QUARTERLY MARKET UPDATE

JULY 2020

MARKET RECOVERY

Name	YTD 2020 Return (%)
Barclays US Aggregate Bond	6.1
Barclays US Credit	4.8
S&P 500 TR USD	-3.1
Barclays US Corporate High Yield	-3.8
MSCI Emerging Markets	-9.8
MSCI EAFE	-11.3
Russell 2000 TR USD	-13.0

Data Source: Morningstar Direct

Equity market behavior year-to-date can be described as a tale of two quarters. The Standard and Poor's (S&P) 500 declined 19.6% in the first quarter of 2020, while in the second quarter it posted a 20.5% gain. The index still sits in negative territory, but investors are no doubt in a better frame of mind currently than a few short months ago.

We imagine some of the optimism catalyzing a significant portion of the reversal stems from the sequential improvement and strengthening of economic data. This, along with certain policy actions have lifted the stock market off its March 23 low, as perceptions that the worst of the COVID-linked downturn is behind us, restoring elements of confidence.

The magnitude of assurance felt by investors is proportional to their individual perspective. That is, higher levels of optimism are felt when utilizing month-over-month data comparisons; decidedly more pessimism exists when using year-over-year assessments of the landscape. The fact is, while things do look relatively better than they did in April, on an absolute basis, weakness still exists. It is the expectation that improving trends will continue that informs the index price increases.

A good example of this would be the employment report for June. It is fair to say that employment activity in June moved in the right direction as millions of workers on temporary layoff returned to work. Accordingly, it might be more accurate to write that nearly 4.8 million jobs were restored rather than 4.8 million jobs were created, but that is semantics. Nonfarm payrolls increased by that amount in June; on the other hand, total nonfarm payrolls are still 14.7 million less than they were in February and 12.9 million less than they were a year ago.

Further, the unemployment rate fell 2.2% in June to 11.1%. That is great news, but not compared to a year ago when the unemployment rate stood at 3.7%. Finally, 3.2 million fewer workers were unemployed than in May, though 17.8 million workers are still counted officially as unemployed versus 5.9 million in June 2019. The labor market (along with many other economic conditions) is absolutely improving, though its overall health is still marginal at best.

Earnings Estimates

A similar dynamic holds for corporate profitability. Earnings-per-share growth is showing improvement from recent levels, yet they reside at multi-year lows. According to FactSet, the S&P 500 index should register earnings decline of -21.5% and a revenue decline of -3.9% on the year. As bad as these estimates seem, they are better than projections from two months ago.

The S&P 500 has risen 42% from its March 23 low and is currently down just over 3% for the year. This rebound is not reflective of current real-world economic circumstances; it represents expectations of a much-improved future.

S&P 500 Sectors	YTD 2020 Return (%)
Information Technology	15.0
Consumer Discretionary	7.2
Communication Services	-0.3
Health Care	-0.8
S&P 500	-3.1
Consumer Staples	-5.7
Materials	-6.9
Real Estate	-8.5
Utilities	-11.1
Industrials	-14.6
Financials	-23.6
Energy	-35.3

Data Source: Morningstar Direct

Given this dynamic (high index price relative to current earnings), the S&P 500 is trading at an elevated 21.8x forward twelve-month earnings. That is roughly as high as it has been since the early 2000's, though that comparison is probably misleading given the differences in conditions accompanying each time period. We are experiencing extremely low interest rates now and consistent with the prior discussion, there is justified optimism regarding the likelihood that estimates will be going up as the economic reopening accelerates.

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It would be fair to point out, though, that it would require a 30% upward revision to earnings to restore the 10-year historical average of 16.8-time forward earnings. Moreover, if the economy picks up steam to the degree that consensus forward twelve-month earnings estimate expects, it stands to reason that interest rates would be noticeably higher than they are today, which would remove a significant pillar of justification to the high price multiple.

Narrow Leadership

We have been referencing the equity markets rebound since the S&P 500 bottomed on March 23. Looking into the underlying performance of the market, it becomes evident that not all sectors and securities have participated in the rebound equally. Market breadth, which compares the number of stocks that have gained relative to the ones that have declined, has been (or continues to be) particularly narrow.

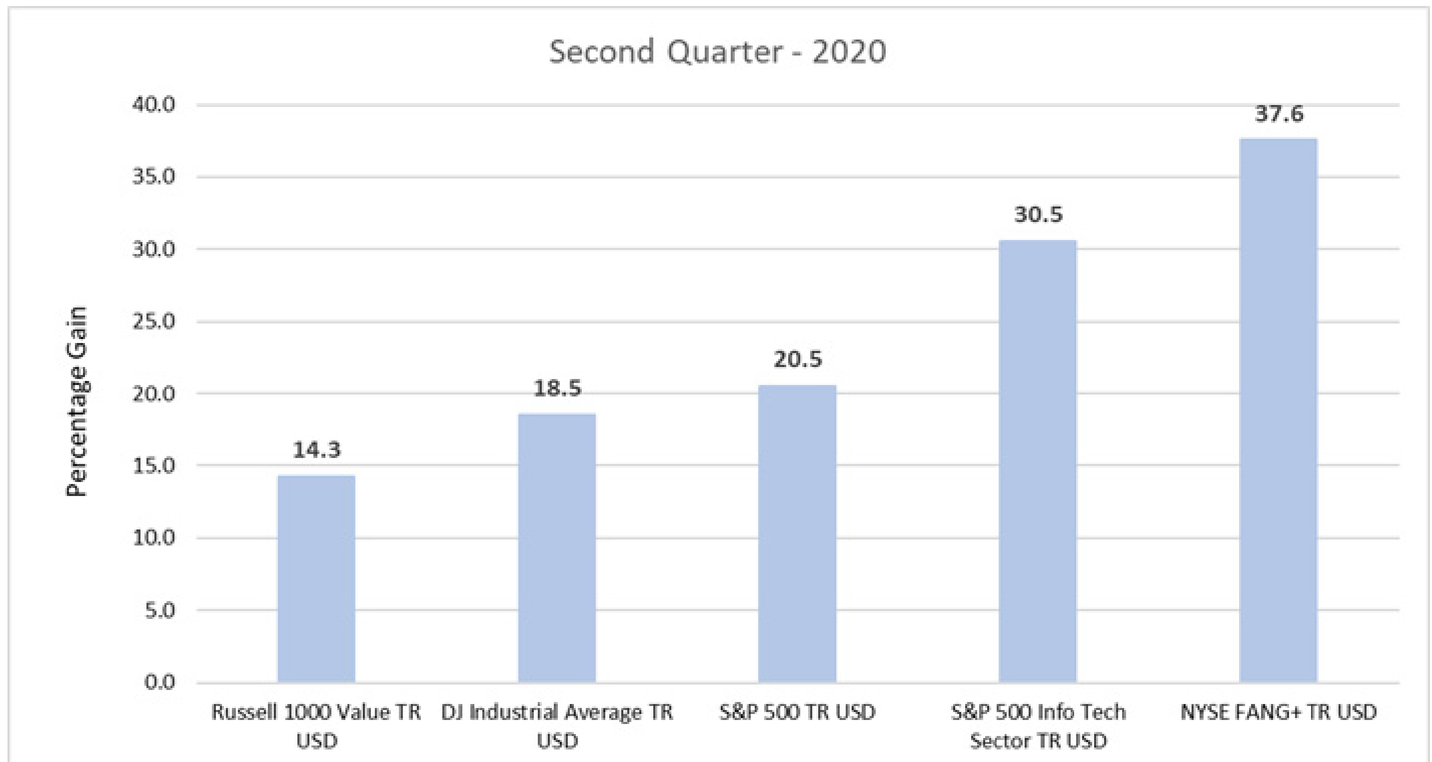
As a result, the market can be separated into a of couple categories; one comprised of the largest five companies in the S&P 500: Facebook, Apple, Amazon, Microsoft, and Google (FAAMG), and basically the other 495 companies in the index.

As the S&P 500 is a market-cap weighted index, these largest top five companies account for almost 22% of its weight. Chart 1 below demonstrates the outsized gains and influence these companies held in the performance of the broad market during the last quarter.

The longest period of similarly narrow breadth occurred in the two-plus years leading up to the end of the technology bubble in 2000. Periods of narrow breadth are often a harbinger of market declines as ultimately reliance on only a few companies or sectors results in a period of retracement as conditions inevitably change. It is natural to think that investors are overreacting to tech's resilience in 2020 and that its outperformance cannot continue indefinitely.

There is fundamental support to favoring FAAMG, though. Microsoft continues report double digit increases in sales, Google surpassed revenue expectations despite the potential for a decrease in advertising sales, and Apple has one of the most cash-rich balance sheets in the world. So, it is plausible that these stocks can continue to outperform.

Chart 1 – Index Returns Supported by a Few Companies



Source: Morningstar Direct

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Looking at profitability metrics, earnings, margins and balance sheets, these companies seem attractive based on their ability to heavily reinvest in their businesses or return capital to shareholders when other sectors currently cannot.

We know that eventually the other 495 stocks in the S&P 500 will have more attractive fundamentals and will command relatively higher prices. At that point, the return dispersion between the two groups will normalize, we just do not know when, though it will likely coincide with more positive economic data and greater confidence regarding the containment of the coronavirus.

Treasury Markets

To repeat prior assertions, equity markets are looking ahead to next year and even beyond to justify the rapid bounce and sustained climb from the recent lows. There exists the expectation of a coronavirus vaccine to be in circulation and the economy to be mostly back on pre-pandemic footing.

The Treasury market holds a different view. When the year started, the S&P 500 stood at 3,237 and the yield on the 10-year note stood at 1.92%. On March 23, the S&P 500 went as low as 2,174 (down 33% for the year) while the yield on the 10-year note settled at 0.76%.

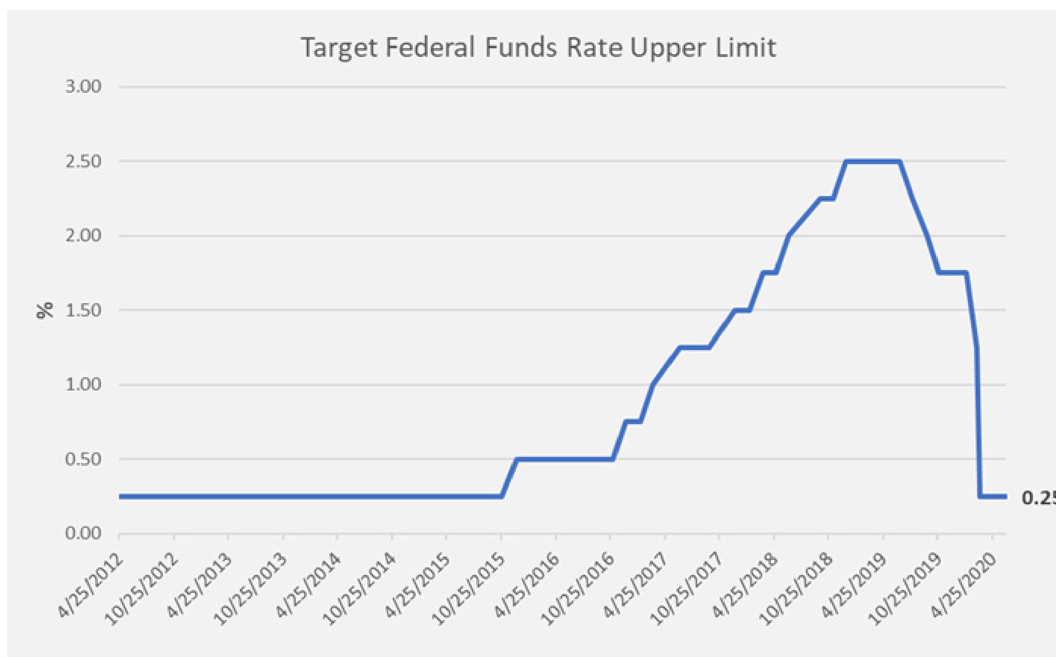
By June 8, the S&P 500 had recovered enough to be positive for the year. Correspondingly, the 10-year yield hit 0.88%; still significantly below beginning of year levels.

Today, the 10-year note yield sits at 0.64%, further away from where it began the year and even lower than it was on March 23. Remarkably, the yield on the 10-year note is lower despite an inflow of new issuance hitting the Treasury market, the expectation of more to come, potentially more stimulus being enacted (both fiscal and monetary), and sequentially improving economic data.

It is a peculiar standing for the Treasury market, but it is one that speaks to the Treasury market's perspective on the recovery. It is less hopeful. The spread between the 2-year note yield and the 10-year note yield is 50 basis points today, which is basically where it was on the S&P 500 market low on March 23.

The message of the Treasury market does not convey the belief of a V-shaped economic recovery. In his most recent semi-annual monetary policy testimony to Congress, Federal Reserve (Fed) Chair Powell indicated a belief in an extended recovery period and that the economy will require accommodative policy support for an ongoing period. He also cautioned Congress not to back off fiscal stimulus measures.

Chart 2 – Federal Reserve Fed Funds Target Range



Data Source: : Y-Charts

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Mr. Powell also said at the June 10th Federal Open Market Committee (FOMC) meeting that the Fed is not inclined to consider raising interest rates anytime soon. That view is congruent with the median projection of holding rates zero bound through 2022.

Not Out of the Woods

A figure that has been on everyone's mind lately is the coronavirus case count in the U.S. It had been decelerating due to the prolonged stay-at-home efforts, but in recent weeks case counts have been accelerating in some states as reopening plans have been initiated.

Though this was unavoidable and expected, the market is expressing concern about the rising case counts in some states and regions. This dynamic is again bringing uncertainty regarding reopening plans (will they be delayed and/or reversed?), thereby slowing the pace of recovery efforts by preventing hiring, discretionary spending, and business investment activities.

This is potentially problematic, given the magnitude of optimism residing in the expectation of a continued strengthening of activity. Investors can handle a likely largest on record second quarter Gross Domestic Product (GDP) growth contraction if there is a reasonable chance that the third quarter will exhibit a rebound.

And frankly, the question is not so much about whether there will be a rebound in activity the third quarter and beyond. The issue is whether it will be sufficiently strong (align with positive expectations) and whether the second half of the year and beyond exhibit a return to normalcy.

It remains to be seen which path the economic recovery will continue to take, but the road will not be a short one if consumers hoard their disposable income waiting for another bout of coronavirus to pass. The answers to these recovery questions will depend in large part on the path of the coronavirus, the path of vaccine/treatment efforts, the path of the labor market, and the election outcome in November.

To conclude, Bespoke Investment Group highlighted a noteworthy phenomenon last week. Using data going back to 1928, they confirmed that following quarters which register returns of 15% or greater, forward performance is quite strong. The average gain in the next quarter is 4.28%, followed by another average gain of 6.27% the quarter after that. To review, the S&P 500 just returned 20.5% in the second quarter.

Shortening the period to include only a post-World War II time frame, the average next-quarter gain increases to over 9%. Additionally, there has never been a negative quarter immediately following one which gains 15% or more; in fact, the S&P 500 has never been up less than 4% in the following quarter.

That is not to say that stocks cannot or will not go down over the next few months, but it is definitely a more encouraging (or perhaps interesting) historical record than it might otherwise be.

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bergankdv

WEALTH MANAGEMENT
by BerganKDV

Minneapolis
3800 American Blvd W
Suite 1000
Minneapolis, MN 55431
952.563.6900

St. Cloud
220 Park Avenue S.
P.O. Box 1304
St. Cloud, MN 56301
320.650.0250

Cedar Rapids
2720 First Ave. NE
Suite 300
Cedar Rapids, IA 52402
319.294.8000

Coralville
2451 Oakdale Blvd.
Suite 204
Coralville, IA 52241
319.354.3000

Des Moines
9207 Northpark Drive
Johnston, IA 50131
515.727.5700

Waterloo
100 East Park Ave.
Suite 300
Waterloo, IA 50703
319.234.6885

Kansas City
3550 NE Ralph Powell Rd.
Lee's Summit, MO 64064
816.525.9699

Omaha
16924 Frances St.
Suite 210
Omaha, NE 68130
402.330.7008

bergankdv.com

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