Market Action Through the Lens of Corporate Earnings

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The great 17th century French philosopher and mathematician, Blaise Pascal, once famously wrote "The nose of Cleopatra: if it had been shorter, the whole face of the earth would have changed." Indeed, it would have. In the classical world, a sizable nose was a sign of strength, nobility, and beauty. The storied queen of Egypt is said to have had such a prominent nose that the two most powerful men in Rome, Julius Caesar and Mark Antony, fell head over heels for her. Their armies eventually fought a civil war against each other because of her, and that war changed the course of history. Ultimately, if not for Cleopatra's nose, Rome might have stayed a republic and Western civilization might have been completely different.

For investors today, this colorful anecdote offers a valuable lesson: sometimes it's the prosaic realities in the world that make a big difference to the direction of the stock market or that offer clues to its future.

Big picture issues such as Covid-19, the launch of an effective vaccine, the economic recession, and the upcoming presidential election will certainly impact markets in the coming months, as they already have. But less prominent stories and trends may also hold clues to the future and aid us in our understanding of the investment climate months or even years ahead.

Following the news flow as a means to making investment decisions is a time-tested approach and has considerable value. Yet, the challenge faced by investors who use only this method is that the sheer volume of news crisscrossing the globe often makes it difficult to discern which stories are valuable and which are not. Ultimately, an investor's buy or sell decisions cannot be based solely on media reporting.

The best litmus test for investors is corporate profitability. Profits are the fuel that propel long-term share prices, so it makes sense to relate news to the question of earnings. For the investor, a profits-focused view of the world can work to minimize portfolio risk, and to prevent rash decisions.

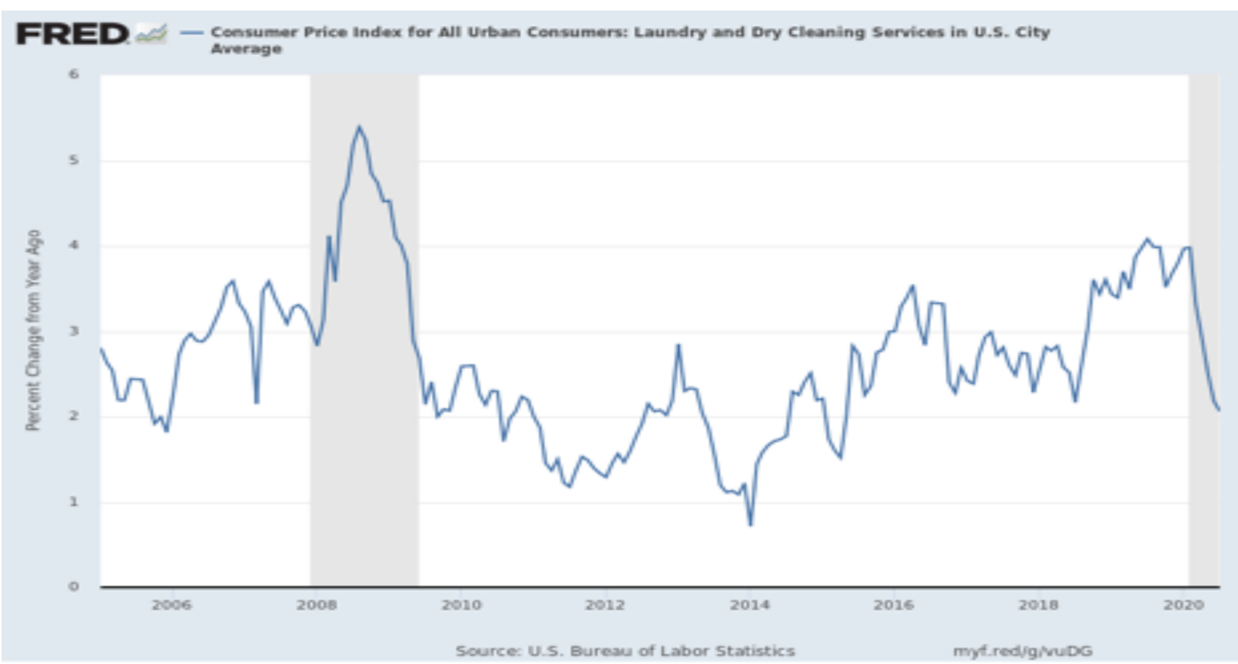
Just as sound investing requires analysis of different kinds of information, stock picking also benefits from attention to the performance of a wide spectrum of industries, even small ones. While name brand sector benchmarks like technology or healthcare are indeed barometers of broad trends, there is an entire economic ecosystem that bears monitoring for clues to the direction of corporate profits.

This quarter we focus on one of the most basic and necessary segments of the economy, laundries and dry cleaners. This much-overlooked industry can offer us some clues to the direction of the economy, and hence to the direction of the "average" stock on the stock market.

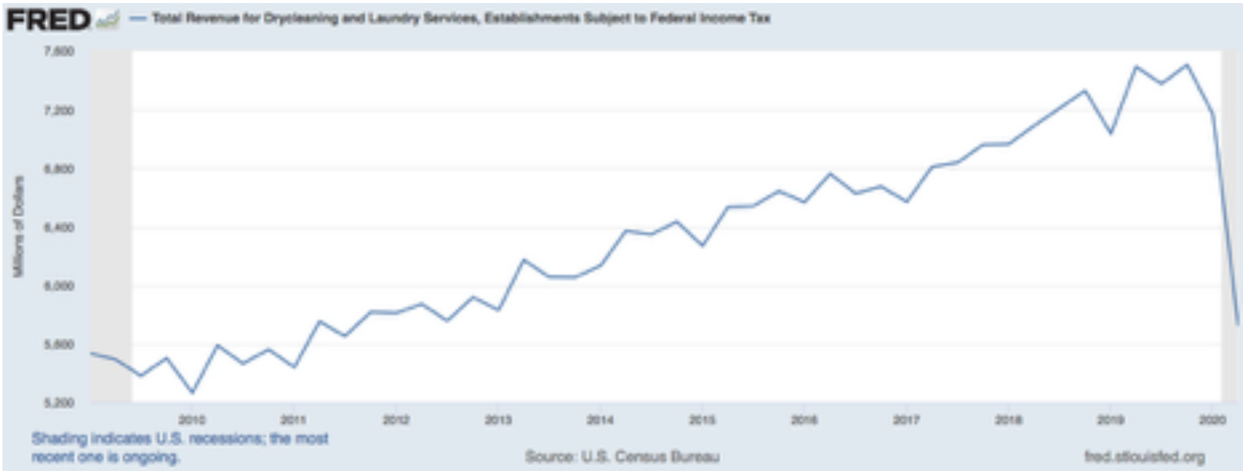
<u>Laundry and Dry Cleaning Services and the Current Economic Environment</u>

How can laundry and dry cleaning services tell us anything about the economy? Often, before major economic indicators hint that the economy is emerging from a recession and starting to strengthen, laundries and dry cleaners see an increase in business as job applicants prepare for their interviews, furloughed workers return to their work places, hotels and restaurants perk up, and events such as weddings and social gatherings return to their normal cadence. Conversely, before the economy turns down and workers are laid off or furloughed, dry cleaners and laundries see a drop in their business as fewer shirts, pants, suits, dresses, uniforms, tablecloths, and so on, need to be cleaned, and as clothing alterations are postponed.

The U.S. Bureau of Labor Statistics maintains an index that measures activity in this sector. The Laundry and Dry Cleaning Consumer Price Index is a street level view of the economy that has a lot of common sense appeal. A chart of the index's year-over-year changes is provided below.



Another chart highlights the dramatic pandemic-induced drop in the industry’s revenues.



Both charts show that there has been a marked slowdown in this $9 billion slice of the U.S. economy since slightly before the start of 2020, with no visible return to normalcy in business as yet. Employment in the industry has also fallen, dropping from roughly 209,000 workers in 2019 to under 200,000 today. As a fragmented industry of roughly 30,000 cleaners nationally, 85% of which are small family-owned establishments, the effects of the pandemic are hard for stand-alone firms to avoid.

The International Drycleaning and Laundry Institute reports that laundries and dry cleaners were operating at only 15% of their normal capacity directly after the pandemic hit the U.S. in March. They indicate that while business is recovering in the industry, it is doing so slowly. Dry cleaning delivery volumes are down between 25% to 35% since the start of the pandemic, and in-store volumes remain between 45% and 60% below the industry’s pre-Covid levels. Research firm IBIS/World expects the entire industry to contract by -20% in 2020 after already contracting at an average rate of -3% each year from 2015 to 2020.

One mitigating factor in the laundry and dry cleaning industry’s slowdown may be that millions of people are now working remotely and therefore need fewer dry cleaning services. However, the implication from the industry’s continuing weak performance is that despite the recent upturn in hirings and re-hirings of workers, the broader U.S economic weakness has not ended yet. While some workers may never return to an office environment and may not need much in the way of dry cleaning and laundry services, most eventually will. When they do, this industry is likely to pick up noticeably, possibly even before hiring numbers are reflected in the broader national employment statistics. That should signal a return to some normalcy in the country’s economy.

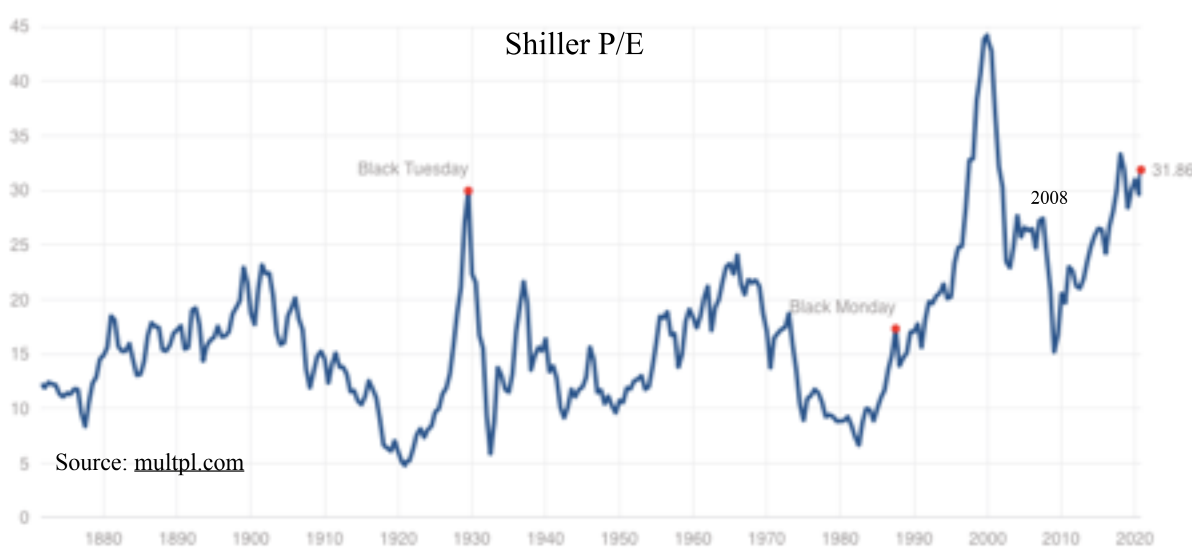
Elections and High Valuations - Two Headwinds to Stock Market Gains

Elections are often hard to predict. Historically, this four year cycle has been relevant to the investment climate mostly for the policies that a president will adopt, particularly in the areas of taxes, legislation, regulations, and trade. In the past, change has occurred at a glacial pace in these four areas, making it relatively easy for corporations to operate and to plan for the future with a relatively high degree of certainty.

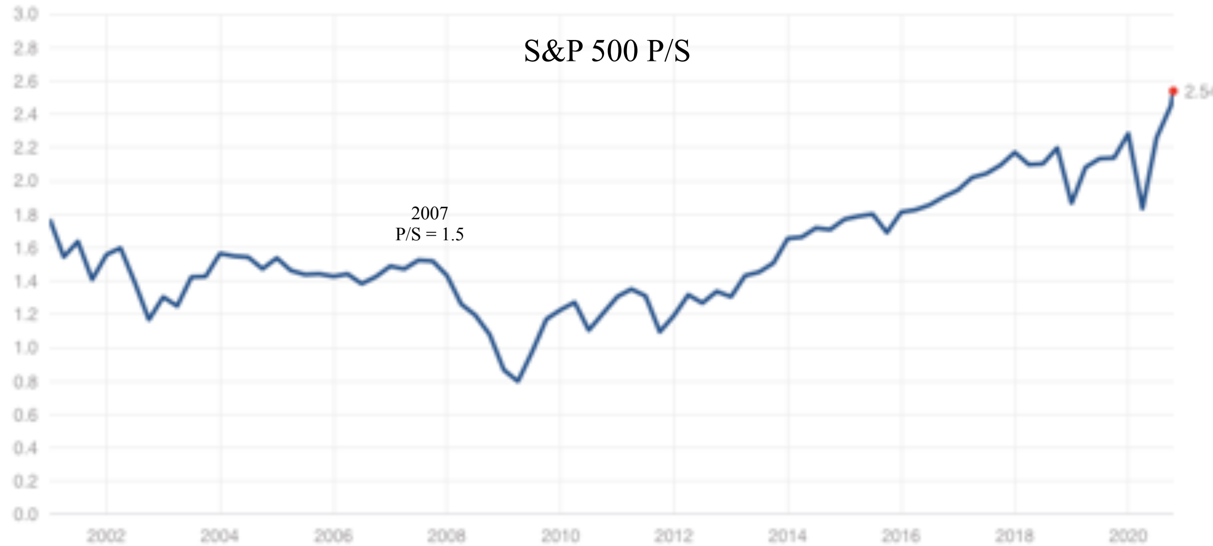
However, 2020 is different. This year, with the hyper-partisan tone of the presidential campaigns, there is a new risk around the elections that investors cannot ignore. Namely, it is the risk that the presidential election will be contested, and that it will be contested for an extended period of time, perhaps for months. The old axiom that "investors hate uncertainty" could apply here with real-life consequences to both the economy and the stock markets. There is perhaps no greater uncertainty than not knowing who your next president will be or what their policies will look like once they are in office.

Investors should expect this possibility to be a bit of a Cleopatra's nose event in the sense that the transfer of power or the uncertainties of a contested election, could become a driver of corporate profits or losses. CEOs make decisions on the basis of what they know, or what they don't know.

In addition to the elections, valuations continue to be a headwind for stocks. For the past several years the stock market has traded in overvalued territory. The Shiller P/E (chart below), which measures the current price of the stock market divided by 10 years' worth of corporate earnings, is trading at almost 32, versus its historical average of 16. It was roughly 27 just before the 2008 market downturn.



Another measure of valuation, the S&P 500's price-to-sales ratio, currently stands at 2.54 versus its 2007 value of 1.50 .



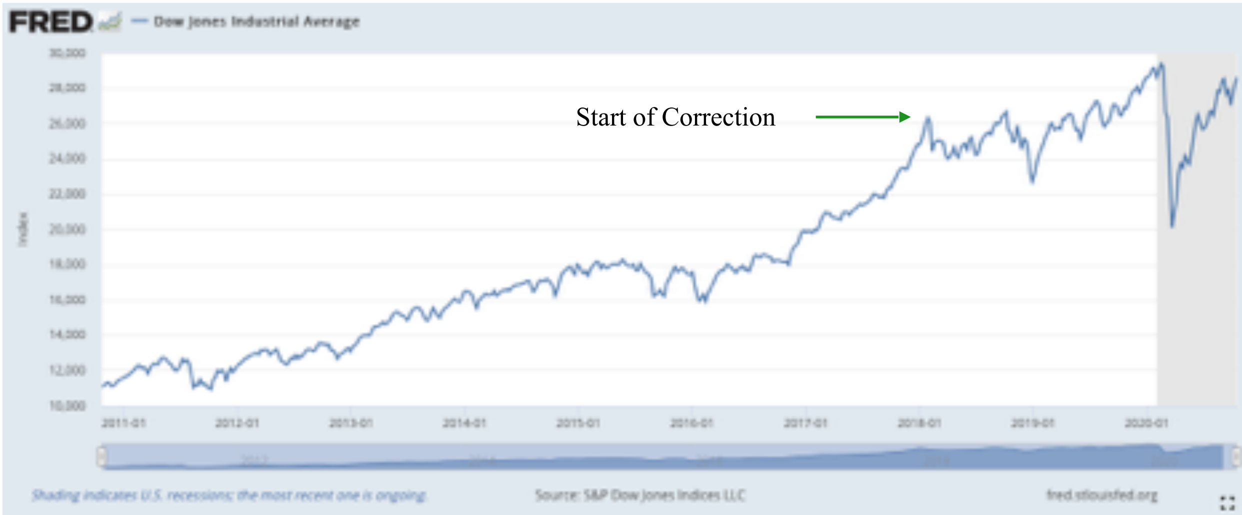
These two commonly used measures of valuation continue to be warning signs for long-term investors. For sure, overvaluation can persist for months or years even as the stock market continues to rise. In the face of a recession, a pandemic, and an uncertain presidential election, however, overvaluation is reason for caution. High valuations, *under all circumstances*, eventually succumb to gravity.

The Stock Market Correction Is Likely to Continue

Since March of this year when the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite hit their pandemic low points and then began their steady climb to their pre-Covid highs, investors have been asking if we are now in a new bull market? Clearly, their question is not idle curiosity. They are asking whether or not they should buy stocks, sell or trim what they own, or just sit tight?

My answer remains the same as last quarter: we should expect the stock market correction to continue for now. The trend of the market will likely be down or sideways, not the broad upward trend that we would hope to see in a bullish scenario.

The chart below shows the trend of the Dow Jones Industrial Average and may add some perspective. Please note the start of the current correction, which by my estimation can be dated to early 2018.



The uncertainties in the economic and political spheres are sufficiently weighty at this time that they could continue to impact corporate profitability over the coming months. When combined with persistently high stock market valuations, this lack of clarity skews the stock market's risk/reward scenario far more toward risk than to reward. The economy still officially remains in recession. The Covid-19 pandemic continues to hobble business activity throughout the country. And the 2020 elections inject uncertainties into the question of policies and regulations under the next congress and administration. These factors work in concert to weigh on a necessary aspect of long-term earnings growth, namely corporate planning. The tariffs of 2018 and 2019 did the same.

Corporate profits growth has continued to stagnate throughout this year. Factset Research estimates that full-year profits for S&P 500 companies will be down over -20% in aggregate for all of 2020. Last year S&P earnings were up a bit over +5%.

The Fed to the Rescue? Not Quite

In response to these challenging realities, the Federal Reserve Bank, the Fed, has promised to hold interest rates at near-zero until the end of 2024. Last quarter they promised to keep rates low only to the end of 2022, so this new timeline highlights their worry about economic conditions.

Clearly, the economy is weaker than the Fed originally thought it would be and will take longer than anticipated to recover. Under more normal circumstances, when broad uncertainties are fewer, low interest rates tend to be strongly supportive of higher share prices.

But this time the signaling effect of the Fed's decision to maintain low rates for years is less an acknowledgement that stocks have a good environment in which to grow, and more a confirmation of harsher realities about current and future economic conditions.

Minimize Risk and Keep Your Ear to the Ground

With that in mind, it is fair to conclude that this is not an optimal time to take on more risk than necessary in our portfolios, especially for investors who may need to use their assets in the next 12 to 24 months. It is a time for continued caution and for keen attention to the news flow as it affects the trajectory of corporate earnings, and hence share prices.

High stock market valuation levels mean that a basket of high valuation stocks bought today and held in a passive buy-and-hold strategy stand a fairly poor chance of delivering acceptable returns over the next few years. In fact, research firm Morningstar reports that a number of major investment firms are projecting average stock market gains of only 1.7% over the next ten years. This projection is well below the actual average return of the past decade, during which stocks rose approximately 13% per year, as measured by the S&P 500 ETF, the SPY.

"Cleopatra's nose" and our search for clarity, need not be more complicated than our ability to relate the vast array of daily news to trends in corporate earnings. We can say with confidence that ***over time***, corporate profits drive stock prices. As earnings rise, so do share prices. As earnings fall, so do share prices. It's an elegantly simple formula whose elements can be clearly observed, tracked, understood, and used to make rational investment decisions. Combined with patience and perspective, this is an effective approach to investing for the long term.

V. Henry Astarjian