HIGHTOWER
Westchester

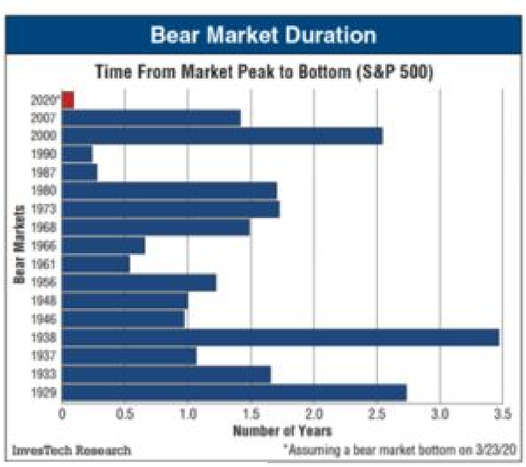
Market Commentary Q2 2020

Is it just us or has the use of the word unprecedented become, well, unprecedented! Our minds are still reeling given what has transpired throughout this fateful half year (yes, the year is only halfway over!).

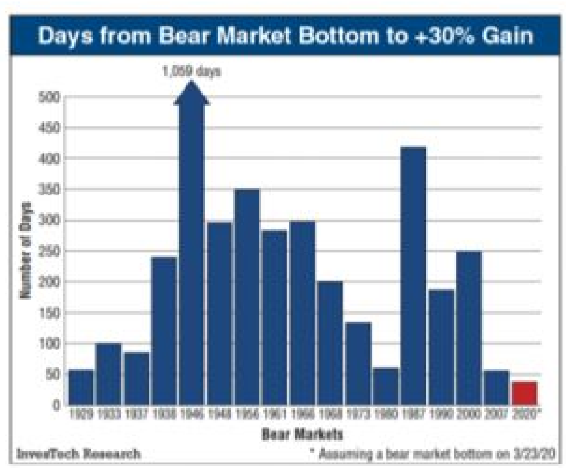
If you had a crystal ball and forecasted that a global pandemic would infect over approximately 12,700,000 people across the globe with over 560,000 deaths, 136,000 deaths in the U.S.[1], a global depression unfolding in a matter of weeks, U.S. unemployment skyrocketing from 4% to 15%, Federal ("Fed") interest rates falling from 2.5% to 0%, 30-year mortgage rates falling to all-time lows of 3%, PMI collapsing from 52 to 37, stock volatility tripling, oil plummeting -70% and yet, over the past year, stocks are, dare I say it, flat![2] Could you have believed such an absurdity would occur?

As this letter is being written in early July, the S&P 500 Index is up a staggering +45%, off the bear market lows of March 23rd.[2] According to our calculations, the market plunge and rebound has been the equivalent of 3 standard deviation quarterly moves, back-to-back! Not to get overly technical but that basically means that times like these are historically rare, very rare. The Feds liquidity firepower has thus far easily exceeded the social and economic devastations shaped by the pandemic with market expectations having priced in a Fed balance sheet in excess of $10 trillion by year-end!

The second quarter seemed like the first quarter movie was played in rewind. At the beginning of the year, stock prices increased modestly and then quickly plummeted in the fastest ever bear market, with the S&P 500 Index dropping by 34% in 23 trading days.[2] The second quarter started with the fastest ever 50-day stock price recovery, during which the S&P 500 shot up 40% (including a few days at the end of March), which was followed by a modest decline.[2] Though not intuitive, a 40% gain doesn't offset a 34% decline. The speed of both the decline and the recovery shows why maintaining diversified portfolios and using large market moves rather than the calendar as the signal that it's time to rebalance your portfolios is the prudent way of managing money.



Source – InvesTech Research



In addition, the first quarter began with all of us working in our offices and ended with everyone working from home. That, too, played out in reverse in the second quarter as businesses began returning to their offices in June. As you likely saw in our recently distributed email, we are now back in the office, be it on a part-time basis. Though we're incredibly proud of how well our employees functioned in the work-from-home environment, it is great being back in the office and collaborating with peers, despite the various restrictions.

As we look around the markets from an attribution standpoint, it is difficult to ignore the fact that the NASDAQ Composite Index is up approximately +53% from the March lows and becoming ever more concentrated into a two-tiered market.[2] The top-10 best-performing NASDAQ stocks have accounted for 90% of overall index's +16% year-to-date gains, while just the top-5 stocks generated 73% of gains.[2] The jury is still out on if the economic rebound will ultimately be a V-shaped recovery, a W-shaped recovery, or perhaps a square-root sign recovery. It is clear that the stock market has clearly looked beyond 2020 fundamentals and at current valuations, it is going beyond 2021 too and into 2022.

While the stock market takes its cue from the Fed, the economic rebound and recovery will continue to take its cue from the unfolding pandemic. New COVID-19 case data unfortunately has become politicized, but several state trends have worsened, and hospitalizations have worsened too. The pace of slower business and school re-openings in these states is now posing a new economic risk. Education remains a key wild card. Online learning has been an economic body blow to the nation's countless college and university cities and towns, plus no doubt students and parents. As of this writing, Harvard just announced online classes for the fall semester, as well as limited on-campus room boarding.

Speaking of the Fed, they continue to purchase Treasuries and mortgage-backed securities to support fixed income liquidity. And now having added corporate bonds into the mix, the Fed announced plans in mid-June to purchase individual corporate bonds in addition to exchange-traded funds containing corporate bonds. So far, the Fed has purchased $7 billion in corporate bond exchange-traded funds since the ETF purchase program began in mid-May.[2] The Fed then disclosed that it has purchased $428 million individual corporate bonds through the Secondary Corporate Credit Facility with an end goal of purchasing up to $250 billion or approximately 3.5% of the Fed's current balance sheet.

Source: Bloomberg, LP

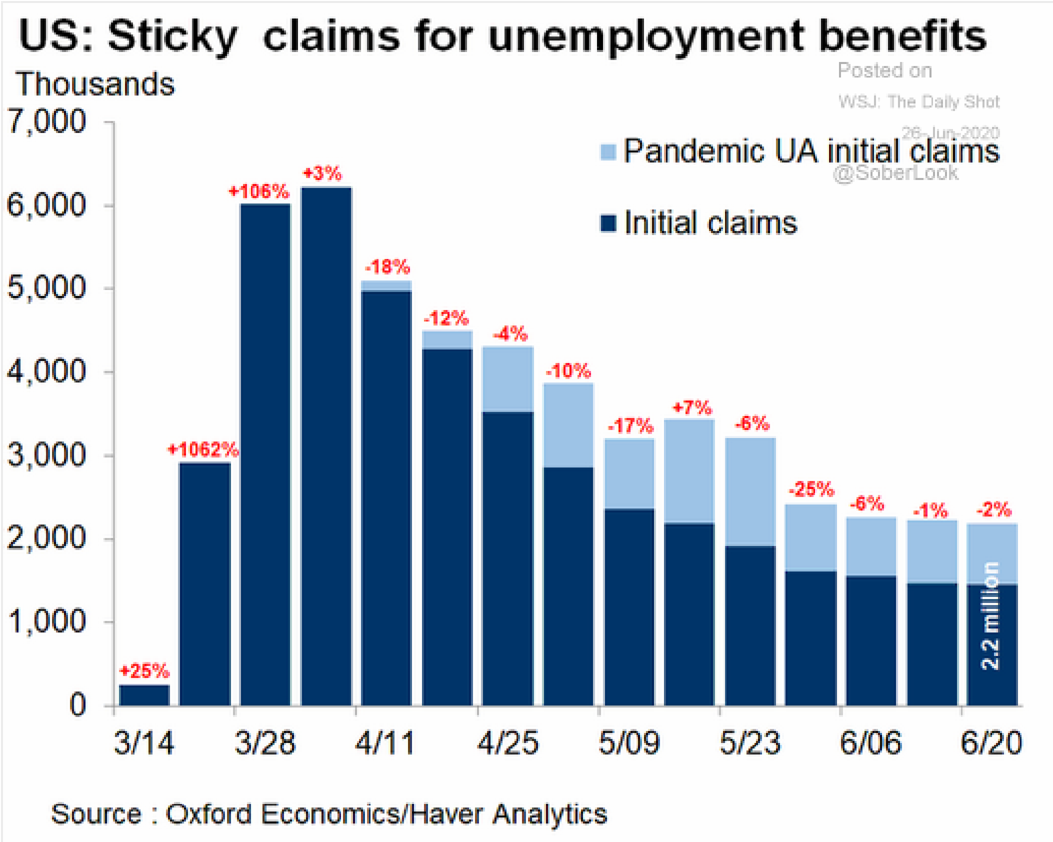
This is a very odd earnings season. It is one of the most anticipated quarterly earnings seasons in a long time, but at the same time, the second quarter earnings results are likely going to be overlooked as investors know it was a disastrous quarter. There is one caveat and that is most notably among the FAANG stocks (Facebook, Amazon, Apple, Netflix, Google). But abysmal numbers will come as no surprise to investors, and so will likely have no meaningful impact on the market. Moreover, looking through the pain of the second quarter's reports, there is a reasonable prospect of upside surprises in earnings in the second half and upward revisions in earnings estimates, which will help to support U.S. equity prices.

Source: Gavekal Research

The U.S. BLS jobs report was generally strong month over month in June, with nonfarm payrolls up +4.8 million.[6] But the effects of lingering unemployment (11.1%) are still being felt.[6] The BLS report reflects the pay period that contains the 12th of the month, so the most recent state (re-)closures will filter into next month's numbers. Initial jobless claims were still elevated at 1.4 million in the June 27th week, and continuing claims were 19.29 million in the June 20th week.[6]

The level of jobs is still devastatingly depressed, but the healing has started. The importance of this is that people are coming back into the workforce, which is holding up the unemployment rate. This is a very healthy signal.

The important piece of employment right now is that the enhanced benefits could become an employment headwind. With two-thirds of laid-off employees better off on enhanced benefits than they were in work, enhanced benefits could become a headache for employers trying to rehire workers.[6] If the enhancements expire as scheduled at the end of July, or are extended only as long as lockdowns, the effect will be small. But if they are extended for longer than justified by the immediate COVID crisis, they could retard the recovery in jobs, production and profits.



Oh, and let's not forget about the election we have coming up. Investors continue to fade Trump's re-election but as we saw in 2016 an identical signal of a democratic sweep was present, and it turned out to be false. We have witnessed in past elections that the last 90 days of one's campaign are what is important for investors. This raises the stakes for Trump to have strong growth and no COVID flare-ups come the Fall.

Global markets continued their advance on the hopes of progress being made on COVID-19/coronavirus medical treatments as well as signs that the worst of the global economic contraction may be behind us. MSCI All-Country World Index returned 3.2% for the month led by Emerging Markets (up 7.4%) followed by international ex-U.S. developed (MSCI EAFE up 3.4%).[2]

Emerging market equities and currencies performed well primarily due to perceived progress in U.S./China trade negotiations (despite mixed signals from both China and the U.S. over security issues tied to Hong Kong and Taiwan).

Additionally, bond yields have declined this year, and the 6.1% return for the Bloomberg Barclays Aggregate US Bond Index in just six months was much higher than we should expect for bonds in the long run as well.[2] The Bloomberg Barclays Intermediate Government/Credit Index returned 2.6% in the quarter and is now up almost 5% year-to-date.[2] The Treasury market saw yields fall throughout the quarter. Though major equity indexes hit all-time highs, Treasuries rallied alongside a relationship that does not occur often. Asset allocation teaches us that as risk assets perform better, safe haven securities tend to move lower. Conversely, a risk-off market such as the equity selling in May would bring more investors into Treasury securities, pushing prices higher. Fixed income found reasons to rally in

May as the market was in risk-off mode, as well as times equity prices were moving higher.

Switching to the municipal bond market, the theme for the quarter was very much the same as the first three months of 2019. Tax-free yields fell gradually while prices rose. Volatility was somewhat lower in the municipal market versus other sectors, highlighted in June when 10-year AAA-rated yields moved in a four-basis point range (a basis point is 1/100th of a percent.)[2]

The broad market municipal bond index returned 2.14% for the quarter (YTD 5.09%) while the Bloomberg Barclays Quality Intermediate Municipal Bond Index, our tax-free benchmark, returned 1.69% (YTD 4.08%). Once again, longer maturity bonds aided in the outperformance of the broad market index as tax-free mutual fund inflows remained exceptionally strong.

Another recurring theme in the municipal bond market was the strong demand by residents of high tax states such as New York, New Jersey and California. Compounded by the reduced supply in many states, municipal bonds of lower rated issuers traded at similar yields to much higher quality names in low tax states.

Shifting our attention to alternative investments and more specifically Gold, we are seeing 52-week and 8-year highs.[2] Gold spot prices rose above $1,800 an ounce for the first time since 2011 recently as investors continue to favor the traditional haven. Flows into bullion-backed exchange traded funds have already topped the full-year record set in 2009.[2]

As we look forward, there is nothing historical nor traditional about the Fed pegging interest rates at zero. In addition, there is nothing historical, nor traditional about the Fed borrowing money from the U.S. Treasury to lever up to purchase corporate bonds and junk bonds. Lastly, there is nothing historical, nor traditional about the Fed buying the bonds of such stalwarts as AT&T, Berkshire Hathaway Energy, Boeing, Coca-Cola, Exxon Mobil, Ford, or Wal-Mart.[7] The Fed doesn't need to commemorate the buying of common stocks by writ policy. They already have by fiat. The "Fed Put," commemorated by the Fed Chairman to staunch the 1987 stock market crash, is woefully obsolete circa-2020. Under Chairman Powell, the Fed Put has become a supercharged Fed Trampoline.

The financial media has made a parlor game out of guessing what letter or other shape the economic decline and recovery will look like, so our clients ask us the same question. We are estimating values based on a scenario that looks kind of like a check mark: a quick, nearly vertical decline, followed by a less vertical, longer recovery that ends up at a higher level than from where the decline started. When that comes to fruition is anyone's guess.

A lot of market pundits have been quoted saying that if we are going to baseball games, eating indoors and re-booking travel plans, the stock market will likely be higher. We aren't quite there yet, but baseball is developing rules that would allow fans to safely attend games, restaurants are open at reduced capacity and domestic travel has resumed. Three months ago, when less was known about the coronavirus, there was a fear that walking past someone who didn't know they were sick, or touching the same doorknob as they did, was risking one's life. With that said, there is still a lot of unknown around the virus and its impact on our day to day lives as we move forward, let alone the markets.

Going forward, we expect market volatility to continue as investors wrestle with daily coronavirus headlines and whether optimistic outlooks for a recovery are getting too ahead of themselves. Though we believe the market is now reasonably priced, when looking out over a full market cycle we expect the economy to recover and believe that our portfolios are well positioned and diversified for this "unprecedented" time.

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To discuss this commentary further, please contact us at 914-825-8630.

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[1] https://www.yalemedicine.org/stories/2019-novel-coronavirus
[2] Morningstar Direct
[3] https://www.investech.com/
[4] Bloomberg, LP
[5] Gavekal Research
[6] Strategas Securities, LLC
[7] https://markets.businessinsider.com/news/stocks/federal-reserve-buys-corporate-debt-berkshire-hathaway-walmart-mcdonalds-cocacola-2020-6-1029349199#