Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES

JULY 31, 2020

Equity Market Summary

U.S. Equity Markets	Month	YTD
S&P 500	5.6%	2.4%
Russell 1000 Growth	7.7%	18.3%
Russell 1000 Value	3.9%	-13.0%
Russell 2000	2.8%	-10.6%
Russell 2000 Growth	3.4%	0.3%
Russell 2000 Value	2.1%	-21.9%

Top/Bottom Sectors	Month	YTD
Technology	5.6%	21.4%
Consumer Discretionary	9.1%	17.0%
Communication Services	6.8%	6.4%
Industrials	4.4%	-11.1%
Financials	3.8%	-20.8%
Energy	-5.1%	-38.4%

Non-US Equity Markets (in USD)	Month	YTD
MSCI AC World Ex U.S.	4.2%	-8.4%
MSCI EAFE (Developed)	2.2%	-10.6%
MSCI Emerging Markets	8.4%	-3.2%
MSCI China	9.5%	13.6%
MSCI United Kingdom	1.4%	-22.0%
MSCI Brazil	14.3%	-30.0%

Non-US Regions (in USD)	Month	YTD
Developed Americas	5.8%	-6.4%
Developed Asia	-0.2%	-9.1%
Developed Europe	3.9%	-8.8%
Emerging Americas	11.0%	-27.8%
Emerging Asia	9.8%	6.1%
Emerging EMEA	3.2%	-17.9%

What's changed since our last report (on June 30, 2020):

Coronavirus (CV-19) continues to spread and the global rate of infection is doubling every five weeks, showing no improvement since late May. Deaths are slowing to a doubling once every ten weeks, from once every five weeks at the end of May. In the U.S. cases are doubling once every six weeks, an acceleration from the month ago level. Reproduction Rates (R_0) are over 1 in 35 states, up from 11 in early May. Early and middle re-opening states are continuing to experience a surge in cases, although most are showing improvement over the past two weeks. We remain convinced that full recovery is dependent on a widely available and effective vaccine and the odds of an early 2021 option continue to rise. Pfizer announced they expect to have 100 million vaccine doses available by late 2020 and 1.3 billion doses by the end of 2021.

Where are we now:

CV-19: More than 18.1 million cases (58% M/M rise, down from 85% at June 30) and 691,000 deaths (29% M/M rise, down from 44% at June 30) worldwide. Daily new cases are averaging 260,000 over the past week, up from 185,000 for the week ended June 30. Daily new deaths are averaging 5,700 over the past week, up from 4,500 for the week ended June 30, but still well below the peak of 7,000 in mid-April. Despite accounting for just 4% of global population, the U.S. accounts for 26% of global cases and 23% of deaths. Brazil, Russia, Mexico, India, Columbia and South Africa are experiencing a surge in cases and deaths. Europe is experiencing a modest uptick in cases, primarily attributable to a surge in Spain. UK, Spain and Italy still have the greatest number of deaths per population among developed countries.

Economy:

- Second quarter U.S. real GDP fell 32.9% Q/Q annualized, a post-WWII record. This followed a first quarter decline of 5.0% Q/Q annualized. It was known that the second quarter would be challenging; however, businesses are re-opening and the economy appears to have bottomed in May.
- German second quarter GDP declined a similar 35% Q/Q annualized. Most European economies are showing similar weakness, despite generally re-opening more successfully than the U.S.
- The U.S. personal savings rate remains elevated at 19% but that is down from the 33% reading in April. Consumer spending rose 5.6% M/M and the continued high savings rate implies further gains in spending are likely.
- Initial jobless claims have risen each of the past two weeks and have now tallied greater than 1 million for 19 straight weeks. The uptick in initial claims the past two weeks follows a period in which claims declined for 15 straight weeks. The claims data is consistent with other real-time indicators which are showing modest slowing of the U.S. economy over the past four weeks, coincident with the recent rise in CV-19 cases.
- Housing remains a bright spot for the U.S. as pending home sales rocketed up 16.6% M/M in June and are now up Y/Y. With rates low and the economy likely having bottomed, housing is likely to remain strong.

Earnings:

- To date, 312 (62%) S&P 500 companies, representing 73% of the market capitalization of the index, have reported second quarter earnings. Earnings are down 33.8% Y/Y vs. and expected decline of 43.0%, and revenues are down 10.4%, vs. and expected decline of 11.8%.

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- 82% of companies have reported better than expected earnings with an aggregate earnings beat of an eye-popping 22%. Consumer Discretionary stocks are reporting the largest earnings and second largest revenue beats, although earnings for the sector are still expected to fall 77% Y/Y. Information Technology, Health Care and Utilities are the only sectors expected to report a Y/Y rise in earnings at 1.4%, 1.1% and 2.7%, respectively.
- The five largest companies in the S&P 500 (Microsoft, Apple, Amazon, Google and Facebook) have reported Y/Y earnings growth of 23% and revenue growth of 17%, despite the second quarter being the worst period for the U.S. economy on record.
- Energy companies are expected to report a 45% Y/Y decline in revenues and greater than a 160% drop in earnings on lower energy prices and demand.
- 85% of Financials in the S&P 500 have reported earnings with a Y/Y decline of close to 50%. Investment Banks have seen their earnings decline more than 40% Y/Y despite one of the best trading environments on record.
- U.S.-centric business are expected to see their revenues and earnings decline by less than half that of export focused companies.

Financial Markets:

- The dominance of growth stocks continued in July and the Russell 1000 Growth has now outpaced the Russell 1000 Value by 31.3% year-to-date and 68.5% over the past three years. The three year peak of growth stock outperformance in the TMT bubble was 92.4% for the period ended March 31, 2000.
- Treasury yields do not appear to reflect the same enthusiasm for a swift economic recovery that equity, commodity, housing and credit spreads reflect with 10-Year Treasury Note yields hitting new 2020 lows over the past week.
- The U.S. Dollar continues to fall, hitting new 52-week lows over the past weeks. Gold is rallying for multiple reasons, but dollar weakness is likely chief among them. Historically, dollar weakness bodes well for high margin, strong free cash flow businesses, which may give further support to already strong momentum in growth stocks.

Summary:

The recession that began in February likely ended in late May to early June. But unemployment remains high and that is an unstable state for the economy. This past week the Fed reiterated their support for the economy by leaving rates near zero and extended their accommodative policies. But the Fed can't create demand, at best they can provide a liquidity bridge to the other side and assist in keeping a liquidity crisis from becoming a solvency crisis. To date the Fed has shown extraordinary ingenuity and effectiveness with their policies, but they can't take the economy to the next step. It will require further fiscal policy to advance the economy and while we expect the next stimulus bill to pass soon, it's not yet a done deal and time is running out. Over the past 20 weeks more than 1 in 3 American workers have filed initial jobless claims and the trend the past two weeks is in the wrong direction. So far markets do not seem to be overly focused on Biden's lead in the polls. While his proposed policies would be negative for corporate earnings he would need a Democratic Senate to get everything on his platform. That is a possibility, but so is a last minute Trump surge. While we expect the campaign season to introduce uncertainty, all the stimulus in the system and a new vaccine might make it a moot point. In prior letters we've stated it was difficult for the economic figures to get much worse. That appears to be true and any bounce off the bottom was destined to look "V-shaped." Earnings are generally surprising to the upside (off of rock bottom low expectations) but a relative surprise does not mean the absolute level is good, as S&P 500 earnings are likely to decline by more than $300 billion Y/Y in 2020. The absolute level of earnings and economic activity matters and at some point that will come back into investors' view. We welcome the good earnings news of the past few weeks and the uptick in timely economic indicators since late May, but we remain convinced full economic recovery is not possible without a widely distributed vaccine. U.S. equity markets are now trading at more than 20x CY 2021 expected earnings. A level that appears to us to reflect a near certainty that a widely available vaccine will be the spark that lights the enormous monetary and fiscal stimulus poured onto the economy over the past five months. A period of side-ways movement of markets into the election, and awaiting confirmation of the effectiveness of one of the many vaccines now in trial stages, would seem to be likely given how much ground the markets have plowed since the March 23rd low.

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