Making Sense of Finance

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Second Quarter 2020 Review

STOCK MARKET

The second quarter of 2020 was certainly a memorable one; not only for the stock market but for the economy, as well. However, they moved in opposite directions. As the economy sank, the S&P 500 Index rose 20%, its best quarterly performance since 1998. Granted this was on the heels of a tremendous loss for the index in the previous quarter; on a year to date basis the S&P 500 still showed a decline of 4% as of June 30th. The stock market is typically forward looking, however; anticipating a strong economic recovery in the second half of 2020. Other major indexes also increased substantially in the second quarter. The Dow Jones Industrial Average and the Nasdaq Composite index rose over 17% and 30%, respectively. The tech laden Nasdaq even has a positive return year to date, at 12%. It has been a tale of the have and have nots among stocks this year, even more so than most years. Those stocks benefitting from the forced “Work from Home” situations and the generally imposed quarantines have done very well, while most of the remaining stocks have seen their market values drop significantly. This may be a secular trend rather than just a cyclical trend, time will tell. The market makes moves daily based on this ongoing debate.

Every stock sector increased in value during the second quarter rebound. After being the biggest loser in the first quarter, energy stocks rose the most last quarter, with a sector gain of 34% (however still negative for the year). This group was aided largely by the huge increase in oil prices. After the worst quarterly drop ever, oil prices had nowhere to go but up in the second quarter. West Texas Intermediate crude rose 92% in that time period. Another stock sector which outperformed the broader market was consumer discretionary (+32%), as investors were hopeful of a quick bounce back in consumer spending and thought that these stocks had been oversold. Information technology stocks also rebounded considerably in the quarter (+30%) and are the leading sector year to date (+15%). Laggards for the second quarter yet still posting positive returns were consumer staple and utility stocks. These sectors fare better in a “risk off” market which the second quarter was clearly not.

International stock markets did not fare as well as the US market last quarter. The MSCI EAFE developed market index increased 14% as measured in US dollars.

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Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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The recent weakness in the US dollar helped foreign stock performance when translated into US dollar terms. Australia, Germany and the Netherlands were the leading developed foreign stock market performers while stocks in the United Kingdom and Spain lagged. Emerging market stocks did better than developed markets, part of the “risk on” trade. Although stocks in Brazil and Mexico bounced back in the second quarter, they still struggled with large losses year to date, in part due to low commodity prices.

BOND MARKET

Bond prices in every category rose in the second quarter as yields declined. The Bloomberg Barclays Bond Index, a measure of quality US bonds, had a total return of 3%. Those sectors that were hit hardest in the first quarter rebounded the most. These are the riskier areas of fixed income – high yield (below investment grade) and emerging market debt. The lower the quality, the better the performance last quarter. Higher quality corporate bonds also did well as spreads tightened. This was despite record corporate debt issuance in 2020 ($1.6 trillion in the first six months). Much of the rise in prices can be traced to the Federal Reserve keeping interest rates low and providing liquidity in the credit markets by purchasing individual investment grade corporate bonds and exchange traded funds (investment grade and lower quality bonds). Treasuries, although posting gains last quarter, lagged other sectors. Yields on a one-year Treasury ended June at approximately the same level at end of March, 0.16%. The yield on a ten-year Treasury declined to 0.66%. Yields during the last recession of 2008 were also low, but the yield curve was steeper; a one-year Treasury then yielded approximately 0.45%, and a ten-year Treasury yielded 2.5%. With yields currently so low, it is difficult to stay ahead of inflation investing in fixed income securities. The CPI index increased 0.6% over the past 12 months. A large part of the reason that stocks have still been considered attractive to investors; no appealing alternatives.

Municipal bonds also lagged the broader bond market returns. Likewise, the lower grade municipal bonds outperforming quality. The Federal Reserve is also buying investment grade quality state, county and city bonds. This is also part of the effort to maintain low interest rates for the foreseeable future. In essence, an individual investor is competing with the Fed in purchasing bonds, which has been driving up prices and in turn, lowering yields.

OUTLOOK

Opportunities still exist in this market, in our opinion. Yes, the broad- stock market averages are near all-time highs, but those indices are usually cap-weighted; i.e. the larger companies represent a larger share of the index. An equal-weighted S&P 500 index is actually still down over a still respectable 10% for the year, given the circumstances. The larger companies also tend to be skewed towards the digital side of the economy which in many cases is booming due to the pandemic. Stock selection will be crucial in the next year, in our view. We think the rest of the index will eventually catch up to the technology leaders such as Apple, Alphabet (Google), Microsoft, etc. Obvious sectors to avoid are Commercial Real Estate, Bricks and Mortar Retail, Oil & Gas, and Hospitality. We do admit though that a recovery from the companies that survive in these troubles sectors could see some strong gains in a rebound. This ultra-low interest rate environment will likely continue bolstering the strongest players, as well.

We think the upside for stocks is more limited than in the past, but remains your best bet over time. With a 10-year treasury bond yielding less than 1%, we think stocks have a good chance of beating that hurdle. Furthermore, even though inflation has been low, it will likely outpace treasury yields at current rates.

Real estate will likely be stagnant for the foreseeable future, and we admit we can’t see very far. Corporations have learned that decentralized workforces can be beneficial, and anecdotally, many institutions seem to be reducing their office footprints. However, we suspect this trend will reverse itself somewhat, as virtual meetings and digital communication is still not an ideal way to operate a business. Again, those who are not over leveraged and are in sound financial standing will likely benefit the most when the reversal occurs

We still don’t give market predictions. There are simply too many ways the markets can move. Perhaps the general stock market stays flat for three years, or dips and recovers back and forth 10x, or continues to go straight up for a time? Who knows, but that is why we utilize a “bottoms up” method. This means we look at the companies and its fundamentals first. A well-run company will do fine in any of those settings which will be reflected in its stock price not due to the tides of the broad stock market.