HALLMARK CAPITAL MANAGEMENT

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UNHAPPY BULLS?

Future historians will have a field day writing about 2020. A lot was packed into the first six months: the worst global pandemic since the 1918 Spanish Flu, unemployment levels not seen since the Great Depression, Federal deficits rising at a World War II spending pace, social unrest reminiscent of the 1960's civil rights era, a stock market crash ranking with 1987 or 1929, followed by a rally with some of the flavor of the 1999 Internet Bubble. Unsurprisingly, data from various sources show that the turmoil has made many people unhappy. Two universities studied billions of stored tweets and they determined that Americans were more unhappy during the last week of May than at any time since Twitter was founded in 2006. Similarly, a new AP-NORC poll showed that only 14% of Americans described themselves as "very happy," a number that had previously never dipped below 29%. Perhaps future academics will be able to make sense of it all.

In addition to all the above, many observers thought the stock market became detached from reality this year. With the economy reeling from the virus lockdowns, it seemed counter intuitive that the Indexes would post their fastest increases in eighty-seven years. Unless Wall Street was being driven higher by the 14% of the population who were very happy, there must have been some unhappy, but optimistic, investors out there. What were they thinking? Part of the answer lies in the unique nature of this economic contraction and some strong divergence in performance among stocks within the Indexes.

GOVERNMENT MONEY TO THE RESCUE

Past downturns generally arrived unannounced and unexpected. By the time fiscal and monetary officials realized there was a problem, a recession was already well underway. Their delayed response was generally too little, too late. This time, however, government officials immediately knew that a recession was starting, because they were the ones causing it. They also recognized they needed to respond dramatically because of the massive damage they were inflicting. The flood of trillions of dollars from the CARES Act and the emergency measures taken by the Federal Reserve cushioned the full force of the blows from the lockdown. Millions of Americans were thrown out of work, but a fortunate, sizable minority received more in unemployment benefits than their former wages. Thanks to the receipt of government checks, April recorded the largest monthly rise in personal income, even in the face of record unemployment. Nothing like this has ever been seen before. Retail sales were up 17% in May and were only down 6% from the year-ago period. New home sales actually increased on a year-over-year basis in May. The risk profile from this recession is totally unlike any in the past and investors have responded in different ways as well.

Fiscal spending put cash into consumers' pockets, but the lower interest rates from the Federal Reserve was the spark that set the value of stocks and bonds on fire. There has always been a strong relationship between the level of inflation-adjusted interest rates and the value of financial securities. Bond prices and interest rates are mathematically tied, but the impact on stocks is more complex. First, income-oriented investors compare the cash generated from holding stocks and bonds. If bond rates are too low, then stocks appear the more attractive choice to generate income. After the Fed cut rates, the 1.9% S&P 500 dividend yield was almost triple the yield on ten-year U.S. Treasury notes, providing more than enough incentive to shift asset classes. Also, financial theory states that a stock price should represent the sum of a company's expected earnings stream, discounted to present values by the prevailing rate of interest. Changing that interest rate generates an outsized effect on the theoretical fair value of a stock. For example, assume an investor was convinced that a company was going to grow its earnings to $10/share in 2070, half a century from now. If the prevailing interest rates happened to be 10%, that single $10 of earnings in the far future would translate into only $0.09 of theoretical value today. Given the uncertainty of achieving any particular level of earnings that far out, such estimates probably wouldn't factor into anyone's decision making. At a 2% interest rate, however, that single future $10 of earnings would theoretically be worth $3.72 to the stock price now. Earnings from other years would add to the present value in the same manner. Through this mechanism, it is easy to see why the stock market has reacted so strongly once Chairman Powell announced the Fed's policy changes. Future earnings became far more valuable in a very low interest rate environment. Companies exhibiting fast rates of growth, with the potential to compound their earnings well into the future, received a larger benefit than other stocks from the lower discount rate.

SIZE MATTERED

Small businesses took the brunt of the forced closures, while most large businesses had the financial resources to weather the virus shutdowns. This can be seen in the relative performance of the smaller capitalization S&P Indexes compared to the larger-cap S&P 500 Index. The ten largest stocks in the S&P 500 Index were up 7% in the first six months, while the entire 500 Index suffered a 3.1% loss on a total return basis: the smaller S&P MidCap 400 Index declined 12.8%, while the SmallCap 600 Index was down 17.9%. Outside of the largest firms, the performance of most stocks was more consistent with the public's expectations of how the markets should be behaving, given the horrid economic news. Through the end of June, 73% of the stocks in the S&P 500 Index and over 80% of the names in the MidCap and SmallCap Indexes were down, posting average declines of 22.5%, 25.5% and 31.8% respectively. Investors in anything but the largest stocks likely shared at least some of the pain that was being felt by the rest of society.

TECHNOLOGY RUSH

The COVID-19 crisis pulled the cloud-based, virtual economy forward at a rapid pace. As employees were forced to work from home, the need to modernize and equip a mobile staff accelerated the adoption of many technology platforms. At the same time, the established shift in consumer spending toward online stores and delivery took a massive leap ahead. It is estimated that over 40 million Americans ordered at least some of their groceries online in March and April. Probably ten years of anticipated change in consumer behavior occurred in ten weeks. Due to the pronounced trends, many investors believed that the large-cap tech companies had largely broken free of recession worries, even though the earnings estimates of some of these companies actually were impacted and the results of a few of them look far from stellar.

After outperforming value stocks by 30%, valuations for the favored growth companies are now very steep, so these companies will have to maintain, or accelerate, their growth rates to fully justify their recent prices. The only times that growth stocks have been as relatively expensive to value stocks was back in the so-called "Nifty Fifty" era in 1975 and during the Internet Bubble. In those earlier cases, investors over-estimated the ability of companies to sustain above-average rates of growth and the stocks eventually suffered. It is possible that the rapid adoption and vast improvements in technology might prove to be more resilient this time, but it is inescapable that posting 20%-25% growth becomes far more challenging for a behemoth than a smaller company.

Also, the tech giants, with such obvious profitability, could be an attractive tax target for hard-pressed state and local governments now facing sudden revenue shortfalls. According to the Tax Policy Institute, the COVID-19 pandemic will have a devastating effect on many states' receipts, possibly to the tune of $200 billion this year and next. Four states are already studying proposals for ways to tax the large technology companies, including adding an online sales tax, imposing taxes on the collection and sale of consumer data and also raising payroll taxes on companies above a certain size. If a few states are successful in passing these laws, others will be tempted to jump on the bandwagon. Also, anti-trust investigations on several of these companies are winding their way through the Justice Department and could change the competitive position of one or more of the big firms.

THE RECESSION IS DEEP AND BROAD, BUT FOR HOW LONG?

The magnitude of a recession is measured not only by its depth and breadth, but also its length. The peak-to-trough drop in GDP of this downturn will be remembered as one of the deepest and broadest declines the U.S. has ever experienced. The unanswered question is how long it will last. Statisticians do not mark the end of a recession when life returns to the pre-recession levels. It is simply the point where the economy stops shrinking and starts to grow again. Conditions can remain distressed for some time afterwards. We fully anticipate that second quarter earnings announcements are likely to be brutal. There are signs of improvement, even with the difficulties of containing the coronavirus. Retail sales, home buying, gains in employment, gasoline usage and population mobility, show the glimmerings of an economy coming back to life. If it continues and the economy stops its decline, this recession may go down in history as one of the shortest on record, only four months.

FED'S FOCUS IS UNEMPLOYMENT

In 1977, Congress decreed that the Federal Reserve's operating objectives should be achieving maximum employment, along with stable prices, now known as the "dual mandate". For most of the past decade, monetary policy's primary focus has been achieving the Bank's targeted inflation goals. That changed in March with the enormous spike in job losses. With double-digit rates of unemployment, policy makers are understandably concerned about any additional downside risks that could push even more people out of work. The Central Bank has pulled out all the stops and moved well beyond the traditional monetary tools of lowering interest rates, slashing bank reserve requirements and Quantitative Easing. For the first time, the Fed has adopted an assortment of unorthodox policies, including directly holding loans from non-financial businesses and state and local governments. Chairman Powell has made it clear that the Fed will continue to use all available devices to the fullest degree possible until they believe the crisis has passed. The message is plain – the Fed has the intention of keeping interest rates at very low levels for a long time.

With interest rates likely to be stuck at generational lows, our outlook on the bond market remains tepid. Short-term rates are likely to be anchored near zero, with only small additional returns available for moving out the maturity range. If the economy were to surprise on the upside, there is a modest risk that the Fed might allow a slightly steeper yield curve to develop in the longer end of the market.

INVESTORS EXPECTING THE FUTURE TO LOOK LIKE THE PAST

The old saying is that generals fight the last war and investors often do the same with market cycles. The temptation is to look back at the Financial Crisis and see similarities to the present situation, then assume that the upcoming recovery will mirror the last one. It is easy to see similarities between the Virus Crisis and the Financial Crisis. In both cases, a massive shock cascaded into an economic freefall and the Federal Reserve, along with the other major global central banks, reacted. Interest rates were slashed, and the financial system was flooded with liquidity. It all sounds familiar so far. If the story stays the same, then one would expect a long period of relatively weak GDP growth to follow, with low inflation, low interest rates, and a strong dollar. Future events may, in fact, unfold this way, but history does not provide many examples of one decade closely repeating the prior one. The future may hold a wider range of potential outcomes than the consensus forecast allows. In addition to the many similarities, there are also some major differences between the Virus Crisis and the Financial Crisis.

It is hard to remember now, but many governments around the world instituted austerity programs following the Financial Crisis. The 2010 Tea Party elections changed the dialog in DC and spending sequestration policies followed. Overseas, the Eurozone's debt crisis caused deflationary recessions across southern Europe, resulting in forced austerity across the Continent. Britain's Conservatives refused to follow Keynesian prescriptions and tightened government spending during a recession. Nothing could be further from the fiscal response to the coronavirus. Reporters sometimes say the COVID fight is analogous to fighting World War II. It is, but perhaps not in the way they intended. After the trillions spent on the various relief bills, the Federal deficit is expected to be 17.9% of GDP, 83% higher than the 9.8% deficit/GDP run up in response to the Financial Crisis. Only the World War II years saw deficits higher as a percentage of the economy, with the 1945 deficit equaling 20% of GDP. To give some perspective, the Great Virus fight represents more spending, in constant dollars, than the Apollo program, the Marshall Plan and the New Deal all added together. Eventually, the debt piled up from all this spending will weigh on the economy, but in the short-to-medium term this stimulus could provide quite a kick.

Also, the economic crisis is intertwined with the public-health crisis and any positive news on the health front has to be seen as bullish. If the virus caused the economy to suddenly collapse, then the reverse may also be true, and a vaccine would make a huge difference. With a world-wide vaccine hunt underway, over 100 potential candidates are under consideration. Some of the brightest scientists in the world are working with an urgency rarely seen, often incorporating novel technologies only recently made available. There are no guarantees, and all the research might prove to be fruitless, but those closest to the research are encouraged by the results so far. In looking to the future, one should acknowledge that there is a reasonable chance of seeing a successful vaccine available, perhaps as early as next year. That would give the hardest hit sectors of the economy the means to recover.

THERE ARE RISKS

According to modern financial theory, the stock market is supposed to reflect the collective wisdom of investors by efficiently processing their decisions to buy and sell securities. We believe this is largely true. Unfortunately, many people take this a step further and assume that the market is always right. As noted in Barron's, if this were true, then why does the market have such frequent corrections?

The skeptics may have been right. Perhaps the stock market has lost touch with economic reality, driven by momentum investors and the fear of missing out. Economic activity may have been more severely impacted in June and July than investors realize, as the pace of new coronavirus cases has accelerated. Markets can and do overshoot fair value on both the upside and the downside and high valuations leave little room for error. While we still believe a more positive outcome should be acknowledged, there are risks.