Second-Quarter 2020
American Portfolios Quarterly Market Commentary
by Chief Investment Officer Clifford T. Walsh, CFA

THE SECOND QUARTER was another one for the record books. While actual GDP numbers won't be released until later this month, the results will show the largest decline ever, and by a huge margin. Estimates range from a decline of 35 percent to a decline of more than 50 percent, due to the economic shutdown that persisted through most of the quarter. Meanwhile, the S&P 500 rallied roughly 19 percent during the quarter. On their own, these numbers would be incredible; together, they are mind blowing.

Since our first-quarter market commentary, the financial markets have rallied on massive Federal Reserve (the Fed) and U.S. government stimulus, as well as the hope of a significant economic recovery. With the Fed already reducing the size of its balance sheet and government stimulus for both individuals and businesses set to expire in a few weeks, a reality check, rather than a stimulus check, is likely to occur in the second half of the year, in our view.

Government doesn't create economic value; it only has the potential to destroy what value has already been created. It taxes and borrows to fund its spending. It subsidizes some industries while slapping tariffs on others. Government cannot create prosperity by borrowing to send out stimulus checks nor can central banks do so by printing money to buy bonds. These actions only weaken the future to pay for today.

Eventually, the results will have to speak for themselves. As the saying goes, "in the short-run, the stock market is a voting machine. Yet, in the long-run, it is a weighing machine." The Fed, and hope, can only support stock prices for so long until the economic reality sets in and the market readjusts. When we look at current consensus S&P 500 earnings expectations for 2021 of $163/share, which matches 2019 actuals and is $2 higher than 2018 results, we see only downside to expectations and the S&P 500, which trades at a P/E multiple of more than 19x. Unfortunately, timing such things is extremely difficult; however, with an important election approaching and tensions rising with China, potential downside catalysts exist and could play out rather quickly.

THE IMPACT OF COVID-19

In aggregate terms, we continue to believe that the COVID-19 pandemic will have lasting negative effects. Certainly, some industries will benefit, spurred by increased technological adoption and shifts in behavior, but many labor-intensive industries will be impacted for years to come at best, and their survival threatened at worst.

One of our major concerns is that the rush of economic activity resulting from pent-up demand and stir-crazy consumers will fade as the extended unemployment benefits expire, case counts rise and the current attitude wanes with reality setting in that future employment prospects are still at risk. In our first-quarter market commentary, we warned about the likelihood that many weaker businesses would eke by during the first few months after the shutdowns with whatever cash and government support they had at their disposal, but would ultimately succumb to poor demand, along with cash flow and debt repayment problems; we are beginning to see that predicted scenario play out. Many well-known brands in food service, clothing apparel, entertainment, travel, telecom, real estate, automotive, energy and even addiction treatment have filed for bankruptcy and/or announced significant store/location closures. Unfortunately, this is likely to continue in a significant way in the back half of 2020.

We are amid a balancing act to reach pre-pandemic economic levels while suppressing the spread of the virus; it appears unlikely this will be achieved. Many have dismissed the rise in positive tests of COVID-19 due to the sheer increase in the amount of testing conducted. While testing has increased to over 600,000 per day in the U.S., the rate of positive tests has also increased from about 3 percent in mid-June to 8 percent in mid-July, a rate that experts suggest is too high to indicate that COVID-19 is fading.

Unfortunately, we believe the U.S. is headed for another round of lockdowns in many states. We are already seeing high-traffic and close-proximity businesses like gyms, bars and restaurants already being closed in California and Texas. This is also happening across the globe. The longer the opening/closing cycle continues, the more likely it is to lead to permanent business closures and job loss.

The recent surge in economic activity is a welcome occurrence, but obviously not a positive indicator when we are off the bottom of the worst economic numbers ever experienced in the U.S. Therefore, our focus has been more on the aggregate levels where the economy will “settle” and not on the rate of change from temporarily-depressed levels.

A vaccine is seemingly the only catalyst that will propel the U.S. economy back to its former heights, at least in our opinion. While a handful of companies have received accelerated FDA approval for potential vaccines, recent research raises concerns about how quickly the presence of antibodies declines in the body, suggesting a COVID-19 vaccine may be more challenging than originally hypothesized. As such, we do not see the economy returning to normal levels of activity at least until 2022—and that is a best-case scenario at this point.

FED AND FISCAL RESPONSES

Since the beginning of the COVID-19 pandemic, the Fed has entered into the most aggressive monetary campaign we’ve ever experienced. Its goal was to support the short-term funding markets to restore confidence in the financial system and then for some reason spread to include the purchase of investment-grade and high-yield bonds, as well as ETFs. Meanwhile, the U.S. government provided substantial unemployment benefits and business loans to support individuals and businesses through the forced economic shutdown. While the jury is still out on the long-term ramifications of such actions, these moves certainly took the worst case off the table. But will it be enough to generate a significant recovery? We don’t think so. Businesses have been saved. Profits have not been.

That being said, we can’t discount more Fed and U.S. government actions to at least stimulate economic spending and financial market bullishness in the short term, regardless of long-term consequences, which appear to be mounting, in our view.

Currently, we feel deflation is likely to remain the key risk; and the Fed seems to agree, guiding the markets to a forecast that stated the Fed would not raise interest rates through 2022. The velocity of money is in the midst of a historic decline and the output gap between productive capacity and demand is likely to remain unbalanced for quite some time, in our estimation. This could mean more fiscal and monetary stimulus.

While the Fed can provide the necessary liquidity to stabilize activity briefly, it is unlikely to be a longer-term solution; the same rings true for government stimulus. The U.S. government could continue to run massive deficits, as it is currently, and pile more long-term debt onto a growing burden, but such strategies have limits. Already, the Fed balance sheet has started to shrink, reducing support. With this tightening in play, deflation is more likely than not; however, if the Fed reverses course and continues to monetize the deficit to support economic growth, we could face an inflationary surge and rate hikes could come sooner than 2023.

Many have watched with disbelief as the equity markets surged while the economy cratered. We've witnessed a breakdown of the financial markets as efficient allocators of capital. The markets are rampant with speculation and have seemingly become addicted to government bailouts and central bank support since the Great Financial Crisis, and it has only become more so during this current crisis. The massive disconnect between the real economy and global stock markets is unprecedented. Rising stocks suggest record earnings, which are nowhere to be found, while tumbling bond yields suggest quite the opposite.

The only thing that seems to matter is how much prices will rise through unlimited fiscal and monetary policy distortions. As long as the central bank is prepared to buy, investors seek risk with the "Fed Put" in hand. These are very dangerous assumptions for any investor to make. What happens when government or central bank actions spook the bond and/or currency markets? The consequences will be severe.

THE FALLOUT IN CHINA

We are concerned about a rise in tension with China for a wide variety of reasons. The origination of COVID-19 in China has already created a backlash. Should proof surface that the virus was created in and spread from a lab in Wuhan, the backlash will mushroom, in our opinion.

While members of President Trump's staff disagree, at least publicly, on the state of the first phase of the China trade deal, it has been acknowledged that the second phase is dead—and we don't have much hope for phase one at this point, either. Blame for the crisis, along with geopolitical tensions between China, Hong Kong and India could continue to strain China's relationship with the U.S. and other nations around the globe. We think U.S.-China relations have peaked for quite some time and have the potential to deteriorate significantly, a serious issue for the two largest economies and militaries in the world. Not to mention, China—the largest holder of U.S. debt—could dump its treasury holdings and/or could look to upend the U.S. dollar in trade outside the U.S.

That being said, there are some potential positives from the COVID-19 crisis and our faltering relationship with China, albeit longer term. On June 30, Senators Warren and Rubio introduced the "U.S. Pharmaceutical Supply Chain Review Act," which will require the government to study the effects of over-reliance on foreign manufacturers for drugs on the U.S. market; however, the results of the study are not expected before mid-2021, and any subsequent response likely won't boost economic results and job prospects until 2022, at the earliest. Ultimately, the U.S. is likely to see manufacturing jobs return to the U.S. Emerging markets in Asian nations surrounding China, India and Mexico, along with Canada, are all likely to see long-term boosts from the U.S. fallout with China.

ELECTION DAY IS RAPIDLY APPROACHING

With November just a few short months away, we think the financial markets will soon begin to shift focus to U.S. elections. Former Vice President Joe Biden is leading in the polls by a significant margin. While we know from past experience that polls can have a wide margin of error, an administration change would drive a significant shift in fiscal policy. The House is a lock to remain in Democratic control, while the Senate could go either way. Political beliefs aside, a clean sweep by the Democrats would likely not be welcome by the financial markets, in our view.

A "blue wave" would likely bring higher payroll taxes and fewer income deduction for many Americans and corporations, a move to fully-taxed capital gains at the top marginal rate instead of 20 percent, and a host of social-program spending. A green deal, a higher minimum wage, tax-payer-funded college education, re-regulation in many industries and, perhaps, new regulations in technology are all strong possibilities. We do not believe the markets reflect this outcome and think it represents a sizable risk to the U.S. equity markets.

PUTTING IT ALL TOGETHER

We foresee lasting challenges and changes in corporate and consumer behavior in the short- to intermediate-term. Additionally, some consequences, like increased government debt, will be long-term detractors from economic growth and stability. We do not believe that the financial markets accurately reflect this. With business closures mounting and the government unemployment boost set to end soon, we think the back half of the year could put pressure on equity prices, especially considering what now looks to be a very uncertain election in both the White House and Senate.

The recovery in part-time employment is outpacing that of full-time employment by nearly five-to-one, which is not necessarily surprising and probably good business sense, but also not supportive of a V-shaped recovery. We think that high unemployment will persist for years and the U.S. will not regain 2019 output levels until at least 2022, and growth going forward will be even worse than the weakest-ever growth of the 2009–2020 recovery. This is certainly not reflected in current market valuation multiples.

Certainly, with businesses reopening, economic activity will improve sequentially, but equities are long-term assets and currently fail to discount the lasting damage that the COVID-19 crisis has done to many

businesses and the consumer, along with government finances and public debt. Not to mention, many state economies are taking a step back and closing down certain industries, further weakening recovery hopes.

During times like these, with such a murky outlook, we believe it is best to implement a defensive stance until volatility subsides and there is a clearer economic picture. We believe caution is warranted in an effort to protect against long-term capital impairment. Selectivity and a focus on smaller investment themes will be increasingly important as we look at the back half of 2020 and into 2021.

QUESTIONS AND COMMENTS

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