Market Update- September 14, 2020

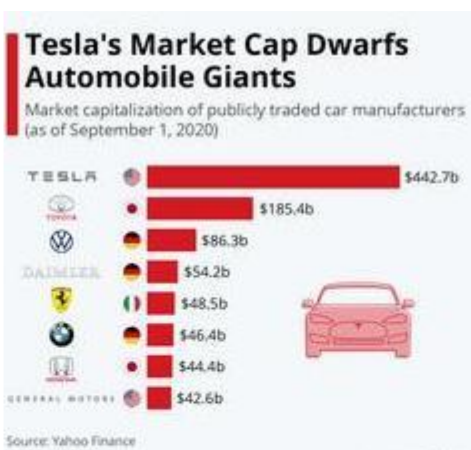
I hope that this finds you healthy and as positive as one can be during this continued odd time.

This past weekend, the Detroit Lions held a commanding 17-point lead in the fourth quarter, only to find themselves down by 3 points with 6 seconds to go. They proceeded to drop a winning touchdown pass just as time expired. Another inexplicable loss, S.O.L. or Same Old Lions. While mourning yet another loss, it occurred to me that perhaps I should be rejoicing. Maybe this is an indicator that life is beginning to return to normal?

Stock Market and Big Tech

The stock market continues to defy odds with technology companies carrying lofty multiples and valuations. Although we are grateful for a short-term V-shaped recovery (but not GDP), more volatility could be right around the corner, ultimately ending at some point with something that is more complex than a simple V. To provide the most notable example of extreme-valuation, consider the following from our electronic vehicle friends at TESLA, familiar to most in the Detroit area.

- TESLA's market cap (stock valuation) is more than $400B as of September 1, 2020. (1)
- TESLA's valuation is greater than Toyota, VW, Daimler, Ferrari, BMW and HONDA…combined. (GM is next on the list FYI and equals roughly 10% of TESLA).
- TESLA delivered fewer than 400,000 cars in the 12 months ending March 31st.
- During that same period Toyota sold 10.5 million vehicles.(2)
    - This is greater than Tesla has built in its existence.
    - Insert an electrified car zoom sound you can't hear. (3)

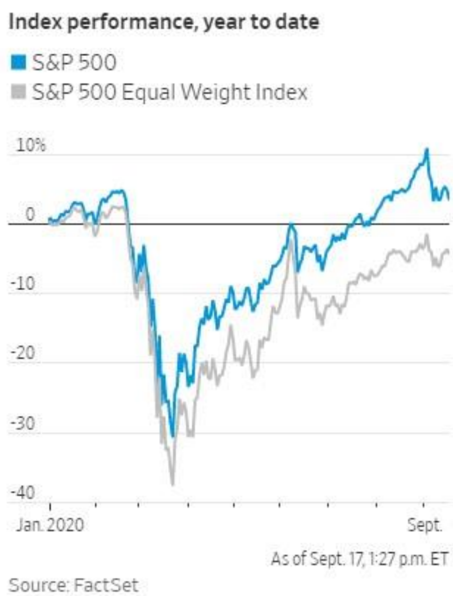


Make no mistake, after riding in a TESLA, they are admittedly genius vehicles. However, considering that they make up less than 2% of the U.S. auto market, the current stock price and valuation simply do not make sense mathematically. This holds true even if TESLA's growth prospects are dramatically higher than projected.*

Value vs Growth

Year-to-date the World Growth Index has outperformed the World Value Index by a stunning 27%. The ratio of the World Growth Index relative to the World Value Index is now exceeding the prior peak level it achieved in 1999 at the top of the last tech bubble. Digging deeper if the S&P 500 was equalized and not weighted (meaning all stocks are created equal) then the return goes from +2.6 year -5.9%. This 9% differential is due to the unimaginable performance and weight of the tech based FAANG stocks which continue to carry the overall market and now represent a quarter of the S&P Source. The market value of US Tech stocks is now greater than the entire European Market and Apple alone is larger than the entire British Stock Market. (4)

Over the next 5-10 years value may outperform growth. Obviously, this is no guarantee. The one thing we know for sure in this current market environment is *that the prices of the market darlings have gone up by far more than their revenues and cash flows.* As such, this melt up means lower prospective returns, and those companies now need to grow into much larger valuations to support these current prices.



It is a reminder of a lesson learned very early in my career that what you leave out of a portfolio can be more important than what you include in it. It reinforces our conviction in positioning into a more value concentrated portfolio. Understand that we do own some SAMSUNG, Google, Facebook and Oracle (inside of FPA, First Eagle, Yacktman. (5) But their valuations and industry dominance appear much cheaper than the likes of TESLA, Netflix and the ZOOMs of the world.

International Exposure

The US market has grown rapidly compared to that of the rest of the world stock markets and is now more expensive compared to other countries. Moving forward more opportunity may lie in overseas markets. First Eagle has noted that their largest overseas weighting is in Japan and interestingly enough, Warren Buffett recently added to Japanese stocks as well. (6)

I also question how much more juice can be squeezed by US Corporations in the coming years. Note in prior newsletter that U.S. corporate net income margins were at 50-year highs. US corporations in general have gotten very efficient, which leaves much less room to improve going forward. Cutting US corporate tax rates from 35% to 21% has been an unbelievable accelerator and hugely beneficial to cash flows. Most of this free cash flow went into stock buybacks and dividends which are being viewed at critically by those in Washington DC currently and likely moving forward.

Gold Questions and Covid-19

Gold is up over 60% since the bottom in March and has been a very important contributor to many of our portfolios this year. While I wouldn't have guessed that the stock market rebound ahead of December 2019 levels with the largest GDP contraction on record, the bounce in gold is not terribly surprising as mentioned in the last newsletter due to two main points:

1. uncertainty
2. printing money/ stimulus/ currency devaluation

With D.C.'s printing press in full production mode and a potential weakening of the dollar, gold and miners may fare well. Although First Eagle has started to sell a bit into the gold rally, it still maintains a much higher weighting than the historical average. Second, Warren Buffet has long been an outspoken critic of gold and gold stocks. Recently it is worth noting that he invested heavily into a few gold stocks. And while I'm completely unsure as to the short-term direction of the market, gold still seems to fit nicely into a portfolio as a hedge against future uncertainty, a weakening dollar, unrest, etc. (7)

Summary

"We learn from history that we do not learn from history."- Georg Hegel

Irrational behavior has once again entered pockets of the market. Faith-based investing is questionable, whether it be blind faith in a charismatic CEO or simply praying the tech bubble and the FAANGS will never go down. Central bankers are the ones widening the gap between the Haves and Have Nots. They are encouraging continued risk taking when they purchase high yield bonds and exacerbate bailout money. If you give a puppy a treat when he's behaving poorly, you reinforce bad behavior.

Low interest rates encourage risk and greed in both equities and the desire for growth, coupled with overborrowing. Ultimately with rates so low, investors who are thirsty for growth will gravitate to stocks vs bonds. I believe low interest rates will continue for years to come after years of believing they must slowly appreciate. Governments have an imperative to keep rates low, if for no other reason than minimizing interest and budget damage. But a reminder that over extending to stocks is a fool's errand, and a careful selection for your individual portfolio need is critical. We are hardly out of the woods, just a few miles into a treacherous hike. Consider that this morning that the Federal Reserve noted that unemployment figures might not return to pre-Covid-19 levels until 20238.

Second, as important as this presidential election is to many on so many different levels, perhaps the more important vote economically is if the Senate were to flip to the Democrats. You can expect higher corporate taxes together with more social programs. This would likely put an even more significant crimp in our economy, and we don't think the markets yet appreciate that, along with the spending that Trump fully supported prior to Covid-19, including the tax cuts. To conclude, I feel strongly that spending will occur with whomever is elected, and the national debt will grow. Long term, this is a huge headwind, but not discussed.

For these reasons and perhaps more attractive valuations outside the United States, our eye remains on quality and long term. Prep for more volatility and know that your buckets for spending inside of your portfolio are in a galaxy far-far away from direct stock exposure.

"You are unwise to lower your defenses." Darth Vader, Star Wars

Furthermore, the reality is that a gravitation toward Covid-19 related business feels comforting and safe, but isn't. As for Covid-19, there is no roadmap for a pandemic and little for the type of social unrest and polarization that I have discussed in the last three newsletters. Strong opinions on the far left and the far right make it nearly impossible for those in the middle to have a voice. With businesses closed, schools completely discombobulated, the elderly scared and lonely, socialization hijacked, and the health crisis itself, there continues to be more question marks than we have ever encountered.

However, we will survive and get better. We have progressed as a society. I am proud to be an American although critical of many Americans. And while critical, I feel a responsibility to look in the mirror. That is the only way to make our own communities and world a better place (along with realizing how much gray is in my beard). Pointing the finger, blame, and wearing blinders simply serve no purpose.

Keep smiling through your mask and thank you for your business.

We are working hard for you and will provide another update shortly prior to the election.

Sincerely,

Corey and Dan