"The Great Cessation"

Market Commentary – May 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 -4.8% in the first quarter of 2020. This is the lowest reading since -8.4% in 2008 Q4 during the depth of the financial crisis. The components of the 2020 Q1 GDP number are: consumer spending -5.26 percentage points, investment -0.96 percentage point, net exports +1.30 percentage points, and government spending +0.13 percentage point. The sum of these numbers equals -4.79%. As atrocious as these numbers are, remember that the coronavirus (COVID-19) economic disaster engulfed only one month in the quarter (March). GDP for the second quarter of 2020, which will be announced in late July, will be even more shocking/historic. Economists are using terms like recession and depression to describe the economy, but we are really in the middle of a *cessation*. As we all know by now, to help limit the spread of COVID-19, the federal and state governments have *stopped* major portions of the U.S. economy. While such a move is unprecedented, investors now know that this is part of the playbook in the future when the next pandemic eventually occurs.

In its regularly scheduled monetary policy announcement on April 29, the Federal Open Market Committee (FOMC) maintained its commitment to providing financial markets with unprecedented liquidity. It wrote, "the ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term…and medium term". The benchmark federal funds rate continues to be at a rock-bottom range of 0% to 0.25% and it will stay this low until the FOMC is "confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals". Moreover, the Fed will continue to purchase Treasury and mortgage-backed securities "in the amounts needed to support smooth market functioning". While treatment of the *medical* symptoms of COVID-19 are being debated, the Fed has been effective treating the *financial* symptoms.

The annual update of our universe of stocks in March confirmed many of last year's choices and revealed some new potential gems. We analyzed a total of 1,831 companies one at a time, with a cumulative market capitalization of $30.6 trillion. Our process allowed us to identify "our universe", which is comprised of stocks we believe have the best risk/reward prospects (based on a combination of low valuation, low beta, low debt to market cap, and, usually, high dividend yield). A total of 91 stocks made the cut and have the following market capitalization ranges: $29 million to $500 million (17 stocks), $500 million to $2 billion (16 stocks), $2 billion to $10 billion (25 stocks), $10 billion to $100 billion (25 stocks), and >$100 billion (8 stocks). In the coming months, we will perform in-depth fundamental research on the companies in our universe with attractive technical chart patterns to determine which ones to buy.

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 $170.87, which implies a price-to-earnings (P/E) ratio of 17.0 with the S&P 500 at 2,912. The earnings yield (E/P) of 5.87% represents attractive value relative to the 10-year U.S. Treasury note yield of 0.63%. Valuation is fairest when evaluated with "normalized" earnings. Coronavirus will skew 2020 financials so drastically that it is better to use 2021 estimates instead. Stocks can march higher as long as interest rates stay at these historic lows.

A handful of mega-cap, richly priced technology stocks have led the S&P 500 index's stunning 33% rally from the low of 2,191 on March 23. In 2020 year-to-date, the *market-cap weighted* S&P 500 has returned a whopping 6.8% more than the *equal-weighted* S&P 500! As of April 27, the top five companies in the S&P 500 (all technology) made up 20% of the index! Every dollar placed into an S&P 500 index fund or Exchange Traded Fund blindly invests $0.20 in these five companies without considering their valuations. Moreover, purchases of these five stocks by mutual fund and hedge fund managers who are closet indexers add fuel to the fire. Investors who ignore valuation do so at their own peril.