Daniel Wildermuth's
MARKETCOMMENTARY

August 2020

- Presented by Wildermuth Asset Management

US is Resilient, but Both Short and Long-Term Outlooks Face Challenges

After March's sharp equity markets sell-off followed by April and May's strong recovery, broad equity markets have continued their mostly upward climb during the summer. Yet, absolute performance differs dramatically by index, as primarily big tech stocks continue to drive positive returns.

Through nearly the end of July, the tech heavy NASDAQ index, with approximately 40% of its total weight derived from the big 5 (Facebook, Amazon, Apple, Microsoft and Google) is up over 15% on the year while the Dow Jones Industrial Average, which has only 2 of these stocks included in its basket of 30 companies, is down over 7%. The S&P 500, with just over 20% exposure to the same five stocks, is about where it started in 2020. Usually, these indexes track each other closely, but the COVID lockdowns have seemingly pulled forward the digitization of society by several years, leading investors to flock into tech stocks while largely shunning more traditional firms.

The emergence of very significant winners and losers during the ongoing uncertainty of COVID has created many unique circumstances that are likely to drive markets for years to come.

In the near-term, key issues remain COVID restrictions, uncertain economic recovery, record low interest rates, and pending elections. Longer-term, high current valuations, record-low interest rates, and lower expected economic growth all appear likely to stunt returns over the next decade.

Daniel Wildermuth
CEO, Wildermuth Asset Management

"The emergence of very significant winners and losers during the ongoing uncertainty of COVID has created many unique circumstances that are likely to drive markets for years to come."

Last quarter, the U.S. economy contracted at a 32.9% annual rate while dropping 9.5% from last year's second quarter. The drop in GDP was the steepest ever recorded in records dating back to 1947. The US economy is expected to shrink more than 5% this year, and despite an expected recovery starting possibly as early as third quarter this year, US GDP is likely to be about 2.5% smaller at the end of 2021 than it was going into the COVID crisis.

It appears that investors are largely looking past current COVID-related challenges with an expectation that the economy and earnings will recovery fairly quickly. Yet, several issues seem likely to pose challenges to equity markets.

First, while an economic recovery in 2021 appears likely, we believe next year's earnings will be well below today's consensus expectations, and it seems unlikely that COVID's economic damage will simply melt away in the near future as seems to be assumed by many projections.

Second, much of today's market strength derives from a relatively small number of tech stocks. These companies have brought tremendous innovation, but their stock prices seem well ahead of actual earnings. While Amazon is undoubtedly a market impacting company, is its PE ratio of nearly 150 versus the market's average of around 27 justified? Maybe, but history suggests that established companies with high relative PE ratios struggle to generate enough growth to justify such lofty prices.

Longer-term, the US Federal Reserve's policy of keeping rates incredibly low seems likely to result in misallocation of capital as various projects are funded that probably should not have been. A growing body of research shows that growing government involvement and constant government stimulus has been a major contributor to many of modern capitalism's most glaring ills and has had a "significant negative effect" on per capita GDP growth. Easy money including crisis bailouts fuel the rise of giant firms while keeping alive heavily indebted "zombie" firms at the expense of startups which typically drive innovation. The result is low-

Continued ...

11525 Park Woods Circle | Alpharetta, GA 30005 | Ph. 678/506-3200 | www.WildermuthAsset.com

er productivity leading to slower economic growth. "Zombies" is a term used by the Bank for International Settlements for firms that failed to generate sufficient profit to pay even the interest on their debt over the previous three years.

Before the pandemic, the U.S. was already generating startups and shutting down established companies at the slowest rate since at least the 1970s. Today, an astonishing number of surviving public companies exist because of credit. In the 1980s, only 2% of publicly traded companies in the U.S. were considered zombies, but by the start of COVID, zombies accounted for 19% of US-listed companies.

In addition, growth remains low by historical standards. Aging populations present a key headwind, and inflation will likely fall short of central bank targets in most countries. Today's valuations following a 10-year bull market are also high by historical standards, partly because low interest rates have already encouraged investors to flee bonds and buy stocks. As a result, forecasted equity returns over the next decade are well below the historical norm. Still, equity return expectations remain well ahead of bonds given today's ultra-low interest rates.

These and other trends are causing analysts to voice caution. JP Morgan's "Long Term Capital Markets Assumptions" 2020 report released in November 2019 projected expected returns for a 60% stock and 40% bond portfolio at 5.4% of the next decade, well below the approximately 10% returns of the unusually strong last decade.

Morgan Stanley is less enthusiastic. The bank projected that a traditional 60/40 stock/bond portfolio would return 2.8% over the decade, a near-century low. Notably, both forecasts predate the COVID crisis, and it is difficult to envision that the future outlook should somehow have improved over the past six months.

Ongoing technology innovation could counter many challenges. JP Morgan's Long Term Capital Markets Assumptions report projects that automation and artificial intelligence could add 1-1.5% points to global growth over the next decade. Yet, their lower return projections already include the projected technology contribution to productivity.

Today's circumstances create both unique challenges and opportunities. The sharp rebound of equity markets give investors much flexibility to reposition assets if desired. Low expected returns from bonds create a challenge for investors as the days of simply insulating exposure to risky assets through an allocation to bonds are over. Future challenges likely require both greater innovation and skill in creating and implementing portfolio strategy. Investors seeking higher returns and greater diversification will probably continue to focus on private markets including private equity and real assets, much like larger endowments and institutions.

Yet, even with stock valuations at elevated levels, equities will likely serve a key role in portfolios. They still offer significantly better prospects than fixed income over the next decade, and the US has remarkable history of excelling through challenges and rewarding investors. While expectations over the next decade for equity and fixed income markets should probably be tempered, they should probably not be written off. However, volatility should also be expected given much ongoing near and long-term uncertainty.

This commentary is furnished for informational purposes only and is not investment advice, a solicitation, an offer to buy or sell, or a recommendation of any security to any person. Opinions, beliefs and/or thoughts are as of the date given and are subject to change without notice. The information presented in this commentary was obtained from sources and data considered to be reliable, but its accuracy and completeness is not guaranteed. It should not be used as a primary basis for making investment decisions. Consider your own financial circumstances and goals carefully before investing. Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not indicators or guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. Diversification strategies do not ensure a profit and cannot protect against losses in a declining market. All indices are unmanaged and investors cannot invest directly into an index. You should not assume that an investment in the securities or investment strategies identified was or will be profitable.

Investment Advisory Services offered through Wildermuth Asset Management, LLC, an SEC Registered Investment Advisor.

Market Commentary by Daniel Wildermuth
11525 Park Woods Circle | Alpharetta, GA 30005 | Ph. 678/506-3200 | www.WildermuthAsset.com