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Q2 2020 Market Recap

YTD Market Index Returns	
US Agg Bond	6.14%
US Corp High Yield	-3.80%
Russell 1000 Value	-16.26%
S&P 500 TR	-3.08%
DJIA	-8.43%
MSCI EAFE TR	-11.34%
Russel 2000	-12.98%
MSCI Emerging Mkt	-9.78%
Gold	17.17%

The economic reopening in the US seems to be underway as state and local governments, at various rates, have allowed most businesses to reopen with social distancing measures in place. However, the virus continues to spread and some new "hot spots" seem to be developing in the US and Globally. The virus debate seems to be centered around: is this the continuation of the first wave or is this a second wave of viral spread? As we look back on the first part of the year, it is increasingly clear that SARS-CoV-2, the virus that causes Covid-19, has unleashed the worst global health crisis in a century, the results of which have given rise to the worst economic contraction in the last 80 years. Forced government shutdowns akin to an all economic stop have caused a wave of joblessness as more than 40 million people claiming initial jobless benefits in the US.

The Economic Recovery, the Stock Market and the Element of Time

The National Bureau of Economic Research (NBER), considered the official arbiter of when recessions begin and end, says that the recession began in February. On average, US recessions tend to last around 13 months. Not only has the economic damage of forced shutdowns been of historical proportions, but also the policy response from the Federal Reserve and Federal Government has been of a size and speed not seen. Ever. To the credit of our Fiscal and Monetary authorities, their penchant for acting quickly has reduced to some extent the possibility of a depression like scenario. This quick response has translated into conversations in the business and mainstream media of a V-shaped recovery in the economy. In the following paragraphs we will make the case that there is a time element to this recovery that seems to be overlooked as the stock market has come close to recovering all its peak to trough losses.

Stimulus vs Replacement

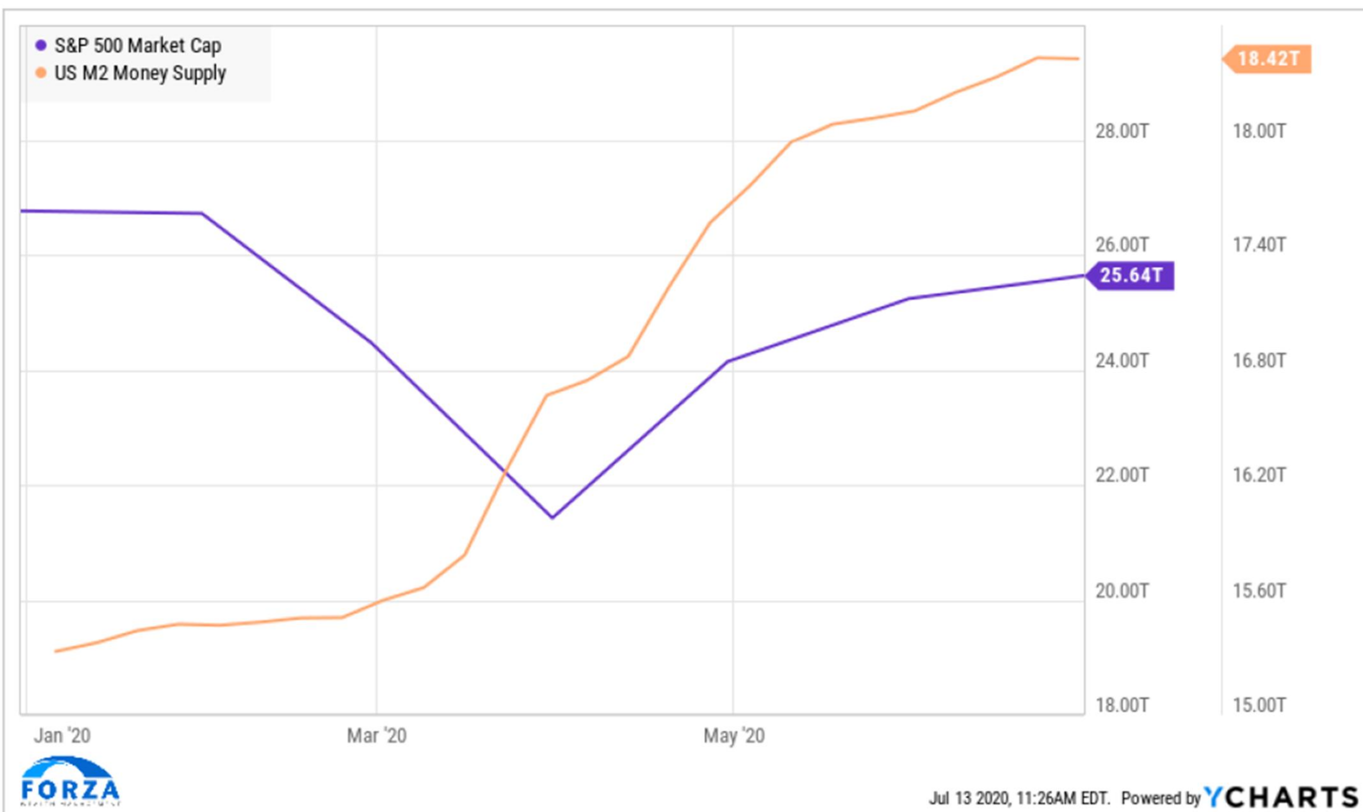
As we mentioned earlier, the fiscal response to the virus spreading, here in the US, has been massive. It can be tracked at an aggregate level via the BEA (Bureau of Economic Analysis) report seen below. During the months of April and May, the Government has injected approximately $3 trillion in "Personal transfer receipts" of which virtually 100% was “Economic impact payments” related to Covid-19. Keep in mind that these monthly figures are annualized. As you can see, and highlighted below, the $3 trillion matches almost exactly the drop in “Personal Outlays” over the February to April timeframe. Much has been made in the press of these fiscal payments being stimulative, in nature, however, it looks as though, that this is simply replacement. Essentially plugging the $3 trillion hole in personal outlays between February and April. If these payments were stimulative in nature, they would have been more than the baseline of $15.5 trillion present in February, before the virus began spreading in earnest and government mandated shutdowns began. This also begs the question: How many more trillion-dollar checks can be written, before the US economy can stand on its own?

Effects of Selected Federal Pandemic Response Programs on Personal Income, May 2020
(billions of dollars, seasonally adjusted at annual rates)

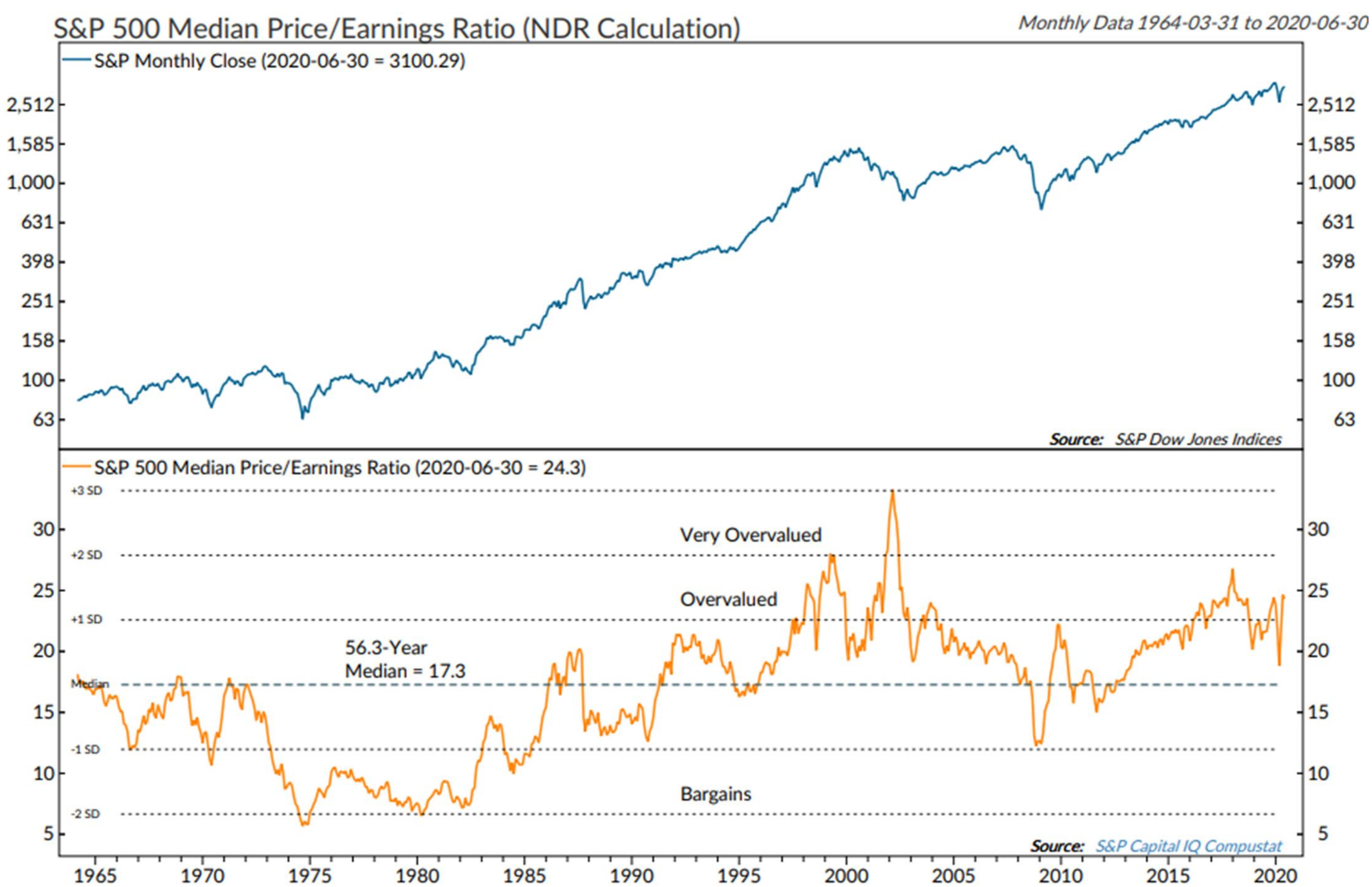
Line		Levels				
		2020				
		Jan.	Feb.	Mar.	Apr.	May
1	**Personal income**	**19,014.3**	**19,117.5**	**18,694.6**	**20,713.5**	**19,839.3**
2	**Compensation of employees**	**11,674.2**	**11,732.0**	**11,335.1**	**10,495.5**	**10,753.7**
3	Wages and salaries	9,505.3	9,555.2	9,202.7	8,499.8	8,733.3
4	Private industries	8,024.0	8,069.3	7,715.1	7,060.4	7,321.8
5	Government	1,481.2	1,485.9	1,487.6	1,439.4	1,411.5
6	Supplements to wages and salaries	2,168.9	2,176.8	2,132.4	1,995.7	2,020.4
7	**Proprietors' income with IVA and CCAdj**	**1,711.3**	**1,764.3**	**1,623.2**	**1,417.2**	**1,457.1**
8	Farm	26.3	61.6	26.2	23.0	19.8
9	Nonfarm	1,685.0	1,702.8	1,597.1	1,394.2	1,437.3
10	**Rental income of persons with CCAdj**	**793.7**	**795.4**	**797.4**	**797.9**	**799.1**
11	**Personal income receipts on assets**	**3,023.6**	**3,007.0**	**2,999.2**	**2,953.2**	**2,911.1**
12	Personal interest income	1,721.3	1,701.4	1,690.2	1,660.8	1,638.8
13	Personal dividend income	1,302.3	1,305.6	1,309.1	1,292.3	1,272.3
14	**Personal current transfer receipts**	**3,270.4**	**3,284.3**	**3,360.3**	**6,388.0**	**5,290.1**
15	Government social benefits to persons	3,214.8	3,228.5	3,304.3	6,331.9	5,233.9
16	Social security	1,067.4	1,071.7	1,075.1	1,077.6	1,080.5
17	Medicare	829.6	833.4	837.3	841.1	861.4
18	Medicaid	638.3	644.2	661.0	689.0	707.7
19	Unemployment insurance	26.5	26.2	69.6	452.6	1,277.9
	Of which: [1]					
20	Pandemic Unemployment Assistance	...	...	...	29.5	131.0
21	Pandemic Emergency Unemployment Compensation	...	...	...	0.9	7.2
22	Pandemic Unemployment Compensation Payments	...	...	...	149.9	841.8
23	Veterans' benefits	124.6	125.2	125.8	126.2	127.1
24	Other	528.4	527.8	535.5	3,145.3	1,179.3
	Of which:					
25	Economic impact payments [2]	...	...	...	2,588.4	605.8
26	Other current transfer receipts, from business (net)	55.6	55.8	56.0	56.1	56.3
27	**Less: Contributions for government social insurance**	**1,458.9**	**1,465.6**	**1,420.6**	**1,338.3**	**1,371.8**
28	**Less: Personal current taxes**	**2,220.7**	**2,233.7**	**2,163.9**	**2,014.8**	**2,051.8**
29	**Equals: Disposable personal income (DPI)**	**16,793.6**	**16,883.8**	**16,530.7**	**18,698.6**	**17,787.5**
30	**Less: Personal outlays**	**15,463.4**	**15,465.4**	**14,453.0**	**12,676.2**	**13,666.1**
31	Personal consumption expenditures	14,909.9	14,914.3	13,925.8	12,168.2	13,162.6
32	Personal interest payments	357.1	354.6	330.7	311.5	306.9
	Of which:					
33	Student loan forbearance [3]	...	...	-21.4	-36.0	-36.0
34	Personal current transfer payments	196.4	196.4	196.5	196.6	196.6
35	To government	106.6	106.7	106.7	106.8	106.8
36	To the rest of the world (net)	89.8	89.8	89.8	89.8	89.8
37	**Equals: Personal saving**	**1,330.2**	**1,418.4**	**2,077.7**	**6,022.4**	**4,121.4**

Liquidity and Valuation

As we have noted the fiscal response with its size and speed was also coupled with a monetary response from the Federal Reserve. In March, the Fed took action so that the liquidity issues in the markets would not feedback and cause solvency problems for companies. This excess liquidity boosted the money supply (M2) by approximately $2.5 trillion. This injection of liquidity was what seemed to have sparked the advance in the stock market that has turned into a rally of historic proportions. We wondered how the boost in M2 stacked up to the market cap gains of the S&P 500. As you can see that increase in the M2 of $2.5 trillion tracks very closely to the gains in the S&P 500 market capitalization over that same period.



So where does all this leave us regarding valuations of the stock market as a whole? The S&P 500 has recovered most of its first quarter declines and as of this writing, is within 10% of its all-time high, despite most forward guidance on earnings being pulled by companies and valuations that are expensive at best, without factoring in a pandemic. It appears the market broadly has accepted and is expecting a flawless recovery from the virus-related shutdowns. Our biggest concern is when will profitability, productivity and valuations matter at the company level? Said another way, the fiscal and monetary support that has been provided, can it manifest into growing aggregate demand in the economy and growing company earnings? This is where time matters.



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Headline Unemployment and Continuing Claims: Who Gets Counted?

Weekly initial and continuing unemployed claims reporting are based on state unemployment and has been the most watched and waited on high frequency economic data point. However, that is not a complete picture. Over the last two decades, those that are contract workers or those working in the "Gig" economy (think Uber and Lyft drivers or Airbnb) have grown substantially and as a result their impact on the true employment picture is meaningful and needs to be accounted for. Since these contract workers are not included in the state figures of initial and continuing claims, the Federal Government created programs like the PUA (Pandemic Unemployment Assistance) for contract workers not eligible for state unemployment. If these programs and those that are drawing benefits from them are included, according to the EPI, continuing claims are approximately 33 million. See chart below. So, with a labor force that is around 160 million people, we are at or near an unemployment rate of 20% assuming continuing claims remain at this level. This might make it a tough go for consumer confidence, for those that remain employed throughout this economic cycle. How secure do the employed feel about their jobs? How are their behavioral patterns around spending going to change in the future? Once again, the time element to this recovery is showing up as an important element.

FIGURE A

Continuing unemployment claims in all programs

January 4, 2020–June 20, 2020

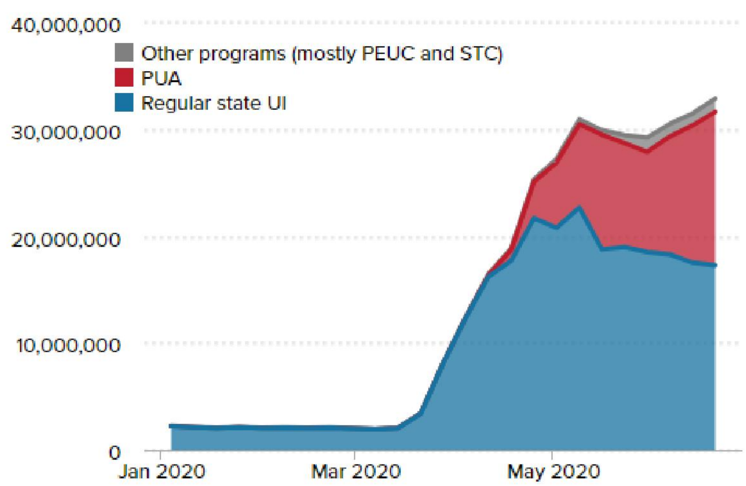

Chart Data

Notes: Pandemic Unemployment Assistance (PUA) is the federal program for workers who are out of work because of the virus but who are not eligible for regular state unemployment insurance benefits (e.g., the self-employed). "Other programs" includes Pandemic Emergency Unemployment Compensation (PEUC), Short-Time Compensation (STC), and others; a full list can be found in the bottom panel of the table on page 4 at this link: https://www.dol.gov/ui/data.pdf.

Source: U.S. Employment and Training Administration, Initial Claims [ICSA], retrieved from Department of Labor (DOL), https://oui.doleta.gov/unemploy/docs/persons.xls and https://www.dol.gov/ui/data.pdf, July 9, 2020.

What about Real Estate?

As the pandemic has taken hold, many commercial real estate landlords and tenants have been at odds. Tenants are looking for some relief on rent payments and landlords are looking for their tenants to perform based on the agreed upon lease terms. Office buildings, restaurants, retail shops are all facing crimped demand, while at the same time, steady lease obligations to fulfill. Leading into the pandemic, cap rates, a measure of long-term returns from real estate, were near historical lows at less than five percent. Clearly, the continued spread of Covid-19 has accelerated the need for less commercial real estate or a reduced amount a capacity utilized within the same square footage as social distancing protocols remain. Moreover, the stay at home trend whether it be for work or play or somewhere in between, is not likely to be unseeded soon. Cap rates at less than five percent combined with typical leverage or debt attached to these properties, did not leave much room for a slowdown, forget a government mandated all economic stop. As an example, a restaurant in the high volume, low margin business may not be profitable at 65% or even 75% capacity. The restaurant tenant may request relief with the Landlord who made need to turn to their debtors for forbearance on their commercial loan. Forbearance requests have also shown up in home mortgages and for renters of apartments, where government moratoriums on eviction have been put in place. Again, the time element of these workouts comes into play.

In Closing

Having seen past recessions real-time from a portfolio management seat, clearly there isn't a playbook for this virus led slowdown and as we have tried to demonstrate, there is a time element to the recovery that does not seem to be important to the overall stock market, particularly at current levels. Perhaps all the support from the monetary and fiscal authorities has bought one thing and that is time. The time needed to become more optimistic about the future growth prospects of the broader economy, work out new lease arrangements on commercial real-estate, forbearance on mortgages or even time to find other gainful employment

Important Information and Disclosures