What Our Portfolio Stress Tests Show Us About the Remainder of the Year

By John Workman, *Managing Director*

For those lucky investors who have a crystal ball, investing is easy. For the rest of us, we must consider a matrix of potential economic outcomes. In order to chart the best course for your portfolio we evaluate the probability of returns for each asset type and weigh each return forecast by scenario. We consider appropriate diversification for situations where our base case scenario is not the one that comes to fruition. Perhaps the proverbial crystal ball will become a reality with leaps in quantum computing technology. Until then our best bet is to utilize a thoughtful, process-driven approach using quantitative and qualitative inputs and a framework for comparing outcomes across an array of probability weighted scenarios. We call that tool our Stress Test Scenario Analysis Tool. It helps us broaden our thought process beyond just what is expected to include what could possibly go wrong.

Our base case scenario, looking out over the remainder of 2021 and into 2022 could easily be called the "Barn Find" or "Dusting off the cobwebs". Highlighting the fact that there is something of significant value in front of us that just needs to be cleaned up a bit. What does that mean? We are coming out of the pandemic-induced recession and are optimistic about the re-opening of the global economy, but, the economy isn't looking like a shiny new Ferrari parked in a spotless garage with one of those fancy speckled and glossy floors. Instead, the economy is a bit of a barn find, more of a classic car, covered in dust and cobwebs, maybe even missing a few parts or having flattened tires, but it is mostly all there. With some clean-up work, it can be returned to show-stopping status in due time. The restoration of the car is the easy part and generally fairly predictable. Think of that as the economy. The hard part is knowing how much that restored vehicle might be worth at auction. This is the conundrum that market participants face today. Let me explain…

Spending and consumption patterns are fairly consistent over time. The variations expressed in those patterns can be affected by a variety of environmental phenomena, but the trends tend to be relatively smooth. Our expectation is that the economy continues to recover and has still quite a way to go to reach full recovery in terms of employment, consumption, etc. Equity prices, on the other hand, tend to suffer much greater volatility on a day to day basis, than say, the sales of toilet paper. Many would argue that markets are priced quite optimistically today, to put it gently. Others would call this a "bubble" suggesting prices are unsustainably high. The key to solving this conundrum is determining what the new baseline level of earnings and interest rates are going to be. The analysis must be dynamic. Our outlook today would suggest that equity markets, U.S. Large Cap being the most extended, are as much as 10-15% overvalued relative to earnings expectations for 2022 of just over $200 for the S&P 500 and anticipated interest rates on the 10-year Treasury of 2 to 2.5%. If we have underestimated earnings and/or overestimated interest rates (note they have fallen to 1.3% recently) then markets may not be overvalued at all.

Our portfolio Stress Tests will consider alternative scenarios. As noted above, we want to evaluate the what-ifs, in order to be best prepared in the absence of the crystal ball. The other scenarios will be based on difficult questions we need to wrestle with including: Will interest rates on the 10-year Treasury remain below 2% while inflation heats up? Will profit margins remain near all-time highs in the face of wage pressures and rising input costs? If not, what does that say about the currently elevated Price-to-Earnings multiples being paid for equities? Will the Central Banks ever willingly allow another recession? What is the likelihood we get further fiscal stimulus such as an infrastructure spending bill? How will tax law changes impact investments?

As we enter the second half of the year the answers to these questions will become more evident. Earnings season is kicking off, the end to heightened unemployment benefits is in sight and we should continue to see whether covid-19 and its variants may further disrupt the re-opening progress or not. In the weeks ahead keep an eye out for our latest tactical recommendations, considering this matrix of risks and return potential as we look to fine tune your portfolio for the remainder of the year.

If you have any questions, or would like to discuss your portfolio, please contact us.

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