CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

July 24, 2020

Financial Markets Commentary 2nd Quarter 2020

Summary

Stock prices rebounded sharply last quarter as investors began to anticipate the eventual economic recovery. Whether the recovery actually comes to pass as soon as the market is hoping is another thing entirely, but it is important to remember that the stock market is a discounting mechanism. In other words, it represents the collective expectation of participants. A great deal of money moved out of the market back in March as a result of virus-related fears. That money does not influence prices until it re-enters the market, which it has been doing steadily since May. Those inflows have provided a cushion for the market on most down days and extra fuel on good days.

Both foreign stocks and bonds also rose during the quarter as well. Bonds benefitted from direct Federal Reserve buying of corporate and government debt, while international stocks were aided by central bank activity in China, Japan, the European Union, and in the United Kingdom. Higher quality bonds might well have declined in price had the Fed not been buying them, since inflation expectations were rising. As it was, the strong performance of stocks was not undercut by rising interest rates, which helped justify even higher prices. As long as this environment persists, financial assets have the wind at their back.

The S&P 500 rose 20.5%[1] last quarter, trimming its loss on the year to -3.1%. While one may assume that technology was the top performing sector during the second quarter, it was actually third behind energy and consumer discretionary (think of Amazon and Home Depot). Energy stocks lost so much in the first quarter that even with a 32% bounce they are still down almost -35% for the year through last quarter. Technology only lost -12% in the first quarter, so its 30.5% surge last quarter pushed it to a gain of nearly 15%. Utilities (+2.7%) and consumer staples (+8.5%) were the only two sectors that didn't gain 10% or more last quarter. Smaller stocks enjoyed an even larger bounce than large caps last quarter with the Russell 2000 gaining 25.4%. While impressive, that gain only reduced the 2020 loss to -13% from roughly -30% a quarter earlier. International markets climbed back 14.9%[2] last quarter but are still down -11.3% for the year through last quarter. There was a lot of variance between regions.

---

[1] U.S. stock average figures are rounded to the nearest 0.1%. They are taken from Standard & Poors through Morningstar Workstation, or in the case of sectors, directly from S&P's quarterly summary.
[2] International stocks performance is taken from Morgan Stanley Capital International (MSCI) again via Morningstar Workstation.

China is up 3.5% in 2020 having risen 15.3% last quarter. That is by far the best foreign market performance this year. European stocks gained almost the same amount last quarter (15.4%), but that still left it down -13.2% for the year due to their much deeper first quarter decline. Latin America soared 19.1% last quarter but that barely registered against the -45.6% first quarter decline. Japan led the way during the quarter (19.8%) but is still down -6.2% for the year.

The Barclay's Aggregate Bond Index rose 2.9%[3] last quarter, but that tells you very little about the average bond because the index is longer in duration (more sensitive to interest rate movements) and higher in quality that most actual bonds outstanding. Most intermediate and long-term bond funds performed much better than that, as Fed led liquidity returned to the sector. The Barclay's 1-5 year corporate bond index swung from a -2.2% first quarter loss to a 3.3% gain for the year on the strength of a 5.6% second quarter rally. Low quality "junk" bonds rose 9.5% during the quarter, which brought them back to -3.1% on the year. On the other hand, safe short-term Treasuries only gained 0.3% last quarter, but are ahead 3.0% for the full six months.

Activity

We began the quarter in a defensive posture. We made some adjustments in late April, essentially removing the downside hedges we instituted in March and building up cash levels in anticipation of a market break in summer that would enable us to deploy some of that cash. Of course, that break hasn't come yet (we will have more to say about that later in the Commentary). In June, we took a fairly incredulous look at market levels compared with the economy and decided to decrease our economic exposure even further. This meant selling down stocks even further while substantially increasing our weighting in high quality bonds. With the bonds, we could still generate some return while we waited for the stock rally to fizzle out. Both stock and bonds have continued to rally into July, perhaps because of the unprecedented financial support of the Federal Reserve.

Outlook

It is really difficult to forecast future market movements under any circumstances, but today it seems especially foolhardy. If the virus has a stronger than expected second wave in the fall, for example, stocks would be vulnerable because that is not reflected in current prices. If there is uncertainty following the U.S. election, as there was in 2000, that would almost certainly have a negative impact (as it did then). If the "it's only a matter of time until we have a vaccine and things can go back to normal" narrative is replaced by something more pessimistic, the market will likely trade lower. On July 23, 2020, the S&P is traded at roughly 3200. The upside from

[3] Bond performance is taken from Barclay's Capital via Morningstar Workstation.

here relies on continued positive developments on the virus front, more normalization of the economy, and no constitutional crisis in November. If the S&P 500 was trading at 2800, simply the absence of bad news might well be enough to push stocks higher, but that is not where we are. In fact, the NASDAQ might be in bubble territory.

It may be time to increase international exposure. American stocks trade at a substantial premium because of our much greater weighting in non-cyclical growth industries (information technology and biotechnology) and our long record of political and economic stability. The former we believe will not change anytime soon, though there are some very impressive foreign technology companies like Alibaba (China), ASML (the Netherlands), MercadoLibre (Argentina), and Shopify (Canada). The latter is overstated, perhaps vastly. Financial professionals are not talking about Brexit or the Italian elections these days; the biggest political wildcard is America.

Commentary

There is a reason we use a navigation symbol in our logo – we think of ourselves as your navigators. There are two things that follow from the metaphor of steering the proverbial ship. One is to be constantly on the lookout for danger, and the other is the idea that our job is not done until you have reached your destination. Everything we do, therefore, is in keeping with those objectives.

We have written previously about our coronavirus concerns, specifically that the market is too optimistic about the timetable for a full recovery. That said, there are certain positives that came out of this crisis. The virus has significantly accelerated the adoption of technology. We are now using services like Zoom and Grubhub because they are convenient and safe, but it is fair to say that most of us weren't clamoring for the chance to talk to each other remotely or have our groceries delivered before the crisis hit. Furthermore, this crisis is accelerating other trends like the demise of the retail store and the use of electronic payment. We are seeing new investable industries form – cybersecurity, data centers, clean energy, and genomics to name a few – while others (office equipment, coal, textiles) are all but gone.

This has had profound implications for the stock market in terms of driving investor cash toward companies that are disrupting the status quo (even if they aren't yet profitable) and away from those whose business models are being disrupted (even if they are profitable). Because of this, investment theories that were widely accepted over the past few decades are struggling in this environment. Low P/E (price to earnings) companies are not outperforming high P/E companies as they regularly did last century, so instead of regressing to the mean, under- and over-performance gaps continue to widen.

Think of a company like ExxonMobil. Very little changed for this company from World War II to the Financial Crisis. They discovered oil, extracted it, refined it, and sold it. Other than the emergence of the plastics industry in the 1960s, the main use of oil was for transportation. Exxon stock was valued on the basis of expected future net profits from sales plus the value of their assets (primarily the oil that they owned that was still in the ground, known as reserves). Today the market wonders about the future of internal combustion engines versus engines than run on other forms of power, which are expensive but becoming cheaper almost by the day.

Meanwhile, the disruptive companies trade at extremely high prices. According to Ned Davis Research (as cited in Barron's online, 7/20/2020) the big six technology stocks[4] trade at 36 times earnings and 6 times sales. For perspective, the former was exceeded in early 2000 but the latter is an all-time record. There is more than a whiff of tech bubble here, but just as it was back then, nobody knows what will stop the run of the big six or from what price level that will occur.

Sometimes, you can look back at a practice and say "that was dumb. I should've known that couldn't continue because …" In the tech bubble of the late 1990s many technology stocks were valued on the basis of revenues or even in some cases, eyeballs (meaning how many people had seen the product). When you know your company is being valued by a metric that you can easily manipulate, it is hard to avoid the temptation to do it. Hence products were being sold at a loss in order to generate increased revenues.

Today's equivalent is companies borrowing money at ever lower interest rates (thanks to the Federal Reserve) in order to buy back company stock which gives the appearance of accelerating earnings growth. The 2000 tech bubble ended when the money to fund short term losses dried up (as interest rates rose and investors became nervous that promised future profits would never be realized). Normally, a company would prefer to issue stock during prosperous times (to pay off debt, if necessary). That way a firm improves its financial health. Generally speaking, American firms haven't operated that way in the last two decades. They have no incentive to behave prudently when the Federal Reserve is willing to bail them out every time the economy hits a rough patch.

At some point, the collective amount of corporate debt is so large that the government has to bail them out to save the economy from Depression. After that has happened for multiple business cycles, companies know that they are going to get bailed out, so they have virtually free rein to be as reckless as they want, provided they are big enough that the economy really would be hurt by their bankruptcy. If we were to see a meaningful increase in interest rates today, the cost of the debt taken on to inflate earnings would be unserviceable for many companies.

---

[4] Microsoft, Amazon, Apple, Alphabet (Google), Facebook, and Netflix

You can see that this is not a situation that can last indefinitely. However, knowing when and how it will end is especially difficult. Again, we believe it is our responsibility to help you reach your financial destination safely, whatever your particular definition of that is.

Today we are faced with a very serious virus threat, but even if and when that threat is neutralized there are significant economic concerns that will continue to make investing difficult. Having the choice between very expensive new technology companies and reasonably priced but highly vulnerable firms subject to the forces of disruption, is not that attractive from an investment standpoint. For the time being, therefore, we are going to continue to err on the side of conservatism.

Eric C. Graber, President
952-926-3000

Mark A. Carlton, CFA, Trademark Financial Management
Consultant to Capital Strategies Financial Corporation
952-358-3395