February 2021

“Well, now, about this new budget. It’s a billion here and a billion there, and by and by it begins to mount up into money.” - New York Times in 1938

Substitute trillion for billion, 2021 for 1938, and now the question: Did Mr. Market begin to notice last week? From the front page of Friday's WSJ:

Stocks Slide as Treasury Yields Shoot Up

Tech leads the decline, signaling an investor retreat from risk amid signs of recovery

BY AKANE OTANI AND ANNA HIRTENSTEIN

The Dow Jones Industrial Average fell more than 550 points Thursday as a wave of selling that began in the technology sector took down swaths of the market.

Stocks’ momentum has faltered the past week as investors have faced a sharp and swift rise in bond yields. The yield on the benchmark 10-year Treasury note marked its biggest one-day advance since November and settled at its highest level in a year.

Money managers have broadly attributed the shift to bets on the economy picking up, something that should be a boon to corporate profits. But the swiftness with which yields have moved has also had another effect: It has tempered enthusiasm for more richly valued, risky parts of the market.

The selloff continued early Friday in Asia with major market benchmarks in Tokyo, Hong Kong and South Korea falling more than 2%. ...

On Thursday, investors rushed out of some of the hottest stocks of the year, sending shares of companies like Apple, Alphabet and Netflix down more than 2% apiece. Tesla shares dropped more than 8%.

While relatively cheap corners of the market appeared to hold up well at first, with bank stocks and energy producers initially higher for the day, those gains dwindled in afternoon trading, leaving few places for investors to shelter.

The Dow dropped 559.85 points, or 1.8%, to 31402.01, pulling back from Wednesday’s record high.

The S& P 500 decreased 96.09 points, or 2.4%, to 3829.34, and the Nasdaq Composite lost 478.53 points, or 3.5%, to 13119.43, notching its biggest one-day pullback since October. ...

Rising bond yields don’t always augur poorly for stocks. In fact, many investors are betting that a sweeping fiscal stimulus package from the Biden administration, coupled with increasing vaccinations, will help corporate profits across sectors improve in the second half of the year. About 91% of fund managers surveyed by Bank of America believe the economy will strengthen this year, the highest share on record since the firm began surveying investors in the 1990s.

U.S. Labor Department data released Thursday showed the number of people applying for unemployment benefits fell sharply last week.

And many contend that the recent weakness in technology shares has been driven by money managers taking some risk off the table after a long run—not necessarily investors giving up wholesale on the sector.

Even after Thursday’s declines, for instance, Amazon and Netflix are up more than 50% over the past 12 months, more than doubling the S& P 500’s gain over that time.

If the sustained rise in bond yields results in any long-lasting change, many believe it will likely be that investors rethink the balance in their portfolios between fast-growing technology companies and more cheaply valued sectors that have largely underperformed over the past decade. ...

As the broader market declined, one group bucked the trend: “meme stocks,” which have surged in popularity among individual investors this year.

In a wave of volatility reminiscent of last month’s rally, GameStop Corp. jumped $17.02, or 19%, to $108.73, while AMC Entertainment Holdings Inc. initially rose before trading down 80 cents, or 8.8%, to $8.29. The two stocks had soared in overnight trading.

Many on Wall Street scrambled to identify a catalyst for the sudden moves.

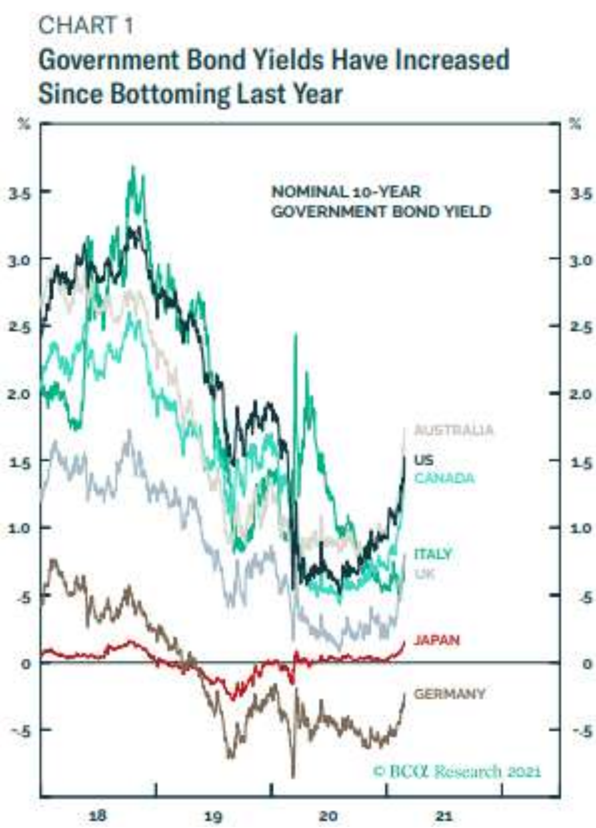
Market observers said the run-up appeared to be the result of renewed interest from investors that was likely exacerbated by activity in the options market. ...

Meanwhile, selling pressure in the bond markets picked up pace. The yield on the 10-year Treasury note rose to 1.513% from 1.388% Wednesday. ...

From Friday's Global Investment Strategy Report:

Higher Real Yields: A Near-Term Risk For Stocks

Bond yields have jumped in recent weeks. After bottoming at 0.52% in August, the US 10-year Treasury yield has climbed to 1.54%, up from 0.93% at the beginning of the year. Government bond yields in the other major economies have also risen (**Chart 1**).



While inflation expectations have bounced, the most recent increase in yields has been concentrated in the real component of bond yields. Optimism about a vaccine led global growth recovery, reinforced by continued fiscal stimulus – especially in the US – has prompted investors to move forward their expectations of how soon and how high policy rates will rise.

How menacing is the increase in bond yields to stock market investors? ... there has been a close correlation between real yields and the forward P/E ratio at which the S&P 500 trades. The 5-year/5-year forward real yield, in particular, has moved up sharply, which could put further downward pressure on stocks in the near term.

Nevertheless, we continue to advocate overweighting equities over a 12-month horizon. As we pointed out two weeks ago, rising real yields have historically been most toxic for stocks when yields have increased in response to hawkish central bank rhetoric. This is manifestly not the case today.

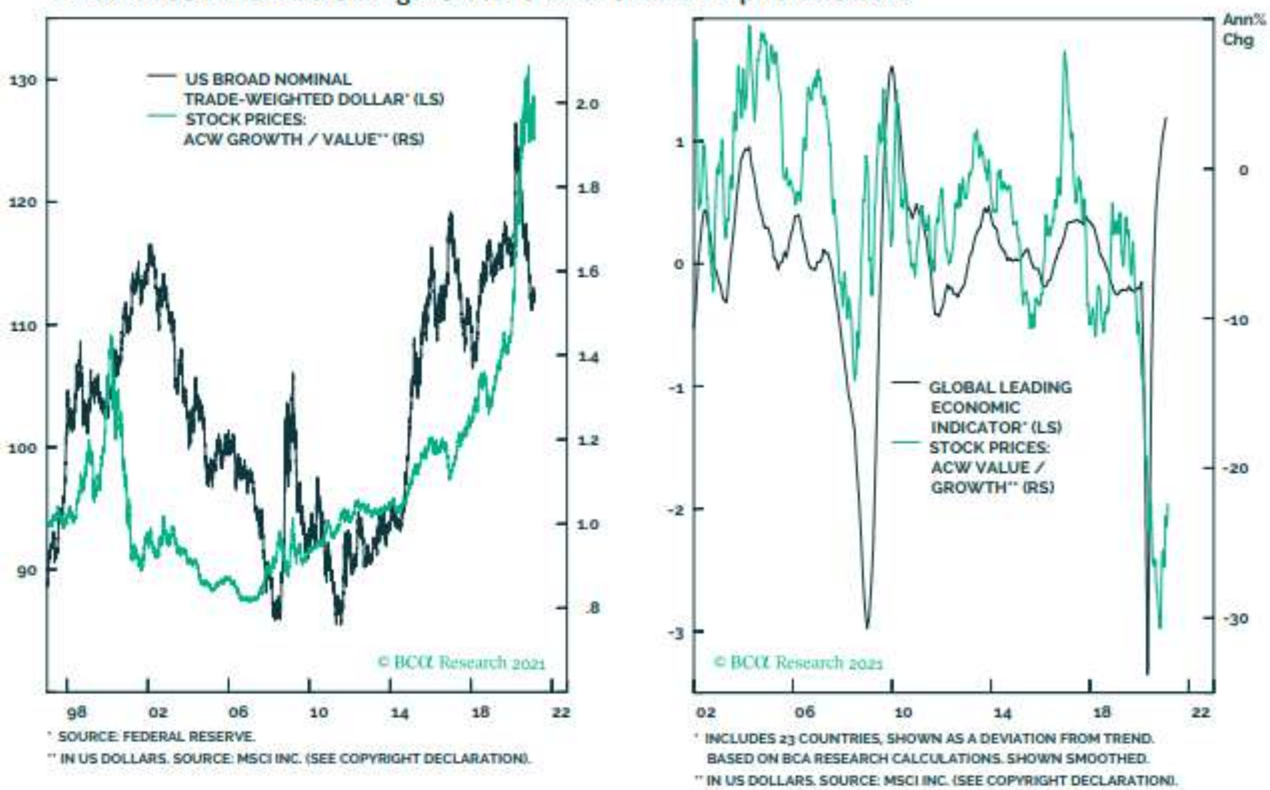
In his testimony to Congress this week, Jay Powell downplayed inflation risks, stressing that the US economy was "a long way" from the Fed's goals. He pledged to tread "carefully and patiently" and give "a lot of advance warning" before beginning the process of normalizing monetary policy. We expect the 10-year Treasury yield to stabilize in the 1.6%-to-1.7% range, still well below the level that would threaten the health of the economy

Favor Cyclical And Value-Oriented Stocks In A Weaker Dollar Environment

The Fed's accommodative stance should limit any near-term upward pressure on the US dollar. Whereas stocks are most sensitive to absolute changes in long term real bond yields, the dollar is more sensitive to changes in short-term real rate differentials with US trading partners. Since the Fed is unlikely to tighten monetary policy anytime soon, US short-term real rates could fall further as inflation rises.

Cyclical stocks, which are overrepresented outside the US, tend to benefit the most from strengthening global growth and a weakening dollar. Value stocks also generally do well in a weak dollar strong growth environment (**Chart 7**). Moreover, bank shares – which are concentrated in value indices – typically outperform when long-term bond yields are rising.

CHART 7
A Weaker US Dollar And Stronger Global Growth Should Help Value Stocks



In contrast, as relatively long-duration assets, growth stocks often struggle when bond yields go up. The same is true for more speculative plays such as cryptocurrencies. In this week's Special Report, we discuss the fate of Bitcoin, arguing that investors should resist buying it.

A cautionary mea culpa on attempting to time the market from Morningstar:

My 2020 Investment Lesson: The Peril of Overconfidence

A little learning is a dangerous thing.

John Rekenthaler
Feb 22, 2021

My Belief
On Feb. 19, 2020, the S&P 500 closed at a record high. It then dropped by 34% over the next five weeks.

That loss did not surprise me. By late February 2020, Japan had announced that it would close its schools for the following four weeks. Shortly thereafter, the Italian government locked down one fourth of the country. Clearly, those stoppages were merely the beginning of the economic problems; the rest of the developed world would soon follow suit. Such shutdowns would cause financial carnage.

Economists then were talking mostly about second-quarter effects, but I thought that the damage would linger. The global economy would not return to full strength for many months, if not years. What's more, I knew that over the past century, the S&P 500 had declined by more than 30% on five occasions, without once reaching its previous high within the next 18 months. Sure, stocks would eventually rebound--they always do--but surely the process would be halting.

At best, I figured, U.S. equities would bounce about their March lows. At worst, they would fall further. Either way, the next bull market wouldn't arrive anytime soon. Those with faith in their hearts and cash in their wallets need not rush to invest. There would be plenty of opportunity to buy stocks at their new, lower prices. Of this I was as certain as I have ever been about the investment markets.

Reality Intrudes
Pride goeth before destruction, and a haughty spirit before the fall. Never had I been so confident in my stock-market expectations--and rarely had I been so wrong. The S&P 500 immediately staged a powerful rally, surpassing its previous high by August, then adding another 15% during the ensuring six months. Not only had I not envisioned such an event, I had not even imagined it.

The problem wasn't with what I knew. My economic forecast was correct. As I had expected, although third- and fourth-quarter gross domestic product rebounded from second-quarter levels, they remained below that of the first quarter. The destruction wrought by COVID-19 on both economic output and employment exceeded that which had been forecast in March. Neither was my stock-market history faulty. The numbers were accurate.

But for other reasons, this time was different. During previous bear markets, stocks would rally briefly, then retreat as sellers appeared, seeking to profit from the temporarily higher prices. Two steps forward, one step back. In 2020, though, the optimists overwhelmed the pessimists. Rapidly, investors worried not about being caught by the market's retreat, but instead forgoing its gains.

Why Equities Recovered
The market's resilience owed to three primary causes, each of which I had considered. But I had not realized their full implications.

1) Structural Strength

Demand shocks, such as that caused by the COVID-19 virus, shove teetering economies over the edge. If the system is wobbly, because corporations are overinvested, or consumers heavily indebted, or banks poorly capitalized, then the shock reverberates. The effect spreads far beyond its original impact.

Such was not the case in 2020. Although the economy was in its 11th year of expansion, companies were not extended, because they (somewhat notoriously) had cut back on their capital investments. Neither were consumers. Adjusted for inflation, mortgage debt was well below its 2007 peak, and delinquency rates on other forms of consumer debt had declined. Finally, banks had greatly improved their balance sheets since the global financial crisis.

This isn't, of course, to deny that tens of millions of households have suffered from COVID-19-related slowdowns. However, those problems have not caused systemic failures. Few large companies have been forced to declare bankruptcy, and the banks remain solvent.

2) Federal Intervention

The U.S. government's response to slumping stock prices was swift and powerful. The Federal Reserve promptly slashed short-term interest rates to just above zero, while announcing that it would purchase an unprecedented variety of investments. Meanwhile, Congress passed the $2.2 trillion CARES Act. With each financial crisis, the government intervenes ever more aggressively.

Whether such intercessions courted future disaster, by suggesting to equity investors that federal officials would inevitably rescue them, has been hotly debated. What isn't up for question are those actions' immediate effects. By flooding money into the system, the government raised stock-market demand, and thus succeeded in its attempt to support equity prices.

3) Weak Competition

Low interest rates stimulate spending economic activity, but they wouldn't much help stock prices if bond yields were steep. Last March, the dividend yield on S&P 500 stocks hit 2.3%--modestly above its recent averages, which have hovered near 2%, but not attractive by historical standards. However, with yields on 10-year Treasuries dropping as low as 0.60%, that dividend payout was relatively high.

Quietly, 10-year yields have doubled since that time, while those of 30-year bonds have climbed above 2%. With the stock-dividend rate shrinking due to market gains, the income from holding equities now roughly matches that of investing in Treasuries. So far, stocks have resisted the challenge from rising bond yields, but if fixed-income yields keep increasing, they eventually will buckle.

In Conclusion

Last spring, I realized that almost nobody can successfully forecast the direction of the stock market. Over the years, I had seen enough market-timers and tactical allocators fail to appreciate the enormity of the task. I also recognized that economists have enough difficulty estimating the next quarter's GDP growth, never mind what will occur in 12 months' time.

Yet, despite my experience, I deceived myself into believing that I possessed special insight. That happened because the market behaved as I expected during the early days of the COVID-19 crisis, thereby leading me to overestimate my abilities. It mattered not if I understood the problem relatively well. To make an accurate prediction--one that would benefit an investment--my understanding needed to be deeper yet.

Thinking through market conditions is a useful exercise. Better to suffer investment losses that were at least partially anticipated than to have them come as a complete surprise. Beware, however, the danger of taking such analysis too seriously. My self-belief was greater than my insights. In making that mistake, I am far from alone.

John Rekenthaler has been researching the fund industry since 1988. He is now a columnist for Morningstar.com and a member of Morningstar's investment research department.

Follow-ups

We have repeatedly expressed our concerns about most Emerging Markets. From Verdad's Dan Rasmussen on Feb. 15th:

Emerging Markets: Slow Growth, High Volatility

In a 2010 interview with USA Today, Mohammed El-Erian, the former CEO of Harvard Management Company and a notorious emerging markets bull, declared confidently that the world was on the precipice of a "global realignment." This realignment, he declared, was "accelerating the migration of growth and wealth dynamics from the industrial world to the larger emerging economies."

At the time, most pundits and investors, particularly those in the developed world, accepted El-Erian's position as common knowledge. After all, they reasoned, globalized trade policies and an increasingly interconnected world naturally shifted capital away from boring, first-world financial centers and toward new, exciting economies like China, Brazil, and Indonesia. To take advantage of this obvious trend, wealthy investors poured money into emerging market ETFs and mutual funds throughout the late 2000s—in their mind, providing capital that would accelerate the inevitable, hockey-stick growth bound to appear in emerging economies.

It never happened. Perhaps we have experienced some sort of global realignment in the last decade, as El-Erian predicted, but that realignment never translated into equity returns—the buy-and-hold EM investors have never experienced the above-market growth about which they were so confident. The graph below shows MSCI's Emerging Market Index returns since August, 2010, the month of El-Erian's interview, plotted against the S&P 500. We believe that EM investors would have been far better suited in traditional, developed economies. In fact, $100 invested in the emerging market index in 2010 would net a measly $47 profit today, compared to a $383 profit from the S&P 500 index.

Figure 1: Returns in Emerging Markets vs. S&P 500 Since El-Erian's Interview

Source: Capital IQ

This underperformance—and the boosterism of the proponents of this asset class—is far from a recent phenomenon. In their 1995 report, "Trends in Developing Economies," the World Bank declared "growth in developing country stock markets will be enhanced as policies liberalizing trade and investment regulations, realigning exchange rates, consolidating public finances, and continuing with privatization are implemented." As with El-Erian, the World Bank's prediction may indeed have come to pass, as today's global economy features liberal trade policies, investment deregulation, and aligned exchange rates. But in a key sense, we noticed that the World Bank was wrong: these changes did not drive equity returns. The graph below plots EM equity returns against the S&P 500 since July 1995, the month of the World Bank report.

Figure 2: Returns in Emerging Markets vs. S&P 500 Since the World Bank Report

Source: Capital IQ

Moreover, these EM equities underperformed their developed market equivalent despite a higher historic GDP growth. According to the IMF, the average annual GDP growth in emerging economies was 4.7% versus 1.8% for developed economies from 1989-2020. (See Appendix Figure 5).

The disappointing results for EM equity investors were even worse for investors who specifically sought to invest in EM growth stocks, which, in theory, should have benefitted the most from the sort of realignment El-Erian and the World Bank described. These stocks were in fact the major cause of EM underperformance, we believe, as EM value stocks delivered returns on par with the S&P 500.

Figure 3: US and EM Equity Performance Indicators, 1989–2020

Source: Capital IQ, Ken French Data Library

$100 invested in EM growth stocks in 1989 would have been worth less than half of the same investment in the S&P 500 or in EM value stocks.

Taken together, these insights paint a bleak picture for EM equity investing over the past 30 years. Over this period, EM investors took on more risk for less reward, while being unable to capture the benefits of GDP growth in these economies.

The frequency and severity of EM crises help explain both slow growth and high volatility in EM equity indices. Since 1989, emerging economies have experienced significantly more crises than their developed counterparts, as measured by the percentage drawdown in their equity markets. Not only are these crises more frequent in emerging markets, they're also more severe.

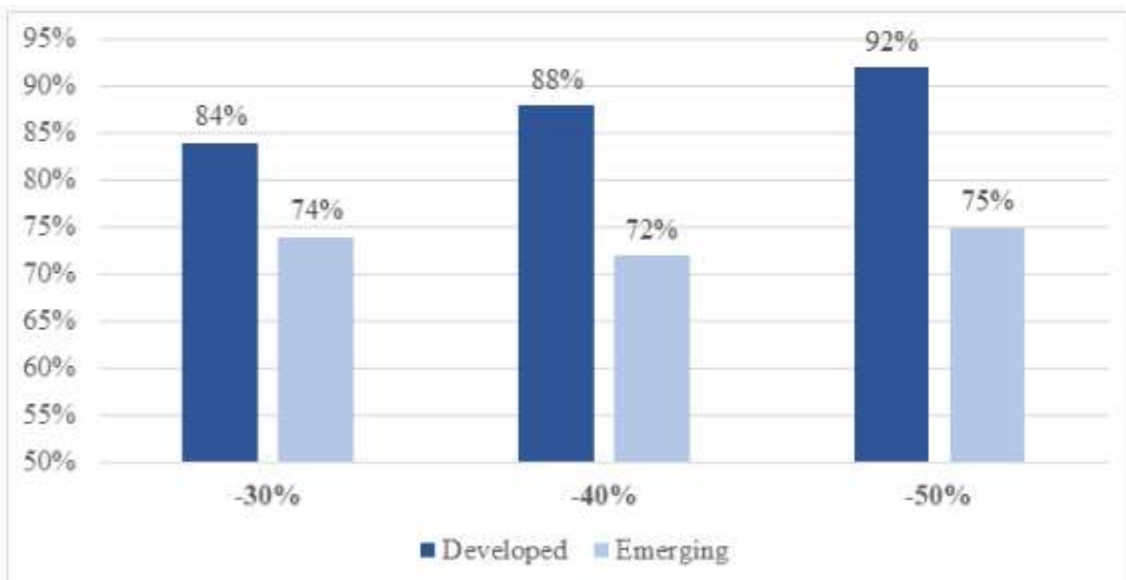
When crises occur in developed markets, investors respond with predictions of the apocalypse. Take, for example, Mad Money host Jim Cramer, who screamed on air in late 2007, "It is not the time to be an academic . . . we have an Armageddon!" Yet, these panicked investors succumb to Chicken Little Syndrome: they've been hit by an acorn and scream that the sky is falling. After all, an investor in New York or London, even in the midst of financial turmoil, never doubts that a government bond will safely store capital, that his political system is stable, or that water will continue to run from his faucet. Indeed, after every American crisis in the last century, market indices have experienced short-term pain and long-term rebound to even higher values.

The same is not true for an investor living in a developing country. When poorer markets enter times of crisis, there are few certainties. Perhaps a government will default on its debt, or, even more extreme, maybe war has uprooted an established political system. When poor countries enter these same financial crises, the question is not when, but whether, their economy will truly recover. Take, for example, the Philippines, a country which—alongside many others in the developing world—experienced a financial crisis in late 1997. The Philippines'

MSCI index, which tracks overall stock market performance, has never returned to its 1997 peak. In other words, when emerging markets enter crisis periods, some countries never recover.

The graph below shows the probability of recovering to pre-crisis levels after 24 months by crisis severity, based on GFD equity data since 1987. For each crisis threshold, emerging economies are significantly less likely to recover, based on our research.

Figure 5: Historic Probability of Equity Recovery after 24 Months by Crisis Severity



Source: Global Financial Data

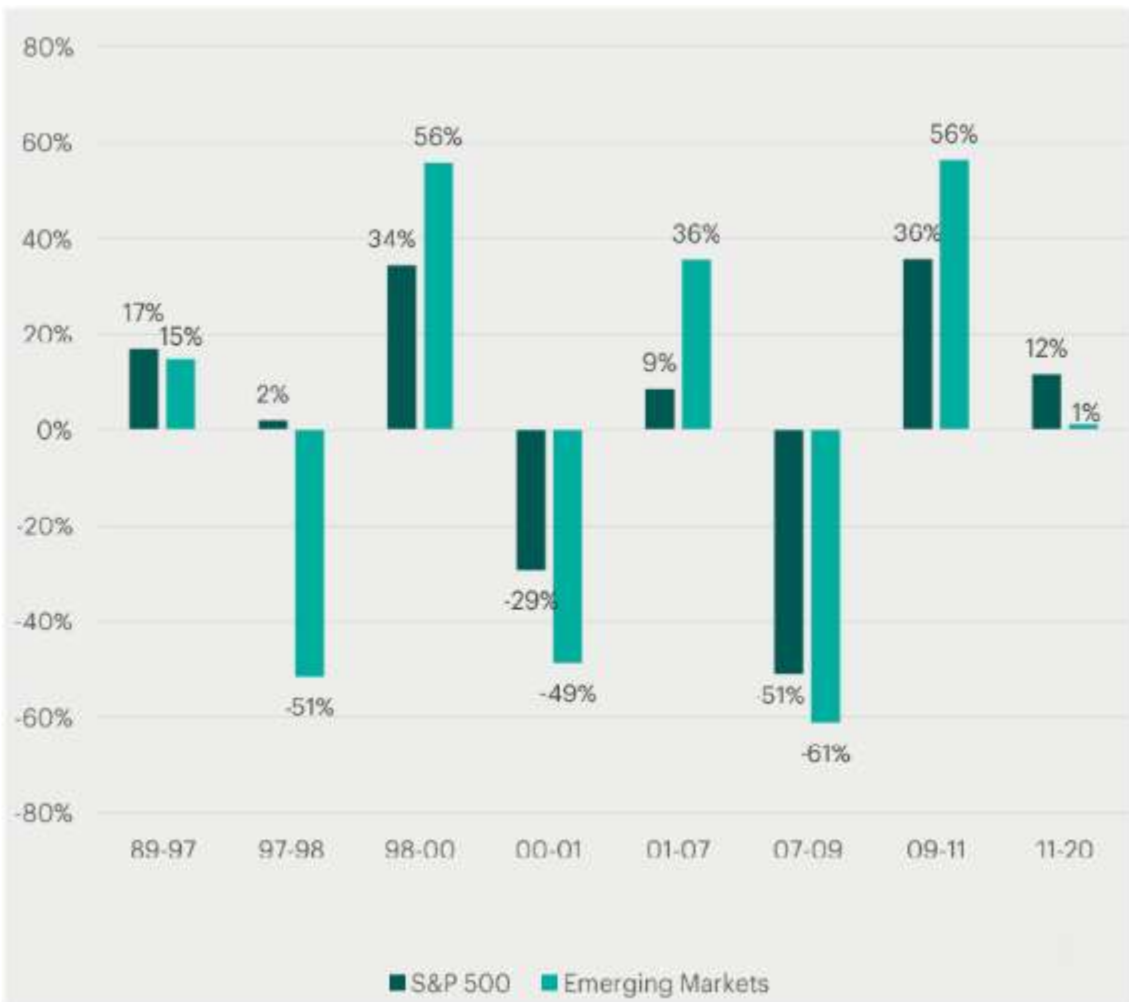
In his book The Volatility Machine, Michael Pettis delivers a compelling theory explaining both growth and crisis. Pettis proposes a model of economic growth that focuses on liquidity conditions in wealthy countries. Typically, we tend to think of capital flow from developed to emerging markets as a function of growth opportunities in poor countries. Pettis argues that the causality is precisely reversed. Instead, increased liquidity conditions in rich countries lead ambitious investors to make nontraditional emerging market bets. These bets, Pettis argues, drive growth in emerging economies. In this way, growth doesn't attract investment; rather, investment causes growth.

That's not to say that conditions internal to emerging markets don't matter. In fact, it's quite the opposite. Because EM growth is contingent on foreign investment, conditions internal to a developing country can scare rich investors, who subsequently remove their capital—triggering a financial crisis. Here, Pettis cites Mexico's 1994 "Tequila Crisis," a financial panic precipitated by the assassination of a popular presidential candidate.

Emerging markets are more prone to these exogenous, market-moving events—political assassinations, tumultuous transfers of power, civil war—and when these events occur, central banks in the developing world often lack the global credibility to comfort wealthy investors. To make matters worse, a disproportionate number of investors in emerging markets are speculators with short time horizons. These investors are often unwilling to ride out a small loss, and their exit further exacerbates existing crises. These structural forces combine to generate more volatility in emerging markets.

Intense liquidity dependence and structural instability combine in emerging markets to generate immense volatility that magnifies both investor optimism and pessimism. In this sense, periods of growth become more lucrative—and periods of crisis become more disastrous. The figure below demonstrates this magnification of gains and losses, showing that emerging markets generally have underperformed the S&P 500 in contractionary environments and outperformed in growth environments.

Figure 6: Boom-Bust Growth in Emerging Markets vs. S&P 500



Source: Capital IQ

If—as Pettis's research suggests—liquidity plays a more important role in emerging markets than in their developed counterparts, investors should be duly compensated for the value of the cash that they provide. At the same time, it seems that the value of this cash diminishes when a plenitude of investors dabble in EM investment.

But this theory of crisis investing in emerging markets is not the result of Pettis's book alone. Through the lens of economic development studies, he was exploring something the finance community had already become obsessed with: the relationship between stock market liquidity shocks and associated asset price returns.

It has been well acknowledged in quantitative finance since the 1980s that (all else being equal):

- Illiquid assets generally trade at lower prices on the basis of their expected cash flows compared to more liquid assets.
- In times of scarce liquidity, investors flee from illiquid assets and toward more liquid safe havens.
- The value factor has dramatically outperformed in post-crisis recovery periods globally as well as in emerging markets.
- Investors who were present to take the other side of these trades were historically rewarded handsomely, beyond what we can explain using other fundamental risk factors. ...