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Second Quarter 2020 Newsletter

Fig. 1 – S&P 500

Fig. 2 – U.S. 10-Year Treasury Yield

Stocks bounced back strongly in the second quarter of 2020. The large cap S&P 500 index (**Figure 1**) posted a total return of +20.5% on hopes of economic recovery. Other indices also registered strong gains. The S&P Mid Cap 400 index finished +24.1%, and the Russell 2000 Small Cap index led with a gain of 25.4%. The rally in the U.S. was led by technology, and growth stocks outperformed value by a wide margin. Many tech companies gained from the stay at home environment, helping with remote work and providing digital entertainment.

International bourses posted solid but smaller gains. MSCI's Emerging Markets index rose 18.1%, while the Europe, Australia and Far East index recovered 14.9%. All of these indices are still negative year-to-date, but the S&P 500, at -3.1%, is approaching break-even.

Earnings estimates for U.S. stocks have fallen precipitously since the beginning of the pandemic. According to Zacks Research, second quarter S&P 500 earnings are expected to fall 44.1% on 10.9% lower revenues, following the 13.2% drop in the first quarter. All sectors except Utilities are expected to post declines, with Energy stocks (-139.4%) suffering the most. Energy companies have been hurt by falling demand and the sharp drop in oil prices. For the full year, earnings are expected to be -24.2% lower. Late in the quarter, negative revisions began to ease modestly, which has aided stocks. As companies report earnings this month, investors will be looking well past current results for signs of improvement later in the year and in 2021.

Economic news through the past quarter was generally bleak but began to improve in June. With stay home orders in place across the country and non-essential businesses closed, economic activity slowed sharply. Gross domestic product (GDP) in the first quarter was -5%, and further shrinkage is expected in the second quarter.

Stock markets bottomed at the end of March and rose consistently in the second quarter. The Federal Reserve's decisive bond-buying and lending initiatives bolstered investor confidence. Thus far, there have been few major bankruptcies and the banking system has functioned effectively. In addition, the federal CARES Act provided relief to businesses, slowing the loss of jobs. Unemployment benefits were enhanced and extended, which has helped maintain a floor on consumer spending.

Many economic indicators improved during the quarter, but from extremely low levels. Permits for new home construction bounced back in May, after hitting a 5-year low in April. June purchasing manager surveys for both

Index returns taken from Morningstar.com

manufacturing and services indicated expansion, after three months of contraction. Retail sales in June increased more than expected over the prior month but are still down substantially from 2019. Employment also began to recover in the quarter. The economy added 4.8 million jobs in June, far more than the 3.5 million expected. However, the unemployment rate remains very elevated at 11.1%. Many sectors, such as dining and travel, are still at historically low levels, and this will likely slow rehiring for many workers. Case growth has accelerated in California, Texas and Florida, the three largest states, putting additional pressure on reopening for these interpersonal industries.

The U.S. economy is estimated to have contracted at an annual rate of close to 35% in the second quarter. Markets tend to look ahead six months or more, and economists now expect growth to resume in the third quarter. However, given the uncertainties caused by the virus, the U.S. may not reach pre-Covid-19 levels of activity for another year or more. Slack in the economy is likely to keep inflation under control, and long-term interest rates are likely to stay low for the foreseeable future (**Figure 2**). Homeowners should be using this time to review and possibly refinance their mortgages, which will lower their interest expenses and increase discretionary cash flow.

The rest of the world is of course also dealing with the pandemic, with varying levels of success. Several of Europe's biggest countries, including Germany and France, have been able to significantly slow the pace of infections, and reopen their economies. China, South Korea, and other parts of Asia have also largely reopened after early struggles. Demand for basic metals, such as copper (**Figure 3**), has bounced back strongly, a sign of global economic recovery. Emerging market stocks have lagged the U.S. for most of the last decade. With attractive valuations, and improving growth, these stocks may be attractive in the coming months (**Figure 4**).

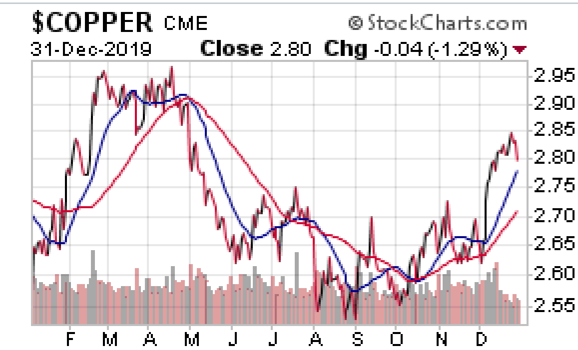

Fig. 3 – Copper

Fig. 4 – iShares MSCI Emerging Markets

We have written before about the difficulty of forecasting changes in the economy and the movement of equity markets. Indeed, stock performance over the past three months was probably stronger than most investors expected. Investors who maintained their asset mix were rewarded with at least partial recovery. In the coming months, markets will almost certainly see further volatility, but the path forward, with quicker isolation of outbreaks, better treatment for the sick, and numerous vaccines under development, does seem hopeful.

Once again, we hope that you and your loved ones are well, and look forward to speaking with you soon.

Best regards,

Kenneth M. Bernard, CFA