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A Strong Start to the Second Half of the Year

July 2020

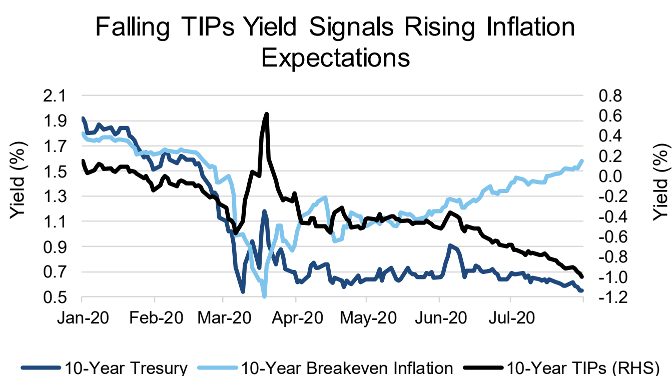
Investors Overlook Falling Earnings and GDP Contraction

Key Observations

- Long-dated treasury yields fell to all-time lows, yet risk assets rallied for the fourth straight month bringing year-to-date returns into positive territory for many segments of the equity market.
- GDP experienced its largest quarterly contraction since 1946 yet economic indicators released in July reflected a sharp rebound in third quarter economic activity.
- With fiscal policy stimulus expiring at month-end, the focus will be on policy makers agreeing on an extension of unemployment benefits.

Market Recap

The broad-based rally in risk assets continued for the fourth consecutive month, bringing many segments of the U.S. equity market back near all-time highs. Investors' attention focused on economic data that reflected a sharp improvement in activity and better-than-expected earnings data, overlooking rising COVID-19 infection rates in portions of the United States. Most Central Banks left monetary policy unchanged yet current policy measures remain highly accommodative as open-ended asset purchase programs remain in place, which have helped anchor long-term rates near all-time lows. Meanwhile, the European Union reached an agreement on an $857 billion stimulus package through collective debt issuance, resulting in grants to member countries hit hardest by the pandemic.



Source: Federal Reserve Bank of St. Louis

Returns were broadly positive across fixed income sub-asset classes. The Barclays Aggregate advanced 1.5 percent driven by the 10-year treasury yield falling to 0.55 percent – one basis point above the all-time low reached earlier in the month. Meanwhile, the 10-year TIPs yield hit a record low of negative 0.97 percent, signaling rising inflation expectations. Corporate credit spreads narrowed back near historical averages, leading to a 4.7 percent gain for U.S. high yield debt and bringing the year-to-date return for the asset-class back into positive territory. Unhedged international developed government bonds returned 3.1 percent, outperforming a comparable portfolio of U.S. dollar hedged bonds as the dollar hit its lowest level since May 2018.

Similar to fixed income, gains were broad-based across global equity markets. In the U.S., large-cap stocks advanced 5.6 percent, outpacing their small-cap peers. The recent gains of broad-based market indices mask the wide divergence in returns by investment style as growth stocks once again outperformed value, bringing the year-to-date return for large-cap growth stocks to 18.3 percent – a 31.2 percent higher return than their value

counterparts. A historically large percentage of companies beating earnings expectations drove equity market gains, despite estimates for a 45 percent contraction in earnings – the largest decline since 2008. Outside the U.S., developed international and emerging market equities returned 2.4 and 9 percent, respectively.

Within real assets, MLPs and U.S. REITs returned -3.6 and 4 percent, respectively. The most significant news was gold rallying to an all-time high intra-month. Gold returned roughly 30 percent year-to-date, reflecting the fall in the U.S. dollar and real yields and rising inflation expectations.

Economic Conditions

The preliminary estimate of second quarter GDP reported a 32.9 percent annualized decline[1]. To put that into perspective, since 1950, the next largest decline in GDP was the 10 percent GDP contraction in the first quarter of 1958[1]. The weakest sector of the economy in the second quarter was consumer spending on services, with recreation down a 93.5 percent annual rate and food services and hotels down an 81.2 percent annual rate[2].

But that's not all! Business fixed investment dropped at a 27 percent annual rate while home building fell at a 38.7 percent annual rate[2]. Outside the U.S., the Eurozone economy shrank 15 percent year-over-year[3], while China's economy grew by 3.2 percent year-over-year following a 6.8 percent contraction in the first quarter[4].

Recent data releases indicate a significant rebound in third quarter economic growth. The Citigroup Economic Surprise Index hit a record high intra-month[5], reflecting a historically large number of economic indicators beating expectations. Nonfarm payrolls was one report that significantly exceeded expectations, showing an addition of 4.8 million jobs, beating the consensus estimate by nearly 1.6 million[6]. Compared to April's trough in economic activity, retail sales have rebounded 25 percent[7] and are now 0.4 percent higher than a year ago[7], during a time where unemployment climbed from 3.7 percent to 11.1 percent[8].

While the Atlanta Fed expects a 20.3 percent increase in third quarter GDP[9], it is likely to be a long path back to the prior peak in economic activity. Per the International Monetary Fund, U.S. GDP will fall 8 percent and global GDP 5 percent in 2020[10]. Additionally, it will take time for the economy to recoup the number of jobs lost year-to-

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[1] Federal Reserve Bank of St. Louis, FRED Economic Data, Real Gross Domestic Product. Retrieved from https://fred.stlouisfed.org/series/GDPC1
[2] First Trust, First Trust Economic Blog, "The First Estimate for Q2 Real GDP Growth is -32.9% at an Annual Rate." Retrieved from https://www.ftportfolios.com/Blogs/EconBlog/2020/7/30/the-first-estimate-for-q2-real-gdp-growth-is--32.9percent-at-an-annual-rate
[3] Trading Economics, Euro Area GDP. Retrieved from https://tradingeconomics.com/euro-area/gdp
[4] Trading Economics, Euro Area GDP. Retrieved from https://tradingeconomics.com/china/gdp-growth-annual
[5] Yardeni Research Weekly Briefing, July 31, 2020.
[6] Federal Reserve Bank of St. Louis, FRED Economic Data, "All Employees, Total Nonfarm." Retrieved from https://fred.stlouisfed.org/series/PAYEMS#0
[7] Federal Reserve Bank of St. Louis, FRED Economic Data, "Advanced Retail and Food Service Sales." Retrieved from https://fred.stlouisfed.org/series/RRSFS
[8] Federal Reserve Bank of St. Louis, FRED Economic Data, "Unemployment Rate." Retrieved from https://fred.stlouisfed.org/series/UNRATE
[9] Federal Reserve Bank of Atlanta, GDP Now (August 5, 2020). Retrieved from https://www.frbatlanta.org/cqer/research/gdpnow
[10] International Monetary Fund, World Economic Outlook (June 2020), "A Crisis Like No Other, an Uncertain Recovery." Retrieved from https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020

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date, which is roughly equivalent to the jobs gained in the past decade. To this end, the Federal Reserve projects the unemployment rate will end the year at 9.3 percent[11] – well above the pre-crisis low of 3.5 percent.

Market Outlook

The four-month rally in risk assets contrasts with the historically deep contraction in economic activity and corporate profitability. Segments of equity and fixed income markets have recovered losses from the first quarter drawdown, despite rising bankruptcies and a historically large contraction in earnings. As a result, recent returns for many segments of equity markets have come from rising valuations, rather than improved fundamentals, and look rich based on valuation metrics incorporating future earnings estimates.

The sustainability of the recovery in growth-sensitive assets will rely heavily on the ability of policy makers to provide further fiscal stimulus. With the Federal Reserve continuing its asset purchase program and rates at historic lows, there is little room for further monetary policy stimulus.

Meanwhile, unemployment benefits under the CARES Act expired on July 31. With initial jobless claims rising in late July for the first time in four months, there are early indications of a slowdown in the economic recovery. The longer it takes for Congress to agree on a further fiscal stimulus, the greater the likelihood that the economic recovery will stall. Given the recent increase in valuations, equity markets appear to have priced in a recovery in earnings. To this end, future returns will be increasingly dependent on fiscal policy supporting the recovery in economic activity and subsequently, driving corporate profits to meet the expectations embedded in market valuations.

For more information, please contact the professionals your advisor at Hightower Texas.

Index Definitions:

Global Equity Style Total Return data: U.S. Large Cap Value: Russell 1000 Value Total Return, U.S. Large Cap Blend: Russell 1000 Total Return, U.S. Large Cap Growth: Russell 1000 Growth Total Return. U.S. Small Cap Value: Russell 2000 Value Total Return, U.S. Small Cap Blend: Russell 2000 Total Return, U.S. Small Cap Growth: Russell 2000 Growth Total Return. Developed ex U.S. Large Cap Value: MSCI World ex USA Large Value USD Net, Developed ex U.S. Large Cap Blend: MSCI World ex USA Large Cap USD Net, Developed ex U.S. Large Cap Growth: MSCI World ex USA Large Growth USD Net. Developed ex U.S. Small Cap Value: MSCI World ex USA Small Cap Value USD Net, Developed ex U.S. Small Cap Blend: MSCI Daily TR Net Small Cap World ex USA USD, Developed ex U.S. Small Cap Growth: MSCI World ex USA Small Growth USD Net. Emerging Markets Large Cap Value: MSCI Emerging Markets Large Value Net Total Return USD Index, Emerging Markets Blend: MSCI Emerging Markets Large CapNet Total Return USD Index, Emerging Markets Large Cap Growth: MSCI Emerging Markets Large Growth Net Total Return USD Index. Emerging Markets Small Cap Value: MSCI Emerging Markets Small Value Net Total Return USD Index, Emerging Markets Small Cap Blend: MSCI Emerging Markets Small Cap-Net Total Return USD Index, Emerging Markets Small Cap Growth: MSCI Emerging Markets Small Growth Net Total Return USD Index

[11] Federal Reserve, Economic Projections (June 10, 2020). Retrieved from https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20200610.pdf

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