

## Market Report Second Quarter 2020

### Key Points

- Equities rebounded strongly off first quarter lows, leaving stocks richly valued through our lens. Bargains are again limited.
- A few ultra-large companies are driving cap-weighted indexes.
- Fixed-income yields declined, and credit spreads tightened during the quarter; we offer a yield table for perspective on page three.
- COVID-19 continues to have a profound negative impact on our country. It should ultimately make us stronger and better.

| Total Return as of June 30, 2020 |       |        |        |            |       |       |
|----------------------------------|-------|--------|--------|------------|-------|-------|
|                                  | QTD   | YTD    | 1 Yr   | Annualized |       |       |
|                                  |       |        |        | 3 Yr       | 5 Yr  | 10 Yr |
| S&P 500                          | 20.5% | -3.1%  | 7.5%   | 10.7%      | 10.7% | 14.0% |
| NASDAQ                           | 30.9% | 12.7%  | 27.0%  | 19.2%      | 16.4% | 18.3% |
| <b>Russell 3000</b>              |       |        |        |            |       |       |
| Index                            | 22.0% | -3.5%  | 6.5%   | 10.0%      | 10.0% | 13.7% |
| Value                            | 14.6% | -16.7% | -9.4%  | 1.4%       | 4.4%  | 10.2% |
| Growth                           | 28.0% | 9.0%   | 21.9%  | 18.2%      | 15.2% | 16.9% |
| <b>Russell Mid Cap</b>           |       |        |        |            |       |       |
| Index                            | 24.6% | -9.1%  | -2.2%  | 5.8%       | 6.8%  | 12.4% |
| Value                            | 20.0% | -18.1% | -11.8% | -0.5%      | 3.3%  | 10.3% |
| Growth                           | 30.3% | 4.2%   | 11.9%  | 14.8%      | 11.6% | 15.1% |
| <b>Russell 2000 (Small Cap)</b>  |       |        |        |            |       |       |
| Index                            | 25.4% | -13.0% | -6.6%  | 2.0%       | 4.3%  | 10.5% |
| Value                            | 18.9% | -23.5% | -17.5% | -4.4%      | 1.3%  | 7.8%  |
| Growth                           | 30.6% | -3.1%  | 3.5%   | 7.9%       | 6.9%  | 12.9% |

### The Quarter in Review

U.S. equity market performance was remarkable during the quarter. However, as share prices rose and cash-flow declined, on average, stocks became more expensive. From a valuation perspective, we are generally back to pre-COVID type levels.

If you were stranded on a remote Caribbean island (with proper provisions, of course), rescued at quarter-end and only used U.S. equity market performance as an indicator of how things were going: **you would never know** the U.S. economy had essentially been shut down for part of the quarter, COVID-19 cases were once again on the rise, civil unrest was elevated and roughly 18 million people were unemployed.

The Federal Reserve's (the "Fed"), Treasury's and Congress's effort to mitigate economic damage through large, well-timed stimulus programs which began in March supported Main Street, fixed-income and equity markets alike. Lower yields and tighter credit spreads contributed to higher prices during the quarter as investors looked across the economic valley to the prospects of better times on the horizon. However, **a heavy dose of caution is warranted** in our view because higher prices must eventually be supported by underlying fundamentals which are compromised in many corners of the economy. We share our thoughts in more detail below.

## U.S. Equities

All 11 economic sectors posted positive results during the quarter, contributing to the S&P 500's 20.5% rise, including dividends. Consumer Discretionary (32.9%) led the way, followed by Technology (30.5%) and Energy (30.5%). Financials (12.2%), Consumer Staples (8.1%) and Utilities (2.7%) were the weakest sectors yet produced attractive results.

| S&P 500 Sector Returns<br>As of June 30, 2020 |        |           |            |             |             |       |            |             |             |             |        |
|---|--------|-----------|------------|-------------|-------------|-------|------------|-------------|-------------|-------------|--------|
|   | Energy | Materials | Financials | Industrials | Cons. Disc. | Tech. | Comm. Svc. | Real Estate | Health Care | Cons. Stap. | Util.  |
| QTD   | 30.5%  | 26.0%     | 12.2%      | 17.0%       | 32.9%       | 30.5% | 20.0%      | 13.2%       | 13.6%       | 8.1%        | 2.7%   |
| YTD   | -35.3% | -6.9%     | -23.6%     | -14.6%      | 7.2%        | 15.0% | -0.3%      | -8.5%       | -0.8%       | -5.7%       | -11.1% |

However, year-to-date (YTD) sector performance tells a different story with only **Technology** (15.0%) and **Consumer Discretionary** (7.2%) posting positive returns. Corporate profitability and growth drive equity markets over time. Through our lens, the YTD results are more reflective of the **broad-based economic toll** COVID-19 and strained trade relationships have taken on corporate profitability in the U.S.

A few ultra-large companies are driving YTD cap-weighted index performance and masking general weakness. For example, the five largest companies in the S&P 500 by market cap, as of April 23, 2020, accounted for roughly **20%** of the total S&P market cap (accompanying table): exceeding the **18%** level of concentration during the dotcom run-up. All are tech-oriented. Furthermore, by June 30 this number swelled to roughly 23%.

Exhibit 4: The concentration of market cap in the largest stocks has soared as of April 23, 2020



Source: Compustat, Goldman Sachs Global Investment Research

The **forementioned concentration**, in addition to seemingly stretched valuations and broad-based deterioration in fundamentals causes us to view the world once again **through a defensive lens**. Note in the accompanying table that all stock averages illustrated are pricey, relative to long-term price-to-earnings.

| Current P/E as % of 20-Year Average P/E |        |        |        |
|---|--------|--------|--------|
|   | Value  | Blend  | Growth |
| <b>Large</b>                            | 132.9% | 140.9% | 158.5% |
| <b>Mid</b>                              | 139.3% | 148.5% | 192.2% |
| <b>Small</b>                            | 168.1% | 265.3% | -      |

Source: Guide to Markets 3Q 2020

However, **value is the least expensive** and the disparity between growth and value today **is as wide** as in the early 2000s. This **should bode well for value-oriented companies in the future** when growth type companies potentially become so expensive their share prices either retrench or trade sideways for a number of years to allow company fundamentals to grow into the valuations ascribed to them. Arguably, the lofty valuations assigned to many companies today **has pulled future returns into the current period**. Of course, the massive amounts of stimulus may further alter the natural course of markets.

### Fixed Income & Commodities

Corporate bonds' total returns, as measured by the BofAML 1-to-10 Year Index, increased 7.9% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, increased 0.4%. The Fed's herculean effort to support the economy and credit markets has made it **increasingly difficult** to find fixed-income investments that adequately compensate investors for the risk taken.

We remain primarily focused on investment grade issues with maturities inside of five years. However, numerous BBB (lowest investment grade rating) issues will likely get downgraded to BBs as financial pressures mount. Many institutional investors are not permitted to hold non-investment grade bonds and will be forced to sell them. If there is a wave of **"forced selling"** that creates a supply and demand imbalance, yields on select issues **could rise to a level** where they become interesting. **Absent unique opportunities** in a few of these so called "fallen angels," yields are likely to be modest for the foreseeable future.

Please see accompanying table for select Treasury and BBB yields, as well as BBB credit spreads. **As**

| Yields as of June 30, 2020 |       |       |       |       |       |       |       |
|----------------------------|-------|-------|-------|-------|-------|-------|-------|
|                            | 6-Mo  | 1-Yr  | 3-Yr  | 5-Yr  | 10-Yr | 20-Yr | 30-Yr |
| <b>U.S. Treasury</b>       | 0.18% | 0.18% | 0.18% | 0.30% | 0.64% | 1.14% | 1.41% |
| <b>BBB Corp</b>            | 0.82% | 0.85% | 1.10% | 1.46% | 2.38% | 3.39% | 3.29% |
| <b>Spread</b>              | 0.64% | 0.67% | 0.92% | 1.16% | 1.74% | 2.25% | 1.88% |

**you will note, yields are low and credit spreads (corporate bond yield minus corresponding Treasury yield) are tight.** The credit spread is investors' compensation for default risk. It ebbs and flows over time.

Commodities, as measured by the Bloomberg Commodity Index, increased 5% for the quarter and declined 19.4% YTD. Oil (WTI) priced at \$39.27 on June 30, was up 92% for the quarter and down 36% YTD. Producers are still working to balance supply with reduced demand.

### The Impact of COVID-19

COVID-19 continues to impact the economy, municipalities, healthcare, businesses and families. It has produced outcomes as wide and varying as the disease itself. Some segments of the economy have thrived (i.e. technology), yet other segments are hanging on the ragged edge (i.e. travel and hospitality). It has further divided a country and strained relationships with global trading partners.

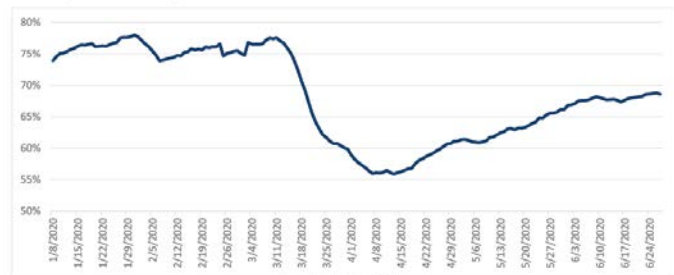
Some families have lost loved ones and others have relatives with lasting complications. Millions of Americans are currently unemployed. Healthcare workers relentlessly perform their duties with the highest degree of professionalism and not only have to worry about their own health, but the health of their family members at home. Millions of workers in various industries who are on the front lines provide essential services so that others can have a generally normal life. COVID-19 is relentless, but so is the American will to defeat it.

Although difficult to appreciate in the current environment, we, as a country, should ultimately be better because of COVID-19. For example, it has accelerated the adoption of digitization which should create long-lasting efficiencies for industry and consumers; caused competing health systems to pull together, sharing resources and best practices; rallied scientists from around the world to collaborate in search of a vaccine; made society more cognizant of how viruses spread; and reminded all of us that life is indeed fragile.

Housing was a **bright spot** during the quarter. Mortgage rates hit all-time lows (thanks to the Fed's intervention), housing supply is constrained, demand is strong and the consumer household debt service ratio is lower than at any point since the '80s. Forbearance programs to date have helped prevent a wave of foreclosures, thus supporting prices. This is relevant because foreclosures impact comparables which in turn impacts homebuyers' ability to get financing. And the ability for homebuyers to get financing ultimately impacts demand. A healthy housing market is generally good for the economy. So far, the foundation looks solid.

Sheltering in place seems to have hit an **inflection point in mid-April** with a greater percentage of the population leaving their home thereafter. This likely bodes well for the economy, but less so for containing COVID-19. Absent a vaccine and/or better treatments, the risk of an uneven economic recovery, political divisiveness and varying approaches to public health policy remain elevated.

% of Population 'Going Out' - Nationwide



Source: SafeGraph, Jefferies  
Percent of population going out, seven-day rolling average. A phone "goes out" if it pinged outside the immediate area (~.02km<sup>2</sup>) surrounding the owner's residence. Aggregated by Jefferies and sourced from SafeGraph.

### Looking Ahead

The broad-based stock and bond buying opportunities that existed early in the quarter were quickly closed by massive stimulus efforts. The swift equity market rebound left stock averages **a bit pricey**, in our view. This makes **ferreting out individual opportunities** ever more important and challenging. We believe our portfolios are durable and able to withstand the economic fits and starts that may persist as we work through the balance of 2020 and into 2021.

Although current Fed policy has put a lid on yields, fixed-income serves an important role in managing overall portfolio risk and as a source of capital for future opportunities. Our search for debt sporting acceptable risk-adjusted yields continues.

Adhering to our **time-tested, value-oriented investment process** with a keen focus on not unnecessarily interrupting the compounding process will be key to navigating the current environment.

*Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.*