Investment Commentary: 5/2020

AWM

Market sentiment shifted dramatically in April. Global stocks and other risk assets rebounded from the steep sell-off in March to post robust monthly gains amid massive government spending and unprecedented central bank stimulus. Additionally, slowing COVID-19 infection rates and the easing of some pandemic-driven restricitions also helped restore market confidence.

"Global stocks and other risk assets rebounded from the steep sell-off in March to post robust monthly gains amid massive government spending and unprecedented central bank stimulus."

As shutdown and stay-at-home orders stifled economic activity, U.S. GDP declined at an annualized rate of -4.8% in the first quarter, compared with +2.1% in the prior quarter. This marked the first contraction in the U.S. economy since 2014. Eurozone GDP declined at an annualized rate of -3.3% in the first quarter. Despite the discouraging economic data, the S&P 500 delivered its best monthly return since 1987, up 12.8%. All major U.S. equity style categories increased significantly for the month, with small-cap stocks outperforming large-cap and growth outperforming value. Foreign developed market stocks had a strong month, up 6.5%, and broad emerging market stocks were up over 9%. U.S. Treasury yields declined slightly for the month, and most segments of the U.S. and global bond markets delivered gains. Corporate bonds led the way up over 5%, while high-yield bonds were up 4.5% and the broad bond market finished the month up 1.8%.

In this month's commentary, we touch on several topics: the stock market is not the economy, a "fat and flat" investment environment, and a review of long-term secular trends.

The Stock Market Is Not the Economy

It is counter-intuitive to many investors but stock market performance is only somewhat connected to general economic conditions. It's important to remember that **stock prices anticipate future developments** rather than dwell on current events, and neither employment statistics nor GDP growth directly affects stock prices. The **primary drivers of stock performance are based on expectations of 1) future earnings and 2) future interest rates**, with interest rates being used to discount earnings. Several studies have shown the correlation between national GDP growth and stock market performance can be flat or even negative. The reality is many factors affect stock market prices and investors shouldn't look at any one piece of evidence. This year has reinforced that message.

As evidenced by the first quarter's GDP coming in at -4.8% and second-quarter GDP expected to be down -30% or more, yet the stock market has rallied strongly since late March. Although the rally has not been evenly spread and we've seen a bifurcation of "have" and "have not" stocks, much of the losses for the year have been recouped. The drivers of the extraordinary recovery have been unprecedented stimulus provided by both the Federal Reserve and Congress. **Massive stimulus, low interest rates, and the expectation of higher future earnings have been the pillars of the current rally**. **For the rally to continue, the three pillars will need to stay standing.**

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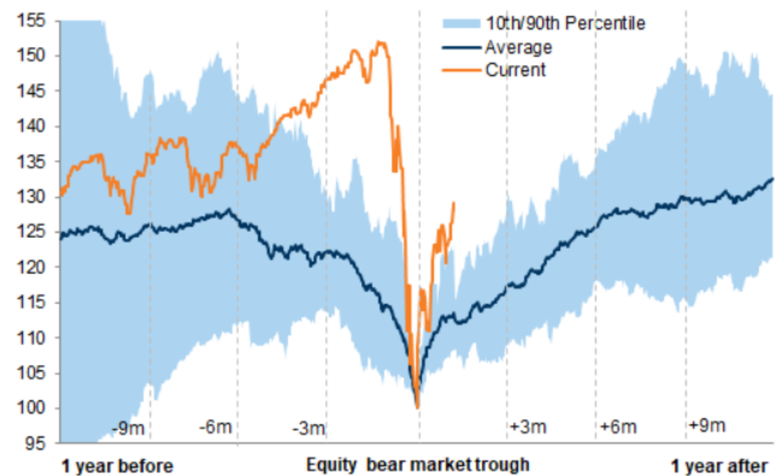
A Fat and Flat Market

Goldman Sach's coined the term 'Fat and Flat', which essentially means the stock market is likely to be range bound and volatility should remain high for the foreseeable future. The Fat and Flat view is based on several factors, including a slowdown in the number of Covid-19 cases, massive stimulus from central banks, and governments that reduced the probability of a worst-case scenario (sell-off). But is also based on the strong recovery of risk assets and stock valuations looking high considering the uncertainty over growth, policy, and inflation. The chart to the right shows how quickly stock prices (and valuations) have recovered compared to previous bear markets. As of May 1st, this has been the strongest rally out of an equity bear market in the last 50 years and assuming the recovery continues, it will also be the shortest bear market in history. **Going forward, we don't expect valuations to broadly increase and dividends may be the largest contributor to future returns, and ongoing uncertainty should keep volatility high. Hence the Fat and Flat environment.**

Exhibit 2 : The current recovery has been the sharpest among historical bear markets

MSCI World around bear markets since 1970



Source: Datastream, Goldman Sachs Global Investment Research.

Long-term Secular Trends

Market cycles, up and down, are usually driven by secular trends that have defining characteristics. GS research recently published a global strategy paper that lays out the defining trends for the last bull market and the current environment. We found the report useful in developing our forward-looking investment thoughts and thought we'd pass along their findings. **The last bull market, from the Great Financial Crisis to February of this year was characterized by four main trends:**

- Rising stock valuations, as stock price performance significantly outstripped earning performance
- The massive outperformance of 'growth' stocks relative to 'value' stocks
- The leadership of the technology sector
- The outperformance of the US stock market relative to the rest of the world

The next market cycle, whether it is a strong bull market or not, is less likely to be driven valuation expansion since interest rates are already at extremely low levels. **However, some key drivers are likely to impact the difference between relative leaders and laggards:**

1. High debt levels, and low economic growth
2. Low levels of interest rates and (and least in the short-term) inflation
3. An ongoing digital revolution

4. Greater diversification of supply chains (de-globalization)
5. Downward pressure on corporate profit margins
6. Greater industry consolidation- the strong will grow stronger
7. More emphasis on social issues and growing interest in ESG

The above factors are likely to shape the investment climate in the years ahead and can be used to sift through the likely winners and losers. **Here's how they will impact our investment approach:**

- We expect economic growth to remain low, and companies that can grow their top and bottom lines in this environment will do very well. We will emphasize quality growth companies trading at reasonable values in portfolios.
- With interest rates so low, investor income will be scarce. Companies that can both sustain and grow their dividends will do very well.
- With corporate debt levels at extremely high levels, companies with the strongest balance sheets will do very well and will be in a position to consolidate their industries.

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

- AWM Investments (May 2020)