To V or Not to V

The stock market enjoyed it best quarterly performance in more than 20 years, as the S&P 500, Dow Jones Industrial Average and NASDAQ Composite respectively surged 20%, 18% and 31% during the second quarter. For the first six months of the year, the S&P 500 and Dow Jones are down -4.04% and -9.55% respectively. Meanwhile, the NASDAQ Composite finished the quarter up a stunning 12.11% for the first half of the year.

Relentless momentum in technology shares has many market participants on bubble watch. To that regard, it is remarkable that Facebook, Apple, Amazon, Netflix, Alphabet and Microsoft (FAANGM) now collectively represent 25% of the total $25.6 trillion market capitalization of the S&P 500. While we are becoming increasingly concerned by the potential ramifications of this concentration, we also recognize that these companies are primary beneficiaries of the accelerated proliferation of digitization caused by the pandemic. Microsoft CEO Satya Nadella recently stated that "we've seen two years of digital transformation in two months." When these technology titans eventually suffer an inevitable correction, it will have a disproportionate impact on the overall market. Meanwhile, according to analyst David Rosenberg, 70% of non-technology S&P 500 companies remain below levels reached in 2018. The disparity between the performance of growth and value stocks is at a 25-year high.

In a recent survey of 190 fund managers by Bank of America, a second wave of coronavirus cases, permanently high unemployment and a Democratic sweep of the election were cited as the most prominent risks facing the market. Let us evaluate these risk factors to ascertain the extent to which the stock market recovery from the March lows may have come too far, too fast.

While coronavirus cases are indeed spiking in hotspot states such as Florida, Texas, California and Arizona, for now there remains little evidence of a commensurate increase in new deaths. While we admit that mortality rate is a lagging indicator and likely to increase in the coming weeks, the death rate nationwide has been steadily declining since mid-April and can be attributed to the availability of treatments such as remdesivir and dexamethasone, widespread access to coronavirus testing, continued social distancing and face covering as businesses have reopened and the appropriate quarantine precautions taken by those most at-risk.

The at-risk population is most noticeable in nursing homes which account for 43% of all coronavirus fatalities in the United States. To be sure, fatality risk escalates substantially for those over age 70 with pre-existing conditions. Stanford University Chair in Disease Prevention John Ioannidis references "more than 50 studies that presented results on how many people in different countries have developed antibodies to the virus" and estimates "that about 150-300 million or more people have already been infected around the world, far more than the 10 million documented cases", implying a dramatically lower mortality rate than what is presently reported, an infection fatality rate "almost 0%" for those under age 45 and a mortality rate about 0.05% to 0.3% for those age 45 to age 70. As testing continues to accelerate and treatments become more readily available, the fatality rate for COVID-19 seems destined to more closely resemble that of the seasonal flu. Interestingly, COVID-19 may soon lose its status as an "epidemic" based on CDC guidelines that require the number of weekly deaths caused by a disease outbreak to exceed a certain percentage of overall deaths. According to the CDC, the percentage of deaths attributed to pneumonia, influenza or COVID-19 (PIC) decreased from 6.9% during week 26 to 5.5% during week 27, representing the eleventh consecutive week during which a declining percentage of deaths due to PIC has been recorded and is currently below the epidemic threshold.

Especially with the odds for a potential vaccine increasing as companies are poised to start Phase III trials this month, we remain cautiously optimistic that the worst of the pandemic has already passed in the United States. Effective treatments are in place, hospitals are better prepared and local governments are more adept at handling intermittent spikes with temporary shutdown measures. Further, we believe the recent spikes serve as an important reminder that we all must remain vigilant with face coverings and social distancing. Overall, we are all learning to cope with the reality that we will be living with COVID-19 for many months to come. Whether we are still in the first wave of cases or a surging second wave, we must recognize that additional spread of the virus was inevitable once states started to relax their lockdowns.

Over the past two months, nonfarm payrolls have risen by 7.5 million as workers began returning to their jobs following the coronavirus-induced shutdown, topping expectations by a dramatic sum. While 2.5 million returned to work in May, the median forecast was for a loss of 7.5 million jobs! Consequently, the unemployment rate has fallen from a peak 14.7% in April to 11.1%. St. Louis Fed President James Bullard anticipates that the renewed health scare will make mask-wearing "ubiquitous", which will in turn reduce the virus threat and boost the economy. Bullard sees the unemployment rate falling to as low as 7% before the year is over. As the economy continues to open, re-employment will outpace job losses and continuing jobless claims are likely to recede. Indeed, the Labor Department reported that 1.8 million workers were laid off in May, down from 7.7 million in April and 11.5 million in March, and in line with layoffs reported in January and February, before the pandemic essentially shut down the U.S. economy. The upcoming July 31st expiration of enhanced unemployment benefits looms large as workers will have a much greater incentive to return to work. While employment numbers are in the midst of a v-shaped recovery, we expect the ongoing rebound to flatten out over a more prolonged period. Until there is a vaccine, social distancing and rolling shutdowns will make it extraordinarily difficult to reach previous low levels of unemployment.

Other surging economic indicators that support a more v-shaped recovery include retail sales, homebuilder sentiment, rebound in the price of oil, mortgage applications, consumer confidence and both ISM Services and ISM Manufacturing Indices. Add in a weakening dollar, improving corporate credit, seemingly endless accommodation and QE from the Federal Reserve, nearly $3 trillion of fiscal stimulus with potentially more on the way, generational low interest rates that are likely to remain so for the foreseeable future, record bearish bets by hedge funds and an unbelievable $5 trillion record cash hoard in money market funds and we have the ingredients for what many analysts believe to be a new bull market in stocks. Morningstar expects U.S. GDP to fall 5.1% in 2020, but sees a sharp GDP rebound in the second half of 2020 with 5.9% growth in the third quarter and 3.2% growth in the fourth quarter, and robust catch-up growth in the years following 2020.

This $5 trillion of cash earning next to nothing gives us increased confidence that buying the dip will continue to prevail. We fully expect additional volatility for the balance of the year, especially as the election draws closer, but this hoard of dry powder, should limit excessive downside risk. JP Morgan forecasts a $16 trillion increase in worldwide debt this year, pushing the combination of private and public sector debt to a record high $200 trillion by year end, coinciding with higher savings rates, very accommodative central bank policies and more cash in the system. JP Morgan sees total global money creation exceeding $15 trillion or more by the middle of 2021 and “most of this liquidity will eventually be deployed into equities as the need for precautionary savings subsides over time”, especially given the low level of bond yields. As a case in point, Calpers (the largest defined-benefit public pension plan in the U.S.), just introduced a plan to use leverage, taking advantage of low interest rates by borrowing and using those funds to acquire assets with potentially higher returns, in order to help meet its target 7% risk-adjusted return.

With regards to the upcoming Presidential election, we have never attempted to trade around potential outcomes. With Democratic nominee Biden soaring in recent polls, we might expect the markets to have some difficulty grappling with the increasing prospects for higher corporate and capital gains taxes. If there is a Democratic sweep of the House, Senate and White House, we would not be surprised at all by a material year-end selloff as investors lock in capital gains at today’s lower rates. The odds for such a sweep seem evenly balanced at the present time. In any case, the stock market’s performance in the months ahead could have a big impact on the outcome of the election. Data going back to 1928 shows that the incumbent party has won the contest 87% of the time when the S&P 500 is positive over three months ahead of the election and lost when it is negative.

With 180 companies in the S&P 500 having withdrawn their earnings forecast and only 49 companies having issued guidance for the coming second-quarter earnings season, analysts and investors are increasingly looking to 2021 and beyond. With today's consensus earnings estimate at $163.32 for 2021 and $186.30 for 2022, the S&P 500 presently trades at 19x 2021 earnings and almost 17x 2022 estimates. While these PE ratios seem relatively high by historical standards, they appear more reasonable given historically low interest rates and considering recession-induced trough earnings. Further, high PE technology companies give the overall market a disproportionately high valuation. We again expect additional volatility as the second half of the year progresses, but it appears to us that the stock market had this recovery right all along.