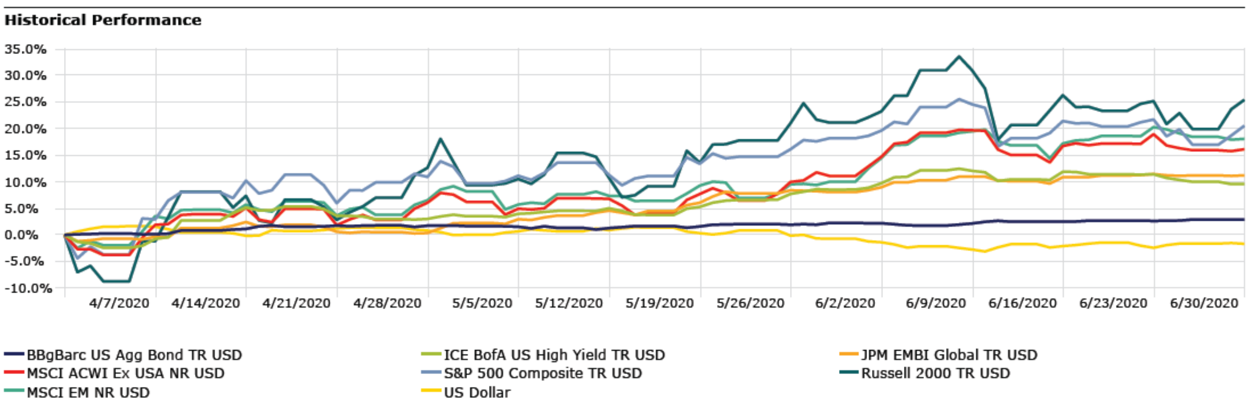
Q2 2020 Market Commentary

As US states began to reopen businesses and public spaces, COVID-19 case spikes have largely left those plans paused or postponed. The underlying economic fallout from the pandemic is growing as revenues wane and defaults rise while the world hopes for a vaccine.

Global Markets Performance

Per Morningstar, the US stock market, as represented by the S&P 500, finished up 20.54% on the quarter, reversing a similarly negative return last quarter and posting a net -3.08% on the year so far. Smaller US stocks[1] rose further, up over 25% for the quarter but are still down -12.98% this year. International stock markets[2] and emerging markets[3] trailed domestic equity markets but performed well in the quarter with returns of 16.12% and 18.08%. On the credit side, core bonds[4] rose 2.90% and high yield bonds[5] rose as well, up 9.61% for the quarter, impacted primarily by significantly tightened spreads[a]. Emerging market (EM) bonds[6] rose as well, up 11.21% on the quarter.



Calendar Year Returns

	YTD	2019	2018	2017	2016	2015
BBgBarc US Agg Bond TR USD	6.14	8.72	0.01	3.54	2.65	0.55
ICE BofA US High Yield TR USD	-4.78	14.41	-2.26	7.48	17.49	-4.64
JPM EMBI Global TR USD	-1.87	14.42	-4.61	9.32	10.19	1.23
MSCI ACWI Ex USA NR USD	-11.00	21.51	-14.20	27.19	4.50	-5.66
S&P 500 Composite TR USD	-3.08	31.49	-4.38	21.83	11.96	1.38
Russell 2000 TR USD	-12.98	25.52	-11.01	14.65	21.31	-4.41
MSCI EM NR USD	-9.78	18.42	-14.57	37.28	11.19	-14.92
US Dollar	1.04	0.22	4.40	-9.87	3.63	9.26

Coronavirus Update

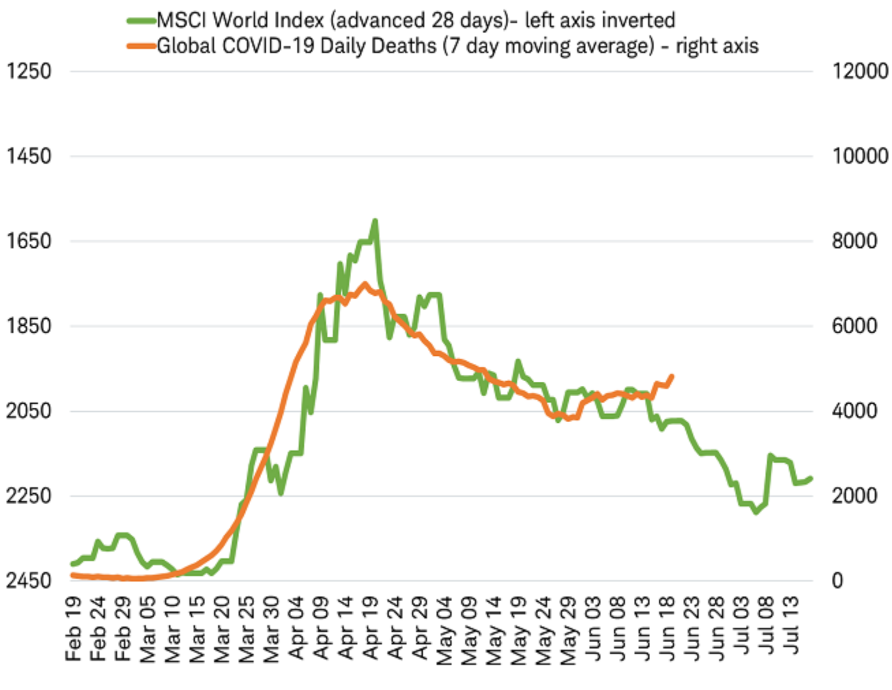
Since our last quarterly letter in early April, the coronavirus pandemic peaked, retreated, and now appears to be spiking again in the United States. As of July 6th, the US reported over 2.9 million cases and over 130,000 deaths related to the pandemic[8]. In addition, the highest daily incidence to date was recorded on July 3rd at over 57,000 new cases[9].

Other countries around the world are facing similarly daunting battles with the virus. While the US holds the highest total case count globally and cases are rising, the virus is currently accelerating most aggressively in Africa, South America, southeast Asia, and the eastern Mediterranean[10]. But countries all around the world continue to fight this disease in various waves.

From an investment perspective, investors are pricing in a complete rebound in S&P 500 earnings to pre-COVID levels by the end of 2021[11]. That pace is much faster than many leading economists and international economic entities forecast, which generally point to the end of 2022 at the earliest[12].

Future stock market performance will continue to be influenced by developments on the virus as they relate to economic shutdowns, case counts, and deaths. However, recent data in the US suggest that the mortality rate may be lower going forward as an increasing percentage of cases are amongst younger generations with stronger inherent immunities to combat the virus[13].

Stocks Focused On Deaths Not Cases



Source: Charles Schwab, Bloomberg. As of June 20, 2020.[13]

This is a relative positive and may in part help to explain the resilience of the US stock markets despite the current economic recession. As seen here, analysts at Charles Schwab Investment Management recently reported that stock markets appear to be focused on the trend in virus-related deaths as opposed to case counts[14]. That reasoning is somewhat logical as there is insufficient testing to capture all active cases and thus case data may not be as robust as fatality statistics.

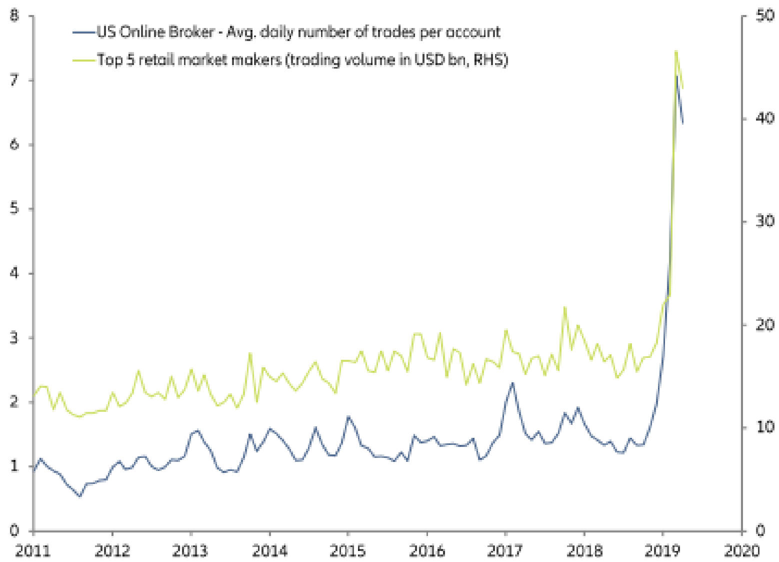
However, we should continue to watch this trend as the US experiences a rebound in cases and as the mortality rate adjusts to reflect the affected demographics. There are myriad forces impacting the markets each day in addition to coronavirus statistics.

The Robinhood Effect

Tuning into the financial news networks these days nearly guarantees a mention of the retail trading boom and its collective effect on the markets. And no app has received greater publicity than Robinhood, which offers free accounts and free trading in stocks, options[b], and other assets to the general population. While it's impossible to quantify the exact impact of increased trading by such investors, there is some likelihood that this trading has led to higher volatility on both the upside and the downside.

Research from German financial giant Allianz illustrates the degree to which retail trading may be affecting certain segments of the markets through the strong increase in trades per day on US online brokerage platforms. Options volume on the S&P 500 in retail-sized trades currently accounts for approximately 13% of total volume[15]. In certain blue-chip[c] individual stocks, the same type of trades now account for 20-30% of total options volume[15].

While Markets Crashed, Retail Trading Increased Significantly



Source: Company data, Bloomberg, Allianz Research.[14]

The recent case of a rental car company offers further evidence of retail impact on the markets. In the three weeks leading up to June 14th, the company declared bankruptcy, saw its stock price rise over 1,400%, and subsequently fell by 75%[16]. During that time, the reported number of Robinhood users holding this stock increased by over 200%[15].

Further, as the pandemic began to unfold and investors anticipated the implications for online communication, the price for an electronic equipment provider was bid up almost 800%[15] in a manner of three weeks. However, some investors had mistaken this equipment provider for a similarly named video-conferencing service run by an entirely different company. The price of the former subsequently declined from $60 to under $1[15].

Thus, it's important to recognize that over the short-term markets can be irrational, exuberant, and sometimes flat out wrong. But investing over the long-term can aid us in avoiding these dislocations and in building wealth through strategic and intelligent planning.

Looking Forward

The third quarter of this year is likely to be dominated by two topics: coronavirus (both case growth and treatments/vaccines) and the US presidential election.

Medical experts including US NIAID Director Anthony Fauci have generally pegged the arrival of a vaccine no sooner than the first half of 2021[17]. As of this writing, there are at least seventeen vaccines being tested in human trials around the world[16], one hundred seventy-nine total vaccines in development, and over two hundred sixty treatments being studied[18]. As these vaccines and treatments progress through trials or fail to prove effective, markets should react accordingly.

The 2020 US presidential election has the potential for greater consequences than prior elections, and thus is likely to become a more dominant topic in markets as we get closer to November. As of July 6th, Joe Biden held a 17.8 point average advantage over President Trump in betting markets[19]. At stake in this election are different approaches to the COVID-19 pandemic, US-China relations, fiscal policy, and the role of government, among others.

As we look forward into a sea of uncertainty, it's important to remember that long-term investing can be a ballast to which we generally can hitch our financial plans. Over time, the probability of achieving your investment goals can be best met not by timing the markets but by making regular contributions, increasing those as possible, and sticking to a disciplined approach[20].

Times of great uncertainty, like the present, are times to reevaluate short-term needs and how they fit within your larger goals. They generally should not be the times to adjust your portfolios based on fear or other behavioral concerns. If your financial situation or goals have changed, please reach out to your financial advisor to discuss your plan.

As of June 30, 2020.

mABC LLC Investment Advisors

References:

Smaller US stocks[1] – as represented by the Russell 2000 TR Index

International stock markets[2] – as represented by the MSCI All Country World ex-USA Index

Emerging markets[3] – as represented by the MSCI Emerging Markets TR Index

Core intermediate bonds[4] – as represented by the Bloomberg Barclays US Aggregate Bond Index

High yield bonds[5] – as represented by the ICE BofAML US High Yield Index

Emerging market bonds[6] – as represented by JPM Emerging Market Bond (EMB) Global Index.

Morningstar performance data[7] – sourced from Morningstar Direct, 2020.

Coronavirus cases and fatalities[8] – sourced from Johns Hopkins University & Medicine Coronavirus Resource Center, "COVID-19 Dashboard by the Center for Systems Science and Engineering (CSSE) at Johns Hopkins University (JHU)", 6 July 2020. https://coronavirus.jhu.edu/us-map.

Coronavirus daily case incidence[9] – sourced from Centers for Disease Control and Prevention, "Coronavirus Disease 2019 (COVID-19)", 6 July 2020. https://www.cdc.gov/coronavirus/2019-ncov/cases-updates/cases-in-us.html.

Virus acceleration[10] – sourced from Our World in Data, "Coronavirus pandemic – Country comparisons," 6 July 2020. https://ourworldindata.org/coronavirus-country-comparisons.

S&P 500 Forward Earnings Estimates[11] – sourced from Yardeni Research, Inc., "YRI S&P 500 Earnings Forecast," 6 July 2020. https://www.yardeni.com/pub/yriearningsforecast.pdf.

Economic growth forecast[12] – sourced from the International Monetary Fund, "World Economic Outlook Update," June 2020. https://www.imf.org/en/Publications/WEO/Issues/2020/06/24/WEOUpdateJune2020.

Age of coronavirus cases[13] – sourced from CNBC, "Dr. Anthony Fauci says the average age of U.S. coronavirus patients has dropped by 15 years as Sun Belt states gets hit," 6 July 2020. https://www.cnbc.com/2020/07/06/dr-anthony-fauci-says-the-average-age-of-us-coronavirus-patients-has-dropped-by-15-years-as-sun-belt-states-gets-hit.html.

Stocks, deaths & cases[14] – sourced from Charles Schwab Investment Management, "What A COVID-19 Second Wave Means For Investors," 23 June 2020. https://www.schwabfunds.com/content/what-covid-19-second-wave-means-investors?mkt_tok=eyJpIjoiTmpaaE56UXlNamxrWlRObSIsInQiOiJSWXZpbVhaRjRXV1I1NUJ5clpEbGRYXC9pTmk5VmltQjU3XC9TVWh0WGoyMjBGbGxMejQyZmlxM1doV294NUhvcWR3MHVrOGR4NlhRalhJNjJiT2pPNXVjYlBBRTZzTElNNis1a0ZNN1FpYVIreENcL3J6R2hxTlV4VExnTjAwQmVjTCJ9.

Electronic equipment provider price data[15] – Calculated with data from Allianz, "When Main Street Makes It To Wall Street," 25 June 2020. https://www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/economic-research/publications/specials/en/2020/june/MainstreetWallstreet.pdf.

Options volume[15] – sourced from Allianz, "When Main Street Makes It To Wall Street," 25 June 2020. https://www.allianz.com/content/dam/onemarketing/azcom/Allianz_com/economic-research/publications/specials/en/2020/june/MainstreetWallstreet.pdf.

Hertz bankruptcy[16] – sourced from Motley Fool, "Why Investors Should Steer Clear of (Most) Robinhood Stocks," 5 July 2020. https://www.fool.com/investing/2020/07/05/why-investors-should-steer-clear-of-most-robinhood.aspx.

COVID human trials[17] – sourced from GoodRx, "Live Updated: The Race for a Coronavirus (COVID-19) Vaccine," 1 July 2020. https://www.goodrx.com/blog/coronavirus-covid-19-vaccine-availability-live-updates/.

Vaccine & treatment data[18] – sourced from Milken Institute FasterCures, "COVID-19 Treatment and Vaccine Tracker," 6 July 2020. https://covid-19tracker.milkeninstitute.org/#vaccines_intro.

Presidential election odds[19] – sourced from RealClear Politics, "Betting Odds – 2020 U.S. President," 6 July 2020. https://www.realclearpolitics.com/elections/betting_odds/2020_president/.

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Glossary:

Spreads[a] – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

Options[b] – a contract that gives the buyer the right, but not the obligation, to buy or sell the underlying asset at a specified price prior to a specified date

Blue chip[c] – typically large capitalization, well-known brands.

Fiscal spending & budget deficits – fiscal spending relates to all government expenses, and a budget deficit implies a government is spending more than it is receiving from taxes, interest, etc.

Liquidity vs Solvency – liquidity relates to having enough cash on hand to continue operating in the short term, while solvency relates to the long-term and whether or not equity is sufficient to continue operating.

Repos (repurchase agreements) – in repurchase markets, borrowers needing cash offer lenders collateral, generally in the form of safe bonds (such as US Government bonds), and in return receive a short-term loan. Repo agreements can be as long as one year, but are generally three months or less, and the most popular tenure is an overnight loan.

Federal funds rate – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Goldilocks – describes an economy that's neither too hot as to spur rapid inflation or too cold to cause a recession; it characterizes an economy operating in an optimal state from a macroeconomic standpoint.

Yield curve – the graphic representation of US Treasury securities as defined by their yield and time to maturity.

One-month & ten-year rates – on the US government yield curve, the securities issued with maturities of one month and ten years, respectively. The US Treasury also issues securities between one month and ten years, and longer than ten years.

Asset location – the tax-arbitrage strategy of placing high-tax exposure assets in low tax-paying accounts, and vice versa. The theoretical benefit is to lower taxes from investments and compound higher long-term capital.