ASHDON
Investment Management

Equity markets rebounded sharply during the second quarter of 2020. Sweeping Federal Reserve policies, along with stabilizing fiscal policy, worked to bring investors back to the stock market. The S&P 500 index rose 20.5% for the quarter, bringing stocks to a modest loss for the year. International stocks also recovered with the EAFE index up 14.9% for the quarter but still down –11.4% for the year. Bonds also responded well: the Barclays Aggregate Bond Index rose +2.90% and +6.1% for the quarter and year to date, respectively. Groups of stocks, particularly in the US markets, have diverged as the so-called "growth" indexes have strongly outperformed the counterpart "value" market segment. The Russell 1000 Growth index, dominated by major tech companies, has returned +27.8% for the quarter while the Russell 1000 Value index returned +14.3%. By the end of the quarter, there were signs of rotation out of the growth names into other market segments that are significantly cheaper, but the demand for growth, like the demand for yield, remains high.

Perspective on the earnings recession and coronavirus recovery

Given our personal experiences at the beginning of the second quarter, the stock market recovery was surprising. The market not only rose above the lows of March, but rapidly recovered back toward the pre-pandemic highs. We would not be surprised if investors listening to news of a rising market index one minute find themselves listening to news of dire economic data the next. The market index levels do not reflect the economic stresses that persist, and economic activity remains well below trend for several key series – particularly labor-related data series. It is important to remember that the market is not the economy and factors beyond economic data drive stock prices in the near term. For example, interest rates are an important parameter for setting the value of stocks and rates are tethered to record low levels now. This has been a clear driver of current stock prices, but with economic data so weak, how can stocks hold value so well?

To answer that question, we have spent significant time listening to earnings calls for several companies engaged in key parts of the economy to hear their perspective on the economic recovery, their stock price, and their earnings. Across the board company CEO's all expressed surprise at the speed with which economic activity had returned. The experiences they had in March, working long hours to assure ongoing operations and employee safety, shaped their expectations. More striking than their fear and uncertainty were their creative efforts to adapt to the uncertainty, and many companies noted that their earnings had rebounded faster than anticipated. In some cases, earnings rebounds were due to nimble management shifting product mix or changing customer interactions. Aggressive cost cutting, through reductions in employment - hours worked and layoffs - were also important to stabilizing earnings. Company management activities were impressive, but large, public companies represent a fraction of an economy. So called Small- and Medium-sized Businesses (SMBs) account for a significant portion of economic activity and the pandemic impact on SMBs has been worse and prospects remain poor in the near term.

Another note from conference calls: companies with international revenue sources have performed better than purely domestic companies. During the second quarter, US segment earnings were weaker than European and Asian counterparts, which gives us insight into a couple of points. First, there is a timeline for economic recovery from social distancing and Asia and Europe are ahead of the US. Second, virus spread suppression must be accomplished before a reliable economic recovery is available.

While the virus is the focus of much of our day-to-day personal lives, one way or another, we will get beyond the pandemic. All things equal, we believe the massive stimulus in place will stabilize market levels in the near term. Longer term, the excess liquidity from stimulus could ignite a substantial advance in stock prices, but the range of outcomes remains broad. So far new economy stocks (e.g. Amazon, Microsoft, etc.) have rallied strongly. Investors are willing to pay ever higher prices for growth they can believe in, especially with low rates. But there is likely growth in "real economy stocks" in the future as we come out of this crisis – and those companies are much cheaper to own now. Our portfolios are well diversified and are poised to participate in the ongoing recovery, offering sustainable earnings that we believe will be valued during periods of weakness.

Thank you for your trust and confidence,
Ashdon Investment Management

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