Equity Market Summary

U.S. Equity Markets	2Q	YTD	Top/Bottom Sectors	2Q	YTD	Non-US Equity Markets (in USD)	2Q	YTD	Non-US Regions (in USD)	2Q	YTD
S&P 500	20.5%	-3.1%	Technology	30.5%	15.0%	MSCI AC World Ex U.S.	15.4%	-12.2%	Developed Americas	20.3%	-11.6%
Russell 1000 Growth	27.8%	9.8%	Consumer Discretionary	32.9%	7.3%	MSCI EAFE (Developed)	14.2%	-12.6%	Developed Asia	17.6%	-6.2%
Russell 1000 Value	14.3%	-16.3%	Communica-tion Services	20.0%	-0.4%	MSCI Emerging Markets	17.3%	-7.1%	Developed Europe	15.8%	-12.3%
Russell 2000	25.4%	-13.0%	Industrials	16.8%	-14.8%	MSCI China	15.5%	3.7%	Emerging Americas	19.6%	-34.9%
Russell 2000 Growth	30.6%	-3.1%	Financials	12.2%	-23.6%	MSCI Italy	16.7%	-17.4%	Emerging Asia	18.0%	-3.4%
Russell 2000 Value	18.9%	-23.5%	Energy	30.6%	-35.1%	MSCI Brazil	23.2%	-38.7%	Emerging EMEA	19.8%	-20.4%

What's changed since our last report (on May 31, 2020):

Coronavirus (CV-19) continues to spread but the global rate of infection has slowed to doubling every five weeks from doubling every four weeks. In the U.S. cases are doubling once every seven weeks, but the rate is accelerating meaningfully. States with Reproduction Rates (R_0) over 1 account for more than 75% of U.S. GDP[1]. Early and middle re-opening states are seeing the largest surge in cases. We remain convinced that full recovery is dependent on a widely available and effective vaccine and the odds of an early 2021 option are rising. While large scale production likely remains at least a year away, production has already begun on multiple promising candidates and doses could be available in limited quantities as early as late third quarter.

Where are we now:

CV-19: More than 11.5 million cases (85% M/M rise, down from 88% at May 31) and 535,000 deaths (44% M/M rise, down from 64% at May 31) worldwide. Daily new cases is averaging 185,000 over the past week, up from 110,000 for the week ended May 31. Daily new deaths is averaging 4,500 over the past week, up from 4,200 for the week ended May 31, but still well below the peak of 7,000 in mid-April. The U.S. accounts for ~25% of global cases and deaths. Brazil, Russia, Mexico, India and South Africa are experiencing a surge in cases and deaths.

Market Review:

As the quarter commenced the market had bottomed, but there was still considerable uncertainty. The April/May trajectory was higher as investors got comfortable with fiscal and monetary efforts to backstop the global economy and began to look through to a recovery. The news/data tug-of-war in June led to a flatter trading range with heightened volatility. The S&P 500 ended with a 20.5% return, one of the best quarters on record. The NASDAQ 100, up 30.1%, had its best quarter since 1998. The March bottom is another example of the adage "be greedy when others are fearful". The rise has not been homogenous. In fact, the conversation around the market rise is clouded by the dramatic differences in returns to various segments of the market. Value stocks have underperformed Growth stocks by a margin reminiscent of 1999 during the TMT surge. But even those classifications do not capture the essence of how the market has splintered. Five companies (Microsoft, Apple, Amazon, Alphabet, and Facebook) now make up almost 22% of the S&P 500, a concentration rarely attained. The equal weighted quarterly return of those five stocks was 34.5% compared to 21.7% for the equal weighted S&P 500, a 12.8% margin. They are heralded as new economy companies and together with other disruptors have been the darlings of the rally, especially among young millennials experiencing their first bull market momentum trade.

Given the collapse in consumer spending, it is counterintuitive that the Consumer Discretionary sector would be the best performer during the quarter. Of course, Amazon is almost 40% of the sector. But within the sector some of the best returns are surprising. The best subindustries were auto components, electronics retail, and home-builders - all outpacing Amazon. Financial stocks, which are 10% of the S&P 500, have been laggards. The sector returned 12.2% during the quarter, weighed down by the banks that only managed a 10.1% return. Low net interest margins, the potential for high defaults, and questions about dividends were all overhangs. The recovery trade has not been for the faint of heart. Airlines are -50% off their high and only eked out a 1.8% gain for the quarter, but those willing to take a punt at the bottom have been rewarded with a +48% return. Similarly, restaurants are -15% off their highs. But at one point in June they were +55% above their March low. The quarter certainly was one for the record books. After the steep bear market in the first quarter a 75% retracement of the decline in the following two months gave many investors whiplash.

Market Outlook:

The current frontrunner for a sell-off catalyst is a slower than expected economic reopening. Economic data releases point to a dramatic swoon in activity but most of the

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recent reports have been positive surprises. However, pockets of CV-19 case acceleration still send shivers down investor spines. New CV-19 cases in the U.S. are hitting new highs. While current hospitalizations are also picking up they are far from challenging the previous peak, around 65% of peak levels as of this writing[2]. Flattening the national curve to allow for hospitals to handle the number of patients is still a viable path for most locales with some notable exceptions. For now it seems that a full scale second lockdown is not in the cards and the discussion has moved to learning to live with the virus until a vaccine is found. This could change abruptly, however as the landscape is constantly shifting.

The other cloud on the horizon is the upcoming election. It is still a long way to November, but a Biden win is looking more likely. The campaign is heating up and the rhetoric is growing nasty so the balance could tip either direction. Still, there is a growing possibility of a Democratic sweep. A corporate tax increase and less business-friendly policy are beginning to make their way into investor outlooks. The Baker, Bloom, & Davis Global Economic Policy Uncertainty Index spiked to new highs in June. This ambiguity is likely at least partially responsible for a flatter quarter-end. It is interesting though that high levels of policy uncertainty consistently lead to positive future returns. Yet, that uncertainty generally occurs closer to market lows and reflects a rebound. The indicator may not be as effective when a big recovery has already happened and the resolution of the policy question is a less business-friendly environment. But as demonstrated in the 2016 election sometimes an assumed negative outcome proves positive for markets.

The bullish contingent regularly points to policy stimulus. One of the first rules learned in Investing 101 is “don’t fight the Fed.” Today the bears are fighting the Fed, the ECB, the BOJ, the PBOC, Congress, the Bundestag, and the EU Recovery Fund, amongst others. Neither fiscal nor monetary policy has ever been this large or swift. This is especially so in the U.S., and a new round of stimulus is growing more likely. A multitude of economic indicators are pointing toward a global inflection. Purchasing managers’ indices have universally bottomed. The U.S., China, and France June surveys are even showing expansion. Dr. Copper, a strong indicator of global activity, is +30% off its bottom. Baltic Dry container ship rates are going straight up and some ship classes are in short supply. Oil prices have achieved a nascent recovery. The U.S. Citi Economic Surprise Survey ended the quarter at record highs showing momentum is quickly shifting. The G10 survey is more moderately positive and rising. This global momentum is important to U.S. large cap earnings, of which ~40% are derived from overseas. A synchronized global expansion would be a powerful earnings driver.

The consumer is still key to a U.S. recovery. Compensation is set to decline in 2020, but this may be offset by government payments. But savings is elevated due to uncertainty. The key to any recovery will be better job certainty, which will not only drive higher income, but also release some of that savings to consumption. Consumer confidence is off of the bottom but still miles from what would be considered normal.

Consensus currently expects S&P 500 earnings per share to bottom in 2Q20 with the full year dropping to a level roughly equivalent to the 2014-16 earnings recession. You could say that this recession wiped out six years of growth. That compares to the three years erased during the 2001-02 recession and six years during the 2008-09 dip. A full recovery to pre-pandemic levels is expected by 3Q21. This timeframe seems aggressive to us given the limitations on business activity likely to continue until a vaccine is found. Even after that the economy will take some time to sort out what “normal” will look like. But we also recognize the potential for pent-up demand and significant liquidity as a possible upside surprise. Most investors are looking through the current earnings recession to the recovery late next year. Shorter term, only 49 of S&P 500 companies have provided guidance for the upcoming reporting season. Normally that number is closer to 100, so surprises could be strongly positive or negative. This is apt to add to the volatility thesis for the market in the near term.

Like many of our peers our head tells us this market has run too far too fast and is due for a correction. However, in a world where the returns on bonds are close to zero, the outlook for real estate is uncertain at best, hedge funds are struggling, etc., the search for future returns becomes difficult. Investors have been hoarding cash and are now looking for places to spend it. Segments of the stock market appear to be the best candidates. The run up in stock prices while earnings expectations have fallen has ignited a heated debate about valuations. Market multiples have skyrocketed. The second quarter bounce probably has eaten into future stock returns, but that does not mean a dramatic correction is necessarily the outcome. It may mean that the market trades sideways with continued high volatility. Given the opposing forces of positive and negative news, reversals are a natural condition for the current environment, and a state that is expected to continue. Yes, multiples are high. But that is not unusual for trough earnings in cyclical sectors where expectations are starting to bottom and even beginning to improve in some cases. Multiples for new economy stocks are a different story. Many of them have legitimate earnings growth. How do you value earnings growth in such an uncertain time with interest rates at such low levels? Multiples are very high on 2020 expectations, but easier to defend if 2021 and 2022 consensus is close to correct given the outlook for continued low interest rates.

For the foreseeable future this market is set to continue to be news driven and volatile. Valuation has proven time and again to not be effective at predicting turning points. With earnings expectations stabilizing, interest rates low, plenty of liquidity in the system, and a market that has recovered 75% of its downdraft, a period of sideways movement is our base case.

[1]: Strategas Securities, LLC, June 2020, All rights reserved;
[2]: The COVID Tracking Project at The Atlantic

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