Madison INVESTMENTS

MONTHLY PERSPECTIVES - DISCIPLINED EQUITY

May 2020

These are disorienting, dizzying times. As April ended most of the country was still deep into COVID-19 sheltering, with anxiety over the pandemic and the shut-down economy unabated. And yet the month closed with a surprising 32% S&P 500® Index rally from its March 23 intraday low, with a monthly return of a robust 12.8%. This was the best monthly return since 1987. With the economy reeling and unemployment setting new records, the market was still down year-to-date, but just -9.3%, a far cry from the -30% loss we were looking at in late March. Disruptions in the bond market had also settled, but by April 30 investors looking towards the safety of Treasury Bonds were getting paid a mere 0.6% on the 10-year Treasury. With even the top scientific experts unable to reliably predict the path of the virus and the parallel inability of economists to chart the likely economic future, and knowing that the stock market hates uncertainty, why the rally?

Perhaps the best answer came from Minneapolis Federal Reserve President Neel Kashkari who told his 60 Minutes interviewer on March 22, "There is an infinite amount of cash at the Federal Reserve." This suggestion that there was no limit to the Fed's potential monetary stimulus along with the federal government's massive $2 trillion spending bill which indicated a similar position on fiscal stimulus was the tipping point for the market. The comfort of substantial and promissory stimulus was enough to balance, at least for the moment, the anxiety over the viral and economic unknowns. At the Fed's latest meeting on April 29, the central bank's policy was reaffirmed by Chairman Powell, as he pledged to do everything within the Fed's powers to set the stage for recovery, even as the first quarter's GDP was announced as slowing by -4.8%. The prospects for second quarter GDP are considerably worse.

The consensus, which we subscribe to, is that this government commitment has put at least a temporary bottom in the stock market. As we've seen in the price of oil, short-term effects of the economic slowdown (the early stages of what will certainly be deemed a Recession) are disinflationary, while the longer-term effects of expansion of the money supply and other federal actions are worth watching as they could be inflationary down the road, although Japan has shown us otherwise. If indeed there is a rethinking of supply chains and a move towards reshoring, that too could be inflationary as labor costs percolate through the economy. This would require greater investment which would drive productivity improvements and ultimately GDP growth, but this will take time. This is an important consideration for investors whose appetite for equities has been diminished by the disturbing volatility, since stock investing has traditionally been one of the better hedges against inflation.

It's not only the virus which is novel -- investors haven't witnessed anything like this either. These unique circumstances have led us to a renewed review of the market action and the holdings in your portfolio. One of the complications with comparisons to the broad index returns is the narrowness of the indices. The five largest stocks in the S&P 500 now constitute 20% of the index -- more than even at the height of the technology boom twenty years ago. Since the market's all-time February high the median stock in the S&P 500 is trailing the Index by about -10%, which is one reason most diversified portfolios are finding it difficult to match their benchmarks, which are capitalization weighted and as such, heavily reliant on those mega-caps.

While the April market rally was of some comfort to investors, the overhanging question for most of us is "when will we be back to normal?" Here we profess no better crystal ball than the multitude of experts who are hardened to the same inquiry. So much remains unknown and so much depends on human behavior. It would be nice if we could end it all by declaration as some politicians seem to believe. This is belied in the late April actions of Georgia Governor Brian Kemp who "opened up the state" only to find that there is a difference between a restaurant open for business and customers willing to eat in public. What we do have is faith in the long-term resilience of the U.S. economy and the ability of the world's mobilized scientific community to find a solution to COVID-19. The April market rally was augmented by late-month news of advances in both COVID-19 treatment and prevention, the first steps toward this resolution. While the extended sheltering might try our patience (cabin fever, anyone?), we expect to be able to look back at this time as another of the incredibly trying, difficult periods our country has survived, including world wars, the flu pandemic of 1918, the Great Depression and the financial crisis of 2008-2009.

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