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Market update

While the rapid spread of the Coronavirus and precipitous drop in the market was shocking to most, the sharp recovery of stocks–despite the persistence of the virus and the economic damage it has caused–has also been confounding to many. Given the apparent disconnect between Main Street and Wall Street, investors are pondering whether the market has topped or whether an economic recovery and continued dominance of certain technology-driven firms will justify record high stock prices.

While we view the overall market as fully-valued to slightly expensive today, we still see opportunities in various pockets and believe that maintaining a disciplined investment approach is more important now than ever.

The stock market isn't the economy

With equity markets near all-time highs even after last week's sell-off, many of our clients are asking us:

- How can stocks be doing so well during a severe pandemic and recession?
- Have the securities markets decoupled from reality?
- Is this irrational exuberance?

Though showing some signs of improvement, the economy is still struggling. The unemployment rate of 8.4% at the end of August has more than doubled since the start of the year, but is much improved from the near 15% rate seen in May. U.S. GDP plunged 9% in the second quarter and economists expect GDP to decline 5% for the full year. Uncertainty remains around the ultimate impact from the ongoing pandemic for a large portion of the economy, including traditional retailers, commercial real estate, and the travel sector among other industries. However, even after this past week's sell-off, financial markets seemed indifferent to this bleak economic snapshot, with the S&P 500 Index near an all-time high and up 6.6% year-to-date through September 9 after rebounding 53% since bottoming on March 23.

The familiar refrain that markets are forward-looking remains true and investors are clearly pricing in expectations for improved growth and corporate profits in the near future. Even if a recovery doesn't materialize as expected, history provides several examples of similar disconnects between the economy and stock prices that can last for prolonged periods. For example, as Warren Buffett pointed out in a 1999 article for *Fortune Magazine,*[1] the Dow Jones Industrial Average remained flat for the 17-year period starting in 1965 through 1981, despite U.S. GDP growth of almost 370% during the same time. However, the same index rose almost 10 times from 1981 through 1998, despite GDP growing only 180%, or less than half the previous 17-year period.

Source: http://www.econ.yale.edu/~shiller/data.htm

While economic growth didn't correlate with equity market returns in those past periods, interest rates and corporate profits did play a significant role in how markets performed. We'll discuss our thoughts on interest rates below.

The "haves" and "have-nots"

The S&P 500 has shown admirable resilience since the virus-related bottom in March, but much of the index's returns have come from just a handful of companies. In fact, the top five companies in the S&P 500 now make up 23% of the index's total value compared to only 12% just three years ago. This concentration amongst the largest companies masks the struggles of smaller firms. The median stock in the S&P 500 is still down almost 3% as of September 9. Smaller companies and non-U.S. markets have similarly lagged, with the Russell 2000 Index down 7.7% year-to-date, and the MSCI EAFE Index down 5.5%.

Recent S&P 500 Index returns may not reflect the struggles experienced by smaller firms.

The top companies in the S&P 500 are all dominant firms with attractive growth opportunities, fortress balance sheets, and strong competitive positions. Conversely, many of the businesses most impacted by the pandemic include smaller or privately-held companies, many of which operate brick-and-mortar business models or lack the resources needed to pivot like many larger firms did. As the largest company in the S&P 500, Apple's approximately $2 trillion market capitalization is almost equal to the combined market capitalization of the entire Russell 2000. As these firms now make up a smaller portion of the publicly traded equity market, their struggles may not immediately appear in index returns.

Some would argue that valuations across growth companies are now stretched relative to other parts of the market. For example, the technology-dominated Russell 1000 Growth Index has seen its trailing 12-month price-to-earnings (PE) multiple expand to a lofty 39 times earnings compared to 26 times earnings just a year ago. At the same time, the energy and financials-heavy Russell 1000 Value Index saw its PE multiple expand from 16 to 21 times earnings, with the expansion due mostly to declining earnings rather than expanding stock prices. While the merits of either index's valuation can be debated, there is a clear sense of speculation in the market today that was not prevalent in recent years, including the emergence of seemingly inexperienced day-traders proclaiming that stock prices can only go up.

What about the Fed?

As Buffett further explained in his 1999 article, economic activity did not directly move equity markets, but interest rates did. The period between 1965 to 1981 was defined an inflationary environment that led to the 10-year Treasury rate steadily increasing from 4% in 1965 to peaking around 15% in 1981 before starting its almost 40-year downward trend to levels below 1% that we see today. The chart above shows the market multiple expanding since 1981 at the same time as rates began to decline. Buffett described the relationship between interest rates and asset prices:

"…the rates of return that investors need from any kind of investment are directly tied to the risk-free rate that they can earn from government securities. So if the government rate rises, the prices of all other investments must adjust downward, to a level that brings their expected rates of return into line. Conversely, if government interest rates fall, the move pushes the prices of all other investments upward. The basic proposition is this: What an investor should pay today for a dollar to be received tomorrow can only be determined by first looking at the risk-free interest rate."

In other words, much of the stellar equity returns investors have realized over the past 40 years were supported by interest rates consistently declining during that period. In an environment where "safe" Treasury bonds effectively offer zero return, investors have moved further out into the risk spectrum to achieve their desired returns.

The Federal Reserve recently implied a willingness to let inflation run above its 2% target, suggesting that rates could remain low for quite some time and continue to support elevated equity valuations. That stance was further supported by almost $6 trillion in monetary and fiscal stimulus injected into the economy almost immediately after the pandemic began, resulting in massive federal budget deficits not experienced since the end of World War II.[2]

That stimulus, along with the Fed's new approach, suggests that an inflationary period might be just around the corner. If this occurs and rates eventually rise in sympathy, it is reasonable to expect that equity returns may lag relative to the recent past.

So now what?

Given the market's run-up since April, along with the sell-off in recent days, investors may be considering reducing equity exposure and staying in cash or low-yielding bonds. An upcoming Presidential election will add to the uncertainty; even though most studies suggest that election outcomes do not actually impact either the economy or markets.[3] We would caution against attempts to time the market in response to this uncertainty, as we've recently seen how mis-timing the market can adversely impact long-term returns.

The long term direction of interest rates determine future equity returns. Focus on the long term.

While we expect continued volatility, these risks are balanced by the opportunities created by disruption from new innovative technologies and relatively attractive valuations for some companies that could benefit from inflation (commodities, lenders, and other levered entities). We believe that staying invested in a long-term approach focused on an appropriate asset allocation, diversification, and an ownership mentality will continue to serve investors well.

If you have any questions or would like to discuss these topics or anything else, please reach out to us at any time.

Sources:
1. https://archive.fortune.com/magazines/fortune/fortune_archive/1999/11/22/269071/index.htm
2. https://www.cnbc.com/2020/09/02/budget-deficit-to-hit-record-3point3-trillion-due-to-virus-recession.html
3. https://www.morningstar.com/articles/1000663/presidential-elections-dont-matter-for-investments

Data as of 9.9.2020.
Important Information:
The **S&P 500 Index** is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.
The **Dow Jones Industrial Average** is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.
The **Russell 2000 Index** is an index measuring the performance of approximately 2,000 smallest-cap American companies in the Russell 3000 Index, which is made up of 3,000 of the largest U.S. stocks.
The **MSCI EAFE Index** is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.
The **Russell 1000® Growth Index** measures the performance of the large cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to book ratios and higher forecasted growth values.
The **Russell 1000® Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.