Portfolio Managers' Commentary

Emidio Checcone | **Brian Ear** | July 2020

The U.S. equity market saw a dramatic recovery in the second quarter on unprecedented government intervention, even as the economy continues to struggle through a set of challenges arguably greater than anything faced since the Great Depression. While we can debate whether the latter's recovery path will more closely resemble a U or an L, the sharp V-shaped recovery of U.S. stocks, and the large-cap technology franchises in particular, has created a difficult environment for value-oriented investors seeking returns commensurate with risks. We see the market likely pricing too much good news into an underlying economy still ridden with many risks that either pre-date the pandemic or that have been exacerbated by it. Yet recognizing the need to remain invested under these difficult conditions, we seek to balance our portfolio exposures between those names that should prove defensive in these difficult times and those that we believe present opportunity as the underlying economy begins a broader, sustainable recovery. Our differentiated investment strategies, focusing on fundamentals and sensitive to value, afford us an ability to balance these two types of investments.

The U.S. equity market experienced during the second quarter a continuation of the robust recovery that began in mid-March. The epic bounce in equities was led by the continued momentum of large-cap growth stocks, which powered the Russell 1000 Growth Index up 27.8% during the second quarter, while the Russell 1000 Value index increased 14.3% over the same period. Meanwhile, the S&P 500 rose 20.5% in the recently completed quarter, and is now down only 3.1% for the year.

The cumulative move from the bottom would appear to have put the markets at the higher reaches of historical valuation ranges, even as the underlying economy continues to suffer through very difficult times. The reason for this dramatic divergence is the unprecedented pace of monetary intervention by the Federal Reserve, along with record levels of governmental fiscal stimulus. The monetary and fiscal programs deployed to date are multiple orders of magnitude greater than those used during the prior global financial crisis (GFC) in 2008. Moreover, the Federal Reserve has reached still further into its box of unconventional tools, broadening the type of assets acceptable as collateral through various new lending facilities that permit the purchase of short-term municipal, corporate or even junk bonds, along with the origination of loans to small and medium-sized businesses. The result of the ongoing money printing and asset purchases associated with this new level of quantitative easing (QE) will likely be a Fed balance sheet exceeding $10 trillion by early next year.

The implications of this extraordinary intervention are profound, and they include profound risks. First, the government programs have likely delayed but not eliminated the economic carnage following the pandemic and resulting lockdowns. Take unemployment numbers. We were told in June that the official unemployment rate had declined to 11.1%, from an 80-year record high of 14.7% in April; however, due to the misclassification of many unemployed (i.e., workers temporarily furloughed but not fired under the Paycheck Protection Program), the real unemployment is likely much higher that the official number, with total claims as a percentage of total non-farm payrolls approaching 25% at the end of June. Because many individuals through multiple programs are receiving more money while sitting out of the workforce, it is hard to understand what the real unemployment rate is, nor fully observe yet what the impact of such joblessness will be on the economy

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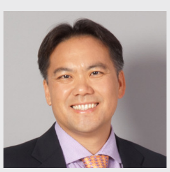

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going forward. Indeed, the stimulus checks, enhanced unemployment benefits, and unemployment insurance have not only replaced lost income for many newly unemployed, but has caused the total personal income figure in May to actually exceed the pre-pandemic number posted in February. This artificial boost in buying power drove a rebound in retail sales in May, up about 17.7% over April, and has enabled many consumers to meet their debt obligations, as has substantial forbearance. Furthermore, the fiscal and monetary stimulus likely also supported the apparent record increases in online brokerage account openings and epic retail investor participation in the market (n.b.: Robinhood, a brokerage popular among millennials, saw a doubling of its online accounts between mid-February and the end of June). However, this sugar high cannot continue indefinitely since more government aid will be needed, as many begin to expire at the end of the current month, with uncertain prospects for the likelihood, size and timing of their renewal. In short, the full picture of the damage cannot yet be taken in by watchful investors, and some of the indicators currently visible are likely misleading.

Second, this unprecedented monetary and fiscal effort by the Fed and federal government may still not be enough to circumvent a credit crisis from occurring, so an extended economic recession or depression remains possible. By many measures, this is the worst economic downturn since the Great Depression. Indeed, the Congressional Budget Office estimates that real gross domestic product in the second quarter contracted by 10.1% quarter-over-quarter, equivalent to a 35% year-over-year decline. While the tentative re-opening attempts and epic stimulus could reverse some of this, the economy is far from out of the dark woods, and there is growing risk that this develops into a credit crisis the longer the downturn drags on. There remains considerable uncertainty about whether government fiscal support will be extended and surrounding the amount and duration of future stimulus. Moreover, monetary stimulus is potentially reaching limits, as it is less effective in stimulating demand in the current environment, because recipients might be too fearful to spend, as rising savings rates would suggest. The failure of these government stabilizers obviously could create dramatic reversals for the financial markets.

Third, the purchase of corporate bonds and other riskier assets is likely distorting the market and economy. Since the government is not price sensitive when it purchases these securities and does not evaluate the underlying risk of these businesses, this could lead to mispricing of risk and misallocation of capital, as the price-discovery mechanism of the market becomes overwhelmed by the Fed's activities. The result of Fed intervention is often that asset prices tend to appreciate irrespective of the underlying risk, undermining price discovery and encouraging excessive risk-taking by other market participants, who see the Fed put as license to aggressively assume such risk. Meanwhile, zombie companies that generate inferior returns may be able to access cheap capital and otherwise are allowed to operate longer, which can enable excess capacity and inefficiencies to linger in the economy, thereby harming healthier, efficient companies. The resulting moral hazard can lead to future financial excesses, thus increasing risks that credit problems deferred will merely resurface as a larger problem in the future. Finally, asset prices that are boosted by the Fed's actions could be pressured when assets are eventually sold as the Fed's program ends.

Fourth, all of this intervention also raises the specter of increased inflation risk. This danger could come from multiple places. The enormous money-printing operation that supports both the fiscal and monetary stimulus underway could catalyze investors' concerns about the purchasing power of the U.S. Dollar, and the fact that gold is making new highs as we write this clearly highlights this risk. In addition, the simultaneous reduction in capacity—as evidenced by the extremely high levels of furloughed or unemployed workers—along with the maintained purchasing power of such individuals likely causes overall demand to outstrip supply, which is another inflationary driver. The announcements by some companies of wage increases to entice the subsidized unemployed back to work highlights this dynamic. Furthermore, the long-term risks of additional government intervention—particularly in the event of a Democratic sweep of Congress and the White House—leading to greater inefficiency and upward inflationary pressure are very real. Because so much of the phenomenal increases in stock market levels over the last 40 years have come from multiple expansion, driven by interest rate declines, it is important to understand that a reversion to higher inflation and interest rates will make future financial asset appreciation tougher to achieve.

Even as the economy faces challenges and risks that rival those of the Great Depression, stock market valuations appear by most measures well extended at the highest end of historical ranges, which is at odds with the typical pattern of multiples troughing in similarly severe economic collapses. At present, the S&P 500's fiscal year 2020 forecasted P/E is about 24.8x versus a historical average of 15.1x since the mid-1930s, according to Yardeni Research. Valuations are likely even higher under more normal margin conditions, as the S&P 500's cyclically adjusted P/E (a.k.a., the CAPE ratio) is about 30.0x, which is also well above its 150-year average of 16.7x. Each of these valuation measures troughed at 15x or lower during the Global Financial Crisis, so concluding that a new bull rally is now underway would be to ignore history's lesson concerning the valuation levels upon which new bulls are born.

Many will point to the record low interest rates as playing a key role in driving market multiples and thus equity index levels. With the yield on the 10-year Treasury falling to 65 basis points at quarter's end, the S&P 500 now offers a more competitive dividend yield of 1.87%--in contrast to the historical pattern of the 10-year Treasury yield exceeding the (growing) S&P 500 dividend yield. However, the risk associated with this analysis is that interest rates are at record lows precisely because there is little growth. Indeed, earnings for S&P 500 companies are expected to decline about 44% year-over-year in the second quarter and about 21.5% in fiscal year 2020, which means that even looking out three years, it is likely that one is paying more than 20x for hard-to-forecast earnings in 2022. This lack of growth offsets the benefit of the lower discount rate, and therefore, calls into question the propriety of paying such high valuation multiples on the market overall.

Note that individual companies, especially those emerging from the economic crisis with a strengthened competitive position, might justifiably command such a premium, but it is doubtful that the market overall should do so. Further, the relatively high dispersion of current earnings estimates not only reflects the great uncertainty about the path of economic recovery and the highly varied prospects of companies going through the current crisis, but also underscores the need to actively manage one's equity investments in this uncertain environment.

While the broader valuation metrics appear stretched for the major equity indexes, there remain pockets within the broader stock market that offer attractive risk-reward opportunities. This includes companies offering long-term value not yet fully recognized by other market participants, as well as, strong franchises that benefit from sustainable secular trends that have actually been enhanced during the pandemic and economic downturn. Hence, amidst an admittedly challenging macro environment, with elevated systemic risks around the pandemic and economy, we continue to follow our investment strategy by seeking out fundamental value where we can find it.

Looking beyond the twin problems of the pandemic and the economic collapse, we would note two other simmering issues. First, the Presidential election poses additional risks that do not appear to be reflected fully yet within the market. The stock market has climbed over the last month even as Biden has gained a significant lead over Trump in the polls and betting sites, and even as those polls and prediction markets signal growing prospects of a Democratic sweep in Congress. Such a blue wave would enable Democrats to push forward with an anti-corporate agenda that includes higher taxes and increased regulations, which together could pose a further headwind to corporate profitability and market multiples. Biden has already indicated that he intends to return the corporate tax rate to 28% from 21%. While it is unclear how fast such policy changes would be made under a Biden White House with Democratic Congressional control, we see these risks growing and potentially weighing on certain segments of the market, if not overall prevailing valuation levels.

Finally, we should note that China-U.S. relations have continued to deteriorate through the ongoing pandemic. China appears to have been the source of the pandemic, and has been criticized for not being rapidly or completely forthright in reporting dangers surrounding COVID-19 to the rest of the world. As a result, relations with the U.S. have soured further, as the two economic superpowers have exchanged escalating threats, including China's apparent unwillingness to make previously promised purchases of agricultural and other products under the trade agreement, as well as America's increasing efforts to cut off Huawei's access to critical semiconductor content. Further escalation of these disagreements, which both sides are now describing in rather bellicose terms, could raise additional risks of costly supply chain decoupling and market share shifts impacting many highly-valued companies in the equity market.

In summary, we are still only in the very early stages of recovery from a terrible pandemic and an economic collapse, among other challenges, and the path to a full recovery from these twin tragedies remains highly uncertain and likely will carry setbacks along the way. Ultimately, the recovery will depend both on the course of the COVID-19 pandemic, advances in treatments and vaccines, and efficacy of containment efforts, as well as on the ability to restart fully economic activity in the aftermath of this pandemic, all of which are inherently unpredictable and susceptible to fits and starts in hospitalizations and risks of re-closures. Meanwhile, there remain many unknowns surrounding the shape of the economic recovery, including: 1) an economy still heavily reliant on uncertain future government support, especially in an unpredictable election year; 2) risks of pandemic-prompted re-closures hampering the restart of economic activity; 3) state and local governments may be forced to cut spending and layoff employees, adding incremental challenges to the economy; 4) the Presidential election could result in higher taxes and regulatory burdens that squeeze future earnings; 5) particularly vulnerable industries, such as travel and leisure, will likely be smaller for longer, causing protracted losses of jobs, corporate earnings and market capitalization; 6) the propensity to spend by consumers and the capex levels of businesses could be hampered by the psychological harm caused by the virus; 7) heightened trade tensions with China, exacerbated by the source of the pandemic, could disrupt supply chains further and exacerbate the already weak economy; and 8) longer-term risks of further zombie-fication of the economy and stoking of meaningful inflationary forces, which are potential unintended consequences of the record increase in government debt and money supply from the nearly unlimited quantum of QE that is ongoing.

Although we think the broader market is not pricing in completely these substantial risks and unknowns, we do expect many states will continue to move forward with their re-opening plans, in spite of any resurgences in infections and hospitalization. We would expect this to lead to a slow improvement in the economy over time, as people get back to work, and assuming a major credit crisis is averted with the help of additional government support. Furthermore, we recognize that the recovery could accelerate if a coronavirus vaccine becomes available late this year or early next. We will continue to remain disciplined with regard to valuation, as we evaluate the path of recovery relative to market expectations.

In light of these observations, we continue to search for attractive investment opportunities while believing that an abundance of caution is in order at the present time. We recognize that investors cannot time the market and should stay invested to avoid missing the small percentage of strong rallies that drive a disproportionate amount of long-term returns—Nature's power law applies to the markets as well. We also expect that active management will show its value in the present investing environment, as the differences in relative company positioning begin to emerge through the crisis and into the changed, post-COVID-19 world. We will continue to seek sound, long-term investment ideas and strike reasonable balances within our portfolio among those investment ideas that may offer safety in uncertain times and those holdings that have the potential to represent compelling long-term value once a broader recovery is underway. Our differentiated investment philosophy allows us to capture both of these opportunity sets, in our ongoing effort to secure solid relative returns.

We thank you for your continued interest in DoubleLine Equity. ■

Select Definitions

Earnings Per Share (EPS) – Calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

Price-to-Earnings Ratio (P/E Ratio) – Ratio for valuing a company that measures its current share price relative to its earnings per share (EPS). The P/E ratio, sometimes known as the "price multiple" or "earnings multiple," is used by investors and analysts to determine the relative value of a company's shares.

Russell 1000® Growth Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000® Index – This index typically comprises approximately 92% of the total market capitalization of all listed stocks in the U.S. equity market and is considered a bellwether index for large-cap investing.

Russell 1000® Value Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000® Index companies with lower price-to-book ratios and lower expected growth values.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.