

## The Square Root Recovery

Jerry Chafkin, Chief Investment Officer, AssetMark

### Summary

1. **The stock market rebounded sharply in Q2, rising almost as quickly as it fell in Q1, returning 18.2% for the first two months of the second quarter.** The market's sharp drop and recovery is probably a function of the unique nature of the shut-downs, with state governments imposing restrictions that turned off the economy like a light switch and then lifting the restrictions effectively switching it back on again.
2. **The sharp recovery in the US stock market is unlikely to be mirrored in the recovery of the US economy, which for Q2 is estimated to contract anywhere between 25% and 52% (annualized). The economic recovery will likely be slowed by double-digit unemployment through next year,** given that domestic demand contributes two-thirds of the US economy and continued high unemployment will create a drag on consumer spending.
3. **Today's historically low interest rates across a broad range of maturities reflect the bond market's skepticism about the prospects for economic growth.**
4. **The seeming disconnect between the stock market and the economy is partly explained by timing, but there are also longer-lived issues that probably have greater explanatory power,** including: fiscal stimulus approved by Congress, behavioral biases regarding how investors weigh the probability of positive vs. negative surprises, the distribution of job losses across different economic groups, the very different paths to recovery likely to be experienced by different industries, and a restructuring of the stock market with the effect that a handful of companies are likely to define stock market returns but will not necessarily drive job growth.
5. **While market movement within a quarter, or from one quarter to the next, may be interesting to traders, it is less useful to longer-term investors planning for retirement, or for retirement income. Given the challenges and uncertainty facing the economy and the markets in the next few years, well-diversified portfolios with a modest tilt to the stocks and bonds of high-quality companies are recommended.**

## A SHARP RECOVERY FOR US STOCKS

The US stock market rebounded sharply in the first two months of Q2, rising 18.2% in April and May and 4.8% in the month of May alone. As a result, US stocks have a negative return year-to date, as of the end of May, of only -5.0%. The year-to date return for stocks globally was -8.9%. The sharp decline and rebound in the US market is partly due to the economy effectively being “turned off” by state government restrictions designed to slow the spread of the coronavirus. Even if consumers had been willing to go out to dinner, or to shop, they could not since all-but-essential businesses were closed. The fact that many businesses temporarily furloughed their employees rather than permanently laying them off allowed them to quickly re-open once states lifted their restrictions. As is always the case using a



Source: Zephyr Style Advisor

cap-weighted broad market index to generalize about the performance of stocks, it obscures the variety of return patterns experienced by the many different underlying stocks with some stocks rebounding quickly and/or not dropping and others recovering slowly, if at all. Thus, for example, the top five stocks by market-cap in the S&P 500 (Facebook, Apple, Microsoft, Google, Amazon), performed markedly better than the other 495. At the opposite end of the scale, but in a similar phenomenon, the energy sector was down 36.18% whereas the median stock in the energy sector was “only” 20% below its February high. These kinds of disparities are explained by both the different impact of the lockdown on different industries, and a record-high concentration of the S&P 500 in its five largest stocks.



Source: FactSet, Goldman Sachs Investment Research

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Similar return disparities were evident across sectors (e.g., financials had a YTD return of -23.4% while Consumer Discretionary returned +2.1% for the same period), wide variances in relative return among sectors, styles and capitalization sizes makes sense as the market synthesizes the relevance of new information about infection trends and how quickly people are re-engaging in commercial activity with different industries and companies.

### **THE ECONOMY WILL TAKE LONGER TO REBOUND THAN THE STOCK MARKET**

At the same time that the US stock market is rebounding sharply, the US economy is still in the middle of a particularly deep recession. Q2 estimates of GDP range anywhere from down 25% to down 53%, quarter over quarter. Many professional market observers and investment strategists are now monitoring weekly metrics for virus cases and hospitalizations and a variety of metrics relating to economic activity (e.g., hotel occupancy, retail sales, restaurant reservations, TSA activity, initial jobless claims, etc.) in order to recognize as quickly as possible whether a recovery trend is becoming established or whether a recovery might be stalling or reversing. All of these metrics have been moving in the in the right direction for the past few weeks which has given investors cause for optimism which would seem to be reflected in current stock prices. Investors seem to be looking beyond the “pre-vaccine time period” and seem unfazed that the higher frequency economic metrics, while on a positive trend, are still well below their pre-pandemic levels.

Although updated more frequently than the monthly and quarterly data that used to be the standard, investors need to remember that the metrics are still backward looking and we a dealing with a virus with which we have very limited experience. Like a coin toss that has come up heads six times in a row, investors may feel they know more about the likelihood of future outcomes than they actually do. A history of slowly declining hospitalizations is promising but not determinative of what the future might hold.

If COVID-19 hospitalizations were to spike in any one state, it could cause other states to rethink the speed with which they are lifting their restrictions and it might increase the anxiety of consumers leading them to resume dining out and travelling more slowly than they had been. After three months in their homes isolating themselves and their families, investors (including this investor!) may be inclined to overweight any good “news” available. Indeed, there may be reasons for optimism. Despite outdoor scenes of people not wearing masks and ignoring social distancing recommendations, we have not yet seen widespread spikes in COVID-19 hospitalizations stressing hospital systems. In addition, the speed of vaccine development, testing and manufacturing seems promising. Investor optimism, however, should be tempered by the fact that although the number of new coronavirus cases has plateaued nationally, there are more than a dozen states where new cases and hospitalizations are rising and that while the potential for new vaccines is exciting, not enough information has been released to independently assess effectiveness.

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While I hope the economy will rebound as sharply as the stock market, I am skeptical. The primary reason for my skepticism is the unusually high level of unemployment. My concern about the impact of layoffs on the economy are not just a function of the number of workers laid off, it also reflects the fact that the impact of layoffs was disproportionately higher on low-income households who spend the highest percentage of their incomes, putting it back into the economy. 29.9 million people received unemployment benefits in May which is a much larger number than the 13.3 million number cited in many press accounts as the official BLS statistic. The difference is explained by: 1) the Bureau of Labor Statistics (BLS) counts anyone who employers say is still being paid (e.g. as part of the Payroll Protection Program) as employed even if they are not at their jobs; 2) furloughed workers who said they were not looking for work (because they were expecting to go back to their most recent jobs) and were not considered to be part of the workforce, and 3) furloughed individuals who checked "Other" on the survey as the reason they were not working are not counted as unemployed because the BLS expects them to return to their jobs (as if they were on jury duty or taking a few days off to care for a sick child or parent).

Given that approximately two-thirds of the US GDP is attributable to domestic consumption, it is hard to believe that having almost 1 in 5 American workers unemployed will not curtail consumer spending and slow an economic recovery. We have not yet seen any impact on consumer spending because of the Payroll Protection Program that allowed companies to keep workers on their payroll even though they were not at work and the CARES Act that extended and supplemented unemployment benefits helping American workers to temporarily avoid personal financial crises. In effect, the US government, either directly or through corporate employers, has been giving money to otherwise unemployed workers to help their finances, and our economy, outlast the virus.

Most state unemployment benefits last for 26 weeks and so workers who were laid off in March will stop receiving unemployment checks in September. If before then Congress has not authorized a second coronavirus relief bill, consumer spending would drop precipitously. Because the stakes for our economy are so high, most investors probably assume agreement between Republican and Democrats on a second virus relief package will be reached, but we should not discount the potential for good politics to get in the way of good policy.

Current unemployment has fallen below its April high point, but otherwise remains higher than at any time since the Great Depression. Historically, job creation has been a slower process than job elimination. Pre-pandemic the US economy was adding roughly 200,000 new jobs per month, and while the 2.5 million jobs added in May was a very positive surprise, we are unlikely to keep adding jobs at that pace. This means that we will almost certainly still have double-digit unemployment at the start of 2021 and maybe for another year or two after that because it would be surprising if the economy was finished shedding jobs. The stay-at-home restrictions that basically shut down retail sales and decimated sales tax collections which, absent relief from the Federal government, will result in layoffs of teachers and state

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and local government employees. We should also expect a second round of corporate layoffs later this year as corporate managers, who now have a much better understanding than they did in March of the impact of the virus and social distancing restrictions on their revenues, develop plans to right-size their expenses to achieve their 2021 profit targets. Investors should expect announcements of additional layoffs as we get closer to year end.

With almost 30 million Americans out of work, unless the Federal government is willing to continue its extraordinary payments to employers and workers/consumers, it's hard to imagine that even temporary unemployment won't affect consumer confidence and therefore, the economy. Until there is a widely available vaccine and layoffs have stopped, it is unlikely consumers will be travelling and dining out at pre-pandemic levels. Even if half of currently unemployed workers are called back to work between now and the end of the third quarter, at the current rate of job growth, we will likely still begin 2021 with a double-digit unemployment rate.

Other considerations weighing on the economy are the cost of government debt service and in time, the likelihood of higher corporate taxes to help pay down some of the debt associated with the trillions spent on virus relief/stimulus programs.

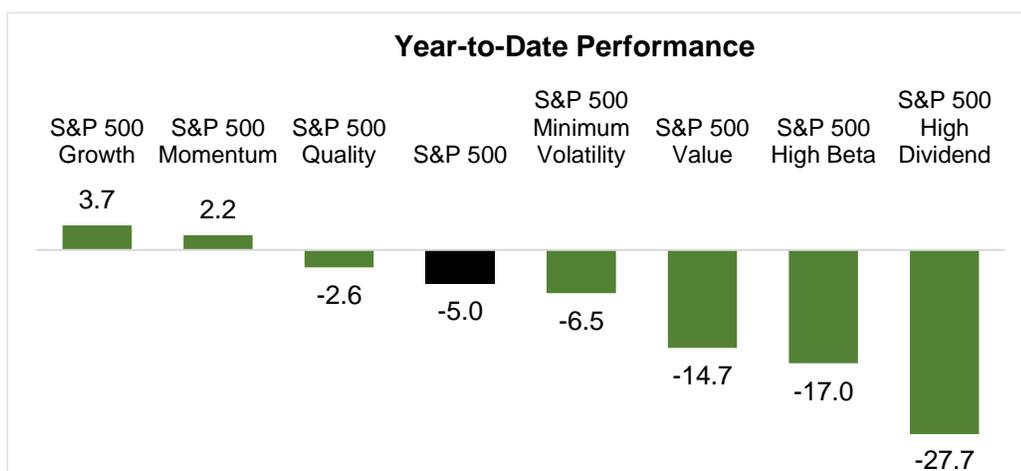
### **INTEREST RATES WILL REMAIN LOW**

Today's historically low short-term interest rates are not surprising, given that we are in the middle of a deep recession. But the fact that interest rates are also low for maturities as long as ten years probably reflects the bond market's skepticism about the prospects for economic growth. Interest rates are likely to remain low for the foreseeable future for a number of reasons, including:

- 1) We are in the middle of a recession with record job losses; there is no inflationary pressure on wages or prices
- 2) Even if the economy rebounds sharply it will be because it is starting from a low baseline with no risk of "overheating"
- 3) Low interest rates are politically popular and economically desirable as they support the price of a wide variety of assets from houses to stocks, making people feel wealthier; low interest rates are associated with higher price-earnings multiples for stocks
- 4) Low interest rates can reduce the cost of borrowing for consumers and help them to bridge a recession until they can return to work
- 5) If the Fed were to allow rates to rise, the debt-service burden on US corporations could devastate profits for debt-heavy companies and exacerbate the recession
- 6) Given the massive debt the US government added in order to finance, its extraordinary pandemic relief packages, a rise in interest rates could potentially crowd-out all discretionary government spending and necessitate painful budget cuts
- 7) In order to avoid creating anxiety among investors that it will inadvertently short circuit any potential economic recovery, the Fed is likely to wait a few years before beginning the process of raising rates and even then, would do so very gradually

## MARKET OUTLOOK

Given that bond yields are expected to stay “lower for longer”, we expect stock prices to hold up, if for no other reason than the TINA (There Is No Alternative) phenomenon for investors. Historically low interest rates can support historically high P/E multiples. Looking across styles, sectors and geographical regions, we’ve seen markedly different returns. We’re likely to continue to see a lot of “noise” as different investment themes advance and retreat depending on the news of the day. Some of these advances may be short-lived but will nevertheless fuel speculation of a longer-term rotation in market leadership. Over very short horizons, performance leaders may change as different stock characteristics (e.g., value, small cap, or high dividend) begin to appear relatively cheap compared to their own histories, but longer term the current performance leaders are characterized by large and profitable companies with low debt ratios (aka “quality” stocks). Their size and profitability provide them with the capital to grow EPS by expanding into adjacent markets, M&A and/or share repurchases. In this uncertain environment we believe a similar theme makes sense for fixed income, where investment-grade corporate bonds represent what we think is an appealing balance between yield and stability, given that their liquidity is backstopped by the Fed, but they provide some yield premium over US Treasury notes and bonds.



Source: S&P Dow Jones Indices

Given consumer confidence/spending challenges once a vaccine is broadly available, we think economic expansion will come back, but it will be slow growth for at least a few years. When I use the term “slow” to describe growth over the next few years, I mean it relative to historical equity returns. Unusually low interest rates mean that the stock market can deliver returns well below its long-term average annual of about 10% and still provide an equity risk premium of 500 or 600 basis points. Asset allocations will not need to change, but investor expectations probably will.

## PORTFOLIO POSITIONING

Based on the market outlook outlined above, we believe stocks are likely to outperform bonds and that ‘quality’ – defined as companies with a history of

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sustained profitability, low debt ratios and high return on equity – will continue to be among the best-performing equity characteristics styles, especially when one considers the resilience of these stocks if market dynamics were to unexpectedly change. The attractiveness of quality as an investment style leads us to suggest advisors consider including a modest allocation (i.e., a tilt) to ESG strategies (Environmental, Social, Governance) which happen to exhibit an emphasis on quality (perhaps because they tend to screen out debt-heavy oil companies for environmental reasons and are attracted to information technology companies as sustainable). From our perspective, the appeal at this time of quality/ESG as a tilt in the equity portion of portfolios is independent of whether an investor feels passionately about the environment or social responsibility or good corporate governance when investing. Regardless of any modest tilt to quality/ESG that investors might include in their portfolios, there remains enough uncertainty in the markets, regarding the path of the virus and the timing of a vaccine, that for short periods different sectors, styles and global regions will fall behind or bounce back. For this reason, we think it remains important and advisable for investors to maintain broad diversification within and across asset classes and strategies.

### **THE LONG VIEW**

Investors have an innate fear of uncertainty (which I'll define as risk that cannot be quantified). One of the lessons from the Great Financial Crisis is that it is nearly impossible to correctly anticipate short-term market behavior based on fundamentals—or even history – when there is the potential for government actions, statements, or rumors to overwhelm whatever investor behavior might otherwise have been. It is my suspicion that the same is true about the news and developments around the spread of a virus and the research and development activity around vaccines and treatments for that virus. The potential for volatility and whipsaw market movements is high, especially when you combine potential government intervention and virus-related developments with the policy speculation that usually accompanies a presidential election year in the world's largest economy.

Sometimes when markets are in flux, the most accurate view of the future is achieved by trying to rise above the daily fray to understand the longer-term pattern or trend, which based on current employment and consumer demand challenges suggest positive but lower stock market returns than investors have typically experienced. Thirty years from now when we look back on the early half of the 2020's, the pattern of stock market return over the course of the next few years is less likely to look like a V or a U than it is to look like a square root symbol: a steep drop, followed by a steep rebound, followed by a few years of relatively flat returns.

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**AssetMark, Inc.**

1655 Grant Street  
10<sup>th</sup> Floor  
Concord, CA 94520-2445  
800-664-5345

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