Inverness Counsel

2Q 2020 Commentary

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A quick economic recovery is underway from the recession caused by the COVID-19 pandemic

Equity markets experienced one of the biggest rallies in decades, recovering a good portion of the steep losses suffered in the prior quarter. The S&P 500 is now down only 8% from its February peak as investors expect a strong and quick (i.e., V-shaped) economic recovery from the current severe recession caused by the COVID-19 pandemic. With the Great Financial Crisis (GFC) of 2008 as a guide, the Federal Reserve and Congress acted rapidly with enormous stimulus programs equal to roughly 40% of gross domestic product (GDP), and this action has given investors optimism. Since this response was quicker and larger than the response to the GFC, the markets are expecting a sharper recovery (see Figure 1).

Figure 1

Comparing Two Crisis Periods

	Great Financial Crisis	COVID-19 Pandemic	Takeaways
GDP	**5 quarters** of negative U.S. GDP growth	**2 quarters** of projected negative U.S. GDP growth	Sharper drop with a quicker projected recovery
Peak Unemployment Rate	**10%** U.S. unemployment rate in October 2009	**14.7%** peak U.S. unemployment rate in Q2 2020	Sharper drop and sharper projected recovery
S&P 500 Cash	**$0.9 trillion** S&P 500 cash balance in 2008	**$2.0 trillion** S&P 500 cash balance in 2019	120% increase in S&P 500 cash from 2008 – 2019
Private Equity Dry Powder	**$1.1 trillion** private equity dry powder in 2008	**$2.5 trillion** private equity dry powder in 2019	130% increase in private equity dry powder from 2008 – 2019
Government Stimulus (Size)	**$700 billion** authorized to purchase troubled assets in the U.S. (later reduce to $475 billion)	**$2.4 trillion** U.S. stimulus package Similar in RoW	More than 3.0x amount of Government Stimulus in the U.S.
Government Stimulus (Timing)	**10 months** after initial proposal	**2 months** after the first COVID-19 case in the U.S. and before even one quarter decline in GDP was reported	Significantly faster pace of monetary and fiscal stimulus
Interest Rates	**2.0%** in April 2008 (cut from 5.25% in September 2007)	**0%** in March 2020	Lower interest rates in addition to quantitative easing program
Cause of Downturn	**Systemic** economic and financial system issues	**Temporary** employment and demand shock	Current downturn caused by an event unrelated to the economy

Figure 1 Source: Evercore Partners. All data as of 6/30/2020.

Is the Bear Market Over?

From February 19 to March 23, the S&P 500 saw the quickest meltdown in history with a loss of 33.9%. This drop started a bear market, which is defined as a decline of at least 20% and generally coincides with an economic recession. On average, it takes 24 months for markets to recuperate the initial 20% loss and end the bear market. S&P 500 has rebounded 39.3% since the March low, so perhaps this bear market ended after 23 trading days, given the unprecedented level of government support highlighted above.

Inside

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Many investors are left wondering whether this is a bear market rally and prices are likely to decline in the future, or whether this is the start of a new bull market—an environment where prices will continue to rise to new record highs. In general, a new bull market starting during a recession is not unusual, but if the bear market did end in April, it would be one of the fastest on record, comparable to the crash of October 1987.

About 40% of the recent market rebound can be attributed to the five largest stocks in the S&P 500, which constitute 20.6% of the overall index. All of these stocks, except Google, are now trading at record highs, while many economically sensitive companies are still well below their highs (see Figure 2). For the market to move substantially higher from here, we would expect to see broader participation from this second group.

Figure 2

The Big Getting Bigger—Can They Keep Leading the Way?

Stock	S&P 500 Weight	Return since February 19, 2020*
Leaders		
Microsoft	6.0%	9%
Apple	5.8%	13%
Amazon	4.5%	27%
Google	3.3%	(7)%
Facebook	2.2%	4%
Laggards		
Bank of America	0.7%	(31)%
ExxonMobil	0.7%	(25)%
Boeing	0.4%	(45)%
General Electric	0.2%	(46)%

Figure 2 Source: *Bloomberg*. All data as of 6/30/2020 — **S&P 500 all-time high*

A Bumpy Road to Recovery

Consumer spending accounts for 70% of the U.S. economy. As we noted last quarter, several factors will be important in determining whether the consumer can quickly return to the healthy confidence levels we saw pre-virus: the length of shutdowns, the timing and process for restarting the economy, and the level of support from the CARES Act for people and businesses.

When the U.S. shutdown started in March, many of us thought it would last only two to three weeks. Memorial Day weekend finally marked the point when all 50 states were at least partially reopened. Retail foot traffic was down 82.6% year over year in the middle of April, but it steadily improved between then and the last week of June. Many states are now pausing or rolling back their reopening plans as the spread of infections seems to be accelerating in many parts of the country. According to recent data from the retail consultancy ShopperTrak, traffic declines have accelerated in states such as Florida and Texas. We are not expecting a second national shutdown, but consumers may retrench on their own if the virus continues to spread. Nonetheless, the process of restarting the economy is off to a bumpy start and needs to be watched closely.

During the shutdown, we saw unemployment leap from a 50-year low to a 90-year high, with 45 million people initially filing for unemployment benefits. There is no doubt that the U.S. CARES Act, which includes the Paycheck Protection Program (PPP), was an important bridge during this time of economic stress, and many of the worst-case scenarios have not occurred as employers kept many on the payroll during the shutdown. As the economy reopened, we saw employers bring back 7.5 million jobs each month. Yet the economy still has nearly 15 million fewer jobs than before the pandemic, and many of these positions may not come back. Small and medium-sized businesses represent 82% of U.S. employment, and these businesses may find it difficult to produce profits at a reduced capacity and may therefore not need the same number of employees. Although the recent employment headlines were better than expected, some of the underlying numbers are a bit more troubling, with the number of permanent layoffs growing as temporary layoffs fall (see Figure 3). Airlines and related businesses all expect slow recoveries and will be hesitant to rehire workers. Retailers and restaurants will also be cautious. Most businesses have learned from this period of stress, and we may hear about more restructurings as companies adjust to virtual offices and other new processes. Unemployment could be a drag on growth longer than expected.

Figure 3

Permanent Layoffs Growing

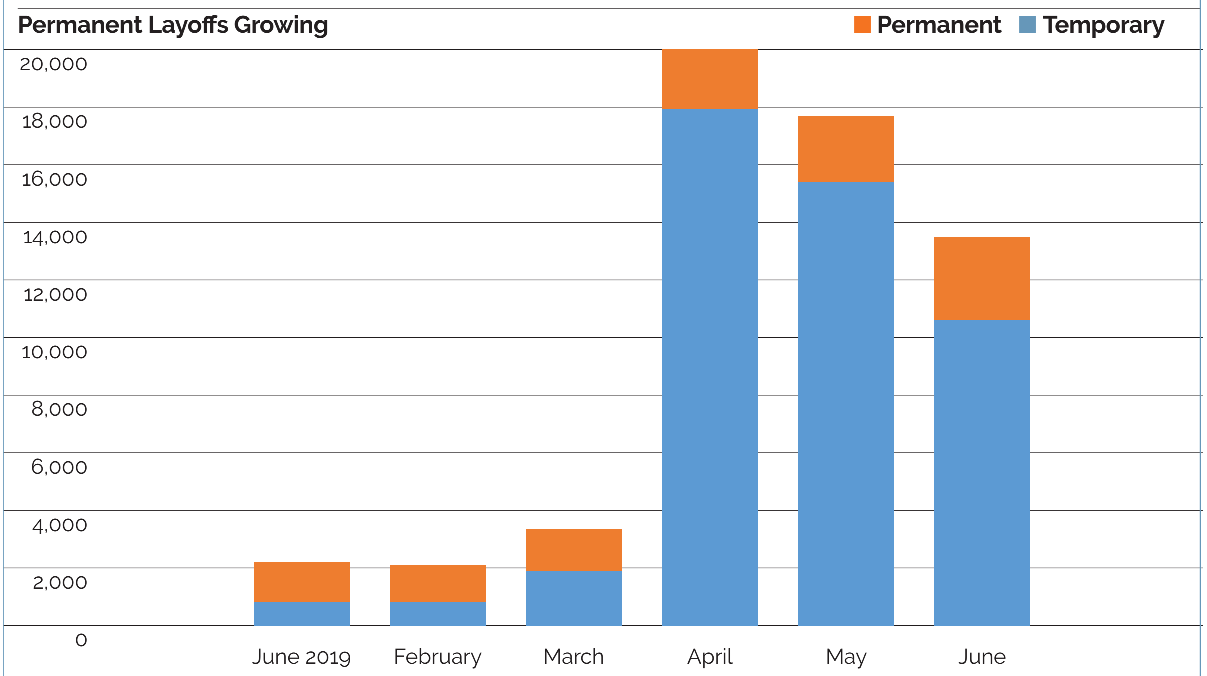

Figure 3 Source: *Bureau of Labor Statistics (BLS). Latest data as of 6/30/2020. Seasonally adjusted.*

Climbing the Wall of Worry

Although there are many things to be concerned about, stock markets tend to do pretty well as investors climb the wall of worry, and today's environment is similar to that of 2019 (concerns about a trade war with China, interest rate increases by the Federal Reserve, a looming recession). Given the severity of the current recession, a number of structural changes could provide tailwinds for the economy as it recovers:

- Don't fight the Fed. More than $6 trillion has been printed by the Federal Reserve to support lending and to purchase assets. This action has repaired the majority of the liquidity issues experienced in the markets during the decline in March.
- Interest rates are at record-low levels, and the Fed has signaled a willingness to keep rates close to zero for the foreseeable future. This approach should help both businesses and consumers as companies refinance and homebuyers enjoy record-low mortgage rates.
- Although higher unemployment may present a headwind to growth, it also provides a relief valve for inflation. For years we have closely watched rising wage inflation to see whether it translated

to higher overall inflation. With slack in the employment market now, this outcome is no longer a concern. In addition, oil prices are down 35% this year, which will help alleviate any inflation pressure and allow the Fed to keep rates lower longer.

- Individuals with household income below $40,000 were hit hardest by the pandemic, with almost 40% being laid off or furloughed. In contrast, only 13% of those with incomes exceeding $100,000 experienced layoffs or furloughs. Many households in this second group were able to save a substantial amount of money early on in the pandemic, since they were employed and had limited opportunities for discretionary spending (see Figure 4). This scenario has allowed the personal savings rate to reach its highest level in history.

Figure 4

Change in Consumer Spending during COVID-19 Crisis by Income Group

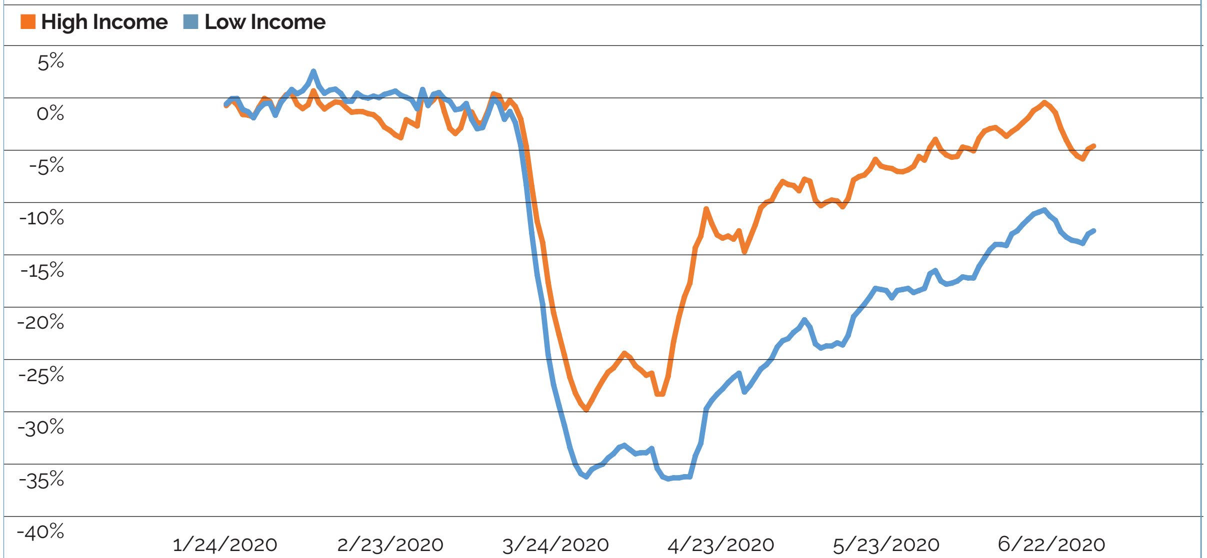

Figure 4 Source: *Opportunity Insights: Economic Tracker.* Latest data as of 6/30/2020

Course of Action

Figure 5 looks at the S&P 500 sector performance for the quarter. The blue bars indicate each sector's percentage drop from the peak in February to the trough in March. The orange bars indicate the total performance for the first half of 2020. The growth sectors (Technology, Communication Services, and Healthcare) have led the way in this recovery. We have meaningful exposure in these sectors, and that exposure has been helpful throughout the year. At the same time, we have not added in these areas, as we find valuations to be at the higher end of historical ranges.

We increased equity exposure during the quarter primarily in the economically sensitive Consumer Discretionary and Industrial sectors. Many of these stocks still have plenty of room to recover as the economy heals, although this may be a bumpy process, and we have sized positions accordingly.

We think the market is likely to remain volatile for a while. At its March low, the S&P was near the average decline for a recession, and many stocks were pricing in a dramatic slowdown. Some stocks are back near these lows again, while others are at record highs. We may see some rotations in the market as investors grapple with the trajectory of the economic recovery and fear of an ongoing increase in COVID-19 infections.

In addition, political risk may mount as we approach the U.S. election. The presumptive Democratic nominee, Joe Biden, has launched his "Build Back Better" plan. This agenda includes higher corporate tax rates, rising income tax rates for wages above $400,000, and increased capital gains tax rates, along with other ways to generate revenue, which may factor into stock market sentiment as election day approaches.

Figure 5

A Tale of Two Quarters—Performance during Correction and First Half of 2020

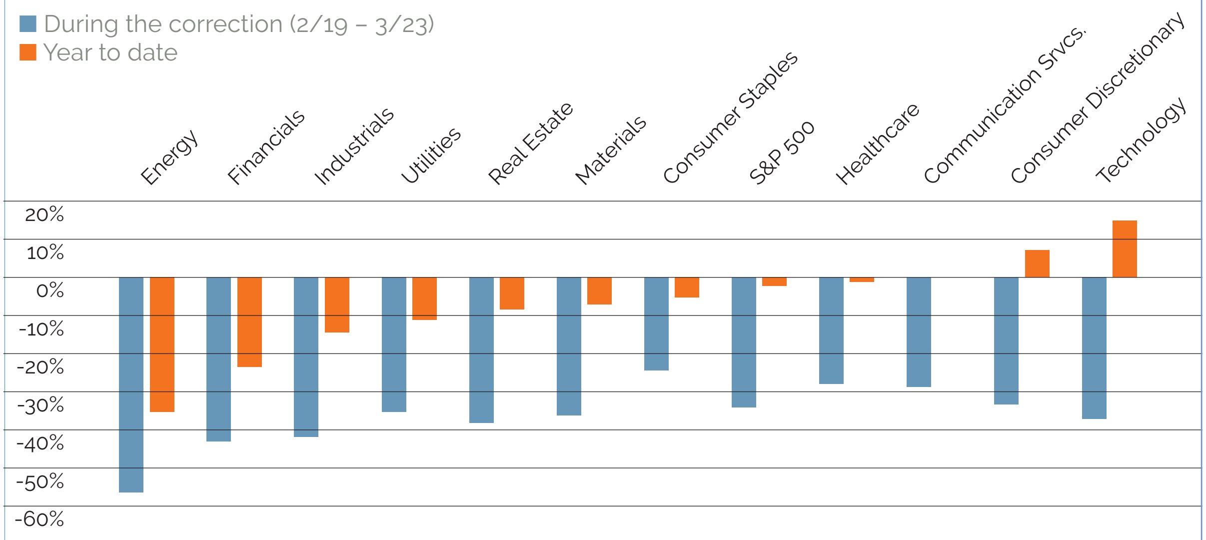

Figure 5 Source: *Bloomberg*. All data as of 6/30/2020.

Disclosure

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