MFS INSIGHTS: MARKET KNOWNS AND UNKNOWNS

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In brief:

- Macroeconomic data may potentially worsen, but that's a market known.
- CEOs and CFOs are scrambling to secure liquidity. Profit maximization is no longer the priority. Survival is. Recapitalizations will likely become necessary, diluting existing shareholders. The post crisis economy may not resemble the pre-crisis one.
- While many are making high-conviction calls that the economic recovery will be strong, we don't share that level of conviction. We don't think you should either.

Over the next several weeks, investors are unlikely to be surprised by the horrendous macroeconomic data. For instance, based on initial jobless claims data, more jobs have been lost in the past four weeks than were created during the entirety of the now-ended eleven-year business cycle. So yes, economic data will get worse, but they may not matter to capital markets because this is a market known.

Markets are a discounting mechanism of "known knowns" and the weighted probabilities of many "known unknowns." And an upcoming earnings recession won't surprise markets any more than terrible labour data will.

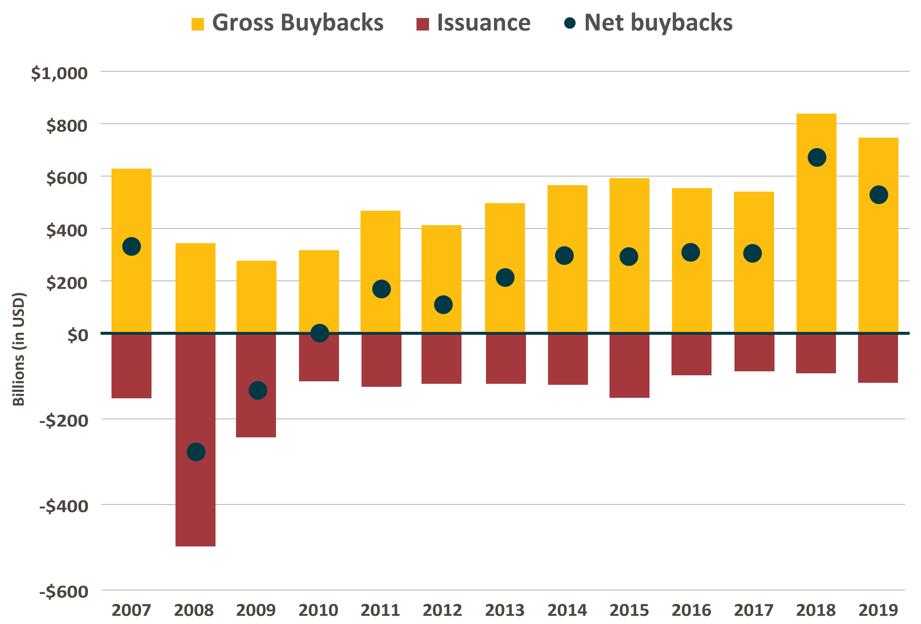
Two known unknowns are the pace of the economic recovery and the path of post recession earnings. Since the March lows, U.S. equities have retraced over half of their losses. Stated another way, in the face of the worst recession of our lifetimes, equity valuations are down only to June 2019 levels. Over the past few weeks, investors have increasingly assigned a higher probability to a shorter-than-anticipated recession and a stronger acceleration in profits. We're not epidemiologists, so we won't opine on the infection curve or the risks of a second wave, though we certainly hope for the best. But as they say, hope isn't an investment thesis.

Regardless of when the virus peaks or the economy reopens, life will be different. Politicians, the media and investment strategists and economists (but not us!) have equated the world's efforts to contain COVID-19 with fighting a war. While it may feel that way with everyone pulling together (thank you to the brave health workers and first responders!), pandemics alter long-term behaviour differently than wars. The catalysts that generally drive V-shaped postwar recoveries are very different from pandemic-driven ones. We'll address this another time, but in short, precautionary savings by both consumers and businesses create very different economic and inflation environments than those previously observed in postwar economies. Now, back to the concern and the point of this article.

In "Looking at Equity Markets Through an Earnings Lens, Part II," we detail some of the reasons we believe this earnings recovery will be weaker than what's being priced. A market known unknown, if you will, that we want to explore further is the likely earnings dilution resulting from future equity capital having to be raised.

During periods of economic strength, many corporations take advantage of all available levers to maximize their appeal to equity investors. Part of the reason for this is that the wrong incentive structure is in place for many corporate leaders, but that too is a topic for another day. Over the past decade, working capital has been the priority for most CEOs, and lower balance sheet quality has been the lever. That dynamic has been on display more in the recent past than in any other period of recorded history. See Exhibit 1 below, which details the steady increase of billions of dollars' worth of shares repurchased in the S&P 500 Index.

Exhibit 1: Equity recapitalizations surged during the financial crisis



Source: Goldman Sachs Global Investment Research. Annual data from 31 December 2007 to 31 December 2019.

This isn't new information, so we highlight 2008. As the fat tail risk of the global financial crisis faded, emphasis turned from maintaining liquidity toward recapitalization. That recapitalization came via the equity market and at the expense of shareholders who suffered substantial dilution on a per-share basis.

Today, CEOs and CFOs — particularly those of companies that might not be able to carry on — are scrambling to secure liquidity. Profit maximization is no longer the priority. Survival is the goal, as meeting next month's debt maturity is all that matters. Balance sheets are now the focus, unlike in the past dozen years. However, the nature of this recession is different from that of 2008, and not only because the recession is driven by a pandemic. The 2008 meltdown was driven by an overleveraged financial sector. However, this time around, banks and REITs weren't the entities that extended balance sheet leverage to unsustainable levels in order to repurchase stock. Instead it was every corporate sector but financials. And a fresh wave of recapitalizations is likely just getting started. Over the past couple of weeks, for instance, there's already been equity issuance by leisure and professional services companies in the U.S. and Europe.

None of us can guess what the duration of this recession may be, nor can we tell how strong the recovery may be. Yet many seem to believe they have sufficient visibility into any such recovery's many known unknowns to make the high-conviction call that the recovery will be strong. We wish we had such conviction, but we don't, and we don't think you should either.

Instead of trying to make those calls, we've chosen to invest carefully, owning assets of enterprises for which the growth of working capital isn't dependent on externalities such as financing, recognizing that you can't plan perfectly for black swan events such as the one we're experiencing.

IMPORTANT INFORMATION

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