KWB WEALTH®

JULY 2020

# COVID's Effects on Stocks and Bonds

## 3RD QUARTER NEWSLETTER

### KEY TAKEAWAYS

GDP might have bottomed in April or May. Did we just live through history's shortest recession?

The S&P 500's P/E ratio is at its highest level since 2000's Dot Com bubble. How? Corporate earnings estimates were revised down, and the market remains near all-time highs.

The traditional 60/40 stock to bond/cash ratio might not be enough risk to get investors through retirement these days.

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When I write the Quarterly Newsletter, I always like to review previous newsletters to get a sense of what was on our minds. A year ago, we were discussing tariffs and a trade war that some economists believed would derail the economic expansion ... oh, simpler times.

Obviously, last quarter's newsletter painted a bleak economic picture. The economy did indeed enter a recession that began in March according to the National Bureau of Economic Research (NBER). The NBER declares when the US enters and exits a recession. While it usually takes a few months after the bottoming of the economy for the NBER to declare a recession "over," it's certainly possible we just lived through the quickest recession in history. The Gross Domestic Product (GDP) may have bottomed out in April or May, making this a 2 to 3-month recession. Businesses are now opening back up, and while we're not out of the woods, repeating an economic shutdown does not seem favorable to any politician. There may be more targeted shutdowns (like the recent shutdown of bars in various California, Texas, and Arizona counties), but the same full-scale shutdown we experienced a few months ago seems unlikely.

As for the stock market, here's what I wrote last quarter:

> *The COVID-19 virus falls into our "TOO HARD" pile, because we have no clue when the news will start getting better or when the market*


**CHART ONE:** SOURCES: FACTSET, FRB, ROBERT SHILLER, STANDARD & POOR'S, THOMSON REUTERS, J.P. MORGAN ASSET MANAGEMENT.

*might look past the headlines and start to go back up. For all we know, the market could have bottomed on Monday, March 23rd. If the market leads the economy by six months, as the saying goes, then it's certainly possible.*

Hindsight is, of course, 20/20. Virus news did get better (a little), but largely it seems the market has decided to look even further forward than usual when pricing in what comes next. Unfortunately, it is still much too soon to know what will happen in the coming months, but this hasn't stopped the market from roaring back from March 23rd's lows. Here's what this year has looked like for the S&P 500 (including dividends):

January 1st – February 19th: +5.21%

February 20th – March 23rd: -33.86%

March 23rd – June 8th: +45.33%

June 9th – June 30th: -4.15%

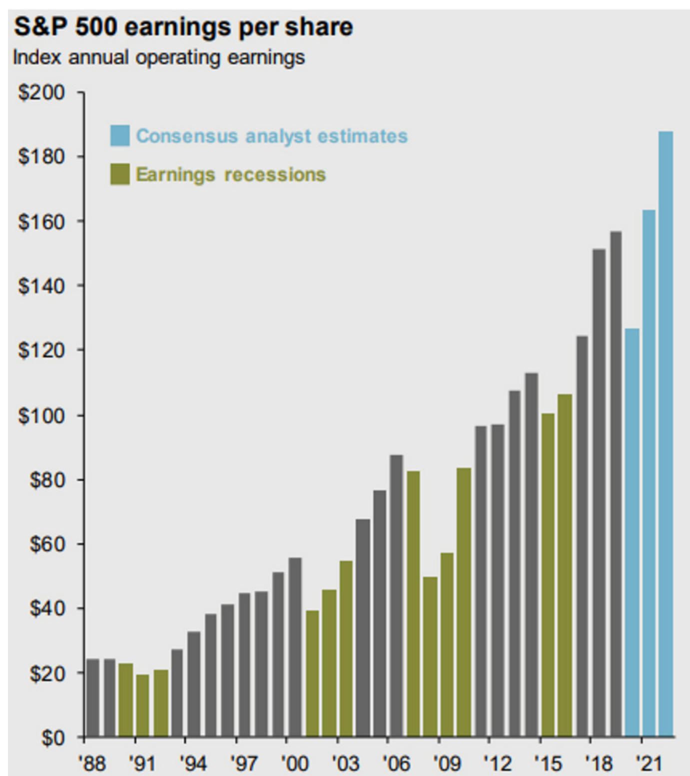


**CHART TWO:** SOURCES: COMPUSTAT, FACTSET, STANDARD & POOR'S, J.P. MORGAN ASSET MANAGEMENT.

Corporate earnings estimates are being revised down and the market is only about 10% away from it's all-time high. This has spurred the Price-to-Earnings ratio of the S&P 500 to its highest level since the Dot Com bubble in 2000 (as shown in Chart 1).

Chart 2 shows analysts' projections that 2020 earnings will fall to 2017 levels but will bounce back in 2021 and beyond. Are market participants too optimistic that companies will bounce back this quickly after 2020? It's hard to say at this juncture, but we expect volatility will remain elevated as news/earnings reports come in over the next few quarters. This is a truly unprecedented event, and no one knows the correct way to handicap how the current situation will play out – and if they say they know, they're lying.

Perhaps our biggest concern moving forward has to do with bonds. The 10-Year Treasury Bond is currently yielding 0.66% and the 30-Year Treasury Bond is yielding 1.41% (see in Chart 3). After inflation, you are basically paying the government to hold your money – even over 30 years.

That leaves the traditional 60/40 balanced allocation (60% stocks and 40% bonds/cash) little to no growth from 40% of the total. If you were to receive the historical real (after inflation) return of 6.8% from your stock allocation, you'll likely only earn a total of 4% from a 60/40 allocation. If inflation were to climb any higher, it would eat away even more from that number. Jeremy Siegel, author of "Stocks for the Long Run," said on a recent conference call that he believes 75/25 – which under the same return assumptions would return ~5% - will be the new 60/40. Investors will need to accept additional risk to outlive their money in retirement.

We still believe bonds serve a necessary purpose in asset allocation; they are the safety net when stocks experience their inevitable bouts of volatility. However, bonds no longer serve as a secondary growth vehicle – an additional function they have provided since the 1980's. Considering this fact, it will be important to have a plan that shows the necessary portfolio growth to fund your retirement, then compare that with your risk tolerance. You may discover additional risk is needed to meet your retirement goals.

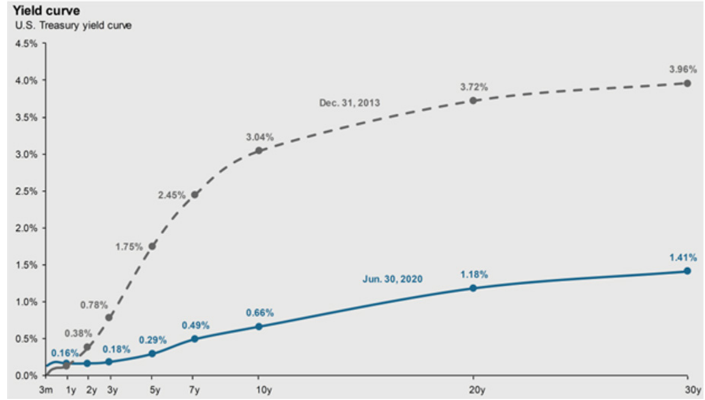


**CHART THREE:** SOURCES: FACTSET, FEDERAL RESERVE, J.P. MORGAN ASSET MANAGEMENT.

If you'd like to hear additional thoughts from our team, please join us Friday, July 17th at 9 a.m. for our Virtual Economic Discussion! We're meeting via Zoom, allowing you to join from the comfort of your own home using your computer, tablet, or smart phone. You can submit questions during the discussion, and we'll answer them at the end. Go to our website for more information and to register for the event. We hope to see you there!

**As always, if you have any questions please contact us and stay safe.**

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