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S&P 500

Stocks Rebound Fast, Recovery to be Slower

The U.S. Treasury and the Federal Reserve have pulled out all the stops to ensure that U.S. businesses withstand the exogenous shock of Covid-19. The programs implemented by the government are numerous, including low interest loans to medium sized corporations, with special programs for the airlines, forgivable loans to small businesses with fewer than 500 employees, an extra $600 per week in payments to the unemployed in addition to the standard state unemployment insurance, and a one-time $1,200 "stimulus" payment to most people. Also, the Fed reduced short term interest rates to approximately zero and sharply expanded its balance sheet by providing huge amounts of dollar liquidity through the purchase of U.S. Treasuries and risky assets including mortgage backed securities and fixed income ETFs. Furthermore, the Fed has provided additional dollar liquidity to foreign central banks through f/x swaps.

Investor confidence is growing and prices are rising. The extreme response has given confidence to investors that the economy will be in recovery during the second half of 2020. Stock prices have retraced about two-thirds of the decline that started in February. The market is already looking toward an earnings recovery later this year and forbearance has been shown by investors as many companies report weak first quarter figures. We feel confident that the March lows in the S&P 500 will not be retested. Markets are always volatile and another 5% to 10% pull back is always possible, but prices are likely to grind higher as the year progresses.

Naturally, our expectations of a recovery are predicated on the ongoing progress against the virus. In the U.S., there was a peak rate of 38,000 new cases and 2,800 deaths per day. The recent figures were 18,000 and 1,000, respectively, and that pace continues to slow. The greatest risk to the world economy is a renewed wave of infection that would cause ongoing closures in economic activity. However, there are several factors that will mitigate such risk. The reason why the political class quickly moved to shut down the world economy and force quarantines was to "flatten the curve" so as not to overwhelm the hospitals. A great deal has already been learned about the virus such as the circumstances where it is most transmissible. Enclosed spaces and time duration are major factors. The virus appears not to be easily transmitted outdoors nor in a passing environment like a short elevator ride. Common face masks do not necessarily protect the wearer from catching the virus, but they are effective in preventing the wearer from spreading the virus. Production of healthcare capacity and equipment has been substantially increased. Furthermore, while a vaccine may not be developed for a long time or maybe ever, methods and treatments for the afflicted has been notably improving. Lastly, in places like New York City, more than a fifth, and now perhaps as many as a third, of residents have tested positive for the antibodies. Growing numbers of people with antibodies will further slow the spread. Increasing testing and plans for tracing people who have come in contact with people who have tested positive will also limit future spread. A reasonable baseline assumption is likely that the virus will be with us for years, but that it will become manageable as are many health afflictions.

The economy hit a wall in the 2020 first quarter when real GDP contracted at a 4.8% annualized rate in the U.S. Along with the sudden contraction in production, the unemployment rate spiked to 14.7% as large segments of society were forced to stay at home. Data has shown that the hardest hit sectors were in the restaurant and hospitality areas, and other personal services. Employment in the healthcare sector was also hit as people delayed elective procedures and stayed away from doctor's offices in general. Least affected were technology and non-cyclical businesses including pharmaceuticals and consumer staples. Looking ahead, it is difficult to see certain businesses rebounding soon. Travel and entertainment may have the most stubborn time as it maybe many months before people are willing to attend a large sporting event or fly to a Disney theme park. Restaurants may reopen but at reduced capacity and with reduced employment. Because unemployment is likely to decline slowly, we are least optimistic about consumer discretionary stocks. The high level of uncertainty that remains will dampen enthusiasm for expensive purchases, like homes, cars and vacations, that can be postponed. Businesses, if they did not already know it, are certainly now realizing the advantages to cloud computing and communications. Many areas of the technology sector are likely to remain the best performing businesses. Real growth should resume by July but real GDP growth is forecast at a negative 4.3% for all of 2020 with good gains expected in 2021 (see Table 1).

Chart 1

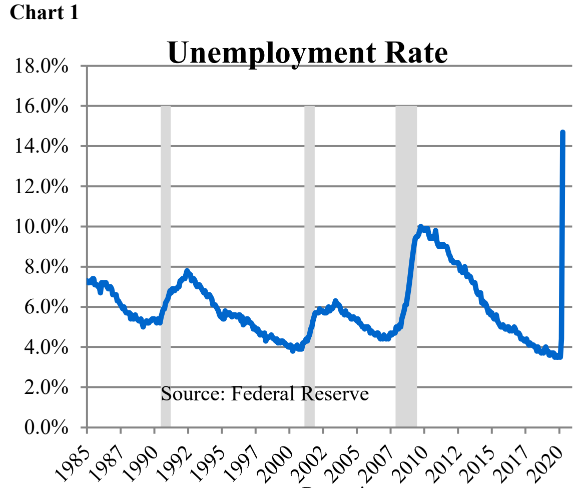


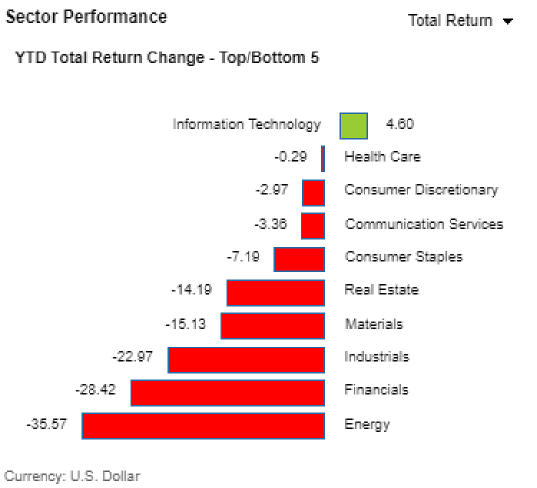
Table 1

	Country	CY '17	CY '18	CY '19	CY '20	CY '21	CY '22
G7							
	Canada	3.2	2.0	1.6	-6.2	4.4	1.8
	France	2.4	1.7	1.3	-6.7	4.5	1.5
	Germany	2.8	1.5	0.6	-6.1	4.3	1.8
	Italy	1.8	0.7	0.3	-7.9	5.0	0.6
	Japan	2.2	0.3	0.7	-3.4	1.7	1.3
	United Kingdom	1.9	1.3	1.4	-5.9	3.6	2.1
	United States	2.4	2.9	2.3	-4.3	3.4	2.2

Source: Factset

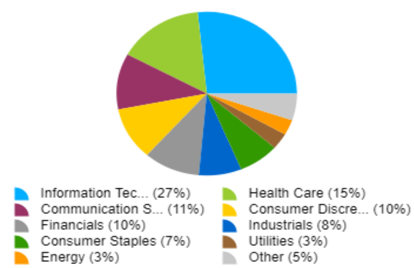
Technology, already the largest sector in the S&P 500 (see Chart 3), is the only sector that has had a positive performance year-to-date. As just noted, the importance of technology has become increasingly clear during this crisis and spending is only likely to be reinforced. But sector classifications below have some limitations. Apple is in the technology sector but could arguably be considered a consumer discretionary company. Indeed, Apple has been rolling out lower priced phones as consumers have begun to resist high prices. In contrast, Amazon makes up about 40% of the consumer discretionary sector but its business has acted more like a staple (people need their home deliveries including food) as well as a technology company because of Amazon's AWS cloud computing operations. Indeed, the relatively good performance of the consumer discretionary sector (Chart 2) reflects a 30% gain by Amazon as well as gains by Home Depot (8%), Ebay (17%) and Tractor Supply (17%). Almost everything else was sharply negative and is likely to continue to face headwinds because of lingering unemployment.

Chart 2



Source: Factset

Chart 3



GICS Sector	Symbol	Market Value	% Weight
Information Technology	99900701	6,471,594	26.63
Health Care	99900565	3,756,488	15.46
Communication Services	99900793	2,677,403	11.02
Consumer Discretionary	99900285	2,521,984	10.38
Financials	99900621	2,452,961	10.10
Industrials	99900125	1,860,130	7.66
Consumer Staples	99900477	1,771,059	7.29
Utilities	99900821	769,522	3.17
Energy	99900001	735,640	3.03
Other	-	1,281,632	5.27

Source: Factset

For the S&P 500, the consensus forecast is that sales will decline about 5%--in line with GDP--while operating earnings contract by about 20% in 2020 (see Table 2). Now trading at 22.6 times the depressed 2020 earnings estimate and 17.9 times the 2021 estimate, stocks are by no means cheap. But the S&P 500's 1.9% dividend yield compares favorably with the 0.68% yield on a 10-year Treasury bond and the high P/E ratios are consistent with a low inflation economy. As economic and corporate earnings growth resumes in the second half of 2020, stock prices should rise in parallel, but the rate of gain will be limited by the relatively high valuation. The bottom line is that returns should outpace bonds by a good margin, but we are not counting on any big double-digit spikes upward. Any price weakness would best be used to accumulate additional stock in companies least affected by a conservative consumer.

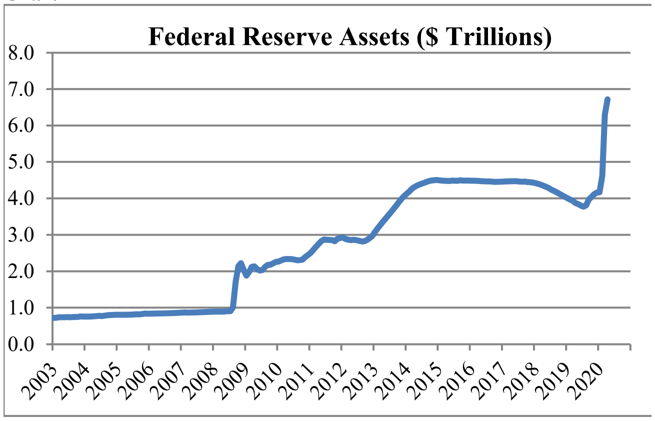
Table 2

	Dec '15 CY	Dec '16 CY	Dec '17 CY	Dec '18 CY	Dec '19 CY	Dec '20E CY	Dec '21E CY	Dec '22E CY
EPS	116.79	118.22	131.46	159.65	162.07	128.28	163.75	185.80
Dividends per Share	44.76	46.53	49.60	54.18	58.17	59.05	61.95	67.38
Sales per Share	1,116.95	1,150.51	1,219.04	1,341.97	1,406.65	1,339.30	1,456.61	1,555.49
Cash Flow per Share	167.14	172.83	184.33	209.91	220.07	192.26	235.07	281.72
Free Cash Flow per Share	97.79	103.83	111.74	128.38	132.60	114.73	152.19	171.56
Book Value per Share	727.80	757.44	801.02	834.52	891.53	900.82	961.44	1,199.83

The Big Picture is about Debt

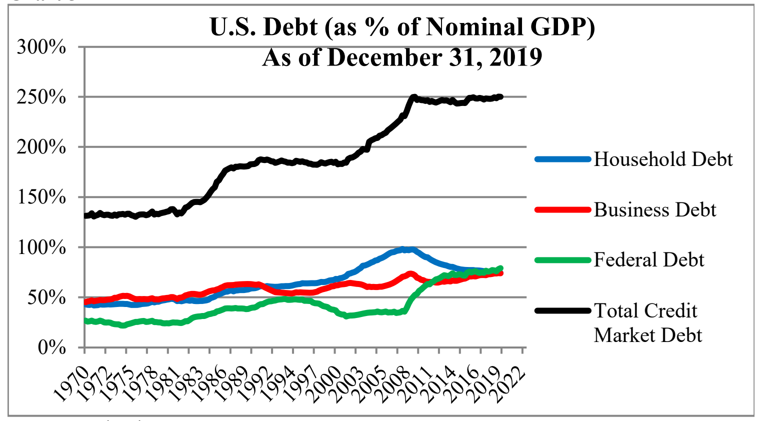
Like it did during the financial crisis of 2008, the Federal Reserve has been buying financial securities and expanding its balance sheet in order to provide liquidity and support spending. Like the questions raised when the Fed first utilized "quantitative easing (QE)" in 2008, people are now asking whether the Fed's open market operations along with the U.S. Treasury's income support and lending programs will lead to inflation. First let us recognize that consumer prices contracted at annualized rates of 5.0% and 9.1% in March and April, respectively. The immediate problem appears to be deflation, not inflation. The question that is logically asked is how deflation can persist when the Fed is effectively pumping out cash in exchange for debt securities. The answer is that debt levels have been rising relative to GDP for decades. When substantial income is already committed to paying for debts, it's difficult for people and businesses to commit to new spending. It is a simple truth that debt depresses spending and, hence, inflation.

Chart 4



Source: Federal Reserve

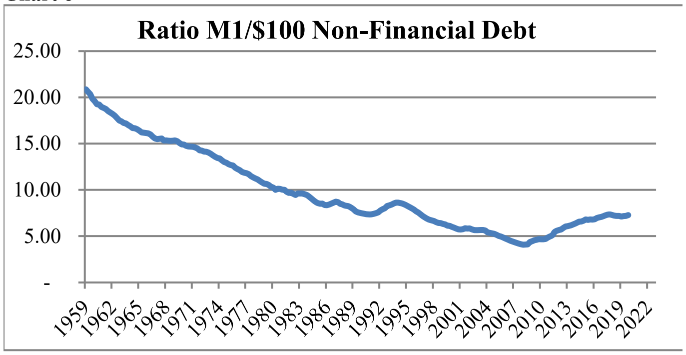
Chart 5



Source: Federal Reserve

The level of liquidity, as measured by cash and bank demand deposits (M1), has been declining for decades relative to non-financial debt (Chart 6). If you accept the idea that people seek to hold cash balances relative to their income and spending, it also follows that cash balances are affected by debt and the liquidity needs to support that debt. Stock investors can think of the situation another way: When you have money in the bank you are *long* cash; when you have a debt, you are *short* cash. An event like a pandemic essentially triggers a short-squeeze whereby people must cut spending in order to hoard cash sufficient to cover the maintenance of ongoing debt payments. Without the Fed providing cash to meet the increased demand for liquidity, the spending contraction and deflation would be more severe. As we have seen the Bank of Japan engage in quantitative easing for thirty years while the price level stagnates due to debt, a similar dynamic is expected for the U.S. and Europe for as far as the eye can see or until debt levels are reduced relative to cash and incomes.

Chart 6



Source: Federal Reserve

Note: Financial debt is the liability side of the bank balance sheets and includes customer deposits. It is excluded here since a primary function of banks is to take deposits. The ratio would also be meaningless because it would be measuring deposits (M1) as a percent of deposits. Lastly, if bank liabilities/deposits were included, it would especially distort the picture of countries with a large banking sector like Switzerland.

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