PCA Monthly Commentary

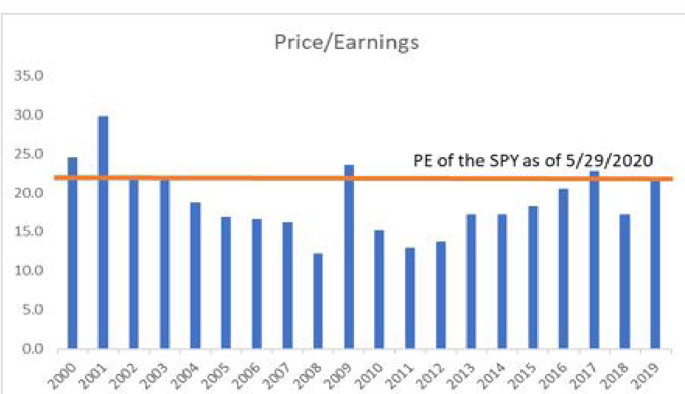
June 2020

The Disconnect Between the Stock Market and the Economy

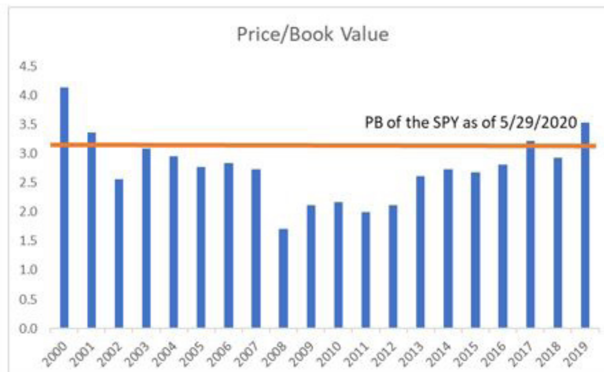
Where is the Disconnect?

The current market movement represents one of the strongest dichotomies that we've seen in recent history between economic indicators and investor sentiment. Despite record levels of unemployment where first-time claims topped 40 million over a ten-week period, the S&P500 is within 8% of all-time historic high's and currently valued near the top of its ten-year range of historic P/E multiples. The markets have climbed more than 40% since the March 23rd bottom, despite roughly 1 in 4 US employees experiencing a job loss.

Considering the following chart, expectations are that 2021 will be a year of profitability and growth of equal magnitude to pre-pandemic conditions. In other words, the collective wisdom of investors is currently projecting forward levels of interest rates, corporate profits, employment and inflation that are all similar to that of past years. From a valuation standpoint, market multiples currently reside at 21.9x earnings and 3.1x current book value.



Source: Pallas Capital Advisors, Factset



Source: Pallas Capital Advisors, Factset

Some recent economic data is showing positivity. Jobs creation has rebounded off historic lows. Gasoline usage has climbed (EIA data), airport traffic is up (TSA data), hotel occupancy is off the bottom, and people are venturing back to theaters (Box Office Mojo). In addition, the MBA's Purchase Index (home loan applications) registered its fifth-best reading over the last year for the week ending May 22nd. It seems that low interest rates and confidence of a near term recovery are both lending support to housing.

Narrative Economics

The topic has been discussed in various forms through history, and most recently popularized by Nobel Laureate, Robert Shiller, within his book "Narrative Economics." Contained in this book that is based upon the original working paper of the same title, he connects epidemiology with the spread of stories that seems to impact markets. The irony of this month's PCA commentary lies with how we think about concepts of a "narrative" for market behavior as it relates to a global pandemic, which actually derives from infectious disease models that make connections back to psychological tendencies of the investment collective.

So why are stories so important to consider in context of markets? Shiller contends that, "The human brain has always been highly tuned towards narratives, whether factual or not, to justify ongoing actions, even such basic actions relating to spending and investing." While acknowledging that quantitative studies are hard to perform for this type of research, it remains important to understand because "stories motivate and connect activities to deeply felt values and needs," while "spreading far, even worldwide, with economic impact."

He proposes that narratives represent powerful exogenous factors that push markets in very real terms and applies a long-studied epidemiology model first created 90 years ago by William Kermack, a chemist, and Anderson McKendrick, a military physician. The Kermack -McKendrik model provided a reasonably accurate and simple to understand framework to describe the dynamics of infectious disease. Of the several versions, the most basic model segmented the population into three groups.

- **SUSCEPTIBLE GROUP** – represented by those that do not have the disease but may be prone to receiving it.
- **INFECTIVES GROUP** – represented by those that have the disease and actively spreading it.
- **RECOVERED GROUP** – represented by those that have had the disease and are no longer capable of catching the disease or spreading it.

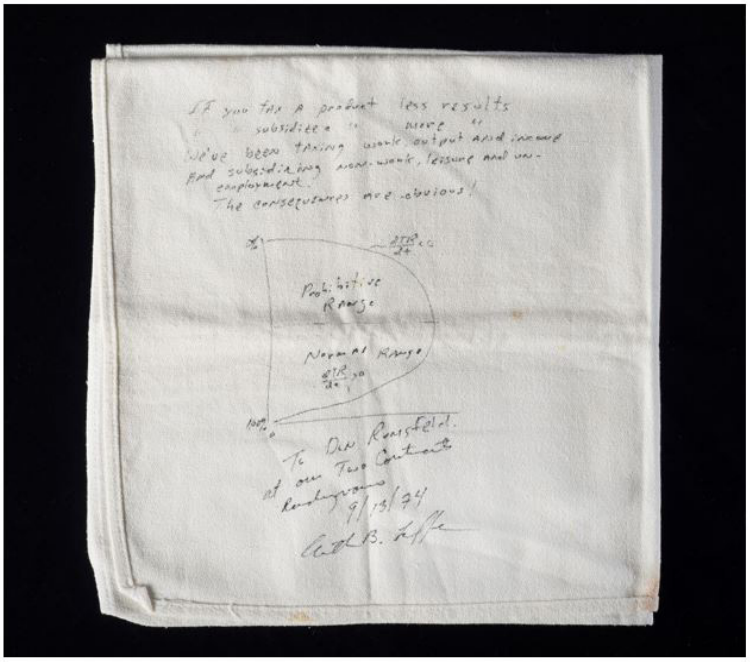
From a social context, the model can be applied to the spread and adoption of an idea, where an 'infected' adopts a story and is interested in passing along the information to a 'susceptible' that is prone to accept the story. In a similar manner in which a infections accelerate and then declines, the growth and decay of a story follows a similar process where fresh ideas gain adoption, but eventually fade, perhaps influenced by new stories that suggest the old narratives are contrary to more recent developments. In time, various models have evolved from this foundation that connects the expansion and decay process of stories to psychological tendencies.

We have seen through history how the substantial impact of stories has challenged long-held beliefs that market participants *consistently apply rational expectations to all available information.* Such assumptions have been progressively weakened by the findings of behavioral-economics practitioners, where very often, people act in a manner that is counter to predictions.

When Stories Fill the Void

Narratives help us connect our hopes and fears in a way that explains unknowns that often oversimplifies a very complex world into simple heuristics. The current hope as related to the global pandemic, lies with the discovery of a vaccine that leads to a balanced solution where the condition is improved by accelerating the herd immunity and the economic toll is minimized as sheltering in place policies are quickly loosened. As Shiller illustrates, these narratives can leave a very powerful stamp upon markets that are seemingly disconnected from data.

We know that the backbone of supply-side economics, preached throughout the Reagan administration, is based upon a drawing on a napkin. The story is simple - tax proceeds are zero when the tax rates reside at the extremes, either 0% or 100%. At high taxation, there is little incentive to work, hence few proceeds will flow to the government. At low taxation, the incentive to work is high but proceeds remain small. This concept is beautiful within its simplicity and intuition, and became viral years after its genesis in the mid-70's when a Wall Street Journal reporter tells the narrative.



Source: National Museum of American History

The irony is that no one, including the artist on the napkin, Arthur Laffer, pointed out where the peak of the curve sat, or which side of the curve the taxes were situated at the time. This implication was critical in the debate on whether higher or lower taxes would be better. While the question of "which side" was raised by economists and generally left unanswered, the story rang with validity because other luminaries (Dick Cheney and Donald Rumsfeld) sat down with Laffer at the "Two Continents" to chat about the idea. This anecdote helps us recognize how narratives can have the power to drive movements, and ultimately, decades of tax policy.

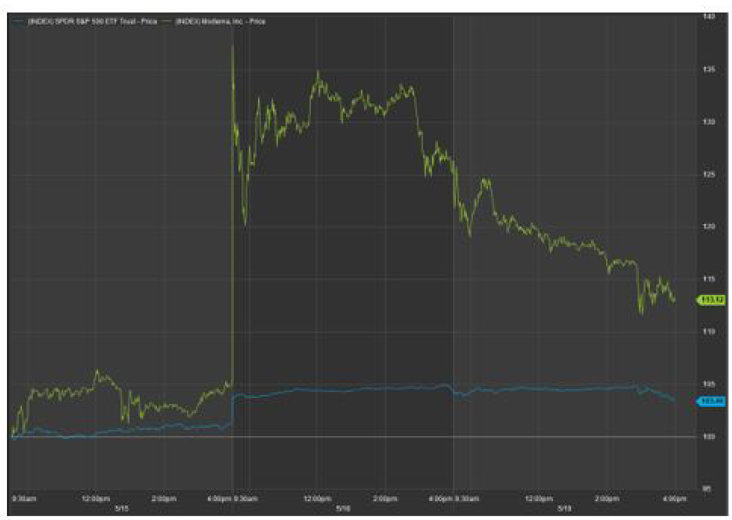
In some respects, the evolution of narrative economics is a bigger counterpoint to traditional theories than concepts from behavioral economics, which mainly offered sidebar explanations to why the "rational" investors occasionally veer from the data. Behavioral economics does not fundamentally explain the actions of market participants when the data is clouded by noise.

Soundbites of COVID-19

In addition to many of the current narratives that include "flattening the curve" and "building herd immunity," we have embraced the belief "once we find a vaccine, then we are ok." Each of these soundbites are intuitively satisfying, provide hope, and undoubtedly contain some very important truths. But in reality, we are still sitting mostly in the dark. After all, what level of flattening and sustained period of infectious decline would provide the right baseline for population health recovery? What percentage of the population would need to carry antibodies to satisfy levels of herd immunity? Given the lack of reliable, consistent, and broad-based testing, how do we know when herd immunity has achieved a safe level?

Because of this cloud of uncertainty, the story surrounding Moderna, the Cambridge, MA biotechnology firm, produced a dramatic reaction in its stock, and further resonated through the broad markets. Over the weekend of May 16-17, investors extrapolated that "we are going to be ok!" The story of positive test results from a vaccine under development by the firm drove the stock price (green line) upwards by +20% and the broad index (blue line) by 3% on the following Monday. The CEO was quoted as saying that results "couldn't have been better."

However, much of that enthusiasm waned the next day as Statnews pointed out that most of the Moderna disclosure was in the form of words, not of data, and further challenged that "the figures the company did release don't mean much on their own, because critical information — effectively the key to interpreting them — was withheld." The competing narrative drove the stock down 10% the following day.



Source: Pallas Capital Advisors, Factset

Thus far, we see that the current inconsistency between economic data and market performance is a natural outcome of competing stories, where uncertainty abounds within the progress of a medical solution, global economic challenges, and the fractious state of politics. Our best course is not only to examine the data, but to also understand how narratives drive the markets even when those stories fly in the face of our own views.

By no means do we believe that building an investment discipline upon narratives is remotely sensible. Yet, acknowledging the dynamics and power of stories can bring some comfort within the dissonance that we currently face. At the very least, the stories of “vaccine discovery” or “curve flattening” are intuitively rational and provide a framework where no prior precedence is truly applicable to the challenges that we face today.