FUNDAMENTUM
INVESTMENT MANAGEMENT

Weekly Snapshot 7/13/20

Market Review: Week Ending 7/10

US stocks continue to look through worsening Covid-19 news as new cases have tripled to over 60k/day from month-ago figures[1]. The S&P 500 gained 1.8%, closing at 3185 while yields on 10-year US Treasury Bonds fell to as low as 0.57%, a two-month low, before ending the week at 0.63%[1] as it appears that stimulus dollars are primarily boosting financial markets and not the real economy. Led again by the mega-cap Technology stocks, the NASDAQ rose over 4% as Netflix surged 14.3%, Amazon gained 10.7% and NVIDIA 9.0%[1]. The NASDAQ Index is now up over 18% in 2020[1], as investor attention remains on a handful of mega-cap stocks that stand to widen their competitive moat during the Covid-19 crisis. Volatility in stocks remains high, with the VIX measure hovering above 30[1] most of the week, as markets continue to anticipate the economic impact of the surge of virus cases as most states have now rolled back plans for reopening to some degree. The upcoming Q2 earnings seasons could lead to additional volatility, as S&P 500 companies are expected to report a 44% decline in Y/Y earnings, the largest annual decrease since the financial crisis[1]. Investors will also be focused on the potential for an "income cliff" should the funding for the Covid-related federal unemployment benefits ($600 weekly) be allowed to expire on July 31st. Through the close Friday, year to date results for the major indices are as follows: S&P 500 -0.4%, Russell 2000 -14.1%, MSCI EAFE –9.7% and Bloomberg Barclays Aggregate Bond 6.7%[2].

What We Are Watching in the Week Ahead:

- ***Earnings Reports*** - Q2 earnings season begins in earnest this week, led by the major Banks and Financials, but also includes blue-chips such as PepsiCo, J&J, Netflix, UnitedHealth Group and Abbott Laboratories[1]. Q2 results are expected to be dismal and matter less to investors than the outlook for the back half of the year and for 2021, as at some point, earnings recovery will have to be expected for equities to remain close to previous highs. The outlook for dividends will also be watched. While dividends are not expected to fall as dramatically as during the financial crisis when dividends fell 21% y/y[1], dividends are expected to be cut by the companies most impacted by the shutdown.
- ***Economic Reports*** - The impact of the recent rollbacks in reopening plans will be watched in economic reports this week, which include the NFIB Small Business Optimism Index, Housing Starts for June, University of Michigan's Consumer Sentiment Index as well as June's CPI Index[1]. Economic reports following the initial phase of the economic reopening were largely better-than expected, leading to optimism over the potential for a V-shaped recovery. That optimism has recently disappeared following rollbacks to reopening plans.
- ***Valuation*** - Stocks typically sell at a discount to normal valuation levels during uncertain times. This year we believe the uncertainty of where earnings will bottom during a once-in a-lifetime pandemic has contributed to the performance of stocks. Rather than debate whether stocks are already discounting the improvements expected from an economy that is re-opening, without company guidance or precedent for a pandemic, valuation has effectively been eliminated from consideration. We do know that 2019 S&P 500 EPS were $165. What we do not know is what level the economy (and earnings) will recover to - 80% of the previous level? 90%? 100%? And when? It will take many months to answer the question about the level of earnings likely in 2021 (the Congressional Budget Office revised its 10-year economic forecast, projecting that the U.S. economy would require the entire decade to make up for output lost in the pandemic). Until then, investors have largely eliminated high multiples as a reason for stocks to pause. We have been skeptical that stocks could go rally beyond 3000 on the S&P 500 as we've been assuming $150 for "normalized EPS," and willing to assign a 20x PE multiple during this time of extraordinarily low interest rates. Without considering the question of valuation, stocks have rallied beyond that level without much pause.

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References: 1. FactSet 7/12/20, 2. Morningstar Direct 7/12/20