STRATEGIC OUTLOOK

Strategic Frontier Management

Q4 2020

Economic and Financial Market Whiplash

- The last six months have been a challenging time for households, businesses and investors worldwide. We've all been affected economically, emotionally, physically, or socially by the global COVID-19 pandemic. Economic lockdowns of businesses and other activities led to rapid a collapse in the global economy. *Social distancing* rules were implemented too quickly to evaluate alternatives or the cost to the economy and society. The global economic damage will take time to overcome, but capital markets often discount future recoveries, seemingly disjointed from current economic conditions—this is not surprising to us, nor that equities lead turning points.

- Key to our updated forecasts in ***Fear Itself of Geoeconomic Panic*** on March 16th was the notion of transitory "V-shaped" economic decline and recovery. Directed lockdowns by state and local governments can reverse much quicker than correcting natural imbalances, for example observed during the Global Financial Crisis. The *New Normal* playbook proved woefully misguided. The tactical opportunity to at least rebalance, if not overweight equities was missed by many, worse for those that reduced equity exposure during March. Why is the stock market so far ahead discounting a strong economic rebound? Equities and fixed income have marched to different time horizons—greater uncertainty of a more distant outlook results in greater volatility for equities.

- March 23rd was a turning point for US equity markets, ahead of the summer rebound in the economy. We have observed a classic Main Street vs. Wall Street *Whiplash*. Unlike disorderly natural causes of most other recessions and financial crises, the economic dislocations were *transitional*. Once relaxed, a rapid "V-shaped" equity market and economic recovery took many by surprise. US large-cap growth companies led the way, but cyclical value and smaller cap stocks should catch up. Companies that facilitated work-from-home or internet commerce soared, beyond those deemed *essential businesses*, including grocery stores, pharmacies, emergency services, health services, home improvement, ride hailing, utilities, financial services, Amazon, and Wal*Mart.

- Election 2020 has consequences for US potential growth, global competitive advantage, inflation, profit margins, education, opportunity, liberty, freedom, and taxes driven by the balance of power. The respective platforms couldn't be more dissimilar. We are concerned about probability of a Blue Wave, although *status quo* gridlock seems more likely to us. Reversing tax, trade, energy, and regulatory reforms could slow potential growth, reduce margins, limit earnings growth, and stall economic recovery. Pensions and retirement 401Ks hang in the balance with their dependency on equites. Spending more than we can afford on government programs won't make it OK. Soaring federal, state and local debt, burdens future generations and limits crisis flexibility.

- Balanced 60/40 strategic asset allocations may need some tuning (i.e., shorter maturity, less overvalued large-cap growth), but investment managers of alternative products suggesting the balanced portfolio are dying or dead begs the question what is the alternative? How can alternative products exceed return of public market asset class combinations, off which they're priced and to which they are correlated? There is no alternative asset allocation that has beaten a global balanced strategy on a risk-adjusted basis, certainly net of all fees and costs. Even if future returns to equities and bonds are likely to be lower, so will likely returns of all alternative strategies.

- Global tactical return forecasts offer objective guidance in challenging periods such as this. Global equity returns should far exceed expected negative government bond returns over the next 12-18 months. Upside-down performance of risk factors, such as value and small-cap premiums, reached new extremes, after persisting longer than ever observed. We've seen it before in 1998-2001 (Tech bubble) and 2007 (Quant Quake), but never has value underperformance turned the 10/20/30-year risk factor premium negative. The reversal in small-cap and value from 2002-2005 was equally breathtaking. Our value-growth model remained thankfully neutral last year, but value and small-cap could reassert leadership soon. However, it may take rising interest rates and inflation to do so. Small-cap equities and fixed income credit tilts are preferred.

Brighter Side of Life Under COVID-19

Economic conditions have been grim since March with millions of layoffs and businesses closing, many that will fail. Unprecedented global lockdown of *nonessential* businesses and activities, affecting travel, discretionary spending, entertainment, and investment strangled a thriving US economy. This economic recession is unlike any other given its transitory underpinnings of quarantine policy decisions, self-inflicted by government decision makers. Universal lockdowns initially seemed to make sense given uncertainties about the virus, but as we learned more about COVID-19, there were differences in how each county, state, or even nation needed to manage health and wellness, beyond just slowing infection. Without clear consensus among many experts grappling with so many unknowns, how can government leaders make reliable policy decisions balancing needs of all interests?

Worldwide lockdowns caused a rapid collapse in global economic activity and implemented without much time to evaluate alternative guidelines with regard to economic fallout or unintended consequences of social isolation. Broad lockdowns limited many outdoor and other activities that were resistant to transmitting infection. As lockdowns moderate, we expected economic growth to recover quickly, in contrast to typical cyclical recessions. Unemployed and displaced workers can be rehired elsewhere, but others will have to adapt to an evolving job market with new skill needs. Thus, macroeconomic effects should be limited, despite devastating effects for specific companies or industries. Empty storefronts and offices will be leased again and failed businesses will be replaced, as new business formation takes hold, and thereby create many new jobs.

We expected *peak panic* around April 15th, but the equity market troughed just a week after we published *Fear Itself of Geoeconomic Panic* (March 16, 2020). Therein, we made the case that the US economic impact should be of shorter duration and rebound more quickly than assumed. We believe a government directed *recession* was neither cyclical, nor the result of financial imbalance. State and local government decisions to manage this crisis shut-down *non-essential* businesses and other activities, including education, sport, entertainment, consumer services, travel, and socializing, which caused a steep economic recession. Given similar effects for similar reasons were observed worldwide, the US experience was not unique. We said in March: "*This threat is not a financial crisis, but a health security crisis unlike any other crises—investor panic has been unprecedented given equity volatility, despite inevitable transitory economic consequences.*"

Typical economic recessions depend on economic factors, trends, or imbalances that are not so easily reversed. Just as fast as stay-at-home orders were imposed, they may also be relaxed or suspended at any time. So, we just observed the briefest US recession ever and shortest equity bear market since 1987. We left our revised S&P500: 3000 target in the dust, headed back toward our original 2020 S&P 500 target of 3450. Government policy decisions are difficult with so much uncertainty and many unknowns.

The challenge for political leaders is that there wasn't universal agreement among the experts about how to *balance* limiting infection rates and mortality *versus* economic and wellness consequences of lockdowns. Such moral judgements are not quantifiable. Unintended consequences of prolonged social isolation and dysfunctional society were never weighed against *whatever it takes* to isolate us from contact. Incidence of addiction, abuse, anxiety, suicide, depression, social unrest, lawlessness, murder, and other crimes—beyond economic loss of businesses, jobs, income, property, and opportunity—were far greater than ever imagined. Deferred medical tests and procedures also have had personal health consequences, including debilitating injury, pain, and death other than from COVID-19.

Society's challenge how best to manage this crisis may be a no-win irreconcilable moral dilemma. Arbitrary political decisions shutdown *nonessential* activities, instead of minimizing risky points of contact particularly for more vulnerable individuals in a smarter approach to *physical distancing*.

The uncertainty of how best to extinguish the coronavirus was challenging for all of us. We've learned a lot in six months about COVID-19 and coronaviruses in general, but found there is no simple solution to extinguish its widespread impact. Experiences and challenges varied between countries, states, counties, and cities as the pandemic raged globally. Assumed best practices in March contrast with those presumed today, so blaming the President for economic volatility or the coronavirus doesn't seem to work beyond partisanship.

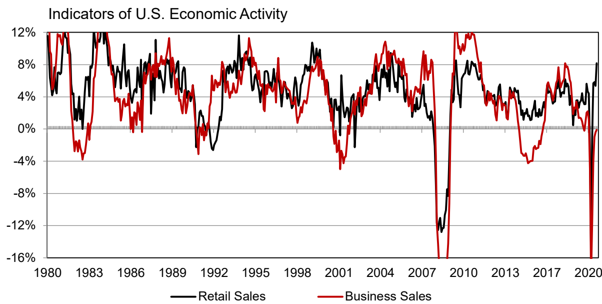
Economic Outlook

The economic recovery is under way after the worst quarter of the post-World War II era. The clock on one of the longest business cycles recorded was finally reset with sequential declines in real GDP with the Q2 headline of the -31.4% annualized growth rate (-8.9% Q/Q). Not surprisingly given the monthly data, real GDP rose 33.1% in Q3 with IPD inflation up 3.6%, so we now expect real growth to decline about -3.0% in 2020. Below we summarize our latest headline forecasts.

Economic Forecasts	2016	2017	2018	**2019**	**2020e**	**2021e**	**2022e**
GDP Growth (Y/Y Real)	1.9	2.6	3.0	**2.4**	**-3.0**	**5.0**	**4.0**
S&P500 Earnings Gr.	0.5	11.8	22.7	**0.6**	**-14.1**	**28.6**	**11.1**
CPI Inflation (Y/Y)	2.1	2.1	1.9	**2.3**	**1.5**	**2.0**	**2.3**
Unemployment	4.7	4.1	3.9	**3.5**	**7.0**	**5.0**	**5.0**
Fiscal Deficit (vs.GDP%)	-3.1	-3.2	-4.2	**-4.7**	**-15.0**	**-8.0**	**-6.0**
Fed Funds Target[1]	0.75	1.50	2.50	**1.75**	**0.25**	**0.75**	**1.75**
10y Treasury Notes	2.45	2.41	2.69	**1.92**	**1.00**	**1.75**	**3.00**
S&P 500 Target	2239	2674	2507	**3231**	**3400**	**3800**	**4000**

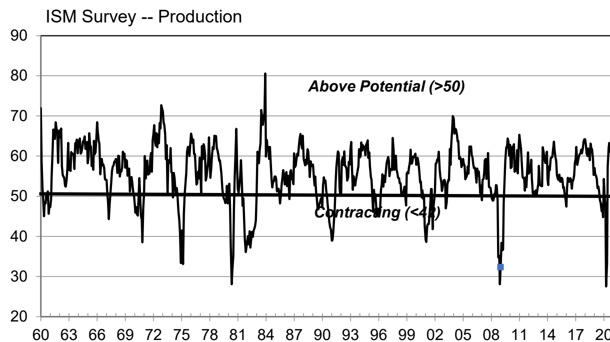
We expect sequentially positive quarters for the foreseeable future without much risk of a double-dip recession. Monthly economic indicators like industrial production, retail sales, consumer confidence, housing and the unemployment rate all traced the *V-shaped* decline and recovery of US economic activity. Equity markets appear to have correctly anticipated these trends, although bond markets remain disconnected, but maybe bond investors are following the Fed's forward guidance, while decoupling from inflation dependency.

Neither additional monetary nor fiscal stimulus is needed given economic conditions. Change in retail sales over the last year increased 8.2%, while construction (2.5%) and business sales (-0.2%) are flat. After Q3 real GDP of 33.1%, nominal GDP of just -2.7% year-to-date, additional spending stimulus is not needed, certainly not another $3 trillion including checks of patronage, demanded in the party-line approved House bill. It further blunts the notion that the Administration mismanaged the economy, particularly relative to other countries considering conditions in Europe, Japan, or elsewhere.

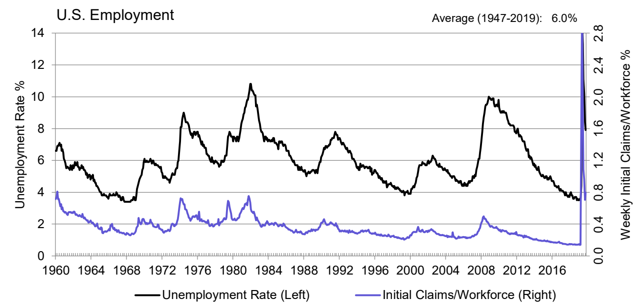


Source: Refinitiv DataStream & Strategic Frontier Management

The ISM Survey has been one of the best leading indicators for the economy—the meaningful recovery in business sentiment beginning in June and reflected here is reassuring the economic volatility is artificially induced and transitory, therefore short-lived. The election is approaching and the relevant economic headlines have printed already. Yet, how the economy is being judged is uncertain, given this atypical cycle—few can look beyond the last GDP or unemployment report, but these lag timelier indicators we also follow and show herein.

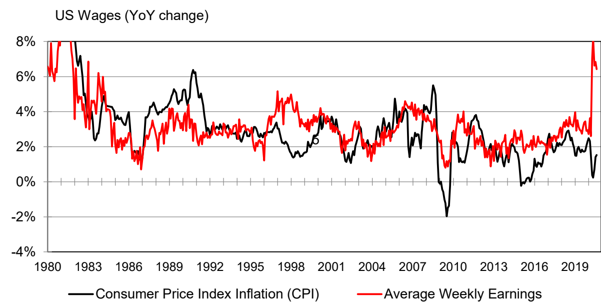


The unemployment rate jumped from 3.5% in February, to 14.7% by the end of April, near the trough of the recession. As states re-opened to varying degrees, business activities rebounded and unemployment has dropped to just 7.9% by the end of Q3. Compare this rapid job recovery to four years required during the Obama-Biden Administration to drive unemployment below 8%, despite an unusual seasonal drag on payrolls in September among public schools, which delayed opening. There are still 10 million people not working versus a year ago, after adding about 5 million jobs since January 2017, but we expect to reach 6% unemployment before year-end.



Source: Refinitiv DataStream & Strategic Frontier Management

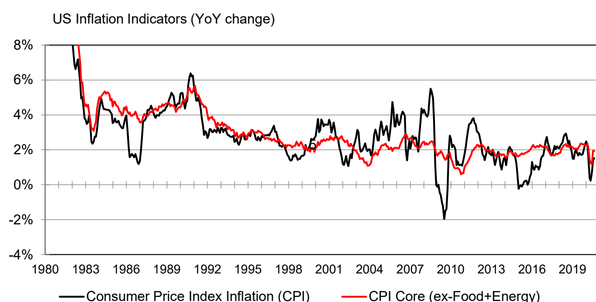
This was the first recession that household income actually increased given government stimulus checks, plus unemployment insurance benefits, which replaced up to or more than 100% of wages for many households. This will wash out as the supplemental income program winds down, but higher wages can boost inflation.



Source: Refinitiv DataStream & Strategic Frontier Management

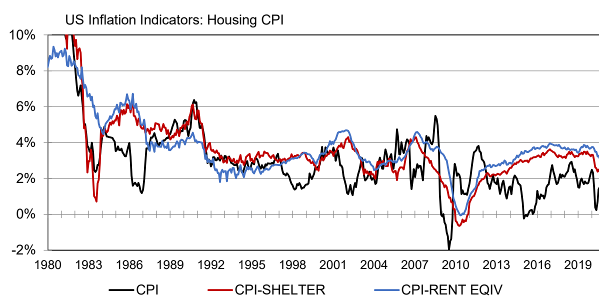
In 2018, we raised our US potential growth expectation from 2% to 2.7% given improving US competitive advantages from fiscal, trade, energy, and regulatory policy reforms, particularly relative to Europe and Japan. Limited profit margins and productivity in Emerging Market struggled with advances in artificial intelligence, sensors, additive manufacturing (3D printing) and adaptive robotics, which undermined their lower labor and overhead cost advantages. Reliance of the *Fourth Industrial Revolution* on key future themes has been key to understanding of trends and divergences of potential growth, inflation, productivity, and thus profit margins.

CPI inflation should continue to rise toward at least 2.5%, with core CPI (ex-food, energy) already increasing 1.7% over the last year. Listening to the Fed, you might assume extended deflation has overcome the economy. Yet, fundamental forces still underpin inflation, including housing, wage growth, utilities, food, and now increasing demand for basic resources and energy. Fuel consumption is increasing with traffic, as companies call back employees. Travel picked up with unbelievable low fares and hotel room rates. The economic recovery is under way now, so our focus shifts to how quickly can we recover, and minimize permanent losses.



Source: Refinitiv DataStream & Strategic Frontier Management

Commodity disinflation, including energy, has persisted for 15 years since we identified as a consequence of Conservation, Substitution, and Innovation (*CSI*, as known by readers). This long-term future theme drove lower energy demand intensity, which accelerated demand declines despite global growth. Transportation fuel will grow more slowly from a reduced base level with accelerated permanent adoption of remote work. Energy supply increased with recoverable oil and gas reserves do to fracking--more supply at lower cost drives down prices. Oil prices peaked in April 2011 ($113, last of OPEC cartel influence), then declined through March-April 2020 (WTI: $18). Lower energy prices drove down book value of reserves, thus negative earnings, resulting in lagging Energy sector performance, but these forces shouldn't be mistaken as environmental impact alpha. We also think higher energy and basic resource prices overshot, and are more likely to drive higher inflation.



Source: Refinitiv DataStream & Strategic Frontier Management

Companies may enjoy higher margins as fixed costs and city head taxes decline, but maintaining collaboration, culture, support, employee connection, and thus productivity is ever more challenging. How do quiet thinkers get noticed and how do you efficiently manage your teams? Employees will benefit from lower costs of commuting, clothing, lunches and coffee, as well as fewer services that enable us to go to work. Net take home income may rise, but it is hard to say how that will drive inflation.

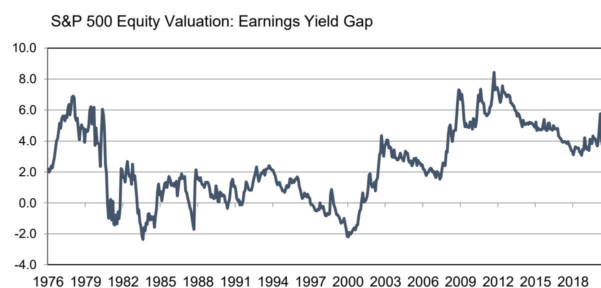
Earnings

Economic growth translates revenue into earnings growth through profit margins. Lower tax rates can drive up profit margins (lower costs, which pass through to consumers in competitive markets), as productivity increases with increased or incentivized investment and R&D spending. Earnings growth upside is likely with stronger revenue growth when margins are higher.

Operating Earnings	2022e	2021e	2020e	2019	2018
IBES Consensus	194.09	173.74	141.00	162.93	161.93
Growth	11.7%	23.2%	-13.5%	0.6%	22.7%
Strategic Frontier Mgmt	195.00	180.00	150.00	162.93	161.93
Growth	8.3%	20.0%	-7.9%	0.6%	22.7%
S&P 500 @18x SFM	3510	3240	2700	2933	2915
SFM Target S&P 500	3600	3300	3000		

Source: I/B/E/S and Strategic Frontier Management

Our S&P500 Earnings Yield valuation, combining low interest rates with trailing and future earnings estimates remains supportive of equity returns. We expect operating earnings to decline about -8% in 2020, then recover with 20% growth in 2021. A rapid earnings recovery explains how investors discounted a transitory economic decline and drove US equity indices back to new highs recently.



The S&P 500 margin increased toward 13% between 2003 - 2019, translating modest revenue growth plus buybacks into greater operating earnings leverage, particularly for large-cap growth and service companies. We've noted that global profit margin divergences supported US outperformance versus China, Japan, and Europe. Japan's low ~1% potential growth and low profit margin in particular risks a value trap despite a lower P/E that still tempts many strategists, as it has for years. This is a key reason we maintained a US equity overweight.

Will Interest Rates Rise Again in 2021?

Central banks hoped to prevent a broader financial crisis by dropping interest rates back toward 0% and increasing quantitative easing (buying government bonds), while offering forward guidance that they will keep rates low for some time to come. However, interest rates and central bank holdings must eventually normalize in in pursuit of stable prices and maximum sustainable employment—implicitly, real growth. US history suggests if CPI inflation averages 2.5%, then policy interest rates should average about 3.5%, and 10-yr Treasuries should average 4.7-5.2%.

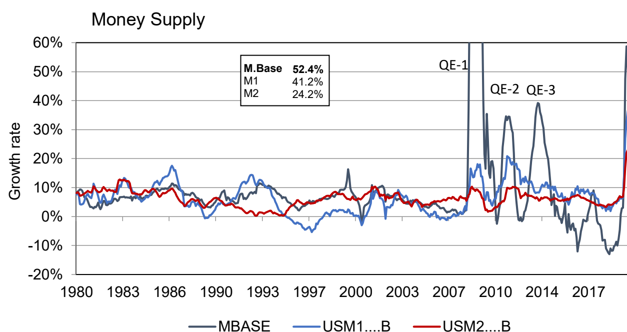
Median Forecast U.S. Fed %	2018	2019	2020e	2021e	2022e	2022e	LongRun Forecast Fed	 SFM
GDP	3.05	2.15	-3.70	4.00	3.00	2.50	1.80	2.70
U.Rate	3.70	3.55	7.60	5.50	4.60	4.00	4.10	4.50
PCE	1.85	1.45	1.20	1.70	1.80	2.00	2.00	2.50
Core PCE	1.85	1.50	1.70	1.80	2.00	0.00	2.00	2.50
Implied CPI	2.35	2.00	2.20	2.30	2.50	0.00	2.50	3.00
Federal Funds	2.38	1.85	0.10	0.10	0.10	0.10	2.50	3.25

Interest Rates	2018	2019e	2020e	2021e	2022e	2022e	Longer Run
FOMC Avg.	2.38%	1.63%	0.13%	0.13%	0.15%	0.26%	2.49%
SFM[1]	0.25%	1.75%	0.25%	0.75%	1.75%	2.75%	3.25%
Rate Change	1.00%	1.50%	-1.50%	0.50%	1.00%	1.00%	

1. Top-end of indicated Fed Funds range

Source: U.S. Federal Reserve and Strategic Frontier Management

Bond market manipulation increased moral hazard implicit in keeping interest rates too low, expanding bond purchases (QE), and forward guidance *for an extended period*. With US interest rates at the 0% lower bound, forward guidance is all that can provide any monetary stimulus. The survey above suggests the Fed will keep rates at 0% through 2023, while continuing to purchase Treasuries and Agency mortgages. But this could prove difficult if inflation rises persistently above 2%, as we expect. Emergency monetary stimulus is no longer needed. Let any monetary taper tantrum run its course.

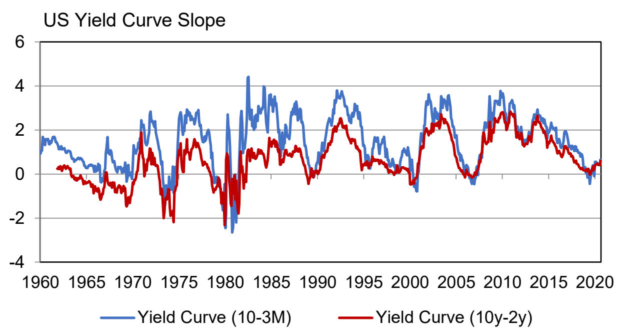


Source: Refinitiv DataStream & Strategic Frontier Management

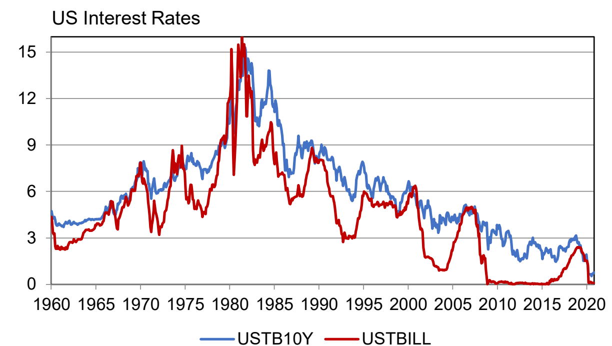
The FOMC loses credibility by suggesting long-term inflation has declined to 2% or about half of the rate for the last 50 years. In January 2012, the policy definition of *inflation* changed (see prior CPI vs. PCE discussion), and defined a new inflation target of 2% PCE inflation for the first time, contrary to the *Federal Reserve Act, Section 2A: Monetary Policy Objectives,* which by statute pursues goals of *maximum employment, stable prices, and moderate interest rates*, which is commensurate with the economy's long run potential growth rather than an explicit inflation target adopted by other central banks.

We expect the maturing *Fourth Industrial Revolution* will result in further moderation of the disinflationary tailwinds highlighted since 2005, as associated with our *Future Themes*. In lasting longer than expected, many seem to mistake transient lower cyclical inflation as a *new inflation regime*, but industrial revolutions go through phases that can span multiple cycles.

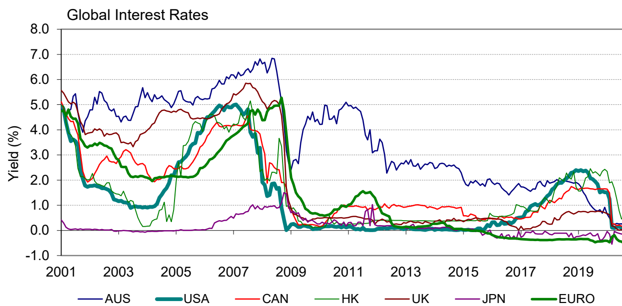
Global bond yields should rise as the yield curve steepens with higher inflation. We anticipate interest rate hikes (2 x ¼%) beginning in 2H/2021, as well as ending QE bond purchases. Bond market *manipulation* is evident in a persistently flatter or inverted yield curves. Low cost of debt encourages imprudent leverage and risk-taking, thus foster financial imbalances. Explicit *moral hazard* results from manipulating bond markets and keeps yield curves flatter than conditions would dictate. A global bond correction after a decade of manipulation could trigger the next financial crisis.



We saw previous yield curve inversion differently with regard to recession risk. We rightly argued that inversion was a transitory consequence of external forces, rather than endogenous economic decline. Global economic conditions in 2019 did not justify negative real interest rates or bond yields, so when the pandemic hit, Japan and European Central Bank had little room to maneuver, while the US, UK, Canada, and Australia cut rates.



Financial imbalances must eventually normalize as central banks withdraw emergency crisis intervention still lingering from 2008. Bond market risk has increased with duration (interest rate risk) and higher convexity (change in interest rate risk) with such low rates. Is it rational for investors to assume such risk without being compensated for it, or even pay interest to lend money with negative rates? Normalizing bond yields will eventually result in colossal losses for retirement plans, pension funds—particularly those with leveraged bond holdings, sovereign wealth funds, family offices, and even central banks (taxpayers). Monetary policy has failed for a decade to compensate for poor fiscal policy decisions and deteriorating demographics that limited global growth.



Source: Refinitiv DataStream & Strategic Frontier Management

Japan, and other Eurozone countries with burdensome fiscal debt are of most concern. Europe and Japan face difficult fiscal challenges with little room to bolster spending in a crisis, burdened by high tax rates and excessive regulation that had them teetering on recession before 2020. Fiscal deficits continue to compound high debt burdens, which will increase with inevitably higher interest rates that can't go much lower.

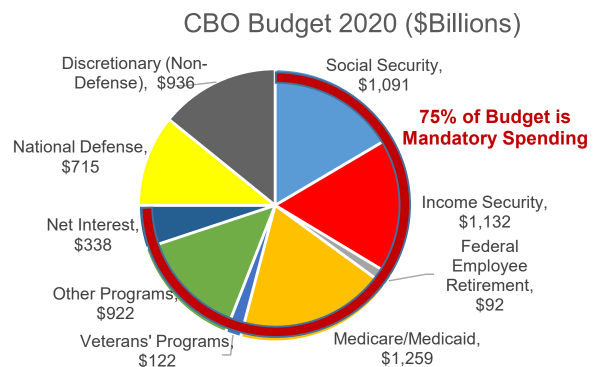
Moral hazard is acutely problematic for Japanese investors, where Japan's BoJ bond holdings increased to about 50% of government debt as Debt/GDP exceeds 250%. We see no obvious pathway to normalize BoJ holdings or interest rates, increasing risk that Japan cancels its bond holdings when struggling to refinance its debt. The BoJ also purchased equity ETFs on a massive scale (ref: 80% of ETF equity shares or 5% of market cap). Japan's equity ETF purchases is particularly treacherous for taxpayers on the hook for speculative losses. Financing costs should soar if investors lose confidence in Japan's ability to repay debt or its credit rating further deteriorates.

We prefer short-term corporate credit or even leveraged loans. Persistent unprecedented easy money policy only reinforced explicit moral hazard for households, businesses, and investors that increased financial imbalances. Overreliance on unconventional monetary policy stimulus left little room to address any future crisis. Eventually the Federal Reserve balance sheet must decline toward $2 trillion and heroic leap with critical liquidity issues eventually managing sustained negative money supply growth to normalize the balance sheet.

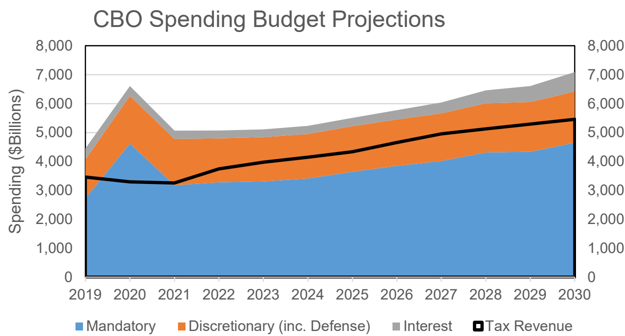
Government Debt and Fiscal Deficits

The CARES Act was exceptional in the size and speed appropriating government economic stimulus spending in excess of $2.2 trillion, equivalent to 64% of 2019 tax revenue ($3.46T). Haste makes waste, and these programs have already shown to be prone to fraud, misappropriation, and abuse, notwithstanding a terrible precedent it set. Last years' $1 trillion fiscal deficit rose to 4.5% of GDP. Household stimulus checks and forgivable business loans (PPP) appear to be experiments in *Universal Basic Income*. Supplemental unemployment insurance benefits of $600 per week had unintended consequences of increased government dependency—workers resisted returning to work as 68% of claimants earned more on unemployment insurance.

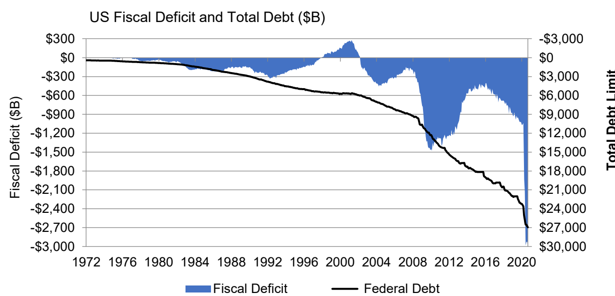
Mandatory government spending growth such as Medicaid, unemployment, Obamacare, and other entitlements are unsustainable, having increased to 75% of total spending in 2020. Mandatory outlays plus interest soared from $4.4 trillion to $6.6 trillion in 2020 with the CARES act. Significant reforms are needed, such as increasing eligibility age of Social Security and Medicare as life expectancy increases. Instead, the House wants to spend another $2-3 trillion that is not needed or equity investors might throw a *taper tantrum*. We'd be better off considering ways to help the economy's return to normal.



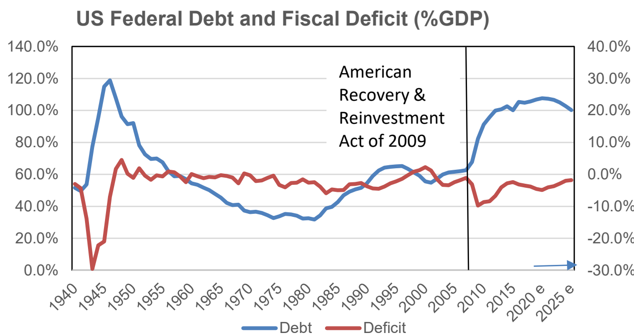
The problem nobody seems to worry about is how our interest burden could soar if Treasury yields normalize to 4-5%, let alone overshoot to 6-7%. That little blue sliver below expands quickly if we anticipate 5-6% bond yields versus 2% or less budgeted for most of the next decade. Expanding Treasury issuance must surely crowd out corporate and mortgage debt issuance, resulting in higher borrowing costs and increasing taxpayer interest burdens as interest rates normalize. The black line is tax revenue, which is well below total spending for the period—who would run a household or business with income revenue well below spending?



Government leverage has gotten progressively worse during the post-war era, but at what point must we reduce debt burdens? Rising bond yields will raise interest expense, which focuses attention quickly on the issue. Unfortunately, the US Treasury hasn't taken advantage of low bond yields to extend bond maturity by issuing a lot more 30-year bonds, while we can. The current average US Treasury maturity is under 6 years with federal debt exceeding $27 Trillion, up $3.7 trillion in 2020, not including increases in state and municipal debt. The Federal Reserve holds about 15% of this debt.

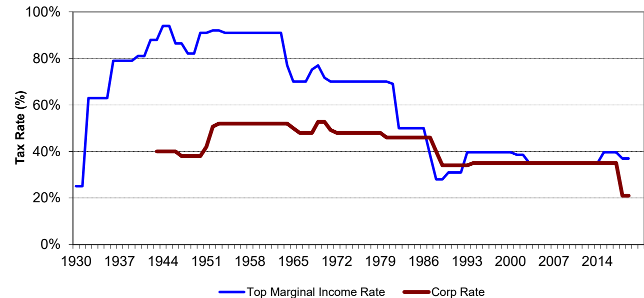


Social Security trust fund reserves are expected to be exhausted in 2037 according to Trustees, as Medicare's Hospital Insurance Trust Fund, will be insolvent by fiscal year 2024, according to the CBO. How about *Medicare for all*? That is not even feasible, even if we could double tax revenues. Spending reform is politically difficult—it has the opposite effect of generous stimulus, offering voters lots of progressive new programs and free stuff.



Source: Office of Management & Budget (OMB)

Tax rates have fluctuated through history, yet politicians think it can be different this time with no waste, fraud, or inefficiency. Alluring populist sentiment remains sympathetic to: *raising tax rates on thee to benefit me* (free stuff), but ignoring the debt burden. Federal debt now exceeds 100% of GDP, plus state and local debt that must be repaid by future generations.

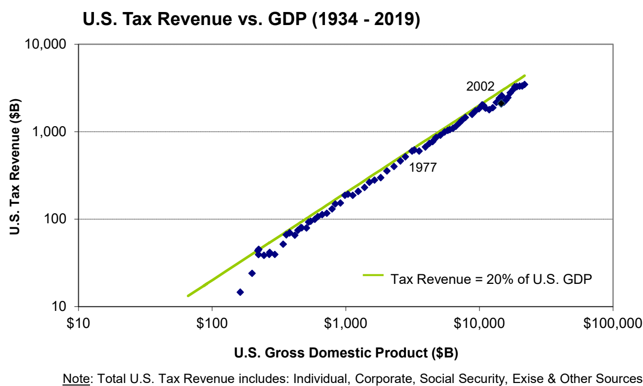


Given the critical condition of the US Debt exceeding 100% of GDP, how can we afford Joe Biden's plan for about $10 trillion (ref: Tax Foundation) in new programs? Just a few of the more expensive programs include: $1.4 trillion expansion of Obamacare (public option), $300 billion to reduce Medicare eligibility age to 60, $2 trillion for a *Green New Deal*, $1 trillion to extend Social Security solvency, $1.5 trillion for free tuition, $550 billion for expanded family leave, $700 billion in "Buy America" investments, and $640 billion in low income housing

Joe Biden's progressive $3.05 trillion tax increase funds just a portion of his $10 trillion platform of new spending programs by raising corporate, individual, and investment income tax rates. He hopes animosity toward "income inequality" and big business provide cover for this terrible idea, but history suggests tax increases never realize revenue expectations once tax avoidance schemes kick in, and money walks—wealth taxes cause greater capital flight, as Europe observed and reversed.

New taxes on households would includes a 12.4% Social Security payroll tax for income over $400K, while raising long-term capital gains and dividend tax rates from 20% to your marginal income tax rate, then increasing the top marginal rate from 36% to 39.6%. The other half of new taxes target business by raising corporate tax rates from 21% to 28%, plus a new 15% minimum tax and foreign profit taxes. The US had the third highest corporate tax rate of 39.9% worldwide in 2016, only exceeded by the UAE and Puerto Rico. The global average tumbled from 40.4% in 1980 to 24.2% in 2019, undermining the US competitive advantage. So, the 21% corporate tax rate just got us back to a competitive global average. This will disproportionately hit small businesses with limited means and reduce competitiveness. Raising tax rates tends to slow potential growth by reducing incentives for investment, innovation, and business formation.

We have written about *Hauser's Law*, and thought it might be interesting to update our graph. Total federal tax revenue has never exceeded 20% of GDP, despite wide swings in corporate and individual tax rates. It highlights why raising tax rates never works as hoped, while other variations depend on growth and periodic recessions. Raising tax rates never boosts tax revenue, because raising taxes slows economic growth and thus earnings, which reduces growth in tax revenue. Similarly, if tax rates are cut and real growth increases, then tax revenue growth tends to increase.



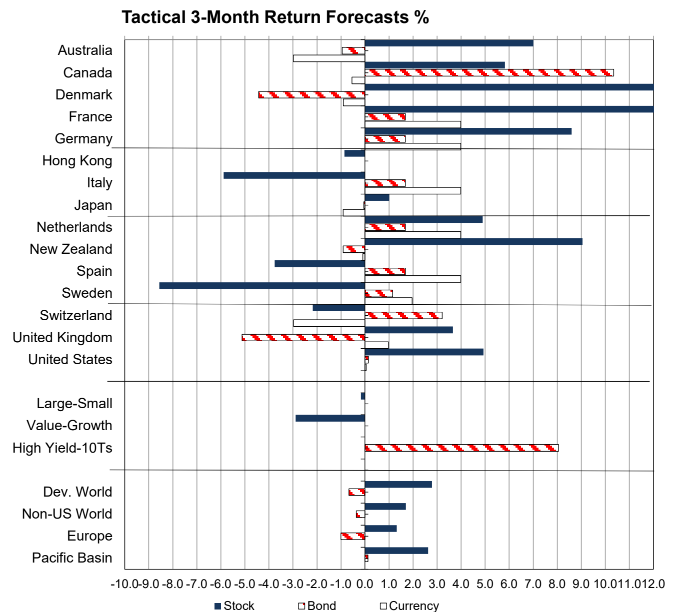
Source: OMB & Strategic Frontier Management (Dec 2019)

Consider that the top 10% (incomes over $140,000) pay 69.5% of US income taxes. Furthermore, individuals already pay 50% of all tax revenues, plus payroll taxes (Social Security, split between individuals and employers) that account for 36% of tax revenues. Most of any tax increase in a progressive tax system like ours is paid for by the top 10%. If the bottom 50% pay just 3% of taxes (CBO, 2018), do the rich pay their fair share?

Global Tactical Asset Allocation Forecasts

Our Global Tactical Asset Allocation models have entered middle age, turning 30 years old this quarter. They have grappled with a wide range of valuation and economic conditions over the last three decades of nurturing them. Our tactical discipline forecasts global equity, bond, risk factor, and currency return across 15 countries (83% of All Country World capitalization) with an 18-24-month horizon. We expect global equities will outperform bonds by a wide margin led by US stocks.

Global equity forecasts remain compelling nearly across the board, and US equity returns still are expected to significantly exceed Treasury bond returns. While P/E ratios have stretched with earnings declines, we should expect earnings to recover following economic recovery. Our Global Tactical Asset Allocation (GTAA) models routinely identified overvalued markets, including Aug. 2000–Sept. 2002 and the October 1987 Crash. In 2020, equities declined first on sentiment, followed by a collapse in earnings potential. No valuation model can help with that unless you can precisely forecast earnings growth. Misguided ratios of CAPE (cyclically adjusted Price/Earnings) or Market Capitalization/GDP, which were unable to discern previous periods of equity market overvaluation, are having a particularly hard time lately being right for the right reasons, and didn't provide any indication to buy equities at their lows either.



MSCI	Citi WrldGvt	Oct 2020	Local Markets Equity	Bond	In (US$) Stock	Bond	US$ Currency
100%	100%	World	2.8	-0.7	**2.8**	**-0.7**	0.0
20%	34%	Europe	1.8	-0.2	**1.3**	**-1.0**	-0.6
9%	21%	Pacific Basin	2.1	-0.6	**2.6**	**0.1**	0.6
34%	56%	Non-US World	1.8	-0.3	**1.7**	**-0.4**	-0.1
66%	44%	US	3.3	-1.1	**3.3**	**-1.1**	
		Cash		0.0		**0.0**	

	Lg-Sm	Va-Gr	High Yield - 10yT
US Style	-0.2%	-2.9%	8.1%
	Small -	*Growth*	*HighYld*

Source: Strategic Frontier Management, October 2020

Our tactical models favor small-cap with potential upside if earnings rebound, as we expect. Earnings growth for the S&P 600 tumbled about -51% with many smaller businesses failing. Another wildcard might be a reallocation preference for listed small-cap companies versus private equity or venture capital, which just haven't delivered net return, despite greater risk. The illiquidity risk factor assumed positive could become perceived as negative, as some academic studies now suggest. Stretched valuations in a "crowded sandbox" has been a chronic issue for some time. This seems intuitive and empirically observed given my experience chairing investment committees and managing a private equity fund of mostly direct investments.

In the table below, historical returns over various time horizons offer some interesting observations: (1) US equity returns exceed bond returns over all key horizons (2) Remarkable unintuitive divergence of *Value* and *Small-cap Equity* risk premiums, (3) *Emerging Market*

risk-adjusted returns lagged expectations for a decade, (4) US equities outperformed non-US equities, (5) *US dollar* hasn't undermined competitiveness, (6) Oil remains volatile, but cheap below $50, (7) Gold is too volatile to be a safe haven and expensive over $1800.

Total Return	3-Mon	YTD	1-Yr	3-Yr	5-Yr	10-Yr	20.Yr	30.Yr
S&P 500 Index	8.9	5.6	15.1	12.3	14.1	13.7	6.4	10.6
NASDAQ Composite	11.0	25.0	4.0	20.6	20.23	17.9	6.9	13.4
Russell 2000	4.9	-8.7	0.4	1.8	8.04	9.9	6.9	10.1
Russell Value-Growth	-7.6	-35.9	-42.6	-19.0	-12.4	-7.3	-0.2	-1.2
Non-US (World xUS)	5.0	-6.7	0.6	1.1	5.9	4.9	4.1	6.14
Emerging Markets	9.7	-0.9	10.9	2.8	9.4	2.9	8.2	8.6
Small-cap Global	7.6	-4.7	4.2	4.2	7.2	9.3		
US 10-Year Treasury	0.1	14.8	12.6	7.8	4.9	4.5	5.6	6.3
US Aggregate Bonds	0.2	6.3	6.5	5.1	4.1	3.6	5.0	6.0
BAML High Yield Bonds	4.7	-0.3	2.3	3.8	6.6	6.3	7.0	8.5
Short-term Bonds	0.4	4.3	4.9	3.5	2.4	1.7	3.2	4.3
JPM Non-US Bonds	4.4	5.6	5.4	3.5	3.8	1.3	4.7	5.5
US Dollar (TWI)	-2.8	2.0	1.0	2.5	0.5	2.2	-0.5	0.2
CRB Commodity Index	12.6	-2.1	4.8	0.4	1.1	-2.6	3.0	1.8
WTI Oil (US$)	-2.8	2.0	1.0	2.5	0.5	2.2	-0.5	0.2
Gold (US$)	6.5	24.9	28.9	14.0	11.3	3.9	10.2	5.3

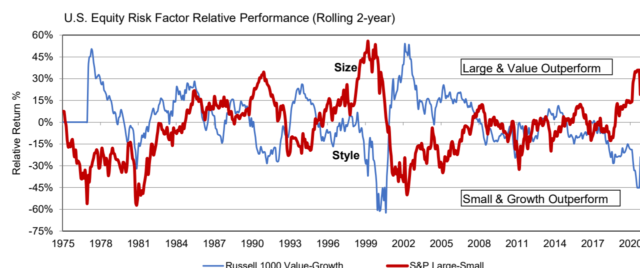
Note: Periods greater than a year annualized thru September 30, 2020

Source: Strategic Frontier Management and Refinitiv

Investors should be compensated for undiversifiable market risk, as reflected in the equity risk premium over bonds or cash. Perspectives from *Mars vs. Venus* (equity vs. bond investors) recently highlighted the differences of two seemingly different worlds. Flip-flopping investor economic concerns coincided with increased volatility-of-volatility in equities. After US equity volatility hovered mostly below 10 for a number of years, volatility has remained steadily above 20 for the last two quarters. It is remarkable that even sophisticated investors ignore eventual mean reversion of volatility, repeatedly chasing income-seeking or liquid alternative strategies, such as selling volatility. This year's VIX victims repeating previous experience with volatility, including Canadian pension funds, clients of Allianz Global Investors, and hedge funds, such as Malachite Capital Management, should know better. It might be tempting to chase short VIX now, but VIX is a trading and hedging index tool, but is inappropriate to be deemed a risk factor premium. Faulty risk management and imprudent investment judgement are not dissimilar to CSFB and Nomura's failed short VIX strategies of February 2018—why would it be different this time?

Typical equity risk factors include value vs. growth, size (large vs small-cap), dividend yield, quality, momentum, or even low volatility. We believe the later two are cyclical being diversifiable, and lacking basis for an intuitive risk premium. Equity investors have shied away from small-cap (-3.8% A.R.) and value (-7.3% A.R. vs. growth) ***over the last decade,*** given the dominance of large-cap technology titans. We observed a similar issue in 1998-2001. We have often marveled at their earnings growth and resilient margins, touting the importance of *future themes* tied to US technology innovation. However, their secular growth slowed and earnings became more cyclical, suggesting high P/E ratios are difficult to justify.

We've observed anomalous returns to investment styles (i.e., risk factors: value vs. growth, large vs. small, momentum, minimum volatility, etc.), sectors, countries, and currencies. Upside-down performance of risk factors, such as value and small-cap premiums, reached new extremes after persisting longer than ever observed. We believe that the long draught in value investment surely has had an impact on active management, as a few notable value managers surprisingly closed their doors. If value doesn't matter, how else can a portfolio manager differentiate good from bad? We've seen it before in 1998-2001 (Tech bubble) and 2007 (Quant Quake), but never has value underperformance persisted enough to turn the 10/20/30-year risk factor premium negative—of course, the reversal in small-cap and value from 2002-2005 was equally breathtaking. The lesson for investors is that risk factor investing may yield long-term benefit, but the pathway is cyclical and can try our patience for quarters, if not years.



The stock market doesn't always track the economy, and the economy doesn't always respond to policy changes as expected, even with a long lag. Yet, there is still value in trying to forecast asset returns and risk—the discipline of doing so is both instructive and insightful. Direction can be valuable, even if magnitude and timing are allusive. Extreme equity volatility can provide tactical allocation opportunities, as suggested earlier this year.

Vaccines and Therapies to Extinguish COVID-19

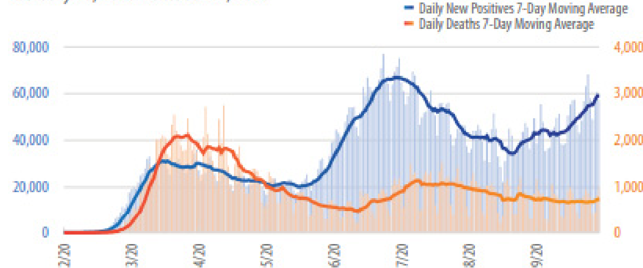
No country has managed to avoid the economic and health impact of the Wuhan Coronavirus with over 45 million people infected, resulting in 1.2 million deaths globally. Countries approached the problem differently, as did most US states, but infection rates and mortality were not that different statistically. There was no optimal policy response given still many unknowns to eradicate the infectious virus, except accelerating development of vaccines and other curative therapies to minimize mortality. The unique challenge for tracking and quarantining this virus is that 80% of infected people are asymptomatic or have mild indistinguishable symptoms, but also implies mortality is much lower than assumed.

Deemed *essential businesses* enjoyed robust revenue, but profit margins were limited by increased costs of doing business. Wal*Mart, Amazon, grocery and liquor stores, home improvement, ride-hailing, delivery services, remote technology and internet services have benefited. Other businesses were shuttered, particularly smaller businesses lacking financial and other resources. Permanent loss is evident in business closures, but productive capacity should not remain idle for long—new business formation should eventually surge, adding new jobs.

Broad-based lockdowns failed to extinguish the virus, and had crippling side effects for society, wellness, and the economy. We are only beginning to appreciate cost and individual harm of an immeasurable toll on society. Disagreement among so many health experts about how best to manage this crisis raises complex moral ethics issues about the universal greater good. Many are still fearful, particularly those with compromised immune or raspatory systems, and seniors. And, if lockdown policies were a treatment undergoing clinical trial, the trial would be halted due to adverse side effects. Increasing infection cases headed into Fall are concerning, acknowledging greater testing too. Yet, US deaths and hospitalizations *from* COVID-19 declined, although exaggerated by *other* contributing causes.

Daily Reported New Positive COVID-19 Tests vs. Daily Reported Deaths from COVID-19 in the U.S.

February 26, 2020 - October 21, 2020



Source: Covidtracking.com

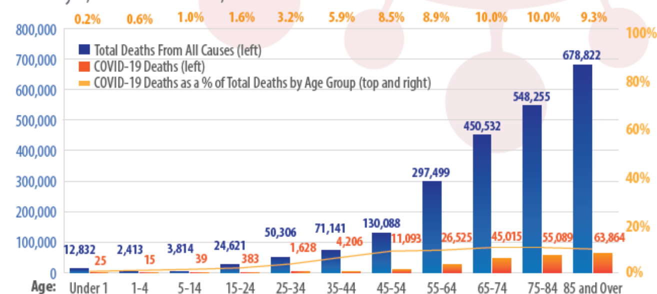
The most important contribution to global society may have hinged on accelerating development of vaccines and therapeutics with $11 billion from flexible discretionary funding in the CARES Act directed by HHS for *Operation Warp Speed*. The Administration directed this program, not Congress, to accelerate research and development in manufacturing at least 7 promising COVID-19 vaccines and therapies in private-public partnerships. US leadership rapidly marshalling our biotech industry could be a marvelous contribution to society, if successful, and restore American confidence sooner to safely re-open its economy.

The good news is that six vaccines clearing Phase 3 testing were approved for early limited use, followed by 11 other vaccines in Phase 3 trials. Imagine that 48 other candidates are also in Phase 1 & 2. Pfizer's vaccine appears to be the first available in November, followed closely by Moderna and AstraZeneca/Univ of Oxford vaccines in December. The Administration also expedited the FDA's regulatory approval cycle, which many experts otherwise assumed would limit availability until well into mid-2021. Naïve lockdowns of all non-essential activity in March was the only alternative initially, but the coronavirus proved less lethal than many presumed. Experts forecasting the future offer different opinions and struggle to sort out still many unknows. Greater insight understanding the virus and its epidemiology might have yielded a smarter approach to eradicating infection, but learned a lot about managing pandemics and battling coronaviruses, in general.

Operation Warp Speed was modeled after various war-time research programs, including 1980s IR&D funding used during the Cold War to accelerate National Defense research and development, which subsequently enabled many commercial applications. In a Capitalist society, profit motive encourages research and development, but during a crisis, companies often hunker down, slowing investment. This is where public-private partnerships can be very effective.

Total Deaths and COVID-19 Deaths in the U.S. by Age Group

February 1, 2020 - October 17, 2020



Sources: CDC.gov, National Center for Health Statistics

Several vaccines will begin wide distribution before year-end. Other funded research supported therapies, including Regeneron—an antibody therapy mimicking natural immune response to viruses. Approved off-label use of the antiviral drug Remdesivir, developed to treat Ebola, and antibody-enriched plasma have showed promise too. Betting against American problem-solving ingenuity typically never works out well, but the US response has provided a long-term solution.

We've learned a lot about how to manage epidemics in the future. We accelerated development of effective vaccines and therapeutics against COVID-19, which will be useful in fighting future coronaviruses and other inevitable pandemics. Older folks and those with compromised immune or raspatory systems suffered higher mortality, while those up to their 40s are most often asymptomatic, but can still transmit the disease.

Any double-dip would require ignoring all that we learned in the last six months and return to draconian lockdown

restrictions begun in mid-March. We learned a great deal about ways to slow the spread of infection and treat the disease effectively. The observed COVID-19 fatality rate was much lower than expected overall, although it rises exponentially above 40 years of age and for those with compromised immunity or raspatory systems. We avoided rationing of care and hospitals were never overwhelmed, nor experienced shortages of life-saving equipment, including ventilators. The US government stepped up manufacturing and secured strategic availability of PPE and other needed equipment. We also discovered we were too dependent on foreign sources for critical pharmaceutical ingredients (70% from China) and other strategic necessities—agencies are driving a a shift to minimize risk of foreign reliance on strategic goods and services.

This election is critical to continue momentum of tax, trade, and regulatory reforms that played a critical role in boosting US global competitiveness and economic potential growth. Managing control of the House, Senate, and Executive Branch, including legislative oversight (revealed breathtaking foreign corruption and conspiracy) and government agency leadership and hinges on the balance of power after the 2020 election.

May Your Sails Find Favorable Winds

Constructive trade, regulatory, and primarily tax (fiscal) reforms have bolstered US potential growth to 2.7%, as well as investment, employment, and global competitiveness. We believe that a shift in the balance of power, flipping the Senate or Presidency (or both) could severely limit US potential growth and profit margins. Policy changes usually take some time to have an effect, but we've noted that the window narrowed under this Administration, which proved its possible to focus on many issues in parallel without mentioning concern for scarce *political capital*. This suggests a new thesis: *Clear meaningful policy changes with known economic consequences can be discounted more quickly* than was historically observed. Sentiment now anticipates realistic expectations for policy changes, accelerating feedback. Businesses no longer wait-and-see, instead anticipate changes in the economy.

Early this year we suggested global equity volatility-of-volatility *can provide contrarians with a tactical opportunity for any correction of 7-10%*. Buying the dip anytime after the 15-29% decline in US equity indices was quite profitable again this year. We don't expect an economic "W" or double dip. Global economic recovery with excess capital and low interest rates begs the question whether it's just a longer cycle of disinflation or to expect a *new secular inflation regime*? Global equity volatility remains elevated, so hedging is more costly.

Although equity markets rebounded (S&P500: 5.6% YTD), US 10yr Treasury yields remain below 1%. US real interest rates across the yield curve are negative, as Treasuries seem unresponsive to normalizing growth and inflation. US Treasury continues to purchase bonds at the market, limiting higher yields, but eventually investors must demand higher yield to compensate for interest rate risk, if not concern about the US spiraling debt burden. We think government bond returns will struggle to earn a positive real return over the next 5-10 years after central bank market manipulation.

Thus, we recommend favoring shorter maturity fixed income or variable floating rate debt. Short-term bond funds with higher credit exposure enjoy higher yield without much interest rate risk, particularly as credit spreads have widened. We don't expect much volatility in the US dollar. We are overweight cash, which is the only true safe haven now for investors—not gold or bitcoin, and certainly not commodities. Money market funds tend to still to have high fees—but getting little more than 0.1% at a bank is about as good as it gets.

US equities will struggle to return 13.5% A.R. observed over the last decade, or even 8.8% A.R. for the S&P 500 over the last 60 years. However, both small-cap and value have significantly lagged, and once earnings normalize, could provide potentially greater return than large-cap growth. Negative real bond returns for 10-year Treasuries over the next five years with increasing debt and refunding central bank holdings could exacerbate a correction in overvalued global bonds.

Portfolios including alternative strategies (inc., private equity, venture capital, private debt, real estate, hedge fund, infrastructure gold, commodities, and foreign currency) remain inferior on average to simple global balanced portfolios on a *true* risk-adjusted basis (meaning realistic volatility and correlation), particularly net of management and transaction costs. Lack of timely mark-to-market pricing of private market securities (i.e., quarterly, if not annual, lagged valuation pricing for real estate, hedge funds, and private company holdings) make it difficult to calculate volatility or relative correlation, resulting in chronically understated risk attribution. The likely myth of illiquidity and unlisted/non-public risk premiums may be actually negative and remains illusive if never empirically observed or diversifiable for capacity constrained private market assets as discussed in: *Alternative Reality*.

We expected adverse economic effects would be transitory until America returns to work, but the equity market has rebounded even more quickly. Directed non-essential lockdowns were not endogenous to fundamental forces or financial imbalances typical of cyclical recessions. Permanent effects of business closures, lost jobs, stalled education, and lost opportunity slow cyclical recovery, but secular potential growth, inflation, and profit margins should be relatively unphased longer-term. Reforms providing US

competitive advantage through 2019 will help America lead the global economy forward from this crisis.

Society learned a lot in battling the coronavirus, and the world will benefit from rapid US government-funded research, development and distribution soon of at least a half dozen vaccines, plus assorted therapeutics, to fight the global pandemic originating from Wuhan, China. Workforce trends, in our *Future Themes,* accelerated as we adapt to technology enabled remote access by necessity, rather than just efficiency.

The global financial crisis playbook that so many seemed to adopt need not apply. The effect of a transitory self-directed shutdown of deemed non-essential activities is quite different than any previous cause of recession. Yes, the economy matters, but voters are smart enough to appraise opinions of posers, critics, politicians, and celebrities with no more insight than you or me.

Thomas Jefferson in 1786 wrote: “Our liberty depends on the freedom of the press, and that cannot be limited without being lost.” The free press of news media and free speech of individuals are still key pillars of freedom and democracy, thereby indispensable to inform the public, participate in democracy, and sustain the rule of law. Increasingly, we rely on Twitter, Facebook, LinkedIn, Google, YouTube, Instagram, and other social media platforms to aggregate news, but these platforms enjoy narrow oligopoly status to thrive on redistribution of content with protection from prosecution of Title 47: Section 230—we don’t need Twitter, Facebook, or Google to restrict free speech or censor content they deem offensive, way beyond the law’s provision. Their anticompetitive advantage is in jeopardy from legislative correction or judicial interpretation to restore basic rights of opinion and freedom of speech.

Geopolitical risk pivots to the US election and potential policy effects of any change in the balance of power. Progressive fiscal and social policies have become deeply imbedded in the *Democratic Party Platform*, but there is no evidence of typical moderation from primaries to general election. Election results will be consequential to increased US potential growth, global competitiveness and sustainable profit margins, but challenging fiscal condition. A Blue Wave would likely drive up taxes more than $3 trillion and debt well over 100% of GDP, as well as reduce US potential growth, particularly if trade, energy, and regulatory policy reforms are reversed. A *Red Wave*, last seen in 2016, is again as unlikely, but would bolster potential growth and America’s retirement savings, which hangs in the balance with dependency on equites. Spending more than we can afford on new government programs won’t make it OK, and future generations will be stuck with a bill they can’t afford.

We wish you and your family peace and well-being this Fall during this challenging period, as well as a brighter outlook for 2021.

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