July 2020

Dear Clients and Friends,

The stock market staged a rebound of historic proportions in the second quarter of 2020, recovering from an equally historic meltdown in the first quarter. The rebound came as the Federal Reserve aggressively intervened in the markets, launching an unprecedented array of tools to backstop markets and shore up investor confidence. In concert with the Fed, Congress issued checks to the populace, thus putting a floor under consumer spending. In short, the federal government stepped in to provide a bridge across the recession, similar to what was done during the 2008 financial crisis but much quicker and more aggressive. The question investors will increasingly wrestle with in the coming weeks and months is whether the bridge is strong enough to hold and long enough to actually get to the other side.

When the economy was essentially shut down in March, investors fled risk (stocks) and sought safety (bonds). As the chart below shows, this shutdown now looks like merely a very painful four-week stretch of massive uncertainty. Once the Fed stepped in with UNLIMITED support for markets on March 23rd, stocks stopped sliding and reversed upward. Outside of a handful of days here and there, markets haven't really suffered since. The Fed had restored the efficient functioning of markets, assuring investors they would aggressively intervene if needed. In doing so, the Fed had removed a primary fear of investors, the fear of markets coming unglued. Congress's action to fund suddenly ailing businesses and individuals removed a second fear, that the economy would enter a depression.

The challenge that investors face now is discerning whether the market recovery has gotten too far ahead of the economics of recovery. The market recovery has been very focused, with the same internet-focused companies receiving all the attention and money while financial, energy, and other broad line industrial companies see far less investor enthusiasm. This continued focus on a relatively small swath of companies has pushed their valuations to ever-higher levels. In a period of near-zero interest rates, however, traditional valuation metrics are a less reliable indicator as stocks become almost the only way to achieve a reasonable return on investor capital. That's what investors are telling themselves currently.

The economic data remains somewhat murky. Unemployment continues to be extraordinarily high with some 15-20 million people likely not working to the extent they were back in February. The government's benefit program has substantially lessened the economic impact of this severe drop in employment. It's unclear whether that support will continue through the rest of the year, though much of it likely will. Under that scenario, there should continue to be a slow bleed of bankruptcies as companies choose not to operate unprofitably for such an extended period. We can also expect a lingering and expanding level of negative economic effects that ultimately land in sharp reductions to state and local finances. How deeply that economic pain goes is anyone's guess at this point. For an examination how that could go, consider a college town whose university substantially drives the local economy. Imagine that college town with many fewer students on campus (because they are all taking classes online), no Saturday football to generate bursts of revenue for local businesses, and sharply reduced university budgets leading to layoffs at the school. There are very tough decisions ahead for many business and government leaders. All of those decisions have significant economic ramifications.

Meanwhile, the Nasdaq 100 index sits at record highs; the businesses of Amazon, Google, Microsoft, Apple, and Facebook seemingly little affected by the above economic issues, at least so far. The strength in these companies and their online business models has brought the stock market back from the edge of the abyss, thus far preventing the double-dip that bear markets typically experience. But how much focus is too much? The chart below shows the ratio of the Nasdaq 100 to an equally-weighted stock market. To say it's "off the charts" is an understatement! This stock market has become almost entirely about the above five companies.

There is some recent optimism that overseas economies are beginning to recover. If so, that will add another arrow in the market quiver. If so, it's entirely possible stocks will hold on until the U.S. economy finds its way back to firmer footing. But it's a historically uncertain time for investors, with exceptionally low visibility going forward, and government officials seeking to merely keep the wheels on the bus until this Covid-19 virus is defeated. Managing risk and uncertainty is and always has been our focus. We continue to take a moderate, risk-focused approach to investing, ready to act quickly if the market falters again. Be safe and let us know if there is anything we can do to better support you.

To future profits,

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