History Doesn't Repeat Itself, But It Often Rhymes.

– *Mark Twain*

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Key Issues for U.S. Equity Investors

01

HOW HEALTHY IS THE MARKET BACKDROP ?

02

SO, WHAT HAPPENS GOING FORWARD ?

03

WHOA! THAT SOUNDS LIKE A VERY DIFFICULT BACKDROP FOR EQUITIES...

How Attractive is the Equity Market Currently?

SKY-HIGH VALUATIONS

- At 24.5X and 21.5X, respectively, consensus EPS expectations for '20 and '21 for the S&P 500 are among the most challenging for investors I've seen.
- I see **LITTLE margin of safety**.

WATER, WATER EVERYWHERE, NOR ANY DROP TO DRINK

- Will **Central Banks' grand monetary experiment succeed**?
- Can both the cost of money and the rate of inflation be managed?
- Liquidity provided in excess of the real economy's needs has, as it did in 1998 - 1999, driven the performance of speculative assets, such as stocks and high yield bonds.
- With U.S. Debt/GDP at post-Marshall Plan high of 1.0X+ are investors losing faith in the U.S. Dollar (which is –11.0% YTD)? If so, what will this do to demand for long-dated U.S. financial assets?

A WORD OF CAUTION…

- If Dollar weakness continues, what will be the **impact on inflation**?
- **"Canaries in the coalmine"** suggest caution:
  a. The Dow Jones Commodity Index is +8.2% YTD, but +59.0% since May 2020;
  b. Gold, despite a recent pullback is +20% YTD, after peaking +34%;
  c. Lumber is +62% YTD, after having peaked at +150% in Q3. **Industrial metals** have screamed, beginning in Q3.
- Equity markets have **fully bought into** the notion to **"never fight the Fed"**. The old saw is still embraced, despite it having been a disastrous strategy from 2008 to mid-2009.

Whoa! That Sounds Like a Really Bad Backdrop for Equities…

If this thesis plays out long-only investors will have a difficult time posting absolute returns, but there is a **HUGE opportunity** to **generate ALPHA.**

Growth vs. Value

- Historically, Growth and Value have **swapped market leadership** in **5 – 7 year cycles**.
- This Growth cycle has played out over a **record 10 years**.
- The longevity of this cycle has been driven by progressively lower interest rates since the Financial Crisis. The **Russell 1000 Value** has **underperformed by 53% since 2010**, almost all of that has occurred since 2017.

Calling the End of Market Trends is a Fool's Errand…

HOWEVER

Thoughtful investors should consider the following factors,

which give me **high confidence** that **VALUE** is **poised to lead the market** going forward

1. Valuations are at EXTREMES: The Russell 1000 Growth and Value indices trade at 29.3X and 17.8X '21 consensus EPS, respectively. A 40% discount is consistent with what prevailed in the 1999 Value bottom.

2. Value's outperformance looks timely, as monetary and economic drivers seem in place. Value has outperformed when interest rates are rising:
   i. the main driver is that shorter-dated cash flows become more valuable in widely followed DDM's.
   ii. Value begins to outperform when economic recovery becomes evident. Historically, outperformance begins about 2Qs into recessions.

3. Investors are at record levels of **UNDEREXPOSURE** to Value: this is much like 1998-1999. Value outperformance should drive enormous allocation shifts. Investors missed 50% of Value's relative outperformance, which occurred in the first two years.

4. All stripes of fiduciaries have made the easy decision and trend-followed. When an investment thesis is widely accepted, **who is the Marginal Buyer?**

Where to Look for New Ideas?

Despite being a huge Value bull, a cautious stance on the broad market keeps me focused on stock-specific drivers.

I seek idiosyncratic investment opportunities, which have reasons to appreciate due to internal drivers.

It is very hard to find stocks with my requisite 30%+ total return hurdle rate over 12-18 months.

Recent illustrative purchases have been:

1. A fallen-angel retailer with an underappreciated, highly accretive rent roll opportunity.
2. An underperforming, consumer–oriented industrial company with a new CEO who has sterling turnaround credentials. Both cost-cutting and competitive positioning improvements look very material.

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