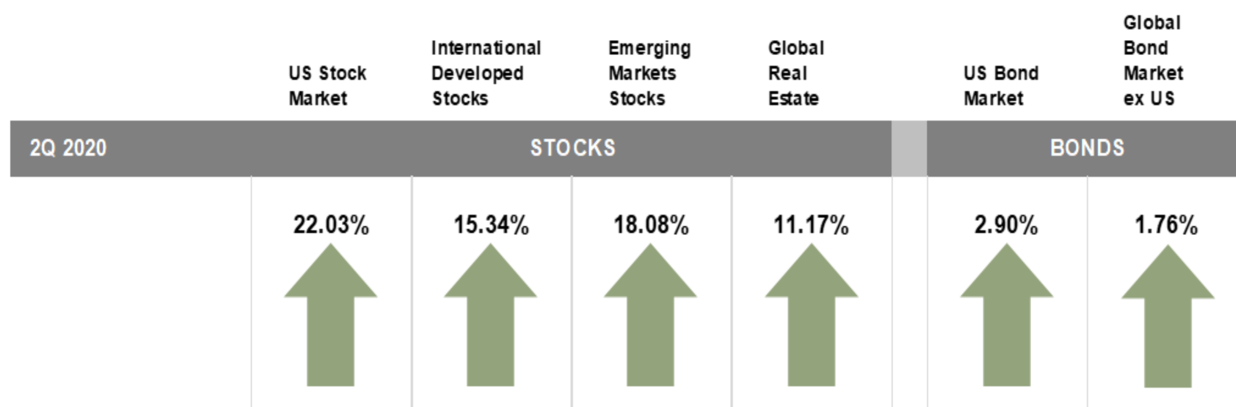
PRIVATE CAPITAL MANAGEMENT

Q2 2020 Commentary

July 2020

"Like it or not, we live in interesting times." –Robert Kennedy, 1966

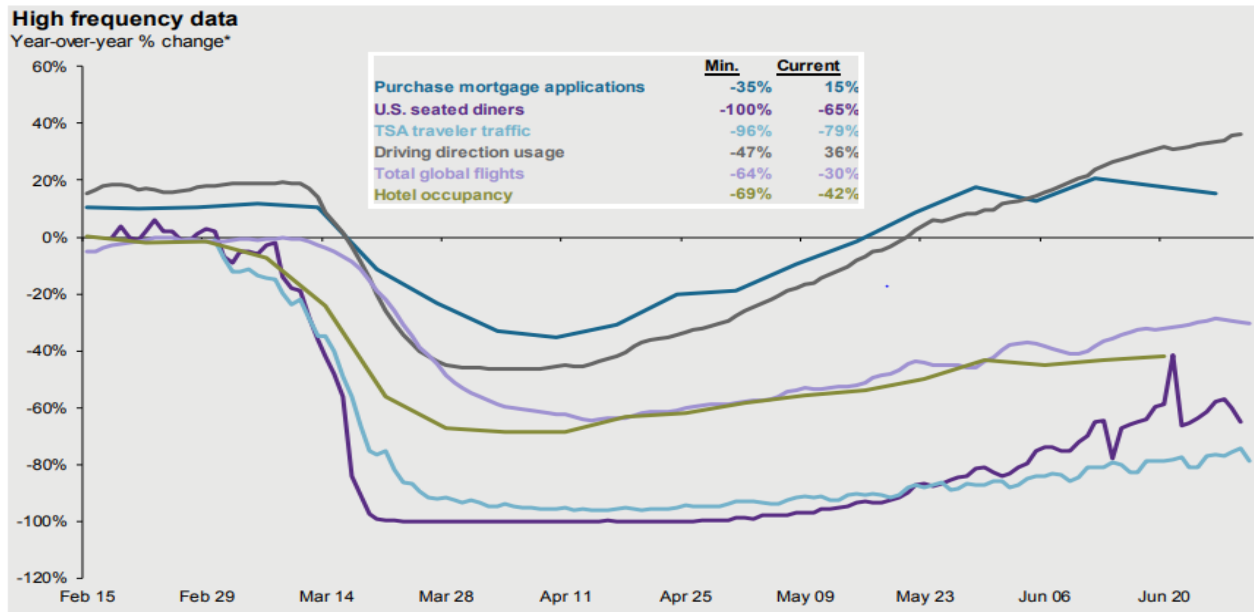
Market returns in the second quarter of 2020 rewarded investors who stayed the course. While most broad stock indices have yet to make new highs, the double-digit gains for many risked-based assets during the quarter significantly pared the losses experienced earlier this year. Within indices, there has been notable variation in returns, with growth and large cap stocks outperforming value and small cap stocks by a wide margin. Core fixed income indices continued to provide positive returns, as investors increasingly sought the perceived safety of bonds to escape the volatility of stocks.



Source; Dimensional Fund Advisers. US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

Second quarter price appreciation was primarily driven by the gradual reopening of the U.S. and global economies, improving trends in reported economic data, and continued support from the Federal Reserve. While the conditions of daily life have yet to return to the pre-pandemic normal, progress has been made. Stay-at-home orders have largely been lifted, many non-essential retail businesses have reopened, workers have slowly returned to offices, and manufacturers have started to see a pickup in new orders. In addition, historically low interest rates and seasonal demand have supported housing market activity.

The chart below helps to tell the early reopening story. It provides a visual summary of the extreme falloff and subsequent recovery to date in certain high frequency data points such as restaurant bookings, airport traffic, and hotel occupancy—all areas that were greatly impacted by efforts to contain the spread of COVID-19. While volumes in most of these activities are still significantly negative compared to year ago levels, the short term trend is moving in the right direction for now as economies slowly reopen and consumers venture out.

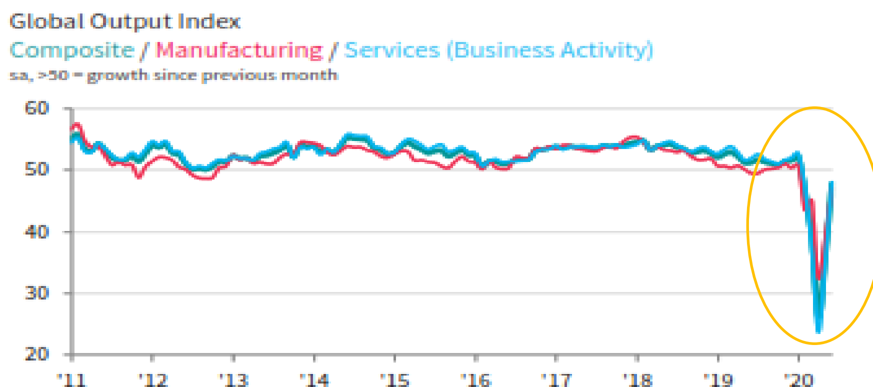


Source: JP Morgan *Guide to the Markets* June 30, 2020

This data bears close watch, however, as COVID-19 cases have recently experienced an uptick in states and countries that have more liberally eased social distancing requirements and other public health initiatives. The potential need to reintroduce lockdowns or other restrictive measures to fight the virus poses a risk to the current recovery momentum. A return to growth in the second half of 2020 remains dependent on the extent to which activity resumes and demand continues to strengthen.

Traditional economic reports have generally confirmed the positive short term activity trends noted above, further contributing to risk-on sentiment in the quarter. Weekly claims for unemployment insurance, monthly jobs reports, retail sales data, and Purchasing Managers Index (PMI) surveys continue to signal broad-based economic weakness, but have shown significant improvement in short term trends.

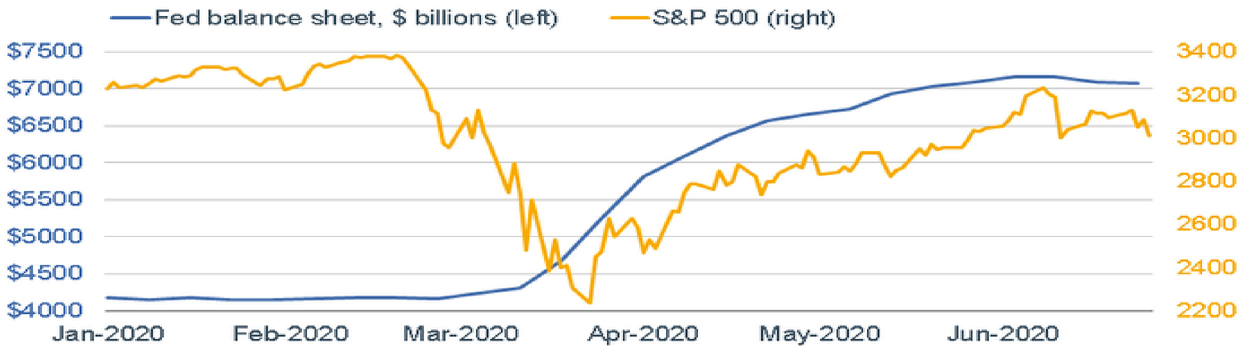
The chart below for Composite PMI data provides a good example. Global output for both manufacturing and services remained contractionary for the 5th consecutive month in June, but has been rebounding swiftly from the lows reported in April. Of the 14 countries included in the PMI calculation, three registered expansionin in June—China, Australia, and France. The remaining nations, including the U.S., all recorded sharp rebounds in the rates of contraction, in many cases representing the largest monthly change in the history of the series. The pace of both the decline and the recovery has resulted in a V-shaped pattern for the survey data since the start of the pandemic. PMI data presents a comprehensive snapshot for the global economy and is highly correlated with GDP growth.



Source: JP Morgan, IHS Markit; readings < 50 = contraction, readings > 50 =expansion

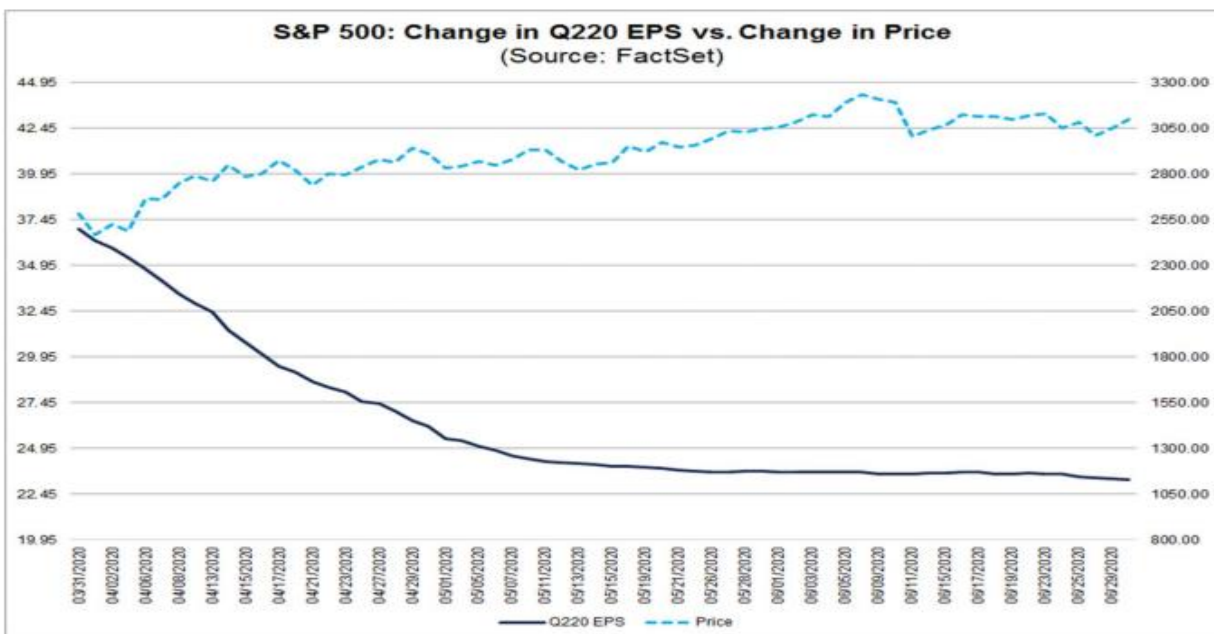
The Federal Reserve's historic backstopping of the economy has also calmed markets and increased investor confidence. The Fed's balance sheet expanded from $4.2T at the beginning of the year (19% of GDP), to $7.2T at the end of June (33% of GDP). Fed balance sheet activity has included $1.8T in treasury purchases, an additional $400B in mortgage backed securities, expanded repurchase agreement operations, and the introduction of multiple credit and liquidity facilities to support areas most impacted by the pandemic. The chart below shows the relationship between the Fed's balance sheet expansion and performance of the S&P 500 for 2020.

Federal Reserve Balance Sheet vs. S&P 500



Source: Bloomberg, Charles Schwab

The saying "Don't fight the Fed" has never been more applicable. Strong stock returns during Q2 have occurred despite continued negative revisons to earnings per share (EPS) estimates. The chart below shows the significant gap between changes in price and changes in EPS estimates for the S&P 500 during the second quarter of 2020. Over this period, the S&P 500 price increased by 20%. At the same time, analysts cut quarterly EPS estimates by a record -37%. The prior revision record was -34% in the 4th quarter of 2008. All eleven sectors recorded a decrease in earnings estimates for the period, led by Energy, Consumer Discretionary, and Industrials. Earnings are expected to bottom in Q2 and improve in the second half of the year. Earnings growth rates, however, are not expected to turn positive until the first quarter of 2021.



Source: Factset, July 2020

As of June 30, the S&P 500 was trading at 21.8x forward 12 month earnings estimates, a level significantly above the 25 year average of 16.4x. The steep decline in interest rates, extraordinary support from the Federal Reserve, and a market perhaps looking past COVID-19 may offer short term explanations for current valuation levels. Markets will most likely need greater support from earnings, however, to move meaniningfully higher from here. The relationship between price and earnings is something we continue to watch closely.

In June, the National Bureau of Economic Research (NBER) unsurprisingly declared that the U.S. economy had entered a recession. The NBER defines a recession as follows:

A recession is a significant decline in economic activity that is spread across the economy, and normally visible in production, employment, and other indicators. A recession begins when the economy reaches a peak of economic activity, and ends when the economy reaches its trough. Between trough and peak, the economy is in an expansion.

The NBER determined that February 2020 was the peak for the economic expansion that began in June of 2009. That 128 month period marked the longest expansion in the chronology of U.S. business cycles dating back to 1854. The previous record was 120 months and occurred during the 1991 to 2001 technology era. Given the unique circumstances related to COVID-19, the NBER acknowleged that the current recession could be uncommonly short in duration, a fact that will only be determined in hindsght.

The table below summarizes the latest economic projections from the Congressional Budget Office. Current estimates call for calendar year GDP growth to return in 2021, accompanied by a modest uptick in inflation and moderation in the unemployment rate.

CBO's Economic Projections for Calendar Years 2020 to 2030

Percent

					Annual Average	
	Actual, 2019	2020	2021	2022	2023–2024	2025–2030
		Change From Fourth Quarter to Fourth Quarter				
Gross Domestic Product						
Real[a]	2.3	-5.9	4.8	2.2	2.2	2.1
Nominal	4.0	-5.7	6.2	4.1	4.2	4.2
Inflation						
PCE price index	1.4	0.4	1.3	1.7	1.9	1.9
Core PCE price index[b]	1.6	0.6	1.3	1.7	1.8	1.9
Consumer price index[c]	2.0	0.4	1.6	2.0	2.2	2.2
Core consumer price index[b]	2.3	1.0	1.5	1.9	2.2	2.2
GDP price index	1.6	0.2	1.3	1.8	2.0	2.0
Employment Cost Index[d]	3.0	1.7	2.6	2.3	2.6	3.0
		Fourth-Quarter Level				
Unemployment Rate	3.5	10.5	7.6	6.9	5.9[e]	4.4[f]

Source: Congressional Budget Office, July 2020

The path out of the current economic downturn remains highly uncertain. Many factors will be in play between now and year end. Key drivers we will be watching include daily new virus case counts, clinical progress on a COVID-19 vaccine, continued improvement in employment and non-essential business activity, and a return to growth for GDP and corporate earnings. Not to be overlooked, the United States is less than 120 days away from a Presidential election. Given this backdrop and the current strength of the market, we are actively reviewing portfolios to ensure current positioning continues to strike an appropriate balance between risk and reward relative to each client's unique circumstance.

Sincerely,
The Private Capital Management Team

By the numbers…

Index	2020 YTD
S&P 500	-3.1%
Dow Jones Industrial Average	-8.4%
Russell 2000	-12.9%
MSCI EAFE	-11.3%
MSCI Emerging Markets	-9.8%
Barclay's US Aggregate Bond	+6.1%
Bloomberg Commodity	-19.4%

Source: Morningstar as of 06/30/2020

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Not FDIC Insured	No Bank Guarantee	May Lose Value
Not A Deposit	Not Insured By Any Federal Government Agency	