MONTHLY PERSPECTIVES - DISCIPLINED EQUITY

July 2020

The second quarter of 2020 was remarkable in two seemingly contradictory ways. The economy in the midst of the COVID pandemic experienced one of its worst periods since the Great Depression. Unemployment soared, small businesses struggled, and entire segments of the economy were in distress. Meanwhile the S&P 500® Index had its best quarter in twenty years, soaring 20.5%. This left the market down -3.1% year-to-date (as of June 30, 2020), a result that would have seemed improbable during the market collapse in March which left the market in the hole -19.6% for the year. In June, the trend line of the epidemic and the protests sparked by the police custody death of George Floyd dampened the market's ascent with the S&P rising 2.0% in the final month of the quarter. Two factors explained the disparity between the broad economic disruption and the quarter's market rally: massive monetary and fiscal stimulus and forward-looking optimism.

First, we want to celebrate the few rays of positive news that broke through the clouds over the past weeks. The U.S. housing market has remained surprisingly strong despite the complications of buying, selling, moving and building during a pandemic. China's economy, where COVID appears to be under control, rebounded with unexpected vigor towards the end of the quarter. In June, we added 4.8 million jobs as we struggled to open the economy by stages and with considerable geographic disparity.

But even with the increase in jobs, the official unemployment rate was at a still dismal 11%, a figure which understates the reality on the ground. There are millions of workers who are getting paid but not working and whose prospects are shaky. In addition, many unemployed remained uncounted since they are no longer actively filing for unemployment benefits while a substantial number more can't get the hours or wages they'd like. In the final week of the quarter, 1.4 million new applications were made for unemployment and news reports showed long lines out of state employment offices.

The massive stimulus passed by Congress has helped millions get through these first few months of disruption, but that lifeline is a precarious one. The $1,200 stimulus checks have either been spent by those in need or dropped into non-economic-stimulating bank and investment accounts by those in rosier financial condition. We are expecting a second round, but time is running out. The extra $600 a week of unemployment benefits that helped many households weather the storm expires in July, while the PPP program that kept millions of small business employees on the job is also winding down.

It is remarkable that the Federal Reserve (Fed) has been able to counterbalance all of this, at least as far as the stock market is concerned, by dropping rates back to the 2008 financial crisis level of close to zero and ramping up its security purchases. The Fed made substantial purchases of Treasuries and mortgage-backed securities (MBS) during the second quarter. The Fed stated recently that the Federal Funds Rate will stay near zero until at least 2022 and asset purchases will continue as well.

The final wild card is the November elections. So far there have been no major market reactions to the polling which projects a change in administrations. In terms of the COVID pandemic, there may be hope that new leadership will be a plus, although should the virus continue to rage it may have all the effect of switching fire chiefs in the middle of a conflagration. In any case, there seems to be a consensus that other factors, including the Fed's actions, will have more impact on the market than who is in the White House.

The stock market is always anticipatory. Normally this view is rather confined, focusing on the next quarter, the next corporate earnings report or the upcoming employment report. This market is different. It is discounting not only the remainder of 2020 but potentially much of 2021. The thinking is that if our economic woes are a matter almost entirely of viral origin, then when we see the end of the epidemic either by natural forces, treatment or vaccination the world will quickly right itself. Not only is the time frame for this optimism out of the ordinary, but we believe it also takes too simple a view. What will the new normal be? We are expecting considerable changes to how business is done and to how consumers will live their lives. And this will have implications for economic growth.

This uncertainty and volatility have unsettled not only institutions but many individual investors. This hasn't kept many who got cold feet in March from warming up to the summer market -- buying has been particularly intense with the favorite mega-cap growth stocks. We have enough of a contrarian impulse to consider this trend somewhat disturbing. While we are fervent in our hope that we will soon find a way out of this viral nightmare, we prefer not to invest with hope as a principal. In the end, we are confident that valuation still matters, and that quality will win out over time. We remain focused on corporate fundamentals which seems to us the best way to prepare for the unexpected. This past quarter's market rally with its high-flying favorites shows the power of optimism. It also, to our minds, increases investor risk, especially to those attracted to the peak of the wave. We prefer to navigate to a more secure harbor and patiently wait out the storm.

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