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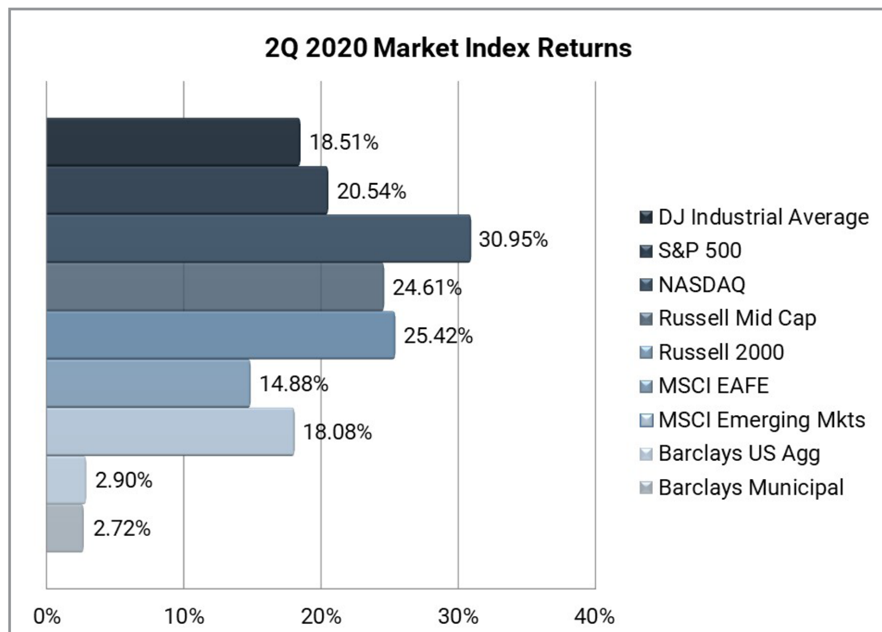
WEALTH MANAGEMENT SINCE 1971

QUARTERLY MARKET COMMENTARY: *Second Quarter 2020*

the ECONOMY

The year 2017 probably seems like a lifetime ago for investors. We were in the midst of an already lengthy bull market, and little did we know that we'd still have another three years left to enjoy it. But lest investors become too pleased with themselves, the ever-quotable Warren Buffett was there to provide wisdom that has proved prescient today. In his 2017 letter to Berkshire Hathaway shareholders, Buffett took some time to discuss major market crashes. "No one can tell you when these will happen," he said, "The light can at any time go from green to red without pausing at yellow." An apt description of the historically rapid decline in stocks during February and March of this year, if there ever was one. Yet, as nerve-wracking as the 1st quarter was, that light flipped back to green just as quickly in the 2nd quarter, as equities experienced an equally historic rebound. Now, the global economy and financial markets are by no means out of the woods, but thanks to signs of business activity returning and a healthy dose of fiscal and monetary stimulus, investors have begun to price in an eventual recovery.

As it relates to the economy, there's no way to sugarcoat it – the 2nd quarter was bad. The global economy will likely record its deepest aggregate contraction in activity ever, thanks to the synchronized shutdown of consumers and businesses around the world. That said, this recession might also be the briefest ever, as activity seems to have bottomed between late April and mid-May in most of the world.



We mentioned last quarter that heading into this downturn, the U.S. economy, and especially the labor market, was in very good shape. That is, of course, not the case currently, but we're already experiencing some progress on that front. The unemployment rate peaked at 14.7 percent in April, but has since fallen to 11.1 percent by the end of the quarter, thanks to approximately 9 million net jobs added back over May and June. Labor force participation also rose to 61.5 percent, up from 60.2 percent. Certainly, this data is still notably weaker than it was prior to the recession, but the improvement is also notable. The wages and income picture are, in short, not reflective of the typical recession. Due to widespread government stimulus, disposable personal income is actually between 5 – 10 percent higher today, compared to the start of the year. There was a large rebound in retail sales in May, and real-time credit card data suggests the trend continued, albeit at a slower rate, in June. Like the labor market, though, total consumption spending is still well below prior peaks. The inflation rate expectedly declined, largely thanks to falling energy prices. The Consumer Price Index is up just 0.2 percent compared to one year ago.

Business confidence has also picked back up. The National Federation of Independent Businesses conducts a monthly survey of small business optimism. It actually improved last month and is at much higher levels now compared to the last recession in 2008 – 2009. The manufacturing sector is showing some life, with the most recent PMI survey crossing back above 50, suggesting expansion from prior levels. The services component of this survey, likely more sensitive to social distancing protocols, also experienced a similar rebound. An important caveat is that these surveys are measuring rates of change, not absolute levels. As such, they point to a general improvement later in the 2nd quarter, but not a return to fully normal operations.

European economies are in recessions, as well, though by some measures may have had more success in containing the coronavirus spread compared to the United States. The reasons for this are hotly debated, but suffice to say, it may allow many of these countries a somewhat smoother reopening process. The unemployment rate for the entire European Union (EU), which had been consistently higher than the U.S. for most of the past decade, is currently just 6.7 percent. Higher than the start of the year, to be sure, but not so bad, all things considered. On average, differing regulatory environments may lead to Europe's labor markets being less flexible long-term, but perhaps more resilient to shorter-term shocks. Similar patterns of increasing business confidence in the U.S. are being seen in Europe as well.

Japan stands out as a country that has done amongst the best jobs of handling the coronavirus outbreak. The exact policy prescription and manner in which the country's respective population responded to the virus, and if it is even possible for that response to be replicated elsewhere, will be studied for years to come. But, nonetheless, the end result is that the Japanese economy has been able to continue operating with relatively less disruption compared to its western peers. The same could also likely be said for South Korea and Taiwan.

China led the way down in this recession but also appears to be leading the way out. They have mostly reopened their economy without any large wave of new infections. The performance of the country's stock market, which is actually positive on the year, reflects that reality.

CENTRAL BANKS

"If you've got a bazooka, and people know you've got it, you may not have to take it out," so said then Treasury Secretary Henry Paulson to Congress, in regards to a potential government backstop of Fannie Mae and Freddie Mac during the 2008 mortgage crisis. That quote seems just as applicable, if not more so, today. Because if the recent response from financial markets is anything to go on, investors are well aware of the Federal Reserve's (Fed) bazooka. We won't rehash the "alphabet soup" of programs that were rolled out late last quarter, but the early evidence is that they have "worked", in the sense that financial markets are operating much more smoothly now, compared to three months ago. This is especially true in bond markets. Corporate bond spreads, a measure of the riskiness of providing credit to corporations, have narrowed significantly, pointing to a more secure lending environment.

There has been little change to the policies announced at the end of the 1st quarter, as the Fed, in tandem with the government, has focused on implementing said policies. At his latest press conference, Fed Chair Jerome Powell stated that he believed interest rates would stay low until 2022.

The European Central Bank (ECB) and Bank of Japan (BoJ) are also continuing on their current policy paths of low interest rates and asset purchases when and where necessary. ECB President Christine Lagarde recently noted that she believed the worst of the crisis was past, but that monetary accommodation would still be needed for some time.

FIXED INCOME

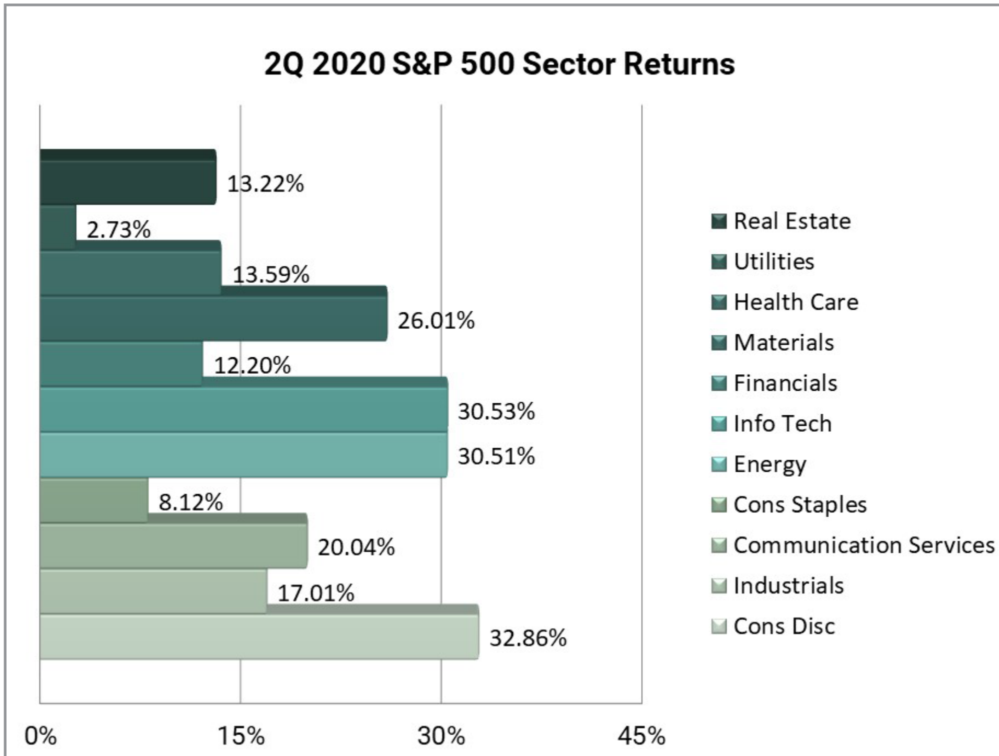
Despite the massive rally in risk assets, government bond yields were little changed over the 2nd quarter. In fact, the 10-year U.S. Treasury yield actually fell another 4 basis points, closing out June at 0.66 percent. The massive new bond-buying programs out of world central banks, combined with the lingering economic uncertainty likely kept yields from rising as they typically might during a period of strong stock returns. The overall shape of the yield curve did steepen somewhat, as shorter-term interest rates did move lower.

After an ugly 1st quarter marked by high volatility, low liquidity, and generally poor price performance, corporate bonds rebounded nicely over the past three months. A basket of investment-grade corporate bonds returned 8.22 percent, bringing year-to-date returns back into positive territory. Lower-rated high yield bonds performed even better, gaining 9.61 percent over the same time period.

Municipal bonds also bounced back after a somewhat shaky start to the year, gaining 2.72 percent last quarter. Recessions inevitably lead to lower tax revenues and budget shortfalls at the state and local level. And while there will certainly be idiosyncratic issues to deal with, our view is that the overall municipal market is unlikely to experience any sort of massive default wave. At the state level especially, governments have the wherewithal to cut spending and raise taxes and fees accordingly. Both are often unpopular, but there is precedence for those actions in prior recessions. Also, many states have general fund reserves to help them manage through this environment.

EQUITY

It's the worst pandemic in half-a-century. The NASDAQ just hit at an all-time high. We definitely didn't think we'd be putting those two sentences back-to-back when the year began, but it speaks to the speedy recovery of risk assets and the impressive resilience of technology and tech-adjacent stocks. In fact, the NASDAQ gained a whopping 30.95 percent in the 2nd quarter, and its year-to-date return is easily positive. Perhaps a bit ahead of itself to be sure, but also may reflect that many technology-focused firms and those with scalable, internet dependent business models are using this crisis as an opportunity to further entrench their competitive advantages. The more diversified S&P 500 was no slouch either, rising 20.54 percent, its best quarter in over two decades, though its return for the year is still slightly negative. Not to be left out, the Russell 2000 Index returned 25.42 percent. Top performing sectors over the quarter were previously beaten down energy and materials stocks, and consumer discretionary shares, largely thanks to Amazon. Laggards included more defensive firms in the consumer staples and utilities categories.



International and emerging market stocks rallied as well, though not quite as much as their U.S. counterparts. The MSCI EAFE and MSCI Emerging Markets were up 14.88 percent and 18.08 percent, respectively. German stocks, which tend to have more revenue exposure to China, led the way overseas.

Interestingly, despite the surge in stock prices, retail investor sentiment is still very pessimistic. According to the latest American Association of Individual Investors survey, just 22.2 percent of investors are bullish, compared to the long-run average of 38 percent. Also, the percentage of bears checks in at 45.9 percent, well above the long-term mean of 30.5 percent. Both deviations are quite large by historical standards.

OUTLOOK

One question that seems to inevitably arise during the early stages of a market recovery is some variation of "Isn't there a disconnect between the stock market and the economy?". The question is not unwarranted, as is doesn't seem intuitive that stocks could be rising given all the job losses, the shutdowns in production, the lingering uncertainty, etc. But our answer to that question has generally been "Yes, there is a disconnect, and that's actually normal." The reason is that stocks typically act as a leading indicator, meaning they often rise in advance of an improvement in the economy. A couple examples may illustrate this point. The bottom of the technology bubble bursting, and beginning of a new bull market, was officially in October 2002. However, the economy continued shedding jobs until June 2003. Similarly, the bear market during the financial crisis found its nadir in March 2009, yet unemployment worsened until April 2010, over a year later. Our current environment is, of course, highly uncertain and without a comparable precedent. But the behavior of stock markets isn't at all out of the ordinary. In fact, it fits rather well with historical patterns.

The speed and strength of the 2nd quarter rally, though, was surprising to many. It is clear that investors are expecting global economies to improve in the back half of the year, which will be necessary for those gains to hold. As we touched on earlier, there has already been a bounce back in activity in late May through June. A number of high frequency indicators we track – mobility data, gasoline demand, restaurant reservations, flight and hotel occupancy, and credit card spending, just to name a few – have all shown rapid improvement lately. So far, it actually has looked like a "V" shape recovery. But most recoveries do take that shape early on. It likely moderates somewhat going forward.

The continuation of the recovery though will depend on a number of factors. The primary one currently is how successful countries are at reopening their economies while still managing the impact of the virus outbreak. A handful of east Asian countries – China, Japan, South Korea, Taiwan, and you could throw Australia in the mix as well – seem to have done well enough on that front in that economic disruptions have been relatively mild. Europe was hit much harder, but currently most countries look to have a handle on the situation, and activity is slowly returning. In a few European countries, schools have even been open for months. The U.S. is more of a mixed bag. It is larger and more diverse than its developed world peers, making definitive comparisons challenging. Just looking at aggregate U.S. virus data masks the heterogeneities amongst different locations. So, while we think the domestic reopening will broadly continue, it will likely be in fits and starts. The odds of another large scale, nationwide type lockdown seem low, but we could definitely see more localized, regional policy disparities amongst cities and states with differing levels of concern regarding the coronavirus outbreak.

Secondly are the ongoing fiscal and monetary stimulus measures provided by central banks and governments. In the U.S., the Fed is committed to as much monetary accommodation as necessary. Certain fiscal stimulus measure are set to expire soon, but we'd expect another smaller, but more targeted package to be passed early in the 3rd quarter. The EU is discussing a new recovery fund which could be upwards of 750 billion Euros. The details have yet to be finalized, and there's bound to be some political wrangling, but there appears to be broad momentum behind the idea. Overall, global stimulus as a percentage of GDP has been huge. And, as the lines between monetary and fiscal policy increasingly blur, cooperation between central banks and government is becoming an increasingly accepted path forward.

And finally, just how much long-term damage has been done to economies is still unknown. But there is reason for optimism here. According to investment research firm, Morningstar, long-term negative impacts due to recessions are typically minimal in the absence of persistent policy errors, the Great Depression representing the worst-case outcome of said errors. But we do not feel like that will be the case going forward. We noted last quarter, and it bears repeating, that the current global policy response is incredibly broad and was enacted very quickly. So, while we don't foresee material lasting harm, these types of exogenous shocks often accelerate trends that were already in place. A few we're watching include increased adoption of technology and new ways of working, potential for deglobalization and new types of protectionist policies, a lower baseline level of interest rates, and the aforementioned melding of monetary and fiscal policy.

While there are budding signs of recovery around the world, the outlook is still more uncertain than usual. We believe economic activity will continue to return, but at an uneven pace. Global asset manager, PIMCO, has dubbed the recovery, "The Long Climb", as social distancing measures may have to stay in place for some time, and capital and labor need to be reallocated to new sectors. Yet, our message remains the same: In times like these, it is best to stick to your plan. As always, the Linscomb & Williams team is monitoring markets and portfolios on a daily basis, and we are available to visit regarding questions or concerns you may have.

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