Second Quarter 2020 Market Newsletter

Table 1: Market indices

(*Returns include dividends*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	20.54%	-4.05%	7.51%	10.73%	10.73%
S&P Mid Cap 400	24.07%	-12.78%	-6.70%	2.39%	5.22%
S&P Small Cap 600	21.94%	-17.85%	-11.29%	0.56%	4.48%
MSCI Emerging Markets	18.18%	-9.67%	-3.05%	2.27%	3.24%
MSCI EAFE	15.08%	-11.07%	-4.73%	1.30%	2.54%
Investment Grade Credit (C0A0)	9.27%	4.84%	9.32%	6.27%	5.69%
Non-Investment Grade Credit (H0A0)	9.61%	-4.78%	-1.06%	2.94%	4.58%
Bloomberg Commodity Index Total Return	5.08%	-19.40%	-17.38%	-6.31%	-7.69%
Dollar Index (DXY)	-1.67%	1.04%	1.31%	0.61%	0.40%
Vanguard Total Bond Market Index (VBMFX)	2.95%	6.29%	8.84%	5.24%	4.21%
10 Yr Rate	% 06/30/2020	2.00% 12/31/2019	3.06% 06/30/2019	1.61% 06/30/2017	2.51% 06/30/2015

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 07/07/2020			
	Latest Release	Recent Trend	Notes
Non Farm Employment	4.8 Million	Negative	Non farm payroll number was much better than expected. After losing over 22 million jobs the previous two months, jobs are coming back. Unemployment rate is at a record 11.1%
Weekly Claims for Unemployment Insurance	1.427 Million	Positive	Initial claims number are high as jobs continue to be lost, but are considerably lower than a few weeks ago. Four week average is over 1.5 Million
ISM Manufacturing Index (Number over 50 points to growth)	52.6	Negative	Manufacturing activity is picking up as parts of the economy re-opens. Most underlying components of the index, such as new orders and production showed growth last month.
ISM Non Manufacturing Index (Over 50 points to growth)	57.1	Negative	Like manufacturing, non manufacturing is bouncing back after two months of contraction.

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	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	-0.1%	Positive	Consumer prices fell for the third consecutive month as demand was subdued in a recessionary environment. Core prices (excluding food and energy) was up only 1.2%
Producer Prices (Month over month change)	0.4%	Positive	Producer price inflation remains benign. Year over year, core prices (Excluding food and energy) was up only 0.3%
Retail Sales (Month over month change)	17.7%	Negative	After falling precipitously, over the previous three months, retail sales bounced up significantly at the highest rate ever.
Consumer Confidence (Conference Board)	98.1	Negative	Consumer confidence perked up after dropping for 2 months. The re-opening of the economy helped improve consumer sentiment about the current conditions.
Durable Goods Orders (Month over month change)	15.8%	Negative	Like other parts of the economy, durable goods orders shot up in May.
Industrial Production (Month over month change)	1.4%	Negative	Industrial production edged up, but unlike other economic numbers, at a rate less than expected. Supply chain disruptions and weak demand had a negative impact.
Capacity Utilization	64.8%	Negative	Not surprisingly, shutting the economy down has created a considerable amount of slack in the economy.
Housing Starts	0.974 Million	Negative	Housing starts were weaker than expected but permits rebounded suggesting starts may improve in the future.
Home Prices (Case-Shiller 20 city Index- Month over Month)	0.9%	Negative	Home prices have remained stable perhaps because of low mortgage rates. As compared to a year ago, home prices appreciated 4%
GDP (Real, Annualized)	1.6%	Positive	This is before the pandemic started. Second quarter GDP is expected to fall steeply.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ism.ws, www.nahb.org.

Stocks and bonds rallied strongly in the second quarter from the lows set in March. Stocks are still down for the year, but investment grade bonds are up as interest rates are at a record low. International stocks rallied during the quarter but could not keep up with US stocks. Value stocks and stocks of smaller companies are down for the year trailing growth stocks and stocks of larger companies, respectively. A collapse in oil price and a steep drop in metal prices, has depressed the commodities sector, which is down significantly for the year. The US dollar depreciated versus foreign currencies during the quarter but is still up for the year because of the inflows into US quality assets seen earlier in the year.

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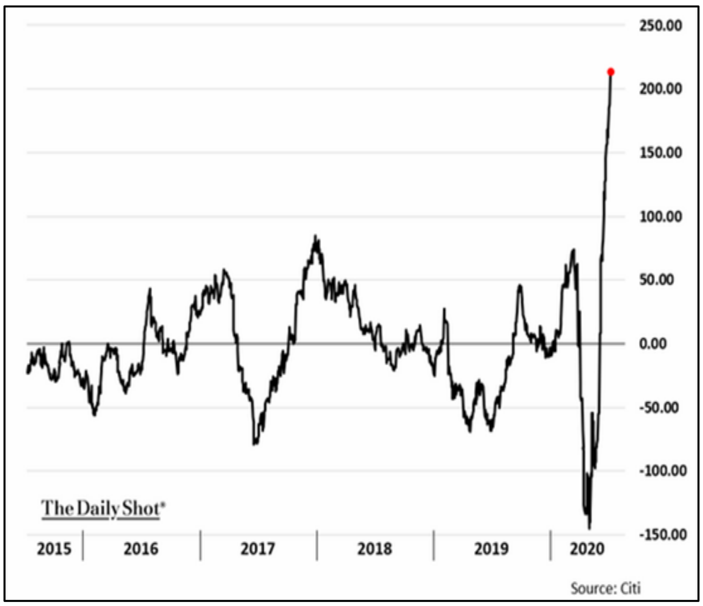
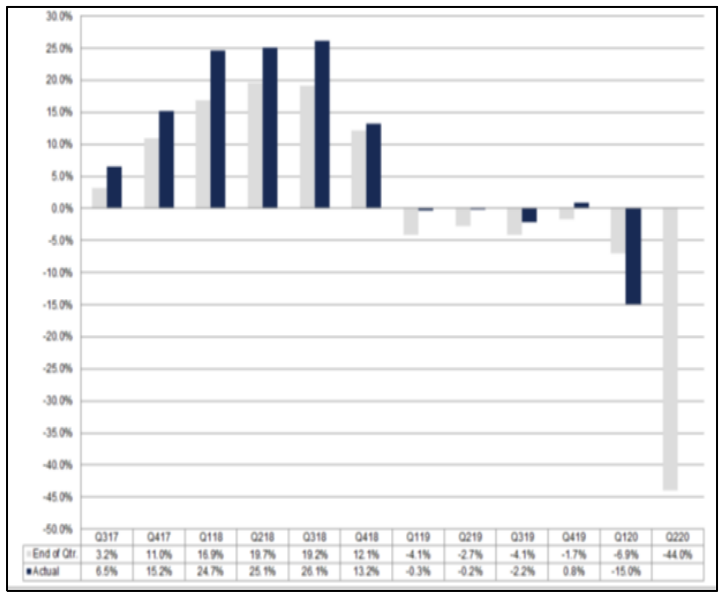
The economy is showing signs of improvement and has bounced off record lows, as seen in the table above. The Citi Economic Surprise index (Fig 1) shows the roller coaster ride of the economy with recent economic numbers improving sharply. The improvement should come as no surprise, considering that the economy was essentially shut down in response to the pandemic and is slowly returning to some semblance of normalcy. However, it still has a long way to go back to where it was before all this started. There is a lot of debate on the shape and path of the recovery and the markets seem to be reflecting a ‘V’ shape recover (i.e a quick bounce back to pre-pandemic levels). However, it is likely that after the initial bounce, the economy may not continue in the same trajectory and the rate of recovery will likely be much slower than the rate of deterioration. The uncertainties facing the markets are political uncertainty around the Presidential election, US-China relations and most importantly the eventual path of the pandemic. On the other hand, as compared to previous crisis, both fiscal and monetary policy reacted much faster, supporting both the economy and the markets. (Fig 3 and 4) The actions of the Federal Reserve (Fed) have provided much required liquidity to the capital markets and the stimulus package of the Government has helped small businesses and the unemployed. Fiscal and monetary conditions are likely to remain easy for the foreseeable future.

Fig 1: The Citi Economic Surprise Index



Source: The Daily Shot/Citigroup

Fig 2: S&P 500 Earnings Growth: Estimate Vs Actual



Source: Factset

Several companies have put their business disaster recovery plans into action including working remotely and in a digital environment. Companies in certain industries such as online retailers and software companies, are faring better than others. As a group, earnings of companies in S&P 500 are expected to drop by over 40% in the second quarter of 2020, according to Factset. However, there is a significant amount of uncertainty around these numbers. According to a Wall Street Journal article, over 40% of the companies have retracted their guidance for the year. In the first quarter of 2020, which was only partially affected by the Pandemic, corporate earnings were worse than expected. (Fig 2). On the other hand, based on the earnings report released so far, earnings are expected to be better than the initial estimates for the second quarter.

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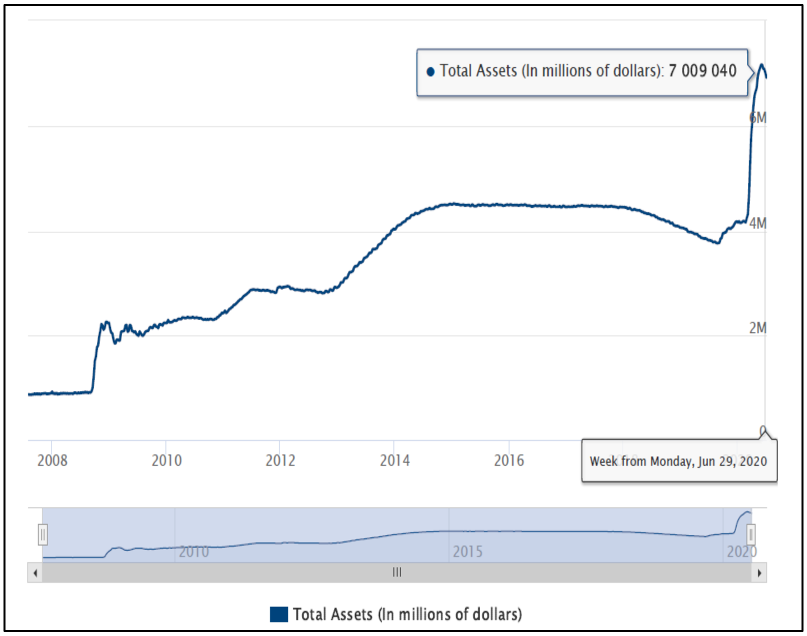
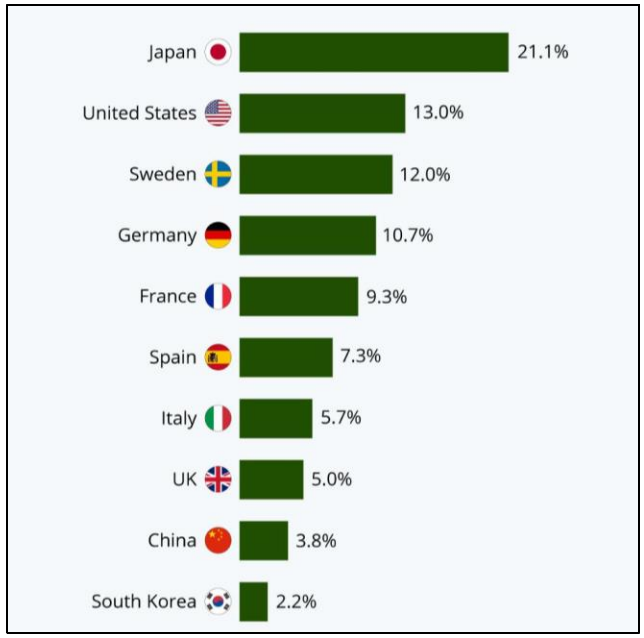
Fig 3 : The Fed’s balance sheet has expanded considerably



Source: The Federal Reserve

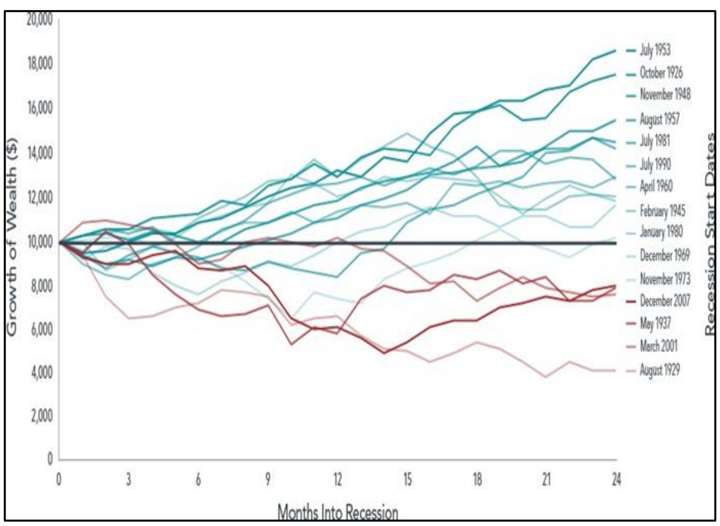
Fig 4: 2020 Fiscal stimulus as a % of GDP



Source: Forbes/Statista

Despite all the uncertainty and dire news, markets continue to rise, because they are forward looking as I discuss in my article [here.](#) The drop in prices earlier in the year, was incorporating the growing chance of a steep recession. The subsequent rally in stocks is in anticipation of an economic recovery, which we are seeing currently. Stocks do a good job of anticipating future economic activity but can overshoot both on the way down and on the way up.

Fig 5: Stock performance after recessions



Source: DFA

Making investment decisions based on perceptions of recessions is not optimal- historically, stocks have had positive performance two years following a recession. In 11 of the 15 instances of recessions in the last century, or 73% of the time, returns on stocks were positive two years after a recession began. The annualized market return for the two years following a recession’s start averaged 7.8%. (Fig 5)

The recent melt up in stocks, is also not a reason to expect subsequent sell off in stocks. As seen in Fig 6, the average one year return (250 trading days) of stocks after the 10 best 3 calendar months (65 trading days) of stock performance is +12.2%. Stocks were up one year later in 9 out of 10 times. There is no guarantee that history will repeat itself this time and there are many reasons to be cautious, but the best bet

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for investors is to own a diversified portfolio, with allocations appropriate to their situation and manage it over the long term. You can be sure, the markets will not go up in a straight line, but the odds of investment success sure do increase with time.

Fig 6: Performance of the S&P 500 after its best 3-month performance

S&P Forward Performance Following Best 65-Day % Changes

	Date	65-Day % Change	+20-Days	+65-Days	+125-Days	+250-Days
1.	6/10/2009	38.8%	-6.0%	11.0%	17.5%	13.1%
2.	11/9/1982	38.7%	-0.8%	3.1%	15.9%	14.3%
3.	1/11/1999	30.2%	-3.8%	4.7%	10.7%	11.0%
4.	3/12/1975	28.6%	0.2%	8.3%	1.2%	19.9%
5.	7/16/1997	25.9%	-1.6%	2.0%	1.7%	25.7%
6.	4/17/1991	24.9%	-5.6%	-1.6%	-1.0%	3.5%
7.	6/12/2003	24.7%	0.0%	1.6%	6.2%	13.3%
8.	4/3/1987	24.0%	-3.7%	2.6%	9.0%	-14.1%
9.	1/28/1963	23.8%	-1.2%	5.6%	3.5%	16.4%
10.	12/2/1998	22.4%	5.0%	9.3%	11.0%	18.6%
Last 65 Trading Days		**36.3%**	?	?	?	?
		Average	-1.8%	4.7%	7.6%	12.2%
		% Positive	20.0%	90.0%	90.0%	90.0%
		Historical Average	0.7%	2.2%	4.3%	8.8%
		Historical % Positive	61.1%	66.0%	70.2%	73.8%

Source: Strategas

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