DICKMEYERBOYCE
FINANCIAL MANAGEMENT, INC.

August 13, 2020

2020 – Second Quarter Review

Attempting to Return to Normal with an Active Covid – 19 Virus

The economic data is coming in and is giving us a numbers' view of the impact of the shutdown and our attempt to reopen the economy. First quarter real GDP decreased at a 5% annual rate. Second quarter real GDP decreased at an annual rate of 32.9%.

While the CARES Act ($2.1 Trillion Federal package) and the Federal Reserve Bank purchasing of assets and lending programs ($3 Trillion) did not fully replace idled industries and GDP, it did impact income and savings. Personal income was up $1.39 Trillion in the 2nd quarter. Disposable personal income was up $1.53 Trillion for an increase of 42.1%. So, we enjoyed more income and less taxes in the second quarter. We also spent less money. Personal outlays declined $1.57 Trillion. Personal savings increased $4.69 Trillion in the 2nd quarter. That equates to a savings rate of 25.7%. For some perspective, as a nation, we have been averaging a savings rate of 8%.

By the end of the 2nd quarter, a 100% stock portfolio with 20% invested in international was down approximately 6.46% with dividends reinvested. Intermediate term bonds were up 6.42% (Barclay's Aggregate Bond Index) and short-term bonds were up 2.45% (S&P Short Term Bond – Gov't/Corporate Index).

Last quarter, we discussed worst case and best-case scenarios for the economy and the securities market. Let's review: We did not anticipate the economy nor the stock market to decline as much as with the Great Depression given the massive action by the Federal Government and the Federal Reserve Bank. But we thought a retrenchment back to the March 23rd lows or worse was possible. It does appear the economic decline has been in the middle (about 36%) of the very wide range anticipated (between 10 and 50%). Thankfully, for all our nerves, the best-case scenario of a gradual recovery in the stock market has occurred. Also, the bond trading facilities established by the Federal Reserve has unfrozen the trading pipes in the bond market. The hardest hit areas have recovered significantly, but still trail the core/high quality government and corporate bonds. Bonds in the energy, travel, hospitality, and entertainment industries are languishing the most.

So, here we are, about half-way through the 3rd quarter. Covid 19 is still with us in a big way. Travel, hospitality, entertainment industries, and office capacity utilization rates are rising slowly from very depressed levels. We all want the economy to pick back up, but we feel trepidation about increased interaction. This points to a gradual economic recovery at best.

What is the evidence around economic recovery? By the end of April, 20 million jobs had been lost and the official unemployment rate was 14.7%. At July month end, the unemployment rate was 10.2% with 9.3 million jobs recovered from May through July.

The Institute of Supply Management (ISM) reading for manufacturing rose to 52.6 in June from 43.1 in May. The ISM reading for service rose to 57.1 in June from 45.4 in May. A reading of 50 is the dividing line between decline and growth. For the month of July, ISM service was 58.1 and ISM for manufacturing was 54.2. We are heading in the right direction.

Retail sales rose 18.2% in May, 7.5% in June, and 8.4% in July. These are annualized rates. The June reading was 5% higher than June of 2019 with the lion's share of the gain coming from non-store retailers.

The National Bureau of Economic Research (NBER) projected an annualized decline in real GDP of 40% in the 2nd quarter. As mentioned above, the actual result was a decline of 32.9%. NBER is also projecting an increase of 20% in the 3rd quarter and a decline in real GDP of 7% for the year.

Add cheap money to the list of Fed Government and Federal Reserve Bank's efforts to keep the economy going in the face of this pandemic. Existing home sales, new home sales, and housing starts had huge gains of 20.1%, 13.8%, and 17.3%, respectively. But this leaves us around 11% behind the pace of 2019. The home ownership rate is now up to 67.9% from 64.1% a year ago. The new reading is the highest since mid-2008.

Durable goods sales were up 7.3% in June from May, with the automobile sector up 85.7% and non-defense spending (proxy for business investment) up 3.3%. Overall, durable goods sales are down 15% from the February level.

The economy has taken a large hit and is being propped up by extraordinary fiscal and monetary action. The stock and bond markets have responded well. Are stocks overvalued? Can this recovery stay in place up until we have a vaccine and or a cure for Covid-19? These questions are difficult to answer and clues are murkier than normal.

Valuation discussion points:

- By the end of the 2nd quarter, as measured by price to book value, growth stocks were 115.7% above their long-term average and value stocks were 6.9% below their long-term average.
- By the end of the 2nd quarter, growth stocks were up 8.41% and value stocks were down 16.71%.
- Technology stay at home companies are thriving and experiencing unprecedented growth in the Covid environment (think growth). Companies more dependent upon people migration and person to person interaction are seeing sales declines (think value). In some cases, sales elimination. There are exceptions, like Clorox, Kroger, McDonald's, trucking, pharma, healthcare, and others.
- The market capitalization weighting of the worst performing industries (department stores, travel services, oil and gas equipment and services, resorts and casinos, hotel and motel, and the next 15 lower performing industries) have little impact on index returns. The top five companies in the S&P 500 account for 23% of its capitalization. These companies (Amazon, Apple, Microsoft, Facebook, and Google) enabled the S&P 500 index to return to positive territory by the middle of July, <u>meanwhile the rest of the remaining 495 companies were collectively in the red.</u>
- Low interest rates validate higher valuations. Think about buying a home, with lower interest rates one can afford to pay a higher price. Similarly, lower interest rates validate higher price/earnings ratios for stocks. One way to evaluate the valuation of a stock is to compare its earnings yield to the yield of the 10-year Treasury bond. Earnings yield is simply the inverse of the price/earnings ratio, or earnings/price. The 10-year Treasury is presently yielding about 0.60%, or 0.006. So, if a company has a p/e ratio of 50, its earnings yield is 0.02. The company's earnings yield exceeds the yield of the 10-year Treasury. Therefore, the company with a p/e ratio of 50 is a reasonable valuation on a relative basis. A p/e ratio of 166 (1/166 = 0.06) is equivalent to the yield on the 10-year Treasury. Amazon's p/e ratio is 118. Tesla's p/e ratio is 711.
- There is a saying, "you can't fight the FED (Federal Reserve Bank)", let alone the federal government. The Federal Reserve has many monetary levers at its disposal to carry out its mission of full employment and stable inflation. It is their mission to help the economy return to health. Many people credit the FED with aiding the longest bull market in history that ended in March at the hands of pandemic hysteria.
- **<u>Economic</u>** volatility's impact upon stock market returns has been studied by Jim Paulsen, chief investment strategist of Leuthold Group. Mr. Paulsen found that since WWII, market returns are highest (average 21.2%) when economic volatility is highest. He also found that when economic volatility is in the lowest quartile, market returns were a close second at 16.6%. In the middle quartiles, market returns averaged 6.5%. Mr. Paulsen expects that the economic volatility index will hit record highs in the coming months. Mr. Paulsen believes that when economic volatility is high, "policy officials are scared to death, and they are bringing every conceivable tool they have to get us out of the situation".

Valuation conclusions:

- In normal circumstances, valuation of growth stocks would be considered out of sight. Value stocks would be in line for a major comeback, but also high given the economic backdrop.

- Covid has created its own set of winners and losers. The valuation of certain growth stocks is made more reasonable based upon their enormous success in this Covid environment.
- A combination of the last three discussion points above indicate support for the prices of all stocks, winners and losers (except in bankruptcy), in this extraordinary time. Low interest rates help justify higher p/e ratios. The federal government and Federal Reserve policy officials are scared to death and will continue to deliver uncommon and exceptional tools to reach the other side of Covid.

DBFM has always included quality "growth" companies in portfolio strategies as we have found some of them to be of reasonable value. We are expanding the use of these quality growth companies as well as mutual funds that use them in client portfolios. At some point, valuations will become even more stretched and investors will sift through value stocks for opportunities. That has been a mini trend since July 10th.

Please feel free to contact us with any questions, or if you would like to schedule a virtual, face to face, or phone meeting.

Thank you,

Dave Dickmeyer, M.B.A.
Wealth Advisor
Principal Owner

Ian D. Boyce, CFP®
Certified Financial Planner™
Principal Owner