



Today's Portfolios "Can't Get No Satisfaction" From Yesterday's Instruments

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Rick Rieder, Russ Brownback and Trevor Slaven contend that in the tug-of-war between the considerable economic damage stemming from the coronavirus and subsequent lockdowns, and the fiscal and monetary policy responses put in place, the latter factor is being underestimated by markets. Further, the instruments used by investors in previous years won't be what's required for the time ahead.

The Beatles, The Rolling Stones, and The Who captured our imagination (as they did much of the world's) from the '60s through the '90s. While we still love listening to them today, we can't help but notice that modern bands use a variety of new instruments. While guitars and drums are still ubiquitous, it's hard to find a band today that doesn't also have a MacBook laptop plugged into a DJ controller and a deck of synthesizers to create richer and deeper overtones for their music.

The investment-instrument landscape has evolved similarly over recent decades. When The Who sang "Talkin' 'bout my generation," the portfolios of that generation would have been well served by traditional high-quality fixed income instruments, such as Treasury bonds, but after a forty-year, 1000 basis point rally, the portfolios of today's generation "... Can't Get No Satisfaction," as The Rolling Stones said, with yields on most components of the Bloomberg-Barclays Aggregate index currently below 1%.

With a nod to the Eagles in "The Long Run," it will be difficult to generate attractive positive real returns from high quality fixed income over a long time horizon, until and unless yields reset meaningfully higher (something we don't foresee for quite some time). In the meantime, investors will need to employ new instruments – MacBook and synthesizer equivalents – to create the portfolio enhancements necessary to meet income and return targets, while still solving for the myriad market influences that have no historical precedent today.

These secular influences have become even more onerous with the onset of the Covid-19 pandemic, a cataclysmic global economic shock that will result in lingering headwinds to growth and inflation for years to come. But offsetting this is an epic global policy response that has exacerbated the existing dearth of attractive yielding assets, while temporarily removing the real economy left tail risk of an entrenched and deep recession. Unpacking the nuances of these policies and understanding the influences they'll continue to have on 2020 asset markets is critical in order to identify the new investment instruments that will help our portfolios remain resilient.

The extraordinary U.S. fiscal and monetary response

The U.S. policy response has been the most remarkable of the developed markets, not least because of the explicit marriage of monetary and fiscal policy for the first time since World War II. In fact, in the first four months of 2020, the U.S. government ran a fiscal deficit of about \$1.5 trillion while the Federal Reserve purchased nearly \$1.8 trillion of Treasuries, amounting to a direct transfer of ~\$1.5 trillion in printed money from the central bank to the private sector. Moreover, the Congressional Budget Office estimates a \$3.8 trillion federal deficit for fiscal year 2020, ending September 30, leaving another roughly \$2 trillion to spend over the next 3.5 months. To wit, the Treasury currently holds \$1.5 trillion in cash, shattering the previous record high, representing demonstrable real-economy policy "dry powder." The impact of such massive *Main Street* targeted programs could be the equivalent of almost 37% *higher* household income over these crisis months, than was the case pre-crisis.

These U.S. policies have also had an immense impact on the financial economy. As with previous bouts of quantitative easing (QE), the Fed bought large chunks of fixed income assets, thereby growing its balance sheet relative to the size of the U.S. Aggregate index in ways that create a "crowding in" effect – essentially forcing investors to buy ever-riskier assets – and the 2020 version of QE has been unprecedented in that regard. The Fed has purchased assets that equate to nearly 10% the size of the U.S. Aggregate index over the last 100 days, bringing the balance sheet to more than 30% the size of this index and shattering its previous record share.

To be sure, the job losses have been devastating to many, and certain segments of the labor market will be negatively impacted indefinitely. However, the first economic readings from the initial phases of the nascent U.S. economic reopening provide evidence that these policies have been highly effective at stabilizing overall consumption, as well as building private sector savings that now provides an important buffer to the uncertainties that lie ahead. As a case in point, the overall policy response resulted in April data on personal consumption spiking with a record increase, which contrasts starkly with the ugly labor market data we've seen in the wake of the lockdowns. As April's unemployment rate rose to 14.7%, U.S. personal income climbed 8.5% from January's pre-virus rate. Moreover, through the first four months of 2020, U.S. personal saving has risen by \$907 billion, more than twice as much as the last four months of 2019. Relatedly, U.S. commercial bank deposits have grown by near \$2.1 trillion since the end of 2019. Thus, there is massive dry powder to offset lost 2020 growth potential, which is estimated to be around \$1.1 trillion (estimated at roughly a 5% full year 2020 U.S. GDP contraction).

The policy response in Europe

Simultaneously, Europe has also instituted some critical initiatives that constructively marry fiscal and monetary policy. In what appears to be a "Here Comes The Sun" moment for Europe, the EU Recovery Fund transcends the decade-long intra-continental debate on how to allocate fiscal leniency. Instead, the Coronavirus crisis has given way to an increasingly common narrative among policymakers that no country is at fault for the pandemic and that this exogenous, symmetric, shock has produced asymmetric outcomes. Accordingly, the EU Recovery Response is intended to provide a disproportionate benefit to peripheral countries, with Italy, Spain, and Greece appearing to be key beneficiaries.

Indeed, PEPP's flexibility on both the timing and destination of policy relief, means the Recovery Fund will likely bring sovereign spreads closer to pre-Covid-19 levels. The mutualization of the program's financing is also an important structural evolution for markets as the EU will ultimately become the largest global class of AAA assets in coming years. The EU already has roughly EUR 50 billion in bonds and we estimate that could ultimately grow to nearly EUR 850 billion over time, making it a major sovereign bond market comparable to Germany and France. Even a \$100 billion re-allocation by foreign exchange reserve managers from USD into EUR bonds would be significant for FX markets.

We are witnessing a historic time for Europe and a potential investment game-changer for markets there. Few incentives have existed over recent years to drive investment toward Europe, but with European asset valuations relatively attractive today, and potentially efficacious economic policy now in place, a low geopolitical risk profile, and U.S. investors increasingly nervous about the upcoming election, Europe may be the beneficiary of incremental capital flows.

The upshot for asset allocation

So, virus-shock challenged fundamentals have quite possibly been more than offset by a blunt-force global policy response. At the same time, a deficit of attractive yielding assets has been compounded by aggressive central bank QE. For asset allocators, a complex, but opportunity-rich, environment of dispersion has become a dominant influence over portfolio construction.

In fixed income, high quality yields are too low to justify holding meaningful positions, so optimal portfolio construction involves moving down the quality spectrum. However, the paradigm of relying on traditional monikers of "Investment grade" and "high yield" is "All Over Now" (hat tip to the Stones). Indeed, the old orthodoxy of maximizing yield for a given rating has given way to a world where IG and HY have "Come Together" (Beatles) in ways that make industry and security selection far more important than adhering to generic asset-rating labels. For example, all else equal, we'd rather own a BB-rated communications company than a BBB-rated energy company.

The same is true for equities, where we choose to eschew the conventional debate about the relative merits of factors such as growth vs. value. Today, identifying durable cash flow generation is the holy grail of equity investing. The wedge between growth vs. no-growth entities, cash flow generators vs. cash burners, those who make ongoing research and development (R&D) investment vs. those who don't, etc., is widening. The market is rewarding those who are investing in the instruments of the future, while the relics of the past stagnate.

Relatedly, we are passionate about analysis around leverage, liquidity, and cash flow. We see the hyperbolic narrative of excessive leverage in the U.S. corporate sector as missing critically important free cash flow trends. In fact, balance sheets are broadly quite healthy and companies' ability to service low yielding debt has arguably never been better. Similarly, the common refrain that equity PE ratios are too high vs. history misses the more relevant metric of free cash flow yield. The obvious and persistent outperformance of companies that generate large cash flows renders traditional valuation metrics less useful and provides a much cleaner comparison to fixed income yields. Through that apples-to-apples lens, free cash flow yields for much of the U.S. equity market offer compelling relative value versus depressed fixed-income yields.

So, the 40-year era of rate declines is largely over. High quality fixed income assets offer tactical opportunities but only *de minimis* return potential from here. Fiscal stimulus is epic and is creating an impact on savings and consumption that will buoy the economy significantly more than most are expecting. Monetary policy stimulus is ubiquitous and will crowd investors into risk as the singular avenue to generate needed return. Europe has put into place a historic evolution of fiscal policy that radically changes an investment climate that was heretofore relying solely on overly aggressive interest rate policy.

And while the world has been screaming “Gimme Shelter” (Rolling Stones) for the past several months, as people are gradually unlocked from their homes, we have little doubt that pent-up up savings and consumption will transition into real economy velocity and growth. Yet perhaps investors still need just a little bit of “Patience” (Guns ‘N Roses), as the coming U.S. election, increased social unrest, and ongoing coronavirus headlines all risk creating more volatility in markets.

It is against this backdrop that we are tasked with selecting the new instruments for 2020’s portfolio. We plan on employing a slate of middle-quality fixed income instruments, mixed with equity exposure (both in the U.S. and in Europe) to sectors that fall on the right side of leverage, liquidity and cash flow dynamics. That combined with opportunistic use of hedges like duration, gold, FX and volatility tools should create a successful and harmonious portfolio, able to withstand the volatility brought on by ongoing virus uncertainty, and the reflationary pressure brought on by its eventual successful resolution.

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