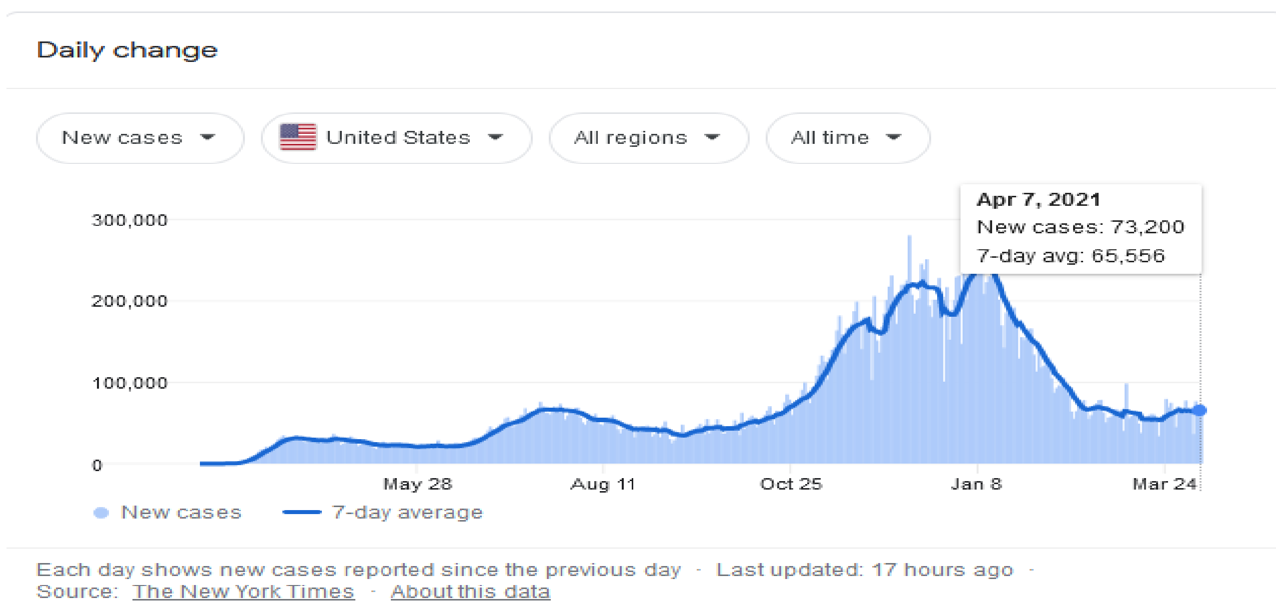
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook - April 2021

COVID-19

The number of reported new COVID cases remains substantially below the catastrophic levels experienced in the December-January period, but there has been no progress in the past month. In fact, the 7-day moving average of new cases is marginally higher than it was in early March, and health experts have reported that the more transmissible and deadly variant that was initially identified in the U.K. has become the dominant strain of the virus here. The good news is that the available vaccines have shown to be effective in immunizing us against this variant. It is also being reported that new case counts are increasingly spreading to the younger and healthier part of the population, so the death rate continues to fall even as case counts rise.



Meanwhile, the pace of immunizations continues to accelerate, with more than a third of the population now having received at least the initial dose. All U.S. adults will become eligible to be vaccinated by April 19th, and we are on pace to achieve herd immunity some time in 2021. The course of this virus as a public health threat remains uncertain in many respects, but its potential to re-emerge as a major economic concern is becoming vastly diminished.

Jobs and the Economy

Non-farm payrolls came in well above consensus expectations in March. The economy created 916,000 jobs against expectations for an increase of just 660,000, and employment gains for the prior two months were revised upward, as well. The unemployment rate fell to a post-pandemic low of 6%.

The employment gains were broad based, but were particularly strong in the sectors most affected by the pandemic. Leisure & hospitality added 280,000 new hires, bars & restaurants added 176,000, while arts & entertainment contributed 64,000 jobs to the total. Education hiring increased as well, as students begin to head back to school.

The ISM Manufacturing index for March came in above expectations at 64.7, the highest level since the 4th quarter of 1983 when the real and nominal GDP growth rates were 8.6% and 11.9%, respectively. The forward looking New Orders Index rose to 68, the highest reading since 2004. The 4-week moving average of initial jobless claims is declining, and business confidence surveys are improving.

If the long term economic outlook needed any additional boost, it got it in the form of the President's $2.25 trillion infrastructure plan, the core of which is long overdue and generally popular. The plan includes:

- $600-billion for roads & highways, benefiting big equipment manufacturers; construction and engineering firms (who lease the big equipment);
- $100-billion for water projects;
- $100-billion for broadband, bringing services into poorer, under-served areas of the country;
- $275-billion for electricity and power

The growth and jobs impact of these measures is obvious, and there is general agreement that such a plan is needed. But agreement on raising the taxes needed to pay for the plan promises to be a long, hard slog. Few issues raise the political hackles more than taxes, but Strategas Research, a macro-economic and policy research firm, points out that any fiscal drag from higher taxes matters less now than in normal times due to the massive build-up in personal savings, the economy's re-opening, and the stimulative effects of the plan, itself.

Interest Rates and the Federal Reserve

Interest rates have moved higher this year as the reopening of the U.S. economy has fueled a strong rebound in growth and rising inflation expectations. The yield on a U.S. Treasury Bond maturing in ten years rose from 0.54% on March 9th of last year to 1.64% as of March 31. 2021. While the increase is significant, current yields are lower than pre-pandemic levels and are not at a level that would choke-off economic growth.

It's important to keep in mind that there is an inverse relationship between interest rates and bond prices. As interest rates fall, bond prices rise; this effect accounted for much of the 7.51% return for the Bloomberg Barclays U.S. Aggregate Bond Index in 2020. With interest rates rising year-to-date, bonds prices have declined contributing to the -3.37% return of Bloomberg Barclays U.S. Aggregate Bond Index in the first quarter of this year.

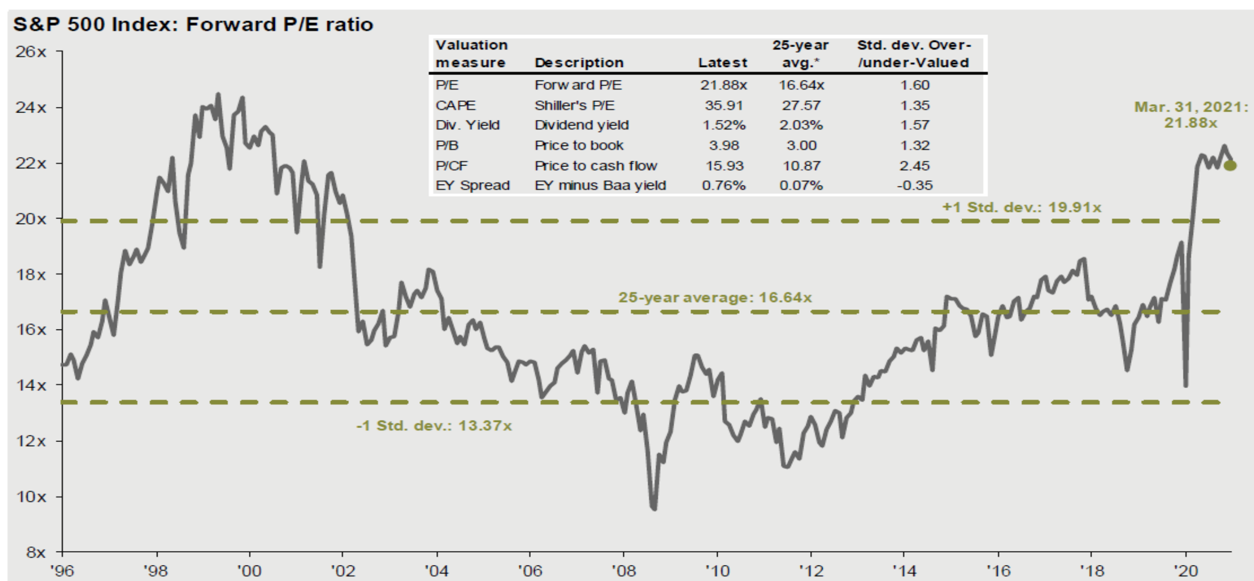
Significantly, the upward move in interest rates is consistent with growing confidence that the economic recovery is in its early stages and will not over heat and result in a surge of inflation. While inflation rates are higher today than during the depths of the shutdown, consensus inflation expectations remain modest. We anticipate that inflationary pressures will be transitory rather than sustained.

As it has since the pandemic arrived, the Federal Reserve remains fully committed to supporting the financial system through the COVID-19 crisis. The Fed has made it clear that it intends to keep its Federal Funds target range between 0.00% - 0.25% until 2023, and that it plans to keep buying $120-billion of Treasury and mortgage-backed securities every month.

The Stock Market

The growing strength of the manufacturing economy is likely a precursor of future increases in corporate earnings and earnings expectations for 2021 and 2022. The bad news is that the market has probably already priced in most

of these expectations. The S&P 500 is currently trading at almost 22-times forward earnings estimates, which is more than 30% above its 25-year average of 16.6 times forward earnings and well above its historical range of 13.3 to 19.9 times earnings. Other valuation measures – Dividend Yield, Price/Book and Price/Cash Flow – show



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.88x	16.64x	1.60
CAPE	Shiller's P/E	35.91	27.57	1.35
Div. Yield	Dividend yield	1.52%	2.03%	1.57
P/B	Price to book	3.98	3.00	1.32
P/CF	Price to cash flow	15.93	10.87	2.45
EY Spread	EY minus Baa yield	0.76%	0.07%	-0.35

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since February 1996, and FactSet for March 31, 2021. Current next 12-months consensus earnings estimates are $182. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
Guide to the Markets – U.S. Data are as of March 31, 2021.

J.P.Morgan
Asset Management

similar extremes compared to historical norms. It is only when equity valuations are measured to current bond yields can one make the case that stocks represent value at these levels. The S&P's current P/E of 21.88 times earnings equates to an earnings yield of 4.57%, which is 0.76% greater than the current Baa bond yield and well above the spread that has existed historically.

One valuation model employed by MKM Research, whose work we regard highly, estimates that the S&P 500 is about 15% above fair value. In order for the market to return to fair value, earnings would have to rise 20% or more; stock prices would have to fall 15%; bond yields would have to fall 90 basis points from current levels; or some combination of the above would have to occur. Given the strength of the economic rebound that is still in its early stages, we would not expect bond yields to fall much below current levels. The most likely course from here is that corporate earnings will continue to strengthen, but stock prices will trail earnings gains causing P/E multiples and other valuation metrics to retreat back within their normal bands. In other words, we are in an earnings driven market, not one driven by plummeting interest rates and expanding valuations.

Archegos Capital Management

Those of us who are old enough to remember when Rowan & Martin's Laugh-In was "must-see" TV on Monday nights, will recall that the program periodically awarded its "Fickle Finger of Fate" to a person or group that had particularly embarrassed themselves that week. It was in that spirit that we commented last month on the pillow fight between the social media crowd on Robin Hood and some vulnerable hedge funds. This month, the award goes to Archegos Capital and its abettors, particularly Credit Suisse and Nomura Securities.

Archegos was initially structured as a family office that was established to manage the $10-billion fortune of Bill

Hwang, a man who had come to notoriety in the early 2000s when he founded Tiger Asia Management, one of the largest hedge funds with a focus on Asian investments. While the firm was very successful, it was not without controversy. In late 2012, Tiger Asia paid a $44-million dollar fine to settle an insider trading scandal and Mr. Hwang was banned from trading in certain Asian financial markets for a period of several years.

Notwithstanding Mr. Hwang's checkered past, Credit Suisse and Nomura, among others, entered into a derivative product with him known as a total return swap. These swaps essentially involve the use of a counterparty, typically a large financial institution (Credit Suisse) to exchange a set of payments based on the return of a stock. When the return on the stock is positive, the investor receives a payment from the counterparty. If the return is negative, the counterparty receives a payment from the investor. If this isn't conjuring the image of a casino in your mind, it should. Mr. Hwang was taking extremely concentrated positions via swaps in a small number of U.S. based media companies, while the institutions were buying up shares to hedge their bets, driving their share prices up. The scheme unraveled when ViacomCBS, one of Hwang's heavily leveraged positions, used the rapid increase in its share price to announce a secondary offering. This news caused Viacom's share price to tumble, triggering a margin call for Mr. Hwang which he could not meet as Archegos' leverage had by now exceeded 10 times the size of its own capital. When it became evident to the banks involved in the swaps that Mr. Hwang could not meet his margin call requirements, they began to unload their shares of the companies in the swaps to mitigate their own losses.

When the dust finally settled, Viacom shares, which had nearly tripled in the weeks leading up to the fiasco, fell 59% in the weeks immediately following. Credit Suisse and Nomura incurred combined losses of $6.7-billion from this single client, and lost approximately 10% of their net worth and almost 20% of their market value. Time will tell whether or not Archegos collapses, but it will certainly live on as a case study for poor lending decisions.

Capital markets are meant to serve two purposes. First, they allocate capital to its most productive uses by bringing together investors holding capital and companies seeking capital. Second, they provide a secondary market where holders of these securities can exchange them at freely established market prices. It is a forum in which everyone can win. But to the Bill Hwang's of the world and his enablers, for whom enough is never enough, the market is a casino where they can hope to make the big score. When Credit Suisse and others choose to sit at the table with Mr. Hwang, they forget the lesson that every professional gambler has learned: If you've been playing poker for half an hour and you still don't know who the patsy is, it's you."

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