From the desk of the CIO
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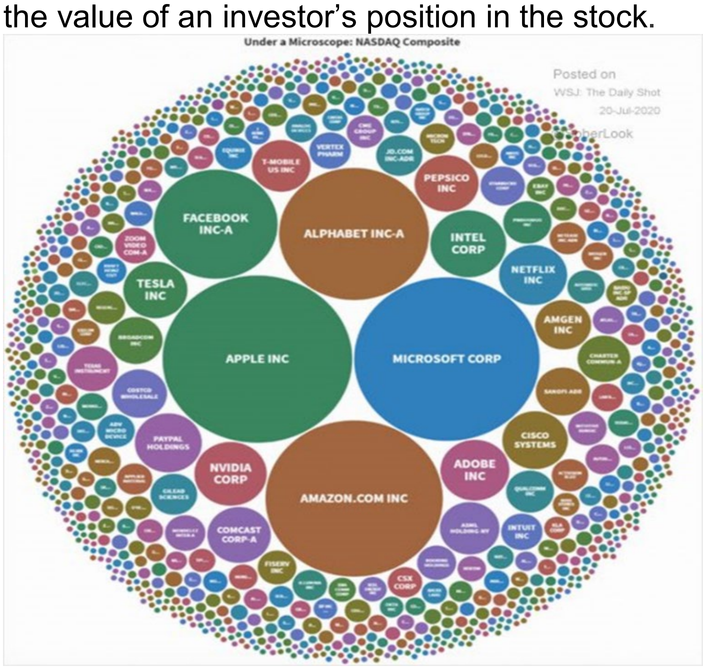
Big Tech Domination

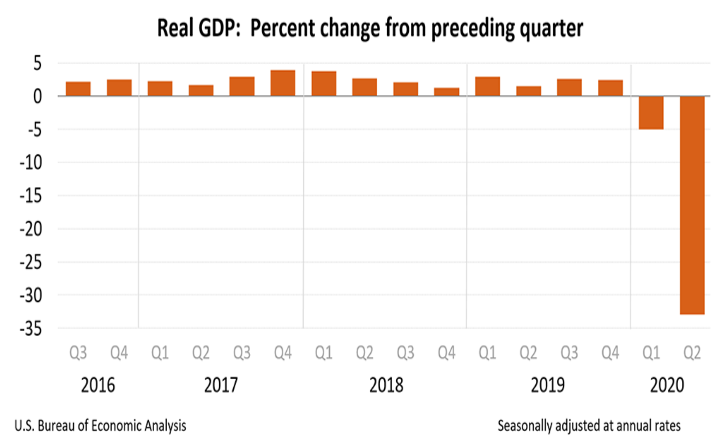
Recovery in the major market averages (Dow Jones Industrial Average, S&P 500 and the Nasdaq) since the March 23rd lows, has been somewhat deceiving. The picture below provides an interesting visualization of just how much the five largest companies; Facebook, Alphabet, Apple, Microsoft and Amazon dominate the Nasdaq index in terms of relative market capitalization (price per share multiplied by the number of shares outstanding). In fact, these five comprise 22%, or one fifth of the market capitalization weighted S&P 500 index, the index most widely publicized and followed. The five have collectively returned 35% year to date, while the remaining 495 S&P 500 components have an average performance of - 5% for the year so far.

Apple reported excellent second quarter financial results last week sending the stock price even higher. In addition, the company announced a 4-for-1 stock split. Typically, a company splits its shares to make the stock more widely available to smaller investors. A stock split has no impact on the value of an investor's position in the stock.



Economic Data

As anticipated, the second quarter "Advance Estimate" of gross domestic product (GDP) for the United States declined at an annualized rate of 32.9% over the first quarter of 2020. Savvy investors tend to look ahead several quarters so the decline in GDP was met with a shoulder shrug by investors. "Stay-at-home" orders were issued in March and April, and then lifted in most areas in May and June. Breaking down the components of real GDP (inflation adjusted GDP) we find decreases in personal consumption expenditures, exports, private inventory investment, nonresidential fixed investment (machinery, equipment, facilities), residential fixed investment (home buying), and state and local government spending. These declines were partially offset by federal government spending.



Government spending includes temporary CARES Act programs such Payroll Protection Payments (PPP), Enhanced Unemployment Benefits, stimulus payments and other programs funded by federal tax dollars and the issuance of U.S. government debt.

Corporate Q2 Operating Results

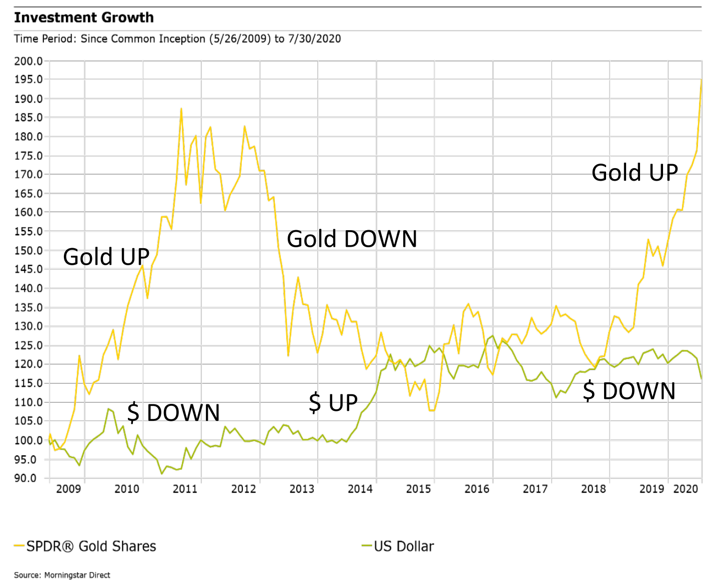
During typical reporting periods, it's all about actual results versus investor expectations. This time is a little different. Presently, analysts are flying blind with nearly half of S&P 500 companies withdrawing full-year earnings per share guidance. With that in mind, more than half of S&P 500 companies reporting second quarter earnings so far have bested expectations. However, better than expected does not mean strong overall. Certainly, some companies, the aforementioned Apple for example, had an exceptionally strong quarter amid the pandemic. For context, analysts expected a decline in earnings of -40%, a low hurdle by which to measure actual versus expected.

In order to determine if today's stock prices are justified, more information, and a lot of patience, is needed. So far, the rally in stocks off the March lows have been driven by an expansion of the PRICE (P) component of the PRICE/EARNINGS (P/E) RATIO. At some point, the "E" will have to support the "P". Investors are anticipating the recovery and continued growth of earnings. Let's hope earnings materialize in the coming quarters as expected or better for a broader swath of companies than just the aforementioned large technology companies.

Gold

The yellow precious metal has once again become a topic of note with its recent rise after a decade of moving sideways. Gold can be a polarizing subject, much like politics. Many purveyors of gold investments, coins, bricks and the like, prey on our deepest financial fears; government confiscation of assets to cover mounting debts, and the dollar's demise as the world's reserve currency.

Over short time periods, the price of gold may rise in times of uncertainty. You could call this the "fear trade". However, like market corrections, the fear trade does not last as the fundamentals of the supply and demand drivers of gold prices take over. It is also important to note that many times gold prices have declined along with stock prices, meaning it is not a perfect hedge.



To understand the behavior of gold as an investment asset I often look to the period preceding and during the initial recovery phase out of the GFC (Great Financial Crisis). It was the environment for the rise in gold prices; the value of the dollar was in decline, people in emerging markets had increasing wealth and were buying gold jewelry and inflation was higher than it is now.

The setup is different at the moment. Yes, the value of dollar versus a basket of global currencies is down, but the value of the dollar versus many emerging market currencies is only down slightly. While some expect inflation to emerge from unprecedented liquidity injections into the U.S. and global economies, it has not materialized yet. Many were calling for rampant inflation resulting from quantitative easing designed to revive the economy from the malaise of the GFC. They were wrong. Disinflation or stagflation was the bigger risk.

Will inflation rear its ugly head this time around? Anything is possible. The cause of this recession is a health crisis, not a financial crisis. Supply chains have been disrupted. Factories have struggled to provide products and components. If demand picks up without supply to meet that demand, and liquidity is running through the financial system, inflation would certainly be the logical conclusion.

Valuation

There are many ways to value an asset. Consider the example of a residential rental real estate. The value of the property could be the present value of future positive cash flows. The value could be established on a comparative basis relative to other similar properties in the same geographic area. Value can also be established by the cost to replace (rebuild) the property.

For purposes of this note, let's just assume there are 13 ways to value the stock market. Of those 13 methods and models 2 indicate the market is inexpensive, 3 indicate the market is fairly valued, 1 indicates a mildly expensive market, the remaining 7 indicate either an expensive or very expensive market.

It is interesting to note that the models indicating an inexpensive market are both based on an analysis that uses interest rates and inflation as inputs. Both measures are at historical lows.

The point here is that valuation is often in the eyes of the beholder. It's not appropriate to call out the market as a binary expression of expensive or inexpensive. This assertion depends on developments no one can know with a high degree of certainty at this point. The best approach is to hold a portfolio consistent with your personal long term objectives and tolerance for value fluctuations that consists of high quality securities.

Rest assured, we are constantly thinking about these dynamics and others in an effort to give you and your family the best possible probability of achieving your personal financial objectives. If you have specific questions about the topics reviewed in this Market Note or the management of your accounts, please contact with your Integra Capital Advisors representative.

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