SUREVEST

Summer 2020

Quarterly Commentary

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Second Quarter Recap

The second quarter witnessed one of the biggest disparities between market return and economic data. Some investors were left puzzled why the markets did so well last quarter in a time when bad economic data was being released. Last quarter, the S&P 500 posted a total return of 19.95%, while the Dow Jones Industrial gained 17.77% and the tech heavy NASDAQ Composite increased an impressive 30.63%.[i]

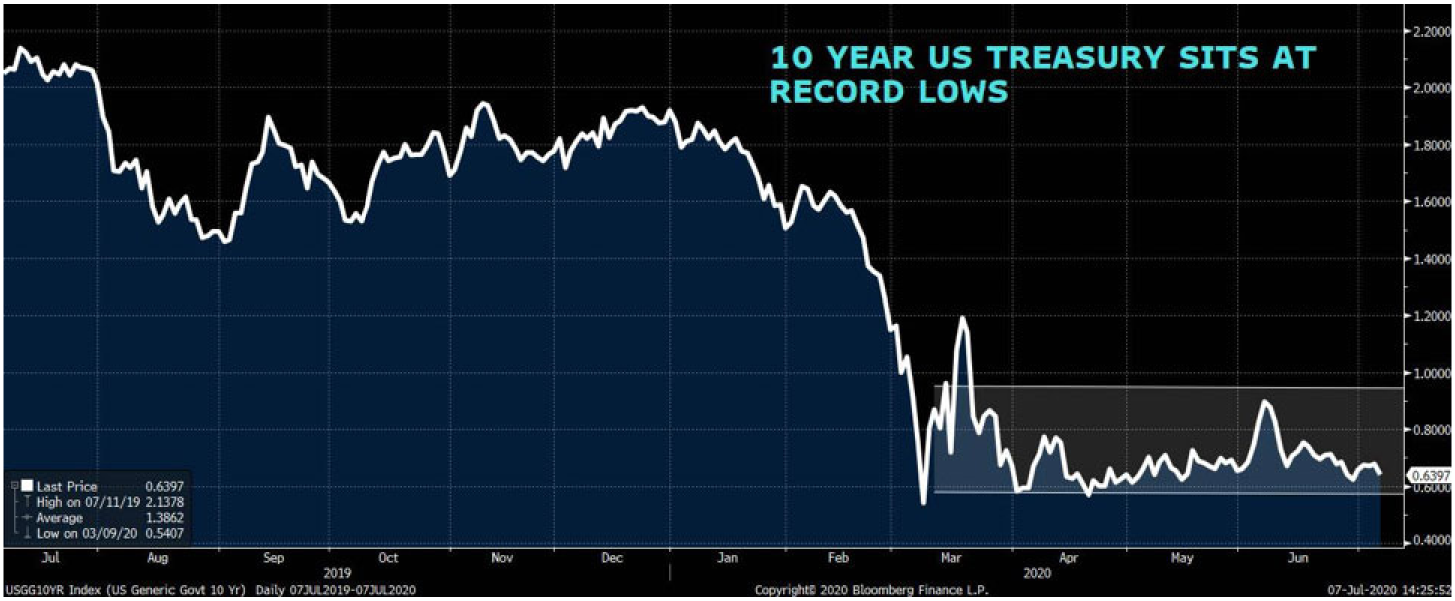
On the economic front, the National Bureau of Economic Research (NBER) announced that we are officially in a recession since February, ending the longest economic expansion on record. The number of people filing for initial jobless claims has totaled 48.6 million (March 20 – June 26), the latest unemployment figure is 11.1%, the most recent real GDP growth was negative 5.0% (QoQ annualized) and Q2 GDP data is expected to come in even worse.

So why did the markets rally despite the onslaught of bad economic news? There were several forces that contributed to the biggest quarterly rally since 1998 on the S&P 500. The Federal Reserve is certainly one; it has made clear near zero interest rates are here to stay through 2022. The Fed also initiated several programs aiming to support the economy. On April 9th, it announced actions to provide up to $2.3 trillion in loans to employers of all sizes and communities across the country.[ii] The Fed resumed buying securities to provide liquidity in the markets, and increased its balance sheet from just under $4 trillion to over $6 trillion in a matter of months. Today, the Fed balance sheet, as a percent of GDP, is at 32.6%, making it the highest since this data is available.

To illustrate how influential the Fed policy is to the markets, we look to a paper written by former Chair of the Federal Reserve, Ben Bernanke and Kenneth Kuttner titled, "What Explains the Stock Market's Reaction to Federal Reserve Policy?" They conclude, "For the overall S&P 500 composite index, an unexpected 25 basis point rate cut would typically lead to a 1.3 percent increase in stock prices."[iii] Add quantitative easing that was initiated again, and the various other programs, and we begin to see how the Fed helped move the markets higher.

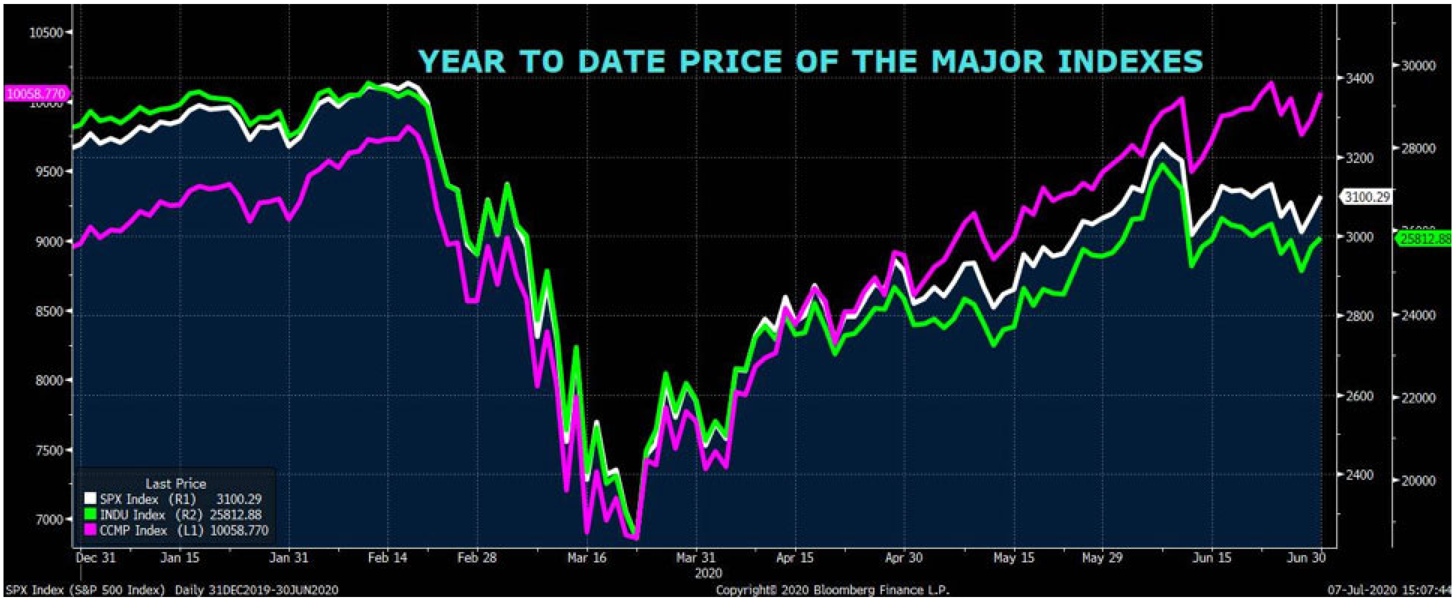
To combat the dire situation we were headed as a country, the House and Senate passed a bill signed by the President that provided a $2 trillion plus stimulus package to help Americans through the COVID-19 environment. This was the largest relief program of its kind and helped many people. The markets liked how quickly congress acted and the magnitude of the new fiscal policy, both of which helped propel the markets higher.

The 10-year US Government Bond Yield decreased substantially as some investors ran to safe haven assets. This caused the yield on bonds to decrease substantially and made it more attractive for income investors to seek out dividend paying stocks, rather than buying bonds. It has been observed that, on average, a half-a-percent decrease in the 10-year U.S. Treasury corresponds with an increase in the price-to-earnings ratio of the S&P 500 of 1x.[iv] At the start of the year, the yield was at 1.91%, and today it is .63%, and trading in a channel. That means we would expect a multiple expansion of 2.5x, and supports stocks trading at a higher price-to-earnings ratio than its long-term average. Looking at 2021 earnings estimates of $162.32 per share on the S&P 500, a 2.5x forward P/E increase would imply a 406-point rise on the index.



Markets are trading higher because they look out 6-9 months and adjust today on what is expected in the future. Just like the February – March selloff took place before any really bad data was released, the recovery in stock prices that we witnessed last quarter is in anticipation of a swift economic recovery. Market participants buy and sell based on what is likely to happen rather than on the current economic data being released. This helps explain why markets have rallied despite poor economic numbers. However, if the actual figures are worse than initially forecasted, the market could still decrease.

Overall, the quarter was strong and as of June 30, the S&P 500 and the Dow Jones Industrial Average have recovered most of their losses, while the NASDAQ Composite Index is now in positive territory.



Looking Ahead

For most of the year, the presidential election has taken a backseat to the COVID-19 environment. However, as November approaches, we think the markets will begin to pay more attention. Markets tend to focus on how policy will affect corporate earnings rather than the political party of the candidates. Naturally, corporate taxes take the spotlight. The Tax Cuts and Jobs Act of 2017 lowered corporate taxes from 35% to 21% and increased corporate earnings. With former Vice-President Joe Biden and President Trump having different views on taxes, our clients are beginning to ask how the markets will react if Biden wins the election. Biden has stated he plans to increase corporate taxes; however, he currently states he would increase them to 28% rather than bring it back to the 35% rate.

To get a general idea of how the markets might react if Biden wins, and in fact raises corporate taxes to 28%, we looked at expected 2021 earnings on the S&P 500 ($162.32 per share) and discounted 7% (proposed 28% minus the current rate of 21%). That brought us down to $150.95 per share, and if we apply the five year forward price-to-earnings average of 18.3x, we get a fair price on the S&P 500 of 2762. On June 30th, the price on the S&P was 3100, which implies the index could drop by 337 points from that level. This is just an estimate, but it does illustrate the market could conceivably drop by approximately 10.9% if Biden becomes the 46th U.S. President. Of course, the economy will dictate policy, so any tax hike may be put off for some time. Also, depending on who ends up controlling the House and Senate, will play a major role in policy. Certain stocks will also do much better under a Biden administration than a Trump administration which would benefit from some slight tactical shifts in our portfolios. History tells us that we will have some time to adjust after we get a bit more clarity in November.

We think in the short-term, the markets will continue to pay attention to news related to COVID-19 as opposed to long-term market fundamentals or the election. Unfortunately, we are observing a spike in cases and death rates, which has led some states to rollback initiatives to open their economies. The markets have, for the most part, shrugged off the potential impact on the economy and 2021 corporate earnings.

According to FactSet, analyst expect earnings in 2020 to decrease by 21.5% from 2019 and increase by 28.2% in 2021.[v] That would essentially make for a V-shaped recovery. We think the markets are a bit too optimistic here and have not priced in a serious potential of a second wave of COVID-19. Most money managers and economist were caught flat-footed during the February – March selloff because they had brushed off a real threat of the virus in the U.S. We think the markets might be making that same mistake again. However, the markets might not react with a ferocious selloff, but rather trade in a channel until we get more certainty around a vaccine. That means that we could expect markets to decrease 10% and bounce back and continue in a pattern. That will provide opportunities for disciplined investors.

We believe investors in money market funds will provide a support level for the markets. We now have $4.6 trillion in money market funds, which is the largest amount since the data has been tracked and 18% higher than during the Great Recession. These investors fled to money market funds during the February – March selloff and missed out on one of the best quarterly returns on record. Investors are also now seeing the yields collapse in these accounts forcing them to look at places like equities not only for growth but income as well.

The rest of the year will not be easy to navigate, but the Surevest Investment Committee members are not new to this type of environment. We have developed a disciplined investment approach and are prepared to deliver good results to our clients. We thank you for placing trust in our team and allowing us to partner with you and your family to help reach your financial goals.

Disclosure

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[i] Source: Bloomberg
[ii] Source: Federal Reserve Press Release: https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm
[iii] Bernanke, Ben & Kuttner, Kenneth. "What Explains the Stock Market's Reaction to Federal Reserve Policy?" 2003. https://www.frbsf.org/economic-research/files/kuttnerdraft_02-07-03.pdf
[iv] Source: J.P.Morgan Asset Management https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/investment-outlook-for-2020/us-equities
[v] Source: FactSet. Earnings Insight