2021
3RD QUARTER
QUARTERLY COMMENTARY

Angeles

2001 · 20 YEARS · 2021

Eternity in an Hour

One day, after school, Pablo strolled along La Rambla, the wide, tree-lined pedestrian street that runs from the harbor to the Plaça de Catalunya, Barcelona's central plaza. He wandered into a used bookstore, and in the back of the store, buried under books and dust, his eye caught a glimpse of some sheet music.

Pablo, only 13 at the time, already knew that music would be his career. His father was an organist who taught Pablo the piano, violin and flute. Pablo picked them up quickly. He was proficient at the age of four and performed in public at the age of six. At the age of eleven, he heard a cello for the first time and fell in love with the instrument. He decided to devote his life to mastering it.

The sheet music he found in that store was unfamiliar to him. It was not part of his repertoire, he had never heard anyone play it, but he bought it and brought it home with him, figuring he would try playing it later.

That this particular boy walked into that particular store and stumbled upon this particular manuscript is a series of coincidences that seems impossible. For into the hands of one of the greatest musicians of the twentieth century fell one of the greatest works of music in all history.

ANGELES INVESTMENT ADVISORS
429 SANTA MONICA BLVD, SUITE 650
SANTA MONICA, CA, 90401
PHONE: 310.393.6300

375 PARK AVENUE, SUITE 2209
NEW YORK, NY 10152

WWW.ANGELESINVESTMENTS.COM

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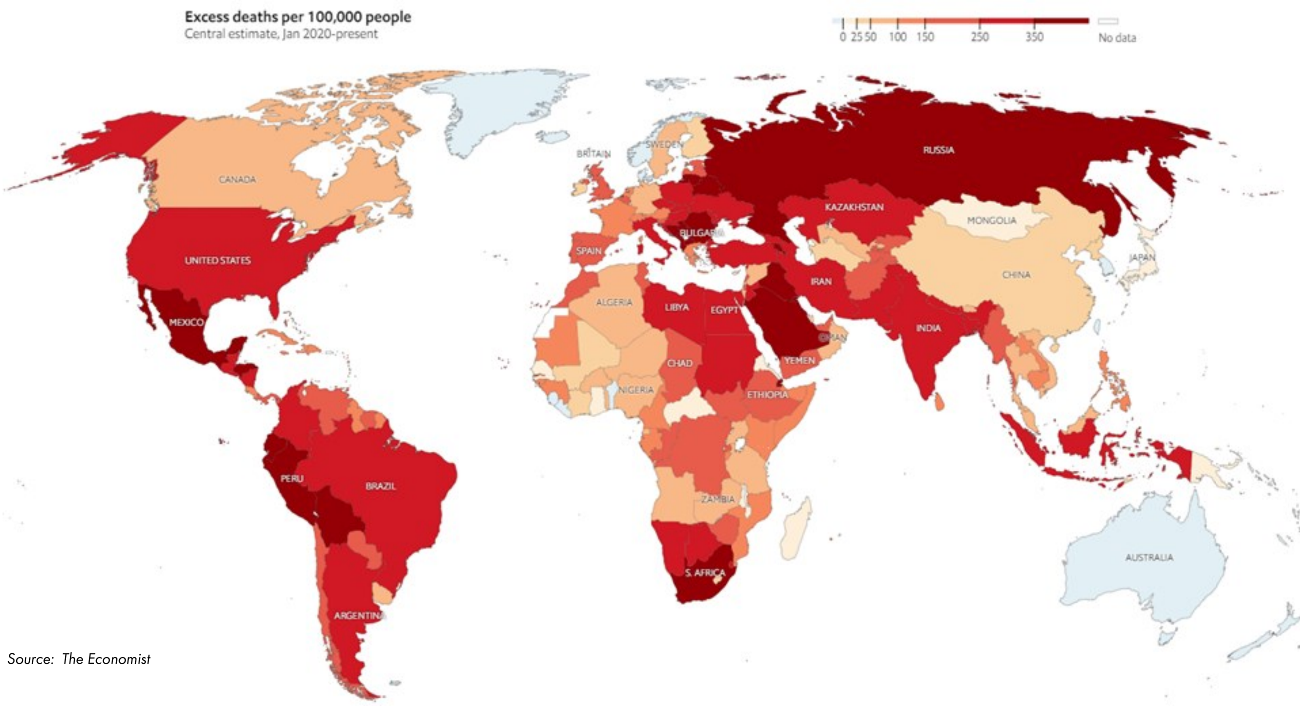
Chart 1 **Estimated Excess Deaths Due to COVID-19**



Source: *The Economist*

Of course, no one, least of all Pablo, knew that at the time. In fact, the world would not know this for another fifty years. This remarkable story is not really about the extraordinary coincidences that led that boy to that store to find that music, but rather why it took so many decades for the world to discover it.

Pre-COVID seems like decades ago. We sensed at the beginning that our world would be forever changed by this virus.[1] That still seems correct, even as its consequences continue to play out.

Most importantly is the enormous death toll. Official deaths from COVID-19 worldwide are close to five million, but this almost certainly undercounts mortality from this virus, which is estimated to be two to three times higher, 15-19 million (Chart 1).[2]

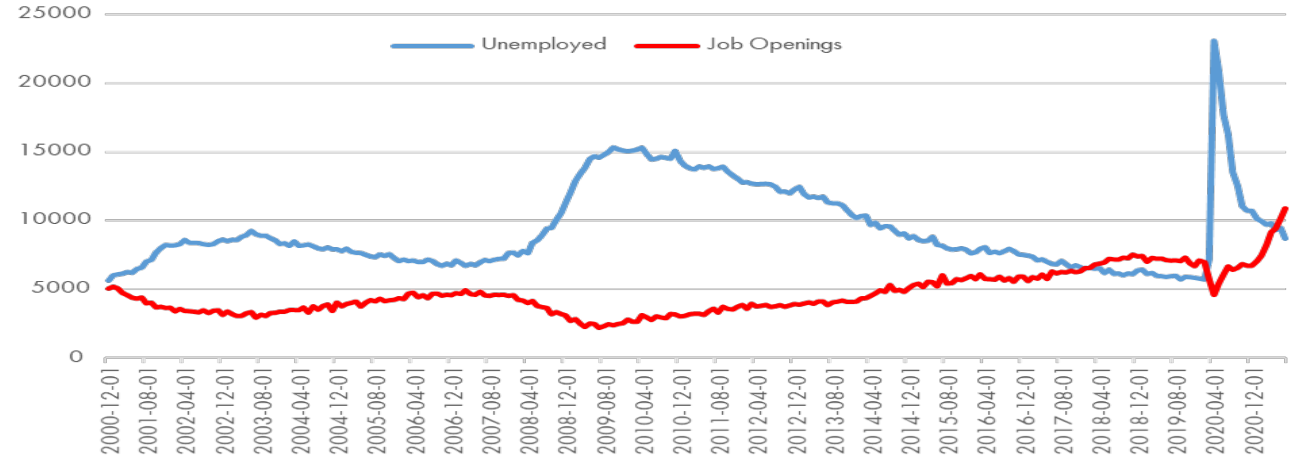
Sadly, the United States is still recording 2,000-3,000 excess deaths daily from COVID-19. That is 40% below the peak in January, but deaths in Europe are 90% below peak. The daily death rate in the United States is eight times the rich world average. Each death is sad; that so many could have been prevented is tragic.

In the early months of the pandemic, more than 22 million workers lost their jobs. We have recovered more than 17 million of those jobs, but there are still 5 ½ million fewer people working today than at the beginning of 2020. One million or so can be accounted for by likely retirement, but that still leaves a large gap we have yet to fill.

1 https://www.angelesinvestments.com/insights/videos/michael-rosen-on-bloomberg-tv-march-5th-2020.

2 https://www.economist.com/graphic-detail/coronavirus-excess-deaths-estimates

Chart 2 **Unemployed and Job Openings, Thousands, 2000-2021**



Source: Bureau of Labor Statistics

Chart 3 **Consumer Price Index for Used Cars and Trucks, 1983-2021**

Source: Bureau of Labor Statistics

Bewildering, to economists and employers alike, is the record number of job openings, nearly 11 million unfilled positions, well more than the 8 million who are unemployed and seeking work (Chart 2).

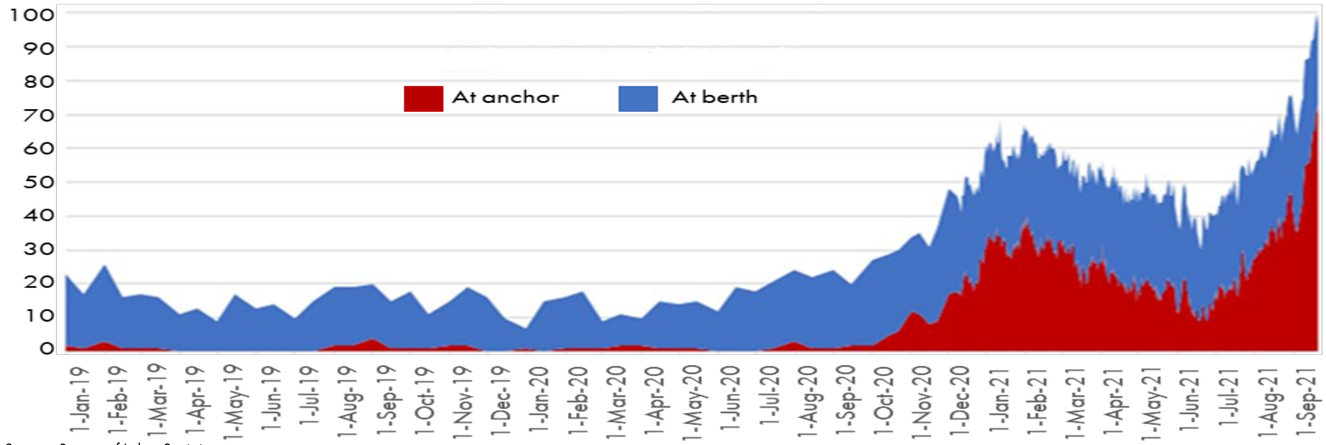
Labor is not the only shortage induced by the pandemic. The lack of semiconductors, the world's fourth most traded good,[3] is causing the short supply of everything from automobiles to toasters. Used car prices are up 30%[4] in past six months (Chart 3).

Shortages are not limited to semiconductor chips. One-third of factories have reduced production due to the lack of availability of non-chip inputs or labor constraints.

[3] After crude oil, refined oil and automobiles.

[4] Absolute, not annualized

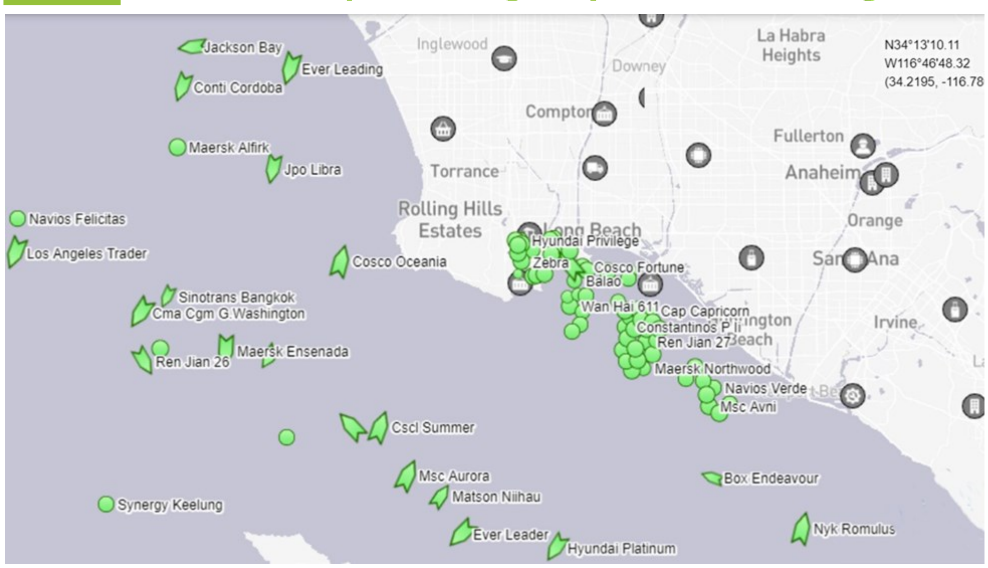
Chart 4 **Container ships at anchor in San Pedro Bay and at berth in Ports of Los Angeles and Long Beach**



Source: Bureau of Labor Statistics

Chart: American Shipper based on data from Marine Exchange of Southern California. Data bi-monthly Jan 2019-Nov 2020; daily Dec 2020-present. https://www.freightwaves.com/news/record-shattered-61-container-ships-stuck-waiting-off-california

Chart 5 **Location of Ships Awaiting Entry to Port of Los Angeles-Long Beach**



Source: Freightwaves

The bottlenecks in transportation can be seen by looking out our office window at some of the 73 ships awaiting entry into the port of Los Angeles/Long Beach, (Charts 4, 5) the largest port in the Western Hemisphere. Not only are there no berths, there are no more available anchorages, so half the ships awaiting entry must simply drift in the ocean until something opens up.

Even if a ship manages to secure a berth, it takes six days to off-load its cargo, a record long wait, nearly 9 days for the cargo to be loaded on trucks, and almost 12 days for that cargo to be loaded on rails.

It's worse in China, where more than 150 ships are waiting to load export cargo off the port of Shanghai-Ningbo. The price for shipping one container from Shanghai to Los Angeles has tripled in the past five months and is up 850% since the pandemic began (Chart 6).

US ports handled almost 2.4 million imported containers in August, a record for any month in history, and are on track to handle 26 million containers in 2021, shattering the annual record of 22 million set just last year. [5]

These supply constraints, in labor, input goods and throughout the transportation system have run head into surging demand for goods. Disposable income is up more than 10% since March 2020, and money that might have been spent on services, from movie theaters to travel, has been redirected to goods. When demand exceeds supply, prices rise.

Most economists expect supply shortages to abate soon, and investors expect inflation to fall by more than half in the coming year, from over 5% currently to around 2 ½%. Some shortages may subside, but these imbalances are likely more than one-off events. Their pervasiveness throughout the global supply chain is indicative of a global economy challenged to conform to a new reality of fragility, from supply chains to world health to our economic and political institutions.

Structural bull markets are multi-year, even multi-decade, periods that see markets advance, not linearly, but persistently.

The end of the Second World War began the twenty-year boom that saw the S&P 500 Index rise seven-fold, from around 15 to 100, by 1968. Economies

Chart 6 **World Container Index, Price per 40-foot Container, Shanghai-to-Los Angeles 2011-2021**

Source: Bloomberg L.P.

[5] Source: Global Port Tracker Report by Hackett Associates for the National Retail Federation.

Table 1 **Valuations Across US Asset Classes**

Metric	Current Level	Historical Percentile
Equities		
Price/Book	4.8	96%
NTM P/E	21.6	93%
CAPE	34.2	95%
EV/Sales	3.4	100%
EV/EBITDA	16.8	98%
Rates		
10-Year Treasury Yield	1.3%	98%
Credit		
IG Yield	2.0%	98%
HY Yield	4.0%	100%
IG Spread	0.90%	89%
HY Spread	3.08%	91%

Source: Goldman Sachs. Data since 1976 except for rates (1921) and credit data (1997).

boomed as the US Marshall Plan funneled billions of dollars into Europe and Japan and new multinational institutions, such as the World Bank, the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT) established a structure and framework that promoted economic development. Tariffs were slashed 35-40% under GATT, for example, leading to a boom in world trade. Rising inflation brought an end to this structural bull market, and between 1968 and 1982, equity markets declined by 75% in real terms.

From 1982 to the beginning of 2000, the S&P 500 Index rose from around 100 to over 1400, a compounded 15% annualized return for nearly 18 years. The Economic Recovery Act of 1981 slashed the top tax rate from 70% to 28%, many industries were deregulated, and in the UK and even in France, public companies were privatized.[6] The bull market ended with the collapse of the Internet bubble, which had driven valuations to unsustainable levels. A few years later, another bubble formed in the housing market, resulting in another collapse in equity markets, ending in 2009 only when massive fiscal and monetary support was provided. Between 2007 and 2010, median household wealth fell 44%, to below the level seen in 1969.

The bull market that began in 2009 took the S&P 500 from below 700 to 4300 today. Each of these multi-decade bull markets experienced some sharp reversals: there was the "Kennedy Slide" in 1962, a 23% drop over a few months; in 1987 markets lost more than 20% in a single day; and March 2020 saw a 34% drop with the onset of the pandemic. These events disrupted, but did not derail, their structural bull markets.

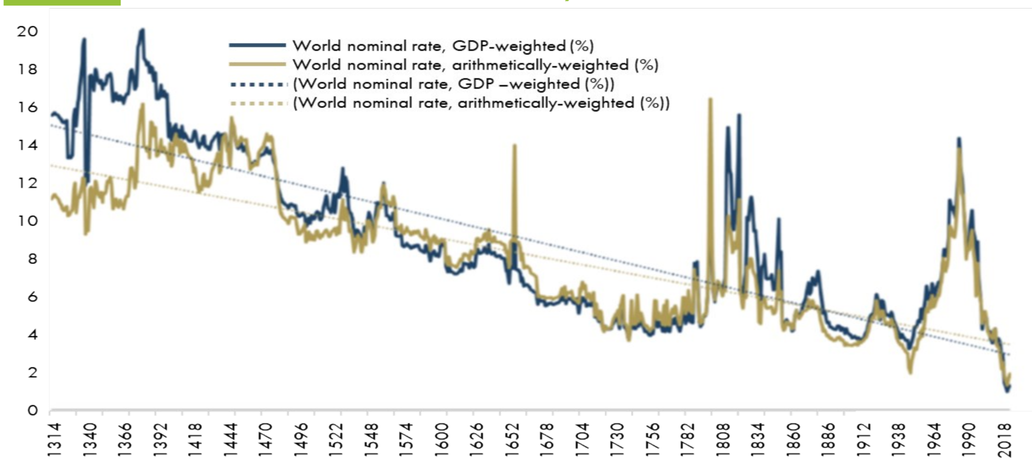
Each of these long-term bull markets began with three similar characteristics: low valuations, a declining cost of capital, and low profit margins. These conditions fueled the multi-year rise and high average returns of the structural bull markets.

None of these three conditions are present today. Valuations across asset classes are high in virtually all metrics (Table 1). Prospective returns in equities have little correlation to valuation in the short-term, but a high correlation over longer periods, implying that we should expect much lower returns in the future.[7]

[6] In the UK, companies in public ownership represented 12% of GDP in 1979 and just 2% by 1997. In 1997 and 1998, the Socialist government of Lionel Jospin privatized France Telecom.

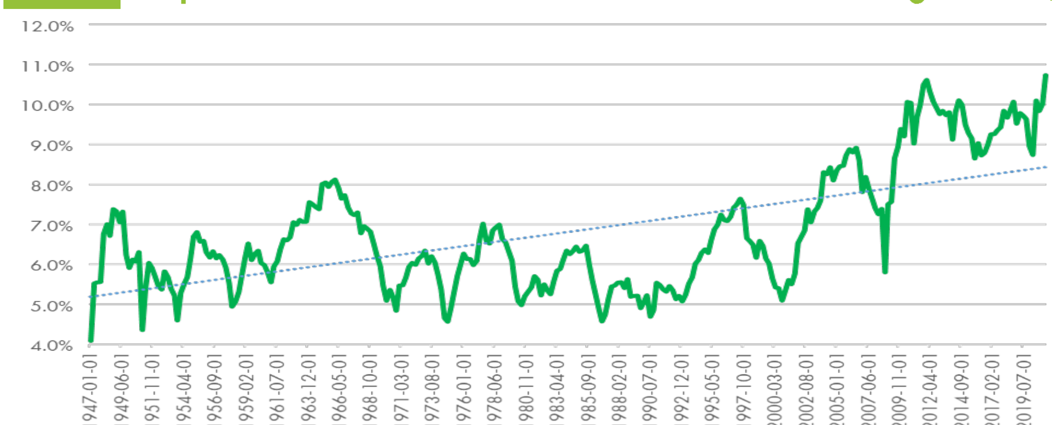
[7] The R-squared between the Schiller CAPE and 2-year returns is 0.20, whereas it is 0.65 over 10 years.

Chart 7 **World Nominal Interest Rates, 1314-2018**



Source: Eight centuries of global real interest rates, R-G, and the 'suprasecular' decline, 1311-2018, Bank of England Staff Working Paper No. 845, 3 January 2020.

Chart 8 **Corporate Profits After Tax with *IVA/CCA* as a Percentage of GDP, 1947-2021**



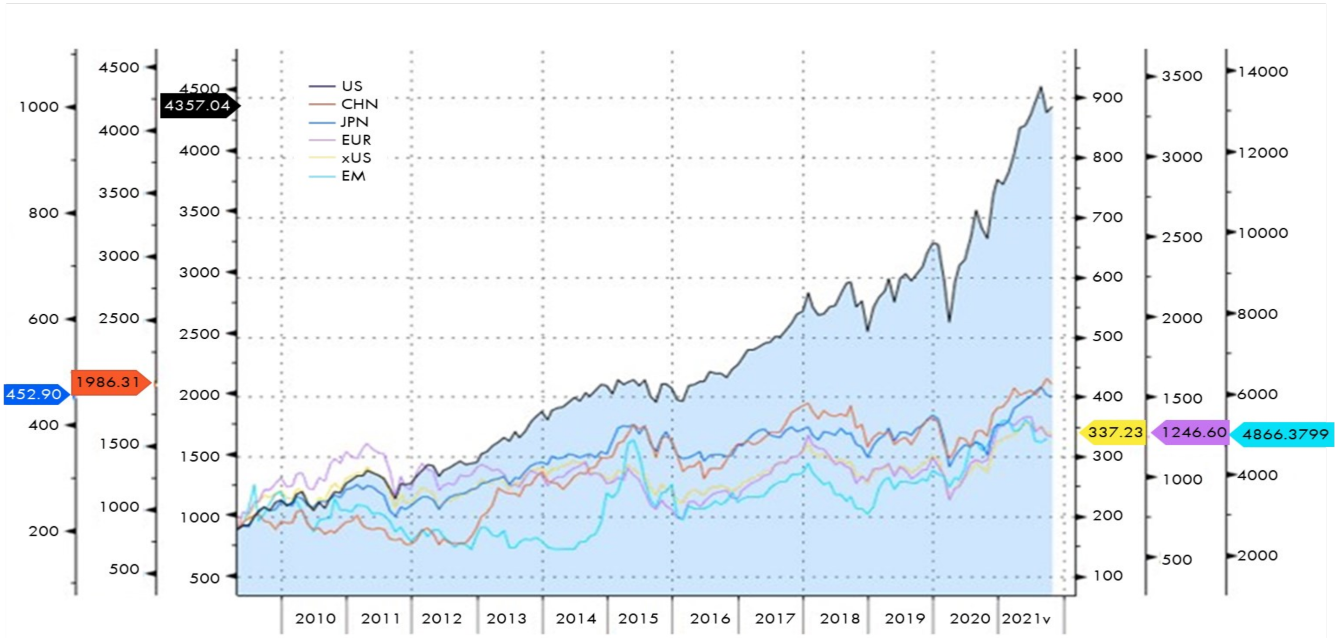
Source: U.S. Bureau of Economic Analysis

As seen in the valuation table, the cost of capital (interest rates) is low. Very low. The lowest in 700 years (Chart 7).

The unprecedented decline in interest rates over the past forty years is due to multiple factors, beginning with Paul Volker's prudent (but painful) tightening of monetary policy in 1979 and a commitment by the Fed and other central bankers over subsequent decades to bring inflation down. This taming of inflation was a principal reason for the bull markets in bonds and equities.

The third condition for the start of a structural bull market, depressed profits, is also absent today. Profit margins in the S&P 500 are nearing 14%, a record high, and corporate profits relative to GDP are also at a record high (Chart 8).

Chart 9 **Performance of US Equities vs. Japan, Europe, China, EM, MSCI ACWI x-US April 2009-September 2021**



Source: Bloomberg L.P.

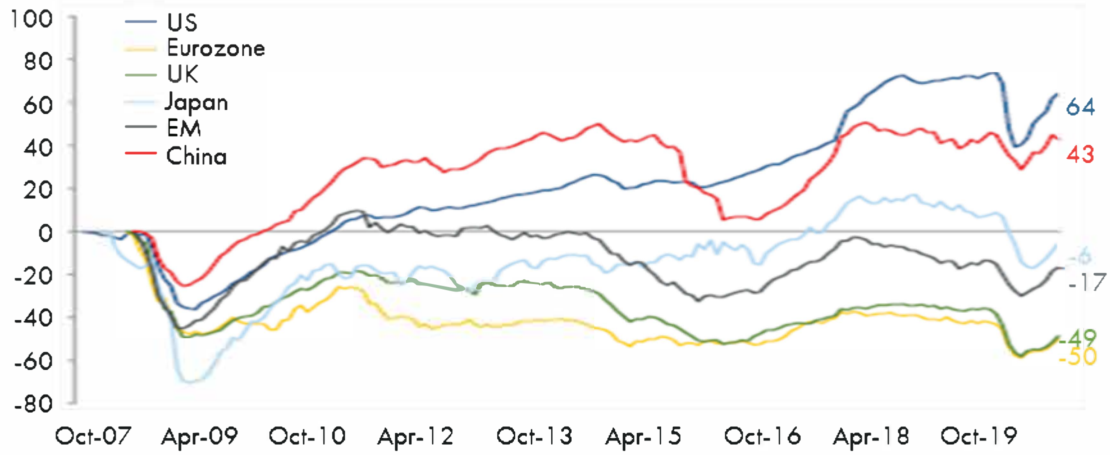
This multi-decade trend of higher profit margins has a number of contributors. Labor costs have been declining with the fall in collective bargaining and the massive expansion of the global labor pool, starting in the early 1990s following the collapse of the Soviet Union and its subject states and then with the entry of China into the World Trade Organization in 2001. Technology as a substitution for low-skilled labor has put further pressure on wages. Falling taxes—corporations paid a 38% tax rate in the 1980s versus 20% today—have also boosted corporate profits. The broader economic shift to less capital intensive, higher-margin businesses (IT, e.g.) and a greater concentration of market share in virtually all industries have also contributed to the rise in profits.

High valuations, low cost of capital and high profit margins do not necessarily mean that a bear market is imminent. These conditions do (strongly) suggest that future returns will be far more moderate than we have experienced since 2009.

As asset allocators, we are as concerned with relative returns as we are with absolute returns. The structural bull market that began in 2009 has been characterized by significant outperformance of the US market over the rest of the world, and by "growth" stocks (primarily technology) over all others.

Since April 2009, the US market has handily outperformed all others (Chart 9). The US market gained 594% through September 2021 while the rest of the world has advanced just 222%.

Chart 10 **Earnings Growth in Selected Countries, 2007-2021**



Source:

Chart 11 **MSCI World Value Index vs. MSCI World Growth Index, 1975-2021**

Source: Bloomberg L.P.

The exceptional outperformance of the US market has been well-justified. American workers are the most productive in the world. Output per worker is around $130,000 in the US versus $100,000 in Europe and just $30,000 in China. Cumulative earnings growth in the US over the past fourteen years has been 64%. China's has been 43%, but the rest of the world has seen *negative* cumulative earnings growth since 2007 (Chart 10).

Since 2007, "growth" stocks have also significantly outperformed "value" stocks, which have fallen off a relative cliff (Chart 11). This gap has been justified by stronger earnings growth among growth companies and record low interest rates (which favor longer duration assets).

This period of outperformance of the US and growth companies may persist, but the gaps will likely narrow. Earnings estimates for European companies over the next few years trail that of US companies, but not by much. Equity valuations are a lot lower overseas, even when adjusted for sector composition (the US market is more weighted to higher valuation industries).

The evidence clearly points to a period of very modest absolute returns across all asset classes. The exceptional performance of US stocks, especially growth companies, may continue, but will likely be a much smaller differentiator in the future. Our job as allocators will get harder.

Johan Sebastian Bach composed his Cello Suites around 1720. We can't be sure because no manuscript in his hand has survived, although we do have one transcribed by his second wife, Anna Magdalena. The music was not even published until 1824, one hundred years after Bach wrote them. They were treated as exercises for students, were never performed publicly, and soon fell out of print and back into obscurity.

From the moment he acquired this music at the age of 13 till he died at the age of 97, Pablo Casals played Bach's Cello Suites every day. Each of the six suites is in a different musical key, and they progress with greater intensity and complexity. Each singular note blends with the notes that come before and those that follow to create polyphonic harmonies that appear to emanate from the hands of multiple musicians. It is the most sublime, and elemental (in the words of Yo-Yo Ma) music ever written.

It is music that demands extraordinary attention and dedication. Bach provided no guidance on how it was to be played, so every note, every phrase, needs to be carefully considered. When Pablo Casals stumbled across this manuscript, no one alive had ever played it or heard it played, so he was on his own. He worked on it every day for ten years before playing it for some friends, but it remained his personal treasure for decades more as he drew out its mysteries.

In 1936, Fred Gaisberg, the head of EMI Records, persuaded Casals to record the second and third suites at EMI's Abbey Road Studios in London. Casals was living in self-imposed exile in France, fleeing the Spanish Civil War. He recorded the other suites in Paris by 1939. Two suites were released to the public in 1940, fifty years after Casals first laid hands on the music. Two more were released the following year, and the last two were made public in 1950. These were the first ever recordings of this music, and they remain among the greatest and most influential recordings of all time. The great violinist Fritz Kreisler described Pablo Casals as "the greatest man who ever drew a bow." Upon hearing the Bach recordings, the great Norwegian composer Edvard Grieg said "[Casals] does not perform, he resurrects!"

It is a miracle that Bach's Cello Suites even survived as an unpublished, handwritten manuscript for over a century. A miracle that it was lost to the world for another century, a further miracle that it ended up in the stacks of a used bookstore in Barcelona, and perhaps the greatest miracle, that it was found by a 13-year-old Pablo Casals.

Equally astonsihing is that Casals sat with this music, working out its intricacies and beauty, every day for fifty years before he felt confident to share it with the world. He saw in each note and in each phrase the larger beauty of the piece. As William Blake waxed poetic in *Auguries of Innocence*, in the Cello Suites, Casals was able,

To see a World in a Grain of Sand
And a Heaven in a Wild Flower
Hold Infinity in the palm of your hand
And Eternity in an hour

The coming years will be challenging ones for investors. Returns will be low, and coaxing opportunities out of the landscape will require patience, diligence and dedication. Precisely how Pablo Casals gave us the gift of Bach's Cello Suites.

Michael A. Rosen

Principal & Chief Investment Officer

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