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ASSET MANAGEMENT

2020 – 2nd Quarter Review & Outlook

Economic and Investment Review

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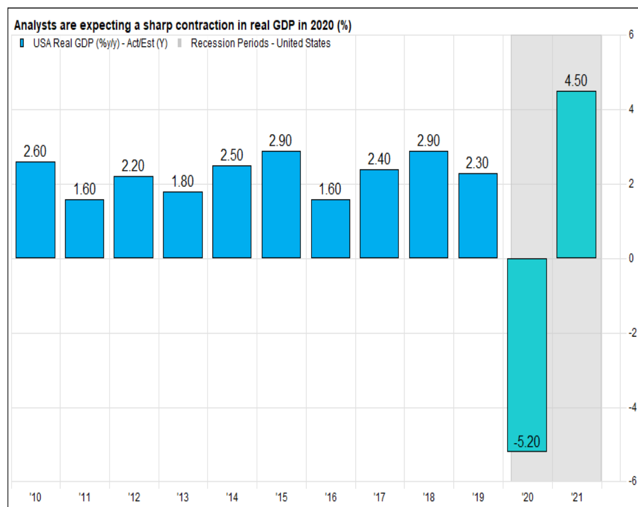
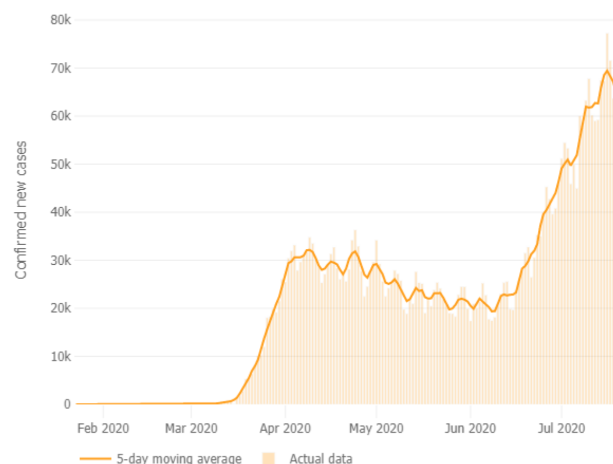
Economic Growth: Real GDP declined 5.0% in Q1 2020. The consensus estimate is -33.3% for Q2 2020 q/q, -9.6% for Q2 2020 y/y, -5.2% for 2020 and 4.5% for 2021. Economic impacts of the COVID-19 Coronavirus have been devastating. It is likely that the current recession will be the largest since the Great Depression. However, it is



Source: FactSet

expected that the recession will be relatively short. Businesses started to reopen in May and June but have since slowed or reversed the process in July as new cases of the Coronavirus have surged on a national and global basis.

U.S. New Coronavirus Cases Confirmed



Source: Johns Hopkins University of Medicine

If efficacious treatments or a vaccine is developed as soon as many anticipate, the recession should give way to renewed growth.

It was feared that COVID-19 related unemployment could exceed 20%, however it appears to have topped out at 14.7% in April. Still, this was the highest level seen since the Great Depression. The unemployment rate has since declined to 13.3% in May and 11.5% in June. Prior to the pandemic, unemployment had reached a 50-year low of 3.5%. It is largely anticipated to take at least several years to return to the same unemployment rate ballpark. There is concern that some job losses may become permanent in certain areas particularly with small businesses impacted by social distancing.

Retail spending has shown improvement over the last two months as consumers have increased purchases of autos, RVs, furniture, clothing and electronics. Auto sales were up due to pent-up demand and commuter hesitancy to jump back on mass transit. RV sales are up as consumers look to vacation without international travel, cruises, flying

and staying in hotels. Other sales are a response to stay-at-home and work-from-home situations. The coming months could be more difficult due to resurgence in the virus.

The Wall Street Journal recently reported that retailers are on track to close as many as 25,000 stores this year due to the impact of the Coronavirus and an ongoing shift to more online sales. Sales are also likely to be negatively impacted by the dire situation that many renters find themselves in. The Census Bureau reports that nearly 12 million adults live in households that missed their last rent payment and 23 million have little or no confidence in their ability to make the next one.

Given the stress that many renters are experiencing, it may seem surprising that housing, as measured by mortgage applications, has picked up. Historically low interest rates and a move from urban areas to suburban and more rural areas appears to have legs. Desire for greater distancing related to the virus, more work-from-home flexibility and greater safety related to civil unrest seem to be primary factors.

The Federal Reserve has been very active in its effort to provide support to the economy and markets. The Fed Funds target rate range is currently 0.00% to 0.25%. The Fed reduced the target rate twice in March by 0.50% and 0.75%. Low interest rates will likely continue to encourage investors to increase investment in riskier assets in a search for higher income and returns.

The Fed has taken extraordinary measures to add liquidity to the markets in an effort to keep them functioning in reasonable order. The Fed has added the purchase of corporate bonds and several lending facilities to their strategy.

The U.S. federal government has attempted to provide a temporary safety net for individuals, companies and state and local governments through a multi-trillion-dollar fiscal package. The hope is that this fiscal package and more like it to come will help individuals, households and families to reduce the impact of the recession until a vaccine can be developed.

The concern for unprecedented government borrowing has taken a back seat for the need to mitigate the impact of the virus. So far, the U.S. government has had no problem borrowing and interest rates are expected to remain low for an extended period of time. However, there will eventually be a reckoning when dealing with a record high debt to GDP ratio. If the future economy grows at just average rates then reality will set in with a decrease in government spending, an increase in tax, or both.

Many are concerned that the enormous amount of monetary and fiscal stimulus being pumped into the economy will lead to higher inflation. However, in order for the stimulus to result in higher inflation, demand would also have to increase. There has been some improvement recently; however, overall demand for goods and services is down significantly. Even so, this may not always be the case. Dr. David Kelly – JPMorgan Chief Global Strategist - stated that "Inflation has been subdued for years. However, we could see a change in that dynamic over the course of the recession and following expansion. Lower oil prices and diminished demand has been disinflationary thus far, but once the economy stabilizes, there is a risk of a spike in inflation due to massive fiscal and monetary support provided by the U.S. government and Federal Reserve."

The November election is quickly approaching. A possible change in the Presidential administration and Senate majority could have significant impact on the economy and investments. One specific area of impact looks to be tax. The Joe Biden tax plan has been significantly influenced by Bernie Sanders. The tax rate on income over $400,000 would increase from 37.0% to 39.6%. Income over $400,000 would be subject to Social Security payroll tax. Currently, wages up to $137,700 are subject to Social Security payroll tax of 6.2%. Capital gains for individuals with incomes greater than $1 million would increase from 20% to the proposed ordinary income tax rate of 39.6%.

Additionally, the Biden plan would have impact on wealth transfer. Currently when an individual passes away there is a step up in basis of holdings passed on to beneficiaries. The Biden plan would eliminate

the step up and capital gains taxes would be imposed upon the transfer of wealth.

Equity Markets

Company profits are down significantly due to the COVID-19 caused recession. It is anticipated that the economic recession will result in an even longer earnings recession. Past earnings recessions have typically lasted 2 – 3 years. The rapid equity market recovery indicates that a faster than average earnings recovery is anticipated.

The U.S. equity market's recovery from March lows is quite remarkable. Typically, investors will judge valuations levels on a combination of lagged and prospective earnings. Lagged earnings are only meaningful if they are used as a base to build on. Prospective earnings are subject to change due to economic variables. Earnings growth for the S&P 500 in 2019 was a modest 1.46%. The consensus estimate for EPS growth in 2020 is -21.85%.

Based solely on these numbers few would expect the recovery that has taken place. However, investors' spirits are buoyed by an expectation for a vaccine and a strong recovery in earnings growth in 2021. The consensus estimate for EPS growth in 2021 is 28.63%. This combined with very low interest rates and unprecedented support from the Federal Reserve provide significant support to equities.

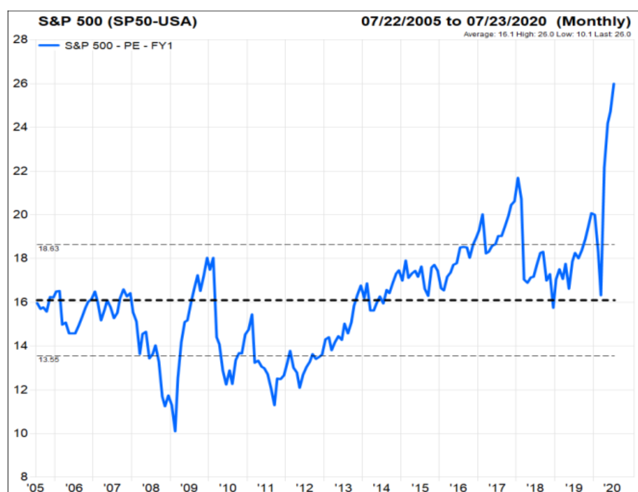
These factors have allowed investors to look beyond the virus/recession valley to the recovery hills and mountains on the other side. However, even with all this support, valuations look to be stretched. The Price/Earnings multiple for 2020 may be meaningless but it still provides some historical context. Prior to the current recession, P/E multiples have peaked in the 20X – 22X range over the past five years.

Source: FactSet

Looking at the same P/E chart for 2021 we can see that we are already in that range well in advance of the actual time period.

Source: FactSet

The S&P is at 3,261 as of this writing. The 12-month consensus target price for the S&P 500 is 3444. This target price indicates a 5.6% upside from current levels. The Price/Earnings multiple required to reach the target price is 21.2X the 2021 EPS estimate and 18.5X the 2022 EPS estimate. The P/E multiples are significantly above long-term averages and near +1 standard deviation from the mean one year in advance.



Source: FactSet

A Yardeni Research study dated July 21, 2020 shows that FANG stocks (Facebook, Amazon, Netflix, Google/Alphabet) add 2.0X to the S&P 500 forward P/E multiple alone.

Due to the unprecedented Fed activity, determining reasonable P/E multiples seems to be more of an art than a science currently.

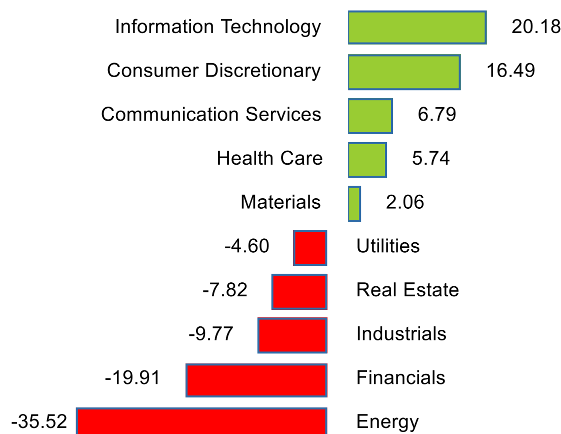
The S&P 500 was up 20.54% in Q2 but remained negative (-3.08) on a year-to-date basis through June 30th. Large cap growth stocks continued to leave large cap value stocks well behind. Mid cap and small cap stocks rebounded strongly in the quarter but continue to lag their large cap counterparts by a considerable margin YTD. Developed international and emerging market stocks also rebounded in the quarter but remain in negative territory YTD.

2020 Q2 Returns				
EQUITY	**Q2 2020**	**YTD 6.30.20**	**1 Year 6.30.20**	**3 Years Annualized**
S&P 500	20.54	-3.08	7.51	10.72
S&P 500 Value	13.15	-15.52	-4.46	3.74
S&P 500 Growth	26.23	7.93	17.75	16.73
Dow Jones Ind Avg	18.51	-8.43	-0.54	9.07
S&P Mid Cap 400	24.07	-12.78	-6.70	2.39
S&P Small Cap 600	21.94	-17.85	-11.29	0.56
MSCI EAFE	12.80	-10.25	-3.83	1.74
MSCI Emerging Mkts	16.85	-5.38	1.73	4.86

Source: FactSet

The Information Technology and Consumer Discretionary economic sectors continue to lead year-to-date performance by a large margin. It may be surprising to see that the Consumer Discretionary sector is a YTD total return leader. The Consumer Discretionary sector includes the Hotels, Restaurants and Leisure industry that has been so negatively impacted by the virus/recession. However, the sector is being dominated by the mega-market cap of Amazon and strong contributors like Home Depot.

YTD Total Return Change - Top/Bottom 5



Source: FactSet

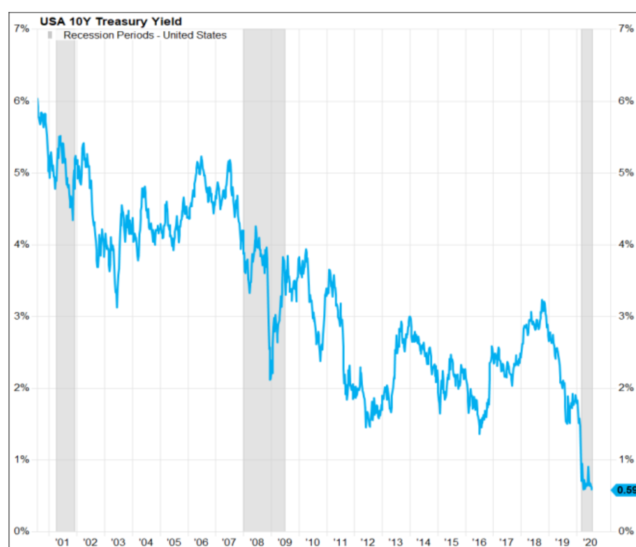
Financials continue to struggle in the low interest rate environment and due to increased non-performing loans and mortgage delinquencies. Energy has been the worst laggard due to demand dropping off during the recession while supply remains near historical highs.

I think it bears repeating that dividend yield for the market weighted S&P 500 companies exceeds the yield for the 10-year U.S. Treasury by a wide margin. The dividend yield of the S&P 500 has declined with the market rally but is still at 1.8% compared with the yield to maturity for the 10-year U.S. Treasury of 0.58%. However, the caution light is flashing. As mentioned last quarter, there are a number of companies reducing or suspending their dividends. Goldman Sachs expects dividend suspensions, cuts, and eliminations will result in S&P 500 dividends per share falling by 25% vs. 2019 levels. Companies will also preserve cash by slashing capital expenditures and share buybacks. Because of these changes, it

becomes even more important to actively select companies with strong balance sheets. It is also important to search for companies that can weather a sharp recession and social distancing and companies that will succeed in a recovery.

Fixed Income Markets

Investors primarily use fixed income investments for income generation and as a tool to manage overall portfolio volatility. Income generation has been challenged due to low rates. The 10- year U.S. Treasury remains at historical low yields.



Source: FactSet

The question then becomes how has fixed income performed in the current recessionary period. There is no question that there was a significant shock to the asset class for a short period of time until the Fed took action to calm the markets. Both taxable bonds and municipal bonds ultimately provided shelter from the storm in the first half of the year. Taxable bonds, as represented by the Bloomberg Barclays U.S. Aggregate index, were up 6.14% YTD through June 30. Municipal bonds as represented by the S&P Municipal Index were up 2.00% during the period.

High Yield bonds generally perform more in line with the equity markets. High Yield bonds, as represented by the Bloomberg Barclays High Yield Index, declined -4.43% during the first half of 2020 as spreads increased markedly. Spreads increased as concern for defaults increased and investors reduced allocations in an effort to decrease perceived risk. However, the lower quality bonds rebounded 9.0% in Q2.

2020 Q2 Returns				
FIXED INCOME	**Q2 2020**	**YTD 6.30.20**	**1 Year 6.30.20**	**3 Years Annualized**
B B US Agg Bond	2.90	6.14	8.74	5.32
S&P National Muni	2.44	2.00	4.23	4.07
B B High Yield	9.00	-4.43	0.60	3.07

Source: FactSet

Municipal bonds have historically been one of the least risky investments available. The virus and its impact on state and local economies has put municipal issuers under varying levels of credit stress. The entire municipal bond market has been placed on negative outlook by the rating agencies. It is likely that there will be credit rating downgrades if the virus continues to impact businesses and related tax revenue. However, downgrades do not necessarily mean defaults. In the current environment it is even more important to focus on higher quality issuers.

Return for fixed income investments in 2020 will likely be largely confined to income generated by coupon payments adjusted for premiums or discounts. However, an allocation to fixed income remains important. In the event of another equity market decline, fixed income and particularly investment grade fixed income should again act as a buffer.

Disclosures

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