TEMPLETON & PHILLIPS
CAPITAL MANAGEMENT, LLC
A BETTER VALUE

July 24, 2020

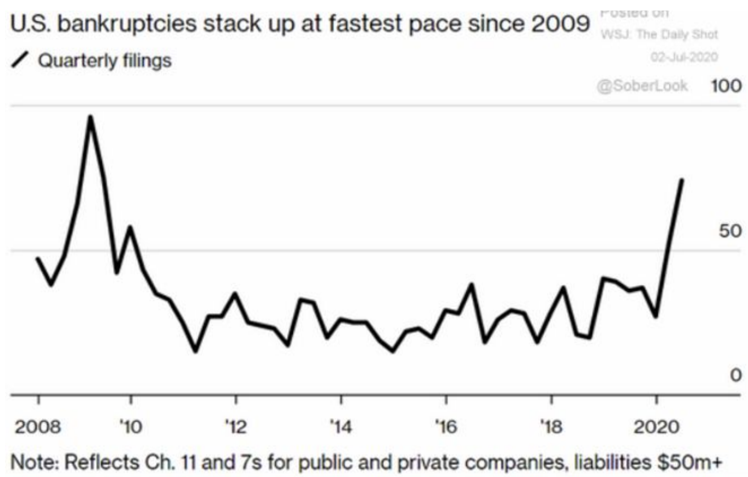
The Instagram Economy

One of the frequent questions we receive, and one that also plays on auto-repeat in the financial media relates to reconciling the superlative rise in share prices when compared to an economy that is improving but still facing uncertainty.

We can answer with two simple premises. First, share prices collapsed so sharply in March that we believe many high-quality firms were trading at valuations not seen since the dark days of late 2008. In response, we acted aggressively to make significant purchases in sudden bargains including Amazon and Paypal. Second, while uncertainty remains, economic data has markedly improved from its April lows. While that summarizes the market's quick decline and subsequent rebound, let us focus now on the stock market's primary responsibility which is to appraise and project the present value of future earnings and cash flows on a per share basis. With the S&P 500 trading at 23.9x estimated earnings compared with a long-term average of approximately 16x earnings, our concern is that the market's view of the economy has been subjected to certain manipulations and embellishments. The market's view today reminds us of young people taking selfie photos through Instagram or Snapchat filters, thereby presenting themselves in ways that range from unrealistic to completely distorted. So, while we do not believe the market has lost its mind—and it is still trying to do its job—we can also recognize that the economic and financial pictures it sees are being heavily filtered and in some cases distorted through fiscal and monetary policies. With that said, let us now turn to the evidence.

For any of you with children or grandchildren you may have run across the Snapchat app that allows kids (mostly) to take photos of themselves transformed into any number of humorous images from grungy bikers to adorable puppies. The point here being that this app allows the user to completely alter an image into something else, while maintaining some hint of likeness. Snapchat reminds us of the Federal Reserve's implementation of emergency quantitative easing measures at the height of the COVID panic in March and April.

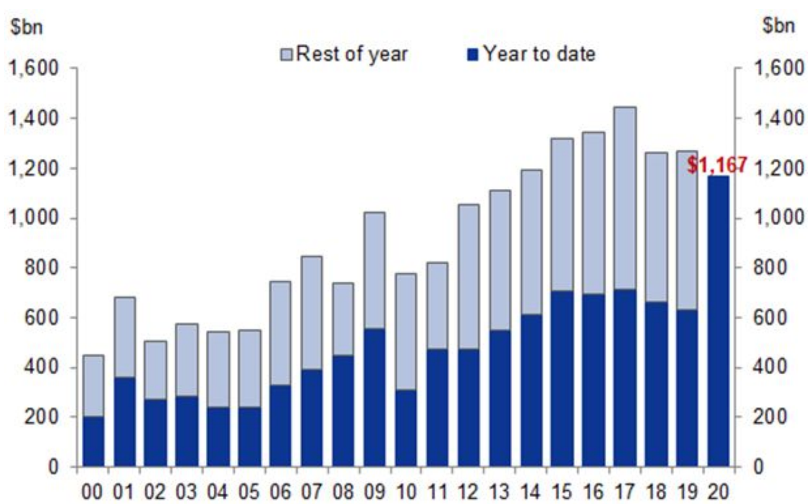
Many of our clients are familiar with our wariness over the build-up in corporate debt during the past six years due to the rampant issuance of junk bonds, second-lien debt, and covenant light bonds. Our doubts were supported by its use towards hasty or short-term measures, ranging from expensive acquisitions to share repurchases and special dividends. Yield-starved investors, desperate for any return in a zero bound rate environment were complicit. Although we first flagged these abuses in late 2014, it remained a constant puzzle as to what would finally halt this activity. Incidentally, it required a global pandemic to do so. As the economy shutdown, many of these indebted, publicly traded companies suddenly found themselves with no revenue and little hope of meeting their obligations. Not surprisingly, corporate bankruptcies began erupting higher at a record pace in March and April.



Source: WSJ

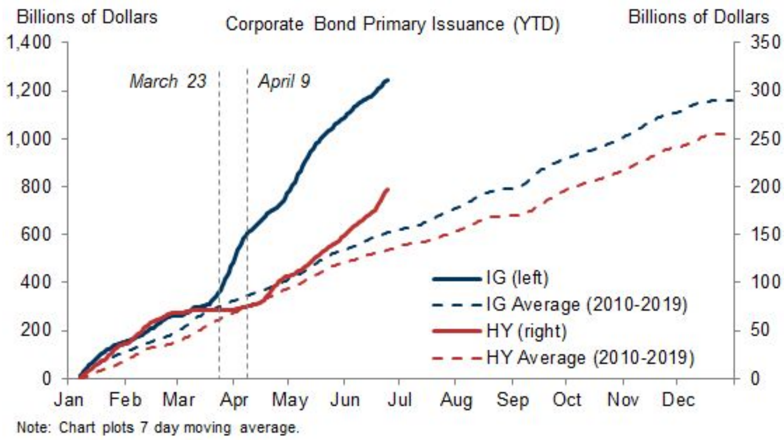
Given the Fed's implicit role in this fiasco through holding interest rates near zero for a decade, it quickly and forcibly stepped into the debt markets acting as the lender of last resort. While the Fed was active purchasing various federal government and agency bonds through its quantitative easing following the Financial Crisis, this represented its first foray into purchasing corporate bonds, much less junk bonds. Indeed, the Federal Reserve now holds a $412 billion position in the SPDR Bloomberg Barclays High Yield ETF. Similarly, the Fed has been an active purchaser in investment grade bonds too. From a logical perspective a swelling number of potentially bankrupt firms should limit the amount of credit the corporate sector could access (investor fear), but instead, thanks to the Fed's heavy intervention we have witnessed a new record in corporate debt issuance during 2020 and we are only half way through the year.

Investment Grade Corporate Debt Issuance, YTD 2020



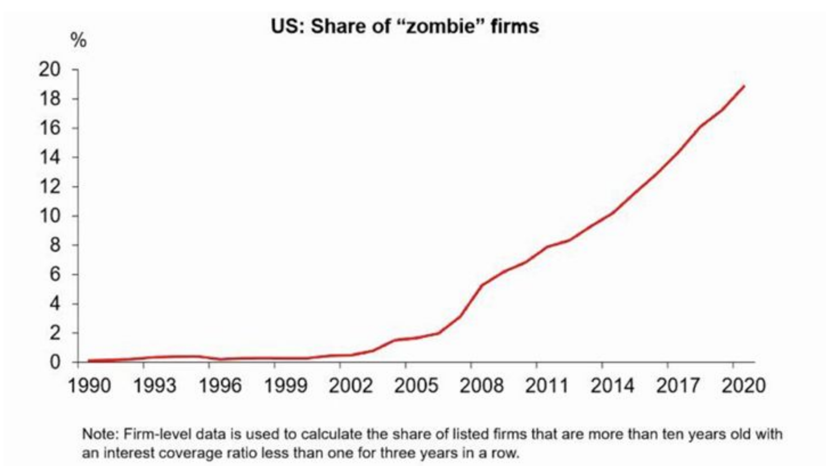
Source: Capital Economics

Investment Grade & High Yield Corporate Debt Issuance, YTD 2020



Source: Goldman Sachs

This brings us to our "Snapchat" moment. The Fed's purchase of corporate debt amounts to overriding the free market and providing a lifeline to a now record amount of "Zombie" companies in the U.S. The Zombie label in our industry refers to firms whose operating profits do not consistently cover their interest expenses (i.e., for 3 years or more). Indeed, the Fed has minted a noticeable population of firms whose best prospect is to stumble forward since their indebted balance sheet prohibits them from investing in new growth initiatives.

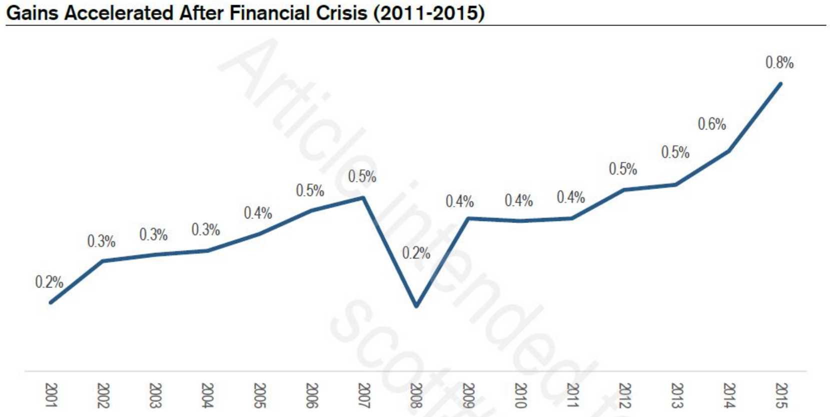


Source: Deutsche Bank

To both the casual observer and policymaker alike, they may have breathed a sigh of relief that the Fed could intervene and change the likely outcome of rising corporate bankruptcies. We disagree. In economics there are no free lunches, and we believe this bailout traded off for a period of slower economic growth going forward. That has been the experience of Japan since its debt bubble imploded in the early 1990s, whereas a large number of firms simply stayed alive, rather than resuming growth. Moreover, we believe that the Fed's rescue probably just postponed the day of reckoning for the most indebted firms. For instance, while $166 billion in debt has been downgraded year-to-date, most analysts anticipate another $540 billion still to come in 2020. Likewise, and analogous to the 2008 crisis we believe a significant amount of debt has been mislabeled and is riskier than believed. Take for example that today an unusually high 50.3% (versus 17% in 2001) of investment grade debt sits in the BBB rating, one notch above junk.

From an investment standpoint we continue to see this as a manageable situation. Our focus during the March decline and still today is to remain concentrated in our existing portfolio, including our newly acquired positions. Based on our studies, recessions provide significant return opportunities for firms that have access to growing markets as well as the capital to invest in that growth. Reviewing the recessions from 1980, 1990, 2000, and 2008-2009, that the top 10-25% of firms by industry continue to grow their sales and profits through the downturn since they are well positioned to take advantage of their weakened competitors. In the current environment, and in reference to the Zombie discussion above, we see no shortage of weakened competitors. If we had to delineate the area where growth and access to capital are well positioned it is in ecommerce. We believe one of the most overlooked facets of the 2008-2009 crisis was the remarkable surge in ecommerce that followed. Based on the data we have seen in the past few weeks this trend is accelerating in an exponential fashion in the wake of the pandemic (i.e., Zoom calls, grocery delivery, etc.). Indeed, while ecommerce penetration doubled in 2009, recent data suggests penetration has already quadrupled in the past several months since March, accelerated by shelter-in-place orders and social distancing. We believe our March purchases in ecommerce leaders Amazon and Paypal are good examples of winners in this environment.

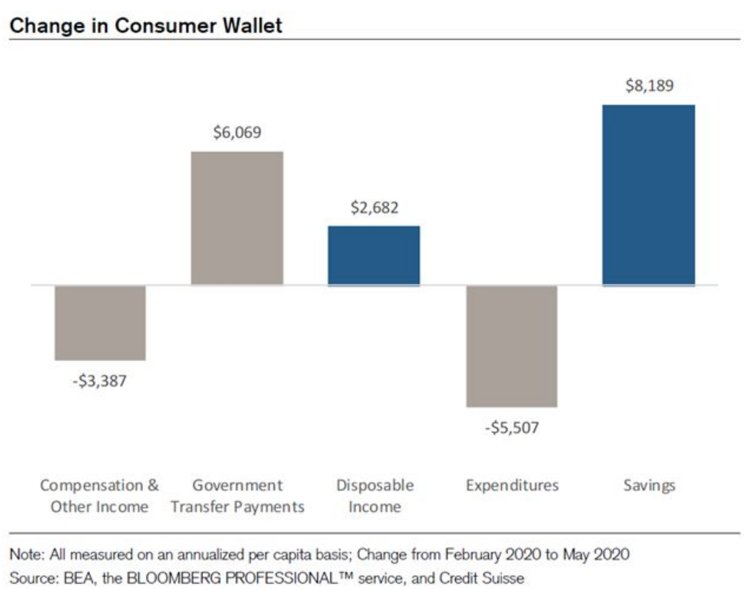
Figure 1: Rate of Change in US E-commerce Penetration – Pace of E-commerce Share Gains Accelerated After Financial Crisis (2011-2015)



Source: US Census.gov, Credit Suisse Research

Source: Credit Suisse

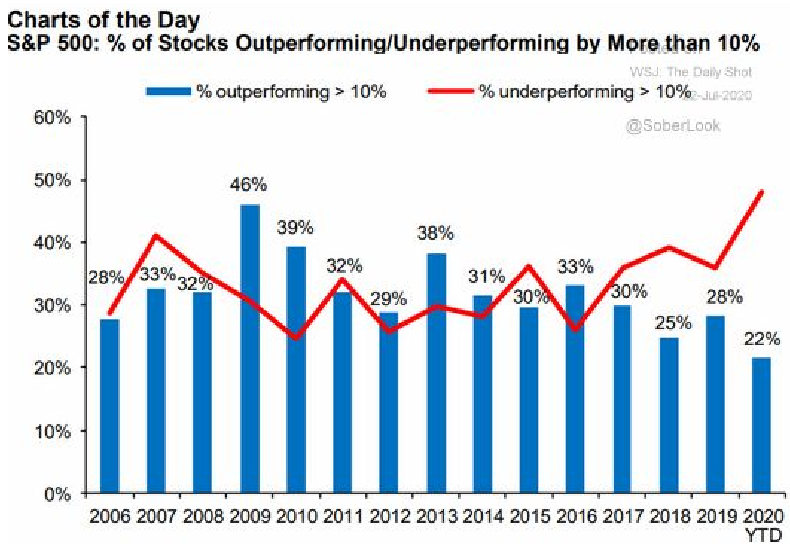
This leads our discussion to the second major distortion we see in the economic data that could be affecting investor sentiment. Compared to the Fed's fantasy image, this phenomenon fits the Instagram mold, where a photo is embellished and altered into a supposedly more beautiful image (they look unnatural). In this case you still see the person's image, but it is heavily filtered, softened, and touched up, and when closely viewed looks phony. However, casual or wishful observers would still be duped. The Instagram filter on the economy is courtesy of the Federal Government's CARES Act. In early June stock market futures awoke to a press release stating retail sales increased 17.7% for the month of May (later revised to 18.2%), and immediately shot higher. Like all investors, we were happy to see the outcome, but the sales growth was a head scratcher in light of the 21M unemployed Americans and warranted a closer look. In this case further analysis revealed once again the enormous government intervention in the economic picture driving the stock market that day. In the period from February 2020 through May 2020, the average consumer saw their compensation and other income decline by $3,387, which seems like an odd backdrop for a surge in retail sales. However, government transfers related to unemployment insurance supplemented through the CARES Act equaled an average inflow of $6,069 into consumer's wallets. Based on our math, the people who qualified were getting paid the annual equivalent of a $46,320 salary, and in 38 states employees are receiving compensation that exceeds their former job compensation. So, despite unemployment levels not seen since the Great Depression, personal incomes have actually risen!



Source: Credit Suisse

Returning to the investment implications, we do not believe our holdings are reliant upon a continuation in strong retail sales to generate attractive returns. Should the stimulus expire before economic growth is sturdy enough, we think it could present issues for investors who were enticed into cyclical and / or consumer discretionary names on the basis of improving spending data.

To summarize our discussion from an investment perspective, we can appreciate the likelihood that the U.S. market has been led astray in some cases pertaining to credit quality and consumer spending levels. At the same time, we have been careful to resist any of these potential holdings in light of our view that the market has bifurcated more than usual into sets of winners and losers in terms of market-share driven earnings growth over the next few years. Moreover, we believe we are beginning to see evidence of this effect in share price return patterns. In the figure below, we can see that an increasingly smaller group of stocks are outperforming the markets by greater than 10%.



Source: WSJ

To be sure, we would not go so far as to say that we have no concerns or worries. However, our concerns are more focused on the potential for detrimental (rich) valuations. The good news here though, is that we do not believe we have reached that point, and that as we look at the international markets we believe we see many attractive long-term bargains still available. We look forward to discussing those views further in a future commentary.

Lauren C. Templeton
Principal

Scott Phillips
Principal

Disclosures:

This information is for one-on-one client presentation only. Past performance is not indicative of future results. The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Templeton & Phillips Capital Management, LLC ("TPCM") reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein. Recommendations from the past 12 months are available upon request. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. All investments have the risk of loss.

TPCM is a registered investment adviser. Registration does not imply a certain level of skill or training. More information about TPCM including its advisory services and fee schedule can be found in Form ADV Part 2 which is available upon request. LTF-19-03