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ASSET MANAGEMENT

# Toroso Market Commentary Nov 2020

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## Post-Election Markets & the Alphabet Soup of Recoveries WUVXYZKPD

With the election in the mirror and a civil war on pause, we appear to be heading towards gridlock in the US political arena with a Biden win and Republican Senate. With earnings season well underway, we turn our focus to 2021 and review the marathon that has been 2020. If you are reading this commentary in hopes of guidance as to what the next 6 months may hold, you will be disappointed. There are far too many possibilities, and cascading dominos that can put us down a totally different path with one turn. How will the world handle Covid-19 in 2021? Will there be a vaccine? Will it be mass produced between countries rich and poor? Or will the protectionism movement cross political boarders into the world of medicine? Will enough people take the vaccine? Will people flock back to cities? What will further stimulus look like?

Our approach has not really changed much in the last year, which we are quite proud of. Twelve months ago, we started writing about how little growth was expected to come from broad based equities over the next few years, and with bond yields where they were (and are), growth prospects on a balanced portfolio were unimpressive at best. Our response was to move further away from market cap weighted equities and barbell risks in our portfolio to a much more extreme level than ever before by pairing high active share / high beta thematic investments with negatively correlated defensive assets. Tracking error and active share are your friends in this world. The only thing we can really say with almost absolute confidence is that the market will have spouts of volatility, and the days of under 15 vol on the VIX for months at a time are over. This leaves rebalancing opportunity between the high beta and defensive portions of your portfolio. If you take anything away from this commentary, we hope that it is this: Your rebalancing strategy for 2020, and going forward, may be the most crucial component of alpha generation for your clients. In our opinion, the S&P 500 Index could end 2021 anywhere from +30% to -70%.

### The Bull Case: Innovation and Quantitative Easing

With yields where they are, and sufficient stimulus, lack of runaway inflation and civil unrest, the innovation wave that was put on super drive by Covid-19 spills into 2021. A P/E of 40 on US equities is not unheard, of given where yields are today. Innovation is deflationary for markets and might be the only thing keeping stagflation in check. While another, larger market pullback ala the great depression feels eminent, one major difference lies in the objectives of the Federal Reserve. In the 1930s they were most concerned with protecting the value of the dollar & banking institutions. In 2020 their primary focus, in our opinion, is protecting asset prices. We believe this is not possible in the long run, but in shorter time periods can absolutely appear so.

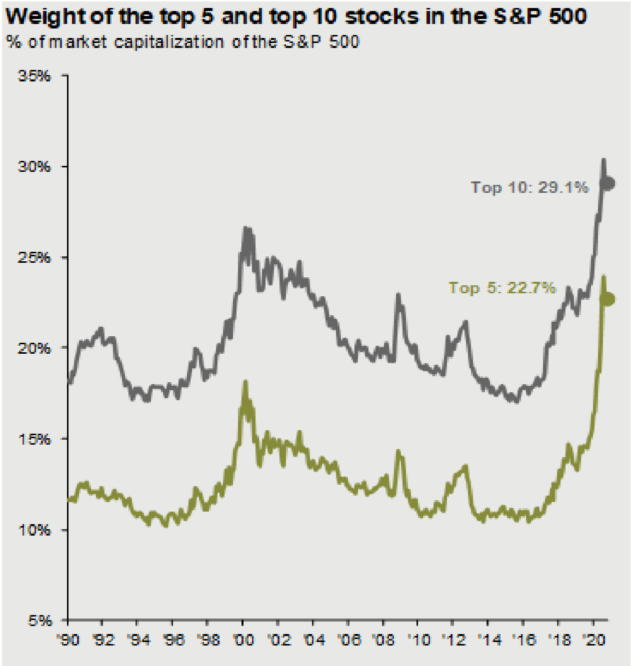
## For the Bear Case

An excerpt from David Einhorn's quarterly client letter defining what a stock market bubble looks like;

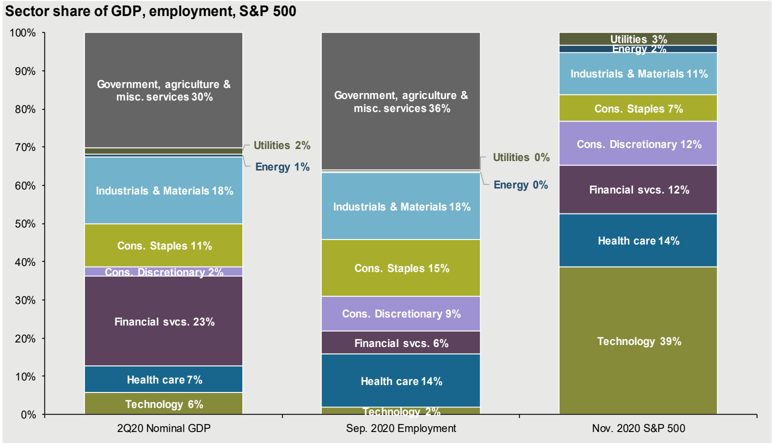
- an IPO mania;
- extraordinary valuations and new metrics for valuation;
- a huge market concentration in a single sector and a few stocks;
- a second tier of stocks that most people haven't heard of at S&P 500-type market capitalizations;
- the more fanciful and distant the narrative, it seems the better the stock performs;
- outperformance of companies suspected of fraud based on the consensus belief that there is no enforcement risk, without which crime pays;
- outsized reaction to economically irrelevant stock splits;
- increased participation of retail investors, who appear focused on the best-performing names;
- incredible trading volumes in speculative instruments like weekly call options and worthless common stock; and
- a parabolic ascent toward a top.

## Politics and Markets

How intertwined are politics and markets? Apple, Microsoft, Amazon, Facebook, Alphabet and Twitter make up almost a quarter of the S&P 500. Facebook and Amazon alone have spent almost 29 million dollars lobbying in 2020, far surpassing any other company. If we dig deeper into how these companies work together it becomes even more clear. Apple receives an estimated $8-12 billion in annual payments for building Google's search engine into its products, accounting for 15-20% of Apple's annual profit. In 2014 the payment was only $1 billion. House Judiciary subcommittee on antitrust released a report earlier this month concluding that Amazon, Apple, Facebook and Google benefit from monopoly power and should be broken up. Tech and Telecom make up 39% of the S&P 500 in size, and yet only make up 6% of its GDP, and 2% of the entire pool of employment within the S&P 500. There's a lot to lobby for.




Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
*Guide to the Markets – U.S.* Data are as of October 30, 2020.



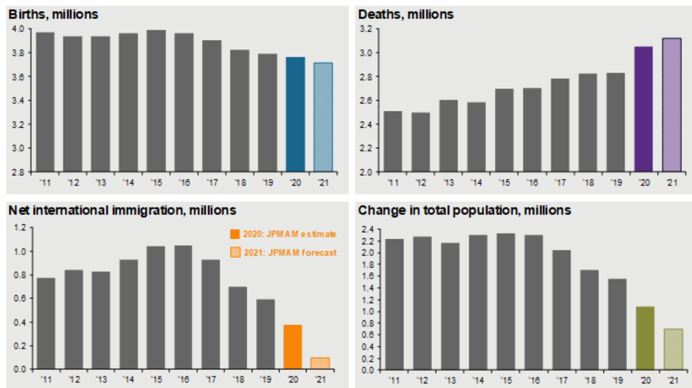

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard & Poor's, J.P. Morgan Asset Management.

## America’s Hidden Duopoly

In a podcast released in October of 2018, Freakonomics compare the duopoly of Coke and Pepsi, controlling 70% of the soft drink market, to US politics. We recently released an ETF Think Tank blog asking why politicians are not held to the same political standards as financial advisors. One could argue their fiduciary responsibility is even greater than that of a financial advisor, and yet the duopoly that is US Politics appears to be running much more like a traditional industry than a public institution. In a Harvard Business School report titled “Why Competition in the Politics Industry is Failing America,” they point out that “the political system isn’t broken. It’s doing what it’s designed to do.”

## US Equities

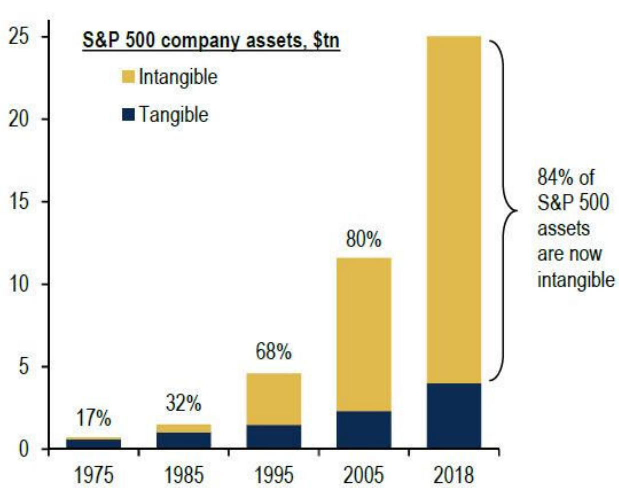
The United States make up about 4.2% of the world’s population. US equity markets make up 58% of global markets. The fate of the S&P 500 may very well rest with how US population numbers trend over the next 10 years. Covid-19 and tight immigration have harmed birth rates and immigration rates and have increased death rates, dwindling our population growth to potentially under 1%. Do we grow / inflate our way out of our debt laden economy, or do we become the next Japan?




Source: U.S. Census Bureau, J.P. Morgan Asset Management. Reported population components are used from 2011 to 2019. Years end on July 1, 2020 is a JPMAM estimate and 2021 is a JPMAM forecast.
*Guide to the Markets – U.S.* Data are as of October 30, 2020.

US equity markets are up 2.75% for the year measured by iShares Core S&P 500 ETF (IVV) after returning -2.66% for October. The shift away from tangible assets, already at historical levels pre-Covid-19, has only heightened post-Covid-19 with a further shift towards the work from anywhere/gig economy market. It has most certainly been the tail of two markets as airlines, hospitality and the energy sector are all still down 40-50% on the year, with REITS and bank down 30-35%. Value is underperforming growth significantly, as is large cap over small, but it has really been a story of FAANG stocks, plus up and coming non-traditional thematic investments that have proven to be most fruitful in 2020.

**Chart 8: Corporate balance sheets are more knowledge-driven**



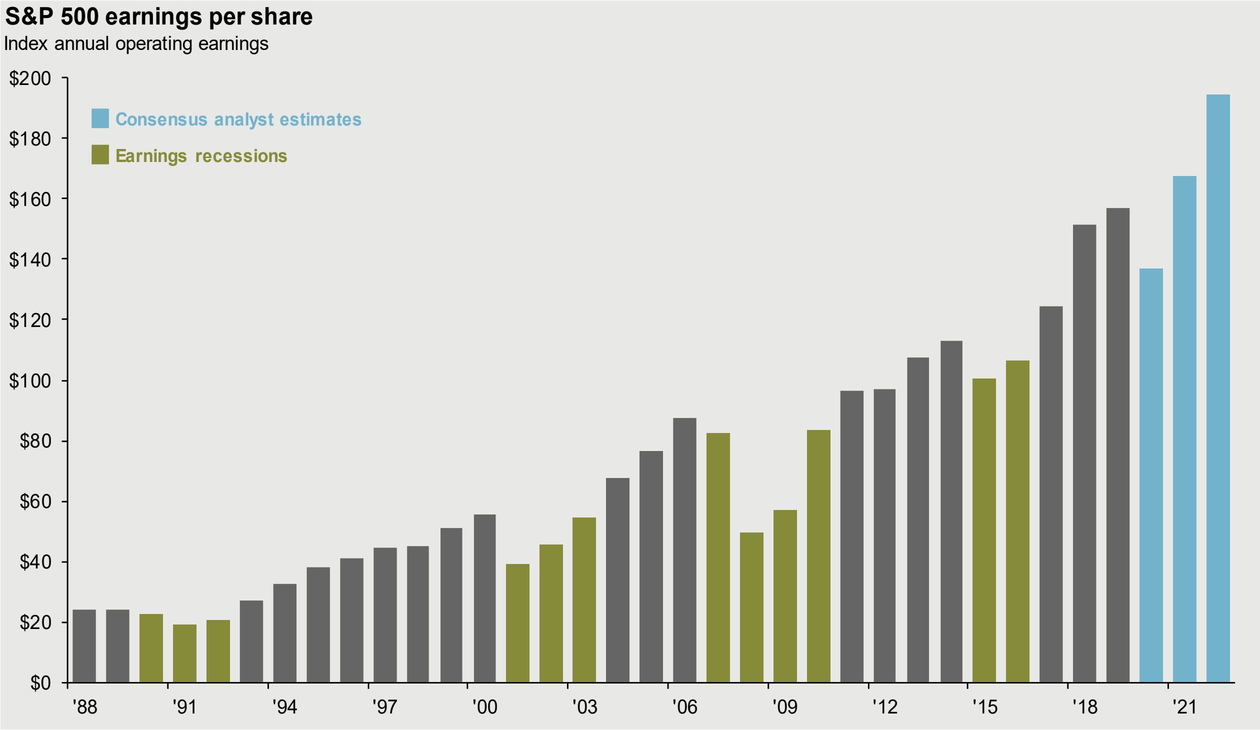

Source: BofA Research Investment Committee, Aon

**Chart 9: Categories of intangible assets**


Source: BofA Research Investment Committee, Ponemon Institute

## Alphabet Soup of Recoveries

GDP is down 10% from peak to valley, the third largest decline in history, trailing only the great depression and post-WWII demobilization. It all comes down to our ability to grow out of this. As of now, in our opinion, earnings expectations going forward are exceptionally lofty. Our ability to meet these is something we question. After decades of markets benefiting shareholders over employees, it feels like political winds are in place to try and balance out the equation – which will come directly from EBITDA.




Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

| Broad | Narrow |
|---|---|
| • None | • Davis Select US (DUSA)<br>• ARK Innovation (ARKK)<br>• SPDR S&P Kensho New Economies Composite (KOMP)<br>• Distillate U.S. Fundamental Stability (DSTL) |

## International Developed Equities

MSCI ACWI ex US, measured by the iShares MSSCI ACWI ex US ETF (ACWX), is down -7.63% for the year and -2.22% for October. International developed equities are the value play of all value plays, or a perpetual value trap lead by an unhealthy banking system hooked on the ECB. We believe there are definitely opportunities here, but would limit market cap beta exposure if possible.

| Broad | Narrow |
|---|---|
| • iShares MSCI Eurozone ETF (EZU) | • Davis Select International (DINT) |

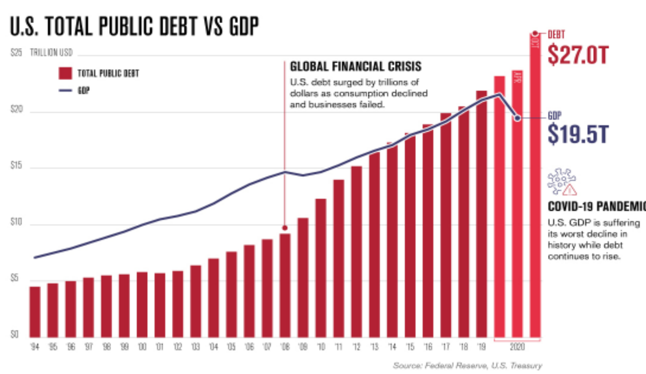
## Emerging Market Equities

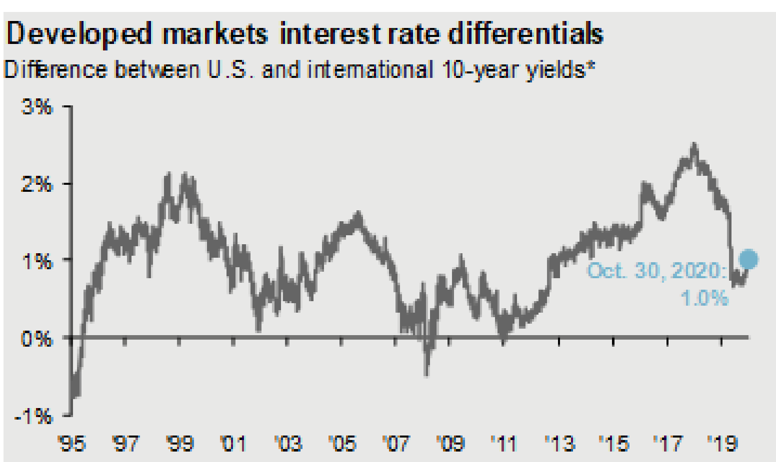
Emerging market Internet of Things (IOT) and ex-state-owned enterprise funds in this space continue to add alpha over broad benchmarks. Many of the IOT funds avoid state-owned enterprises all together. As a whole, emerging markets, measured by the iShares Emerging Market ETF (EEM) is up 0.37% for the year, and 1.96% for October. EMQQ EM Internet & Ecommerce ETF is up 55.68% through October, returning 5.68%. Despite a year of outperformance, EMGG and many other growth themes still have PEG ratios more attractive than broad equities. Anti-trust issues with FAANG names only increase the likelihood of success in EM IOT.

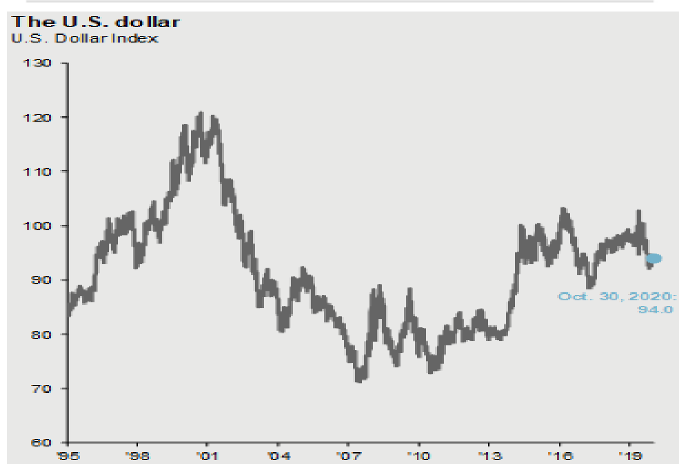
| Broad | Tech focused |
|---|---|
| • WisdomTree EM ex-SOE (XSOE) | • KraneShares CSI China Internet (KWEB)<br>• Emerging Markets Internet & Ecommerce (EMQQ) |

## Fixed Income

Since the 70's, broad market equities has been fueled by a massive run up in debt, only possible by a multi-decade long march towards a perpetual zero interest rate environment.  GDP and Debt have decoupled.

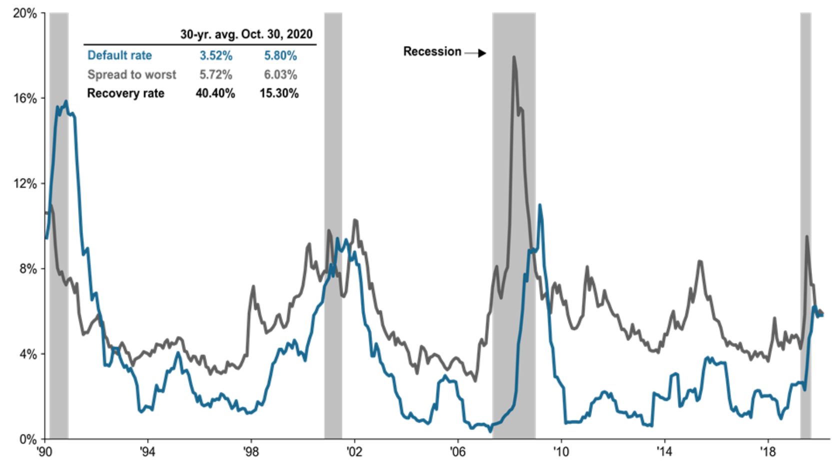


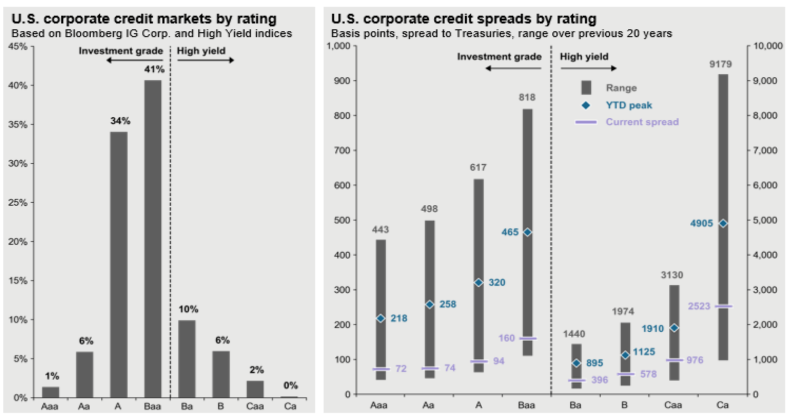




Source: J.P. Morgan Asset Management; (Left) FactSet, ICE;, FactSet; (right).

One interesting chart to watch is the difference between US and international 10-year yields – there is a limit as to how high treasuries can go in relation to international bonds, but we are not near that limit. This is not a warning sign against treasury duration; they still can provide diversification in times of extreme volatility. What we are watching most closely is default rates. Recessions can hit default rates sometimes 12-18 months after the fact. If default rates don't flatten out, it could be an ominous sign for markets as a whole.




J.P. Morgan Asset Management




Source: Barclays, Bloomberg, FactSet, J.P. Morgan Asset Management. Distribution of corporate credit is based on the current market value of the

There's a strong chance that the 41% of corporate debt rated BAA contains many companies that will be considered high yield in the next 12 months. The jump in yield from 160 bps for BAA to 386 for BAA makes us think investment grade, as a category, is overpurchased.

| Diversifiers (pure duration) | Income Generators |
|---|---|
| • PIMCO 25+ Year Zero Coupon US Treasury (ZROZ)<br>• SPDR DoubleLine Total Return Tactical (TOTL)<br>• First Trust TCW Opportunistic (FIXD)<br>• Columbia Diversified Fixed Income Allocation (DIAL) | • Saba Closed-End Funds ETF (CEFS)<br>• VanEck Vectors CEF Municipal Income ETF (XMPT) |

## Alternatives

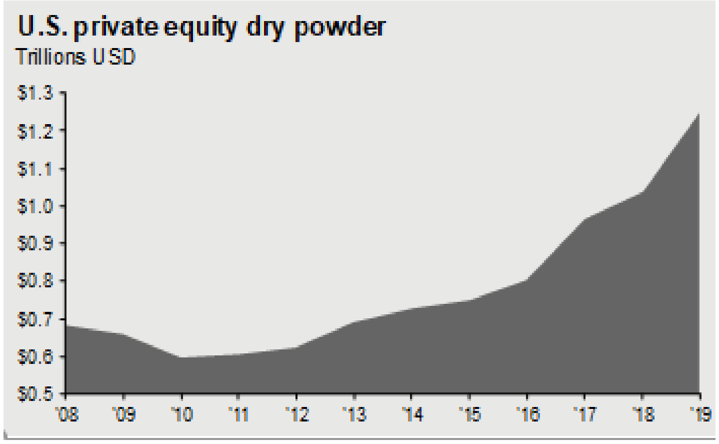
We continue to recommend a mixed alternative bucket consisting of long-term treasuries, gold, and AGFiQ US Market Neutral Anti-Beta Fund (BTAL). All 3 are up double digits this year. If you can access crypto, adding Bitcoin into this mix would also help, despite the complex execution. This year, we were able to rebalance between our alternatives and equities at market dislocations, which was very beneficial for YTD returns.

## Conclusion

There are clear signs that the market is overheated. To reiterate our thoughts from earlier in the commentary, the only thing we feel absolutely confident in stating is that there will not be a return to consistent sub 15 VIX markets. The market could have one of its best or worst periods over the next 3 months, 6 months, and 12 months. Pools of excess liquidity caused by QE are evident in both SPACs and the Private Equity sector that could absolutely extend that timeline.

## A hypothetical high-active-share reconstruction of a traditional 60/40:

- 10% Cash
- 5% PIMCO 25+ Year Zero Coupon US Treasury Index ETF (ZROZ)
- 5% Saba Closed-End Funds ETF (CEFS)
- 10% AGFiQ US Market Neutral Anti-Beta (BTAL)
- 10% SPDR Gold MiniShares Trust (GLDM)
- 15% O'Shares Global Internet Giants ETF (OGIG)
- 15% Davis Select Worldwide ETF (DWLD)
- 10% ARK Innovation ETF (ARKK)
- 7.5% Emerging Markets Internet & Ecommerce (EMQQ)
- 7.5% SPDR S&P Kensho New Economies Comps (KOMP)
- 5% Distillate US Fundamental Stability & Value ETF (DSTL)




Sources: Cambridge Associates, Prequin, Standard & Poor's, World Federation of Exchanges, J.P. Morgan Asset Management.

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