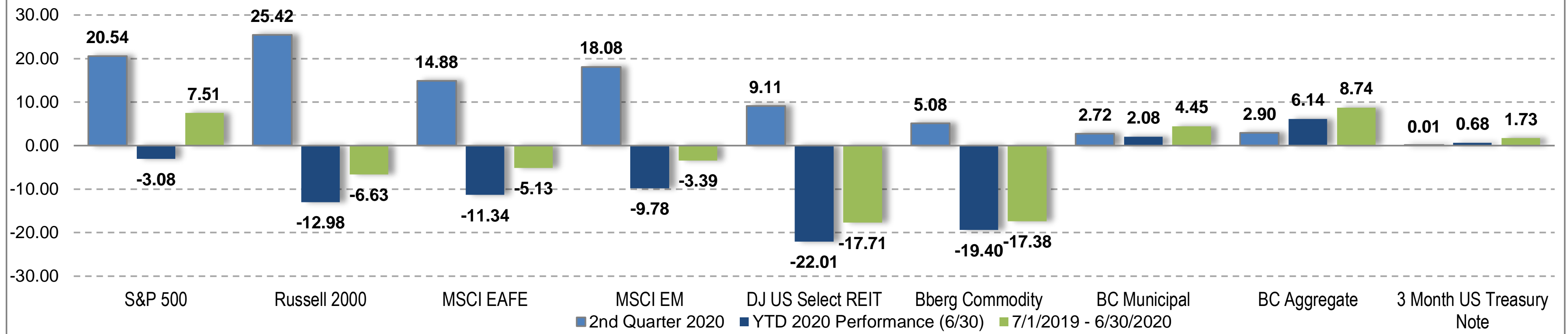
A Tale of Two Quarters: Markets Rebound Strongly After 1st Quarter Struggles… and some Tennyson Too

Schneider Downs Wealth Management Advisors, LP
Q2 2020 Market Commentary

Big Thinking. Personal Focus.



As we began to put the framework of this quarterly letter together, I was reminded of a passage in the famous poem *The Lotos-Eaters*, by Alfred Tennyson.

"Branches they bore of that enchanted stem,
Laden with flower and fruit, whereof they gave
To each, but whoso did receive of them
And taste, to him the gushing of the wave
Far far away did seem to mourn and rave
On alien shores; and if his fellow spake
His voice was thin, as voice from the grave:
And deep-asleep he seem'd, yet all awake
And music in his ears his beating heart did make"

It is hard to believe that 2020 is little more than half way over, given the near daily onslaught of news bombarding our newspapers, tablets and phones, and televisions. The first six months of 2020 will surely go down in annals of history as a first half to remember; from a novel coronavirus to murder hornets, a presidential impeachment in the House of Representatives to a national discussion on the state of race relations in America following the deaths of George Floyd and Breonna Taylor, the United Kingdom exercising their sovereignty in leaving the European Union, and finally, a 22-day plunge into a bear market in the S&P 500,[1] the fastest on record, only to be reversed with the S&P 500 entering a new bull market (using the standard definition of a 20% increase from its low point) IN TWELVE DAYS (the quickest recovery on record).[2] The previous sentence is long, but the past six months have felt longer, packing what seems like six years' worth of news and events into 180 days. When evaluating where we stand at the halfway point of the year, the word that comes to our mind is "volatility," which is exhibited in the events unfolding thus far in 2020, as

[1] https://www.cnbc.com/2020/03/23/this-was-the-fastest-30percent-stock-market-decline-ever.html#:~:text=Twenty%2Dtwo%20days.,from%20Bank%20of%20America%20Securities.

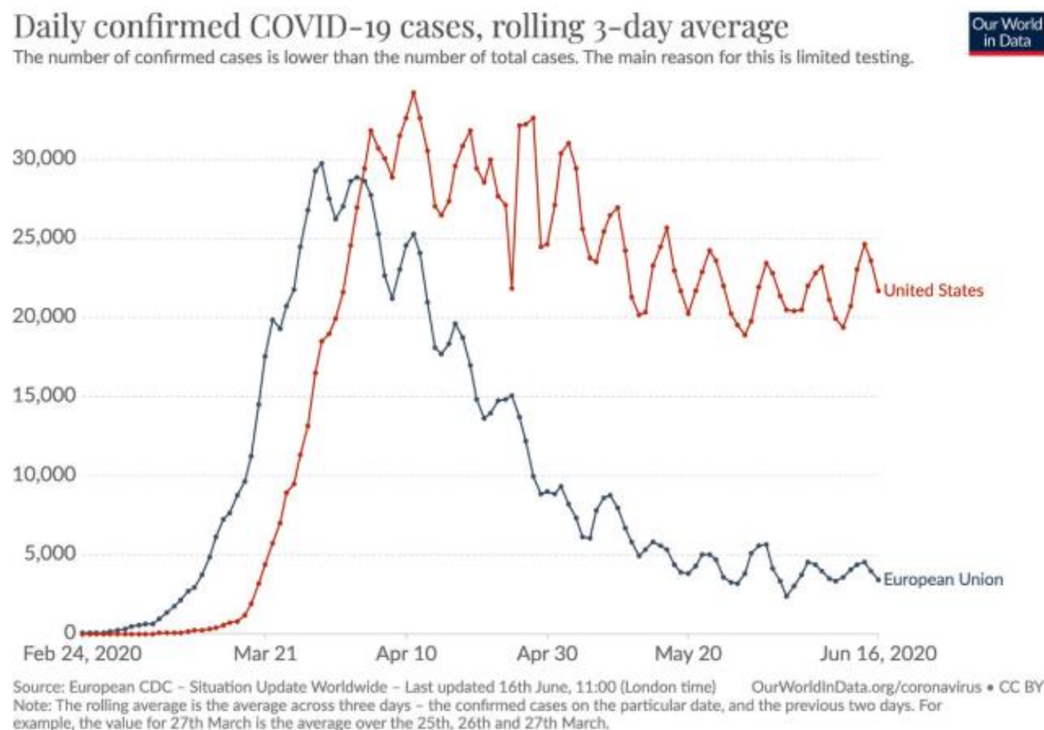
[2] https://www.barrons.com/articles/s-p-500-might-be-entering-a-bull-market-that-doesnt-mean-the-bear-is-over-51586275743

well as in the frenetic movements in capital markets. One could be forgiven, if in 2020, they were somewhat envious of the mariners Tennyson wrote about; isolated from the world in an altered state.

If a market participant was lucky enough to be one of the mariners Tennyson wrote about and emerged from the alien shores to see the S&P 500 down only ~3% for the first six months of the year, it would likely be met with a shrug of the shoulders. However, most of us were not so fortunate and had to watch the daily machinations of a manic and frenetic market. The S&P 500 (U.S. Large Cap Stocks) returned +20.5% for the quarter only to be bested by the Russell 2000 (U.S. Small Cap Stocks) returning +24.5%; for the S&P 500 it was the best quarter in 22 years, trailing only the 4th quarter in 1998. For the widely-followed Dow Jones Industrial Average ("the Dow"), a return of +17.8% for the second quarter provided **the second best quarter since 1938.**[3] However, even those numbers don't adequately explain the swiftness of both the downturn and the rebound, as evidenced by the table below.

U.S. Equity Index	2020 Drawdown	2020 Rebound	YTD Performance
S&P 500 (U.S. Large Cap Stocks)	-33.70%	+35.15%	-3.02%
Dow Jones Industrial Average (U.S. Large Cap Stocks)	-36.75%	+35.36%	-8.43%
Russell 2000 (U.S. Small Cap Stocks)	-41.72%	+42.75%	-12.99%

Outside of domestic equity markets, International equities enjoyed robust and strong returns for the second quarter as well. International Developed stocks returned +14.9% for the quarter while International Emerging Market stocks returned +18.1%. While they were unable to keep up with U.S. large cap stocks, they outpaced U.S. medium and small cap stocks for both the quarter and year-to-date time periods. In addition to the notable performance in the second quarter, Western Europe, Japan, and Asia were able to begin opening up their economies in a more meaningful way as they were able to bend, flatten, and ultimately show consistent decline in COVID-19 infections. The chart to the right shows the rolling 3-day average of COVID-19 cases in the United States (in red) and European Union (in blue). As you can see the initial trajectory of the lines mirrored one another; however, the U.S. cases plateaued out whereas the European Union cases continued to decline.



This chart is similar to ones we have seen in Japan and Asia compared to the U.S., and gives those countries and equities a nice tailwind to start the second half of the year. While International equities, Developed and Emerging, do not

[3] https://www.barrons.com/articles/global-stocks-fall-to-end-best-quarter-in-years-51593512666

have the degree of policy levers (fiscal or monetary) that the U.S. does, monetary and fiscal policy actions enacted by the ECB, Japanese Central Bank, and China remain supportive for risk-based assets. The degree of policy support, along with more attractive valuations and better growth prospects (in the case of Emerging Markets), gives the investment team conviction to remain allocated to both asset classes.

Fixed Income markets stabilized following the massive interventions into the credit markets by the US Federal Reserve in March and April[4], with investment-grade corporate and municipal bonds erasing all of their negative performance from the first quarter. With the Federal Reserve facilitating a more stabilized and functioning market, corporate credit issuance, both investment-grade and high yield/junk were at all-time highs.[5] Corporations, both U.S. and International, were looking to shore up their balance sheets amid uncertainty related to COVID-19 shutdowns, as well as what a recovery in a post COVID-19 world looks like. Bond issuance is currently trending at 2x the pace of 2019[6] with investors showing a large appetite with most issues coming in oversubscribed (more demand than supply). With global central banks serving as a backstop/buyer, most investment-grade fixed income had sterling returns for the first six months of the year. Proving their mettle (yet again) as the ballast of portfolios, core fixed income allocations (municipal and corporate/taxable) weathered the volatility to deliver for portfolios. The investment team continues to believe that core fixed income is an integral piece of client portfolios.

Like you, the SDMWA team is beyond happy to see markets recover so quickly, but the U.S. equity markets remain a paradox. Millions of our fellow Americans have filed for unemployment, with a surge in the unemployment rate eclipsing that which was observed during the Great Financial Crisis and broaching Great Depression era levels. Encouragingly, many of those Americans have rejoined the workforce in some manner; however, 18 million remain unemployed and receiving unemployment assistance from the government.[7] The fiscal (Congress) and monetary (Federal Reserve) responses have been so strong and overwhelming, that markets are, for now, willing to look past the extreme decline in economic activity caused by COVID-19 related shutdowns. The Atlanta Federal Reserve Bank is predicting a -35.5% (seasonally adjusted annual rate) decline in GDP for the quarter[8]. Despite that unprecedented decline in economic activity, investors and the stock market are betting on an economic and earnings recovery that is as dramatic to the upside as it has been to the downside.

That, in essence, is the paradox investors are having to navigate: the S&P 500 continues its upward march in the face of small businesses shutting their doors forever at an exceedingly faster rate, 18 million Americans continuing to need unemployment assistance, and a novel coronavirus that is showing no signs of going away. Understandably, the "market" is not the real economy, and as a forward looking instrument, it doesn't factor in human emotions. However, it seems reasonable to wonder how much longer it (the market) can remain disconnected to the economic destruction that is unfolding. In addition to navigating the disconnect between the real economy and the market, is the fact that a small group of mega cap tech stocks, commonly referred to as FAAMG[9], now account for 22.7%[10] of the overall market capitalization of the S&P 500, and a meaningful portion of the overall return. The lack of overall breadth (number of companies appreciating) and concentration in the market gives investors and market participants yet another variable to consider when evaluating future return prospects. This becomes more evident when you evaluate the Russell 2000, which reflects U.S. Small Cap companies, whose businesses most face the U.S. Consumer. Whereas the mega cap FAAMG stocks have

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[4] https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm
[5] https://www.pionline.com/interactive/corporate-bond-issuance-nears-64-trillion-pandemic-bonds-hit-87-billion
[6] https://www.etftrends.com/innovative-etfs-channel/investment-grade-bond-issuance-is-already-double-that-of-last-year/
[7] https://www.cnbc.com/2020/07/09/weekly-jobless-claims.html
[8] https://www.frbatlanta.org/cqer/research/gdpnow
[9] Facebook, Apple, Amazon, and Google.
[10] https://www.ishares.com/us/products/239726/ishares-core-sp-500-etf

positive double digit returns year to date (and due to their size of the overall market, have been dragging that index forward), small-sized companies that generate most of their business inside the U.S. have continued to struggle. The push/pull of these market dynamics have been a primary reason for the SDWMA team to "trust, but verify" these contradictory capital market sentiments. We have forged a middle path, not becoming overly bullish or bearish, instead electing to make portfolio construction changes (e.g. reorienting International Developed equity allocation) and eschewing more dramatic changes to client portfolios.

As investors, citizens, and humans, we find ourselves in somewhat uncharted territory. A one-in-one hundred year global pandemic, equity valuations touching all-time highs amid the largest recession since the Great Depression, and a global economy that at various points and has seen regional economies voluntarily shuttered. While we have certainly persevered through harder times (World I and World II come to mind), the combination of unique data points of 2020 present societal changing challenges. Corral a global pandemic at the expense a functioning economy; press forward with commerce and experience a dramatic loss of life and corresponding long-lasting emotional toll. The team at SDWMA continues to communicate on topical and timely subject matter throughout this economic downturn. We hope these efforts are being well received by you. Staying in touch, we hope, has helped to moderate the stress and heartburn from the volatility that we have been experiencing in capital markets. Our team is in place and ready to tackle the challenges of the second half of 2020 as we continue to help our clients reach their goals and objectives. Thank you again for all of the trust you place in us and we hope that you and your families are staying safe and healthy.

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