STEWART CAPITAL

# Market Commentary – Second Quarter 2020

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**What Shape Recovery?**

*U shaped, V shaped, W shaped or some other description that has not yet found its way into the economic and financial nomenclature?*

Are we in a recovery? Will the recovery take longer to take hold? Will people get back to "normal," whatever that might be? Is the market ahead of itself? All of these are good questions, and questions that we and many others have been asking as we reset and recalibrate our lives as the COVID-19 pandemic winds down. The answers, like many things in life, are not as clear cut as we would like.

It is or was an odd recession. It started in February specifically because the pandemic forced shutdowns of the domestic and global economies. However, economic indicators are snapping back just as quickly – albeit not to pre-recession heights.

Jobless claims spiked up from just under 1.8 million on March 13, 2020 to approximately 25.8 million on May 15, according to data provided by the US Bureau of Labor Statistics. From that point until now, jobs data have been surprisingly strong. Rather than dropping an additional couple of million for the May month-end data, the economy added nearly 2.7 million jobs. As if to show that the May data wasn't a fluke, the June data was more than two million jobs higher, as the economy added 4.8 million jobs. This, even though there is anecdotal evidence that the additional $600 per week in pandemic unemployment benefits is keeping the ranks of the unemployed artificially high. This is because some people have little to no incentive to return to work when they make more money on unemployment benefits than they did in their jobs. Even though unemployed people must actively look for work by scheduling interviews, many are simply choosing to skip the interview rather than put that extra money at risk. We would expect to see jobless numbers click more sharply downward beginning with the week of July 27 as the extra $600 weekly benefit begins to wind down and the incentive to not work goes away.

Not that the employment situation is the only indication of light. Retail sales, after three successively bigger contractions, showed significant strength, jumping more than seventeen percent (more than twelve percent ex-autos) as pent up demand caused by pandemic closures have people in stores and buying. While we fully expect that the initial rush of buying will slow down, people like the social aspect of going to stores (Amazon and their ilk notwithstanding). Consumer confidence (according to data from the Conference Board as reported on Bloomberg Professional) has also bounced back smartly, with confidence in the future bouncing nearly ten points to 106 from 96.9 and confidence in the present jumping more than fifteen points to 86.2 from 71.1. Both helped to increase the all-in consumer confidence number to 98.1 – up from 86.6 in the previous month.

As if that isn't enough good news, the manufacturing sector changed to expansion mode from contraction or recession, with the Institute of Supply Managers' manufacturing index rising to 52.6 (where readings above 50 indicate expansion and below 50 indicate contraction) from 43.1 the previous month.

So, what shape is the recovery?

*We are less concerned with whether the recovery is V, U or even W shaped. We believe that we are now in a recovery.*

What is less well understood is just how vigorous that recovery can or will be. What is known, but unstated, is that the pandemic caused phase shifts in processes that should have a huge impact on the domestic and global economy.

**Size Matters**

The equity markets have roared back with a vengeance during the second quarter. The NADSAQ has soared to a new high and other broad equity markets are eliminating the losses seen during the Great Bear Market of 2020.

*Yet, returns are not what they would seem and, in our view, do not necessarily provide an adequate view of just what is happening in the market.*

At the bottom, the Standard & Poor's 500 (S&P 500) was down more than 1000 points or 33.92%. From then through the end of the second quarter (June 30, 2020) it came roaring back to finish the period just over 200 points from its mid-February high. In fact, through July 7, 2020, the Index has continued its climb so that it has now moved into positive return territory for the year with a return of 6.88%. (Return is based on Bloomberg Professional Data as of 7/7/20. Performance is calculated as a weighted average performance as of a point in time on 7/7/20, rather than a rolling weighted average performance calculation that would reflect the daily changing capitalization weights of index components, and may result in a return that differs from that provided by Standard & Poor's.) Yet, as good as the Index (and by inference stocks) seem to have been, not all stocks have done nearly as well.

To fully explain, you need to understand that most stock indices, like the S&P 500, are market capitalization weighted (market cap). This means that the largest companies have a greater impact on returns than smaller companies. In fact, the five largest companies within the S&P 500 make up more than 23% of the total market cap totaling $6.787 trillion. To put that in perspective, the five largest companies within the index are roughly equal in size to the total market cap of the bottom 75% of companies ($6.931 trillion), and substantially larger than the bottom half of all companies ($3.031 trillion) within the index.

While the S&P 500 was up 6.88% through July 7, the average return of all the stocks within the S&P 500 was a negative 9.42% and the average return of the top five was 30.31%. This seems to indicate that there may be some significant dispersion of returns within the universe of stocks that make up the index.

Indeed, the largest stocks within the index have had a huge impact on the index's returns. To wit, if we remove the top ten stocks by market capitalization from the benchmark and recalculate returns, the index's return drops from positive 6.88% to negative 1.47%. Further, if we only remove the top five stocks from the benchmark and recalculated, the return is still a negative 1.09%. To put it bluntly, if investors didn't own all five of the largest stocks in the S&P 500 then they probably underperformed and potentially in spectacular fashion.

There are similar experiences with the other capitalization weighted indices. For instance, within the NASDAQ Composite Index, the top five names represent more than a third of the market cap of the index and the top ten names represent more than 47% of the total market cap. The top five names are worth more than the bottom 98% of companies combined. The return differential is not as pronounced as that for the smaller, S&P 500 as the index return was 28.85% versus 27.19% without the top five and 21.41% without the top ten, but there is a huge differential in average returns as the average return of the top five was 51.40% as compared to an average return for the composite of 4.76% through 7/8/2020. The big differential between average returns and market cap weighted returns is accounted for by the sheer number of stocks within the NASDAQ Composite Index.

There are even differences within a much smaller index like the S&P MidCap 400. While returns through

7/8/2020 had not turned positive (-5.53%), there was still a reasonably large dispersion of returns when you remove the five and ten largest names and recalculate. Removing the five largest companies saw the index return drop to -7.92% and removing the ten largest saw a further decline to -9.02%, with a spread between the average return of the top five of more than 66% (51.40 vs. -15.64%).

The takeaways should be reasonably clear: The top five or ten stocks within market cap weighted benchmarks drive returns for the benchmarks; and benchmark returns are seldom indicative of average equity returns.

**Outlook**

Equity markets have made up most of their pandemic shut-down losses and valuations seem to have gotten ahead of themselves when looked from a benchmark standpoint (see benchmark discussion above). As such, this puts us in a real conundrum.

*With equity markets having seemingly moved ahead of what valuation parameters would indicate, does it make sense to maintain our preference for stocks versus bonds and cash?*

From our standpoint, it eventually comes down to the fact that bond returns will likely be close to zero for the foreseeable future (you need to go out nearly twenty years to get a yield of 1% from Treasury securities) and cash returns will be, effectively, zero for the foreseeable future.

*For those simply looking for return, stocks become the best choice out of decidedly difficult options.*

We believe that equity returns will likely be volatile but muted for the remainder of the year – at least until it becomes clearer which candidate wins the presidency. Even though the calendar has flipped from 2020 to 2021 on analyst estimates, and growth prospects for the S&P 500 over that same period currently expect greater than twenty-nine percent growth year over year (after expectations for a decline from 2019 to 2020 of nearly twelve percent), the PE multiple is still extended at greater than nineteen times expected 2021 earnings. There simply isn't much room for PE expansion.

While bigger is better has certainly provided a haven from the current economic storm, valuations do matter. We would not be surprised to see a spike in volatility as pandemic-related news flips from day to day and as we get closer to the presidential election.

We also don't believe that bonds will provide much shelter in a storm. As we indicated in last quarter's commentary, ultra-low bond yields translate into longer bond duration and, by definition, greater volatility. While we are not expecting the Fed to shift its rate stance for the foreseeable future, they do not (directly) control the entirety of the Treasury yield curve. As such, while the low end of the curve should sit in place for some time, the longer end of the yield curve could jump around a bit creating unwanted volatility. This could be doubly problematic for credit investors (i.e., anything not a Treasury security) as credit spreads bounce around depending on the outlook for the economy or sectors of the economy.

For the time being, we are maintaining our preference for stock investments versus bonds or cash, realizing that while the equity indices might have extended valuations, that does not necessarily extend to the entirety of the equity universe.

**Strategy Overview**

*We like to use volatility to our advantage as volatility causes mis-pricings, and mis-pricings lead to opportunities.*

As we stated last quarter, the trick is making sure that one is pricing it correctly. Pricing volatility/risk gives us the option of deciding if the risks with which we are presented are worth the rewards offered, realizing that we don't have to make the decision to buy. Time and patience often reward investors.

In our mind, making sure that we are appropriately compensated for the risks that we take is the single most important decision investors make. Ensuring that our valuation models encompass the risks that we as investors face every day is our primary duty. As risks get elevated, it is our job to ensure that we adjust our return requirements upward in conjunction. Importantly, by ratcheting up our return requirements in times of elevated risks, the opportunities end up being at levels that, were we to own the entire business outright, we should be more than pleased with the result.