Investment Commentary: 6/2020

With the reopening of many U.S. states and European countries and a slowdown in Covid-19 infection rates in May (the virus is showing signs of increasing in June), most stock markets and other riskier assets rose for the month. Additionally, ongoing central bank stimulus and government support programs remained positive influences on the financial markets.

"Ongoing central bank stimulus and government support programs remained positive influences on the financial markets. The S&P 500 recorded its best two-month performance since 2009."

- As economies throughout the world emerged from lockdowns, the U.S. and global stock indices rallied in May. The S&P 500 recorded its best two-month performance since 2009.
- U.S. manufacturing and factory activity modestly improved in May, climbing off record-low levels in April. These upward moves provide hope the U.S. economic downturn may have bottomed in Apri. European manufacturing data displayed similar trends.
- U.S. monthly retail sales sank in response to the pandemic, declining more than 16% in April to mark their sharpest drop ever recorded.
- Oil prices bounced back sharply in May, logging record monthly gains as production eased and drivers returned to the road.
- U.S. Treasury returns declined slightly amid risk-on investing, and the 10- year Treasury yield increased slightly for the month to 0.65%. Riskier high yield bonds bounced back and finished with a 4.4% return.

In this month's commentary, we touch on several topics: lessons from the Spanish Flu, GMO on Value Stocks, and a European Renassaince?

Lessons from the Spanish Flu

The Bank Credit Analyst (BCA) recently did an in-depth study of the 1918/1919 Spanish Flu and detailed some of the lessons that can be applied to today's COVID-19 pandemic. Here is a summary of BCA's study.

Clearly, today's economy is very different from that of 100 years ago. Remember that many countries were in the middle of WW I, which ended in November 1918. The characteristics of the Spanish Flu which struck the world in 1918 and 1919 were also different from this year's pandemic. COVID-19 is almost as contagious as the Spanish Flu but is much less deadly. The 1918 influenza pandemic was the most lethal in modern history. Healthcare systems and treatments today are far more advanced than those of a century ago: many people who caught Spanish Flu died of complications caused by bacterial pneumonia, given the absence of antibiotics. Influenza viruses tend to mutate rapidly: the virus in 1918 first mutated to become far more virulent in its second wave, and then to become much milder. Whereas coronaviruses tend to mutate less easily, according to immunologist and Nobel Laureate Professor Peter Doherty.

Regardless, an analysis of the pandemic of 100 years ago provides many insights into the current crisis, particularly now that policymakers are easing social-distancing rules to help the economy, even at the risk of more cases and deaths. According to BCA, here are the key lessons from 1918-1919 that can be applied to today's pandemic:

- Non-pharmaceutical interventions (NPIs) do lower mortality rates and should continue until a vaccine, effective therapeutic drugs, or mass testing is available. NPIs are actions apart from getting vaccinated and medicine that communities can take to slow the spread (social distancing, masks, etc.).
- Relaxing NPI measures prematurely is as damaging as a slow initial reaction to the pandemic.
- Reacting quickly and imposing multiple measures for longer periods not only reduces mortality rates but also improves economic outcomes post-crisis.
- The economy suffers in the short-term: supply (i.e. Lockdown) and demand (i.e. consumer spending) shocks lead to lower output. The demand shock however is larger leading to lower prices and disinflationary pressures, at least during and immediately after the pandemic.

GMO on Value Stocks

We have written on the "cheapness" of value stocks over the past year and wanted to provide a quick update. Rather than do an extensive write-up we thought we would share a chart provided by GMO in their most recent commentary. As the old saying goes, a picture is worth a thousand words, and the chart shows how discounted value stocks are in the U.S., EAFE, and emerging markets over time. Valuations are a blend of four different value measures for MSCI Value regional indices relative to their base regional index.

EXHIBIT 4: SPREAD OF VALUE FOR MSCI REGIONAL VALUE FACTORS

Source: MSCI, Worldscope, GMO | As of 4/30/2020

As of April 30th, value stocks in EAFE were trading at the largest discount they ever have in history. Emerging value stocks are trading at a slightly bigger discount than that, a level they breached only one month before in history. U.S. stocks are at a similar valuation discount as experienced in December 1999, from where value stocks went on to beat the broad market by 6%, 17%, and 26% over the next 1, 2, and 3 years. No one knows what will happen in the short-term, but over the next few years there is a very good chance value stocks will outperform growth, based primarily on better valuations. The one caveat is investors may need to be selective in how they gain exposure to value stocks and should avoid industries that will be secularly challenged from an earnings perspective. Examples of secularly challenged would be some of the travel and hospitality stocks, among others.

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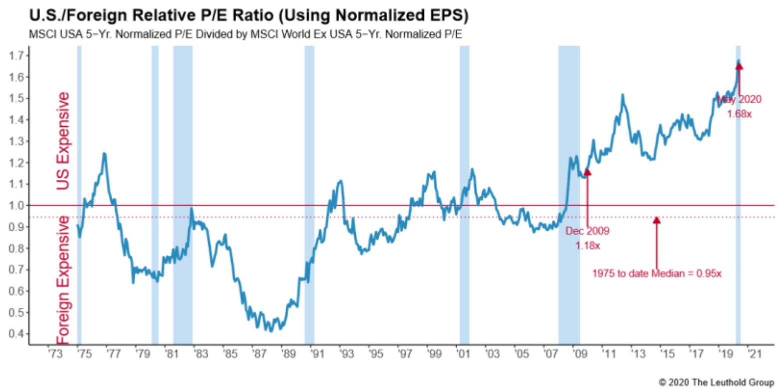
European Renaissance?



Since mid-May European stocks have outperformed U.S. stocks by a wide margin. Investor confidence in a stronger EU recovery has grown as a result of a controlled number of Covid-19 cases during the re-opening phase, the EU recovery fund, and large stimulus from Germany and ECB support. A case can also be made that European stocks may be more attractive as the risk of a U.S. corporate tax increase seems to be growing higher. We are also seeing the U.S. dollar start to drop and the Euro start to appreciate based on higher growth expectations and reduced sovereign risks. Combined with much lower valuations in foreign stocks compared to the U.S. (see the chart from Leuthold), we may be seeing a shift in relative performance that could continue for a while.

If you have any questions on this commentary or would like to discuss your investment strategy give us a call.

- AWM Investments (June 2020)