NORTHEAST SEQUOIA
PRIVATE CLIENT GROUP

## The Great Disconnect

Last week, we suggested that much of the market resilience and rebound was driven by five companies that represent 20% of the S&P 500's market cap (size). We further suggested that to get more comfortable that the current equity rebound has teeth, that we'd need to see the bottom 20% of companies (that fifth quintile), representing over 320 companies, exhibit a more "V" recovery in terms of demand, earnings and profits.

We got wide-ranging feedback from clients on this thesis, as well our more bearish sentiment toward markets, especially as the S&P 500 now stands down only 5.4% YTD (total return), and up by a remarkable 36% since the market bottom back in late March. Clearly, recent market trends do not have the makings of a "W" recovery, but more "V-like" then we, or many (*see our note*, Dazed And Confused, May 15, 2020) other investors and analysts expected.

Animal spirits and stay-at-home fatigue have, in our opinion, trumped reason and math. It is as though investors are numbed to the notion that days borrowing to buy back stock are gone, or that 41 million unemployment may not find a job waiting for them when the U.S. reopens or that the U.S./China relationship is solid ground. *Hence the Great Disconnect.*

**"We believe these are the three big mechanisms that have supported equities over the last 12-18 months, and yet is seems wishful thinking they will be there to bolster the capital markets going forward."**

First, according to Goldman Sachs, buybacks in 2020 will decline by 50% or more, from over $742 billion in 2019. As a result of reduced buyer demand, investors will witness increased volatility and less downside support. Also, as firms were borrowing to buy back equity in droves over the last 5-10 years, it was easier to drive earnings-per-share (EPS) higher, as the denominator was shrinking. Given this "synthetic demand" for equities, we are also starting to question the bullish technical argument going forward.

Next, let's discuss the employment backdrop. As we sit here today, the U.S. has lost almost 41 million jobs over the last ten weeks, wiping out the gains of the previous 10+ years. While fiscal-stimulus is helping put paychecks in the hands of these displaced workers, we fear that many will find their previous job no longer exists. We are noticing several companies from large national chains to the small mom-and-pop franchises, to gym operators, and even local pubs will be out of business. And for those Americans fortunate enough to keep their jobs, many are being faced with salary reductions or partial furloughs. This must have some negative impact on spending, lower retail sales, and weaker aggregate demand, not good!

Finally, we view the current accord between the U.S. and China to be far from copacetic. From concerns over Hong Kong's autonomy to increased rhetoric surrounding a trade war 2.0 in retaliation to covering up COVID fears, we fear that market volatility exhibited through much of 2018 and 2019, may return.

**We'd love to hear your thoughts.**