Investment Newsletter

Second Quarter 2020

The U.S. and international stock markets recovered significantly during the quarter, with the S&P 500 advancing +20.5%, the MSCI All-Country World ex-U.S. Index increasing +16.3%, and emerging markets advancing +18.2%. Investors reacted positively to the unprecedented levels of fiscal and monetary stimulus in the U.S. and the rest of the world to combat the negative economic impact from the COVID-19 pandemic. In addition, the early predictions of the number of deaths tied to COVID-19 have so far proven too pessimistic, notwithstanding the fact that COVID-19 remains a serious health issue. Early economic data from state re-openings, although not altogether smooth, have been encouraging. Year to date, the S&P 500 is down -3.1%, and the MSCI All-Country World ex-U.S. Index is down -10.8%.

To call stock market performance in the first half of 2020 unprecedented is not an exaggeration - from hitting an all-time high in mid-February, to having the quickest 30%+ drop ever (less than 20 trading days) by March 23, to having the strongest quarterly performance (second quarter) in over 20 years. Incredibly, as of this writing, the S&P 500 is off just -6.5% from its all-time high. Clearly, there will be good days and bad days. While we have already seen "winners" and "losers" in the stock market from the necessity of 'shelter-in-place' and 'social distancing' guidelines, we believe there are still interesting investment opportunities for us to pursue prudently.

The fixed income markets also performed well during the quarter, with the Bloomberg-Barclays US Intermediate Government/Credit Index increasing +2.8% (+5.3% year to date) and the Bloomberg-Barclays (1-5 Year) Municipal Bond Index increasing +2.4% (+1.9% year to date).

Fixed income markets rebounded sharply during the quarter in response to the massive amount of monetary and fiscal stimulus initiated by the Federal Reserve and Congress. In a reversal from the first quarter, riskier assets, particularly lower-quality corporate bonds, outperformed higher-quality bonds. Municipal bonds also improved; however, not to the degree that corporate bonds did due to ongoing credit concerns related to the effects of COVID-19 on state and local budgets.

The most significant factor in the outperformance of corporate bonds was the creation and implementation of two new credit facilities by the Federal Reserve. For the first time ever, it directly purchased outstanding corporate bonds and ETFs in an attempt to stabilize the fixed income markets. A key side effect of this action has been the lack of supply of high-quality bonds for investors to purchase. As a result, we may occasionally invest client portfolios in short-maturity corporate ETFs as a placeholder if we are unable to find appropriate and reasonably priced bonds.

Due to the Federal Reserve's explicit support, we expect corporate bonds to continue to perform well relative to Treasuries. We expect to see the yield curve continue to steepen as the Federal Reserve keeps short maturities anchored at very low rates, and a combination of rising inflation fears and increased Treasury issuance puts pressure on longer rates. For these reasons, we remain cautious and are maintaining a conservative bond portfolio structure with a relatively short average maturity.

Despite the strong recovery in the equity and fixed income markets, the global pandemic worsened in the quarter. Global daily new cases broke out of a range of 70-97K in late May to reach a new single-day record of 216K on July 1. The three reasons for the dramatic acceleration: 1) South America exploded with new cases as the fall and winter seasons set in. As a result, Brazil (#2), Peru (#5) and Chile (#6) all entered the top-10 worst countries for highest total cases; 2) U.S. states re-opened prematurely and many young people refused to socially distance or wear masks, resulting in new cases reaccelerating to a new single-day record of 60K on July 7 vs. the old record of 36K set on April 24; and 3) India's relentless daily new case growth vaulted the country to the 3rd-worst in the world behind the U.S. and Brazil.

On the positive side, despite the reacceleration of new case growth in the U.S., current hospitalizations and deaths in the U.S. have not returned to previous record levels. In fact, current hospitalizations are -27% below the record set on April 15, and average daily deaths are -73% below the record set in mid-April (The COVID Tracking Project). This is largely because most new COVID-19 cases are younger people. Indeed, the average age of new COVID-19 patients has recently dropped by 15 years.

U.S. testing growth has also accelerated dramatically. The U.S. has now conducted 36,878,106 tests (11% of the U.S. population), or 110K per million (The COVID Tracking Project). This compares to global #1 Russia at 145K per million. The FDA has currently authorized a total of 169 virus tests for the U.S.

In addition, vaccine and drug development continued to make solid progress. There are now 21 vaccine candidates in clinical trials, and 139 candidates in pre-clinical trials (WHO). An FDA-authorized vaccine, however, is still not expected until sometime in 2021, at the earliest. For drug therapies, Gilead Sciences' Remdesivir received FDA authorization for hospitalized patients after showing it could shorten hospital stays by four days, and generic drug dexamethasone proved in a clinical trial that it can actually cut the risk of death for hospitalized patients with advanced COVID-19 who are on ventilators.

While investors will debate whether we are in a 'second wave' or still in the 'first wave,' the point is irrelevant - the reality is it will take time to reach 'herd immunity,' and science can only be rushed so much. There is no easy or quick fix to resolve this global pandemic. Consequently, the world will continue to grapple with striking the right balance between protecting lives and protecting livelihoods.

Given such an unprecedented time for so many, why has the U.S. stock market performed so well? The main reasons: massive monetary and fiscal support, reopening of state economies, progress on medical innovation, lower COVID-19 hospitalizations and deaths, increased retail investor participation, and accelerating estimated S&P 500 earnings growth of +28% in 2021 vs. -22% in 2020 (FactSet).

Finally, the negative human side effects of the pandemic - high unemployment, social distancing, self-isolation, and declining mental, emotional and physical health - have created a fertile, combustible environment for social unrest tied to racial, wealth and income inequality, with both peaceful and violent protests having erupted across the U.S. Many companies have responded positively to these issues, and it has only reinforced our conviction in the utilization of environmental, social and governance (ESG) factors as a critical part of our investment process to ensure our clients are invested in companies whose business practices are both ethical and sustainable in these uncertain times.