ANCHOR
CAPITAL ADVISORS LLC

GLOBAL MARKETS REVIEW Q2 2020

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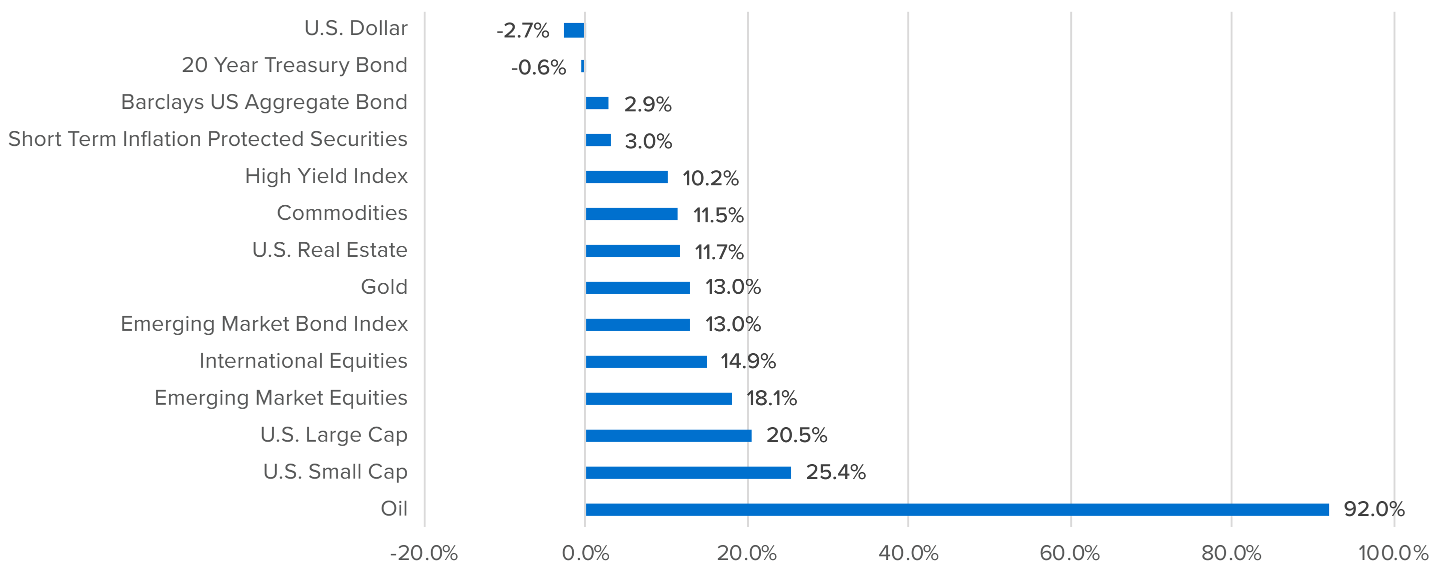
Q2 Review

At the time of the last quarterly letter, global markets had corrected sharply, most European countries and many U.S. states had just locked down, while many Asian countries were tentatively reopening. Other parts of the world like South America had yet to see the COVID-19 virus take hold. Three months later, many countries around the world are in various stages of reopening, with varying degrees of success. The availability of COVID-19 testing in the United States is increasing but does not yet appear to be adequate. Several pharmaceutical companies have started vaccine trials but current projections indicate that the earliest a vaccine will be commercially viable is 2021.[1] Still, despite the ongoing disruption and uncertainly, the S&P 500 has rallied and the NASDAQ has set new all-time highs.[2] Emerging markets had one of their best quarters in many years and most equity markets showed a strong rebound.

Around the world, government stimulus has been an underlying factor in the equity market rally. With entire economies shut down for extended periods and high levels of unemployment, governments provided support through quantitative easing, direct cash payments and loans. All of these measures are meant to help individuals and companies get through this unprecedented time, so that global economies are able to get back to recovery conditions. The amount of global liquidity has propelled the markets back to previous levels.

Second Quarter 2020 Returns



Source: FactSet financial data and analytics

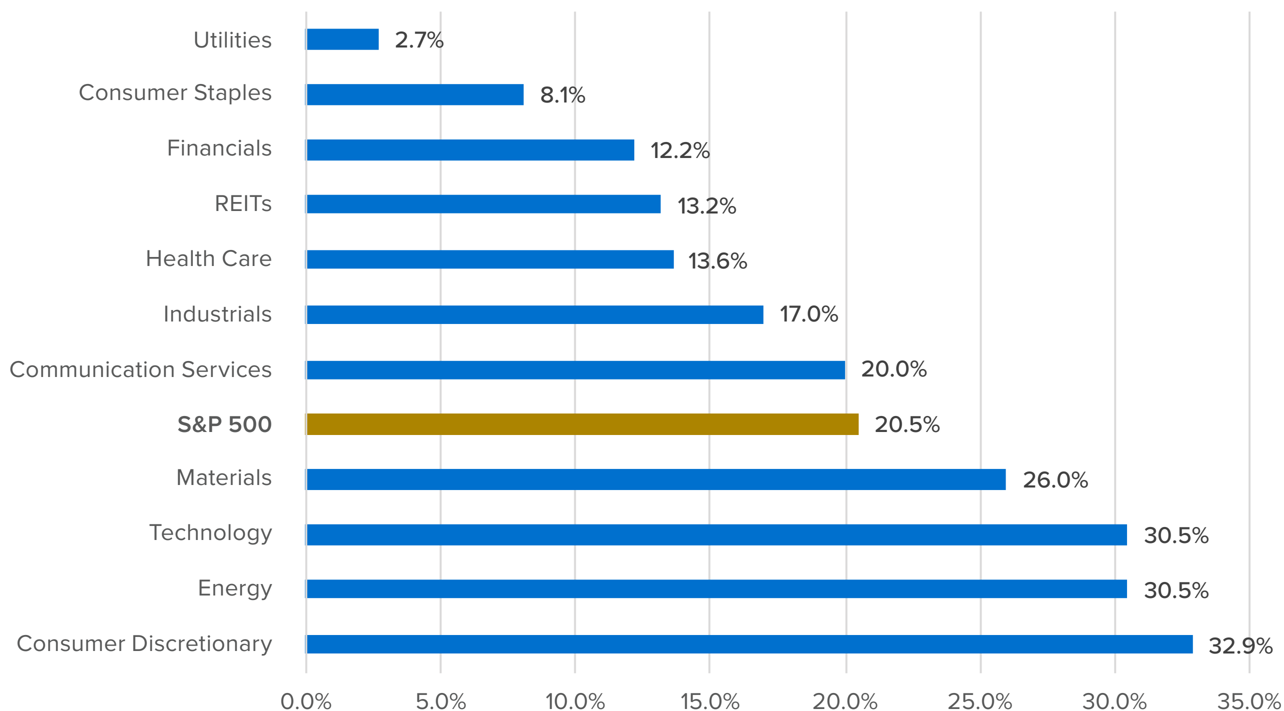
U.S. Markets

Consistent with an economic recession and recovery, small and mid cap stocks sold off more than large cap stocks in March, but since have rebounded more than large cap companies.[3] That said large cap stocks are still up more year-to-date relative to small and mid cap stocks.[4] It is believed that investor flows into ETFs and indexes has resulted in outsized concentrations in the largest names. In particular, the five largest companies – Facebook, Amazon, Apple, Microsoft, Google – account for 50% of the NASDAQ Index and over 20% of the S&P 500.[5] While the size and extended valuation of these five names has resulted in the S&P 500 selling at high valuations, the remaining 495 of S&P 500 stocks are still down, some more than 20%, and are trading at what we consider to be attractive valuation levels.[6]

This also has created a historically large dispersion between the growth and value indices. For the Russell 1000 (large cap stocks) indices, the spread is 26%, which has not been seen since 1999.[7] Many believe that the growth stocks have the ability to keep growing, but we are hitting the law of large numbers. The top five stocks had combined trailing 12-month revenue of $915 billion.[8] Analyst consensus calls for revenue growth of 17% next year and 18% thereafter.[9] In order to meet the growth required to maintain analyst's high valuations and prices, these companies would have to generate $155 billion in additional sales next year. To put that in perspective, in dollar terms, $155 billion is the combined total amount of revenues that Johnson & Johnson and Procter & Gamble (#5 and #8 in the S&P 500) generate annually.[10]

Finally, we are coming into a Presidential election where the outcome feels very uncertain. If we do have a change in the political regime, we may see more political/anti-trust focus on the big technology stocks. This period of time feels similar to the technology boom period in the late 1990's and is something we are watching carefully.

Second Quarter 2020 S&P 500 GICS Sector Returns



Source: FactSet financial data and analytics

U.S. Economy

As expected, the economy looks very different from the first quarter of this year. Businesses across the U.S. shut down and a record 33+ million people filed unemployment claims.[11] A number of service oriented industries like restaurants, retailers, and travel, which generally pay workers lower wages, have suffered the most. As the economy reopens, we are seeing people go back to work, albeit at reduced levels, and we feel it will take quite a while for employment to get back to pre COVID-19 levels. Government backing currently in place for workers will run out mid-July, which will require Congress to consider passing another round of support.[12]

Given how low economic activity fell, we are currently seeing a V-shaped sharp recovery trajectory. Economic indicators like retail spending dropped significantly at the end of March, but since mid-April (coinciding with stimulus checks) numbers have steadily improved.[13] Home purchases, impacted by stay-at-home orders, came back fast in April and May as people took advantage of the low interest rates and followed up on delayed purchases.[14] Other indicators such as number of airline passengers,[15] hotel room occupancy,[16] and road miles driven,[17] all point to the rebound in economic health.

China

After the Chinese GDP contracted 6.8% in the first quarter, most of the economy has reopened and they too are seeing a V shaped recovery.[18] The Purchasing Manager Index for May returned to positive territory with a 50.6 reading.[19] Even though China's economy reopened in March, with other countries shutting down, there was less demand for Chinese goods. It is positive to see the economic activity improving. Data from the Chinese consumer is mixed with domestic retail spending and travel well below pre-crisis levels, but we are seeing pockets of strength including home and auto purchases.[20] The Chinese government has not introduced the same level of stimulus as other governments due to concerns of potential for bubbles in certain parts of the market. The stimulus measures which added to 4.5% of GDP were focused on infrastructure construction.[21]Economists are expecting 1% GDP growth for 2020.[22]

Europe

Parts of Europe were already struggling before the COVID-19 pandemic and it could be some time before Europe fully recovers. Italy, Spain, and Greece have been particularly hard hit, because a high percentage of their GDP is reliant on tourism.[23] Currently, the EU has managed to contain COVID-19 and started to reopen parts of the economy. At the end of May, the EU approved an over $800 billion stimulus package, which included buying back bonds.[24] Economists are projecting GDP declining by 7% for 2020.[25]

Fed Reserve/Fixed Income Markets

The Federal Reserve acted quickly in March to provide liquidity and stability to the markets. The Fed quickly cut interest rates and told the market it would provide facilities to buy back bonds including treasury bonds, mortgage backed securities, corporate bonds and ETFs, and even high yield bonds.[26] Since mid-March when we saw a significant pull back in the credit related bond markets and very low liquidity, the fixed income markets have recovered with the backstop of the Fed. In fact, with the bond market open and accessible to all borrowers, corporations have raised over $1.2 trillion – a record level year-to-date.[27] Even borrowers like Boeing and Macy's that are greatly impacted by the shutdown related to COVID-19 have been able to borrow.[28] There are concerns about zombie companies that have cash to keep them afloat.[29] We do expect as the year progresses that the corporate bond defaults will increase to similar levels we saw in the Global Financial Crisis (GFC) of 2008. At the June Fed meeting, Fed Chairman Powell said that interest rates will remain at 0% until 2022.[30]

Oil

The energy sector, which was destroyed by the steep sell off in oil, had an interesting quarter. On April 20th when oil futures rolled over contracts, the price of oil declined into negative territory (the only time in history this has happened) but has since rebounded.[31] In fact, the price of oil was up 92% in the quarter to close to $40/barrel.[32] That is still at levels that makes it hard for most oil companies to be profitable.

Gold

Gold has continued its rally and was up another 13% during the second quarter to $1,793/oz.[33] Many investors see the expanding government balance sheets and fiscal deficits providing the potential for inflation down the road. Gold tends to rally during these periods, but given how fast it has run, it could face some pullbacks.

U.S. Dollar

The U.S. Dollar index, DXY, recently peaked and has declined 2.8% over the quarter.[34] If the market expects inflation, then we may see the U.S. Dollar weaken relative to other currencies. If we see a weaker U.S. Dollar it can be beneficial for emerging markets that tend to borrow in U.S. dollars.

Changes due to the COVID crisis

There have been some companies and industries that are clear beneficiaries of consumers being required to stay at home during the shutdown. The increased use of technology, higher levels of streaming and increased use of online subscriptions benefitted stocks of related companies. Examples of this being Zoom, Netflix, DocuSign, Peloton, and Teledoc, as they all performed well during the shutdown.[35] In our value oriented portfolio we too have a number of stocks that have benefitted from the shutdown. As you would expect, consumer staples stocks such as Clorox, Procter & Gamble, and Mondelez saw a lift due to people stocking up on supplies and eating at home more.[36] Retailers that were deemed essential and remained open also continued to do well. For example, Dollar General and WalMart both saw healthy sales over the quarter driven by people stocking up on household staples as well as more discretionary purchases as consumers received stimulus checks.[37] Home improvement retailer Lowe's showed strong sales, which they expect to continue, as consumers stay closer to home this summer.[38]

Not surprisingly, Lowe's is just one of many retailers that noted a 100% increase in online sales. Retailers recognize that this trend will only continue and are building e-commerce specific distribution centers to help support this increase. In 2019, e-commerce reached 16% of overall retail sales.[39] In a span of weeks during the shutdown, e-commerce penetration increased to 27%.[40] This recent move over the past several weeks amounted to over $600 billion of annualized e-commerce moving online. The digital payments space continues to grow with the rise of e-commerce, digital wallets, contactless payments and the move away from cash and checks.

Thanks to government stimulus and companies having access to capital, those companies more impacted by the COVID-19 pandemic rallied as investors started to look out beyond 2020 to what the recovery might look like. Many cyclical oriented companies including industrials and materials rebounded. With the upcoming election and the reality of a slower sustained recovery in jobs, we would expect the government to look to infrastructure as a way to support this recovery. Infrastructure spending would further support cyclical industries.

Conclusion

While the equity markets have rallied back, the focus has mainly been on U.S. large cap stocks. U.S. small and mid cap stocks are still down year-to-date and have room to continue to increase. If the U.S. Dollar continues to be weaker, we believe that could be potentially attractive for emerging market stocks and commodities. Fixed income will be choppy, but backstopped by global central governments, which will keep interest rates low for some time. While we continue to monitor the reopening of the global economy and the upcoming U.S. Presidential election, overall we are optimistic about the recovery and are finding opportunities for investment.

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