

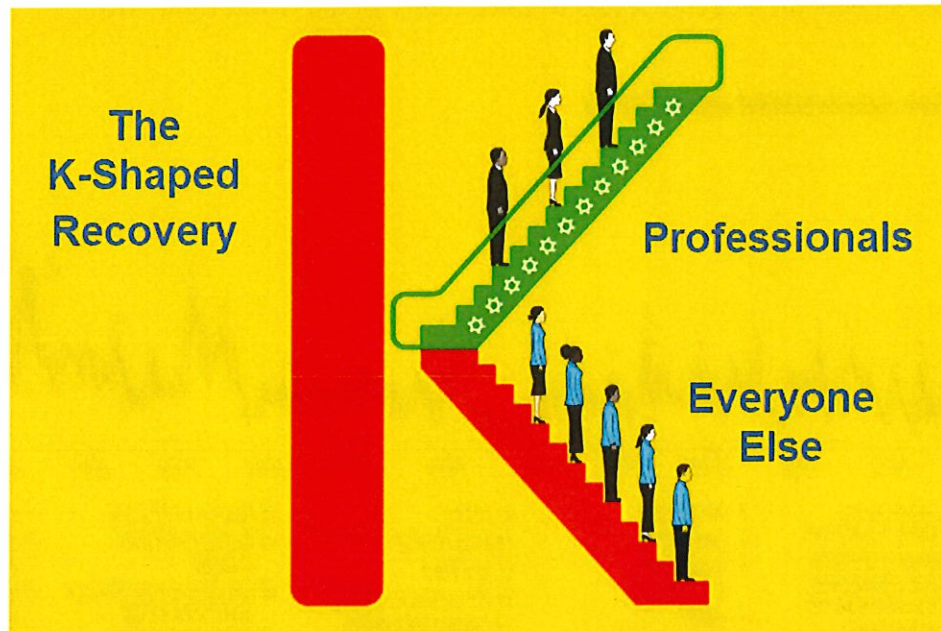
Katonah Capital Group, LLC

BALANCE IN A CHANGING WORLD

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THIRD QUARTER 2020 INVESTMENT ADVISORY REPORT

~ On Average, We're Doing Just Fine!

Globally, equities continued their rebound from the pandemic-induced implosion in the first half. This was fueled once again by fiscal and monetary stimulus pumped into economies. A recent McKinsey report discussing the unprecedented depth of the pandemic crisis stated “Governments’ economic responses to the crisis is unprecedented too: \$10 trillion announced just in the first two months, which is three times more than the response to the 2008–09 financial crisis... Western European countries alone have allocated close to \$4 trillion, an amount almost 30 times larger than today’s value of the Marshall Plan.”¹

¹ <https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-10-trillion-dollar-rescue-how-governments-can-deliver-impact>

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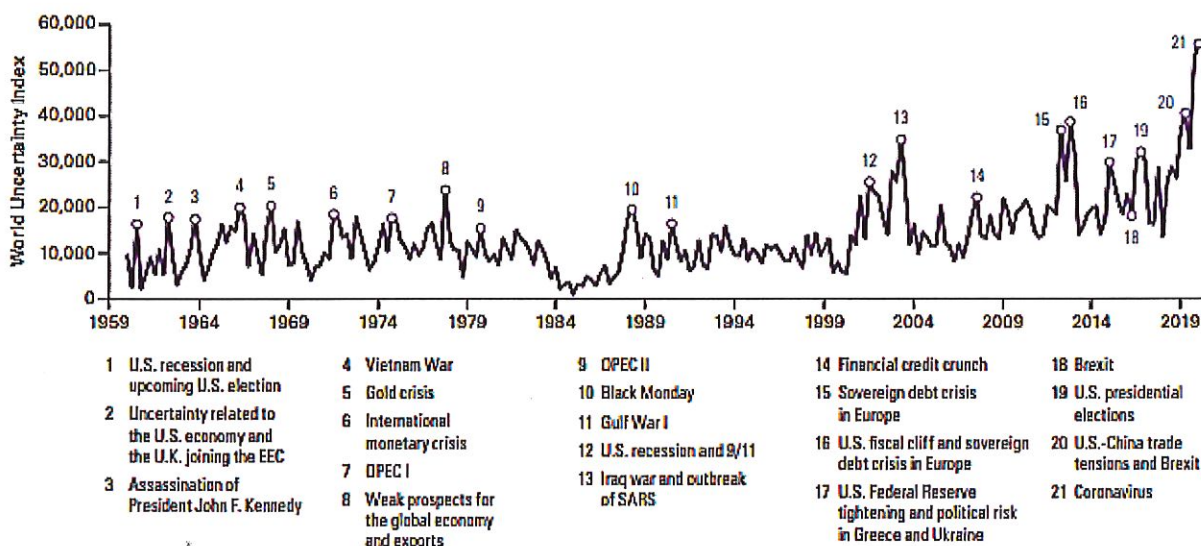
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The resulting economic recovery has been uneven though, and after rallying to new all-time highs in the beginning of September, markets have experienced renewed bouts of volatility and have basically chopped sideways for the past month. There is clearly a “bull market” in uncertainty right now. Europe is experiencing a resurgence of coronavirus and cases are picking up in the US. As of this writing, we are in the midst of elections in the United States and unfortunately, I must use that term loosely, for this country is far from “united”. The chart below from Vanguard depicts the extreme levels of uncertainty in the world right now.²

FIGURE I-1
COVID-19 has exacerbated uncertainty



Notes: The World Uncertainty Index tracks uncertainty across the globe by text mining the country reports of the Economist Intelligence Unit.
Source: World Uncertainty Index, available at <https://worlduncertaintyindex.com/>.

Right alongside the worlds governments have been the central banks. According to Fidelity, “The Federal Reserve delivered massive monetary accommodation, pushing its balance sheet above \$7 trillion by the end of Q2.” Globally, more than \$6 trillion of liquidity has been injected into world financial markets. However, Fidelity astutely observes that “While both the policy response and the market recovery have been dramatic, *some of the near-term remedies may have exacerbated pre-COVID underlying weaknesses. The Fed’s emergency lending facilities have driven corporate debt – already at record levels – even higher. In addition, gains in financial assets tend to benefit wealthier households but not lower-income tiers, which face greater economic distress* (emphasis added).”³

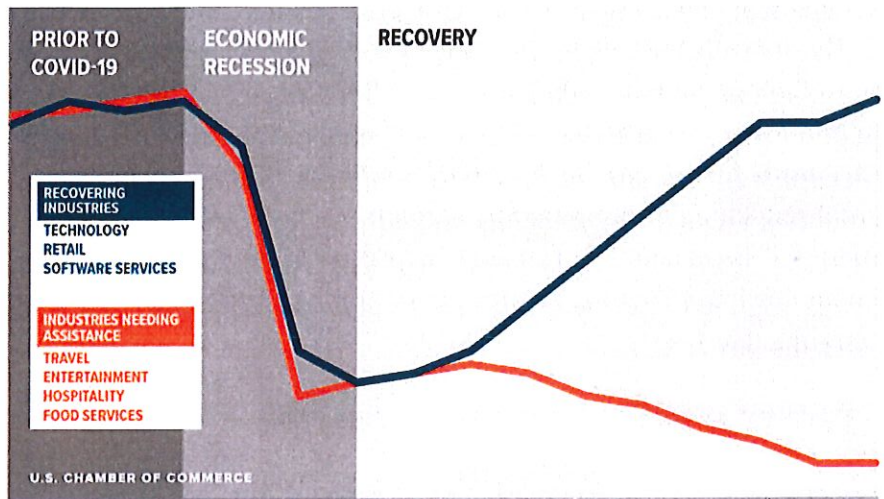
² <https://advisors.vanguard.com/iwe/pdf/ISGMVEMO.pdf#page=5>

³ “Quarterly Market Update: Third Quarter 2020”; Fidelity Investments; pg.2

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The article notes that “The trade war is on the back burner now but...(other) factors are at play, too; the pandemic is encouraging automation, for instance. US manufacturers may come back, but the jobs they once provided may not.”

60% of GDP and 85% of the workforce are astounding statistics. But it’s a key factor in the development of the “K shape” of the current recovery. It is well captured in the image below from a cnet.com article:



This is what a K-shaped recovery looks like.
US Chamber of Commerce

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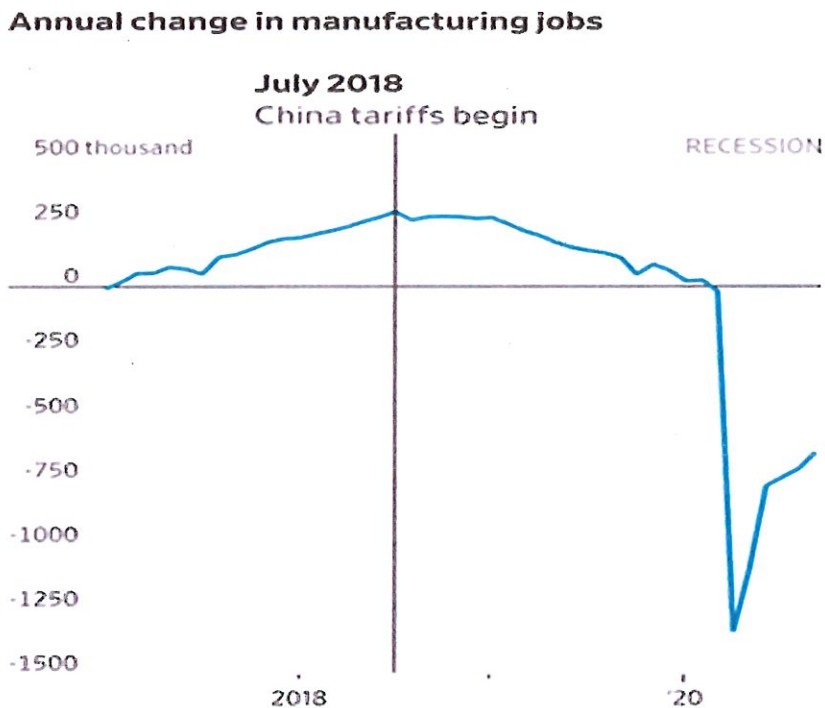
The article explains: "The K analogy is certainly appropriate, given how specific the recovery is to different industries,' said Holly Wade, executive director of research and policy analysis for the National Federation of Independent Business, the largest small business association in the US. 'If you're in an industry that relies on public crowds -- entertainment, gyms, restaurants -- you're still under serious restrictions, and consumer spending has shifted to products and services without crowds.'"

The impact of this on unemployment has been pronounced. On the surface, the data indicates that claims for unemployment are declining. But as a Hedgeye research report explains, “We are now 32 weeks into the onset of the pandemic driven increase in Jobless Claims. Normal State UI (Unemployment Insurance) Benefits last 26 weeks. Continuing Claims continue to fall but mostly due to people exhausting eligibility. Those individuals losing eligibility will either drop-off altogether or will roll-into PEUC (Pandemic Emergency Unemployment Compensation)

⁶ <https://www.cnet.com/personal-finance/americas-v-shaped-vs-k-shaped-economic-recovery-what-does-it-all-mean/>

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These are three extremely significant points, and we'll examine each one. First, regarding existing underlying weaknesses in the economy, recent GDP data shows the economy growing at a record 33.1% in the 3rd quarter. However, as Barron's recently noted, "...after a record annualized contraction of 31.4% in the second quarter and a 5% annualized decline in the first, that still left the U.S. economy some 3.5% below its pre-covid peak." The article quotes Joe Carson – one of the first economists to warn of the depth of the recent downturn – who noted that "...this was the first recession in the post-World War II era concentrated in the services sector...consumer spending on services, such as travel, recreation, and entertainment, has been shifted to goods. But that shift has its limits. Once you buy a new laptop, exercise bicycle, or riding mower, you're not about to buy another soon. After you go to a restaurant today, you'll want to eat again tomorrow. 'A sustainable recovery cannot occur until the service sector is fully open because *it accounts for roughly 60% of GDP and over 85% of the workforce*' (emphasis added)...The partial reopening of the economy still left service sector jobs 10 million below the levels of early 2020,'" Carson added.⁴ The next chart from Mauldin Economics drives home Carson's point about needing to get the service sector going again because the manufacturing sector will not carry the day.⁵



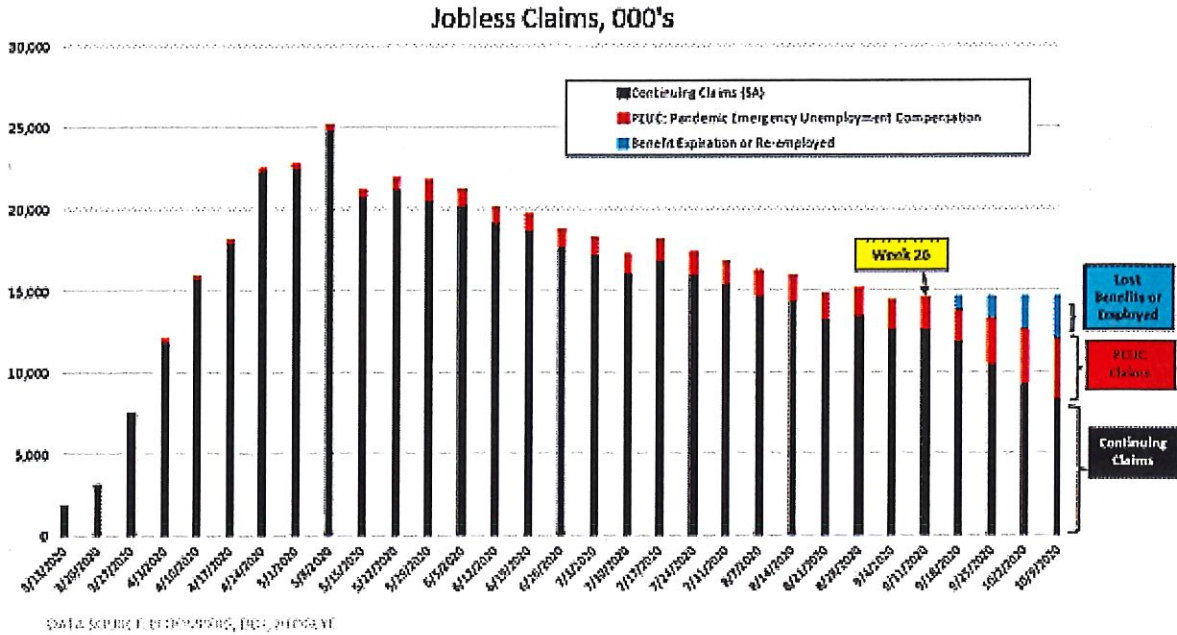
Source: Labor Department
Source: The Wall Street Journal

⁴ "Up & Down Wall Street"; Barron's; November 2, 2020; pg. 9.

⁵ Over my Shoulder: Clips That Matter; Mauldin Economics; October 28, 2020; pg. # 2.

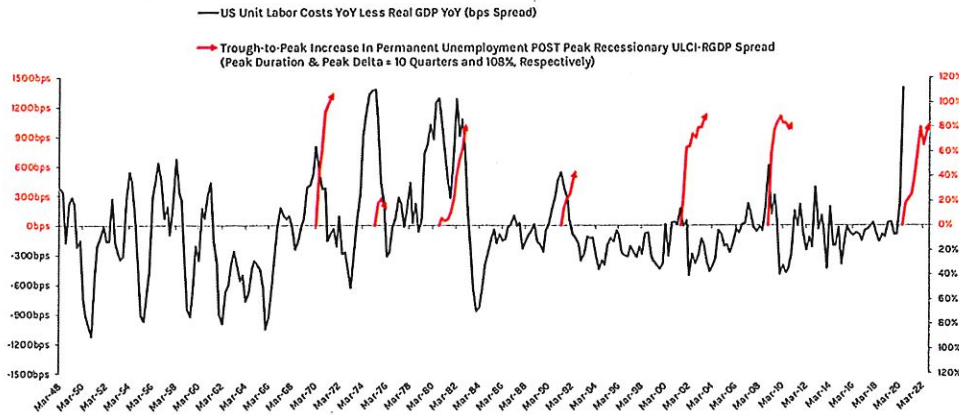
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claims or other Extended (state) Benefits.”⁷ Thus, as shown below, the 10 million unemployed that Carson referenced above is closer to 15 million and holding steady:



Permanent Unemployment Could Double From Here

HEDGEYE TV
The Macro Show
October 15, 2020

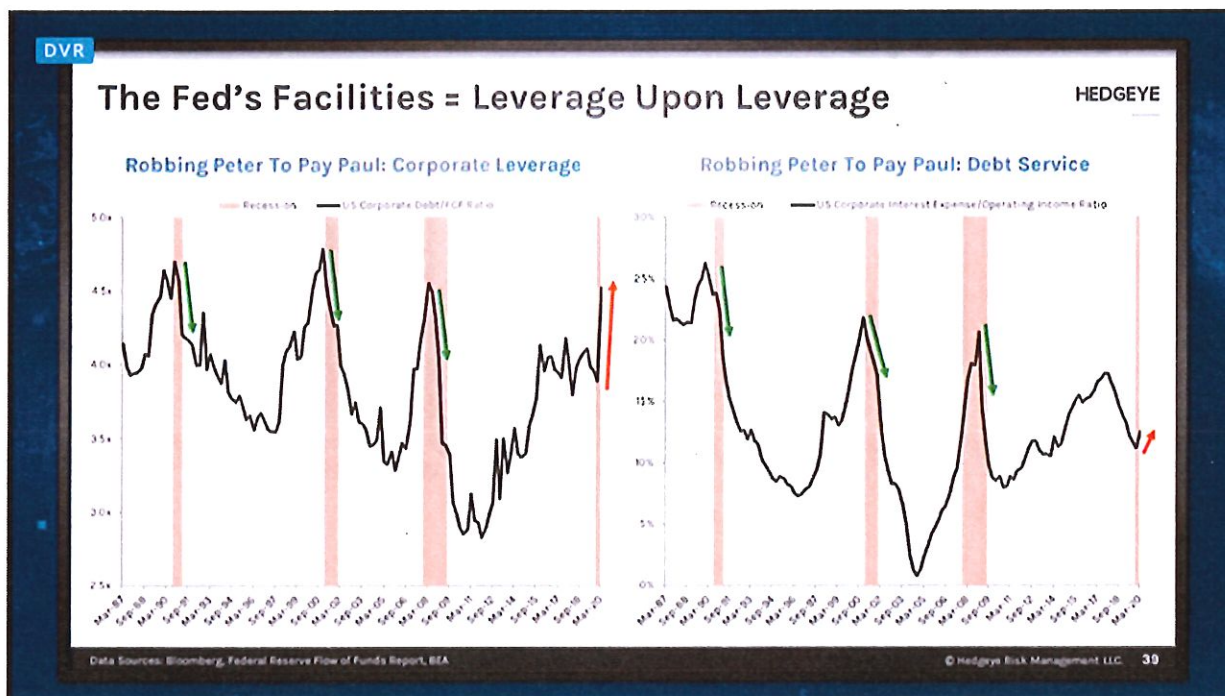


The growth in the blue and red bars above indicates that Permanent Unemployment is increasing. However, as shown above, Hedgeye feels that it could get much worse because at this point in

⁷ Market Edges: “Leave Your Emotions at the Door”; Hedgeye; 11/02/20 11:31 AM EST; pg. 3

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the cycle unit labor costs become an increasingly burdensome expense for companies relative to the (lack of) growth they're experiencing.⁸ As much discussed in prior reports, the "tried and true" response has been and remains ever more and more stimulus. According to Ben Bernanke and Tim Geithner, this has saved the universe from certain collapse. However, the next chart shows an astounding occurrence.⁹



In every major recession going back over 3 decades, there was a pronounced corporate deleveraging. This makes intuitive sense. During tough times, companies hunker down, reduce debt and interest servicing burdens, and/or declare bankruptcy. Not so in today's brave new world of trillion dollar deficits and QE infinity. During this most recent collapse, debt leverage and debt servicing expense has actually increased! Sadly, this is still barely addressing the underlying issues of weak economic growth and consequent subdued growth in employment.

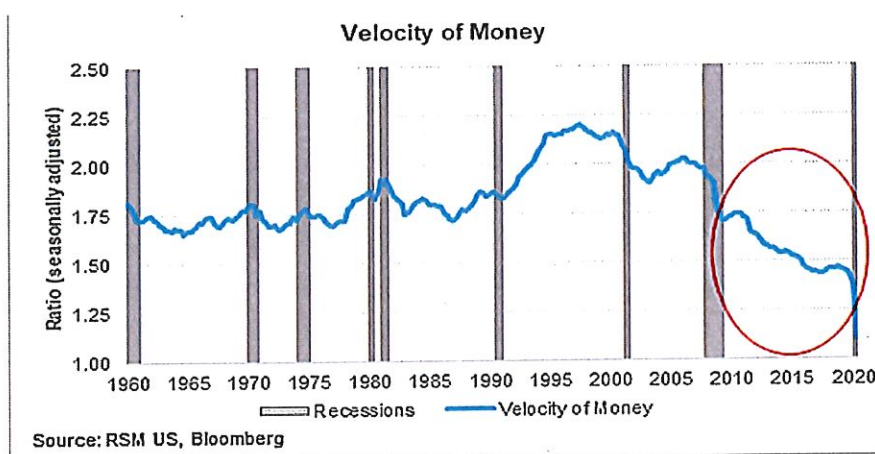
If the injections of liquidity were in fact generating growth, it would be apparent in a measure called the velocity of money. This is essentially the rate at which a given measure of money or currency changes hands in the economy. According to The Real Economy Blog, "the change in the velocity of money is generally a function of two things: the pace of growth in the economy and growth in the money supply. Despite strong M2 growth, the velocity of money has declined

⁸ The Macro Show; Hedgeye Risk Management; October 15, 2020; slide # 8.

⁹ The Macro Show; Hedgeye Risk Management; September 17, 2020; slide # 39.

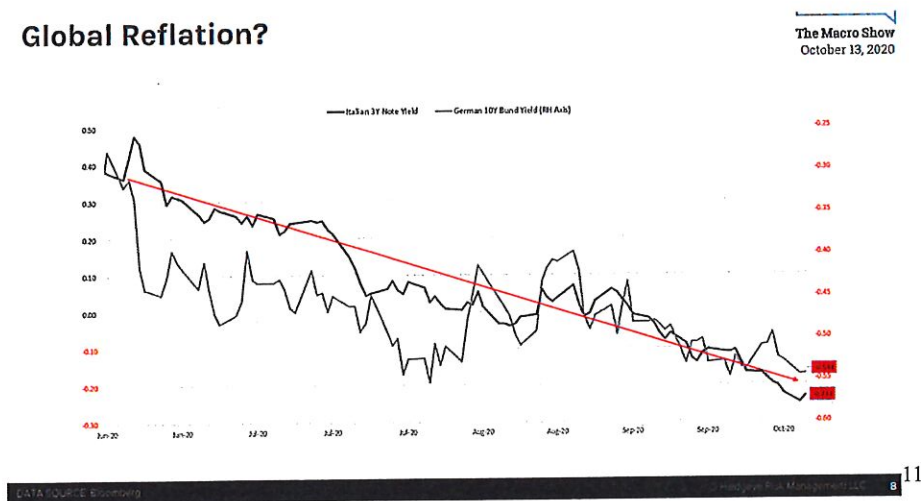
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sharply. This would tend to suggest that growth will remain quite slow once the initial rebound of the economy reopening passes. Moreover, despite the robust increase in fiscal and monetary policy to prevent a greater economic catastrophe, that risk to the outlook remains skewed toward disinflation or outright deflation in the near to medium term.”¹⁰



This can also be seen in the next chart showing Italian and German bond yields. Yes, they are both *negative* meaning the buyer either has to pay the borrower for the privilege of lending them money, or the buyer must find someone else who’s willing to pay an even higher price (lower, even more negative, yield).

Global Reflation?



As Fidelity referenced above in their Market Update, “The Fed’s emergency lending facilities have driven corporate debt – already at record levels – even higher. In addition, gains in

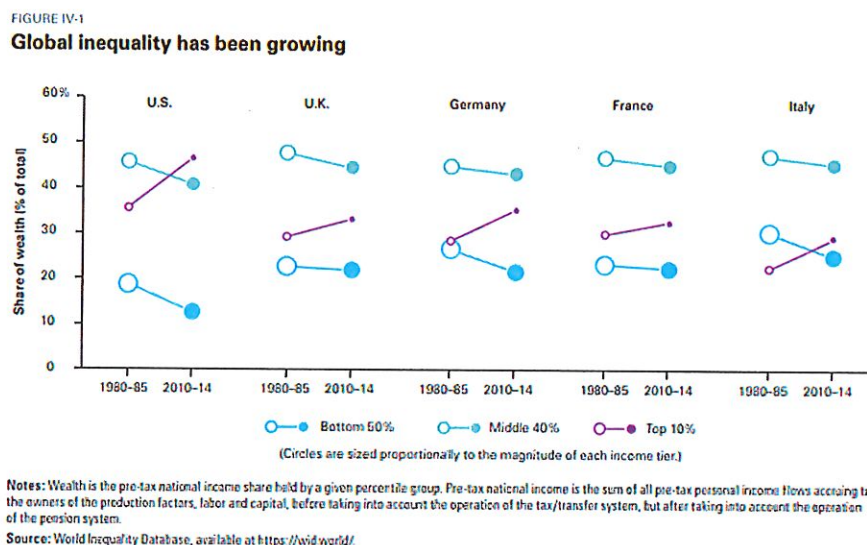
¹⁰ <https://realeconomy.rsmus.com/velocity-of-money-pandemic-induced-slowng/>

¹¹ The Macro Show; Hedgeye Risk Management; October 13, 2020; slide # 8.

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financial assets tend to benefit wealthier households but not lower-income tiers, which face greater economic distress.” The c/net article makes the same observation. “The K shape manifests in other ways, too. The stock market is doing well, but almost half of the country doesn't own any stock, according to Gallup. People who can work from home can continue working more easily than those whose job requires them to show up, and regions that rely more on tourism or hospitality obviously suffer more than those with a high density of technology jobs.”¹²

Lest any of this be misinterpreted as political commentary, it must be noted that while these trends just happen to be becoming more pronounced during the current administration, they absolutely did not originate here. They have in fact been progressing for decades, and across the entire Western world. This can be seen in the chart below from Vanguard: ¹³ In every instance over the past 4 decades, the percentage of wealth accruing to the top 10% has increased while the percentage accruing to the middle 40% and bottom 50% has decreased.



The disparity is glaringly obvious in current news stories. To wit, a recent headline in the FT reports that while commercial airline flights have been reduced by half, “Private Jet Operators Reap Windfall as Wealthy Flyers Splash Out to Avoid Virus.”¹⁴ Or, “Bonus Plans Redrafted to Prop Up Pay”, a story which relates how “Companies are rewriting bonus plans, switching performance metrics and ignoring missed targets so that executives do not suffer a big drop in

¹² Op. cit.; # 6

¹³ Op. Cit. # 2.

¹⁴ “Private Jet Operators Reap Windfall as Wealthy Flyers Splash Out to Avoid Virus;” FT; 10/26/20; pg. 1

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pay as a result of the Covid -19 crisis.”¹⁵ Contrast that to the unemployment data presented above!

Where this ends is impossible to say. It could be this month, or this could be a decade similar to the “roaring twenties”. That decade, of course, ended poorly, but that gives us 9 more years of a bull market! A JP Morgan report proclaims that “A new economic cycle...started this summer. If the Fed gets its way, it’ll be a long one, marked by falling unemployment, rising wages and higher corporate profits... The Fed’s change is a positive for economic growth...In the near term, the post-lockdown recovery still looks robust, and consensus expectations for economic growth still seem too pessimistic. Consumer spending on houses, home improvement and electronics are all impressive and unexpected, and companies will need to rebuild their inventories.”¹⁶ Artificial intelligence, 5G networks, robotics, autonomous vehicles and renewable energy, Genome sequencing...are all alive and well. They are certain to transform our lives over the next decade in ways only few can imagine today.

For now, in any case, we believe the overall trend in the stock market remains up. There is still far too much liquidity sloshing around the system to believe otherwise. The most important question for us now is the possible rotation away from the large cap FAANG and into smaller/more value types of stocks. There has been evidence that this trend might be unfolding.

To this point, we do believe in the theme of “reshoring” our supply chains. This was obviously accelerated by the coronavirus, but according to a recent paper from MIT discussing a presentation from Professor David Simchi-Levi, “Supply chain restructuring was underway before the pandemic... This includes companies reconsidering their relationship with China because of the trade war between the U.S. and China. According to a survey of more than 3,000 companies released in February by Bank of America, companies in 10 of 12 global sectors said they intended to shift at least a portion of their supply chains from current locations. Companies cited tariffs, automation, and national security among the reason for the changes. Some companies are thinking about bringing manufacturing closer to demand, said Simchi-Levi...while others are looking toward fully reshoring.”¹⁷

And from the Brookings Institute, “Supply chain resilience strategies that localize critical industries and their component supply chains could not only alleviate the weaknesses uncovered during the COVID-19 pandemic, but also *increase employment growth across historically well-*

¹⁵ “Bonus Plans Redrafted to Prop Up Pay”; FT; 10/13/20; pg. 8

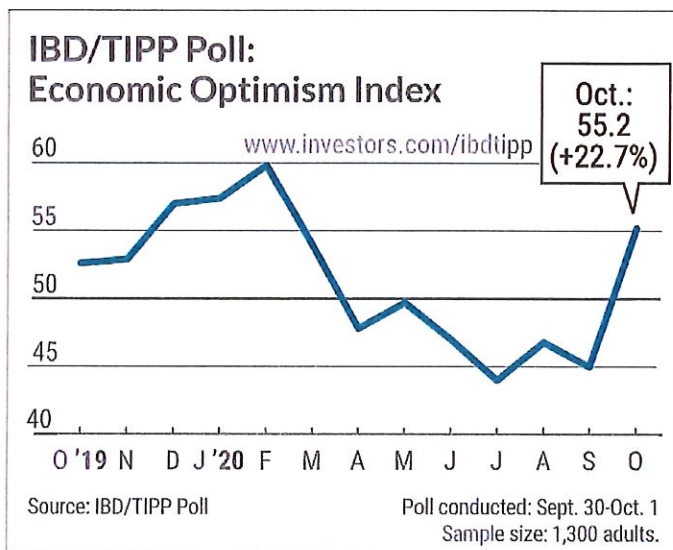
¹⁶ <https://www.jpmorgan.com/securities/insights/we-are-more-optimistic-why-you-should-be-too>

¹⁷ <https://mitsloan.mit.edu/ideas-made-to-matter/reshoring-restructuring-and-future-supply-chains>

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paying industries and provide economic development opportunities for U.S. regions with the economic fundamentals conducive to advanced manufacturing (emphasis added).¹⁸

Further, optimism seems to be returning to investors. According to the most recent IBD/TIPP Poll, optimism about the economy jumped by 22.7% in October and optimism about the outlook for the next six months jumped by 30.4%¹⁹



At Katonah Capital Group, we are optimistic that we will soon be long of fresh baked apple and pumpkin pie – even if this will be a rather subdued Thanksgiving. We are thankful for medical advances we’ve experienced such that we’ve been able to identify the entire genetic makeup of the new coronavirus within days, as opposed to taking nearly 3 months for the 2003 SARS coronavirus. We’re thankful for advances in autonomous driving vehicles so that we will probably be the first generation in recent history whose children won’t have to take away the car keys from us. And, we’re thankful for you, our clients and for the trust you place in us to safeguard your assets each and every day.

Thanks for reading,



Jason

¹⁸ <https://www.brookings.edu/research/reshoring-advanced-manufacturing-supply-chains-to-generate-good-jobs/>

¹⁹ <https://www.investors.com/news/economy/ibd Tipp-poll-economic-optimism-index/>