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Monthly Market Review

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FALLEN LEADERS

Rising public intervention; Greenback singing the blues

It was a month of hefty numbers and big moves. The second quarter U.S. real GDP data came in at a record-setting 33% annualized decline. More than 150,000 Americans have succumbed to COVID-19 and daily new cases and deaths in the U.S. started rising again, pouring cold water on the much-hyped V-shaped economic recovery. Fed Chairman Powell cautioned that the economy still faces considerable risks over the near and medium terms, and the Fed is "not even thinking about thinking about raising rates." The loss of momentum in the post-lockdown rebound pushed 10-year U.S. Treasury yield to new lows by late July. Equity investors, however, were not about to let weak fundamentals get in the way of rallies. The S&P 500 Index gained 5.5%, thanks largely to a handful of tera-caps (a more fitting term for trillion-plus market cap stocks) as well as tech and alternative energy stocks. The day trading craze was still in full swing as shown in the movement of Eastman Kodak's share price. The erstwhile American photography icon enjoyed a Kodak moment in seeing its share price surge from $2 to as high as $60 on the news that it received a $765 million government loan to produce pharmaceutical ingredients.

Across the pond, the European Union formally approved its €750 billion recovery fund, which turbocharged the euro's rise against the greenback to the tune of 5% for the month. The pace of the U.S. dollar's decline accelerated while gold surged past its prior peak of $1900 with no resistance. Gold and silver had soared 11% and 34%, respectively, in July. Unfortunately, the month ended with tens of millions of unemployed Americans casting their longing eyes on Washington's contentious debate as the scale and duration of the much-needed extra unemployment benefit extension hung in the balance.

On the geopolitical front, the U.S. rejected China's maritime claims in the South China Sea and dispatched two aircraft carriers to conduct a freedom-of-navigation operation. The U.S. then ordered China to close its consulate in Houston on espionage charges, prompting China to retaliate by closing the U.S. consulate in Chengdu. China cemented a partnership with Uncle Sam's enemy by signing a 25-year economic and military agreement with Iran. We expect the tension between the U.S. and China, including the risk of an accidental skirmish in the South China Sea, to be ratcheted up further. Surprisingly, investors have remained blasé about this new cold war between the world's two largest economies. Is it an oxymoron to say the tsunami of monetary and fiscal stimulus has numbed their sense of risk?

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CURSE OF THE MONSTROUS MONUMENT

It was a contest that no self-respecting artist wanted to win, but many were coerced to enter. The year was 1949, a year after Klement Gottwald, the Chairman of the Communist Party of Czechoslovakia, staged a coup d'état to take control of the government. Eager to please his puppet master Joseph Stalin, Gottwald ordered a contest for the design of a grand monument in honor of Stalin.

Otakar Švec was one of the sculptors asked to participate in the contest. At 57, he was an accomplished artist but kept a low profile under the new authoritarian regime. Švec was known for his 1924 futurist sculpture Sunbeam Motorcycle and two public monuments – statues of Tomáš Garrigue Masaryk, chief founder and the first president of Czechoslovakia, and theologian Jan Hus. The two monuments were demolished during the Nazi occupation. Švec halfheartedly submitted a model that featured the mustached Soviet boss leading eight proletarian workers wielding flags and guns. He figured the contest was already rigged in favor of a Party-favored sculptor.

To Švec's surprise, the selection committee wound up awarding the project to him, though he had to make the figure of Stalin larger and taller. The giant monument – 51-ft high, 40-ft wide, and 72-ft long – would be mounted on a huge plinth at the Letná Park, situated at the northern bank of the Vltava River that meandered through Prague. The 14,200-ton behemoth would take years to construct, with the unveiling ceremony scheduled for May Day, 1955. It was designed to be the world's largest statue of Stalin.

A lot changed in the ensuing years. Stalin suffered a cerebral hemorrhage and died on March 5, 1953. Gottwald was literally heart-broken with Stalin's passing. Shortly after attending Stalin's funeral on March 9th, he suffered a heart attack and died 5 days later. A year later, Švec's wife committed suicide. Their marriage was on the rocks as Švec had sought to escape from the pressure of the project with heavy drinking and womanizing. He was stalked by the secret police and his mail box was inundated with hate mail from both Stalinists and anti-communists. The monument was ridiculed as symbolizing Prague's food shortage – Stalin was leading a queue for scarce meat. The project had turned into an albatross around his neck.

On May Day, 1955, in front of a hand-picked cheering crowd, Communist officials gave pompous speeches thanking Stalin for their liberation. Canons were fired into the sky and the band played Soviet and Czechoslovakian anthems. Conspicuously missing from the speeches and the ceremony, however, was the creator of the monument. Two months earlier, Švec had finally succumbed to depression and ended his own life to join his late wife.

With Stalin and Gottwald both dead, the monstrous monument seemed out of step with the times from the get-go. Less than a year later, Nikita Khrushchev, the new Soviet leader, denounced Stalin in what became known as the "Secret Speech" to a closed session of the Soviet Communist Party Congress. It kicked off the de-Stalinization movement across the Soviet Union where buildings and places bearing Stalin's name were renamed, and thousands of Stalin monuments were destroyed.

Back in Prague, the monument had turned into an albatross for the Czechoslovakian government, which finally decided to demolish it with explosives in 1962. Legend has it that the first blast broke Stalin's statue and its giant head fittingly fell into the Vltava River.

Equity Markets Indices[1]	6/30/20 Price	7/31/20 Price	MTD Change	YTD Change
MSCI All Country World	525	552	5.1%	-2.4%
S&P 500	3100	3271	5.5%	1.2%
MSCI EAFE	1781	1820	2.2%	-10.6%
Russell 2000®[2]	1441	1480	2.7%	-11.3%
NASDAQ	10059	10745	6.8%	19.8%
TOPIX	1559	1496	-4.0%	-13.1%
KOSPI	2108	2249	6.7%	2.4%
Emerging Markets	995	1079	8.4%	-3.2%
Fixed Income				
2-Year US Treasury Note	0.15%	0.11%	-4	-146
10-Year US Treasury Note	0.66%	0.53%	-13	-139
BarCap US Agg Corp Sprd	1.50%	1.33%	-17	40
BarCap US Corp HY Sprd	6.26%	4.88%	-138	152
Currencies				
Chinese Renminbi (CNY/$)	7.06	6.98	-1.3%	0.2%
Brazilian Real (Real)	5.47	5.22	-4.5%	29.5%
British Pound ($/GBP)	1.24	1.31	-5.2%	1.3%
Euro ($/Euro)	1.12	1.18	-4.6%	-4.8%
Japanese Yen (Yen/$)	107.93	105.83	-1.9%	-2.6%
Korean Won (KRW/$)	1202.90	1191.15	-1.0%	3.0%
U.S. Dollar Index (DXY)	97.39	93.35	-4.2%	-3.2%
Commodities				
Gold	1781	1976	10.9%	30.2%
Oil	39.3	40.3	2.5%	-34.0%
Natural Gas, Henry Hub	1.75	1.80	2.7%	-17.8%
Copper (cents/lb)	271	287	5.7%	2.5%
CRB Index	138	144	4.1%	-22.7%
Baltic Dry Index	1799	1350	-25.0%	23.9%

Source: Bloomberg

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SHADES OF GREY

In today's parlance, Comrade Stalin was "cancelled" and no one shed tears over it given his reign of terror. These days, however, the so-called *cancel culture* – the concerted attack on someone's reputation and even livelihood based on an opinion, a comment or an action alleged to be objectionable – is going after many heretofore venerable figures. We have seen the toppling of statues of Presidents Washington, Jefferson and Grant. Christopher Columbus has become persona non grata as his statues have fallen like dominos across the country. The most notable case may be the eponymous city in Ohio, which removed a 22-feet tall bronze statue of the explorer without a public hearing. The statue, a gift from Genoa, the explorer's birthplace and a sister city of Columbus, Ohio, had stood in front of the city hall and weathered pigeon attacks since 1955. The city is even considering changing its name to Flavortown. Here in New York, the bronze statue of President Theodore Roosevelt at the entrance to the American Museum of Natural History since 1940 was banished. Some people are now agitating for the demolition of the Mount Rushmore National Monument.

While some view this wave of statue-toppling as a national awakening to many historical injustices, others think it has gone too far. San Francisco Archbishop Cordileone condemned the toppling of the statue of Saint Junipero Serra, who was canonized by Pope Francis in 2015, as "violence, looting, and vandalism." Joe Biden has also gone against his progressive base by calling for protection of statues of Columbus and former U.S. presidents.

For investors, the question is how cancel culture will impact businesses from within and without. Facebook, for instance, has to deal with internal employee protests and external pressure regarding its handling of President Trump's postings and the issue of hate speech. Activists were successful in pushing hundreds of major companies, such as Unilever and Starbucks, to join an advertising boycott against Facebook in order to force the company to curb hate speech on its platforms. It's a laudable goal to rid the world of hate, but should Facebook be the arbiter on what content gets "cancelled?" The ACLU argued that Facebook should *not* censor offensive speech as it will "inevitably take down important speech and silence already marginalized voices."

Ironically, Unilever's virtue-signaling in boycotting Facebook was greeted with activists calling the company out for selling skin-lightening cream, which they consider a symbol of colorism, or prejudice against darker skin tone. Unilever then tried to appease them by rebranding its *Fair & Lovely* skin-whitening cream sold in India to *Glow & Lovely*, which we suspect will not quell the controversy. After all, Johnson & Johnson had succumbed to the pressure by discontinuing two lines of skin-lightening products popular in the Middle East and Asia. It begs the question on whether beauty ought to be viewed through the lens of political correctness. If selling skin lightening products promotes colorism, are users of these products also guilty? How about hair coloring products? Should the 1953 film *Gentlemen Prefer Blondes* be banned for what may be construed as an insensitive undertone?

I bring up these points not to make light of the legitimate grievances behind some of these movements, but to point out that many issues exist in shades of grey and often procure unintended consequences. As former President Obama said last October, the real world has ambiguities and "people who do really good stuff have flaws." He called out the cancel culture and said people should get over "this idea of purity and you're never compromised and you're always politically woke." The zeal to rectify historical wrongs may wind up impinging on traits that make America the shining city upon a hill for so many around the world – liberty, diversity, individualism, mobility, etc. Rightly or wrongly, the COVID-19 crisis has already significantly expanded the government's role in our economy and markets; we are all direct or indirect recipients of Uncle Sam's debt-financed largesse. As the pendulum of policies and public opinion swings further toward institutionalized intrusion and coerced conformity, we fear it will take a toll on America's exceptionalism. It seems that these trends should "cancel" a few points in valuation multiples rather than moving P/E ratios substantially higher as has been the case of late.

UPCOMING CANCELLATIONS

While statues of various former presidents were being desecrated, Brooks Brothers, America's oldest men's clothier that boasts having outfitted every U.S. president since its opening in 1818, also fell from grace. The 202-year old retailer, battered by COVID-19 along with changing times and tastes, filed for bankruptcy and is due to close dozens of stores and lay off many employees. Unfortunately, Brooks Brothers may be a microcosm for many businesses. As the much hoped-for V-shaped rebound gives way to the realization that COVID-19 will continue to disrupt the economy and weigh on confidence, many companies will institute their own "cancel culture" with respect to jobs, capital spending, and even debt repayment.

On the job front, the weekly initial jobless claims have declined significantly from the all-time peak of 6.87 million at the start of the lockdown in late March to around 1.4 million by late July. To put things into perspective, the current weekly run rate is still more than doubling the *peak* level during the Great Financial Crisis. Layoffs have spread beyond industries hardest hit by COVID-19 like retail, hospitality and travel. There have been job cut announcements from industry leaders such as Airbus,

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Wells Fargo, Bridgewater Associates, Nike, LinkedIn, and many hospitals that have received generous CARES Act bailout funds. State and local governments will also take out the axe due to the collapse in tax revenues. Various institutions of higher education are working on belt-tightening as a result of lower enrollment, especially from overseas students, less fund raising, and in some cases, vanishing sports revenues. The pandemic has even forced some religious entities to lay off workers due to declines in donation and attendance.

In the face of continued uncertainty, companies are deferring capital spending to conserve cash. A recent McKinsey survey of top 500 global companies found planned capex cuts ranging from 10% to 80%, with average around 25-30% across industries. Unfortunately, one company's spending cut is lost revenues to others.

Personal bankruptcies during the second quarter had declined year-on-year thanks to Washington's generous assistance – stimulus checks, extra unemployment benefits, small business loans, moratorium on foreclosures and evictions, and forbearance on debt collection. However, problems will start to mount as government support subsides over time. The expected surge in business default has started with commercial Chapter 11 filings having gone up 40% year-on-year in the second quarter. It's ironic to see investment banks making record profits on debt issuance while bankruptcy attorneys gear up for a deluge of bankruptcy filings. Well, at least the latter will be hiring more staff.

The macro environment is so tough that former Treasury Secretary Larry Summers warned he has never seen a more uncertain recovery, asserting Congress needs to extend the fiscal stimulus for many months to come. Indeed, Washington has become the life-line for tens of millions of Americans, businesses, and state and local governments. For the first 9 months of fiscal year 2020, Uncle Sam has already run up $2.7 trillion of deficit, and the projected budget shortfall for the fiscal year is over 17% of GDP. Long live the Modern Monetary Theory!

FROM FREE LUNCH TO INDIGESTION

For much of the last few months, Uncle Sam was able to enjoy a free lunch by having the Fed effectively underwrite Washington's debt-financed spending spree with impunity. Inflation and bond yields were both subdued, the U.S. dollar was in high demand, and financial assets were rallying with investors contorting themselves to justify higher valuations. Lately, however, the market is starting to push back against the profligacy by driving the greenback lower. U.S. dollar's initial decline may be spun as a positive since it helps our exports. However, if the downward spiral accelerates, it could create a vicious cycle and trigger concerns about the greenback's reserve currency status. Foreign investors may unload U.S. Treasuries, forcing the Fed to defend the currency by scaling back its ultra-loose monetary policies. This would in turn drive Treasury yields higher and pull the rug out from under the equity market. Higher interest rates will increase the burden of our bloated national debt and impose limits on Washington's spending. In short, the proverbial free lunch may wind up giving Uncle Sam chronic indigestion.

The recent surge in precious metal and gold miner stocks indicates that some investors have started to hedge against this potential outcome. The declining U.S. dollar may also enable global and non-U.S. equities to finally outperform the S&P 500 Index. We expect politicians in Washington to reach a deal imminently to keep the fiscal largesse going, but one potential side effect is that the greenback's safe haven status could be cancelled.

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