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MARKET COMMENTARY

October 1, 2020

THE GREAT SNAP BACK

Economies are not designed to stop. Prices can rise or fall, demand will wax or wane, but like a shark that must swim to breathe, movement is essential to its proper functioning. The exchange of goods and services frequently slows, but rarely does it grind to a halt.

We got awfully close in the second quarter, when gross domestic product (GDP) declined 31.7% at an annualized rate(1). Throughout the 20th century there are few parallels. Even in the throes of the Great Depression, GDP 'only' declined 12.9% in 1932. Unemployment shot from 3.5% in February and peaked at 14.7% in April(2). While not as high as the Depression, most of us haven't seen this level of unemployment in our lifetimes and never have so many jobs been lost so fast.

All of this is to say from an economic perspective, the COVID-19 pandemic is a sample of one. Forecasters typically start by identifying a precedent, asking what happened in the past and hypothesizing if this period is likely to be similar. Many are fond of saying that history doesn't repeat itself, but it often rhymes. If that were true, 2020 would be the word 'orange.' Nothing comes close.

As unprecedented as the decline was, both health and economic data continue to improve. New cases of COVID-19 peaked on July 17th and seem largely in a downward trajectory(3). Third quarter GDP growth estimates have risen from 13% in April to 25% in September(4). Unemployment has fallen from 14.7% in April to 8.4% in August(5). While things are still bad, they are getting less bad quickly.

While no one can say what level of stimulus was appropriate to rouse the sleeping giant that is the American consumer, it looks like it did the trick. Existing home sales in July were the highest since 2007(6). While auto sales are still down year-over-year, they are up 71% since April(7). Retail sales in June and July were higher than 2019(8) as shoppers treated their COVID-fatigue with a dose of retail therapy (additional unemployment benefits likely didn't hurt).

The snap back has been almost as rapid as the decline. Congress, the U.S. Treasury and the Federal Reserve all acted in concert to limit permanent damage to the economy. While additional jobless benefits expired in July and unemployment is consistent with a severe recession, economic data continues to improve. While it could still be years before the U.S. economy reaches its prior peak, the trajectory is clearly one of expansion. Whether a second wave of infection derails this is anyone's guess.

Of course, the economy is not the stock market, but a rapid improvement in fundamentals was not lost on investors. April to August marked the best five-month period of returns since 1938[9]. We highlighted in our last quarterly letter that a sharp recession made for a strange backdrop for a bull market. It would be remiss if we didn't point out that the stock market doesn't care as much about the present as it does about the future. If one plans to own a business for 20 years, its return in the first year is of little consequence.

The current estimate for S&P 500 earnings in 2020 is $130 per share[10]. At $3,350, that would be decidedly expensive. However, the estimate for 2021 is $165[11]. Should the recovery continue its current trajectory, that would equate to a multiple of 20 times earnings, which while historically elevated, isn't unreasonable given prevailing interest rates. Should we see a resurgence in COVID cases, we would expect a decline in equities, although not approaching the levels seen in March and April.

Not surprisingly, we find ourselves thinking more about the long term rather than the next 18 months. We view the actions of the Fed as entirely appropriate to both mitigate damage to the economy and to limit human suffering. But it was not without cost. The Congressional Budget Office projects that Federal Debt held by the public will exceed 100% of GDP by the end of year. This is higher than the Great Depression and it may eclipse WWII. This has implications for tax rates in the future, as well as debt service. The market has come to the same conclusion which explains why the U.S. Dollar has weakened materially since March. After many years of 'U.S. is Best,' it now seems that other countries may experience faster economic growth given their handling of the COVID-19 pandemic.

Real interest rates are currently negative (as measured by 10-year TIPS break-evens)[12]. Said another way, if you buy a 10-year treasury, and inflation remains where it is today, your purchasing power will actually decline. While stock prices are high by historical measures, we believe it is rational to pay a high multiple for a productive asset when capital is cheap. Negative real rates have long term implications for growth as well as the soundness of our currency. One shouldn't look at a 10-year US treasury yielding 67 basis points and conclude that all is right with the world.

While equity valuations strike us as highish, they may not be as high as they seem. The Fed has successfully reduced many other sources of return to be negative in real terms, leaving equities as one of the few games in town. Many have pointed to the strong rise in tech shares as signs of irrational exuberance. While there are obvious examples of froth (when is there not?) comparisons to the dot-com bubble don't strike us as wholly accurate. As an example, Amazon reported 40% sales growth in the second quarter, operating profit almost doubled year-over-year and is up by a factor of eight since 2017[13]. While it's true that multiples have certainly expanded, reality has done a fairly good job of keeping pace.

Every market presents its own fresh reason to worry. Our job as allocators of your capital is to assess those risks, identify investments that have a strong probability of returning capital and providing a reasonable return. Some argue you should sell stocks because of the prospect of a second wave, or because this election has the potential to be highly contentious.

We remind ourselves that not everything can be handicapped and that market-timers have a particularly poor track record. If COVID cases remain in their downward trajectory, unemployment continues to fall, rates stay low and companies continue to report better than expected earnings, we would expect decent returns, although not gangbusters. Our philosophy of buying high quality businesses with strong balance sheets and long investment runways still seems appropriate given the circumstances. We appreciate your confidence and trust in our firm, and as always, if you have any questions, please don't hesitate to reach out to your relationship manager.

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Sources: (1) Bureau of Labor Statistics (8/27/20); (2) Bureau of Labor Statistics (8/20); (3) Wikipedia (8/9/20); (4) FactSet Research Systems (9/16/20); (5) Bureau of Labor Statistics (9/4/20); (6) FactSet Research Systems (9/16/20); (7) Federal Reserve Bank of St Louis (8/1/20); (8) FactSet Research Systems (9/16/20); (9) Wall Street Journal (8/31/20); (10, 11, 12 & 13) FactSet Research Systems (9/5/20)

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