









Economic Commentary and Review

Bulls and Bears

3rd Quarter 2020

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Markets Test Positive...For Steroids

It has been a magnificent run for markets, gaining back much of what had been lost. The rebuilding process has been swift and, at times, very powerful. To their credit, much of the hard work has been done by the companies that hold the greatest weight in key indices. Take the NASDAQ 100 as a good example of this.

On what is now known as the post-pandemic trade, companies that have become beneficiaries of the work-from-home shift have been in favor. Many of these reside within the technology sector and had been thriving even before the Covid-19 outbreak. The advancements in technology have pushed companies to keep up with the latest and greatest innovations and consumers have become more reliant on tech for many of their needs.

So, as the lockdowns, and stay-at-home orders were issued, many of the top names that were already gaining market share went into overdrive. Names like Amazon, Microsoft, Google, and Apple were well positioned going into this global shutdown.

The NASDAQ 100 is a market-cap-weighted index. What this means is that companies with the largest market value hold the biggest positions in the index. So, trillion-dollar companies hold a disproportionately large weighting.

The table above shows the weight of the top-5 names in the NASDAQ 100 ETF (QQQ):

Symbol	Company	Weight in QQQ
AAPL	Apple Inc	11.84%
MSFT	Microsoft Corp	11.67%
AMZN	Amazon.com Inc	11.14%
FB	Facebook Inc	4.22%
GOOG	Alphabet Inc	7.44%

In other words, these five companies together account for more than 46% of the index. Since these are also the companies that have performed well before and during the pandemic, they have skewed the index returns significantly. For example, Apple is up 27% in 2020 through the end of June, Microsoft 30%, Amazon 60%, and Facebook 18%. No wonder why the NASDAQ 100 ETF is up 20% this year.

A similar situation has occurred with the S&P 500 index, although to a lesser degree. The same stocks that have dominated the NASDAQ returns are also high on the list within the S&P 500, another index that is market-cap weighted. What we know from this is that while the major stock indices have recovered a good amount of the losses since March 23rd, not all stocks have seen a similar trajectory.

The large-cap indices are close to breakeven for the year, while the Russell 2000 small-cap index is still down 15%.

What we are seeing now is a bear market – the first time in over ten years that we have observed both an economic contraction and market correction of this magnitude. It is part of the cycle that moves from trough to peak and back again. It is natural that markets correct, and that the economy slows. However, not all

bear markets or economic downturns are equal.

History has shown us that major market corrections come in many different sizes and flavors. Each one has its own peculiarities and reasons as to why it got started in the first place. If we were to look at past occurrences of market breakdowns, we could split them into three basic categories.

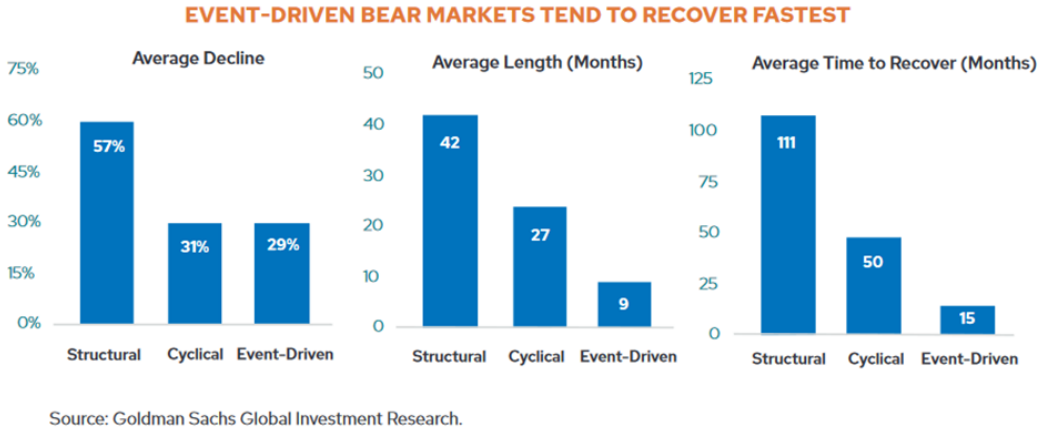
First, there is **structural**. Essentially this is the result of a market player or sector causing a systemic problem, such as over-leveraged banks or consumers. We could put the 2008-2009 financial crisis in this category.

Then there is the **cyclical** type which is more of a natural slowdown in economic activity after a period of growing production and profits. The early 1980s is probably the best example of this type of downturn. After nearly a decade of sustained inflation, the Federal Reserve raised interest rates to nearly 20 percent, pushing the economy into a recession. The combination of high inflation and slow growth — known as stagflation — was a factor behind the market drop of 27% and 21 months of economic sluggishness.

Finally, we have an **event-driven market and economic disaster** type. This is largely what we are seeing play out right now, with an unpredictable shock to the markets, such as a natural disaster or health crisis. This sort of economic condition is usually the worst and the best, all rolled up into one.

It is the worst because no one can see it coming. In the situation of a natural disaster or the current case of a pandemic, it is not something that is highly predictable. Thus, creating a significant amount of uncertainty and massive market volatility.

On the other hand, it is one of the "best" types as the deep market correction is often a temporary condition. While the shock may hit markets hard, it is usually over faster than any of the other types of bear markets. Additionally, event-driven disasters also have the ability to turn into a structural breakdown. As the economy slows due to the event/disaster, if there is not enough fiscal or monetary support sectors that are more susceptible to economic change could become problematic causing a downward spiral. This is why it was so important to see coordinated efforts from both the Federal Reserve and the U.S. Government come to the rescue so quickly.



Source: Goldman Sachs Global Investment Research.

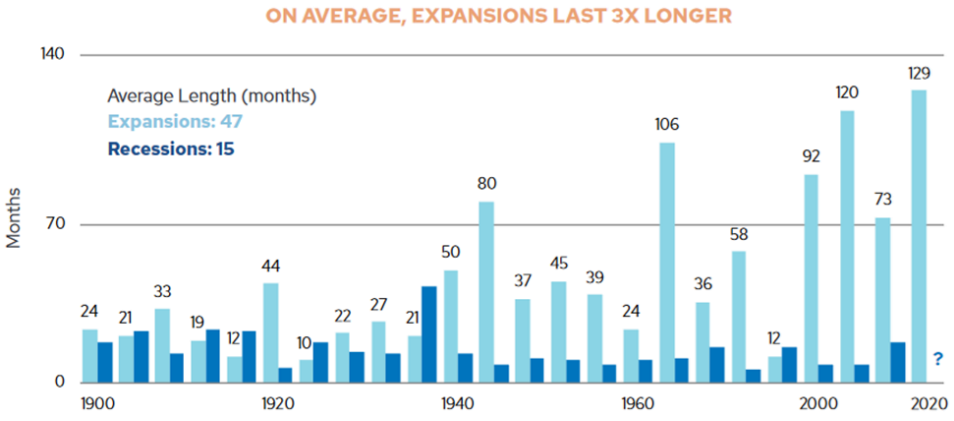
Naturally, there is no specific rule as to the length or depth of the damage that spins off any of these economic storms. We also don't have any idea how far governments are willing to go to provide stimulus and market supportive measures. However, we do have some historical precedent as to average declines for the stock market, recovery, and months that the pain will last.

While there are only a handful of bear markets throughout history that we can glean data from, the notion that event-driven bear markets can recover quicker than structural bear markets makes sense. On average, the historical recovery time from the lows back to the highs has been 15 months. With the current market, the NASDAQ did it in less than 3 months. The S&P 500 is still working on getting back to its previous high that it achieved in February 2020 and the Russell 2000 small-cap index has its work cut out for it.

Obviously, this pandemic needs to get resolved before investors and consumers can regain their full confidence in the economy. The recession that we find ourselves in, just like every recession of the past, feels like the worst one ever. Even as the stock market and the economy have dislocated, there is still a great deal of economic pain that is widespread and far-reaching. Job losses and business closings are just the tip of the problems that millions of people are dealing with on a daily basis.

As investors, we know that eventually, we will experience a market downturn. As individuals and consumers, we also have a great deal of evidence that shows us that periods of recession typically do not last long, and the stock market has a way of recovering over the long-haul.

In fact, if we want to look at the cup as half-full, we can see that, on average, expansions last about three times as long as recessions. As long as your risk tolerance is matched with an appropriate timeframe, there is a good chance that, over time, you will have a much greater chance of expansion than contraction.



Mid-Quarter Reports

On a regular basis, we research various macroeconomic themes and create quick write-ups of what the data is showing us. What follows are some of the recent reports that we have published for use with our overall research process. This may provide some better insights into our thinking and a general update of economic conditions.

Bear Market Recoveries

Considering the recent market drop, it is helpful to put past instances of bear markets into perspective. What we can learn is that - all bear markets are not created equal. Looking back over time shows there have been varying lengths of recovery. From as short as 61 days to as long as 1,462 days.

Interestingly, since 1950, there have been 13 bear market recoveries with an average 1-year return following the event of 35.6%. It is important to note that for the most part, these were not "V" shaped from the bottom of the correction to the top of the recovery.

AVERAGE ANNUAL PERFORMANCE FOLLOWING A BEAR MARKET

Since 1950, 13 Bear Markets



Rebounds From Bear Markets Since 1950													
Bear Market Low	10/22/57 -21.5%	6/26/62 -28.0%	10/7/66 -22.2%	5/26/70 -36.1%	10/3/74 -48.2%	3/6/78 -27.1%	8/12/82 -27.1%	12/4/87 -33.5%	10/11/92 -19.9%	8/31/98 - 19.3%	10/9/02 -49.14%	3/9/09 -56.8%	12/24/18 -19.8%
Return needed from low to break- even	27.3%	38.8%	28.5%	56.4%	93.1%	24.1%	37.2%	50.4%	24.9%	24.0%	96.6%	129.5%	24.7%
Days from low to break - even	233	299	143	451	1,462	366	58	414	148	61	1,166	1008	81
From the low: 1 - year return	31.0%	32.7%	32.9%	43.7%	38.0%	12.6%	58.3%	21.4%	14.5%	37.9%	33.7%	68.6%	37.1%
From the low: 3 - year return	11.0%	16.7%	8.3%	15.9%	15.8%	14.3%	22.4%	13.4%	12.9%	5.8%	15.5%	26.5%	?
From the low: 5 - year return	7.1%	11.9%	6.4%	5.5%	12.0%	12.1%	26.6%	14.0%	19.2%	1.0%	15.0%	22.7%	?
From the low: 10 - year return	9.4%	7.5%	3.5%	4.8%	10.1%	11.9%	15.1%	15.8%	7.6%	3.0%	6.4%	15.0%	?

Morningstar as of 12/31/19. Stock market represented by S&P 500. Stocks PR Index. Principal return only, dividends not included. Past performance does not guarantee or indicate future results. Index performance is for illustrative purposes only. You cannot invest directly in the index.

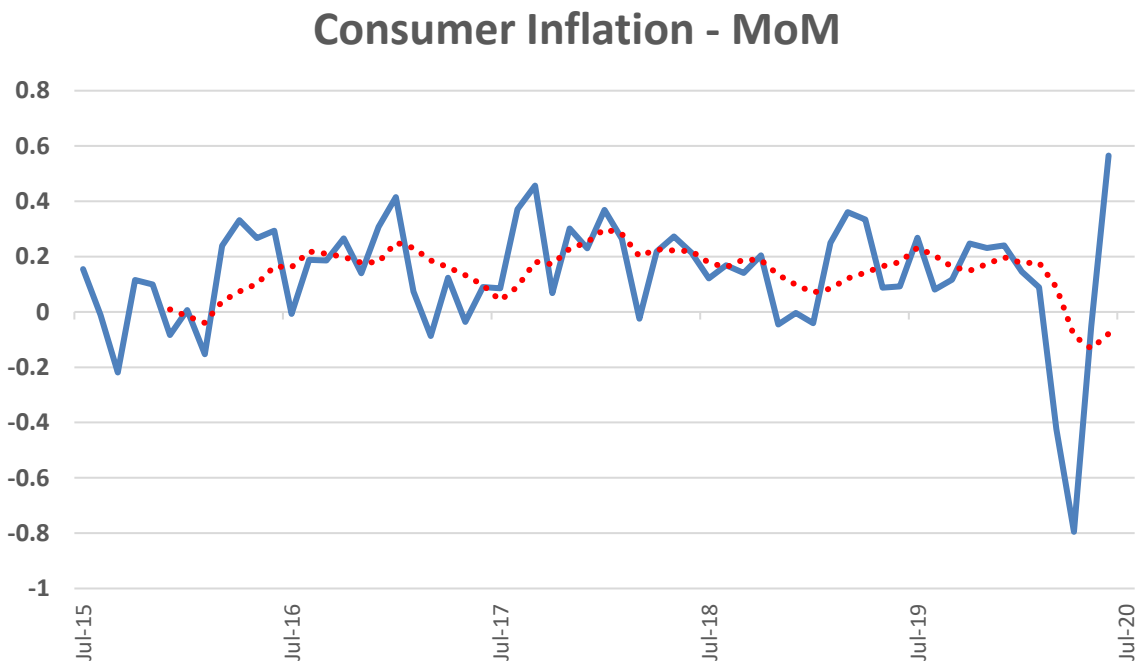



CPI – Consumer Price Index

Looking at the headline number, inflation increased 0.57% for the month and more than 6% on an annualized basis. That would be significant but for the collapse in prices in the previous months when most of the country was closed for business.

The fact that there was a temporary spike in inflation is not totally unexpected. The re-opening of the economy and the pent-up demand was bound to show a rebound in pricing. Add to that the excess liquidity due to trillions of dollars in stimulus and higher prices were pretty much a sure thing.

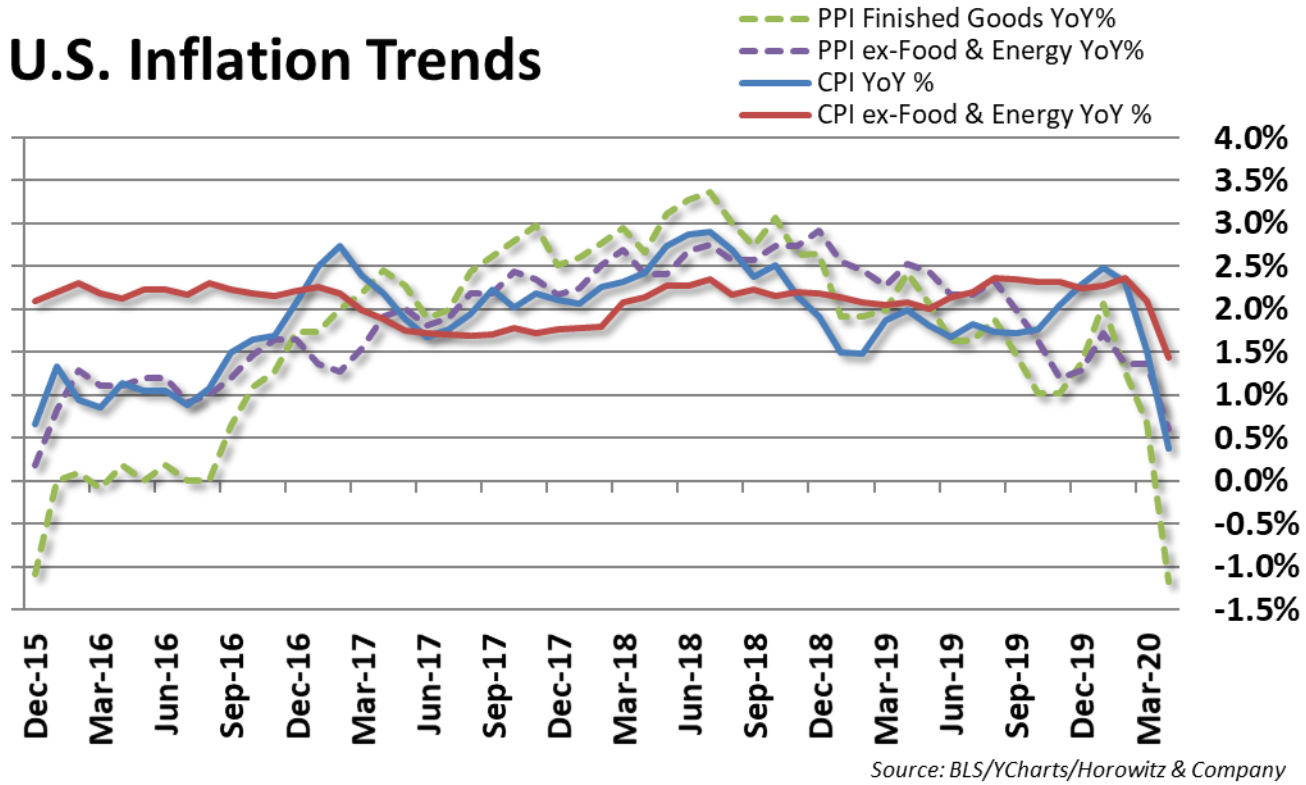
What will be more important is the average over the next few months (red dotted line) and if we can regain that 2% level that the Fed is looking for.



Deflation - Looking for a Reversal

Most agree that deflation is a sign of a weakening economy. Economists fear deflation because falling prices lead to lower consumer spending, which is a major component of economic growth. Companies respond to falling prices by slowing down their production, which leads to layoffs and salary reductions.

Even with the unprecedented amount of monetary debasement in the form of quantitative easing, the Fed (and other central banks) have not been able to sustain their respective target inflation rates. However, with the current economic sudden stop and trillions of dollars poured into the financial system, there is a high probability that after the event clears, a major jump in inflation could occur.

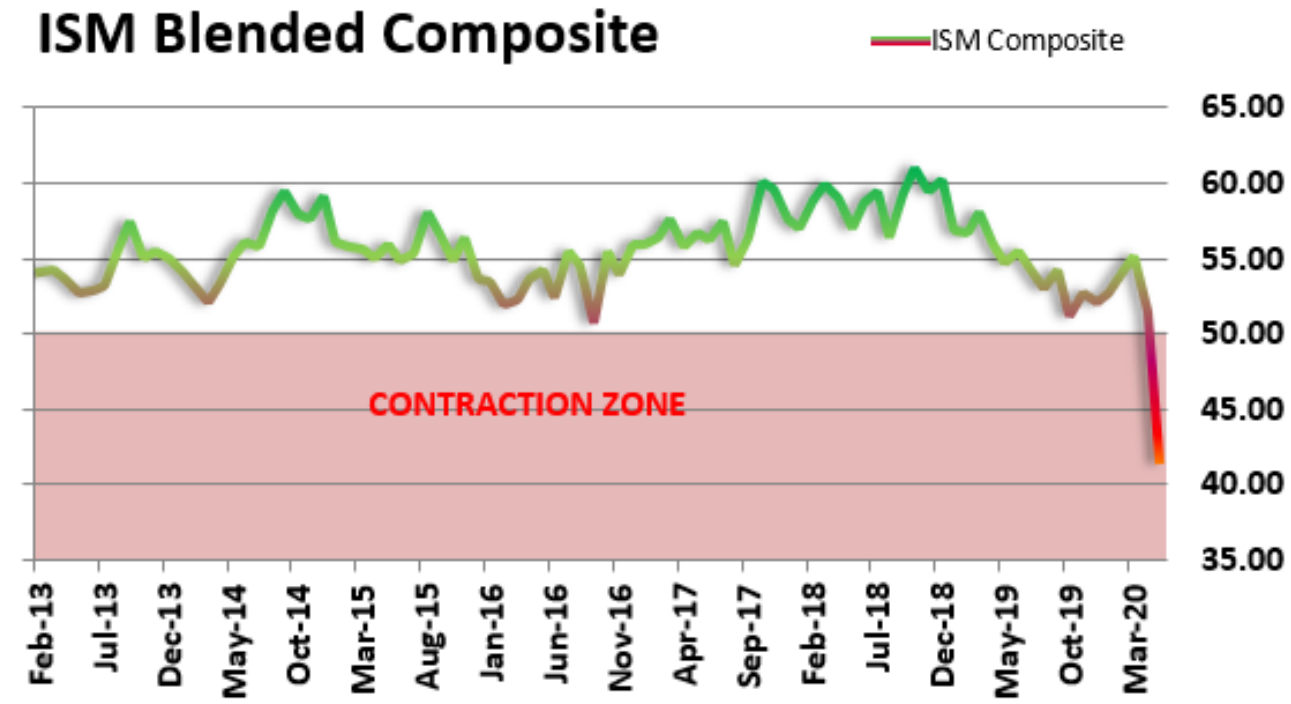


Source: BLS/YCharts/Horowitz & Company

ISM Composite

The ISM Non-Manufacturing Index for April dropped to 41.8%. A number below 50.0% is indicative of contraction.

The April reading was the lowest reading for the index since March 2009. The Composite, which includes the manufacturing index, is now squarely in contraction territory, signaling that we are currently in a recession.



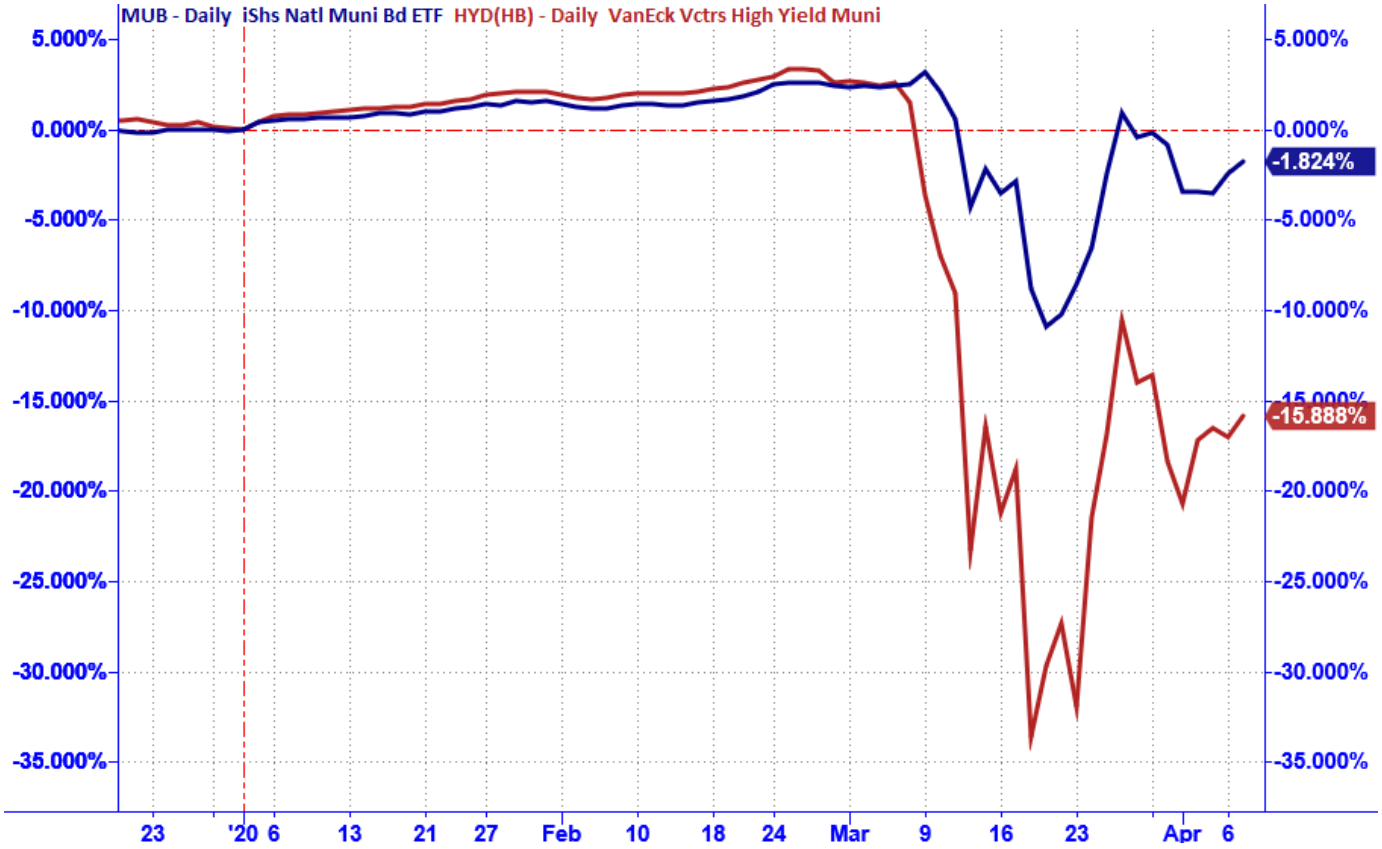
*30% Mnfg. and 70% Services Index

Source: Institue for Supply Management/YCharts/Horowitz & Company

Concern in The Muni Markets

The municipal bond market continues to show stress for those municipalities with weak fundamentals. As the potential for an economic downturn grows, prices on bonds of Puerto Rico, Chicago, New York and other issues with lower ratings have moved sharply lower. Recently, prices have recovered somewhat as there is some talk that the Fed may support this sector through its quantitative easing (bond buying) program.

The chart below compares the year-to-date return of a generic muni-bond ETF versus a high yield muni-bond ETF. Markets are pricing in defaults as municipal revenues are expected to be sharply lower for some time as a broad-based recession is anticipated.



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Note: Information and data are derived from a broad range of sources including Bloomberg, YCharts, Briefing.com amongst others.