Summer 2020

In Moorseville, Indiana, there's a stretch of road that, like the financial markets these days, seemingly defies logic - things are going up, when all indications are they should be going down.

The small town, about 17 miles from Indianapolis, is home to "Gravity Hill," where, after driving to the bottom of a slope on Keller Hill Road, you can put your car in neutral and watch it roll back uphill. (The same thing happens if you, say, set a basketball down or pour a puddle of water onto the pavement.)

Why? There've been many explanations posited - from aliens to mysterious magnetic forces beneath the earth. Some locals believe the cars are pushed by the ghosts of children whose school bus was hit by a train at the bottom of the hill; they're protecting others from the same fate. To test this last claim, some tourists coat their bumper with flour, in hopes of finding fingerprints. (And, in Westminster Abbey, Sir Isaac Newton rolls over in his grave.)

As is usually the case, the dullest explanation is the truth. It's an optical illusion. Like other gravity hills scattered around the world, including Moncton, Canada, the horizon, which gives us a reference point in which to judge slopes, is obstructed from view. So, objects assumed to be more perpendicular to the ground, like trees in the case of Moorseville, may be leaning, and offsetting the visual reference.

The financial markets continuing to roll uphill are not, of course, an optical illusion, and the reasoning is less easily explained. But events over the last several months, suffice to say, have obstructed views of the horizon. Recall last quarter's missive, we noted that determining risk and reward requires careful analysis of numerous factors. In order to do that right now, we need to focus on the future, the time beyond 2020, as the current year's view is obstructed.

Since the shutting down of economies across the globe, stock markets plummeted and bounced back, and fixed-income markets caused many to flee to sovereign debt (like US Treasuries or Canadian government debt) as places of safety. This, of course, caused huge swings in other debt instruments, like corporate and municipal bonds. Governments poured piles of money into their financial systems, and sent considerable amounts directly to citizens. In order to provide liquidity and stability, and reassure investors and the general public, the US Federal Reserve and other central banks purchased debt directly from the financial marketplaces.

Reopenings are proving to be difficult or, in some cases, disastrous. Canada and the US will be spending around $1 trillion and $6 trillion, respectively, in efforts to prop up their economies. Unemployment in the two countries has soared to 13.7% and 13.4%, with 4 million and 40 million people, again, respectively, filing for unemployment in the last four months. Stimulus checks and enhanced employment insurance benefits run out at the end of July (though they could be extended). And many of the "temporary" job losses will be permanent.

With so much bad news and uncertainty, the markets' continued climb might seem mystifying. And it's not as though we have reference points. Searching for records of the last four times a global pandemic shut down the world's economies proves as futile, one would think, as sprinkling flour on your car's bumper. That said, there are strong assumptions to be made, one of which is, very simply, the markets are an investor's best option at the moment, given their time horizon (usually many years), need or desire for return, makes the decision to invest in stocks all the more reasonable.

For example, since central banks have flooded the markets with liquidity, making interest rates very low for the foreseeable future, returns for bondholders are capped.   Other asset classes offer alternatives, of course, but not excess returns for the risk taken. Real estate, as a long-term investment, is always a good diversifier, but with the current conditions, yields are very low, and the risk of default has increased substantially. Commercial real estate typically derives its income from rents, and it's not an ideal time to rely on tenants, whether businesses or individuals, making good each month. Private equity, also attractive over the long-term, may be problematic at the moment, as these investments are not easily convertible to cash, and valuations are more difficult in this environment than with publicly traded equities.

With other investment options either not offering compelling expected returns or coming with significant other risks, the appeal of equities grows, pushing the stock markets higher.

Additionally, many investors are betting on what seems to be massive progress for the treatment of COVID-19. Lastly, and most critically, long-term investors, like us and our clients, are looking to 2021 and 2022 and seeing the next expansion of global economies. Remember, the pandemic shut down an eleven-year run of growth. We've essentially set a new floor, and are anticipating the next multi-year boom.

Much has changed in the world these last four months. But not the continued (and growing) need for goods and services. Continue to look beyond the horizon, even when it's temporarily obstructed from view, and slopes are difficult to judge.