August 15, 2021

SKBA Market Update

July Market *Jeopardy!*

In an effort to bring some humor and levity to the “dog days of summer”, let’s take a random walk among a handful of nominally organized observations…beginning with the Answers and working back to the Questions.

One way to think of financial markets is as a very sophisticated game of *Jeopardy!*, in honor of its late host, Alex Trebek, as he would have done in his day. In this pseudo version, *Jeopardy!* becomes one incarnation of Mr. Market.

We’ll give you a sneak peek at the answers. How well do you think you will do?

Below are the answers, and you get to ask the right questions (since our game isn’t exactly the same as *Jeopardy!*, we won’t dock you if your response isn’t in the form of a question):

1. “The propensity for the markets and economy to experience problems will be minimal.”
2. Baa1
3. New SPAC Equity Funds
4. China & China
5. An Arm & a Leg
6. $2.02
7. Empty
8. “The cost of options”
9. 2022
10. The Wall of Worry
11. Compounding

Have your hands on the buzzers and get ready to pick your category…*then let's play Jeopardy!*

The Questions to the Answers

Answer: "The propensity for the markets and the economy to experience problems will be minimal."

Question: What was Fed Chairman Powell's answer to the question regarding the impact on financial markets from the "transitory" rise in price inflation?

Ok, it didn't really happen exactly like this. The debate has already begun, however, about whether or not Chairman Powell will successfully navigate monetary policy through today's "transitory" price inflation pressures. While July's CPI gain of 0.5% was lower than June's 0.9%, six months ago, investors would have been aghast at the prospect of a 0.5% monthly gain. Treasury Secretary Yellen described the period of high inflation prints as lasting through the summer before becoming "transitory" and going away. Credit remains cheap and plentiful—supposedly no worries here. It's a good time to issue debt to either buy your own shares or to buy other companies (as a private equity buyer or a public company). No?

Of course, just the hint of the need to pay attention price inflation sent both the stock and bond markets into a tizzy of fear regarding the negative impact on the economy of any actions to taper Fed bond purchases. That's the best way to interpret falling stock prices and falling bond yields after Powell's comments in June and July. It is likely that just such uncertainty surrounding future policies could still catch the market by surprise and increase the "propensity" for the market's reaction to be far more than "minimal." This is not an event to look forward to with optimism – particularly for highly-leveraged hedge funds or highly-valued stocks.

Answer: Baa1

Question: What is the average debt rating of the S&P 500 U.S. companies that issue debt securities?

The average composite debt rating of S&P 500 companies with ratings (440 companies with senior unsecured debt ratings) is down to the middle between Baa1 and Baa2. Unlike the days of yore, today there are only two companies in the S&P 500 with Aaa ratings—Johnson & Johnson and Microsoft. Among the 440 S&P 500 companies that have S&P or Moody's debt ratings, over 100 companies, Baa2 is the largest composite rating category. Nearly 15% of the rated companies have non-investment-grade ratings.

Despite huge borrowing at today's low rates, the rebound in cash flows for corporate America has decreased the market's concern about debt leverage. But prior to the pandemic, corporations used huge amounts of cash flow to buy back their own stock. So while cyclical improvement is significant, balance sheet risks haven't gone away. The market sees no problems. In fact, with junk bond spreads near record lows and investment-grade spreads in the lower half of historic ranges, no one appears to fear that anything could go wrong with the economy or corporate profits. The secular deterioration in corporate credit quality as reflected in ratings concentration in Baa1/Baa2 continues—setting up the market for future risks.

Answer: New SPAC Equity Funds

Question: Who are at risk of becoming the "greater fools" in today's market?

Looking around the markets, we are always trying to understand who is playing the "greater fool" game and who is truly trading based on an estimate of the present value of future cash flows from an asset. Right now, more than 600 SPACs (Special Purpose Acquisition Companies) trade in the U.S. and account for around $190 billion of market capitalization. It seems that with these massive amounts of money swirling around the equity market searching for acquisition candidates (usually private companies that mightn't be worthy IPO candidates on their own), new clients of these asset classes are playing the greater fool game, with likely diminishing returns.

Answer: China & China

Question: Who have been the marginal producers and consumers globally?

The simplest way to put it is that for at least the last decade or so, companies had been pushing down costs by adding or shifting production capacity overseas. Rising Chinese incomes fueled rising consumption of both domestic and imported products.

While we don't place a high probability on China's economy "imploding," we do believe that China's controls on capital flows, theft of intellectual property, and curbing of free speech at home and in Hong Kong, have soured U.S. companies' desires to locate production in China. U.S. domestic sourcing is on the rise as a result.

These issues with China, combined with easy money and exploding credit have contributed to the growing trade and capital imbalances, as well as have fueled dangerous upward and downward spirals in Chinese stock valuations. No worry, this is probably just fine if you enjoy rollercoaster rides.

Answer: An Arm & a Leg

Question: What do most consumers say when asked how much it costs to fill up their gas tanks today?

Joking aside, it used to be that the official measurement of the CPI overstated the real rate of inflation. With past changes in the construction of the index, we're not so sure anymore. It is true that energy is not as large a part of consumption as it was 25 years ago, but from our vantage point, the vast array of pricing pressures on consumers and business, and the Fed's willingness to print money to fund all federal deficits is making today's surge in price more than a "transitory" event. Yet industrial and consumer prices (and corporate cost structures) have yet to feel the full burden of higher and rising energy, materials, rents (including the "owner-occupied rent equivalent"), imports and labor costs. Most forecasters view the "core" inflation rate as still tame. No worries here? Who eats the core anyway? In our view, nearly all the risks to the urban CPI and the core CPI are to the upside, eventually putting pressure on real incomes and on corporate profit margins.

Answer: $2.02

Question: What was the last EPS forecast by a tech company CEO just prior to announcing a 2 cent per share earnings shortfall compared to Wall Street's consensus estimates that caused a 20% decline in his stock's price?

The long-lived era of management's giving precise earnings estimate "guidance" and Wall Street analysts routinely accepting and incorporating this "guidance" into their earnings estimates *should* officially come to an end. Unfortunately, it hasn't. This model of communication has failed and actually increased stock price volatility as the narrow range of earnings estimates around consensus (and the propensity of investors to attempt to act simultaneously on disappointing news) has dramatically increased the odds that a shortfall from expectations will generate dire short-term consequences for a stock's price. It's even worse than this as now, even if you beat consensus, but not as much as the "whisper" forecasts, your stock takes a dive.

If the goal is to build sustained wealth, who benefits from this model? No one. CEOs and CFOs are slow to get the message however. Reducing the guidance offered, widening the range of possible outcomes, and/or offering more sensitivity analysis tied to internal or external events would be helpful. Naturally, there will be many CFO's who still offer estimates down to the penny. And we think the result will be ugly for investors.

Answer: Empty

Question: What will be the status of the Social Security Trust Fund in 2040?

The unfunded liabilities of our Social Security system are enormous, and the problems begin far sooner than 2040. Few under 50-year olds really expect to receive the benefits promised from Social Security when they retire—that's many of the late Baby Boom generation and all of those that follow. Further pushing out the retirement age and reducing the CPI boost to benefits would be good partial solutions, but they don't seem to be politically palatable right now. Shifting from today's pay-as-you-go system to a truly funded one would solve the problem—eventually. The solution that would hurt financial markets and the economy the most, however, would be a decision to raise payroll taxes to fund the same level of projected benefits. Not to worry, the real debate on these issues probably won't really begin until the next midterm elections.

Answer: "The cost of options."

Question: What excuse did that tech company CEO give for the shortfall in GAAP earnings versus expectations?

Almost everyone started expensing some level of options costs back in 2006. Of course, managements have figured out how to minimize the effect by lowering volatility assumptions. No one wants to count them as an expense as part of "operating earnings." No worries here, they're just a non-cash charge.

The right methodology is not really debated today, but we have long recognized that the true cost of options has reduced the cash flow that is truly available to be distributed to shareholders (in the form of dividends or NET stock buybacks) or reinvested in business growth. This contingent liability is huge, and determining such costs are important when estimating what a company's normalized distributable earning power really is. It isn't as high as Wall Street analysts think.

Answer: 2022

Question: When are all of the cuts in tax rates enacted in 2017 likely to end as a result legislation that imposes new tax rate increases?

Changes in income tax rates, capital gains tax rates, corporate tax rates, and payroll tax rates all have incentive effects that must be taken into account when such changes are proposed and approved in new legislation. It's a basic economic principle that if you tax a product or activity, you get less of it and if you subsidize a product or activity, you get more of it. Surely the crisis of the COVID pandemic led to extraordinary deficit spending to shield individuals from financial ruin. Yet no amount of increases in tax rates will generate sufficient tax collections to "pay for" $4-5 trillion in spending plans.

Of course, such spending plans and tax increases have to get through an evenly balanced Senate under a reconciliation bill. So the market is just taking a wait and see attitude so far. There's currently no certainty as to the outcome. Oddly, concern about higher tax rates in the future may boost economic activity today at the expense of future activity. If such legislation passes in 2021, you can bet that individuals and corporations will accelerate taxable income into 2021, including capital gains, to avoid even bigger tax liabilities in 2022. Without certainty about these tax rates, how can taxpayers and corporations appropriately plan for the future? So not to worry now, right? Let's just make hay while the sun shines.

Answer: The Wall of Worry

Question: What is the market supposedly climbing over?

What, me worry?

Answer: Compounding

Question: Why is capital allocation so important to returns?

At SKBA, the most important decisions in the investment business are:

1. How we allocate our intellectual capital internally as a firm,
2. How we allocate our client's capital in the portfolio, and
3. How the companies in our portfolios allocate the capital and cash flow their businesses generate.

The allocation of capital at each of these levels is key to sustainable over the cycle returns for companies, portfolios and our firm. Over time, even modestly better upside returns or downside protection compounds into improved risk-adjusted returns. So we're paid to worry at the right time.