"History Was Made"

Market Commentary – August 2020

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. decreased at an annual rate of -32.9% in the second quarter of 2020. This devastating number is the lowest ever recorded for the United States. By comparison, other sharp historic U.S. contractions include -8.4% in 2008 Q4 (Great Recession) and -10.0% in 1958 Q1. During the Great Depression, GDP fell by -8.5% in 1930, -6.4% in 1931, and -12.9% in 1932. While seemingly having a keen sense for the obvious, the National Bureau of Economic Research concluded on June 8, 2020 that the U.S. economy peaked in February 2020. This marked the end of the economic expansion that began in June 2009. While the recession clearly began in February, it is unclear when it will end. Shutting down the economy to attack COVID-19 has come with a steep economic cost.

Thanks to the economic lessons of history, the Federal Reserve instinctively knew it needed to fight the shutdown with aggressive monetary policy easing. The Fed has committed to keeping its benchmark federal funds rate in a range of 0% to 0.25% through at least 2022. Amazingly, fed funds futures are pricing in a *negative* federal funds rate starting in May 2021 (which Fed representatives have insisted will not happen). Thinking about the Fed's balance sheet, assets jumped from $4.2 trillion in February 2020 to nearly $7.2 trillion by June, before stabilizing around $6.95 trillion by the end of July. Future Fed announcements on monetary policy will be scrutinized by investors for clues that the spiked punch bowl will be taken away (bearish for stock prices). The next Fed announcement is scheduled for September 16.

Technical factors of the market are bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) during 2021 is $161.46, which implies a price-to-earnings (P/E) ratio of 20.3 with the S&P 500 at 3,271. The earnings yield (E/P) of 4.94% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.54%. This comparison between bond and stock yields is crucial to the direction of stock prices. A spike in U.S. Treasury yields (of any maturity, but especially the longer dated ones) would be devastating for stock prices. In the meantime, low bond yields should translate into higher stock prices. Value stocks are incredibly attractive.

While the rate of ascension has slowed, the S&P 500 continues to form higher lows and higher highs (the definition of an uptrend). Sitting at 3,271, the index is within striking range of its all-time closing high of 3,386 from February 2020. Resistance should be expected in that vicinity, and support should be found by the 50-day moving average (3,138) and the 200-day moving average (3,049). Investors must remember, however, that the S&P 500 is being skewed by mega-cap technology stocks. In the first 7 months of 2020, the Nasdaq 100 is up 24.9% (without dividends). In comparison, value indexes continue to be down for the year (S&P 500 Large Cap Value -13.9%, S&P 400 Mid Cap Value -20.0%, and S&P 600 Small Cap Value -23.6%, without dividends). As another way to analyze the lopsided performance of stocks, the *market cap-weighted* S&P 500 (the one typically quoted) is up 1.3% in 2020 year-to-date (without dividends), while the *equal-weighted* S&P 500 is down -7.6%! The same 500 companies populate both indexes, but the market cap-weighted version is dominated by five companies (not sustainable).

We are living in a world that is infected with hype and hyperbole; investors should do everything possible to block the corresponding emotions. This is easier said than done. The news headlines have people scared to death of COVID-19, thanks to non-stop warnings from Dr. Fauci and Dr. Gottlieb, among others. COVID-19 is not Ebola, which had a 90% death rate. The Weather Channel is referring to Hurricane Isaias as a "Covidcane" and warns viewers with the ominous tagline "bracing for disaster". Their meteorologists are visibly depressed when the storm shows signs of weakening. Shouldn't they be rooting for such data? In the world of stocks, the financial media is smitten with mega-cap technology. A massive bubble is staring at us. It is mind-boggling that so many investors are blind to it.