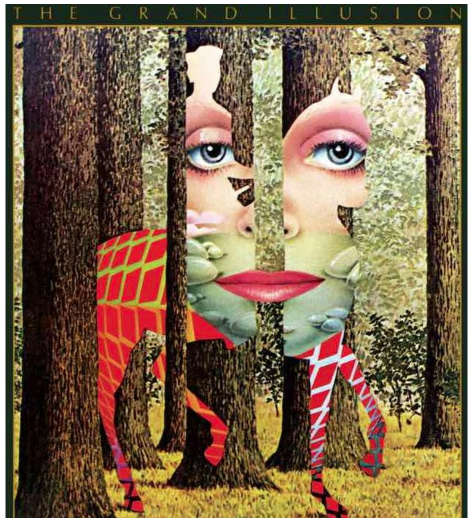
MEDALLION WEALTH MANAGEMENT

November 2020 Market Commentary

The Grand Illusion



So if you think your life is complete confusion
Because your neighbors got it made
Just remember that it's a grand illusion
And deep inside we're all the same

Styx - https://www.youtube.com/watch?v=7U2E-In0DDg

I'm pretty sure we're all struggling with some bouts of "complete confusion" today. We wear masks every day, not just Halloween. We watch sporting events with no fans. We question the safety of eating at our local restaurant. We are fatigued and fed up. Things get better, then they get worse. We step forward, then slide back.

The elections certainly haven't clarified much. If you listen to the media and the politicians, we have a distinctly divided country, left and right. But if you talk to your neighbor, or maybe your daughter, you realize that we agree on much more than we disagree. Life simply isn't just black and white, it is much more nuanced.

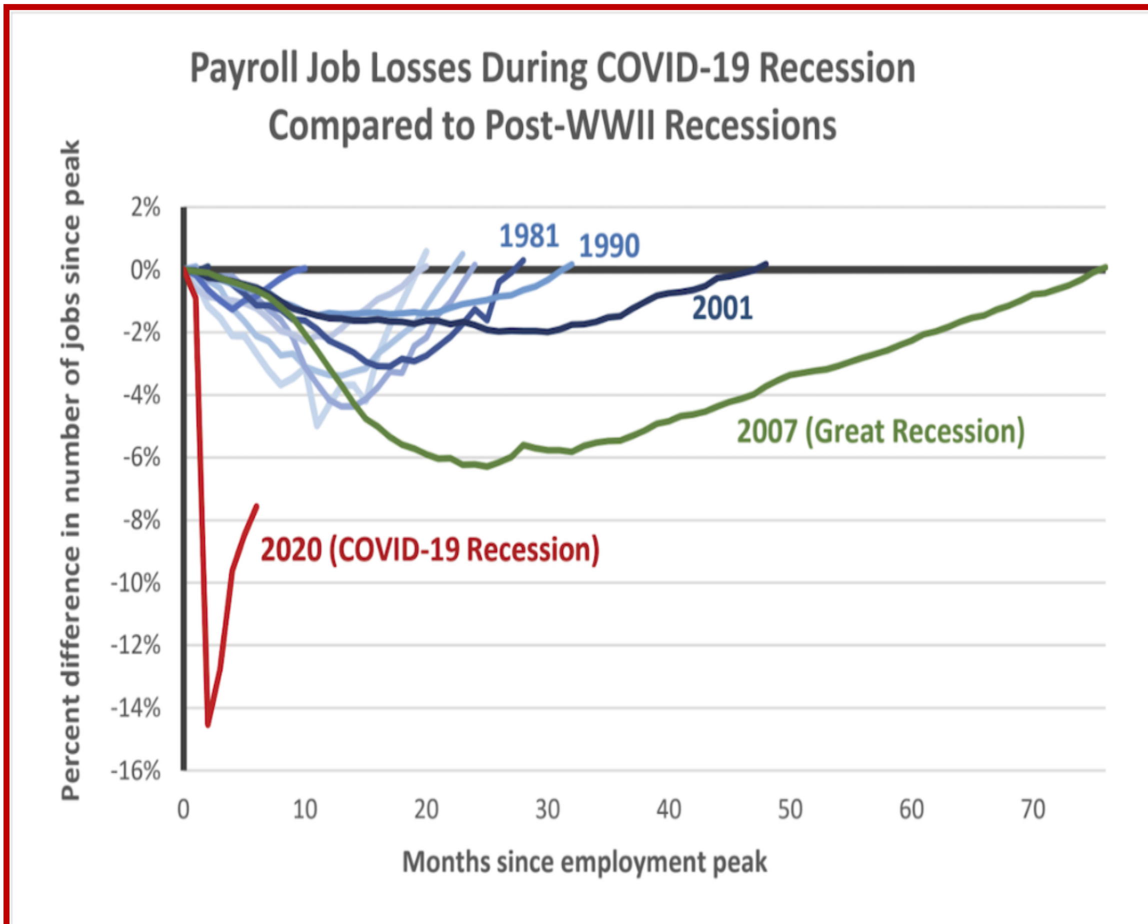
As humans and investors we have to remember to ignore the "grand illusion" and find out what is real. When we look at this M.C. Escher illustration do we see bats or angels? Both are reality, and we can choose what we want to focus on.

If only our economy was so simple. Generally the economy and markets move in cycles. In up-cycles the economy improves, causing psychology and decision making to become increasingly optimistic and eventually euphoric. Productive capacity exceeds what is needed, speculative investment ideas are embraced, and stock prices exceed their underlying value. Eventually when these trends outstrip their fundamentals by a wide enough margin a downturn begins. Investments made at inflated levels don't generate the expected returns. Companies begin to retrench by cutting costs and employees. As unemployment rises consumers cut back, and we enter a recession, until supply and demand, investment and consumption, find an equilibrium.

In a collapsing economy, the Fed has increasingly stepped in to mitigate the effects of increasing unemployment, lowering rates and encouraging investment. Usually this works. Eventually the economy recovers, consumers resume buying, companies hire, and markets rally, and the business cycle continues.

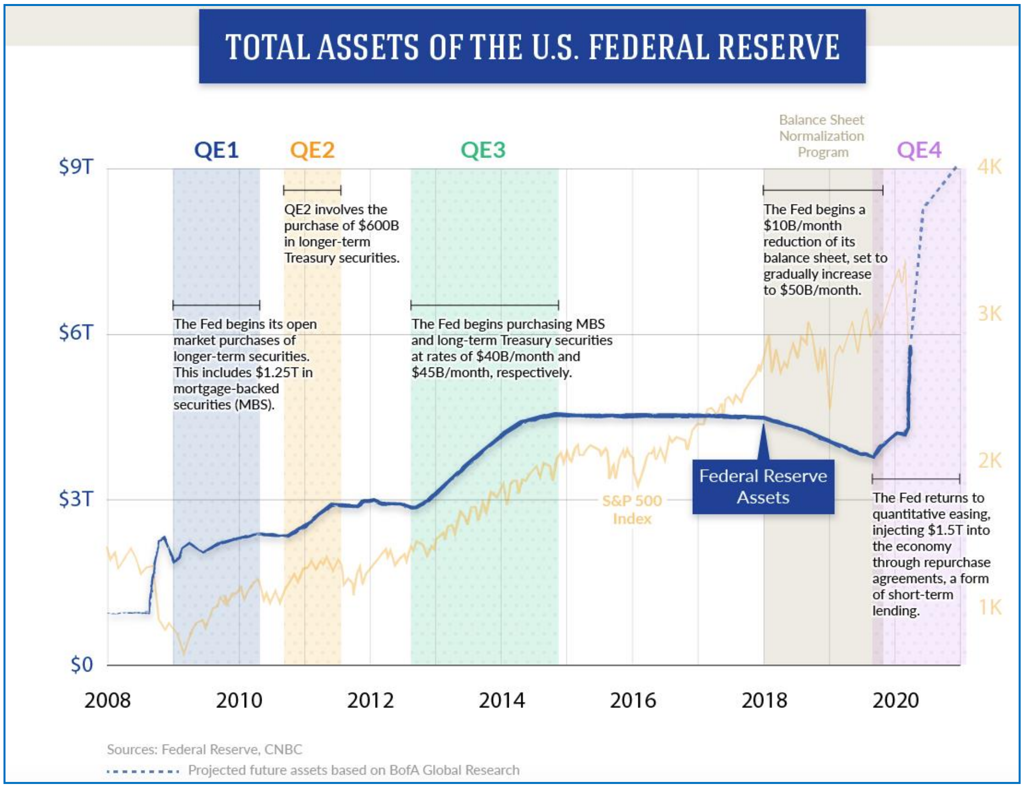
As we're unfortunately aware, nothing about 2020 can be described as normal. This is not a normal business cycle recession, this is an exogenous event caused by a virus and government responses to that virus.

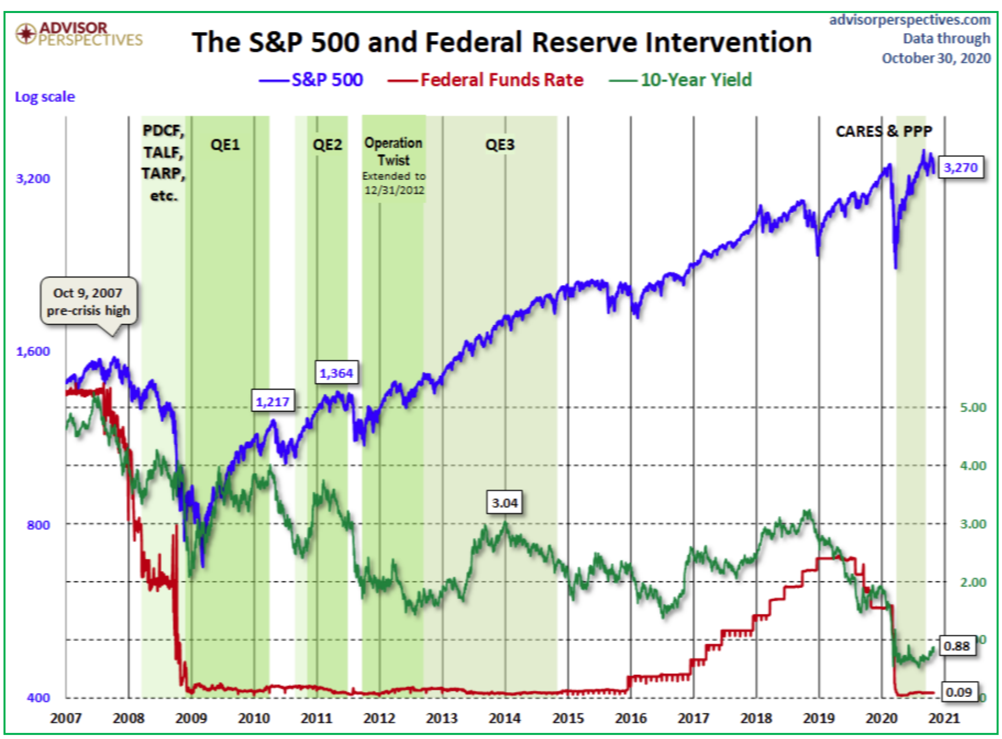
The following graphic shows just how severe the collapse in employment has been this year. Even though we've recovered some since March, we still aren't even back to the lows of the 2007 Great Recession.



Note: Each line represents a recession. Numbers next to lines indicate the year the recession began.
Source: U.S. Bureau of Labor Statistics Current Employment Statistics program and author's calculations.

Since this recession is not a typical business cycle recession, the Fed's response has been anything but typical. As the economy was shut down to battle the virus the Fed injected $1.5 trillion into asset purchases and cut interest rates to zero percent.



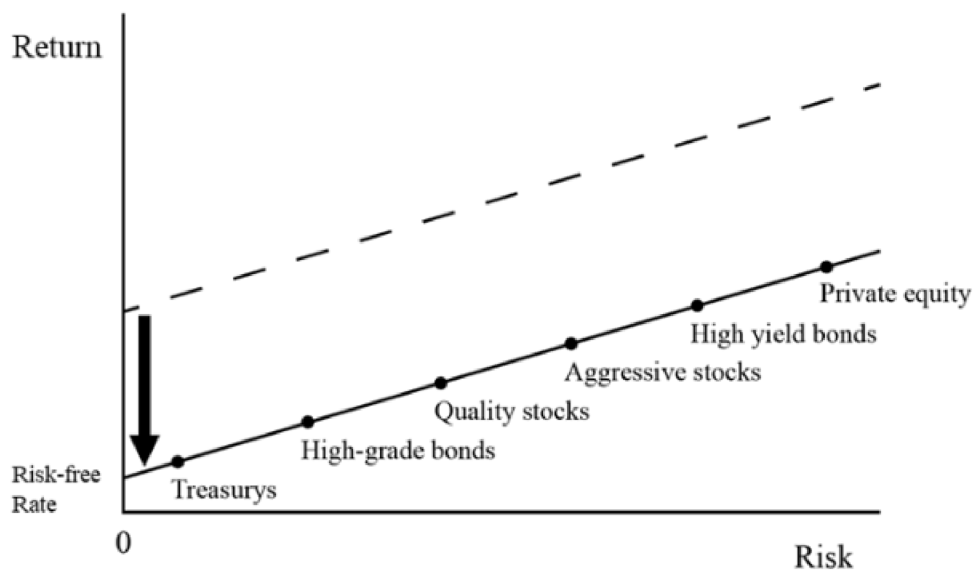


Welcome to the Grand Illusion
Come on in and see what's happening
Pay the price, get your tickets for the show

The initial response to such unprecedented liquidity injections has been very positive, with the S&P 500 quickly recovering from its March lows and reaching new highs. Low rates have a very stimulative effect on the economy, making it cheaper to buy houses, cars, etc. They also lower the borrowing costs for corporations, allowing them to refinance higher cost debt and access the capital markets for growth.

While lower risk-free Treasury rates are very stimulative for the economy, they also have a downside. You see, as the risk-free rate falls then expected returns on all assets also fall. If the risk-free rate on a 30-day Treasury Bill is 0.10%, and the yield on a 10-year Treasury is 0.75%, the expected returns on riskier assets is also lower.

Lower yields drive asset prices higher making prospective future returns lower. If you buy a 10-year Treasury today you will get 0.75% per year for 10 years. If you buy an investment grade corporate bond today you will get about 2.00% over the next 10 years. And if you buy High-Yield Junk Bonds you'll get about 5.00% per year.



Where does that leave equities? Stocks are always a little tougher to forecast, but again on a relative basis versus bonds, and considering their current historically lofty valuations a ten year annualized return of between 4% and 6% would be considered normal.

Let's take a closer look at S&P 500 earnings and valuations. With the S&P 500 currently trading at $3,611 here are our valuations:

- 2019 actual Earnings $163 Price-to-Earnings 22.2x
- 2020 estimated Earnings $133 Price-to-Earnings 27.2x
- 2021 estimated Earnings $167 Price-to-Earnings 21.6x
- 2022 estimated Earnings $191 Price-to-Earnings 18.9x

Currently Wall Street analysts expect corporate America's earnings to fully recover in 2021 and be 14% higher in 2022. Stocks reflect this bullish scenario and are trading at historically high levels.

Wall Street is also cheering the election results, with the expectation that the Democrats will have the White House and a narrow mandate in the House of Representatives, while the Republicans maintain control in the Senate.

The reality is probably that there will be increased pressure for higher taxes and more regulations, combine that with interest rates near zero, and inflation expectations in the 1%-2% range and it is hard to envision very robust equity returns.

Average P/E Ratio in Different Inflation and Tax Environments

Inflation Rate	Dividend and Capital Gains Tax	Years	Average P/E Ratio
>4%	Low Tax	5	14.4x
	High Tax	26	11.2x
0%-4%	Low Tax	24	20.1x
	High Tax	33	16.3x
<0%	Low Tax	9	22.3x
	High Tax	5	12.4x

Sources: Valens Research, CapitalIQ, *Irrational Exuberance* by Robert

So what's an investor (pension plan) supposed to do if they need 7% returns to meet their expectations/obligations? Frankly, not much, 7% returns for a diversified portfolio are not achievable with assets priced where they are. In a classic 60% stocks/40% bonds portfolio, at today's return expectations an investor should expect a return of around 3%-4% (60% at 5% and 40% at 1.50%). Here are some options:

- Invest as you always have and settle for today's low returns. Realistic though not appetizing.
- Reduce risk in deference to the high levels of uncertainty and accept even lower returns. This may make sense, but again it's not very attractive.
- Increase risk in the pursuit of higher returns. This is supposed to work, but it's no sure thing, especially when so many investors are trying the same thing.
- Move some assets from the very low return fixed income space and reallocate to alternative managers.

This last approach is what we are starting to adopt here at Medallion Wealth. Our normal 60%/40% stock, bond allocation is gradually becoming more of a 60%/30%/10% stock, bond, alternatives allocation. We're looking for strategies that have the same risk profile as fixed income but offer a higher prospective return.

The illusion is that low interest rates and an extremely accommodative Fed will lead to much higher returns. The reality is that those higher returns have already occurred. The S&P 500 is up 65% from its March lows and 12% year-to-date.

Someday soon we'll stop to ponder what on earth's this spell we're under
We made the grade and still we wonder who the hell we are

As always, be careful out there,

Chris Wiles, CFA

Where trust is Earned