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Midyear Outlook – June 24, 2020
Equity/Joe Williams

Chris Schildz:

This is Conversations with Commerce Trust Company, and we have Joe Williams on this segment. Joe is our Commerce Trust Company Director of Investment Strategy.

The coronavirus has reshaped the world in about six months. Could you, if it's possible, briefly summarize the wild ride equities have had so far this year?

Joe Williams:

Sure, Chris. Let's start with the S&P 500 then just to bring back (the context) ...The S&P in January, which seems so long ago, and early February, was kind of in a trading range, not going any place, and then we started to move higher. And by February 19th, we hit a new all-time high. We were up 5.1% for the year, everything was looking great. And then the coronavirus scare hit us, and the market started to decline. By March 23rd, the market fell 33.8% in less than 40 days. That's the shortest bear market, and a bear market is defined as a decline of over 20%, we've ever seen. Typically, a bear market in the past that leads to recession, which we are currently in, takes a year to play out. So, this was very short and very steep. After March 23rd, though, the market reversed and we've had one of the strongest bull markets or rebounds off of a low we've ever seen as well. We are now up 41.2% off the lows. And with all this wild decline and move higher, year-to-date we've only lost 2.6%.

So, yes, indeed it has been a wild market. It's interesting though, the market, when it declined that 34% in February to March, it was trying to discount the world economy shutting down and what effect that would have on companies. What is interesting is when we look at what the consensus earnings estimate was for the market at the beginning of the year to where it has fallen to today. Earnings forecast now for 2020 are to decline 37% when we get finished with this year. So, as the markets processed what's happened, the price movement of the stock market did fit with the earnings decline that we have eventually seen in 2020.

Chris Schildz:

Joe would you agree that the liquidity poured into the economy by the U.S. government helped the equity markets?

Joe Williams:

It's certainly been true that the amount of money, the trillions that the Treasury and the Federal Reserve has poured in this market very quickly, has certainly stabilized the economy. And here in the last month, we're actually now starting to see the market recover.

The liquidity has been unmatched (compared to) any other recession, and that liquidity has stabilized most Americans' income level, and that's been very important as far as when we look at consumer confidence. Now consumer confidence (Consumer Confidence Index) is made up of five components, and the first two are present-day situations. When we ask representative groups how do you view the economy today versus a month ago? And how do you view the employment situation versus a month ago, better worse or the same? It's not surprising April saw one of the biggest drops ever. We went from 170 on this index, all the way down to 70, so it dropped a hundred points. That's unprecedented. And then just a small decline in May. That's not surprising.

Joe Williams continues:

But then the next three questions look at the what's going to happen six months from now, and that's the consumer expectation. This is what's different this time around. The first question is how do you view the economy six months from now? That's actually taken a big jump. People are very optimistic that things are going to be better off six months from now, and the job situation will be much better off six months from now. The last question is about income expectations. That did decline.

But when we look at it overall, those three questions really did not decline very much at all. That's very uncharacteristic of say what happened in 2008, 2009, when consumer confidence plunged, both the expectations went coincidentally down. Same thing happened in 2002, 1991, 1980, 1974.

The reason it's very important is as consumer expectations maintained a high level, people did not panic because they didn't think this was going to be long lasting. They didn't panic on their investments. They didn't feel like they had to sell and things were just totally going to fall apart. In fact, they all felt, or most felt things were going to get much better. And the decline was so quick they really didn't have any time to sell. So as things started showing a little improvement, as (COVID) fatality started to level off and decline, as we started opening up the economy, money that was very plentiful out there started to flow back into the stock market, and that's had a very important effect of driving stocks considerably higher.

Chris Schildz:

Joe would you say forward-looking investors have maybe written off most of 2020 and started looking ahead to 2021?

Joe Williams:

Well, I don't think there's any doubt that investors have written off 2020. I hear some concern of, "Well, what happens when second quarter earnings come out and they're going to be fairly dismal?" I think everybody knows that. Everybody has already baked into the cake that earnings are going to be awful this year, as I said, down 34, 35%. That's known. We do expect a good rebound back up to levels that we were expecting at the beginning of this year for the market in 2021.

So the risk is as we proceed through this year, if those expectations for earnings growth in 2021 start to decline either from another round of infections across the United States slowing down the economy, that's probably going to have the main effect on it, but until we see that, and that's probably not going to be until the fall, that stocks probably will continue to move higher.

Chris Schildz:

Joe probably one of the developments (that has taken place) is that growth stocks have really exceeded the performance of value stocks at least so far in the pandemic. Do you expect this to continue or are value stocks really where the value is?

Joe Williams:

Well that's the question we're always trying to answer. Our answer at the beginning of the year was growth looked more attractive. And growth is very heavily dominated by technology stocks, healthcare stocks, and consumer discretionary stocks. Value stocks have their energy, financials and industrials (stocks) that are more economically-sensitive, and we felt growth was better positioned going into a fairly good economy, originally what we thought at the beginning of the year. But then as the pandemic hit, the economy shut down, it really turned to the growth stocks.

Technology stocks are what was going to keep this economy functioning with the majority of people working at home. The internet did not collapse as many feared just with the overuse and everybody trying to work via the internet. Technology held up and technology stocks have been rewarded. They were in the right place at the beginning of the year, they were in the right place during the downturn, and they're all hitting new highs. (The) technology sector alone this year is up 12%, again with the market being down 2 or 3%. So that's been the leadership. Healthcare stocks have done well, and consumer discretionary stocks have done well, led by Amazon there.

Just this year, large-cap growth stocks are up 9.9%, large-cap value stocks are down 15.3%. A 25% difference. Now that is certainly much greater than we would have thought. And you would say eventually value is going to have to close that gap somewhat, but we still believe the long-term trends of technology leadership is going to continue. We will see a rebound in energy and industrials and financials, but it's still going to be a tough road for all three of those sectors as this economy starts to recover.

Chris Schildz:

Joe on the horizon, of course, we have a presidential election coming up and those events are very cyclical. I know you are a student of history. Can you tell us what the presidential cycle might look like heading into this one in November?

Joe Williams:

Well, we do always pay attention to the presidential cycle in most normal years. It goes something like this: if we go back and average all the presidential cycles, election years going back to 1900, typically the market starts off in a trading range moving within 4% to 5% either up or down as if we sort through the candidates, and into August we're typically flat. Once we know the candidates, then the market starts to move higher. We have a fairly strong market in August into September. And then we start becoming concerned about what really could happen if either one of the candidates actually becomes elected, the market trends down into the election. And then the market moves higher after the election, regardless of who wins. The election year is the second-best year of the election cycle followed by the best, which is the third year, which was last year and the stocks were certainly very strong during that time.

That's a typical cycle. Of course, it's been overwhelmed with the coronavirus. So, I really think the election cycle is not really going to start to come into play until we get much closer than normal, say maybe October, and then I think it will start to affect the market. But until then, I think it's all news on the virus and the election presidential cycle is kind of off in the background.

Chris Schildz:

Joe, let's wrap up with a global question. With the world economy reopening, are you still recommending overweighting domestic to international stocks?

Joe Williams:

Yes, we are. So far, as I said, the U.S. market is down 2% or 3%. International is represented by EAFE, Europe, Australia, and the Far East (index), and is down around 10%. Emerging markets are down a little bit over 9%. So international markets continue to lag and it goes back to what we've been talking about the last six months to a year – (this is) just the structural difference between the S&P 500, and that of the EAFE, the large-cap internet national stock and all is around the lack of technology representation in the international indexes.

At the beginning of the year, the S&P had 28% of the market capitalization represented by technology. In the international markets, only 8% is represented by technology. As long as technology leads most all sectors, then domestic stocks are just going to do better than international just because of that structural difference. That's certainly been the case this year.

When we look at how the international indexes are biased, they're biased much more toward financial stocks and industrial stocks, two of the worst-performing sectors, worst being energy, but financials and industrials are the two worst-performing sectors in the world so far this year. So, they're just kind of behind the "eight ball." And until technology gives up this leadership that it certainly had for the last 10 to 12 years, it's hard to predict international stocks starting to outperform on a longer-term basis domestic stocks.

Chris Schildz:

Joe, thank you very much. That was Joe Williams, Commerce Trust Company, Director of Investment Strategy.

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