Second Quarter 2020
Market Perspective

WEALTHPLAN PARTNERS

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Q2 2020 Highlights

- Market Leadership Narrows
- Stimulus Measures Support Rebound
- Speculation & Gloom Simultaneously Present

Category	Index	Q2 2020	1-Yr	3-YR
US Equity	**Russell 3000 Index**	**22.0%**	**6.5%**	**10.0%**
Large Cap	S&P 500 Index	20.5%	7.5%	10.7%
Mid Cap	S&P Midcap 400	24.1%	-6.7%	2.4%
Small Cap	Russell 2000 Index	25.4%	-6.6%	2.0%
Growth	Russell 3000 Growth	28.0%	21.9%	18.2%
Value	Russell 3000 Value	14.6%	-9.4%	1.4%
International Equity	**MSCI ACWI ex-U.S. Index**	**16.1%**	**-4.8%**	**1.1%**
Developed	MSCI EAFE Index	14.9%	-5.1%	0.8%
Emerging	MSCI Emerging Markets Index	18.1%	-3.4%	1.9%
Fixed Income	**Bbrg Barclays Global Aggregate**	**3.3%**	**4.2%**	**3.8%**
U.S. Bonds	Bbrg Barclays US Aggregate	2.9%	8.7%	5.3%
U.S. High Yield	ICE BofA US High Yield TR USD	9.6%	-1.1%	2.9%
Cash	Bbrg Barclays 1-3 Month US Treasury Bill Index	0.0%	1.1%	1.6%
Alternatives	**Morningstar Diversified Alternatives Index**	**6.5%**	**-5.0%**	**-1.1%**
Commodities	Bloomberg Commodity Index	5.1%	-17.4%	-6.1%
Real Estate	MSCI U.S. REIT Index	11.4%	-13.9%	-1.2%

Source: Morningstar

The stock market rallied in the face of some of the worst economic data on record during the second quarter, benefitting from the Fed's do-anything-at-all-costs mantra, paired with a large stimulus safety net in the form of the CARES Act. Most investors remain confounded by the near full recovery of equity market losses, despite all the economic devastation and a pandemic that remains out of containment.

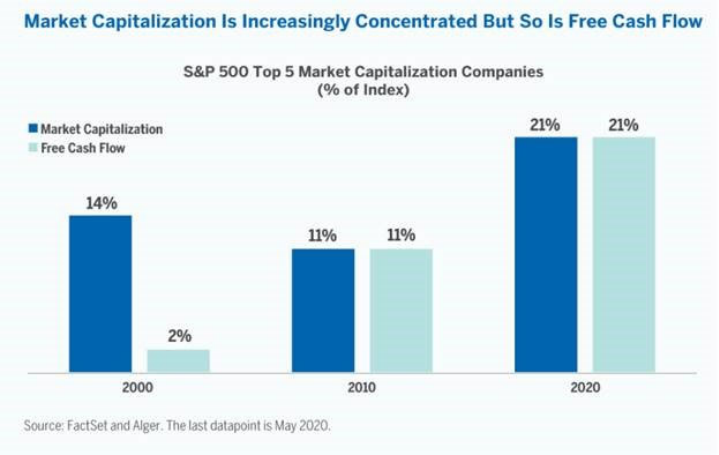
Stocks appear to be forecasting a fairly quick recovery, or simply writing off 2020 and looking forward to coming years in which the Fed has committed to keeping rates low while the economy ultimately benefits from a snapback in spending, boosted by recent stimulus. In any case, the rally has come despite a flood of idle cash on the sidelines, and mostly skeptical investor sentiment.

Even the venerable Warren Buffet has opted to remain cautious, with Berkshire Hathaway a net seller of stocks during March and April. This is in stark contrast to their usual stance of "bad news is an investor's best friend" or "buy when there is blood in the streets". For Berkshire, the missed opportunity (at least so far) could be related to how quick the Fed & Treasury reacted, removing the need for businesses to call Uncle Warren for money, or how fast the markets rallied back in general. Either way, it was evident through Buffet's commentary at the Berkshire annual meeting that uncertainty for even the bravest of investors reigned supreme.

As we hit the halfway point of the year, investors are left with a stock market that looks expensive, unless compared to the bond market that trades near historically low levels in rates, destined to remain low for the foreseeable future. Regardless of where we go from here, this year has shown us the inability for investors to rely on short-term forecasts. The possibility of a black swan event (COVID-19), as well as the ability of the market to trade higher against prevailing logic, both show why proper diversification, as opposed to the reliance on market timing, gives investors the best chance at meeting their long-term objectives.

Market Leadership Narrows

Even though the stock market recovered most of its losses, the rising tide has not lifted all boats. As of June 30th, the S&P 500 index was down just 3.1% year-to-date (including dividends), while the ***equal-weighted*** S&P 500 index, which gives each company in the index the same weight as opposed to weighting by size, was down 10.8%.



That is because the largest companies have become even larger through this pandemic, extending a trend that has emerged over the past five years. As of July 13th, *FAANGM* (an acronym for **F**acebook, **A**mazon, **A**pple, **N**etflix, **G**oogle (Alphabet) and **M**icrosoft) constituted over 26% of the S&P 500's weighting[1]. Stripping out Netflix, it is the highest weighting for the 5 largest companies over the past 50 years and more than double what it was just ten years ago.

Although the dominance is concerning from a concentration standpoint, and because it comes at the expense of smaller companies failing to compete and/or struggling because of the forced economic shutdown, the ascendancy in market cap does not come without merit. As the chart above illustrates, the top 5 companies represented 14% of the market in the year 2000, but only 2% of free cash flow. As of May 2020, the top 5 companies constituted 21% of the market cap ***and*** 21% of total free cash flow for the index. While the valuations have certainly become more extended with this recent rally, they are nothing like what we saw in the late 90's tech bubble, and in many ways are justified by the strong becoming stronger through this pandemic.

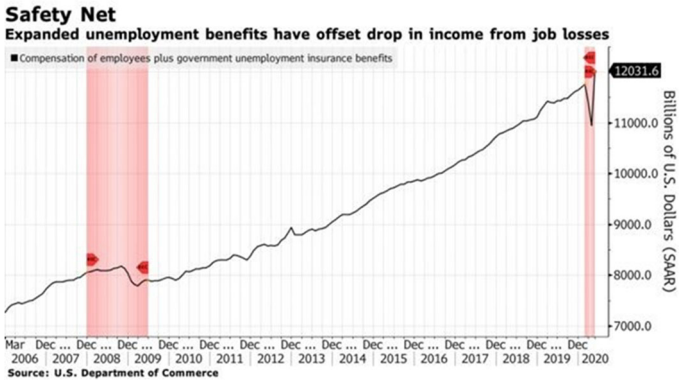
Stimulus Measures Support Potential Rebound

The divergence of the stock market and economy continues to befuddle investors; however, as legendary investor Bill Miller points out in his most recent quarterly letter, the correlation coefficient of stocks to annual economic growth from 1930 through 2019 is .09[2]. In other words, no meaningful correlation at all. That is because economic data is backward-looking, and the stock market is forward-looking. Not just next year, but the long-term discounted valuations of all listed companies, compared to prevailing interest rates.

Although there is plenty of uncertainty left to handle with the virus and economic recovery, a) we know much more about the virus than we did in late February and b) it appears that the economic fallout bottomed sometime in April/May and trends are directionally positive.

And since that time, the market has been treated to two bazooka guns of stimulus in the form of the CARES Act and unprecedented Fed support for interest rates and liquidity, with potentially more to come.

Regardless of what stimulus remains, the fiscal safety net already dwarfs that of the Great Recession. In light of the CARES Act, total income (including unemployment insurance benefits) is already higher than what it was coming into this crisis, whereas it took several years for total compensation to recover from the depths of the Great Recession. For now, this money has not been able to flow through the economy, but the market appears to be pricing in that inevitability and a snapback in economic activity on the other side of this crisis.



Speculation & Gloom Simultaneously Present

Since early March, retail brokers have seen record levels of trading activity and new account openings, with many of these investors appearing to be brand new investors "betting" in a world devoid of sports. Stocks of companies recently declaring bankruptcy have rallied based partly on popularity from trading sites like Robinhood. Options trading is at record highs and many trendy stocks have soared to lofty valuations on "castles in the sky" assumptions.

Yet, investor sentiment still seems mostly grim and skeptical of the market rally all the same. The AAII Sentiment Survey for the week ending July 8, 2020 showed 27% of investors surveyed as being bullish, 30% neutral and 43% bearish over the next 6 months[3]. And despite the market rally, investors continue to be net sellers with money market balances setting a new record-high of $4.6 trillion in mid-June[4], even with interest rates settling back near zero. It is hard to remember a time when we saw such speculative behavior amidst such a general aversion to risk for the broader market.

The pace at which the stock market recovers is often an echo of the preceding selloff. In the dotcom bubble and financial crisis, stocks took 2 ½ and 1 ½ years, respectively, to get from peak to trough. The eventual recoveries, absent much fiscal stimulus, were even more prolonged as the output gap to potential GDP lingered for several years. In this case, stocks experienced their fastest 30% correction on record and were met with a historic level of fiscal stimulus to help close the temporary loss of GDP. It is certainly possible that this mirrored recovery ultimately prevails if history is our guide.

Given that is anything but certain, this is a great time for investors to revisit their portfolio exposures with the house fire now under containment. Rebalancing in late March helped our portfolio returns, as diversification outside of what has worked recently may contribute to future returns. Although market leadership has narrowed and uncertainty lingers, this environment has created very wide dispersion for active managers to go fishing. And with the S&P 500 dividend still yielding nearly 3x the 10-year treasury yield, there are plenty of keepers out there compared to what other options investors have for return on their capital.

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Sources:

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