Market Review & Outlook

July 2020

Only half way through and 2020 has been a year for the history books. Anyone paying attention has likely grown tired of hearing "unprecedented" or "historic" to describe recent events, be it the financial market turmoil brought on by the global coronavirus pandemic or the social unrest that has broken out in the U.S. and much of the West. Coming into the year, most forecasts for the markets and economy, at least domestically, were modestly positive. While the global economy outside of the U.S. looks to have peaked back in January 2018, the domestic economy continued to grow, with both the bull market in stocks and the economic expansion setting records for duration back in mid-2019. Certainly, there was data indicating the economy was slowing, particularly in the manufacturing sector, but U.S. stocks rose 31% last year and consumer spending remained relatively resilient. Then, in late January and February, the coronavirus spread beyond Asia to the rest of the world with many nations instituting various lockdown measures aimed at preventing its spread, measures that took a serious toll on the global economy. Most economic indicators, both in the United States and around the world, fell to levels not seen since the Great Depression, if ever.

Index	June 2020	2nd Qtr. Perfomance	One Year Performance	Description (what the index is comprised of)
S&P 500	1.99%	20.54%	7.51%	Large cap stocks
DJ Industrial Average	1.82%	18.51%	-0.54%	Large cap stocks
NASDAQ Composite	6.07%	30.95%	26.94%	Large & mid cap tech stocks
Russell 1000 Growth	4.35%	27.84%	23.28%	Large cap growth stocks
Russell 1000 Value	-0.66%	14.29%	-8.84%	Large cap value stocks
Russell 2000 Growth	3.84%	30.58%	3.48%	Small cap growth stocks
Russell 2000 Value	2.90%	18.91%	-17.48%	Small cap value stocks
MSCI EAFE	3.40%	14.88%	-5.13%	International stocks
MSCI EM	7.35%	18.08%	-3.39%	Emerging markets stocks
Credit Suisse HY	0.92%	10.00%	-1.78%	High Yield Bonds
Bloomberg Barclays US Aggregate Bond Index	0.63%	2.90%	8.74%	Primarily U.S. Government Bonds

Once it became apparent the coronavirus was going global, stock markets around the world began to crash in late February, with the S&P 500 dropping 35% through March 23. Central banks and governments around the world quickly stepped in to provide dramatic amounts of stimulus designed to provide market liquidity and relief for affected businesses and workers. That stimulus, at least thus far, appears to have worked, as the breathtaking 40%+ rally in stocks since March 23 has nearly matched the shock of the initial 35% decline. We say "initial" because most analysts, at least a couple of months ago, seemed quite sure that stocks would need to "retest the lows" and that the ongoing rally was almost certainly a bear market rally. In other words, if history were any guide, stocks would eventually revisit March 23rd levels (or possibly go lower) given the magnitude of the economic damage. Of course that is still a possibility, but the re-opening of the economy, even when factoring in the recent virus case spike, seems to be going "better than expected," at least according to official government statistics. And stocks have reacted accordingly…if this is a bear market rally, it is one of the most impressive in market history. For a closer look at how various asset classes performed in recent periods, please refer to the table.

To be sure, there are good reasons to be skeptical about the durability of the rally. Stocks were arguably priced for perfection entering the year. If you recall, the market took a 20% tumble back during the 4th quarter of 2018 when the Federal Reserve was signaling its intent to "normalize" interest rates after holding them at zero for many years following the 2008-2009 financial crisis. When it turned out that financial markets did not like that idea, the Fed made perhaps the starkest policy reversal since it came into existence back in 1913. Completely changing its tune at the beginning of 2019, the central bank backed off on increasing rates, stocks reversed their sharp year-end 2018 decline, and the S&P 500 staged an impressive 31.5% advance last year.

We say impressive because according to the numbers, corporate earnings in the U.S. peaked in the 3rd quarter of 2018 and have barely grown since 2015. To the extent that earn-

ings did grow, that growth was really more about earnings per share (EPS) rather than aggregate earnings. The financial press has written extensively about this, but research has demonstrated that much of the rally in stocks in recent years has been driven by corporate stock buybacks. Corporate earnings are reported in EPS, which is measured by dividing a corporation's earnings by the number of shares of the company's stock that trade on the open market. The ability to grow EPS is frequently a determining factor in compensation packages for C-suite executives, so there is definitely an incentive to try to boost this number by any means possible.

The corporate tax cut of 2017 coupled with historically low interest rates (i.e., companies can borrow on the cheap) meant that firms have had more cash flow to go into the market and purchase and retire their own shares, with a subsequent rise in EPS. If earnings are divided by a fewer amount shares, EPS goes up. While the headline numbers may look better, they do not always reflect a real rise in profitability, and stock buybacks have played a much bigger role recently in the growth of EPS than they did even 10 or 15 years ago. Generally speaking, share prices rise and fall based on the EPS numbers. With the economy now digging its way out of a deep recession, many corporations have scaled back or altogether cancelled stock buyback programs, programs that have been the main source of stock demand in recent years. While it's unclear what effect this will have on share prices going forward, there will almost certainly be a (negative) effect.

Notwithstanding this, there has been much optimism surrounding the re-opening of the economy and the potential development of a coronavirus vaccine. The 40%+ rise in stocks since late March clearly reflects this optimism, even if many feel like the market has gotten ahead of itself in an environment characterized by historically weak economic fundamentals. First, there are serious questions about whether a coronavirus vaccine may ever be developed. What many don't realize is that coronavirus, aside from the recent specific usage referring to COVID 19, is a more generic term that refers to a wider family of viruses, including the common cold, of which there are dozens, if not hundreds of strains. There has never been a vaccine developed for a coronavirus, despite widespread efforts to develop one. A major problem is that these viruses tend to mutate rapidly, meaning there's no certainty that a vaccine will be developed soon, or possibly ever.

Apart from that and other questions about what letter shaped recovery may take place, (be it a V-shaped, a W-shaped, or L-shaped, etc.), another big elephant in the room is the extreme valuations in the stock market. We've mentioned in past missives that valuation is a poor indicator of short-term market action, while having a good record of forecasting longer-term performance. According to many valuation measures, the average retail investor likely has no clue that stocks are more richly valued than at any time in history, even compared to the internet/technology bubble market of the late 1990's. Back then, the overvaluation was mostly a symptom of the highly priced large cap technology stocks. Now, the average stock is more expensive than back then, a time when the market was poised for a near 50% haircut. While no one can predict the future, caution seems a prudent approach based on the current poor economic fundamentals and an extremely uncertain outlook. We agree that investors must respect the price action in the markets, at the same time, we just wish the price action was taking place in the absence of Fed intervention. We do cringe hearing the saying that "this time is different," while at the same time rationally arguing that the rally has been a gift, and has given time to those who were caught off guard by the panic of late March to reposition their portfolios for financial conditions that are likely to continue to be volatile.

At the same time, it's difficult to know how effective the stimulus measures taken by the Fed, other central banks, and governments will be over time. The Fed has stated it will print as much money as it takes to quell the current crisis. For now, that has had the intended effect of stabilizing financial markets, but how will printing trillions of dollars in the span of a few months (with more likely to come) work out down the road? We read a comment on Twitter recently that made an impression – "bears sound smart, bulls make money." Over recent history, this has been true, though there are many ways to slice and dice the data while cherry picking time frames to measure. Our humble opinion is that things reverting to pre-coronavirus economic and market conditions is too sanguine of an outlook, but then we think we are often too pessimistic on the market. Please evaluate your current situation and contact us if you would like advice. We will be happy to assist.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you need investment advice, please contact your firm's designated consultant or me. You can reach me at extension 1178 (510-740-4178) or at john.w@wespac.net. John Williams, Manager of Advisory Services – WESPAC