September 2020

Nihilistic Bull Market: Stop Asking it to Care

Summary & Outlook: Following last week's setback equity markets (the S&P500) are still up 6% YTD and more than 50% above than the depths of corona-panic levels in March. We anticipate it getting more difficult over the near-term. The recovery in sectors hurt by Covid19 is decelerating. Meanwhile, many companies that have benefited from the pandemic have their best results behind them. The Fed remains supportive, but more than 10 million people are still without a job compared to last year. It took five years to create 10 million jobs in the period leading up to 2020. Next up, a two-month countdown to a Presidential election in an era of simmering social tension.

Rising Equity Prices = Stimulus to the Economy

The Fed is intentionally creating conditions that inflate equity values. Nearly every day we read an article either asserting that equity prices are overvalued, that the market is a "bubble", or questioning whether prices can go higher, while noting the seeming disconnect between the direction of markets and the state of the "real" economy. This debate is missing the point, in our view. There is no magical mechanism linking equity prices to company or economic fundamentals. You should not expect the market to reflect near-term conditions. Even long-term conditions are frequently not the basis for current stock prices, which are influenced by a great many other things. The market is nihilistic. It does not care.

The current market is a case-in-point. To help illustrate what we mean, we will invert value-investor Benjamin Graham's famous analogy "In the short run, the market is a voting machine but in the long-run, it is a weighing machine." The Federal Reserve, though a combination the near-indefinite promise of ultra-low interest rates, as well as asset purchases (mortgage backed securities, even corporate bonds), has its finger, fist, and boot on the scale. This weight matters in the short-run.

Denying the effects of the Fed's actions will not help you understand the market nor craft a successful investment strategy. Rather, we believe it's preferable to consider the implications of Fed's actions which we believe are intended to indirectly boost equity prices. Why does it care about stock prices? The objective is to stimulate the economy. Higher equity prices create a wealth effect for families. This allows more spending including purchase of real estate, which itself is another important component of the economy. Strong equity fundamentals also provide access to capital for companies. Witness Tesla's (TSLA) recent opportunistic $5B equity offering, which is just one example. This capital will be reinvested in operations, research, capital spending, etc. which supports job creation and growth. Our sense is that the Fed probably does not mind if some individual stocks become untethered from fundamentals and "bubble". This risk associated with allowing a few investors to lose money buying overvalued equities is lower than that posed by an economy permanently atrophied by coronavirus-shutdowns. Besides, making the market go higher is also politically expeditious.

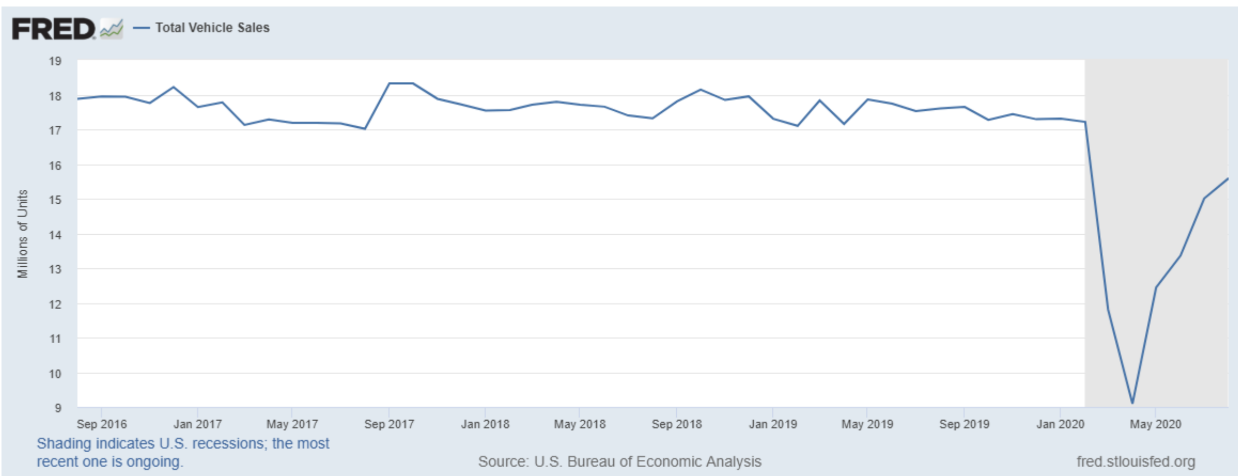
Unfortunately, Big Deltas Will Not Last

Another driver in the recovery of stock prices has been strong sequential increases in economic data and business performance following the lift of lockdowns. However, this is already starting to fatigue. Ultra-low interest rates for longer creates cover for investors to borrow to buy equities and for more capital to shift into the market from other lower-returning asset classes. Large sequential improvements in company results and economic data from the depths of the March-April lows have further propelled stock prices as it reversed fear that we were going into a long-term recession.

Unfortunately, these snap-back performances are already starting to slow. Maybe the initial results were due to the spending of stimulus checks sent to consumers, or perhaps it was a case of pent-up demand. Regardless, it could be starting to dawn on investors that a full recovery is not likely for some businesses or sectors.

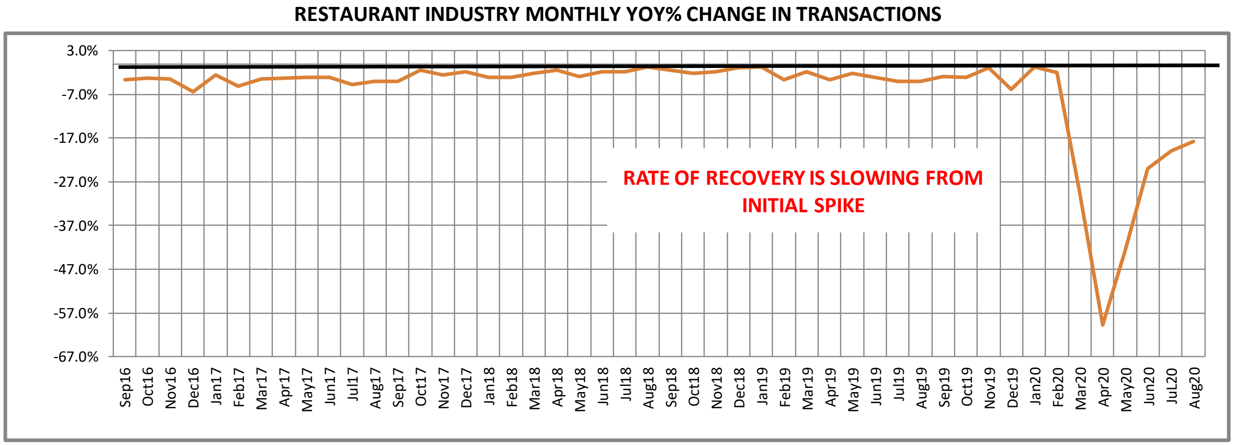
Let's take a quick look at two sectors. First, check out sales of cars and trucks. Americans were buying around 17 million cars and trucks per year prior to Covid19. (The data is presented as a seasonally adjusted annual rate or SAAR.) This purchase rate fell to about 9 million for the month of April 2020. The rebound to May's rate of 12.4, *expressed as a percentage* was a gain of 37%. The market cheered this *really big* increase. By July, the SAAR of car and truck sales reached 15.0 million and in August it grew again, to 15.6 million. This means that August's sequential improvement *was only 4%*. Good, but not exceptional.

Figure 1. U.S. vehicle sales (seasonally adjusted annual sales or SAAR) recovered sharply from April lows but the rate of improvement is slowed in the most recent month.



Our second example is traffic to restaurants. During lock-downs, the dining rooms of many restaurants were closed contributing to a decline in transactions of more than 50% for the month of April. In May, traffic to restaurants was still terrible compared to a year early but it improved sequentially, falling *17 percentage points less* than it had during April. A big improvement! Investors cheered! How about August vs. July? Restaurant traffic continues to recovery but was better by only two percentage points sequentially and remains down nearly 18% from a year-ago. Right direction, but more like baby steps.

Figure 2. Visits to restaurants has jumped from a nadir of down more than 50% in April to August, during which traffic to restaurants fell "only" 18%.



Source: Black Box Intelligence, Quo Vadis Capital, Inc.

And Then There are the Viral Winners

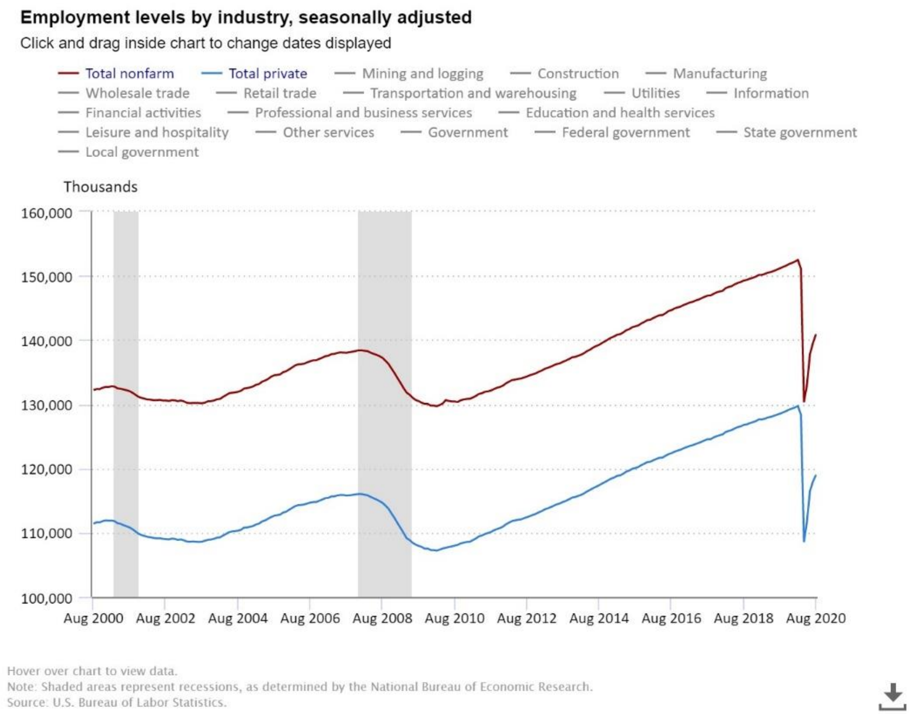
Leaving mega-cap technology companies aside, many other businesses have benefited from Covid19. The stocks of some are now at all-time highs just as demand is slowing. Business could decline year-over-year next year for this group. What do discount retailers, pizza-delivery, video conferencing, and high-end home exercise equipment have in common? All have benefited from being positioned to benefit from distortions in demand caused by coronavirus. None were anticipating it.

There will be lasting secular changes in the U.S. economy due to coronavirus. Work-from-home is here to stay. Sorry, control-freak bosses. Remote learning may also become more regular. Options for food delivery and delivery of any kind have increased. Maybe they will even clean seat-back tray-tables on airplanes in the future. (Not counting on it.) Our view is that it is still too early to know what lasting secular or structural changes will stick. What we do know is that many businesses that benefited from lockdowns have just experienced a peak in demand that may never repeat. We also observe that the stocks of many of these companies have also jumped to all-time highs. These may continue to be great businesses (or not) but demand is likely to decelerate for the balance of the year, and it will be difficult or impossible for this group to grow again next year. Generally, this is not a recipe for continued stock price gains.

Semi-Permanent Demand Destruction

The market wants to believe full recovery is possible, but there is a lot of work to repair lost consumer incomes. Despite improvements from the lows, unemployment In August at 8.4% still compares to a rate of 3.7% from a year earlier. This means more than 10 million people are out of work vs. a year ago representing a member of approximately 8% of U.S. households. Yes, employment should continue to recover and some companies are doing great despite or as a result of Covid19. This does not alter or offset the fact that consumer spending remains the largest component of the U.S. economy. In the period prior to Covid19, it took the country approximately five years to create 10 million jobs.

Figure 3. Five years of work on Labor Day: Total employment (includes government workers and the military) peaked at 152 million prior to Covid19. As of August we've climbed back to 141 million.



Conclusion

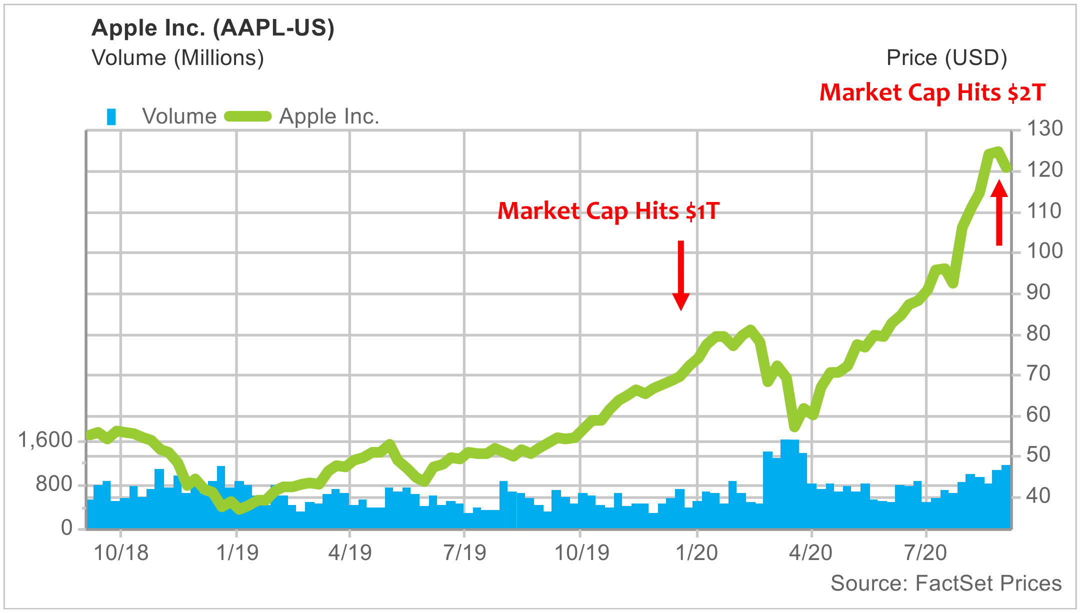
A 50% move off the Covid bottom has put the market in a difficult place. Stocks have benefited as the Federal Reserve labored to create favorable conditions. Giant technology companies proved again the strength of their models. Reopened businesses reported sharp gains. Covid-beneficiaries generated best-ever sales due to distorted demand. However, the rate of recovery is now slowing. The Covid-beneficiaries' best days are behind them. There are still 10 million fewer jobs in the U.S. than a year ago heading into the Holidays. And we're two months away from a Presidential election in an atmosphere of social unrest. We'll make no claim to being able to predict the market, but this does not sound great.

How We are Managing Client Money

Results this year have reinforced the thinking behind our approach. Our investing philosophy starts with the assumption that future market conditions are unknowable. Our strategy is *designed with this uncertainty* in mind. It includes owning a concentrated portfolio of the best companies (based on margins, competitive positioning, brand strength, growth prospects, and especially the ability to reinvest free cash flows at high rates of return, among other factors) and to *remain fully invested throughout the economic cycle*. In fact, one year ago, we wrote about how we felt a recession would benefit the companies we owned. We won't declare victory because anything can happen and there is no finish line, but we can observe that 11 of the 16 names in our book hit all-time highs in the past few weeks. Each one of these names had been down materially during the corona-panic.

A company we've been invested in since the outset is Apple, Inc. (APPL). You may yawn but there are no points for originality in investing. We previously wrote about AAPL last December. At the time, the market capitalization hit recently crested $1 trillion. We conjectured then that APPL could continue to grow and obtain a market value of $2 trillion. Of course, we had no idea it would happen in less than nine months. Is it justified? Looking at valuation measures, AAPL currently trades at multiples well above where it has been in the past (24x enterprise value to EBITDA and more than 7x revenues, if you need to know). We think AAPL is ahead of itself and needs to digest gains. But can APPL be worth $3 trillion? We'll repeat what we said in December. If the company can continue to innovate and take share global markets in current and new categories, generate excess cash flows and return these to shareholders, then continued appreciation in the shares is likely. We think $3 trillion is possible. Some day.

Figure 4. Apple shares are up 65% this year and 127% over the past 12 months.



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Mr. Zolidis started his career in finance in 1996 following degree studies in Philosophy at Kenyon College and the University of Oxford. He has followed U.S. consumer companies as a senior analyst since 1999, mostly on the sell-side, writing research for institutional investor clients. He also managed money in a buy-side role at a long-short equity fund over 2013-2014. He was named in the Wall Street Journal's Best on the Street list in 2005. Mr. Zolidis founded Quo Vadis Capital, Inc., a Registered Investment Advisor (RIA) and research consultancy, in 2017 and works from New York and Paris, France.

Distant from the other tourists. Perhaps the biggest benefit from Corona for us has been the ability (for us) to visit travel destinations that are normally choked solid with fanny-pack wearing tour groups. These people always seem to get into my photos. I have tried, but failed, to find the setting on my iPhone to automatically edit other tourists from my pictures. (If you or those you love wear fanny-packs, I apologize.) I did manage to inadvertently use a fancy iPhone 11 setting in the photo below, which was taken above cliffs overlooking the sea in Malaga, Spain. The photo is taken with a 16:9 aspect ratio, rather than the standard 4:3. But that's not the interesting part. It's that it was taken with the ultra-wide lens, which the internet tells me has a slightly wider field of view than the human eye. It also modestly distorts the image, making it feel even more like the cliff vanishes into the Mediterranean below.

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