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In a Nutshell

The market is not trading on fundamentals at present, rather the idea of hope. Although inspiring, once it runs out, you are left holding an empty bag if the fundamentals do not materialize. Broadly, we believe this theme is accurate, but on a sector or company basis, we find it can tell a different story. Low-interest rates, an influx of additional capital, and the entrance of new market participants have all supported the rapid advance in the market during the second quarter. As stock prices rise while earnings expectations fall, a bubble quietly emerges, but we believe any irrational exuberance on behalf of investors will remain at the company level for now. Interesting dynamics continue playing out across the market, although many are counterintuitive based on conventional wisdom. Namely, value companies have underperformed growth companies in a time when characteristics of the value investment style are typically sought-after. The presidential election is sure to be a source of volatility as the fall campaign season draws into full swing fueled by elevated emotions on both sides. The market may react in the short-term to catchy headlines or soundbites, and pundits, telling you which political party is better for the market. But, this should be set aside for those looking to build long term wealth. Over the 100 years from 1916 through 2016, the 26 election cycles produced an even split of presidents from each political party while the stock market has continued marching higher. Specific policy proposals can impact certain industries assuming they make it through the House and Senate unscathed, but often the bark is much bigger than the actual bite. The market is particularly fickle in the current environment, and unusual activity continues playing out daily. Until we can control the coronavirus spread, we believe the market will remain divided into a clear set of winners and losers. The former includes companies benefiting from people staying at home and heavily skewed toward technology, while the latter is a catch-all for everything we cannot do while stuck at home.

The Only Game in Town

The S&P 500 began the year at 3,231, and at that time, we had valuation concerns on our mind as the index was up 31.5% in 2019 on low single-digit earnings growth. In January, the expectation was for earnings to grow 9.4%, which gave us a forward 12-month P/E ratio of 18.2 (P/E ratio = price/expected earnings), above the 25-year average of 16.4. However, interest rates were low, and many investors could generally get behind the idea of paying a premium for the expected earnings growth given the low-interest-rate environment. This proposition was not too hard of a sell considering the alternative was to purchase a ten-year Treasury Bond not able to keep up with inflation. That brings us to today, the S&P 500 ended the second quarter at 3,100 with the expectation for earnings to decline -21.5% for the calendar year 2020, and a forward 12-month P/E ratio of 21.8. The world is entirely different today than it was in January, resulting in a much different investment landscape. We believe much of the quick rebound in the stock market is a result of actions by the Federal Reserve and notably the indication that the Fed Funds rate will remain at zero for the foreseeable future. This policy has significant ramifications as it leaves the stock market as the only game in town. Interest rates at zero means over time you will lose money by keeping it in a savings account through the loss of purchasing power as it cannot keep up with inflation. This dilemma entices people to put more money into the stock market in hopes of a return better than zero. With additional capital flowing into the stock market, prices rise as there is more demand for stocks. Although prices are rising, earnings estimates are still declining, which causes the P/E ratio to expand, meaning investors are willing to pay even more per dollar of expected earnings. Intuitively this makes sense that an investor would be willing to pay more per dollar of expected earnings, as the alternative is receiving nothing in a savings account and losing purchasing power over time.

Rolling the Dice

Another factor playing into the stock market's rise on the back of declining earnings is a new breed of market participants, they are traders and have turned the stock market into a game, akin to gambling. While generally not worth mentioning, this activity has grown significantly, as people are bored at home with no live sports and not much else to do, so the stock market has captured their attention. Social media has played a role in this activity as anyone can post their recommendations and advice for the world to see. A couple of examples include online forums and social media pushing penny stocks while others were suggesting the purchase of companies currently in bankruptcy. To some degree, this has become a proxy for sports betting, which saw $13 billion wagered legally in 2019 and estimates peg the illegal sports betting market at $150 billion[1]. Not only are people spending less due to the shutdowns, but the IRS has also sent 159 million economic impact payments as part of the CARES Act. These payments have totaled $267 billion so far, providing much-needed stimulus for many, along with burning a hole in the pocket of others[2].

Online brokerages saw a record number of new account openings in the first quarter of this year. Charles Schwab, TD Ameritrade, and Etrade had 1.6 million new accounts combined in the first three months of the year, up 107% compared to the first quarter of last year. Robinhood, the stock trading app favored by millennials, saw three million new accounts in the first quarter[3]. This activity should not come as a surprise as there are virtually no barriers to participate in the stock market anymore as no account minimums, zero commissions, and fractional share trading have become the norm.

Bubble Watch

The S&P 500, frequently referred to as "the market," and often regarded as the best gauge of the U.S. market economy, is quickly becoming the gauge of its top constituents. Looking back to 1980, the combined weight of the top five holdings in the S&P 500 has averaged 13%, today the top five holdings account for 22%. The largest companies continue growing at a faster rate creating a divide between the top companies in the index and the rest. The top 40 companies in the index have a market capitalization equal to the bottom 460. The flagship S&P 500 weights the 500 largest companies in the U.S. by market capitalization and year-to-date through the end of the second quarter returned -3.1%. An alternative version, the S&P 500 Equal Weight Index, assigns equal weights to the same companies included in the market-cap-weighted index and year-to-date through the end of the second quarter returned -10.8%. The top five companies in the index are mainly the cause of the gap in performance between the two indexes. Microsoft, Apple, Amazon, Alphabet (Google), and Facebook returned 29.8%, 24.9%, 49.3%, 5.9%, and 10.6%, respectively, this year through the end of June. The average performance

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[1] American Gaming Association. *97% of Expected $10 Billion Wagered on March Madness to be bet Illegally,* March 12, 2018.
[2] CNBC. *35 million stimulus checks haven't been sent out. Who is waiting for money?,* June 8, 2020.
[3] CNBC. *Young investors pile into stocks, seeing 'generational-buying moment' instead of risk,* May 12, 2020.

of those top five companies is 24.1%, while the bottom 495 companies averaged -11.3%. The limited breadth observed during the first half of the year is not indicative of a healthy market. We would prefer to see all sectors included, signaling a recovery across the economy, instead of one just concentrated in the largest technology companies.

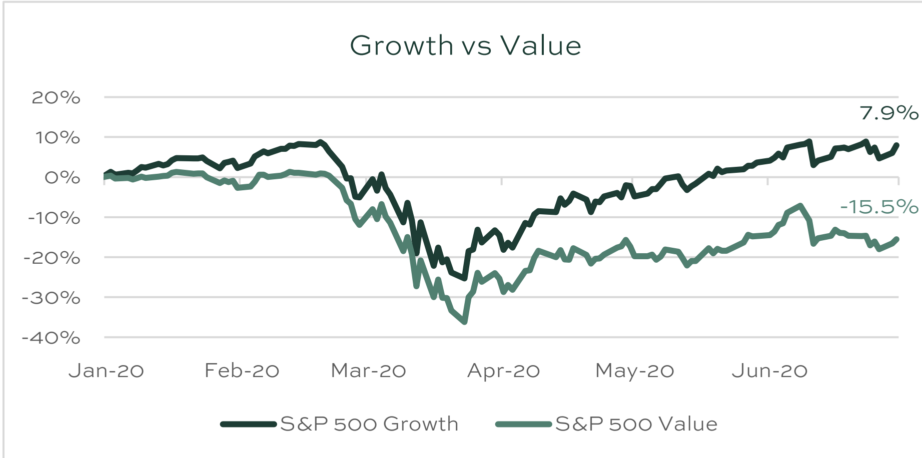
The looming question at this point is, are we in bubble territory, or rather are the largest technology companies in bubble territory, and is now the time to get out before the whole thing comes crashing down? Painting with a broad brush is always risky, and this time is not different. We do not believe the broader market is in a bubble, but we would characterize particular sub-sectors and companies as presently residing in no man's land. Zoom Video is a prime example. The company quickly captured the attention of traders in February as the magnitude of the pandemic became clear and stay-at-home orders were becoming commonplace. The stock is up 273% for the year through the end of June and is trading at 207 times next year's earnings, which assumes earnings grow 268% year-over-year. Any way you slice it, this does not make sense as they have nothing proprietary and numerous competitors such as Cisco's WebEx Meetings, Microsoft's Skype, Google Meet, and BlueJeans by Verizon, to name a few.

There is an important distinction as to why the returns of Microsoft, Apple, Amazon, Google, and Facebook may be justified. What the companies have in common are strong earnings, a high level of free cash flow generation, fortress balance sheets, and flexible business models. Outside of Amazon, trading at 154 times next year's earnings, the remaining stocks are trading between a 30 to 35 times multiple. Amazon has built a business model that lends well to the current environment explaining why people are willing to pay up for a piece of the action. The remaining companies have rich multiples, but in this market-environment, investors are willing to pay a premium for the attractive attributes these companies offer in a time of immense uncertainty.

Bad Value

The divide between growth and value continues expanding with no end in sight. Most troublesome is a year-to-date snapshot showing the S&P 500 Growth up 7.9% and the S&P 500 Value down -15.5% through the end of the second quarter. Adding insult to injury, value underperformed on the way down, tumbling -37% from its all-time high to the March 23 low, while growth fell -31.3% from its all-time high to the March 23 low.

Figure 1.



Value stocks typically trade at lower price multiples, have higher dividend yields, and tend to be more established companies with consistent sales and earnings but lower expected growth rates. With the high level of uncertainty in the market, and companies slashing guidance or refraining from issuing guidance, conventional wisdom says investors would prefer value stocks. Growth stocks trading at high valuations have further to fall should they not be able to hit their expected earnings growth. Investors would not be willing to pay a high earnings multiple if earnings are not growing as rapidly, causing the stock price to fall. Conversely, value stocks have less implied downside as they trade at lower multiples and typically have more stable and predictable earnings.

This year should have been the time for value to shine. Value underperformed growth over the preceding ten years, valuations began the year stretched, and the global pandemic brought a swift end to the longest-running bull market. This type of environment traditionally favors value as investors seek stability in an attempt to mitigate losses.

Simply put, this time was different. We are in an unprecedented situation with one group of industries fighting for survival while another group thrives. The government shut down parts of the economy, with the intent of saving lives, which caused a calculated recession. The home quickly became a universal hub for all activities including, work, school, dining, fitness, and entertainment. As a result, demand surged for toilet paper. More importantly, though, demand swelled for technology and digital entertainment to stay connected and productive while acclimating into this new reality. The sectors most in-demand are those providing technology resources and software services concentrated in the growth investment style. Most of the products and services we do not need while stuck at home are furnished by companies often classified in the value investment style, such as amusement parks, cars, department stores, gas, hotels, movie theaters, planes, and shopping centers.

Figure 2.

Value	
Name	**YTD Return**
The Walt Disney Co	-22.9%
Ford Motor Co	-33.5%
Macy's Inc	-57.5%
Exxon Mobil Corp	-35.0%
Marriott International Inc	-43.2%
AMC Entertainment Holdings Inc	-40.4%
American Airlines Group Inc	-54.3%
Simon Property Group Inc	-53.4%

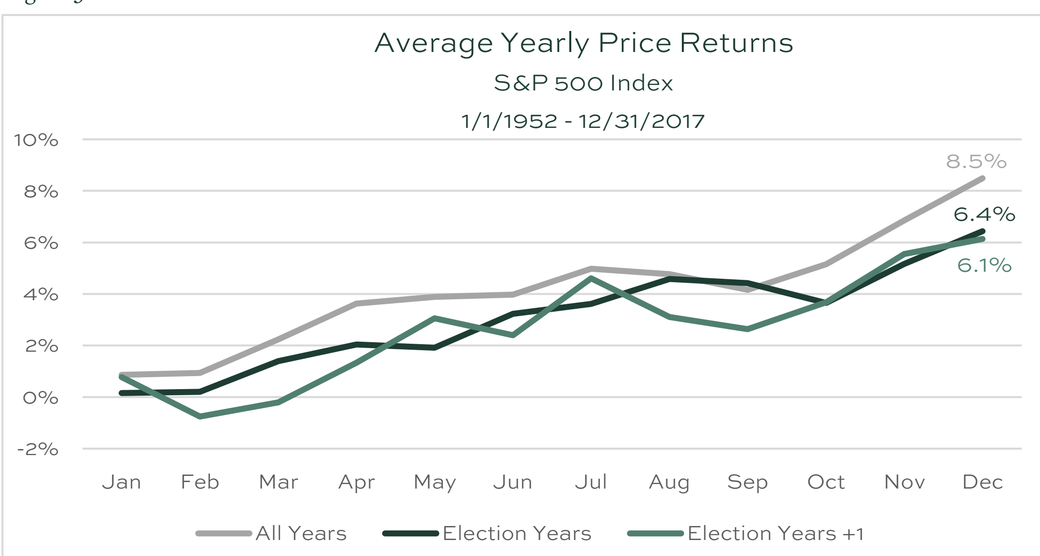
Growth	
Name	**YTD Return**
Microsoft Corp	29.8%
Apple Inc	24.9%
Amazon.com Inc	49.3%
Alphabet Inc	5.9%
Facebook Inc	10.6%
Netflix Inc	40.6%
NVIDIA Corp	61.6%
PayPal Holdings Inc	61.1%

Until a vaccine for COVID-19 is available, demand will likely remain suppressed for those value industries represented above. The shutdowns and restrictions will end, eventually, and we believe the value investment style is poised to outperform once we have a clearer picture of that timeline. Until then, it is hard to make a case against the technology-dominated growth style even with above-average valuations. A rational investor would prefer paying an inflated multiple for a company whose products are in demand, as opposed to a cheap multiple for a company with products facing uncertain future demand.

Buckle Up

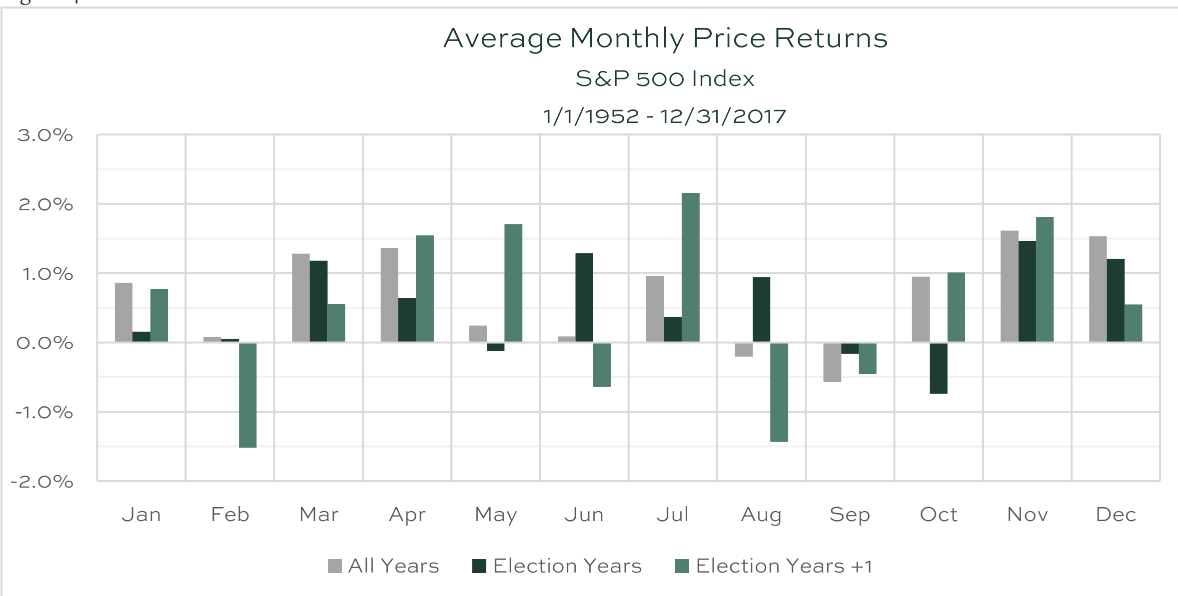
First, we will begin with what we know: from 1952 through 2017, the average yearly price return, excluding the impact of dividends, on the S&P 500 is 8.5%. During the 17 presidential election years over that period, the average yearly price return is 6.4%, and in the year following the 17 presidential election years, the average is 6.1%.

Figure 3.



In figure 4 below, we are looking at the average return for each month during the three periods previously mentioned. Here is what we learned. The month preceding the presidential election is generally negative, while the all-year average for October is positive. Following the election, and just after the presidential inauguration, that February is the worst performing month on average, followed by a strong showing through July, bucking the trend of flat performance during the summer months. In short, the average returns for an election year and the year following the election take different paths but typically arrive at the same point by the end of the year. Again, this is why time-in the market rather than attempting to time the market is the prudent choice for building wealth.

Figure 4.



The events surrounding the presidential election are likely to serve as a source for choppy trading sessions while the market sorts through its feelings on the candidates. With elevated emotions on both sides, the conversation is sure to become heated once the fall campaign season commences. The stakes are high this year, both the White House and Senate are up for grabs, with Democrats likely to keep their majority in the House.

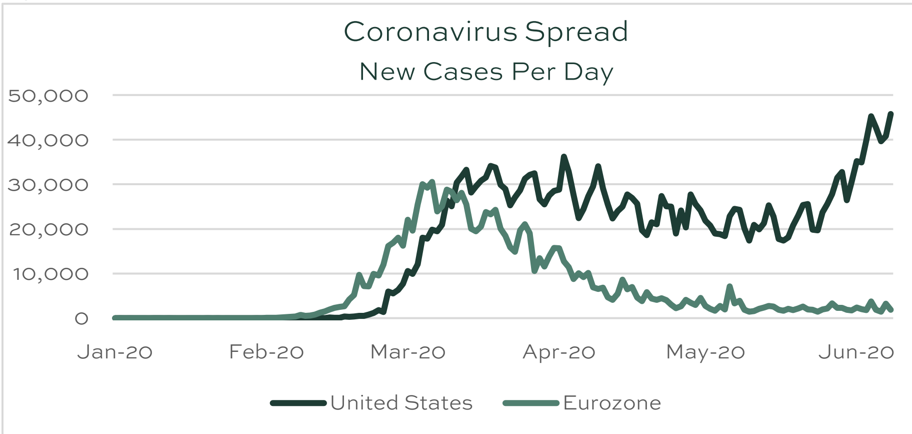
The Real Clear Politics Poll Average on June 30 gave Biden a 9.4% lead, up marginally from 5.7% to start the year. The Real Clear Politics Betting Average tells a somewhat different story. From April through May, the odds for Trump winning hovered around a 50% chance while Biden's oscillated between a 40% to 45% chance, with the remaining odds scattered across various hopefuls not actually in the race. Beginning in June, the dynamic shifted favoring Biden with a 59% chance to win at the end of the second quarter, 23% ahead of the odds assigned to a Trump win.

In the House, Democrats have 214-seats considered safe or in districts that typically lean Democrat. A majority requires 218-seats, so Democrats only need four out of the 31-seats considered a toss-up to maintain their control in the House. In the Senate, Republicans have 47-seats considered safe, not up for reelection this cycle, or in states which typically lean Republican. Democrats have 46-seats considered safe, not up for reelection this cycle, or in States which generally lean Democrat. 51-seats are necessary for a majority, so Republicans need four out of the seven-seats considered a toss-up to maintain their control. Otherwise, Democrats need five-seats to gain a majority in the Senate.

Emerging on Top

Markets outside the United States are on pace for a quicker recovery from the effects of COVID-19. The Eurozone peak in new cases came at the end of March, and growth in new cases per day continued declining before leveling out through June. The United States hit its first peak at the end of April and proliferation in new cases moderated during May before spiking in June, and we continue to see record numbers of new cases each day.

Figure 5.



With many countries outside the United States experiencing slower growth in new cases or leveling off, we believe this dynamic favors international markets as they are cheap relative to the United States and now poised for a quicker recovery. Emerging markets continue to top our best ideas list, and with positive results at the country level in terms of limiting the spread of the virus, we believe this makes the asset class even more attractive.

All Aboard

The market is fragile in its current state, not taking much to move the needle in either direction. The market grabs on to simple headlines and runs in whatever direction the wind is blowing at that particular time, without taking into context the bigger picture. More of a nuisance than anything, this primarily serves as entertainment for those looking to make a quick buck trading stocks. The environment we are in is unsettling, as, on the surface, the market is trading too high since the expectation is for earnings to finish the year considerably lower. But, as previously discussed, the top companies in the S&P 500 have desirable attributes for the current economic state and account for an outsized portion of the index performance.

Below the surface, we can make a greater sense of this juxtaposition. Stocks in industries that benefit from people staying at home may well continue hitting all-time highs until the coronavirus outbreak is under control. Select companies within that group are best-in-class and have valuations that can be justified. High unemployment and increases in bankruptcies are, for the most part, concentrated in industries shut down. Stocks in those industries have been hammered and will get whacked again with even the slightest sign of weakness.

It may not come as a shock the most valuable companies by market cap are ones with business models able to thrive in various economic environments. Those are the companies driving the action in the S&P 500. It is a much less rosy picture for the bottom 90% of companies in the index, but once we emerge from the pandemic, many of the current underdogs able to weather the storm will become the new winners. Meanwhile, we expect to continue riding the technology train, granted, there will be stops along the way for profit-taking, considering that is the only locomotive currently with an engine and a destination.

Figure 2. Performance is year-to-date as of 6/30/2020, including the impact of reinvested dividends. **Figure 3.** Yearly return calculated as the geometric mean of the monthly returns, excluding the impact of reinvested dividends. **Figure 4.** Monthly returns exclude the impact of reinvested dividends.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **S&P 500 Equal Weight Index:** Is the equal-weight version of the S&P 500. Includes the same constituents as the capitalization weighted S&P 500, but each company is allocated a fixed weight at each quarterly rebalance. **S&P 500 Growth:** Constituents are drawn from the S&P 500 using three factors: sales growth, the ratio of earnings change to price, and momentum. **S&P 500 Value:** Constituents are drawn from the S&P 500 using three factors: the ratios of book value, earnings, and sales to price.

Sources: American Gaming Association, CNBC, FactSet, J.P. Morgan Asset Management, Legal Sports Betting, Real Clear Politics, S&P Dow Jones Indices, YCharts.