7-20-20

WEEKLY UPDATE

Economic and Market Performance

MARKET INDEX	CLOSE 7-17-20	WEEK GAIN/LOSS	Y-T-D GAIN/LOSS
DJIA	26,671.95	+2.3%	-6.5%
S&P 500	3,224.73	+1.2%	-0.2%
NASDAQ	10,503.19	-1.1%	+17.1%

Initial jobless claims were 1.3 million for the week ended July 11. Over the past four months, more than 51 million Americans have filed new unemployment claims. At 1.3 million, the level of new claims dropped for a fifteenth straight week, with a steady recovery underway from the late March peak of 6.867 million new claims. Still, the level of new claims remains far above the about 200,000 new unemployment insurance claims filed each week in February before the pandemic hit. Moreover, it is still nearly double the 665,000 weekly claims filed at the worst point during the Great Recession in 2009.

As lockdowns eased, total industrial production increased 5.4% in June. The capacity utilization rate improved to 68.6%.

The Michigan Index of Consumer Sentiment for July showed a drop to 73.2 from 78.1 in June as consumer attitudes worsened in the face of the renewed surge in coronavirus cases and plans in some states to pause or roll back reopening activity. California Governor Newsom announced all counties must reclose indoor operations in several business sectors due to the coronavirus spiking again.

However, a variety of stimulus measures, positive vaccine news and better than expected earnings contributed to the Dow and S&P 500 continuing to rally last week. The Nasdaq took a breather as large technology stocks pulled back following a torrid run which has led to stretched valuations.

Last week, the Dow gained 2.3%, the S&P 500 rose 1.2% and the NASDAQ declined 1.1%.

HI-Quality Company News

The National Institute of Allergy and Infectious Diseases, part of the National Institutes of Health (NIH), recently established the COVID-19 Prevention Network (CoVPN). Its goal is to register millions of volunteers for large-scale clinical testing of vaccines and monoclonal antibodies intended to protect people from COVID-19. As part of this initiative, **Oracle-ORCL** developed a Cloud System called the CoVPN Volunteer Screening Registry to identify and screen volunteers who want to participate in COVID-19 clinical trials. The system has been live for less than a week, and more than 100,000 people have already registered. This program is expected to support hundreds of clinical trial sites across the US and internationally by the end of the year.

Johnson & Johnson-JNJ reported second quarter revenues declined 11% to $18.3 billion with net income and EPS each down 35% to $3.6 billion and $1.36, respectively. These results were driven by the negative impact of the COVID-19 pandemic, especially related to the deferral of medical procedures. Results are expected to improve going forward. Free cash flow approximated $5.5 billion in the second quarter with the company paying $2.7 billion in dividends. JNJ is making encouraging progress on developing a vaccine for COVID-19. Studies have accelerated on the vaccine with Phase III studies expected to begin in September. JNJ is building global manufacturing operations capable of producing greater than one billion doses of the vaccine in 2021. While there has been a resurgence of the virus in certain states, JNJ sees better protocols for treatment leading to better outcomes. If there is a second wave of COVID-19 in the Fall, JNJ does not expect it to have the same impact as during the initial stages of the pandemic as the world is much better prepared in terms of testing, equipment and treatments. In addition, a certain portion of the population has already developed antibodies. JNJ increased their 2020 sales and earnings outlook for 2020 with sales expected to decline 1%-3% to a range of $79.9 billion to $81.4 billion and constant currency, adjusted operational EPS expected to decline 7%-10% to a range of $7.85 to $8.05. In fiscal 2021, JNJ expects financial results to improve in all business segments with operating margins expanding on higher sales growth which will lead to strong EPS growth.

UnitedHealth Group-UNH reported second quarter revenues rose 2.5% to $62.1 billion with net income and EPS both more than doubling to $6.6 billion and $6.91, respectively. These results were substantially higher than expected due to the unprecedented, temporary deferral of health care during the quarter especially among elective procedures. In March and April, people avoided going to the doctor unless necessary as the pandemic advanced. COVID-19 has accelerated telemedicine with UnitedHealth arranging four million digital visits for patients which was more than 30 times the level in January. Digital behavioral services are also helping patients address isolation and anxiety caused by the pandemic. The resumption of healthcare began to recover in May and approached more typical levels by the end of June. With COVID-19 profoundly impacting the health of people around the world, UnitedHealth moved swiftly to assist the people they serve by providing $1.5 billion in direct consumer support through premium credits, waivers of co-pays and other efforts. The company expects another $1 billion in rebates to be paid in future periods. In addition, UnitedHealth used its financial strength to accelerate nearly $2 billion of payments to care providers to provide needed liquidity for the health system. Free cash flow increased 48% to $12 billion during the first half of the year, and the company paid $2.2 billion in dividends and repurchased $1.7 billion of its common stock. Because UnitedHealth expects the resumption of deferred care and future COVID-19 costs will increase in the second half of the year, they maintained their full year earnings outlook of $15.45 to $15.75 per share despite the much better than expected financial results in the first half of the year. Management expects high unemployment will continue well into 2021, and they are taking actions to help provide affordable healthcare to underserved communities. While virus outbreaks in the U.S. will likely continue to spike on a regional basis, UnitedHealth does not expect to see a broad-based shutdown of the economy again.

To help the world respond to COVID-19, **3M-MMM** and researchers at MIT are testing a new rapid test that detects the virus. Accelerated research is underway to learn if a simple-to-use, diagnostic device can produce highly accurate results within minutes and is feasible to mass manufacture millions of units per day. The test could be administered at the point-of-care and would not need to be sent to labs for testing.

Fastenal-FAST reported second quarter revenues rose 10% to $1.5 billion with net income and EPS each bolting 17% higher to $238.9 million and $.42, respectively. These results were driven by a surge in personal protective equipment (PPE) sales, with sales more than doubling. Good cost discipline helped margins expand. The PPE surge masked what were weak conditions in other parts of the business. Fastener sales, which better reflect underlying economic conditions, were down 17% in the second quarter with trends improving in May and June from the bottom in business activity in April. Free cash flow increased 91% during the first half of the year to $402 million thanks to higher earnings, deferral of taxes and good working capital management. During the first half, the company repurchased $52 million of stock and paid $286.8 million in dividends. Fastenal maintains a strong and conservative balance sheet. While business is expected to normalize in the third quarter, the pace is uncertain and will be linked to the trajectory of the pandemic.

PepsiCo-PEP reported second quarter revenue declined 3% to $15.9 billion with net income down 19% to $1.6 billion and EPS down 18% to $1.18. These results reflected the significant challenges and complexities related to the COVID-19 pandemic as the global economy contracted during the quarter due to restrictions and closures from the global lockdown. The global snacks and foods business held up better than the beverages business during the quarter. Quaker Foods was the star of the quarter with sales up 23% and operating profit up 55% as people ate more breakfast meals at home and increased in-home dinners and baking. Frito-Lay North America experienced a 7% increase in sales with a 2% increase in operating earnings as the company gained market share. Tostitos, Fritos and Cheetos all experienced double-digit growth as people snacked at home. On the other hand, beverages saw a sharp decline in revenues and profits due to the closure of restaurants and convenience stores during the quarter. Encouragingly, as restrictions and closure eased, PepsiCo saw improving trends in all their businesses in May and June. E-commerce U.S. retail sales doubled in the quarter. Free cash flow increased 24% during the first half of the year to $274 million. During the first half, PepsiCo paid $2.7 billion in dividends and repurchased $1.1 billion of its common stock. The dividend reflects a 7% increase and represents the 48th annual dividend increase. The environment remains volatile and much uncertainty remains about the duration and long-term implications of the pandemic. PepsiCo does not expect a linear recovery but more of a rollercoaster recovery with many ups and downs depending on the path of the virus. Management believes they have ample liquidity and flexibility to meet the needs of the business and return cash to shareholders including paying dividends of $5.5 billion in 2020 and repurchasing $2 billion of its shares. With a strong portfolio of brands, agile supply chain and flexible business model, PepsiCo is building their competitive advantages to emerge an even stronger company in the future.

Google, a division of **Alphabet-GOOGL**, said it plans to spend $10 billion over the next five to seven years to help accelerate the adoption of digital technologies in India.

Europe's second-highest court rejected an EU order for **Apple-AAPL** to pay 13 billion euros ($15 billion) in Irish back taxes.

T. Rowe Price-TROW reported preliminary month-end assets under management of $1.22 trillion as of June 30, 2020, reflecting a 1% increase since year end.

****

Many are questioning the apparent disconnect between the economy and the stock market. Over the short term, the economic recovery may be a rollercoaster with plenty of ups and downs depending on the path of the virus as PepsiCo management pointed out. At the same time, Mr. Market is asking, “Are things getting better, or are they getting worse than at the beginning of the global pandemic?” Mr. Market believes things will look better four to six months from now, whether it is employment, corporate earnings or promising healthcare advances to treat COVID-19 thanks to encouraging progress reported by companies like Johnson & Johnson, UnitedHealth, Oracle and 3M. The strong market rally since the bottom on March 23rd has been led by large technology companies like Apple, Microsoft, Alphabet and Facebook as a “remote everything” world resulted in exceptional demand for digital products and services. While many technology stock valuations now appear stretched, many other companies appear reasonably valued as earning are expected to significantly improve in 2021 from trough levels in the second quarter of 2020. Our ***HI***-quality companies continue to pay dividends, repurchase shares, and make investments for future growth thanks to their growing cash flows and strong balance sheets. As always, it is a market of stocks and not the stock market that we remain focused on, and we continue to make our investment decisions stock by stock based on business fundamentals and valuations. COVID-19 has not repealed basic investment principles especially when applied to ***HI***-quality companies.

If you have any questions, please let us know.

Sincerely,

Ingrid R. Hendershot

Ingrid R. Hendershot, CFA
President