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Around the Markets

Curb Your Enthusiasm

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Curb Your Enthusiasm

Evidence of the novel coronavirus COVID-19 spread in early March sent the US stock market, as measured by the S&P 500 Index, down 34% from its February 2020 peak into bear market territory in just six trading days. Pandemic-induced closure of the US economy led to the almost immediate loss of more than 20 million jobs and instilled a sense of gloom amongst investors. Q2 of 2020 was quickly characterized by superlatives: expectations for the worst ever declines in quarterly GDP growth and year-over-year earnings growth, and the highest level of unemployment in history.

The Federal Reserve and Congress responded by providing the largest rescue package in history. This infusion of liquidity spurred US stocks to rally over 38% from their low on March 23 through the end of June. And with it came a shifting mood amidst the crisis: states most impacted by early cases gradually lifted stay-at-home orders, the economy added 7.5 million jobs in May and consumers resumed purchases of non-essential goods. It appeared that Q2 was going to be the trough for many economic and financial indicators.

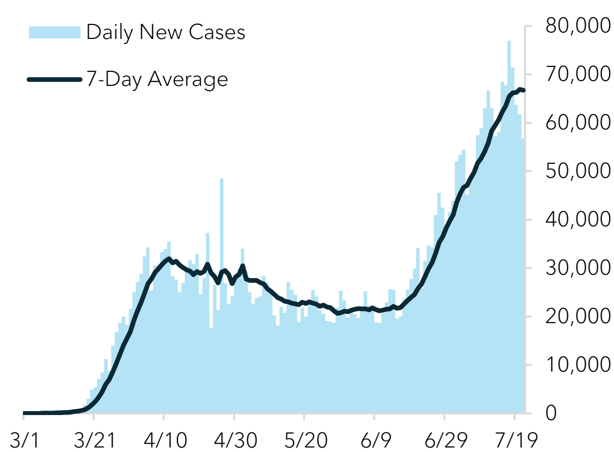
But we think it may be too soon to break out the champagne. The most critical factor to recovery is the trajectory of virus containment and the US is far from claiming victory here as new cases continue to climb at an alarming rate; unemployment extensions and loan forgiveness programs expire soon; and the data surrounding consumer and business spending suggests that economic recovery will be neither swift nor linear. Stocks appear to be trading based on earnings expectations for 2021, but we question that logic in the absence of company guidance and so much macro uncertainty. In our view, investors should take cues from evolving data patterns and may have to curb their enthusiasm until investment clarity improves.

It All Hinges on The Virus

While the past two months have been dominated by upside economic surprises, looking ahead, we expect a more challenging macroeconomic environment led by worsening COVID-19 dynamics in the US.

The 7-day moving average of daily new cases in the US reached over 66,000, the second highest on record.[1] The US now leads the world in coronavirus cases with 3.8 million infections, a 73% increase from just one month ago. In comparison, Brazil and India, the two countries ranking second and third in the world in total infections, have a combined 3.3 million.[2]

US Daily New COVID-19 Cases[3]



Outbreaks remain particularly concerning in Sun Belt states such as Texas, Florida, California, Georgia, and North Carolina. Forty-four states have seen an increase in daily new cases over the last two weeks.[4] Twenty-two states have either reversed or

[1] The Centers for Disease Control and Prevention, 7/20/2020
[2] The Centers for Disease Control and Prevention, 7/20/2020
[3] The Centers for Disease Control and Prevention, 7/21/2020
[4] Johns Hopkins, 7/20/2020

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paused their economic reopening.[5] California Governor Gavin Newsom announced statewide restrictions to order – among other measures – the closing of indoor dining for a second time.[6] Los Angeles revealed that the city is "on the brink" of a second stay-at-home order as cases rise.[7]

The spread of the virus, along with voluntary and government-enforced social distancing, is exacting a measurable adverse effect on economic activity. This is a sobering reminder that any sustained recovery in the US economy depends on effective and sustained virus containment. In the following, we offer three key observations surrounding COVID-19, its implications on the future path of the virus, and correspondingly, the economic recovery.

Antibodies May Be Short-Lived

The "immunity passports" for recovered COVID-19 patients may have earlier expiration dates than initially believed.

A recent study by some of Spain's leading epidemiologists found that – based on over 60,000 participants – 14% of those who originally tested positive for antibodies no longer tested positive in subsequent trials carried out two months later.[8]

A separate study on recovered patients in China reported similar findings. The apparent disappearance of antibodies was mostly seen in those who had very mild or no symptoms. Antibodies fell below the detectable threshold in 40% of asymptomatic patients, compared with just 13% of symptomatic patients.[9]

Such results contrast with the duration of immunity documented in two other well-known coronaviruses, SARS and MERS, where antibodies have been found to last at least one year and often longer.[10] It may be premature, however, to conclude that a significant portion of recovered COVID-19 patients are vulnerable to reinfection. Another study found that even low levels of certain antibodies may offer sufficient protection.[11]

While COVID-19 studies are still ongoing, what we do know from such studies is that it may be risky to assume that recovered patients are immune to a second infection. If natural antibodies do wane faster than previously expected, we cannot rely on natural infection to achieve herd immunity. This has implications for protracted public health interventions such as social distancing and widespread testing, and sparks greater urgency for vaccine development, production and delivery.

A Vaccine Will Not End the Pandemic

The biomedical community is racing to produce a COVID-19 vaccine.

According to the World Health Organization (WHO), 168 vaccines are currently in development, with 26 in clinical trials.[12] As several front-runners report positive results in early-stage Phase I & II trials that focus on safety and dosage testing, attention is rapidly shifting to the candidate vaccines entering later-stage Phase III trials, where tests are conducted on a significantly larger scale to assess vaccine efficacy.

By definition the results of clinical trials are unpredictable. The FDA requires 50% efficacy for a COVID-19 vaccine to win regulatory approval – not a very high bar.[13] For comparison purposes, the effectiveness of the seasonal flu vaccine ranges from 40% to 60%, whereas the effectiveness of the

[5] BofA Global Research, 7/15/2020
[6] Los Angeles Times, 7/13/2020
[7] Daily Mail, 7/20/2020
[8] Prevalence of SARS-CoV-2 in Spain: a nationwide, population-based seroepidemiological study, The Lancet, 7/6/2020
[9] Clinical and immunological assessment of asymptomatic SARS-COV-2 infections, Nature Medicine, 6/18/2020
[10] A systematic review of antibody mediated immunity to coronaviruses: antibody kinetics, correlates of protection, and association of antibody responses with severity of disease, medRxiv, 4/17/2020.
[11] Convergent antibody responses to SARS-CoV-2 in convalescent individuals, Nature, 6/12/2020
[12] The World Health Organization, 7/20/2020
[13] The Washington Post, 6/30/2020

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measles vaccine is around 97%.[14] The 50% efficacy requirement implies that the first vaccines to be approved will likely be, at best, partially effective. While more effective vaccines may emerge later, time is of the essence during a global pandemic.

While many believe that a vaccine holds the key to the world returning to normalcy by creating widespread immunity, we believe that the power of a vaccine may be much more limited. This is because achieving herd immunity depends mainly on three factors: (1) the contagiousness of the virus, (2) the effectiveness of the vaccine, and (3) the vaccination rate of the population. Researchers at Johns Hopkins estimated that at least 70% of the population need to develop protective antibodies to COVID-19 to achieve herd immunity.[15] Intuitively, this level is not achievable with a 50% effective vaccine. Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases (NIAID), stated recently that the effectiveness of a COVID-19 vaccine is unlikely to exceed 75%.[16] This suggests that, even in the best case scenario, unless 93% of Americans are vaccinated – highly implausible given the increasingly vocal anti-vaccination movement – it is unlikely for the US to achieve a high enough percentage of immunity to fully mitigate the need for some degree of continued social distancing.

Once a vaccine is approved, the next hurdle is to ensure that it is manufactured and distributed quickly enough and on a scale that is sufficient to quell the pandemic. Pharmaceutical companies have made bold promises about their ability to scale up vaccine production. We suspect that the timelines promised by many of these firms may be overly ambitious as vaccine manufacturing is notoriously unpredictable.

Given the information available today, we estimate that any mass deployment of vaccines will take place at the earliest in mid- to late-2021. A COVID-19 vaccine is unlikely to rescue us before this year's flu season hits.

A Game-Changing Therapeutic Treatment Is Not in Sight

A vaccine with 75% efficacy taken by two-thirds of Americans will provide half of the US population with protective antibodies. The main benefit of a vaccine is that it lowers the transmission rate of the virus. However, in the absence of social distancing measures, the other half of the country's population will remain vulnerable. To truly reopen the economy and have lives return to normal, we need a game-changing therapeutic treatment – in addition to a vaccine – that fundamentally changes the nature of the threat posed by the virus.

COVID-19 is proving to be a dangerous, deadly virus in part because it is highly contagious, but also because a certain fraction of infected patients require hospitalization, and frequently that includes a stay in the ICU. According to the CDC, the average hospitalization rate is 1.1% (and 3.2% among people aged 65 and older).[17] If we do not intervene and let the virus run rampant, the 1.1% will increase and completely overwhelm the healthcare system.

It is very difficult to kill viruses. Most virus treatments are not designed to cure but rather to alleviate symptoms and prolong patients' lives. The development of a treatment that can effectively mitigate the severity of symptoms and is also readily accessible from one's home (as pills) or a physician's office (as injections) will significantly reduce the utilization rate of hospitals, thus fundamentally alleviating the major challenge that the COVID-19 virus poses to our healthcare system. Such treatment, unfortunately, is unlikely to become available in the near term.

To put things in context, we reviewed the list of COVID-19 treatments compiled by the New York Times. The only two treatments labeled "promising"

[14] Centers for Disease Control & Prevention (CDC), 7/21/2020
[15] Johns Hopkins, 4/10/2020
[16] The Science Times, 6/29/2020
[17] CDC, 7/17/2020

on this list are Remdesivir and Dexamethasone.[18] The former is used to marginally reduce the recovery time of hospitalized patients, while the latter is a steroid treatment that reduces the mortality rate of later-stage ICU patients. Neither is meant to curb the need for hospitalization.

The list includes ten additional treatments labeled "tentative" for having shown promising or mixed early-stage results. Among them, monoclonal antibodies – an artificial antibody syringe injection – may be a potential candidate for our "game-changing treatment." Unfortunately, the jury is still out on its efficacy, as clinical trials for this treatment have only just begun.[19]

The Path of The Virus and The Economic Recovery Are Intertwined

For many governments around the world, it has been a challenging task to strike a fine balance between supporting the recovery of their economies while keeping the virus spread under control. Ultimately, it is not possible to fully reopen the economy until COVID-19 no longer poses a material threat to public health.

While a healthy dose of optimism is warranted as the global biomedical community gathers to pioneer medical breakthroughs at record speed, we, as investors, must maintain a grounded and realistic grasp of the tremendous uncertainty embedded in the potentially overambitious timelines for vaccine and treatment developments. We believe that the path of the virus and the economic recovery will likely remain intertwined over at least the next two quarters.

[18] The New York Times, 7/20/2020
[19] Investor.Lilly.com, 6/1/2020

Picture Holiday Shopping in The Time of Pandemic

The adverse impact of the widespread outbreak on the US economy has become increasingly clear over the past few weeks.

Infections and hospitalizations in the US began to climb sharply around mid-June, led by rising cases in the Southern and Western states, where restrictions eased earlier.

According to credit and debit card spending data compiled by Bank of America, during the period between March and mid-June, consumer spending in states where the virus is currently contained (e.g., New York, New Jersey, and Connecticut) fell behind spending in states where daily new cases are now on the rise (e.g., Texas, Florida, and Georgia).[20] This lag is likely driven by the more rigorous social distancing measures implemented by the states, which suffered deadly outbreaks in March and April. Such consumer spending dynamics reversed after mid-June, as outbreaks began to occur throughout the Sun Belt states.

More recently, with the number of new infections in the US hitting record highs almost every day, we began to witness a decline in consumer spending across the country. The slowdown in spending, however, is most notable in states that have been hit hardest by the virus.

Some economists argue that the surge in infections and hospitalizations in certain parts of the US may have a positive effect in the long term. If the spread becomes more severe, the public may feel less complacent about the potential risk of contracting the virus and, therefore, become more receptive to social distancing. Similarly, state and local governments may take the pandemic more seriously and increase their efforts to maintain a balance between supporting economic recovery and curbing the spread of the virus

[20] BofA Global Research, 7/17/2020

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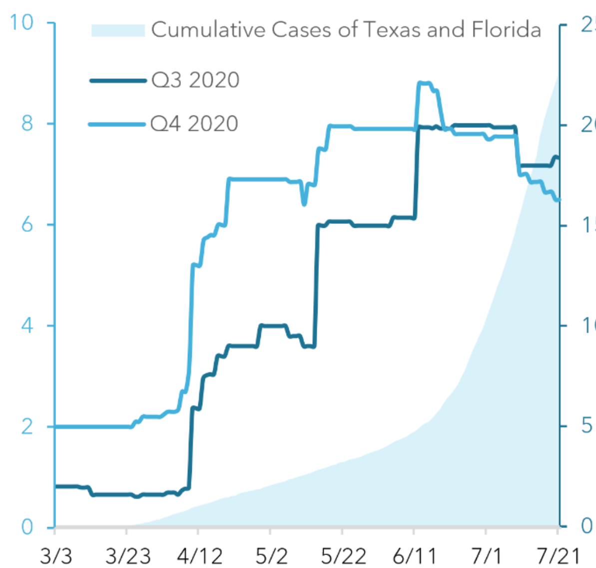
In the near to medium term, however, we believe what is happening on the virus front is more likely to apply downward pressure on US consumer spending and economic growth throughout the second half of 2020.

Cumulative COVID-19 Cases in Texas & Florida

US GDP Consensus Estimates[21]
(Quarter-over-Quarter, seasonally adjusted annual rate, %)



Consensus estimate of future US GDP growth fell as cases continued to rise in the Sun Belt states. The median forecast for Q3 fell from 20.0% one month ago to 18.4%.[22]

What we find more interesting is the revision to the consensus estimate for fourth quarter GDP growth. Compared to Q3, the growth estimate for Q4 fell earlier and more sharply. In fact, its decline began at around the same time as Texas and Florida first reported sharp increases in new infections.

The greater sensitivity of the Q4 growth rate to the trajectory of infections may be related to the fact that US consumers generally spend the most in the fourth quarter, spurred by holiday gift buying as well as increased travel and other holiday-related spending.[23]

While it may not feel like it, the historically second-largest annual shopping period after the winter holidays is taking place right now. Somewhat.

July and August are typically busy for retailers as parents and children stock up on back-to-school gear. This year's back-to-school shopping, unfortunately, is off to a rough start. As cases surge across the South and West of the US, more and more schools have dialed back reopening plans.

For example, on July 17th California issued new rules that would force many of the state's districts to teach remotely in the Fall.[24] North Carolina announced on July 14th that public school districts have the option to choose between in-person and online classes.[25] Georgia declared on July 21st that school districts should decide whether they would reopen for in-person teaching.[26]

With just a few weeks left before the Fall semester starts, many states are scrambling to finalize school reopening plans. Still, given the nature of the pandemic, a lot can potentially happen over the next few weeks. The uncertainty over whether schools will reopen has led many families to delay – and in some cases cancel – purchases of school supplies, new clothes and dorm decorations.

The year's disappointing back-to-school/college shopping season sets a gloomy tone for the upcoming year-end holiday shopping season. Walmart recently announced that it will close stores on Thanksgiving Day due to COVID-19[27] – an ominous sign that holiday shopping will be quite different this year.

[21] Bloomberg, 7/21/2020
[22] Bloomberg, 7/21/2020
[23] Gallup, 1/4/2016
[24] The New York Times, 7/17/2020
[25] www.nc.gv, 7/14/2020
[26] The Atlanta Journal Constitution, 7/21/2020
[27] The Wall Street Journal, 7/21/2020

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Auto Sales Are an Anomaly

According to the Department of Commerce's "Monthly Sales for Retail and Food Services" report, US consumers' retail spending in June increased 1.1% year-over-year. This percentage drops to -0.5% if we exclude auto sales.[28] Indeed, auto sales have been a bright spot in consumer spending, as most other categories are still well below last year's levels.

The recent strong performance of auto sales, which have improved steadily since bottoming out earlier in the pandemic and have since then increased to 7.5% above last year's level, is – in our view – an anomaly, driven by several variables.

First, there is the element of pent-up demand. Auto sales in March and April plummeted, falling 25% and 32% respectively[29] – not surprising given that the majority of the US population was under stay-at-home orders then. As states began to reopen in May, auto sales quickly recovered to last year's level.

Additionally, we suspect that the improvement in auto sales may have been further fueled by consumers' health concerns. Many – those who can afford it – are likely to prefer a safer commute by car to the risk of traveling via confined public transit.

Furthermore, the COVID-19 crisis has disproportionally affected the low-skilled and low-income part of the workforce. We believe that most of the recent auto buyers fall into the higher income group. Such buyers are likely to have greater job security, e.g., being able to work remotely in the last few months. They may have further benefited from historically low interest rates and the recent strong performance of the equity market.

Last, social distancing and working from home have encouraged more people to look for a home in the suburbs. As people migrate from urban areas to suburban and rural areas, a car may be a necessary purchase as well.

The Restaurant Obsession

Just days before New York City was scheduled to enter into Phase 3 of the state reopening plan, which would permit restaurants to provide indoor dining, New York City Major Bill de Blasio announced that indoor dining would be indefinitely delayed, due to increasing concerns about the surging infections in the Southern and Western states.[30]

As a remedy, he would open twenty-two streets for outdoor dining.[31] Within just a few days, thousands of outdoor cafes sprung up across the city. For the restaurant owners, their employees, and the New Yorkers who had been craving to return to their favorite local restaurants for months, outdoor dining has brought life, energy, and – to some extent – a sense of normalcy back to New York City.

On July 20th, as the city entered Phase 4, the final phase of reopening, indoor dining continued to remain banned.

We cannot help but wonder what will happen to many of these restaurants when winter comes and outdoor dining ceases to be a viable option. There is mounting evidence that indoor spaces pose a higher risk for the transmission of COVID-19. In the absence of an effective vaccine or therapeutic treatment, indoor dining not only is risky for the patrons and employees (not to mention the increased risk of doing so during the fall and winter flu season), but also is unlikely to generate sufficient revenue for most restaurants to break even, given social distancing requirements.

The fate of restaurants has been a favorite topic explored by many economists and strategists ever since the beginning of the COVID-19 crisis. Based on Personal Consumption Expenditures (PCE) data reported for February 2020,[32] we found that "food

[28] The Department of Commerce, 7/16/2020
[29] The Department of Commerce, 7/16/2020
[30] The New York Times, 7/1/2020
[31] The New York Times, 7/2/2020
[32] Bureau of Economic Analysis, 3/27/2020

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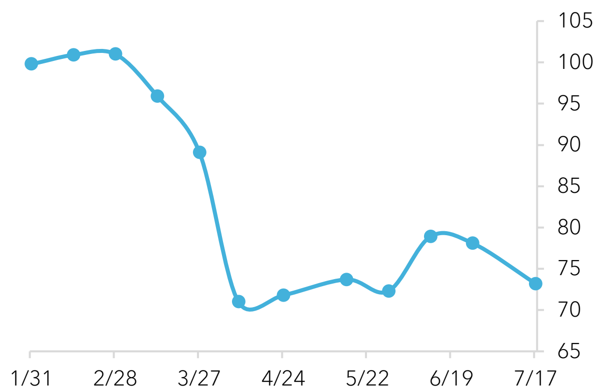
services" only accounts for 6.1% of consumer spending. In comparison, "other durable goods," which includes prescription drugs, toys, household cleaning products, soaps, tobacco, etc., represents 8.6% of consumer spending. Objectively, one may argue that the amount of attention paid to the restaurant industry, through the lens of economists and strategists, is disproportionate to its economic value. However, we suspect that, because the opening and closing of restaurants directly affects the social lives of many people, the health of the restaurant industry may serve as a subconscious, yet highly tangible, indicator for many people of the severity of the pandemic and the pace of economic recovery.

Univ. of Michigan Consumer Sentiment Index[33]



Consumer spending is driven by one's ability to spend, and also one's willingness to spend. When cases began to surge in the Southern and Western states in mid-June, US consumer sentiment started to fall. Consumer confidence, critical in determining the outlook for economic recovery, is heavily influenced by the path of the virus, which we suspect may have been assessed by many consumers based on the health of their local restaurants.

Help: Jobs Wanted

The news media has devoted much attention to recent labor-related data that suggest a recovery in employment is underway. Optimism abounded around a headline unemployment rate for June of "only 11%" and economists tracked by Bloomberg have tweaked down their forecasts for Q3 and Q4 2020 to consensus levels of 10.3% and 9.1%, respectively.[34]

We expect there will be fits and starts to the employment data as the economy gradually recovers. We are less focused on the variations in data points and have become more concerned that virus-induced shutdowns will create long-lasting, structural changes to employment.

For one thing, employers cut a combined 21 million jobs in March & April and added 7.5 million back in May and June. The snap-back in employment, a natural effect of reopening in several states, was driven principally by jobs in hospitality, leisure and retail.[35] These industries are home to many small businesses, where hiring has already slowed in Sun Belt states and stalled in the Northeast and Midwest.[36] Bank of America economists note that as of July 15, twenty-two states have either reversed or paused reopening measures. In their view, this could cause worker layoffs even after re-hiring, and they expect a second wave of initial jobless applications.[37]

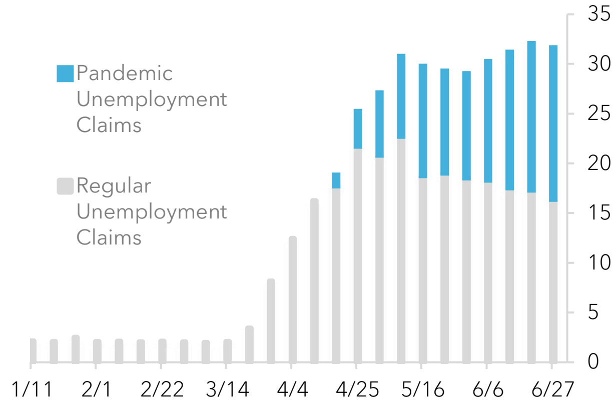
We expect that many temporary layoffs are in danger of becoming permanent. Despite the jobs snap-back in the past few months, several employers in retailing and hospitality industries have recently filed for bankruptcy protection, among them J.C. Penney, Pier 1, Neiman Marcus, Lucky Brand, Hertz, GNC, and NPC International–the major franchisee of Wendy's and Pizza Hut restaurants.[38] Additionally, United Airlines and Walgreens are among the list of companies that have announced significant layoffs; as the back-

[33] Bloomberg, 7/17/2020
[34] Bloomberg, 7/22/2020
[35] Credit Sights, 7/2/2020
[36] The Wall Street Journal, 7/18/2020
[37] BofA Global Research, 7/15/2020
[38] Bloomberg, 7/20/2020

and-forth of reopening lingers, we are less convinced that employment trends will improve markedly.

Continuing Unemployment Benefit Claims[39]

(not seasonally adjusted, unit in millions)



As of June 27, 15.2 million workers were receiving benefits under Pandemic Unemployment Assistance (PUA) programs, almost as many that receive regular benefits under state unemployment programs.[40]

Expanded unemployment benefits and PUA are set to expire at the end of July but Congress has begun crafting an expanded aid package. While both parties appear eager to pass another bill, we expect that bipartisan support will be more difficult this time around. A recent University of Chicago study found that 68% of unemployed workers eligible for benefits receive more in jobless payments than their lost earnings.[41]

Expanded benefits will need to balance necessary assistance without creating disincentives for workers to return to jobs. Both parties also seem to support extending aid to small businesses, so there may be some relief in the form of extended Paycheck Protection Program loans, particularly for smaller firms. No doubt rapidly changing economic and employment data will complicate the decision process. We expect passage of another coronavirus relief bill, but with far weaker provisions.

Most forecasts still expect peak unemployment in Q2, with steady improvement throughout 2021; consensus is for a 7.6% unemployment rate by year-end 2021.[42] This data is dependent on a reversal of furloughs – only possible if businesses can stay open. Given the current state of virus spread and hurdles to reopening the economy, we expect a bumpy path. In its most recent earnings report, JPMorgan Chase management stated that one reason for increasing reserves was to "prepare for double digit unemployment into 2021 and a slower recovery than we expected in April."[43] And payroll processor Paychex noted in its earnings commentary that it now expects the trough in employment to occur in Q3, rather than Q2.[44]

We expect US employment to undergo structural changes. Some jobs are undoubtedly lost forever as businesses shutter for good. Forecasted numbers imply that replaceable jobs will be created and workers trained in timely fashion. However, we are skeptical that this occurs seamlessly during a pandemic.

Data from the Bureau of Labor Statistics show a spike in the number of people who would like a job but are not working because of childcare obligations. Johns Hopkins University economics professor Alessandro Rebucci estimates that decisions regarding school reopenings will affect the current labor market for 5-10 years.[45] Rebucci says that keeping schools closed may have economic impacts for the next 20-30 years as some parents leave the workforce and children fall behind in learning, thereby damaging the long-term labor supply.

[39] US Department of Labor, 7/2/2020
[40] Credit Sights, 7/17/2020
[41] The Wall Street Journal, 7/19/2020
[42] Bloomberg, 7/22/2020
[43] The Wall Street Journal, 7/15/2020
[44] Seeking Alpha, 7/7/2020
[45] Barron's, 7/20/2020

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US Stock Market – The Alternate Universe

The US bond market appears to be acting rationally to the pandemic. Induced by Federal Reserve purchases, Treasury yields are at record lows and the flatness of the yield curve reflects the ongoing presence of the Fed as a willing buyer. Real yields are negative, even with current benign inflation levels, and are helping drive investors out of Treasury bonds.

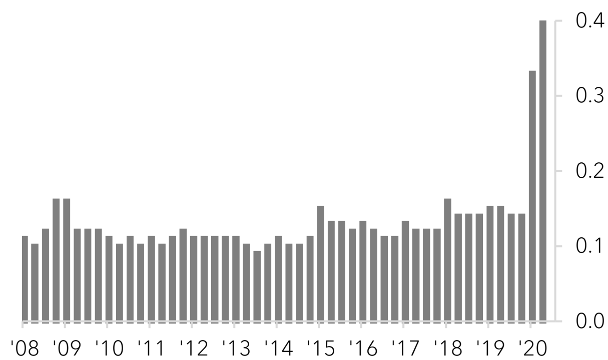
The US stock market's action has been anything but rational over the past few months, as it appears completely disconnected from the global pandemic. The S&P 500 Index recorded its fourth-best quarter in the past 50 years during Q2, boasting a total return of 20.5%.[46] Much of this was due to the massive infusion of liquidity from Washington and a snap-back in industries that were most affected by the shutdown—neither of which is sustainable over the longer term.

Those who defend current levels of the market argue that stocks are looking past the pandemic and discounting much-improved earnings power in 2021 and 2022. While that may have some merit, we argue that current uncertainties challenge the accuracy of predictions and are enough to suggest a tempered optimism.

For several months, analysts have been expecting dire Q2 earnings reports from their covered stocks, and most have not adjusted for the partial economic rebound. According to financial data provider, Refinitiv, as of July 8 consensus estimates for year-year S&P 500 EPS growth were -44% for Q2 and -24.7% for Q3.[47] Actual earnings are likely to beat these low expectations, but either way should be largely ignored by the market. Companies have been given a "pass" on this year's earnings because of the pandemic, and investors are instead looking forward to gauge value in the market. Therein lies another challenge, in our view.

Analysts derive earnings estimates by building complex balance sheet and revenue models, and by "kicking the tires" through visits to company plants, factories, stores, etc. And guidance from company management itself is an important element in their models. The pandemic has complicated this process; analysts following virus-impacted stocks must create new models, and visits to company facilities are on hold. Currently, over 40% of companies in the S&P 500 Index have withdrawn guidance,[48] most likely because they have little to offer with so many unknown variables. As a result, future earnings are more unpredictable; the median spread between analysts' highest and lowest EPS estimates has widened to around $0.40, more than 3x normal levels.[49]

Median Spread in Earnings Estimates[50] (unit in $)



According to data provider FactSet, as of July 17 consensus EPS for the S&P 500 Index at year-end 2021 was $161.89, almost exactly the year-end 2019 number. Based on the value of the Index on July 17, the forward P/E multiple is 20x—not unreasonable, but not very predictable either, in our view. And reaching that level assumes a significantly improved business climate; as of the

[46] Bloomberg; 7/20/2020
[47] The Wall Street Journal, 7/9/2020
[48] The Wall Street Journal, 7/9/2020
[49] The Wall Street Journal, 7/13/2020
[50] Dow Jones Market Data, Factset, 7/13/2020

same date, the consensus EPS estimate for the Index in 2020 is just $125.67.

We already have some cues from companies that have reported Q2 earnings, particularly the banks, that expectations for a smooth recovery may be misplaced. In a few months, Americans will go to the polls; election rhetoric is likely to roil the market. At the very least, with a growing deficit to fund, we expect to hear more discussion of higher corporate tax rates and increased regulation of selected industries, thereby impacting corporate profitability. Globalization has been a key driver of profits in past years; if supply chains are reshored or duplicated, or if trade restrictions become permanent, that would have a negative impact on profit margins. Taken together, we have little confidence that there is a reasonably predictable line of sight into next year's earnings.

The Answer Is Blowing in The Wind

Headwinds appear to be encroaching the path to economic recovery. Most crucial, the coronavirus is not yet under control and successful vaccine development is likely not around the corner. The forward and backward progress toward reopening the US economy has direct impact on employment, spending and corporate earnings. With the Presidential election rapidly approaching, we expect campaign rhetoric to keep financial markets off balance.

One seemingly permanent feature of the US equity market is the dominance of the Technology sector, in terms of Index weight, fund flows and certainly, performance. From the trough in March through July 17, the S&P 500 Technology sector is up 52%.[51] Most portfolios have high allocations to the sector (a "crowded trade") and valuations have skyrocketed. But so far in July, tech has had bouts of vulnerability and some stocks are clearly losing steam. If the sector were to sell off, it would have a material effect on many individual portfolios and the market overall. We think investors should generally be wary of adding to technology-related holdings at these levels.

It has become increasingly difficult to find opportunities to add value in equity portfolios. That is because updates on virus containment and reopening the economy tend to shift daily, complicating timing and selection decisions. Under-owned and underperforming sectors like Industrials and Financials make sense to us, even if investors may need to exercise some patience. Many stocks here are high quality and offer attractive valuations, and they should benefit when the economy recovers. Investors may also consider adding to non-US stocks. Markets outside the US are generally more attractively valued than the US, and those that appear to have control over the virus have already begun reopening their economies.

[51] Bloomberg, 7/17/2020

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