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COVID-19

At the time of the last quarterly letter global markets had corrected sharply, many states had recently locked down due to the COVID-19 pandemic and most people were anticipating that stay-at-home orders would last only a couple of weeks. Three months later, many states are still in early phases of reopening and several have had to renew restriction and closures due to COVID-19 flare ups.ⁱ 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.ⁱⁱ Still, despite the ongoing disruption and uncertainty, the S&P 500 has rallied and the NASDAQ has set new all-time highs.ⁱⁱⁱ

Stock Market Rally

There are several reasons for the rally despite the underlying recession affecting the economy. First, as we mentioned at the end of the last quarter, the Federal Reserve has come to the rescue and stated that it will do what is necessary to revive the economy.^{iv} It dropped interest rates to zero and now has expanded its balance sheet to \$7.1 trillion,^v up from \$4.0 trillion on January 1, 2020. A number of bond-buying programs that include almost all fixed income asset classes have also been introduced.^{vi} We believe this large amount of liquidity has minimized investor selling and has supported all fixed income markets.

Second, Congress passed the \$2 trillion CARES Act. Designed to help individuals and companies that were economically impacted by COVID-19, the CARES Act resulted in direct cash payments to unemployed individuals and forgivable loans to many small businesses to maintain workers on their payrolls – the Payroll Payment Plan or PPP.^{vii} The combination of deferring income tax collection and direct payments has resulted in the Federal Government increasing its debt by \$3.1 trillion since mid-January; financed by an additional \$2 trillion in Federal Reserve holdings of Treasuries and willingness of foreign investors to hold U.S. debt.^{viii}

Further supporting equities, some individuals have received more from CARES Act unemployment payments than they were making in their paychecks while employed, which has led some people to step up their trading of individual stocks. Discount brokers such as Schwab and ETrade had already dropped commissions to \$0 and are now joined by newer entrants such as Robinhood that are, combined with recovering markets, enticing retail investor to make trades.^{ix} The volume in the retail market has increased significantly, as noted by the Citi trade desk, with some even investing in bankrupt companies like Hertz and JC Penney.^x

With interest rates so low, equity markets with dividend yields greater than 2% offer very compelling alternatives to holding fixed income investments.^{xi} Finally, we believe investors have memories of the Great Financial Crisis (GFC) of 2008, when the government provided stimulus to the markets and, as a result, the markets took off on a ten-year run. This is likely contributing to investor's interest in equities now, as those who may have missed out on the post-2008 gains do not want to let an opportunity pass them by during another period of anticipated recovery.

U.S. Economy

As expected, the economy today 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.^{xii} A number of service oriented industries like restaurants, retailers, and travel, which generally pay workers lower wages, have

suffered the most. As the economy slowly 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.^{xiii}

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.^{xiv} 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.^{xv} Other indicators such as number of airline passengers,^{xvi} hotel room occupancy,^{xvii} and road miles driven,^{xviii} all point to the rebound in economic health.

Large vs. Small/Mid and Growth vs. Value

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.^{xix} That said, large cap stocks are still up more year-to-date relative to small and mid cap stocks.^{xx} 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 and Google – account for 50% of the NASDAQ Index and over 20% of the S&P 500.^{xxi} 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.^{xxii}

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.^{xxiii} 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.^{xxiv} Analyst consensus calls for revenue growth on average of 17% next year and 18% thereafter.^{xxv} 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 total combined revenues that Johnson & Johnson and Procter & Gamble (#5 and #8 in the S&P 500) generate annually.^{xxvi}

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 of the late 1990's and is something we are watching carefully.

Federal Reserve/Fixed Income Market

The Federal Reserve acted quickly in March to provide liquidity and stability to the markets. The Fed quickly cut interest rates and announced it would provide facilities to buy back fixed income instruments including treasury bonds, mortgage backed securities, corporate bonds and ETFs, and even high yield bonds.^{xxvii} 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.^{xxviii} Even borrowers that are greatly impacted by the shutdown related to COVID-19, like Boeing and Macy's have been able to borrow.^{xxix} There are concerns about zombie companies that have cash to keep them afloat.^{xxx} 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.^{xxxi}



Our Observations

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.^{xxxii} 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.^{xxxiii} Retailers that were deemed essential and remained open also continued to do well. For example, Dollar General and Wal-Mart 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.^{xxxiv} Home improvement retailer Lowe's showed strong sales, which they expect to continue, as consumers stay closer to home this summer.^{xxxv}

Not surprisingly, Lowe's is just one of many retailers that noted a 100% increase in online sales. Retailers recognize that this trend will continue and are building e-commerce specific distribution centers to help support this increase. In 2019 e-commerce accounted for 16% of overall retail sales.^{xxxvi} In a span of weeks during the shutdown, e-commerce penetration increased to 27%.^{xxxvii} This shift amounted to over \$600 billion of annualized e-commerce purchases 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 beyond 2020 to what the recovery might be 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.

What did we do at Anchor?

Going into March, we raised cash as discussed in the first quarter commentary. During the market pull back and subsequent rebound we used that cash to add new stocks. We consistently and continuously add fully researched and vetted securities to our approved universe of stocks to buy. We have been patient investing though, waiting for the right valuation and price. The sell-off presented us with that opportunity. In late March and early April, we bought several high-quality stocks that we have wanted to own for a while and added stocks that we believe will benefit from the recovery. Examples of these stocks can be found in the highlights section below. As a result, our current cash levels are on the lower end and we are constructive about the stocks in the portfolio. We are conscious that the economy reopening may be choppy, that the timing of the vaccine is unknown, and that we are entering a divisive Presidential election season. However, we believe that our investing approach and the types of stocks we hold will provide both downside protection and upside opportunity during this time.



STRATEGY DETAIL

Quarterly Attribution^{xxxviii}

Security Contribution (5 Highest)
Marathon Petroleum Corporation (MPC)
Insperty, Inc. (NSP)
Microsoft Corporation (MSFT)
Analog Devices, Inc. (ADI)
RPM International Inc. (RPM)

Security Contribution (5 Lowest)
STORE Capital Corporation (STOR)
Ryman Hospitality Properties, Inc. (RHP)
CoreCivic, Inc. (CXW)
Portland General Electric Company (POR)
JPMorgan Chase & Co. (JPM)

Sector Contribution (3 Highest)
Materials & Processing
Technology
Producer Durables

Sector Contribution (3 Lowest)
Utilities
Consumer Discretionary
Health Care

Quarterly Purchases

- JPMorgan Chase & Co (JPM)
- Donaldson Company Inc (DCI)
- Parker-Hannifin Corporation (PH)
- Chubb Limited (CB)
- PBF Energy Inc (PBF)
- Progressive Corporation (PGR)
- Portland General Electric Company (POR)
- Texas Pacific Land Trust (TPL)

Quarterly Sales

- OUTFRONT Media Inc. (OUT)
- Ryman Hospitality Properties, Inc. (RHP)
- STORE Capital Corporation (STOR)
- 3M Company (MMM)
- United Bankshares, Inc. (UBSI)
- CoreCivic, Inc. (CXW)

Further Insight: Stock Position(s)

JPMorgan Chase & Co (JPM)

For many years, our thesis on the banking sector has been to focus on regional banks that have opportunity for loan growth and potential acquisition activity. We believe larger money center banks have fewer opportunities due to their size. What we have observed is that the large money center banks have focused their attention away from trading and investment banking, and more towards the retail client and wealth management (60% of revenue). This is fee generative rather than net interest margin focused. In a lower interest rate environment that is important. Moreover, big banks have been investing heavily into technology and digital banking, which helps to bring in customers and reduce costs.^{xxxix} JP Morgan is the largest bank in North America and in our opinion one of the best-managed banks. It has historically been expensive,^{xl} so we waited for the valuation to come down before adding it to portfolios. We believe JPMorgan has strong underwriting and risk management practices, which should help the bank withstand the current crisis.

Donaldson Company Inc (DCI)

In this current downturn, we have been looking for high quality companies to add to the portfolio and one that we have followed for many years is Donaldson. Donaldson is a critical supplier of filtration products for engines and industrial equipment. Every industrial truck and tractor requires high performing and technologically sophisticated filtration systems. Donaldson has a long history of innovation, strong customer relationships, and high aftermarket retention.^{xli} In fact, 62% of sales are replacement. By our criteria, Donaldson has had a fortress balance sheet and for 60 years has been paying a dividend.^{xlii}



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- ⁱ <https://www.cnn.com/interactive/2020/us/states-reopen-coronavirus-trnd/>
- ⁱⁱ <https://www.usatoday.com/in-depth/news/health/2020/06/30/covid-vaccine-progress-widely-available-coronavirus-expert-panel/3242395001/>
- ⁱⁱⁱ FactSet Research and Analytics, Charting
- ^{iv} <https://www.reuters.com/article/us-health-coronavirus-fed-daly/fed-will-do-whatever-it-takes-to-help-us-economy-likely-in-recession-daly-says-idUSKBN21I2Y6>
- ^v https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
- ^{vi} <https://www.investopedia.com/fed-kicks-off-unprecedented-corporate-bond-buying-program-4844639>
- ^{vii} <https://www.npr.org/2020/03/26/821457551/whats-inside-the-senate-s-2-trillion-coronavirus-aid-package>
- ^{viii} https://www.treasurydirect.gov/govt/reports/pd/pd_debttothepenny.htm
- ^{ix} <https://www.cnbc.com/2020/06/09/retail-investors-buying-beaten-up-stocks-make-for-some-bizarre-trading-days.html>
- ^x Ibid.
- ^{xi} FactSet Data & Analytics, Charting
- ^{xii} <https://www.wsj.com/articles/unemployment-benefits-weekly-jobless-claims-coronavirus-05-07-2020-11588813872>
- ^{xiii} <https://www.cnn.com/2020/06/25/politics/stimulus-check-payment-second-round/index.html>
- ^{xiv} <https://www.washingtonpost.com/business/2020/06/16/retail-sales-may/>
- ^{xv} <https://www.cnbc.com/2020/06/10/mortgage-demand-from-buyers-amazes-again-now-up-13percent-annually.html>
- ^{xvi} <https://www.dallasnews.com/business/airlines/2020/06/04/american-airlines-restoring-some-summer-flights-after-an-uptick-in-passengers/>
- ^{xvii} <https://therealdeal.com/2020/05/20/hotel-occupancy-is-up-for-fifth-week-in-a-row/>
- ^{xviii} <https://www.npr.org/sections/coronavirus-live-updates/2020/05/06/851001762/the-pandemic-emptied-american-roads-but-driving-is-picking-back-up>
- ^{xix} FactSet Data & Analytics, Charting
- ^{xx} Ibid.
- ^{xxi} Ibid.
- ^{xxii} Ibid.
- ^{xxiii} Ibid.
- ^{xxiv} Ibid.
- ^{xxv} Ibid.
- ^{xxvi} Ibid.
- ^{xxvii} <https://www.investopedia.com/fed-kicks-off-unprecedented-corporate-bond-buying-program-4844639>
- ^{xxviii} <https://www.wsj.com/articles/this-isnt-your-fathers-corporate-bond-market-11590574555>
- ^{xxix} FactSet Data & Analytics, Company Analysis
- ^{xxx} https://www.washingtonpost.com/business/if-the-fed-saved-the-day-why-is-there-a-fear-of-zombies/2020/06/11/a5e60a5e-abb9-11ea-a43b-be9f6494a87d_story.html
- ^{xxxi} <https://www.cnbc.com/2020/06/10/fed-meeting-decision-interest-rates.html>
- ^{xxxii} FactSet Data & Analytics, Charting
- ^{xxxiii} <https://www.cnbc.com/2020/03/15/coronavirus-stock-market-how-to-keep-consumer-staples-outperformance.html>
- ^{xxxiv} <https://fortune.com/2020/05/28/dollar-store-dollar-general-family-dollar-sales-stock-revenue-coronavirus-pandemic/>
- ^{xxxv} <https://www.marketwatch.com/story/lowes-benefited-from-delayed-diy-projects-done-during-coronavirus-lockdowns-while-home-depot-saw-professional-jobs-put-on-hold-2020-05-20>
- ^{xxxvi} U.S. Department of Commerce
- ^{xxxvii} Ibid.
- ^{xxxviii} FactSet financial data and analytics; Attribution
- ^{xxxix} FactSet financial data and analytics
- ^{xl} FactSet financial data and analytics
- ^{xli} <https://www.donaldson.com/en-us/about-us/who-we-are-at-a-glance/>
- ^{xlii} <https://ir.donaldson.com/press-releases/press-release-details/2018/Donaldson-Company-Announces-56-Percent-Dividend-Increase/default.aspx>

Strategy detail is based on the strategy model portfolio.

For a complete listing of all strategies contact Anchor Capital Advisors LLC (617) 338-3800.

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