CLARO MARKET INSIGHTS

09/01/2020

Happy Labor Day 2020! A day that is rightfully dedicated to the achievements of American workers and the contributions we have all made to the strength, prosperity and well-being of our country. In any normal year this would be something to celebrate. Not to mention it would also signal the end of summer vacation, a time to get the kids back to school, and a time for parents to get back to work. Yet this is not a normal year! Because of Covid-19, the economy is struggling, the employment situation is in dire straits and educators are uncertain whether it's safe to open schools. How did this happen? Trying to recap the extraordinary events so far in 2020 is not easy. How did a rare, novel virus from halfway around the world wreak havoc on the global population, cripple economies, displace workers and challenge governments? And in the future, how are we better able to deal with such situations on a health, economic, political and even social level? In the years to come there will be many attempts to answer these questions, but for now we can at least reflect on how the events have affected our investment portfolios, review the outcomes and set some expectations going forward.

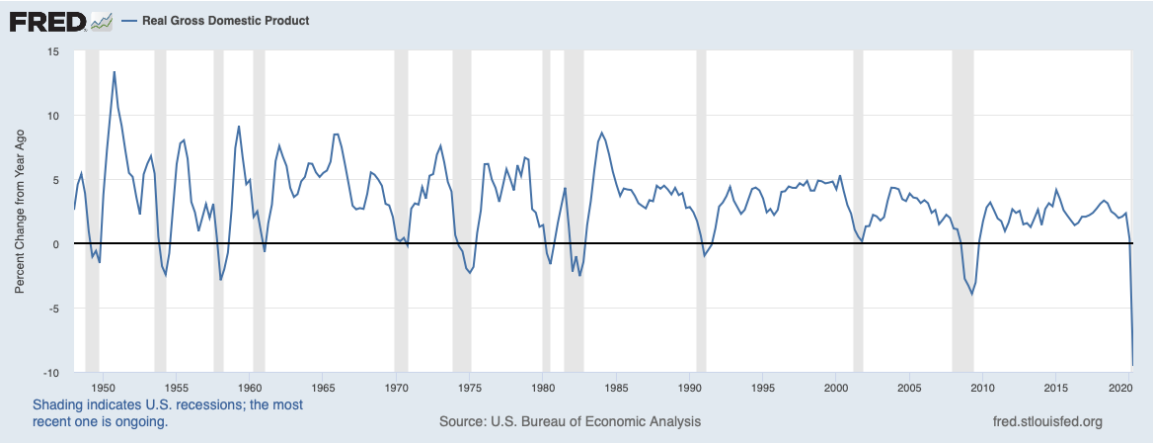
One peculiar outcome has been how fast financial markets have recovered, especially as the economy has faltered. At the height of the market panic in mid-March, equity indices were down -30% to -40%. Yet, despite still being in the midst of an economic recession, most have recouped those losses and then some, while a few are down only single digits. Over the past year, all major indices are actually positive.

Financial Market Data					
	August	**August**	**Q3**	**2020**	**1 Year**
U.S Stock Markets	**Closing Price**	**Monthly**	**Quarter**	**YTD**	**Return**
S&P 500 Index Price	$ 3,500.31	7.0%	12.9%	8.4%	19.6%
Dow Jones Industrials	$ 28,430.05	7.6%	10.1%	-0.4%	7.7%
NASDAQ Composite	$ 11,775.46	9.6%	17.1%	31.2%	47.9%
Russell 2000 Index	$ 1,561.88	5.6%	8.6%	-5.5%	4.5%
International Stock Markets	**Closing Price**				
MSCI EAFE Index	$ 1,909.99	4.9%	7.3%	-6.2%	3.7%
MSCI Emerging Markets Index	$ 1,101.50	2.1%	10.7%	-1.2%	11.9%
U.S. Fixed Income	**Closing Price**				
90 Day T-Bill	$ 203.25	0.01%	0.0%	0.5%	1.1%
Bloomberg Barclays U.S. Aggregate	$ 2,377.43	-0.8%	0.7%	6.8%	6.5%
Bloomberg Barclays Municipal	$ 1,313.64	-0.5%	1.2%	3.3%	3.2%
	Closing Price				
Gold	$ 1,966.38	-0.4%	10.2%	29.8%	28.7%
Oil (WTI Spot)	$ 43.03	6.9%	8.3%	-29.6%	-21.9%
Bitcoin	$ 11,610.17	-1.7%	25.7%	61.5%	18.9%

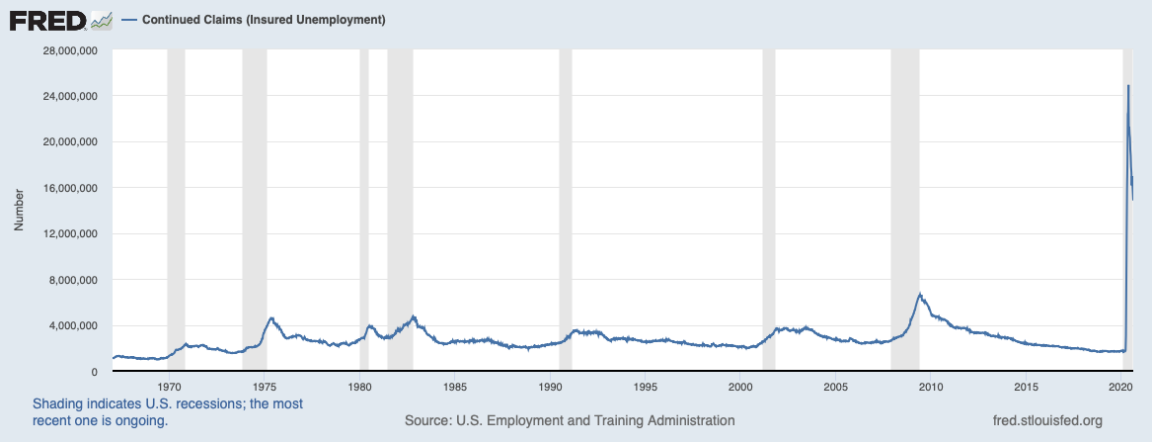
As much damage as the threat of the virus and shutting down economies did to markets in February and March, something has helped fuel them upward since. So much so, that the S&P 500 index (which was off -31% at one point) has moved steadfastly higher and now remarkably leans positive for the year (+8.4% through August). Even the "new-look" Dow Industrials, which went through a refresh in August by saying goodbye to long-time components ExxonMobil (XOM), Pfizer (PFE) and Raytheon (RTN), and welcoming Salesforce (CRM), Amgen (AMGN) and Honeywell (HON), has rallied to just about breakeven after being down -35% in March. One of the biggest differentiators between the major indices is the weighting to the technology sector. The market-cap weighted Nasdaq Composite skews 50% to technology stocks which helps explain its amazing +31% return so far in 2020. Even the more broadly diversified S&P 500 has 28% allocated to technology. While the price-weighted Dow after its refresh still trails with 24% weighting to technology companies.

Why are the markets up so much, while the economy has struggled?

Financial markets are typically great prognosticators and are constantly looking forward, not behind, so it's not too surprising that markets have moved higher despite the weak economy, it's just surprising how fast it has occurred. Especially when you consider that the most recent GDP report confirmed that the economy is in the middle of a deep recession falling a remarkable -9% both in the second quarter (-31.7% annualized as headlines like to report) and -9% for the past year. For some context, these by far represent the largest contractions in any one quarter or any one year since World War II. The largest previous were a measly -2.6% (-10% annualized) over a quarter during the Eisenhower Recession of 1958 and a twelve month loss of -3.9% during the Great Recession of 2008.



Not to mention that since mid-March, more than 58 million people have filed initial unemployment claims suggesting that more than 1/3rd of the 165 million person work force is under some sort of stress. Although the number of ongoing unemployment claims has improved from 25 million back in early May to just under 15 million recently, it is still a significant amount of people who remain out of work (the prior peak during the Great Recession of 2008 was just 6.5 million people). And if history is any barometer, it will be a slow process and take several years to get back to full employment.



So, it would seem that there is a real disconnect between the stock market and the economy. Why is this so? One reason is that publicly traded companies can actually be a narrow representation of the economy. In the past we've written about how shallow the market recovery has been as the "stay-at-home" economy (technology, communication, consumer and healthcare) stocks have benefited, while other sectors and industries that require more robust economic activity (financials, industrials, energy) have clearly lagged. Another reason is the concentration of the market to include just a handful of winners, while others have been left behind. At the end of August, the top 5 stocks in the S&P 500 (Apple, Microsoft, Amazon, Facebook, Google) were up a combined 48% so far this year, while the bottom 495 stocks collectively were down -2%. For the smaller constituents, it clearly shows that they have lagged, but it hasn't really mattered to the performance of the index. While for the bigger companies, with all their success, the more they've carried the results.

Still, if the threat of the virus hasn't gone away, if economies aren't yet operating efficiently, and people are concerned about their jobs, why are markets so optimistic? For one there is the enormous amount of government and monetary stimulus, which we will get into. But if there is a word that can describe the market's resilience it is "Hope" Hope that we can create a vaccine and administer it quickly, hope that our economies can function properly once again, hope that companies rehire everyone back, and hope that we can get back to some kind of normal again. Time will tell if this "Hope" is being misplaced, but for now it is helping to lead markets higher.

Another thing to consider is that the magnitude of the economic pullback can be attributed to the mandatory shutdown, so we should see some real improvement over the coming quarters as the economy reopens. But is it enough to justify markets being so optimistic? After all, the contraction will certainly have lingering effects and a quick bounce back is reliant on several assumptions that are far from certain: 1) A vaccine will need to be effective and manufactured on a grand scale, such that there is no longer a threat of additional viral scares; 2) Commercial activity will need to quickly return to pre-pandemic levels and jobs fully recovered; 3) Additional stimulus is able to fully bridge the gap in economic activity with no long-term ramifications from all the monetary and fiscal stimulus. All this seems like a steep challenge, but so far markets appear to believe it is not insurmountable. Let's hope that optimism can continue beyond Labor Day.

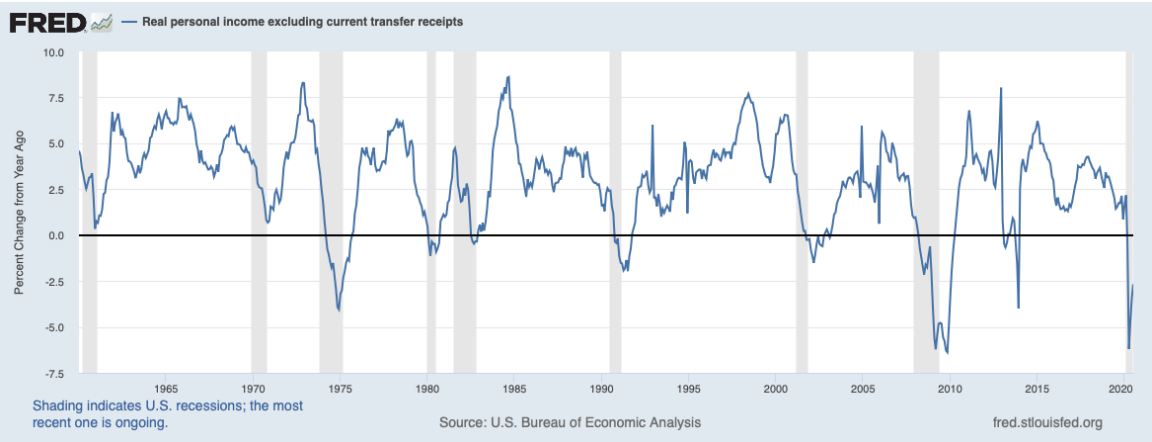
Hope for a Vaccine along with no Second Wave

There have been many advancements within the biopharma industry over the past several months both with creating vaccines and treatments. The CDC is even encouraged that a Covid-19 vaccine can be administered before year-end, even as soon as the end of October. Still, most in the scientific community and the World Health Organization (WHO) feel that we may not know the true effectiveness for some time and that Spring to mid-2021 is a more realistic time frame. A proven vaccine is needed for people have confidence that the ongoing threat is minimal before they will resume normal social and economic activities. Knowing this, it could be a while before economic growth can truly get back on track.

Corporate Activity and Jobs Recovery

With regards to businesses, many companies will not be able to survive despite the huge amount of government support that has been provided. There have already been waves of bankruptcies in retail, hospitality, travel & leisure, energy and the industrial sectors as companies have been unable to endure the economic standstill. Yet there will be a need for those businesses again as we emerge from the carnage caused by the pandemic. It might not be in the same shape and form as before, but as activity resumes, people will need the goods and services that those industries provide. The hope is that consumers are able and willing to spend as the employment situation improves and people get back to work. So far, the government has attempted to bridge the gap by providing an enormous amount of stimulus to help people replace the income they have lost. And Congress will further debate, decide and vote later this month how much more is needed. The hope is that additional fiscal and monetary stimulus will reignite the economic engine.

Some are even celebrating the 10% rise in personal incomes over the past year which is incredible considering the amount of people out of work. However, this has occurred not because people are actually earning more, but rather because of the amount of transfer receipts (benefits received by persons for which no service was performed) such as unemployment benefits and other government social welfare programs which rose from $3 trillion to more than $6.5 trillion in April 2020. Excluding these benefits, real personal income actually declined -2.7% over the past year. With the benefits, people in general have had more money to spend during the pandemic. This might help boost the economy as it gets moving again, but the caveat will be that as these benefits expire, incomes going forward will be dependent on people getting back to work, which is not guaranteed.



More Stimulus and Potential Repercussions

The Federal Reserve has expanded its tools by cutting rates to near zero (0-0.25% range), implementing several lending facilities, and committing themselves to asset purchases including the bonds of below investment grade companies. These measures have helped inject capital into the system, providing liquidity and access to credit, helping to keep the economy afloat. So far it appears to be a successful venture, but it also has some concerned about future inflation. Furthermore, the Fed recently announced a shift in its approach to inflation. While the Fed expects rates to remain low for the foreseeable future, the move permits the Fed to navigate towards an average inflation range which could allow for periods of higher inflation beyond its 2% target.

Political and Societal Anxiety

Another big elephant in the room that we have yet to discuss is the 2020 Election. The outcomes of the Presidential race and Senate races are likely to be highly contested and could pave a different future depending on the outcomes. We will address this more as we get closer to the election, but in the short-term, volatility should be expected amidst the election uncertainties.

Another topic that could affect markets are the ongoing social issues that we face as a country. There is a lot to overcome as the divide on certain social topics is wider than as it has been in decades. One issue that may need to be addressed soon is how to alleviate income inequality. The income disparity in this country has been getting worse over the past several decades, not better. One striking statistic (shown in the following chart) is that the bottom 90% of earners spend more than 101% of their incomes. They are becoming more and more indebted. Meanwhile, the top 10% of earners save more than 30% of their incomes, investing and further enhancing their wealth. One solution that could help is broader teaching at our schools at an early age about financial literacy. Teaching basic topics of budgeting, income, credit and banking can help future generations better manage their finances.

The Bottom Line

Going forward we envision three potential scenarios: 1) The "stay-at-home" economy lingers, and those winning sectors continue to drive market performance; 2) The economy successfully reopens, and the other sectors play "catch-up" pushing markets to new highs; 3) The economic malaise deepens, and markets sell off.

The most likely result will be a combination of these three. Even if a vaccine is administered before year-end, it will take well into next year before it is produced and delivered on a wide enough scale where people are comfortable again to do things like travel for business or vacation, attend large gatherings such as concerts and sporting events, even working from corporate offices or fully attending schools will be a ways off before everyone is finally at ease again. If there can be a combination scenario where "stay-at-home" economic growth can continue to be productive while economies slowly reopen so other industries can begin to catch-up, we believe that is a viable option. Along the way, we will likely experience some dips and false starts as the economy sputters forward, but it will go forward.

For portfolios, this means staying within the range of stocks that you are most comfortable with based on your risk tolerance and time horizon. If you are comfortable with volatility and have a long-term horizon, staying invested in stocks throughout can be worth the ride as long as you don't let negativity or even euphoria affect your investing discipline. If you are risk adverse, though, you may prefer to have a smaller amount dedicated to stocks to better manage your emotions during market scares like we saw in February and March. The same applies if you have a liquidity need in the near future. And, although bonds provide income and can serve as a buffer to swings in the stock market, they can be more interest-rate and inflation sensitive. With rates so low, they can lose value if inflation and rates move higher. Consider adding an amount that can help mitigate the effect of future inflation on portfolios. This could include stocks, inflation-protected or floating rate assets, and hard assets such as precious metals, commodities or real estate. It may also be prudent to have an amount of cash on hand for any liquidity needs and for new investment opportunities as they present themselves.

For the immediate future, we certainly need to factor in the depths of the recent recession and the effects on the labor market and consumers, which will likely take years to recover. However, we are optimistic the economy will eventually right itself and experience robust growth over the longer-term. This bodes well for stocks, including those in sectors that have struggled, to recover further and reach new highs. Perhaps next year we will be able to celebrate Labor Day and the American workers' contributions to a revived economy in a more worthy end-of-summer fashion with backyard BBQs, parents eager to get back to work, and kids bemoaning the start of another school year. Until then, like the market, we continue to have hope for a vaccine, hope for the economy and hope for better times.

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