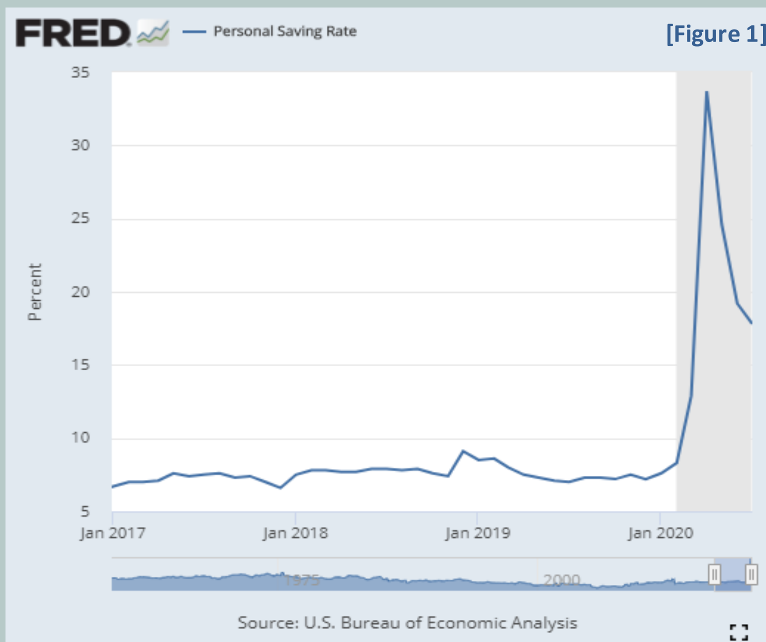
## COGNITIVE DISSONANCE

In many respects, 2020 has been a terrible year. The global pandemic impacts our lives every day with face masks, limited socialization, remote school, work from home, and delivery meals. Through it all, we remain thankful for the front-line workers keeping our economy and healthcare system running. The pandemic devastates small business, humiliates unemployed Americans, foments racial strife, and polarizes our electorate.




Contentious elections loom in November. In the meantime, Congress remains in gridlock over continued stimulus. Cities are on standby for another round of protests. Any forward-looking economic analysis would consider this list of historic problems and come to a bleak conclusion. Future earnings are difficult to predict and analysts are ignoring 2020, instead projecting 2021 and even 2022 in many valuation models. Through it all, global stock markets are reaching new highs. It all feels so wrong. How does this make any sense?

We have a theory on the stock market's persistent rally. Thanks to the historic government stimulus passed this Spring, existing household income increased in aggregate by government support (expanded unemployment, CARES Act, Paycheck Protection Program, etc.). At the same time, household spending fell as consumers quarantined at home. As a result, the personal savings rate increased from 8% to over 30% [Figure 1]. This is an unprecedented spike in savings. Since the mid-1980's, the savings rate has hovered around 7%.

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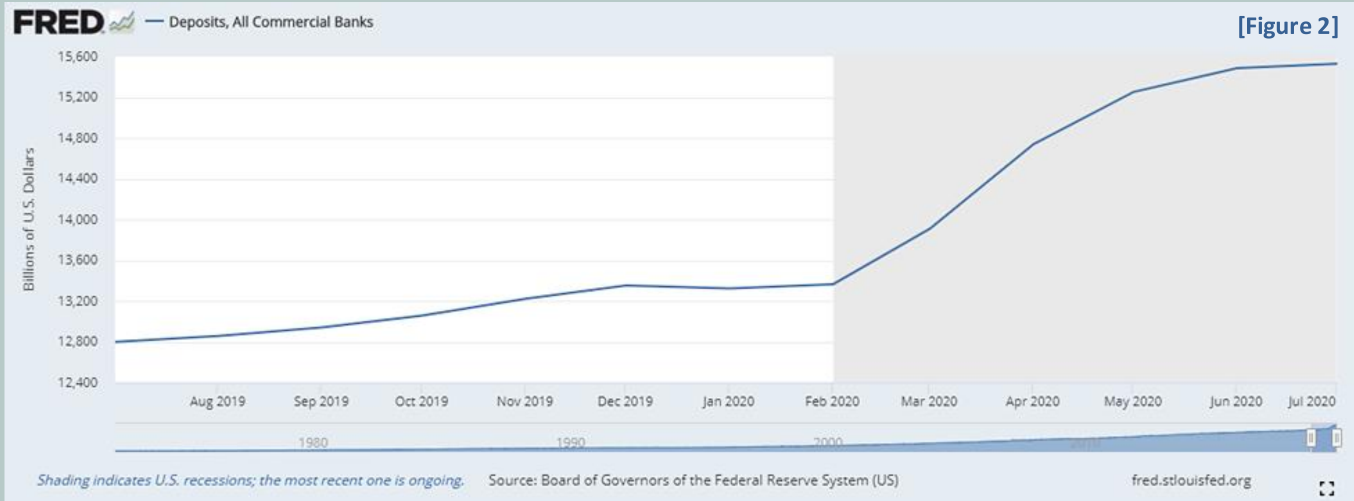
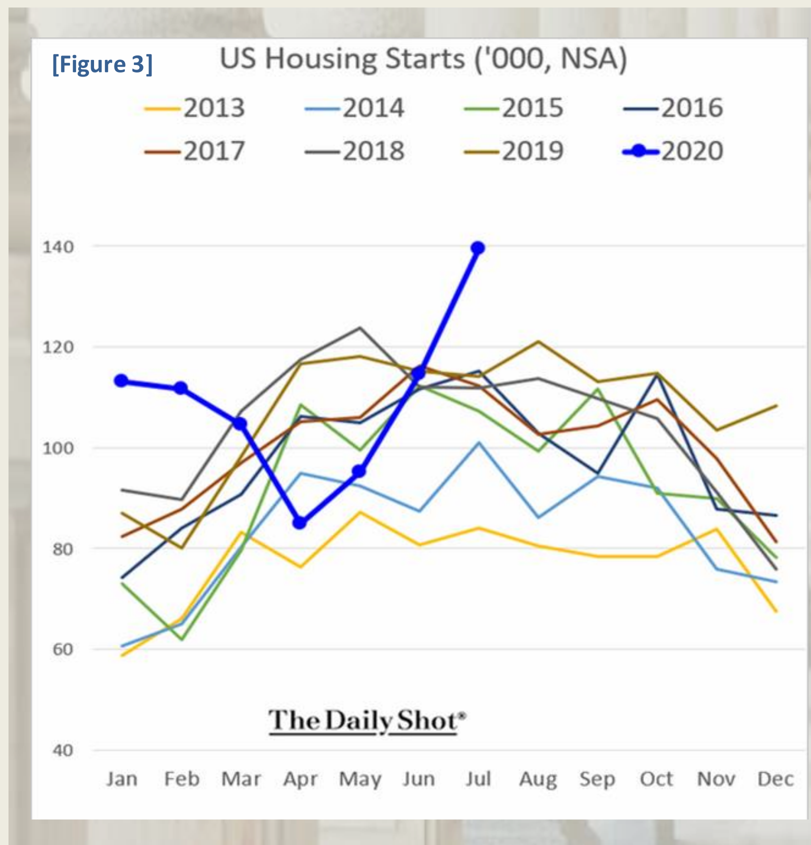
Traditionally, households save money in three ways: bank deposits (cash), housing, and financial investments. In the second quarter, cash into bank deposits increased by over $2.3t (17%+) [Figure 2].




During Covid-19 investments into housing have exploded. Existing home sales, new home starts [Figure 3], and home improvement spending [Figure 4] have all spiked.

While excess savings have flooded into cash and housing, what about financial investments? In allocating investments, investors have a choice between stocks and bonds. For example, many investors are allocated to 60% stocks / 40% bonds. In determining an allocation mix, investors consider their needs for cashflow, risk and total return. The recent actions by the Federal Reserve to stimulate the economy greatly impacted those investor decisions.





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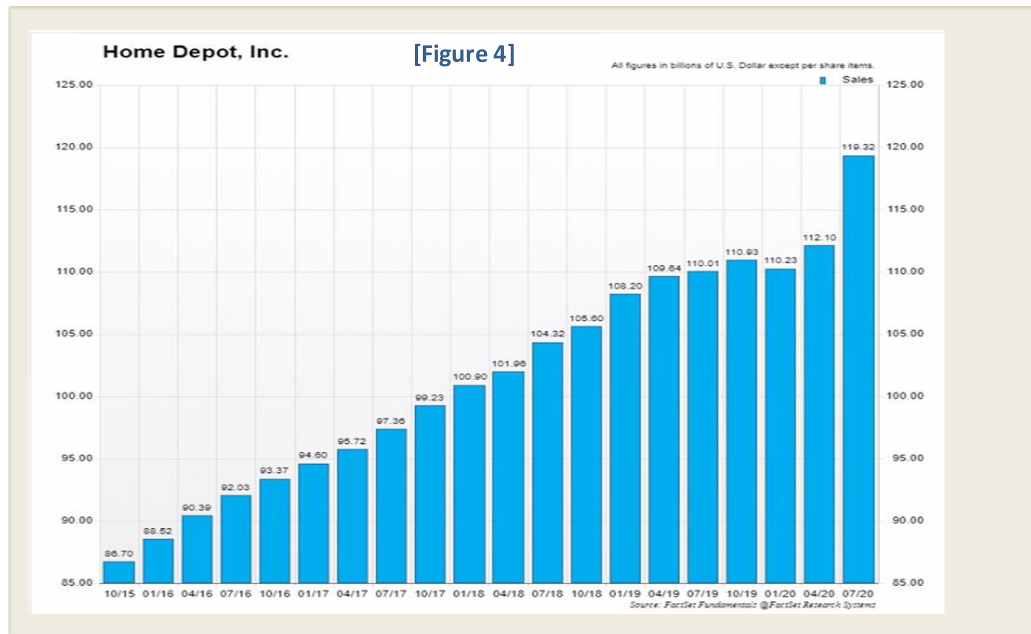
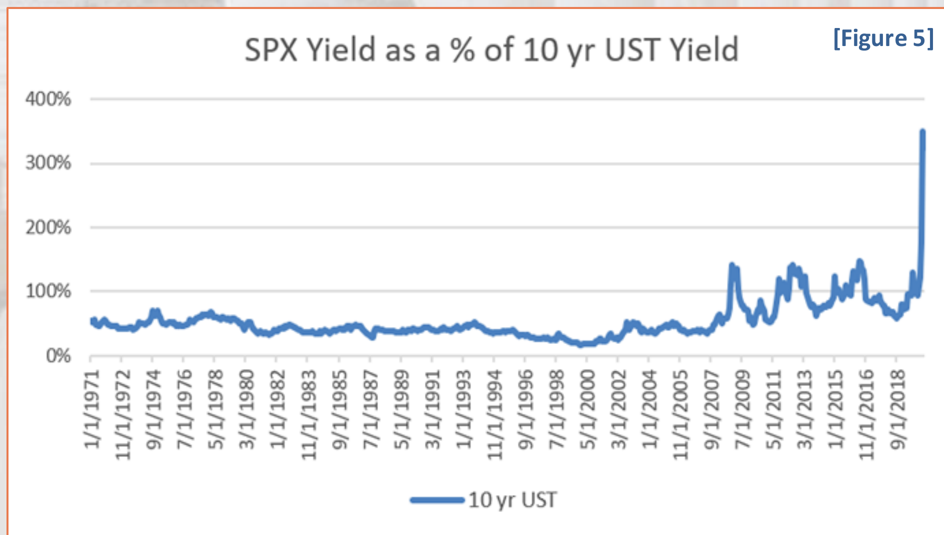
The Federal Reserve has a limited toolset – mainly consisting of interest rate movements and balance sheet expansion. Post-pandemic, the Fed implemented historically extreme measures to backstop financial markets. The Fed dropped interest rates to 0% and purchased massive quantities of investment grade bonds, treasuries, and even high yield bonds. As a result, very little yield remains in higher quality fixed income. Stocks present a different picture. While many companies are struggling, a select few are producing record earnings. This leaves investors at a historic point when allocating portfolios. Virtually overnight, the best source of cashflow is stocks, not bonds. In comparing the dividend yield of the S&P 500 vs. the 10-year Treasury yield, stocks stand to return 300% more cash flow to investors [Figure 5].




As interest rates have declined over the past 30 years, 2020 appears to be the final capitulation for fixed income.

When comparing BlackRock's standard 7.5% return allocation model from 1995 to today, fixed income has declined from a 100% allocation to practically nothing. The latest 2020 allocation model is 30% alternatives, 67% equities, and 3% fixed income [Figure 6].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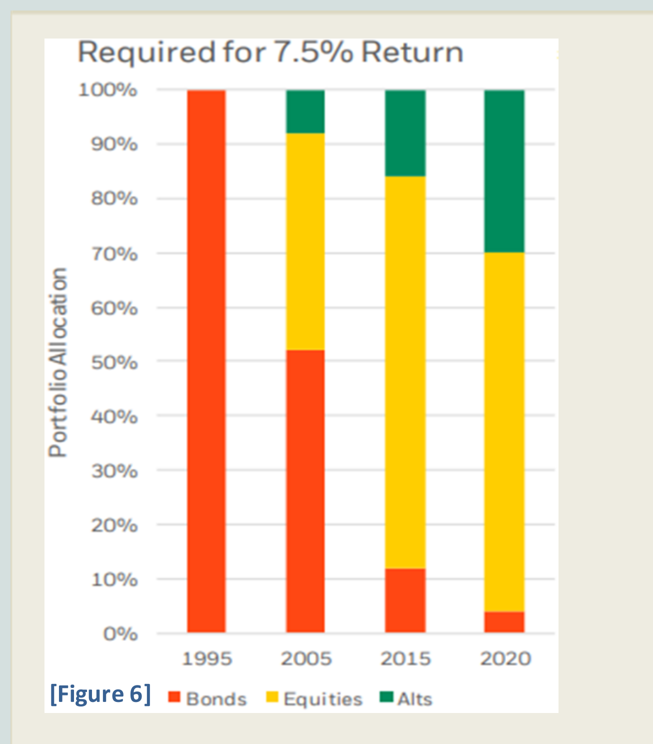
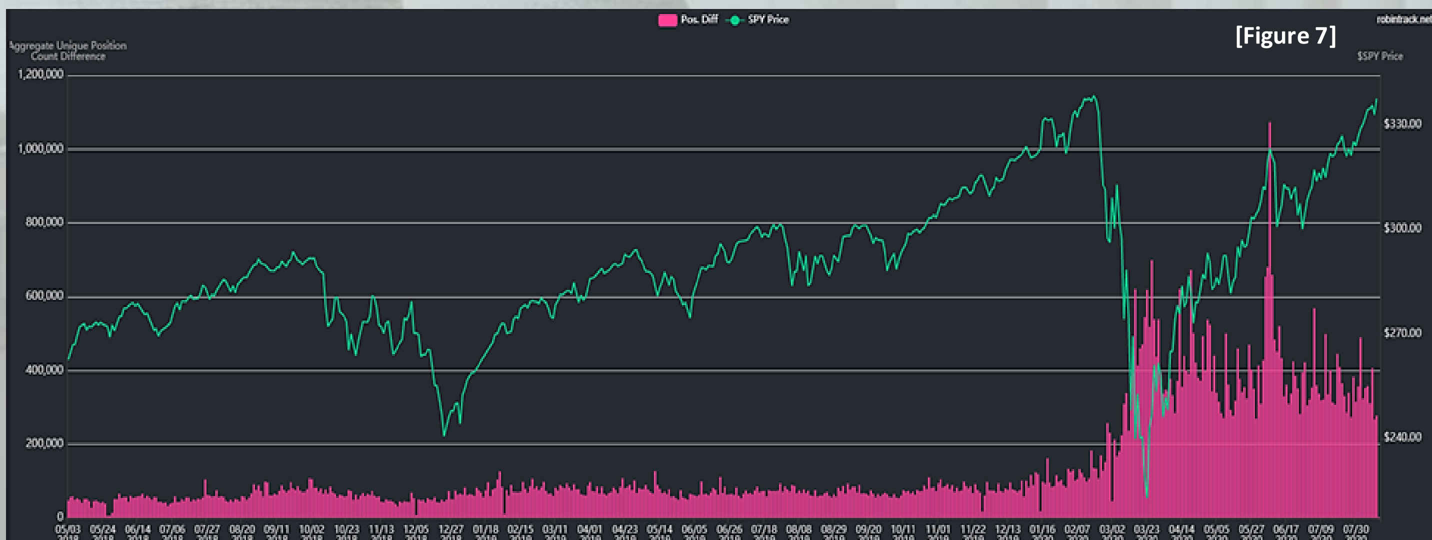
As a result, even as global risks increase at a troubling rate, the pressure to invest in equities is increasing at an even faster pace. While it may take some time for the institutional allocations to shift, retail investors are responding now. Since the pandemic, a flood of retail investors has poured into the stock market. Retail trading platform Robinhood is exploding as active daily users move from approximately 50,000 per day to over 1,000,000 [Figure 7].



[Figure 6]

This leaves investors with a binary market. Allocators face a stark choice: take outsized risks and remain in the market OR sit out, accept a very low yield and watch structural forces push equity prices higher. The biggest risk to the relative appeal of the equity markets might be stability and economic growth, accompanied by higher interest rates. This dynamic creates a state of cognitive dissonance.

We've been busy altering client accounts to account for these historic changes. Where we once allocated to fixed income for yield, today very little cashflow is available without taking outsized risk. Reasonable risk-adjusted returns are still available in relative value strategies; however, these strategies don't offer the yield and liquidity of fixed income. Client families will see significant shifts in equity allocations, as well. While overall equity allocations are similar, portfolios now include more active, sector specific and hedged exposure.



[Figure 7]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While many Covid-19 beneficiaries have experienced tremendous stock price gains, we still see opportunities available in the stock market. We are maintaining client exposure to fintech, biotech, and automation themes. REITs remain oversold even as the Federal Reserve pounds the table for low interest rates. While single-family housing has boomed, demand for mortgage bonds have yet to return.

Over the next twelve months, we see a large opportunity brewing in private markets. The corporate default cycle is very quietly heating up. While many companies have access to liquidity thanks to the Fed, that may not be enough to overcome insolvency. As a result, corporate defaults of large companies are already outpacing 2008 levels [Figure 8]. Commercial real estate is stressed in office, hospitality and retail; however, lenders are not yet forcing asset sales. Once the effects of the pandemic are clear, we expect to see opportunity from forced sellers. Over the short term we are allocating to niche distressed areas such as municipal bonds and shipping. As we progress through the fallout of the pandemic, we are reserving allocation capacity for truly historic opportunities in real estate and distressed corporate credit.

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