Published on *Brightworth* (http://dev.brightworth.com)

Brightworth Investment Commentary: Second Quarter 2020

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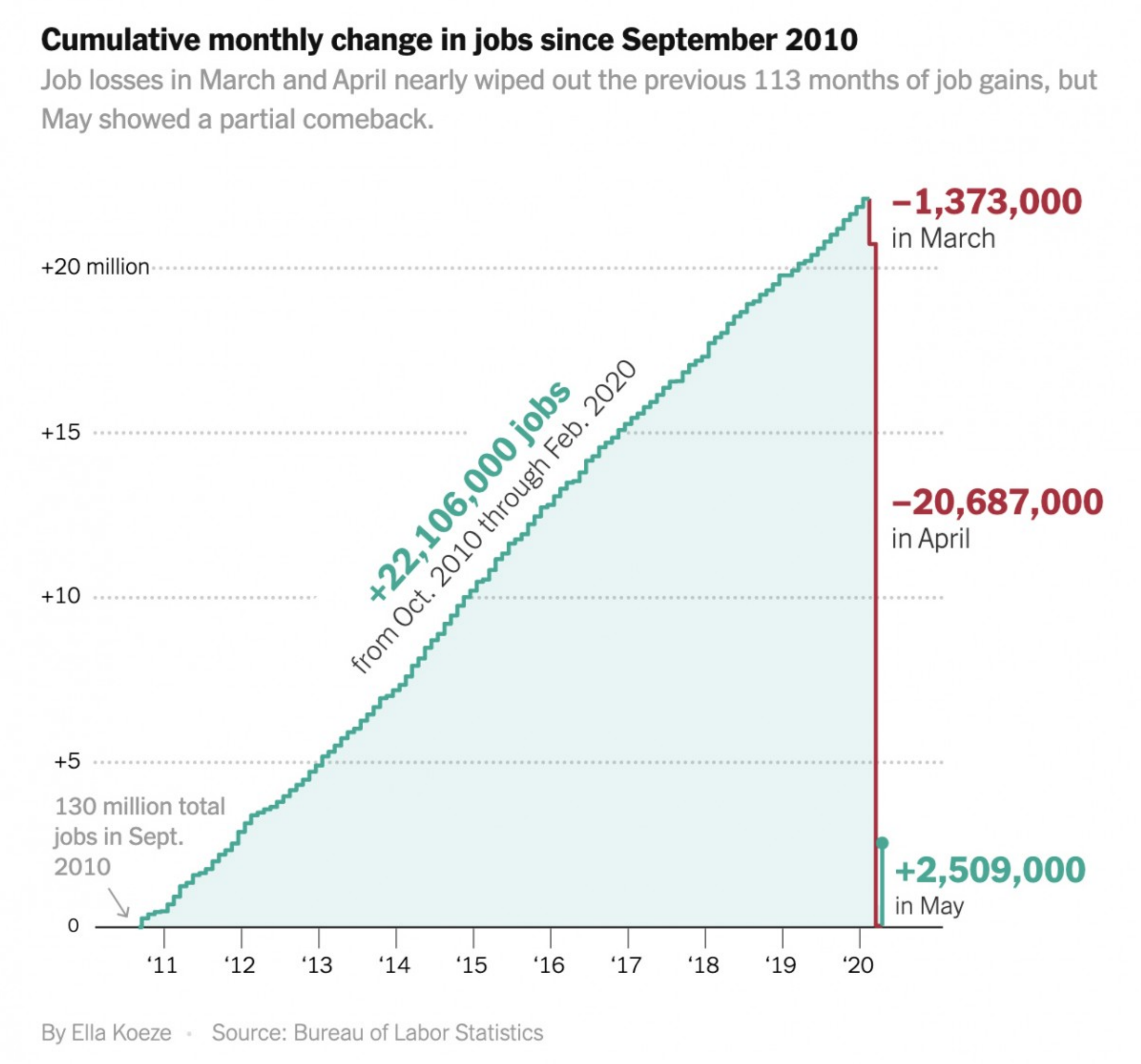
- Stocks posted best quarter in two decades, despite Covid-19 impact
- Tremendous uncertainty remains as the global economy reopens
- Bonds rallied, buoyed by support from the Federal Reserve

Last quarter was another difficult one as efforts to slow the spread of Covid-19 led to the partial closure of our economy. Many of the most financially vulnerable Americans were hit the hardest. Further complicating the situation was the escalation of racial tensions in the wake of the death of George Floyd. Despite these tragic events, investors have seen a significant rebound in their account values as unprecedented monetary and fiscal policies have seemingly stemmed fears that the current economic slowdown will be long lasting.

Economic Review & Outlook

The economic data released over the past couple of months has been some of the most startling in history. Looking at the employment picture, the job losses in March and April wiped out the entire number of jobs created since September 2010. Fortunately, many of these job losses are expected to be temporary and the rebound has already begun with more than 2.5 million jobs recovered in May. Another 4.8 million jobs returned in June. Thus, the recovery is underway, but how long it will take is still completely unpredictable.



Given the tremendous uncertainty surrounding not only the economic recovery in the U.S., but also the increase in political divisiveness and racial tensions all over the world, it is impossible to predict what the economic recovery will look like. Economists have sought to predict the shape of the recovery using an alphabet soup of letters such as V, W, L, U, and so on. Instead of focusing on these short-term prognostication efforts, investors would be better served to recognize that the Covid-19 pandemic has accelerated many of the trends that were already in place. For companies that were struggling prior to the pandemic such as retailers J.C. Penney, Neiman Marcus, and car-rental company Hertz, Covid-19 has hastened their economic demise and these companies have filed for bankruptcy. Conversely, many online companies such as Amazon have benefitted from the accelerated trend to online shopping. The fortune of many other companies will depend on their ability to innovate and adapt to the new challenges of our current situation.

One cannot discuss the current economic situation without commenting on the unprecedented actions of the Federal Reserve. Chairman Jerome Powell has been adamant that the Fed will do whatever it takes to keep the economy afloat. In early April he commented, “There is no limit of what we can do…” when asked about providing support to financial markets. Later in the dialogue he emphasized the Fed was “doing all we can to help shepherd the economy through a difficult time” and would continue to act “forcefully, proactively and aggressively until we are confident that we are solidly on the road to recovery.”

One example of many ways the Fed has intervened is through their corporate bond buying program. This has allowed many hard-hit companies including Boeing, General Motors, and Royal Caribbean Cruises to raise significant capital and prevent possible bankruptcy, at least for now. The Fed’s bold and decisive actions have gone a long way to calm fears and allow capital markets to function normally. By helping vulnerable companies, the Fed also aids their suppliers and those employed by all those companies, which supports the overall economy.
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Bond Market Review & Outlook

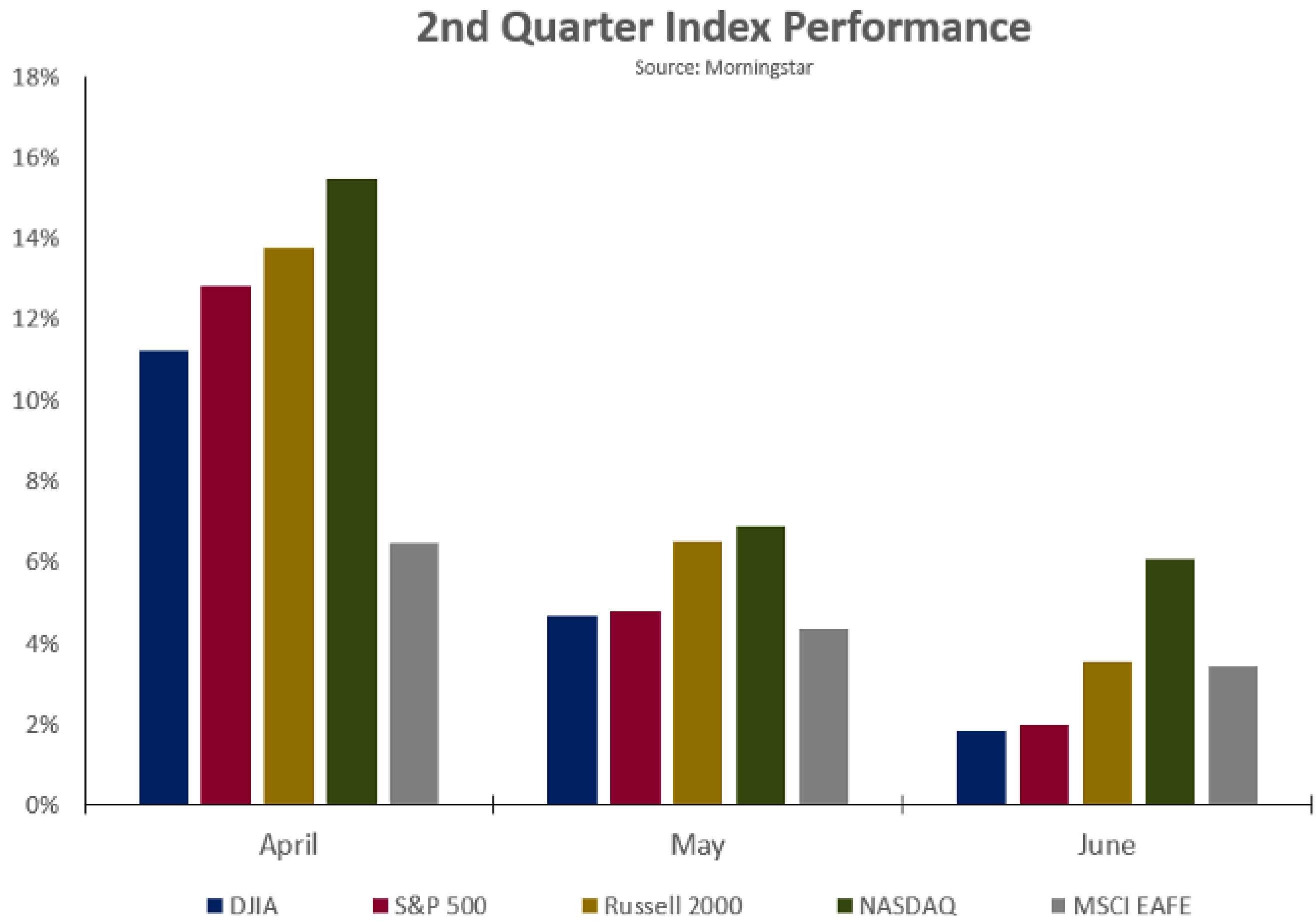
Bonds delivered mostly positive returns in the second quarter. Long term U.S. Treasuries were one of the few exceptions, declining fractionally. The Barclays Core U.S. Aggregate Index returned 2.9%, but the best returns were found in the more economically sensitive areas as the Barclays High Yield Corporate Index gained 9.6%.

This return discrepancy should be of little surprise to investors. The panic driven sell off in the first quarter sent U.S. Treasury prices sharply higher as investors sought out safety of principal as opposed to yield. This reversed course in the second quarter due in part to steps taken by the Federal Reserve to backstop the liquidity concerns that sent nearly every segment of the fixed income market reeling in late March. With financial markets now functioning more normally, many are questioning the Fed’s continued participation in these markets. As the previous comments from Chairman Powell suggest, the degree of the economic fallout from the Covid-19 pandemic is so uncertain they have decided to remain very active in these markets to ensure ample liquidity. As a result of these actions and some hopeful signs of economic recovery, investors now expect fewer defaults than they did just a couple months ago.

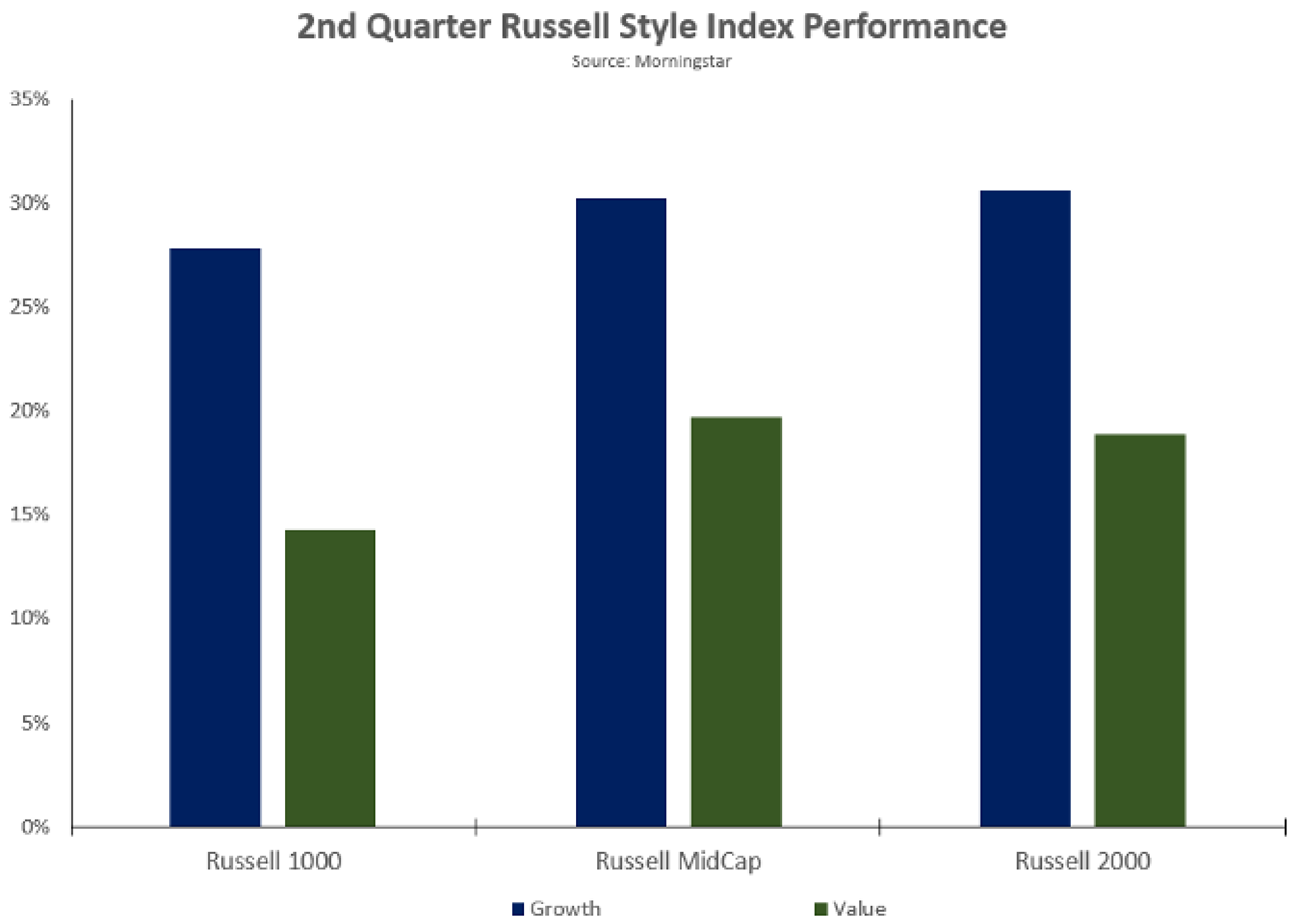
With interest rates continuing to move lower and lower, some investors are fearful of an imminent rise due to either an economic recovery or higher inflation expectations. At least for the time being these fears are likely unfounded as Powell commented after their June meeting, “We’re not thinking about raising rates. We’re not even thinking about thinking about raising rates.” A well-known mantra when it comes to investing is – Don’t Fight the Fed – so if Powell is adamant rates won’t be rising anytime soon, investors should probably listen closely.

Stock Market Review & Outlook

When the first quarter ended many investors were in a state of concern, despair, or outright fear in some instances. Fast forward to today and you now have hope, optimism, and perhaps even a bit of euphoria. The most widely followed indexes, the Dow Jones Industrial Average and S&P 500, rebounded sharply returning 18.5% and 20.5%, respectively during the quarter. Small caps (Russell 2000) outperformed rising 25.4%, but the real winner was the tech laden NASDAQ Composite gaining 31.0%. The laggard of the group continues to be markets abroad as the MSCI EAFE returned 14.9%.



The dramatic recovery of financial markets, the introduction of commission free stock trading at several custodians, and many investors now with more time at home has led to an increase in day trading not seen since the late 1990s. The number of daily trades being processed by discount brokerage firms has more than doubled from the beginning of the year. Speculative investing in companies in or on the verge of bankruptcy has resulted in sharp rallies in share prices for these companies. The largest six companies in the U.S. now have a combined value greater than every country's GDP in the world except for the U.S. and China. Thus, just as important as it was to fight fear in the first quarter, remaining grounded during this transition period is equally as imperative for long-term investors.



As you can see from the chart, growth stocks handily outpaced value stocks during the quarter, continuing their dominance over the past couple of years. The Covid-19 pandemic has only magnified this return dispersion as companies with significant exposure to remote or digital platforms have seen their share prices skyrocket over the past couple of months. Over the past ten years, large cap growth stocks have outperformed value stocks by more than 6% per year. This is one of the widest 10-year performance differentials in history. Gaps of this size have historically predicted subsequent long-term performance to reverse course. However, precise timing of when these trends shift is impossible to predict, so the best advice for investors is to remain invested in growth stocks, but don't neglect value stocks given their long-term attractiveness.

Alternative Investments & Hybrids Review & Outlook

After helping to cushion the downturn in the first quarter, alternatives rebounded with the Morningstar Multi-Alternative category up 4.8% for the second quarter. Publicly traded real estate led the cohort while hybrid managers, who allocate to both stocks and bonds, were also strong performers thanks to the recovery in equity and fixed income markets. Managed futures were down slightly after positive performance through the volatility of the first quarter. Market neutral strategies, including merger arbitrage, were positive contributors as market conditions began to normalize. Real assets strategies - which include allocations to farmland, timberland, and infrastructure assets – also posted positive returns for the quarter. Through the first two quarters of dramatic volatility, alternatives and hybrids provided meaningful diversification to traditional stocks and bonds and reduced volatility for investors.

Conclusion

The first half of 2020 should serve as the ultimate reminder to investors that “you can’t time the market.” U.S. stocks are down marginally on the year, so an investor who ignored the news is not that far off from where they were when the year began. Investors who were able to control their emotions and not react in fear have been served very well. In some cases, the fear investors experienced in the first quarter has been replaced by complacency or even greed in the second quarter. The same discipline it took to prevent an investor from panic selling then can be applied to desires of eliminating diversification and indiscriminate buying now. Remember, the long-term goal of your investment portfolio is to help you achieve financial independence. Eliminating emotional decisions is a key to achieving this.

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