Q2 2020
INVESTMENT PERSPECTIVES

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- **The Road to Recovery:** Countries around the world and states across the US began the reopening process during Q2 with mixed results. Lockdowns clearly stemmed the tide of the COVID outbreak, but the economic cost of the virus is yet to be fully understood. While US data generally surprised to the upside in Q2, many market participants were left wondering if the trajectory was sustainable—particularly with the specter of a second wave of COVID cases looming large.
- **Wall Street vs. Main Street:** The extraordinary returns for equity markets around the world spurred by monetary and fiscal largesse came in stark contrast to mounting job losses and broad economic repercussions from the global pandemic.
- **"…not even thinking about thinking about raising rates":** Fed Chair Jay Powell emphasized the Fed's ultra-accommodative posture at every opportunity during Q2. In addition to the pledge to keep rates low for the foreseeable future, the Fed ramped up asset purchases in an effort to support markets—even venturing into the realm of buying individual corporate bonds and corporate bond ETFs.

MARKET RECAP

Against a fundamental backdrop of rising unemployment and depressed economic activity, markets catapulted higher in Q2 fueled by monetary and fiscal stimulus from around the world. The S&P 500 posted its best quarter since 1998, advancing nearly 21% and returning to within a few percentage points of where it started the year. Non-US stocks lagged their US counterparts but also posted double-digit gains during the period, with emerging markets stocks outperforming developed markets by over 3%.

Within fixed income, Treasury rates were largely unchanged during the quarter. Despite the more upbeat assessment implied by equity prices, the 10-year yield spent the quarter oscillating between roughly 0.6% and 0.8%—hardly an endorsement of an optimistic growth outlook that would break the disinflationary trend.

After the substantial dislocation in Q1 and with help from the Fed's multi-billion dollar programs, investor appetite for riskier debt and higher yielding assets

FIXED INCOME

	USD Total Return (%)	
Index	**Q2 2020**	**YTD**
Barclays 1-10 Yr Muni	2.7%	2.1%
Barclays US Agg. Bond	2.9%	6.1%
BofA/ML HY Master II	9.6%	-4.8%

EQUITIES

	USD Total Return (%)	
Index	**Q2 2020**	**YTD**
Russell 3000	22.0%	-3.5%
S&P 500	20.5%	-3.1%
Russell 2000	25.4%	-13.0%
MSCI All Country World	19.2%	-6.3%
MSCI EAFE	14.9%	-11.3%
MSCI Emerging Mkts	18.1%	-9.8%

Source: Bloomberg (Data as of 6/30/2020)

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helped push corporate bonds and other portions of the credit market markedly higher in Q2. High yield bond indices posted their best returns since the wake of the global financial crisis in 2009, with the BofA/Merrill Lynch High Yield Master Index gaining nearly 10%.

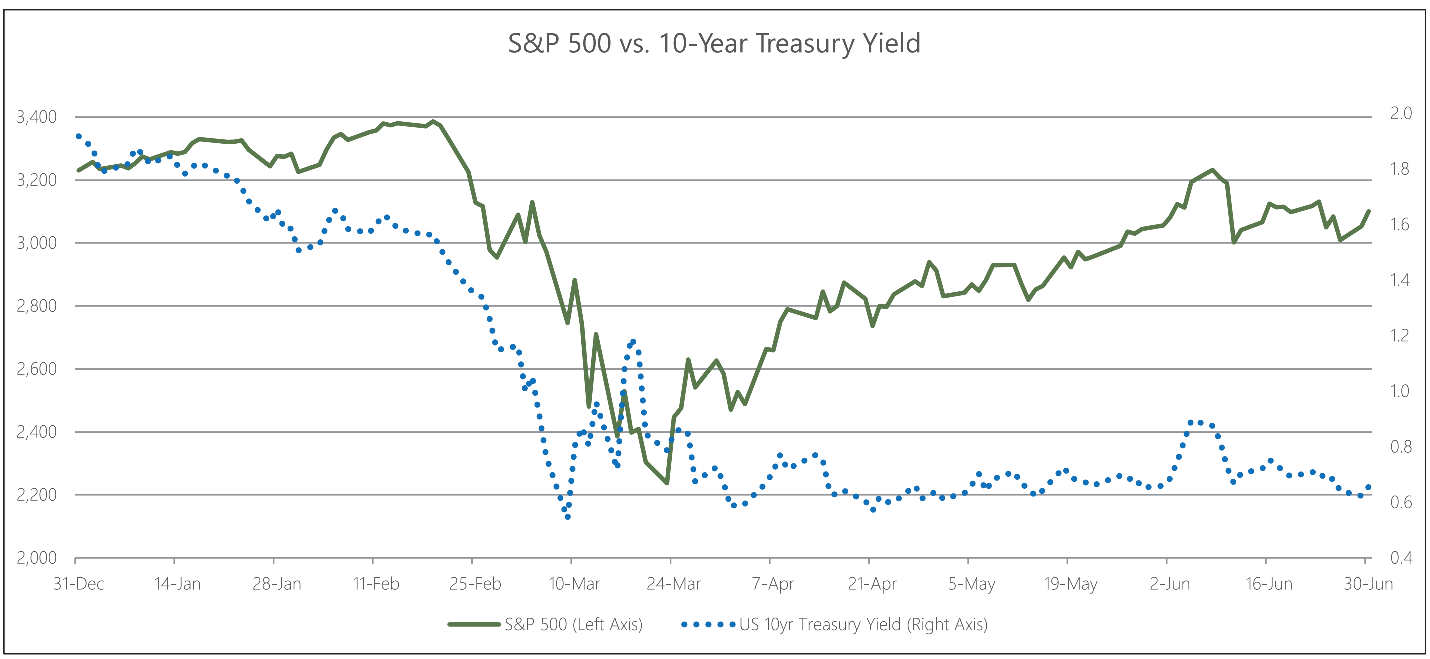
JUST CALL MY NAME, I'LL "V" THERE

Ever since the depths of the market dislocation in March, Fed Chairman Jay Powell and his colleagues have been singing a tune from the Jackson 5: "Whenever you need me, I'll be there." While the shape of the economic recovery remains uncertain, the recovery in US risk asset prices has been unambiguously "V" shaped thanks in large part to the extraordinary amount of stimulus being pumped into the system. Since the end of February, the Fed increased the size of its balance sheet nearly 70%, or roughly $3 trillion, in a four month period. For perspective, it took nearly five years for the Fed to increase its balance sheet by $3 trillion in response to the global financial crisis. Of equal significance, Chair Powell has repeatedly stated a commitment to taking any steps necessary to support the recovery, assuaging investors' fears that stimulus would be short lived or narrow in scope.

MIXED SIGNALS

Mired in one of the worst three month economic periods in the country's history as a result of coronavirus-induced lockdowns, stocks appeared to defy financial gravity by climbing steadily higher during Q2. On the one hand, prominent investors like Stanley Druckenmiller and David Tepper went on the record saying that the risk-reward proposition for equities was among the worst they have ever seen. On the other hand, retail day traders happily snatched up shares of beaten down stocks, even pushing the price of bankrupt rental car company, Hertz, up nearly 900% over a two week period before it reverted to prior levels.

We will offer more thoughts on recent equity performance in a subsequent section, but it is worth observing a few key divergences across asset classes. For one, the rates market appears to be skeptical of the swift recovery implied by stock prices. The chart below shows the S&P 500 (green) relative to the 10-year Treasury yield (blue dotted).



Source: Bloomberg (Data as of 6/30/2020)

If the collective wisdom of bond market participants sensed that growth was meaningfully recovering and that inflation would trend back toward the Fed's 2% target going forward, rates likely would have moved higher alongside stocks. However, you can see that the blue line has essentially gone sideways since late March, perhaps calling into question the sustainability of the equity rally. After all, the bond market was well ahead of stocks in terms of correctly discounting the effects of COVID at the beginning of the year, so this divergence bears watching.

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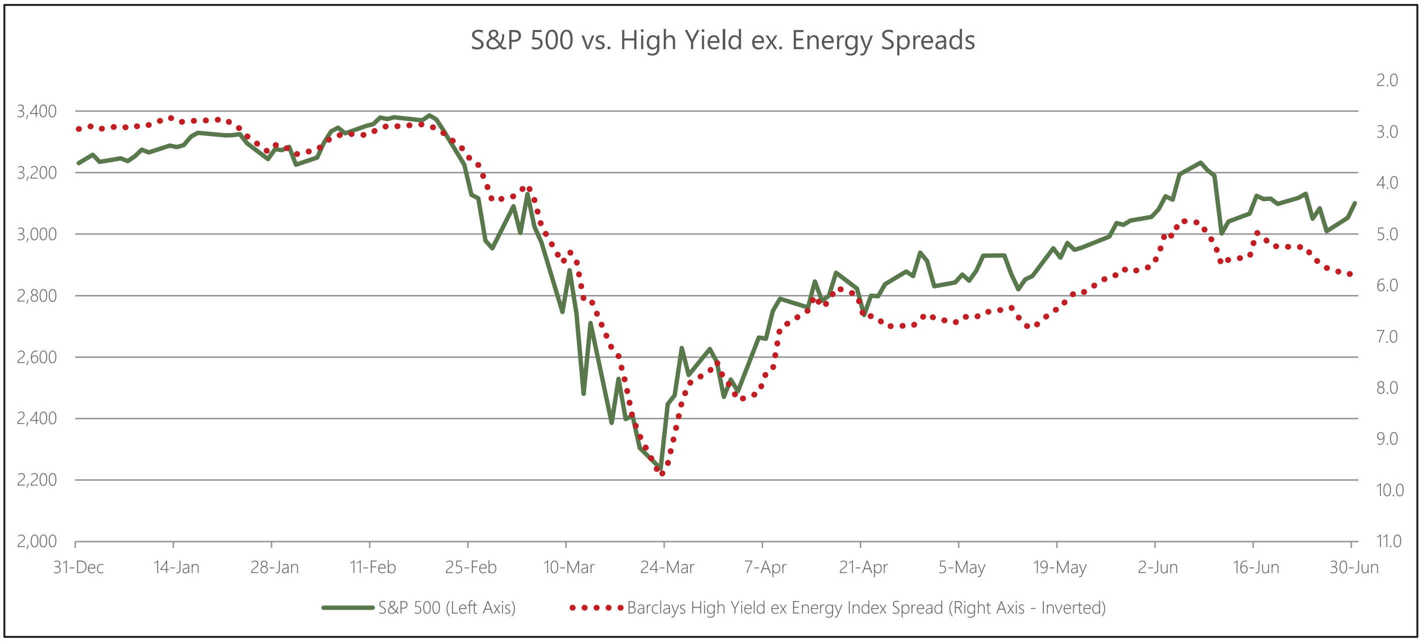
Looking through a slightly different lens, the chart below compares the S&P 500 (green) against high yield bond spreads (red dotted – inverted). Credit spreads measure the additional yield over a Treasury that investors require to lend money to companies, and historically, credit markets have been very sensitive to eroding corporate fundamentals. The chart below shows that spreads generally followed the trajectory of equities—widening as stocks sold off, then rebounding—until April. The gap is not as dramatic as the prior chart of Treasury yields, but it suggests that credit investors are taking a more cautious stance relative to their equity-focused brethren. A growing deviation would be a warning sign for the overall state of investor risk appetite.



Source: Bloomberg (Data as of 6/30/2020)

TECH TAKING OVER THE WORLD

The extraordinary growth of a relatively small group of mega cap technology names—specifically, the "FANMAG" stocks (Facebook, Amazon, Netflix, Microsoft, Apple, Google)—has been widely covered in recent years as their price gains have driven a substantial share of the overall S&P 500 performance. Even beyond this collection of ubiquitous tech leaders, a broader shift toward technology stocks has been afoot. As evidence of this trend, the chart to the right shows that the tech-heavy NASDAQ 100 Index hit a milestone in Q2; its ratio to the S&P 500 surpassed the previous all-time high set during the dot com bubble.

This development is emblematic of bigger themes playing out across markets in recent years. From a global perspective, the outperformance of US stocks versus non-US stocks over the last decade can largely be attributed to the higher tech weighting within US indices—namely, the FANMAG cohort—

Source: Bloomberg (Data as of 6/30/2020)

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relative to a higher weight to the struggling financial sector abroad. Relatedly, the performance of growth indices versus value indices has been driven by similar dynamics. Cyclical sectors like industrials, materials, and energy have struggled to generate outperformance as global growth has sputtered, but secular trends in areas like mobile, digital advertising, and cloud computing have driven substantial cash flow expansion for the types of companies populating growth indices.

Of course, the question investors must now ask themselves is whether this outperformance is sustainable on a forward-looking basis. For starters, a simple glance at the chart would suggest that the parabolic move during the period from 1999 to 2001 was a speculative mania, whereas the period post-dot com collapse has seen a more measured pace of relative growth (at least until this year). Arguably, that would augur in favor of the trend's ultimate sustainability. Moreover, comparing cash flow metrics from the NASDAQ relative to the S&P 500 between now and 2000 shows a threefold relative increase in favor of NASDAQ constituents—commensurate with the index's comparative performance. In other words, there is a far more compelling justification for valuations today than there was twenty years ago. Add on the fact that COVID has accelerated the movement toward things like e-commerce, adoption of work-from-home technology, streaming, etc., and perhaps this marks the end of the beginning instead of the beginning of the end for tech outperformance.

ALL THAT GLITTERS IS GOLD

Investors have rightfully fixated on stock market volatility and the exceptional performance of the aforementioned mega cap tech stocks this year, but gold has quietly been the best year-to-date performer across major asset classes. In US dollar terms, the price of the yellow metal has advanced 17.4%. As monetary and fiscal stimulus around the world has led to a rapid expansion of global money supply, gold's case as a store of value given its relatively constrained supply has garnered investors' attention. Further, with global central banks cutting short-term rates toward 0%—or negative in some cases—the opportunity cost of holding gold in lieu of an interest-bearing security has diminished.

There is an axiom that one ounce of gold has bought a good men's suit for centuries, reflecting its value as a hedge against inflation over time. While the work-from-home era may have a lasting impact on demand for formal workwear, the sentiment holds true; for investors concerned about the potential for inflation and/or currency debasement, gold may warrant a spot in your portfolio. ●

Making Sense of the Markets

Perhaps more so than any other period of our collective careers, the recent rally has left professional and amateur investors alike scratching their heads. We have received countless questions along the lines of "Can you explain why the market keeps going up?" Being at the intersection of so many unique circumstances makes it difficult to draw definitive conclusions, but we offer a couple of thoughts to contextualize the market response and help explain buoyant equity prices below.

- The unemployment statistics have been unprecedentedly bad, and we in no way want to minimize the toll that this period is taking on families around the country. With that said, most people do not realize that US aggregate worker compensation was actually higher in May than it was in February—right before COVID started to impact the economy in earnest—when unemployment benefits are included. The stimulus bill passed by Congress in response to the crisis included an additional $600 per week of unemployment benefits alongside the standard payments. While it may be of little consolation if people are still out of work when the added payments cease, studies suggest that the increased unemployment benefits are paying a majority of unemployed citizens more than the wages they received at their last job.

  Compare this period on the chart on the next page to the global financial crisis. It took nearly two years for aggregate compensation and benefits to return to pre-crisis levels after 2008. The speed with which the government responded this time was clearly well received by markets.

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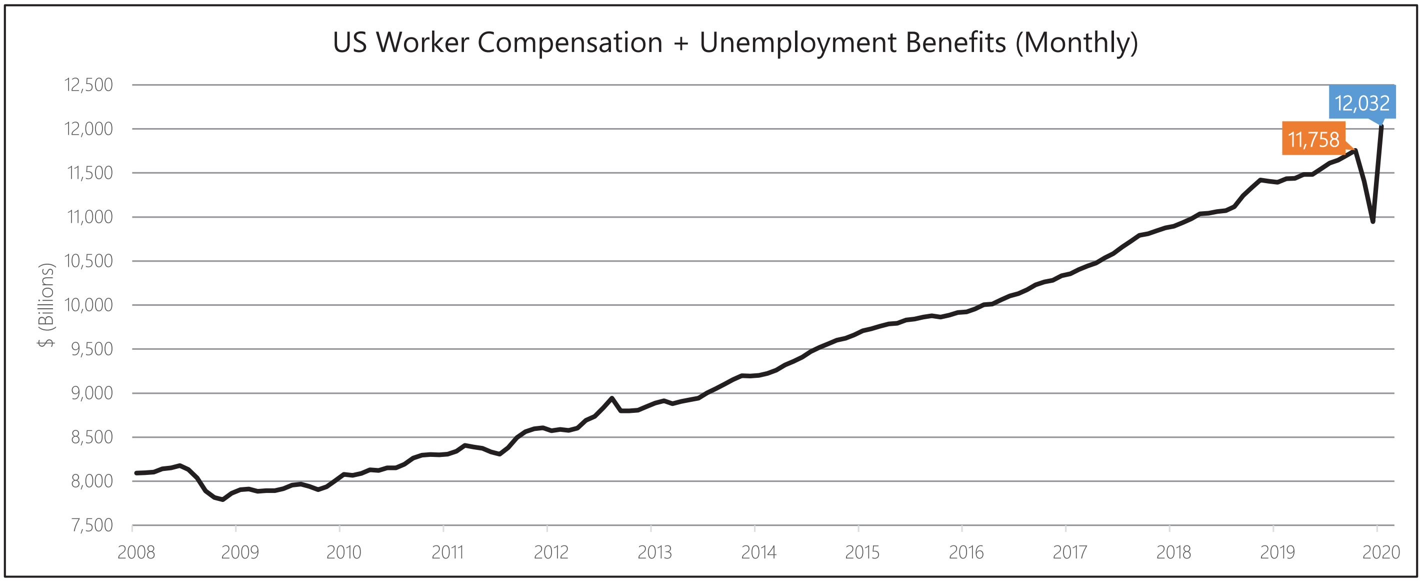
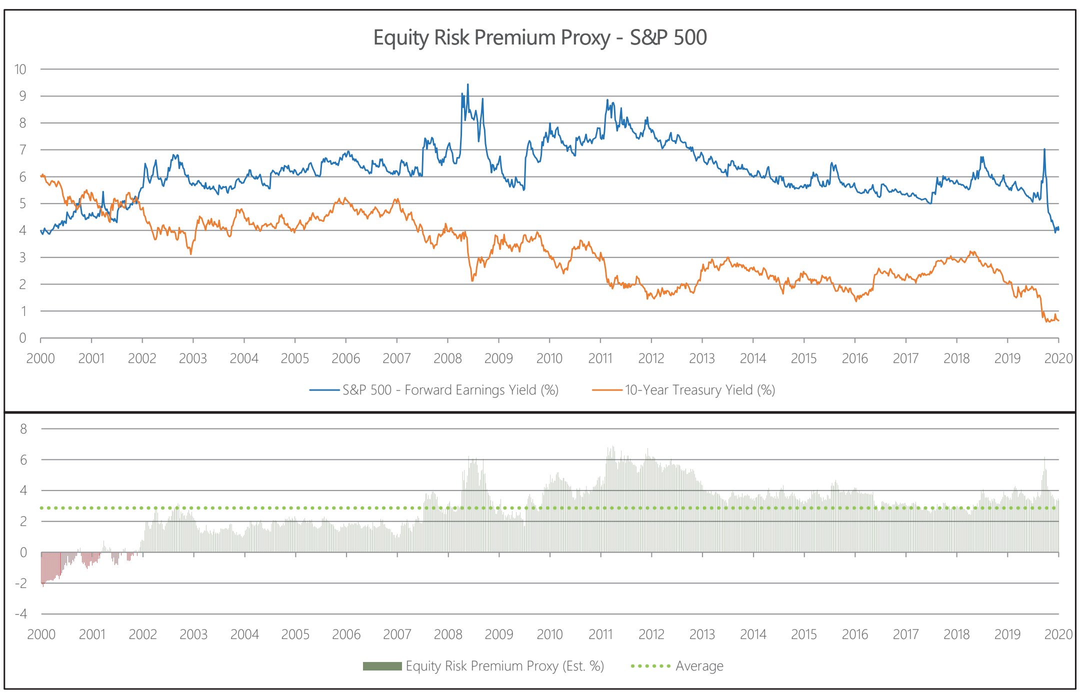


Source: Bloomberg (Data as of 6/30/2020)

- It is difficult to overstate the importance of bond yields on equity prices. Earlier, we showed how the 10-year Treasury yield has remained stubbornly low after markets took their initial leg down in February and March. With interest rates on safe assets at historically low levels, investors are forced out the risk spectrum to achieve higher rates of return.

  One school of thought aims to quantify this relationship by looking at the so-called "equity risk premium" (ERP). Regular readers may recall discussions of this phenomenon from prior newsletters, but in simple terms, a risk premium is the excess return that investors expect to earn by owning a risky asset instead of risk-free Treasuries. To illustrate this relationship, we can use the earnings yield as the basis for an apples-to-apples comparison of expected shareholder returns relative to Treasury yields. The earnings yield is simply how many dollars of earnings an investor expects to receive per $100 invested (i.e., the reciprocal of the more widely-cited price/earnings ratio).



Source: Bloomberg (Data as of 6/30/2020)

  The chart to the left plots the S&P 500 earnings yield in blue and the 10-year Treasury yield in orange since 2000. The gap between the blue line and the orange line represents a rough proxy for the equity risk premium that stock investors expect to receive over the next 12 months—plotted on the bottom panel.

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The average ERP over this period—using our proxy—has been around 3%. With the 10-year yield at roughly 0.7%, that would suggest that an appropriate earnings yield would be 3.7% (0.7% + 3.0% ERP). A 3.7% earnings yield translates into 27x price/earnings ratio. So, while stocks may be more expensive in absolute terms, there is a compelling argument to be made that they are simply recalibrating in comparison to bonds.

To play out the math one step further, consider that the S&P 500 started the year at 3,241 and earnings expectations were roughly $163.52 per share, imputing a 19.8x price/earnings ratio. Even if earnings expectations fell roughly 27% as a result of COVID—going from $163.52 to $119.67—the move from a 19.8x price/earnings ratio to 27.0x would put the index level at the exact same level where it started the year. This is somewhat of an oversimplification and does not scratch the surface of the implications of ultra-low rates on companies' cost of capital or present value of future cash flows, but it is a framework for explaining how stocks could be nearly flat for the year even in a recessionary environment.

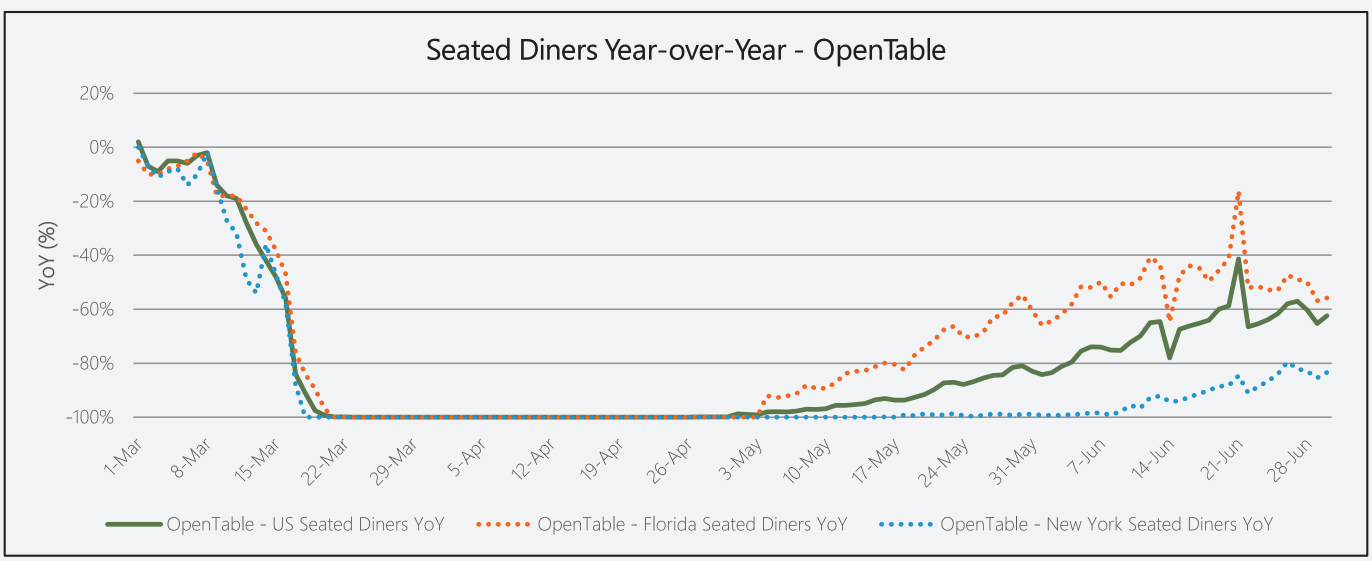
What are the overall implications? For one, investors should get comfortable seeing valuations that would have previously been considered irrational as long as bond yields stay extremely low. Perhaps more importantly, investors should reasonably expect lower rates of return going forward based on today's valuations. ●

Chart of the Quarter

Among the myriad impacts of the COVID pandemic, one fairly trivial development that may go largely unnoticed is the widespread adoption of so-called "alternative data". Rather than rely on government-produced measures like GDP growth that are reported on a lag (and often revised multiple times subsequently) or anecdotal accounts that lack statistical rigor, tech-centric companies and researchers have become increasingly proficient at distilling enormous amounts of data from a variety of sources into daily or weekly indicators that can provide unique insights with multiple layers of granularity. These types of datasets were previously the province of hedge funds willing to pay for—and comb through—esoteric statistics that could provide an informational edge, but the accessibility appears to have hit a tipping point. As researchers and investors alike have tried to make sense of the rapidly changing landscape due to COVID, these types of high-frequency indicators have been enormously useful.

For this quarter, we are presenting a set of charts in lieu of a single graphic for our "Chart of the Quarter" segment. Each of the visualizations below revolve around the growing trend toward the use of alternative data sources to measure economic activity.

1) The online restaurant reservation service, OpenTable, began publishing data that it collects from member restaurants about the number of diners being seated every day. The chart below shows the number of



Source: Bloomberg (Data as of 6/30/2020)

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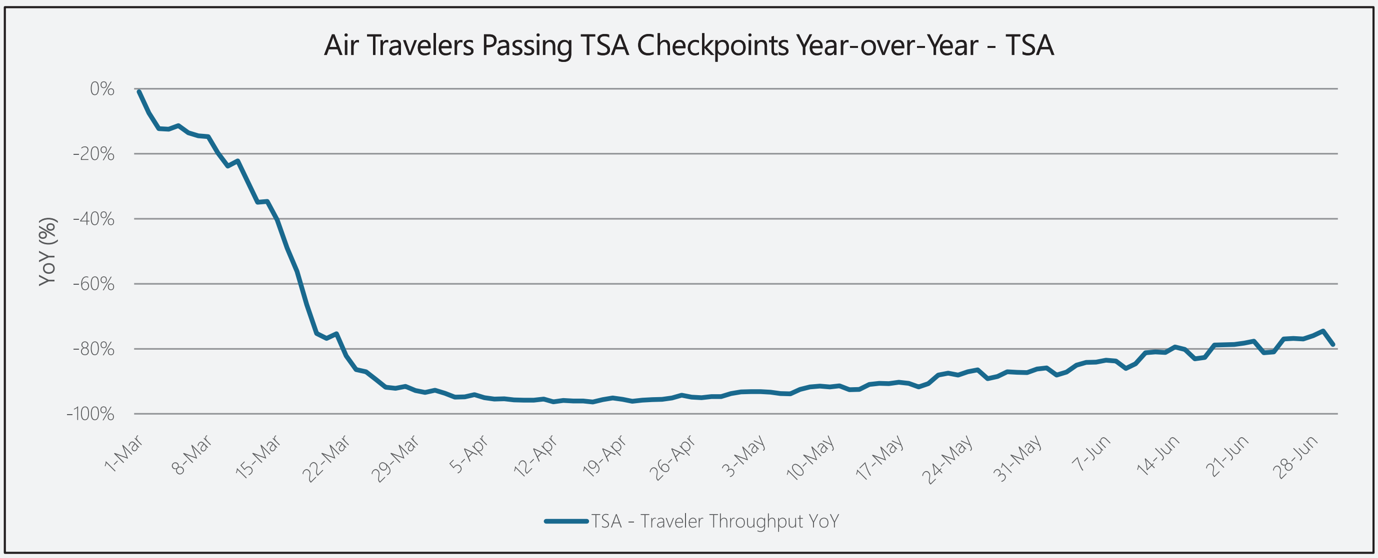
seated diners compared to the same weekday a year prior (to avoid distortions from weekdays versus weekends). The green line represents the entire US; you can see that in-restaurant dining had declined precipitously by mid-March and has only slowly begun to recover over the last two months.

The dotted lines represent subsets of the aggregate US data. Note the difference between Florida (orange) and New York (blue), two states that have had radically different experiences with COVID. While New York was struggling to contain the virus through April and May, Florida began reopening its economy in earnest at the beginning of May—as evidenced by the uptick in restaurant dining. New York loosened restrictions at the beginning of June and has seen a modest trend higher since that point while a growing number of new COVID cases in Florida has likely contributed to the stagnation of their recovery over the same period.

2) While not known as a bastion of tech-forward thinking, the Transportation Security Administration (TSA) started publishing datasets that compare the number of travelers passing through TSA checkpoints in 2020 versus the same weekday in 2019. Similar to the OpenTable data, you can see the rapid drop from early to mid-March, a period of practically zero travel through April, then a very gradual recovery in May and June. Even as states have started to reopen, air travel remains down roughly 80% relative to the same time last year.



Source: Bloomberg (Data as of 6/30/2020)

3) Homebase is a widely-used scheduling tool for businesses with hourly employees across the US. The company began publishing a dataset showing the number of hours worked by hourly employees relative to the median level from January 2020. The chart on the next page shows a trend similar to the prior datasets; hours worked tumbled significantly during the most draconian phase of the lockdowns and have been slowly recovering over the past two months. At nearly 30% below January levels, the most recent reading suggests that the labor market is still in a precarious place.

We would offer two very different concluding remarks. First, from a meta perspective, the democratization of alternative data sources is an incredibly important development for investors and the efficiency of markets. As referenced earlier, the informational/analytical edge from "big data" gathering and processing that used to be limited to the most sophisticated market players is perhaps being eroded by the growing availability of these alternative datasets. The COVID environment has accelerated a move toward methods like "nowcasting" and real-time data collection. All other things being equal, better and higher-frequency data should make the market a more efficient pricing mechanism.

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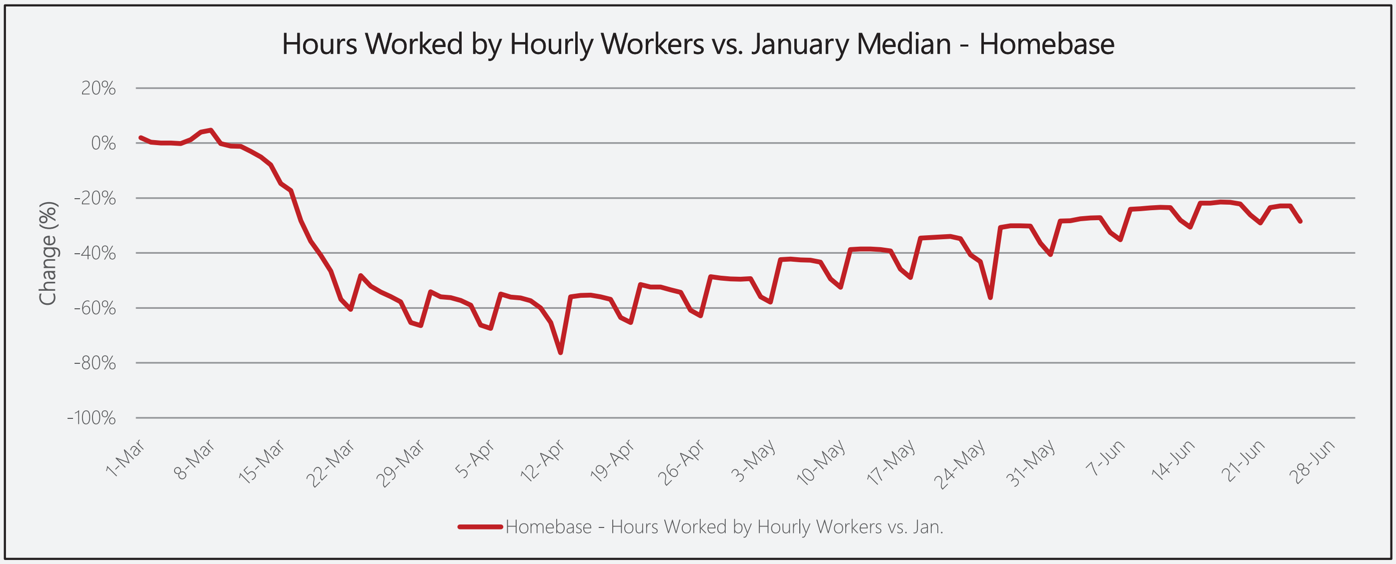

Source: Bloomberg (Data as of 6/30/2020)

Second, whether you look at the measures above or other non-traditional sources such as Apple mobility data, Chase debit card spending trends, satellite images of pollution levels in China, or Twitter sentiment indices, you will see that the global economy still has a ways to go before returning to its pre-COVID state. For now, markets appear content to focus on the direction of the trend as opposed to the absolute levels, particularly given the ultra-supportive stance of central banks and governments around the world. But, indicators like these may provide early warning signs that the recovery is flat-lining or taking a turn for the worse. ●

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