HAS AMERICA BEEN SAVED BY ZERO?

Saved by Zero-1980’s

Song by The Fixx
So maybe I'll win (saved by zero)
Maybe I'll win (saved by zero)
Maybe I'll win (saved by zero)
Who needs to win (saved by zero)

Saved by, saved by, save-saved by zero
Saved by, saved by, save-saved by zero
Saved by, saved by, save-saved by zero (saved by zero)
Saved by, saved by, save-saved by zero
Saved by, saved by, save-saved by zero
Saved by zero (saved by, saved by, save-saved by zero)

Introduction

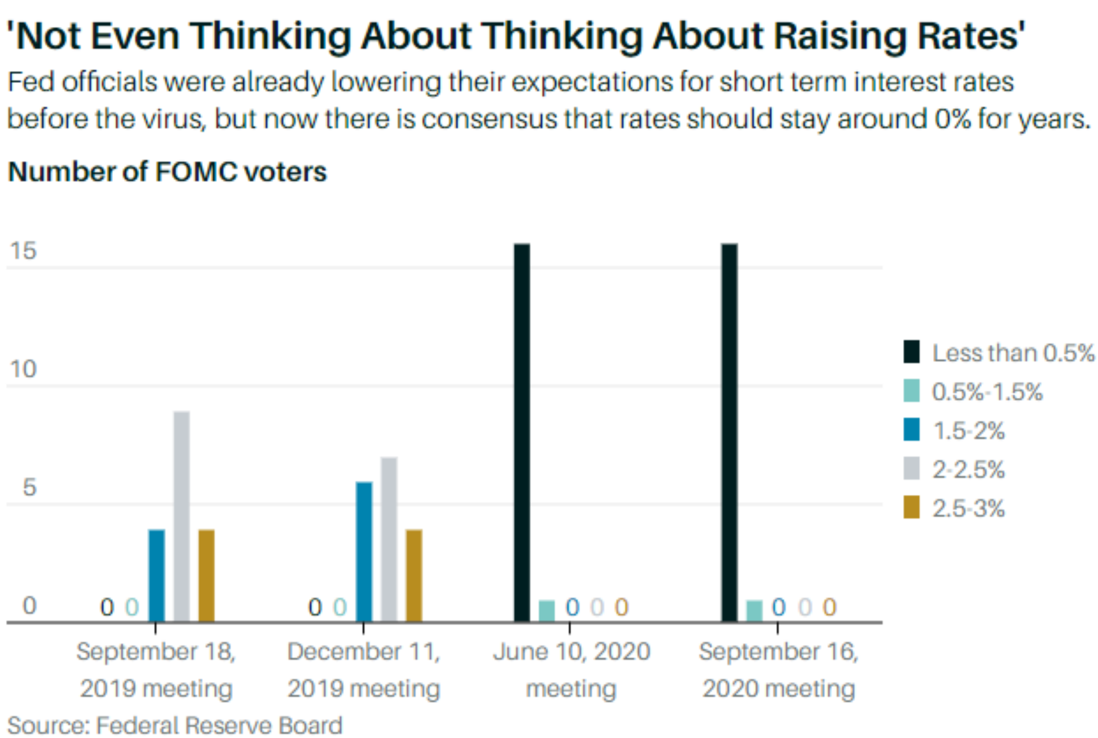
If you recognize this song give yourself an A for 80’s Music 101; if you are familiar with the picture of lead singer, then you spent more time in your bedroom watching MTV than your children spend on their iphones.

The excellent Netflix documentary “Betting on Zero” serves as a cautionary tale of the investment risk of, well...betting on zero. The film chronicles legendary investor Bill Ackman’s failed attempt to prove Herbalife is a pyramid scheme and that the stock price would drop to zero. After five years and almost $1 BILLION in losses, Ackerman surrendered.

Today, for the economy and the markets, it's the Fed betting on zero interest rates (Chairman Powell: "We're not even thinking about thinking about raising rates.") in an effort to spur economic growth as well as provide support for higher equity prices. And much like Ackman, many prognosticators will bet against the Fed in favor of shorting perceived bubbles and betting on runaway inflation. Yet these same traders have been annihilated for decades as they've watched inflation tamed by oversupply of oil, technological innovation, and cheap labor.

This time around we have a rare Fed consensus on zero percent interest rates "for some time." The coronavirus has forced the seven fed governors to go all in - betting on zero and leaving investors with no choice but to abandon bonds in exchange for the the risk/reward of equities. FOMO, Fear Of Missing Out, is driving the stock market higher. Right? Maybe or Maybe Not?

Barrons-"The Fed said that it "expects it will be appropriate" to keep short-term interest rates near zero until three conditions are met: The job market has fully healed, inflation has returned to the target rate, and inflation "is on track to moderately exceed" the target rate "for some time."



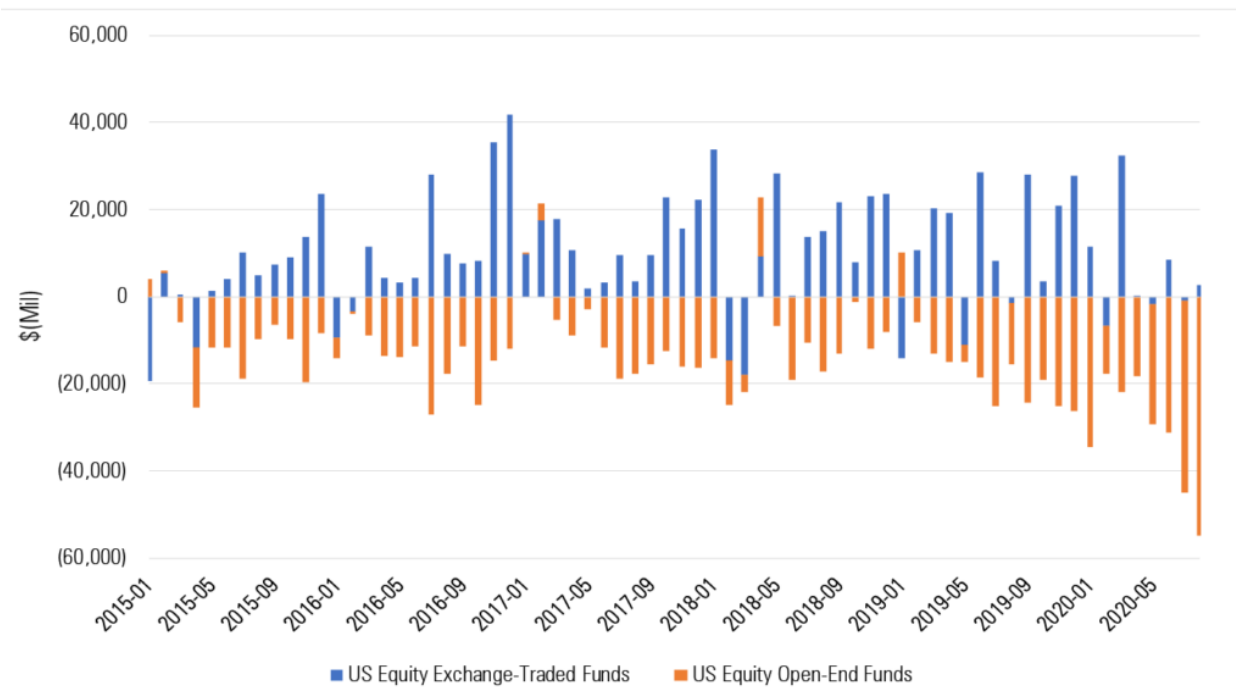
The Fed's Major Policy Shift By **Matthew C. Klein** https://www.barrons.com/articles/the-fed-has-vowed-not-to-take-away-the-punch-bowl-thats-a-major-policy-shift-51600423201?mod=past_editions

Where the Money is Flowing ?

Contrary to the FOMO thesis American investors and corporations are socking away their cash like never before despite earning a negative inflation-adjusted return. The current stock market recovery occurred with more money flowing into bonds than stocks and the personal savings rate skyrocketing to 30%. At the same time S&P 500 companies took advantage of low rates to load up their balance sheets with record amounts of cash. Every stock market category has experienced net outflows in 2020.

U.S. Stock Funds Saw Record Outflows in August with Large Cap Blend Leading The Biggest Withdrawals.

U.S. Equity Fund Flows Since 2015 by Investment Type (Open-End Fund or ETF)

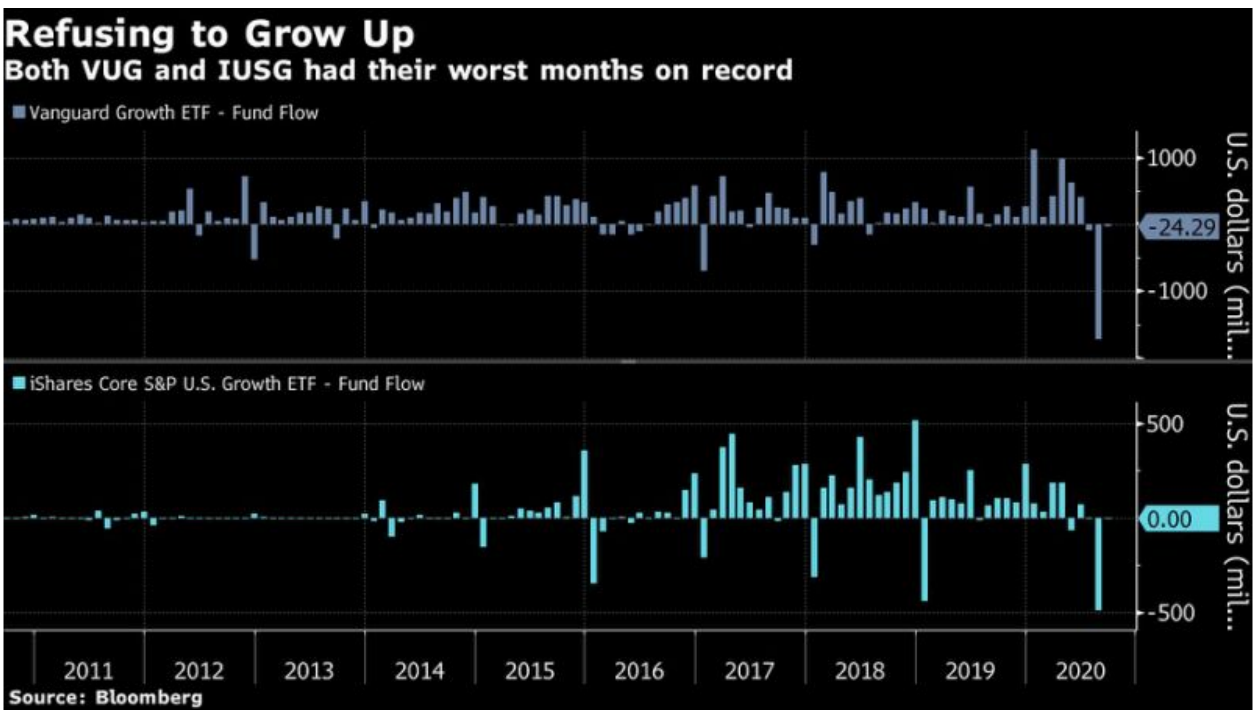


Source: Morningstar Direct Asset Flows. Data as of Aug. 31, 2020.

As the S&P 500 reached highs last seen in February, U.S. equity funds saw record monthly outflows in August that surpassed the previous record of $45 billion set just one month prior. As in July, all Morningstar Style Box categories (large growth, small value, and so on) suffered outflows. The main distinction was between open-end funds and ETFs. Nearly $55 billion left open-end U.S. equity funds in August; in contrast, ETFs collected $3 billion.

Large cap growth stocks have dominated this bull market for 10 years with a handful of tech stocks responsible for a huge portion of the S&P total return. This trend was exacerbated during the Covid crisis as work from home favored tech giants. Therefore logic would suggest that investors are loading up on the growth ETFs that hold these names; but on the contrary, popular growth ETFs saw record monthly outflows in August/September period.

Two Giant Growth Funds Suffer Biggest Selling Stampede on Record-VUG and IUSGClaire Ballentine-Bloomberg



Out of Stocks and Into Betting On Zero Bonds. See 2 grids below, 2020 outflows from stock categories then bond inflows post coronavirus. It does not look like FOMO in the stock market.

Grid courtesy of Blackrock

2020 flows

1/1/20 - 7/31/20 ($ billions)

Morningstar Category	Flows
Large Growth	-$60.5B
Large Value	-$30.7B
World Large Stock	-$23.4B
Mid-Cap Value	-$22.3B
Diversified Emerging Mkts	-$16.6B
Foreign Large Value	-$16.2B
Mid-Cap Growth	-$14.7B
Mid-Cap Blend	-$13.1B
Small Growth	-$12.9B
Small Blend	-$10.9B
[illegible]	[illegible]

Top 10 bond categories for inflows after March

Cumulative flows, April 2020 - July 2020

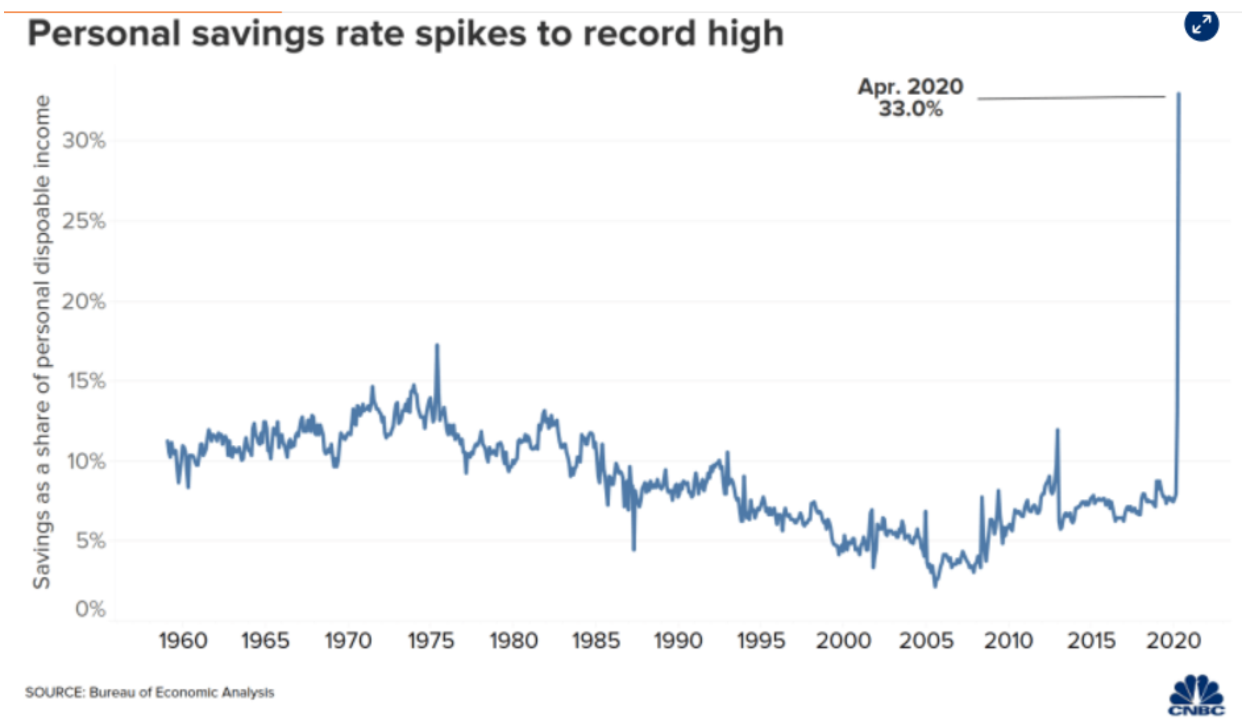
Bond category	Flows since April
Intermediate Core bond	$71.1B
High Yield bond	$58.8B
Corporate bond	$36.5B
Short-Term bond	$34.1B
Ultrashort bond	$24.5B
Intermediate Core-Plus bond	$23.2B
World Bond-USD Hedged	$15.2B
Muni National Short	$12.1B
Inflation-Protected bond	$12.0B
Muni National Intermediate	$11.0B

U.S. Fund Flows Batter Equity Funds in August As stocks rise, investors shift from U.S. equity to taxable-bond funds.**https://www.morningstar.com/articles/1001536/us-fund-flows-batter-equity-funds-in-august**

Found at The Irrelevant Investor Blog **https://theirrelevantinvestor.com/2020/09/17/where-are-they-going/**

American Citizens and Corporations are Betting On Zero

The above action is not the behavior of investors during a stock market bubble. During periods of unsustainable valuations we see investors in a frantic rage to buy more stock. Instead, Covid 2020 is seeing a bubble in, of all things, pure green cash. American investors are paying down debt and building up cash at rates not witnessed in our lifetimes, the polar opposite of the great financial crisis of 2008 when the public was levered up beyond sustainable levels. The personal savings rate is at record highs while simultaneously households have slashed credit card balances by $106 billion.



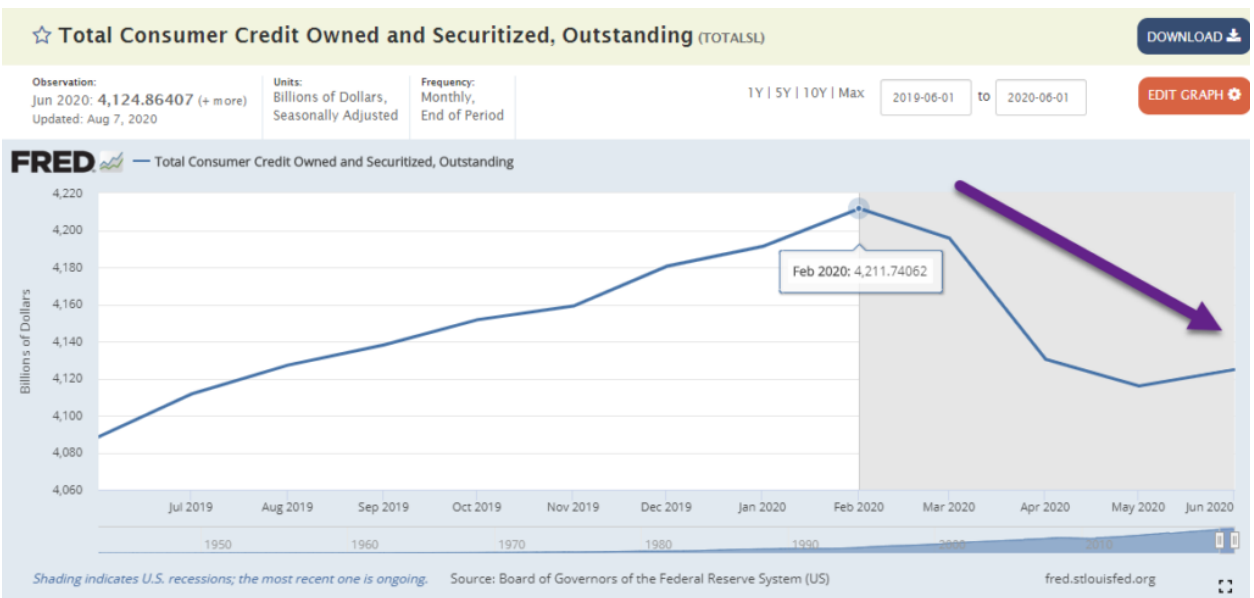
In 4 Months Households Slashed Credit Card Balances by a Record $106 Billion.

Barrons-"That newfound thrift is evidenced further by households slashing their credit-card balances by a record $106 billion in the latest four months, more than double the rate of deleveraging during what is still called the Great Recession—even though the current downturn will dwarf all others since the Great Depression."

What, Us Worry? Lack of New Stimulus Hasn't Roiled the Markets By **Randall W. Forsyth**

https://www.barrons.com/articles/what-us-worry-lack-of-more-stimulus-hasnt-roiled-the-markets-51597422598?mod=past_editions

2020 Credit Card Balances Chart-FRED charts

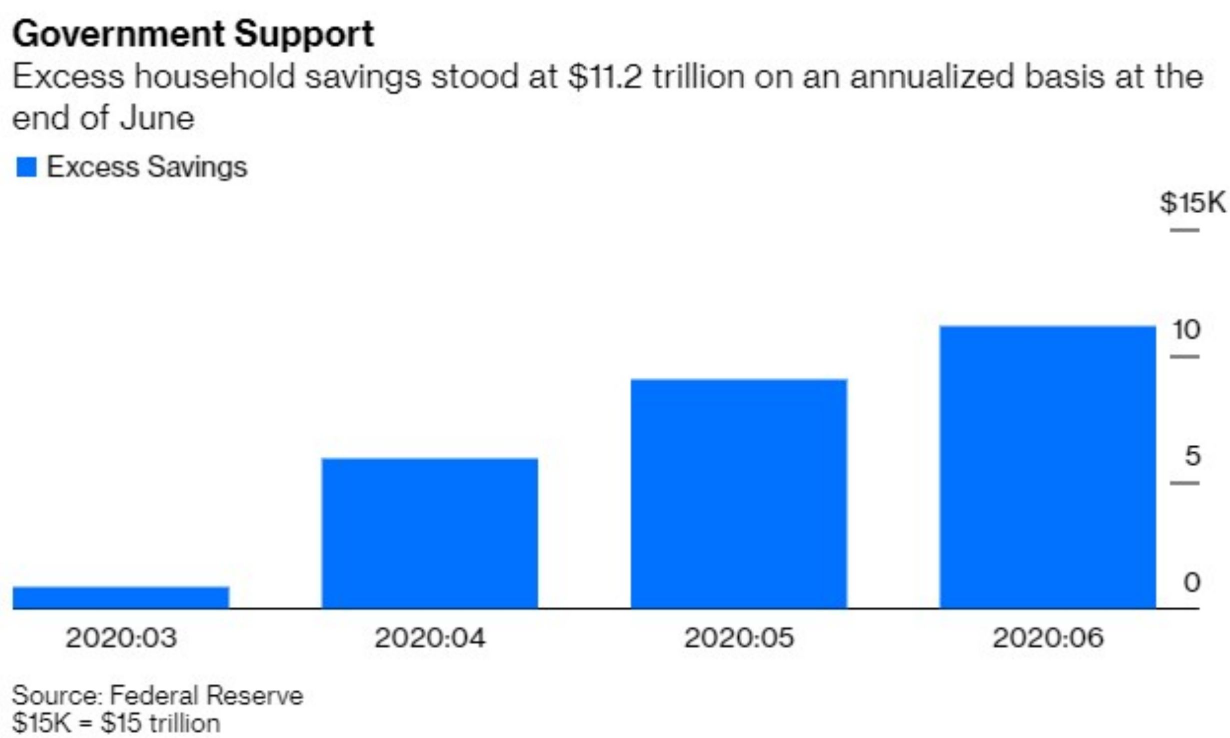


This combination of excess savings, reduced debt and government largesse has left household savings levels at $11 Trillion. This leaves us with 2 giant questions to ponder - especially in the middle of election season. Where will all this excess savings land post-election? How does the government deal with the bifurcated social class situation in America that is exacerbated every time interest rates go lower? At the same time that middle-class Americans are adopting the thrift of the WWII generation, the other half of the United State has less than $1000 dollars in savings.

Most investors are "waiting until after elections", "keeping dry powder", "waiting for a crash", or "trading around the election". John Bogle, legendary founder of Vanguard, is known for saying no one he ever saw on Wall Street could correctly predict these short-term events. Can the stock market crash with $11 trillion of cash waiting to be deployed post virus? If we get a vaccine, how does the economy respond to massive unleashing of pent-up demand? Furthermore, the new normal being a reduction in commuting costs could equate to a 2-5% raise in take home pay for a large part of population.

Excess Household Savings $11 Trillion at the End of June

Tim Duy at **Bloomberg** broke down the numbers on this and they are staggering:



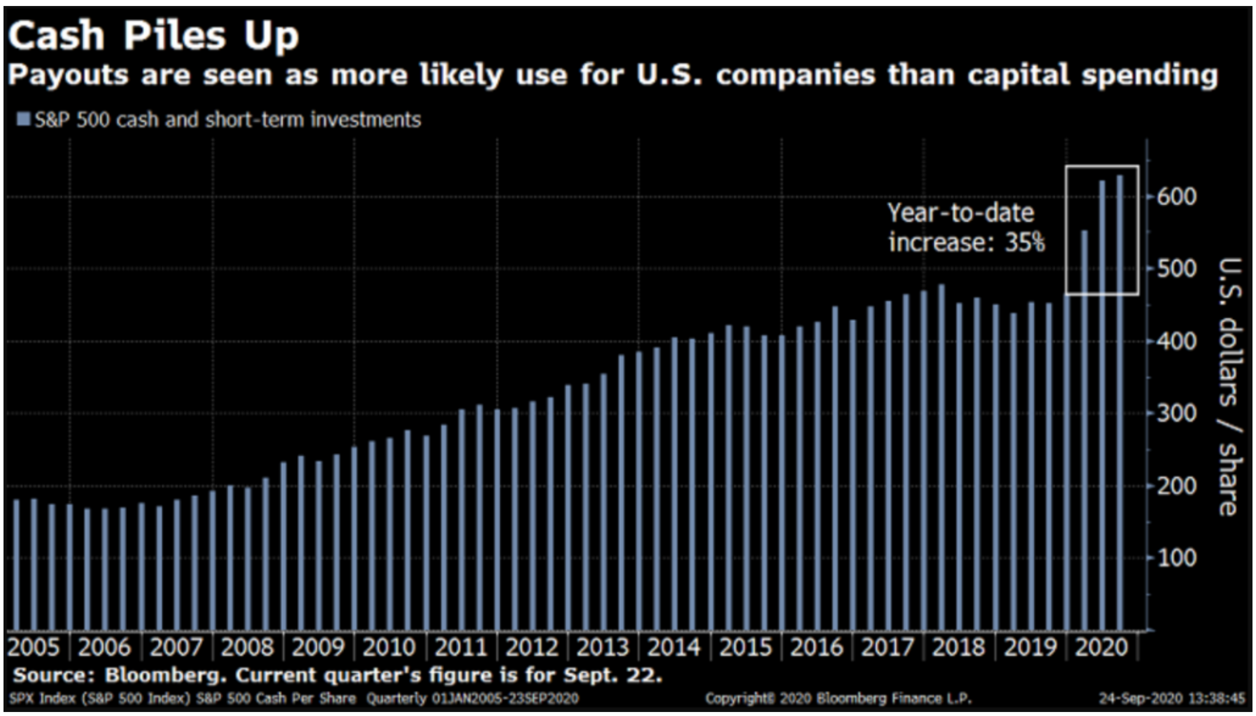
The Case For a Post-Covid Spending Boomby **Ben Carlson**

https://awealthofcommonsense.com/2020/08/the-case-for-a-post-covid-spending-boom/


Most Americans Lack Savings
How much money do you have in your savings account?
$0
45%
Less than $1,000
24%
$1,000-$4,999
12%
$5,000-$9,999
5%
$10,000-$19,999
5%
$20,000-$49,999
4%
$50,000 or more
6%
$
n=846, survey conducted November 25-26, 2019
Source: GOBankingRates
statista

S&P 500 Cash +35% Year to Date

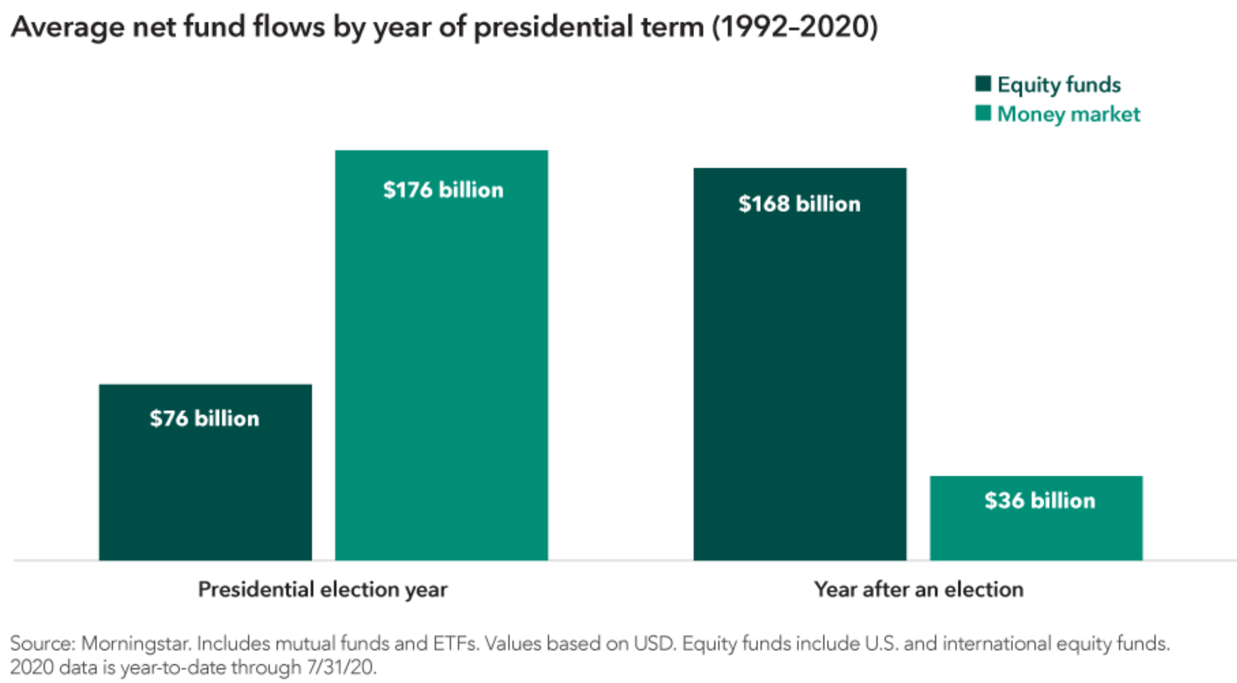
On top of middle-class Americans building up cash, S&P 500 stocks increased cash by 35% post virus. Will this money flow to buybacks, dividends, or capital spending? A capital spending splurge plus a government infrastructure build would be a GDP boosting combination.



From Barry Ritholtz The Big Picture Blog

Although this election in unprecedented due to virus lockdown amongst other reasons, the below history may give us an edge as to where the next set of flows may land. At the same-time, it is my opinion that no matter who wins the election, an infrastructure bill will be in the near-term future.

Investors Become Conservative in Election Years.



https://www.capitalgroup.com/advisor/insights/articles/how-elections-move-markets-5-charts.html

The U.S. experienced the ultimate black swan event and the FED answered with unprecedented fire power. They acted much faster than in 2008, but the bubble created this time could be in government debt or is yet to come in the stock market. Many investors are comparing 2020 to 1999 with huge technology stock outperformance and a red hot IPO market, but we are still nowhere near the turn of century bubble I witnessed firsthand to start my career.

Is the FED Igniting Another 1999?

The below graphic illustrated that the Nasdaq 100, although expensive, is nowhere near 1999 bubble levels. In 1999 the NDX had a price to earning ratio of 73 versus in the 30's today. The returns from 1990 recession lows to 1999 bubble highs was +2400% versus 900% today. Although there are similarities, such as the valuation spreads between growth and value, as well as the percentage market cap share of tech in the S&P, pure returns and valuations are still far below 1999 internet bubble peaks.

The index's most recent ascent began after it bottomed around 1,120 in February 2009 during the Great Financial Crisis (GFC), and, in the intervening 11+ years, it has gained a tad under 900% to hit its recent peak around 11,100, which is quite an impressive run. From its prior recession low of around 172.50 in October 1990, NDX reached a peak just below 4,400 in March 2000 for a cumulative gain of over 2,400%! So, while the index's recent performance has been impressive, it pales in comparison to its run-up in the decade leading up the tech crash.

From its prior recession low of around 172.50 in October 1990, NDX reached a pre-tech-crash peak just below 4,400 in March 2000, a cumulative gain of over 2,400%! The index's most recent ascent began after it bottomed around 1,120 in February 2009, during the Great Financial Crisis (GFC), and in the intervening 11+ years it has gained a tad under 900% to hit its recent peak around 11,100.

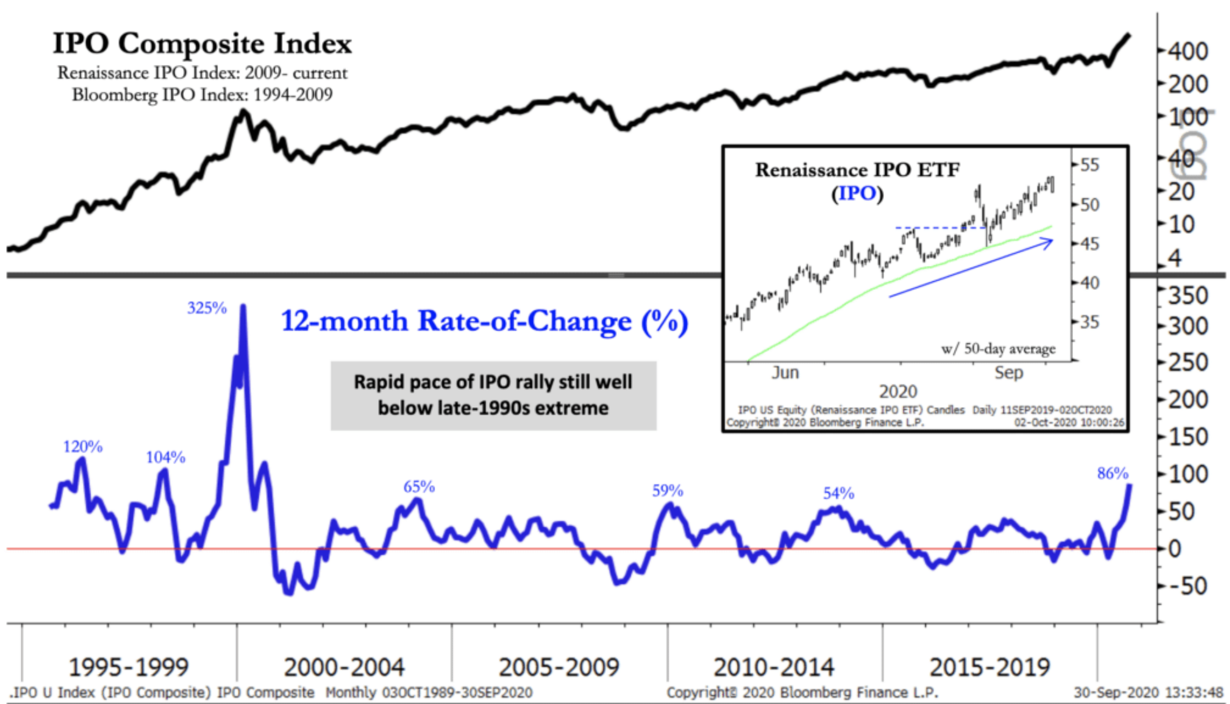
From a fundamental valuation perspective, the NDX of today also looks quite different than the NDX of 2000. The index currently has a price-to-earnings (PE) ratio of 32.74, which is the highest level it has reached since the GFC and significantly higher than the S&P 500's **SPX** PE of 22.99 (Source: FactSet). At the end of 1999 however, NDX had a PE ratio slightly north of 73, or more than twice its current level! It is also worth noting that the S&P's PE ratio at that time was above 30, a level it has not breached since 2000.

https://www.nasdaq.com/solutions/nasdaq-dorsey-wright-stock-market-equity-investment-research-company

<u>IPO Market 12 Month Rate of Change 2020 +86% vs. 1999 +325</u>

The other popular bubble commentary is around the IPO market. New companies are starting to have big spikes on initial trading days but we are nowhere near 1999 bubble levels in new issue market. Josh Brown at Reformed Broker lays out the 12- month rate of change in IPO's today versus 1999 and we see over a 3x higher return in 1999 (see chart below). Companies are staying private longer and coming to the market in much better financial shape. We will see if this changes post-election. If we get an unleashing of the cash on the sidelines, a new bubble might be underway.

Reformed Broker Josh Brown Blog--I'm showing you a chart below that Ari Wald at Oppenheimer just put out, I think it's a good way of viewing the difference between IPO performance in this era, versus that era. One of my guests from the podcast was Kathleen Smith, whose firm Renaissance Capital is actually the sponsor of the ETF Ari is looking at here:



Source: Oppenheimer & Co. and Bloomberg. Note: These results cannot and should not be viewed as an indicator of future performance.

Here's Ari's take (bold is me):*Investor concerns have also shifted to an overheated IPO market. Indeed, the Renaissance IPO ETF (IPO) has rallied since July, and the ETF's* **12-month rate-of-change now stands at 86%***, the highest count in 20 years.*

However, we still think it's premature to compare this strength to that of **the late 1990s, when the IPO market gained 325% in the final year into its March 2000 peak**.

Overall, early signs of IPO froth are worth monitoring, but we don't think it outweighs market positives elsewhere. Source:*Inflection PointsOppenheimer & Co – October 3rd, 2020*

JOSH BROWN BLOG **https://thereformedbroker.com/2020/10/05/this-is-what-ipo-nirvana-actually-looks-like/**

Conclusion

The FED has told the American public that interest rates are staying at zero for at least the next 3 years, but nothing in the markets is ever that easy. In my 25 years-experience, nothing that looks like a 3 year definite bet ever plays out as planned. Rates will either go lower than anyone expects breaking zero or we will get an unexpected increase in rates as sideline cash is deployed.

Where will all this cash go - the ultimate question for 2021 and beyond. It is starting to move into the housing market, but don't expect a housing bubble anytime soon considering we have record low inventory, record high affordability, and hugely positive demographics. In my opinion, the housing market will be healthy for the foreseeable future.

The cash could flow into the stock market and ignite a bubble or could continue to grow on the sidelines in bonds and cash, driving interest rates to below zero levels. Rather than trying to do the impossible and predict markets, we should stick to your financial plan and expect lower but acceptable returns going forward. The following grid from Vanguard illustrates expected returns for the next 10 years based on the math around valuations.

Investors should brace for lower valuations but avoid acting irrationally around elections or media headlines.

Asset-class return outlooks

Our ten-year, annualized, nominal return projections, as of June 30, 2020, are shown below. Please note that the figures are based on a 1.0 point range around the rounded 50th percentile of the distribution of return outcomes for equities and a 0.5-point range around the rounded 50th percentile for fixed income.

Equities	Return projection	Median volatility
U.S. equities	3.9%–5.9%	17.9%
U.S. value	5.0%–7.0%	19.9%
U.S. growth	1.6%–3.6%	19.5%
U.S. large-cap	3.7%–5.7%	19.4%
U.S. small-cap	4.0%–6.0%	23.5%
U.S. real estate investment trusts	3.4%–5.4%	19.9%
Global equities ex-U.S. (unhedged)	7.4%–9.4%	18.6%
U.S. inflation	0.5%–1.5%	2.4%

Fixed income	Return projection	Median volatility
U.S. aggregate bonds	0.7%–1.7%	4.0%
U.S. Treasury bonds	0.3%–1.3%	4.2%
U.S. credit bonds	1.4%–2.4%	5.7%
U.S. high-yield corporate bonds	3.2%–4.2%	10.7%
U.S. Treasury inflation-protected securities	0.4%–1.4%	6.4%
U.S. cash	0.5%–1.5%	0.9%
Global bonds ex-U.S. (hedged)	0.5%–1.5%	2.5%
Emerging market sovereign	3.1%–4.1%	11.1%

These probabilistic return assumptions depend on current market conditions and, as such, may change over time.
IMPORTANT: The projections or other information generated by the Vanguard Capital Markets Model® regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results.
Distribution of return outcomes from the VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of June 30, 2020. Results from the model may vary with each use and over time. For more information, see Important information page.
Source: Vanguard Investment Strategy Group.

Thank you,

Matt Topley
President & CEO
Lansing Street Advisors

Disclosure

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