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Todd Asset Management

The Economy: Better, but Still Not Good

Todd Asset Management Q2 2020 US Market Commentary

	2Q 2020	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	20.5%	-3.1%	7.5%	10.7%	10.7%	12.1%	14.0%
Russell 1000 Value	14.3%	-16.3%	-8.8%	1.8%	4.6%	7.1%	10.4%

* *Annualized Total Returns.*

The biggest surprise of the first quarter was the speed we descended into a recession when governments, worried about a coronavirus, shut down economies. The biggest surprise of the second quarter was the speed with which the recessions ended and recoveries started. One of our favorite economists, Ed Hyman, tells us we are starting a new expansion and it should last years. The best description we have heard for the current economy is "it's better, but still not good." Economic results are improving from record setting weakness but it will take some time before we reach pre-virus activity levels. We are seeing a resurgence in Covid-19 cases, expecting a contentious election and stocks have seen a significant run off the bottom. The market is anticipating better economic times ahead, and normally surges in the S&P (like the one we just saw) are followed by several strong quarters. We believe an economic recovery is unfolding, but the market might trade sideways for the summer while awaiting further evidence that the recovery is taking hold.

Items of interest during the quarter:

- The S&P gained over 20% in Q2, the best showing since 1998. Historically, gains of this magnitude tend to be followed by continued, though more modest gains and economic growth.
- The economy took a hit about twice the size of what was experienced in the Global Financial Crisis, but has been rebounding faster than any other time in history.
- Governments and Central Banks worldwide responded quickly with tremendous stimulus programs. These programs should bolster economic results for a long time, once a self-sustaining recovery develops.
- Several notable "V" shaped recoveries unfolded, with record breaking weakness being followed by sharp recoveries. Worldwide GDP and Employment are experiencing a V, and earnings are expected to experience a V later this year. We are monitoring to make sure these V's don't turn into W's, Square Roots or L's.
- Dramatic civil unrest is occurring in the US. Politically, many polls are suggesting the election results in a Democratic sweep.
- The Virus remains with us. New cases appear to be increasing again, while deaths have not increased as much. Setbacks have been reported, but we do not believe another complete

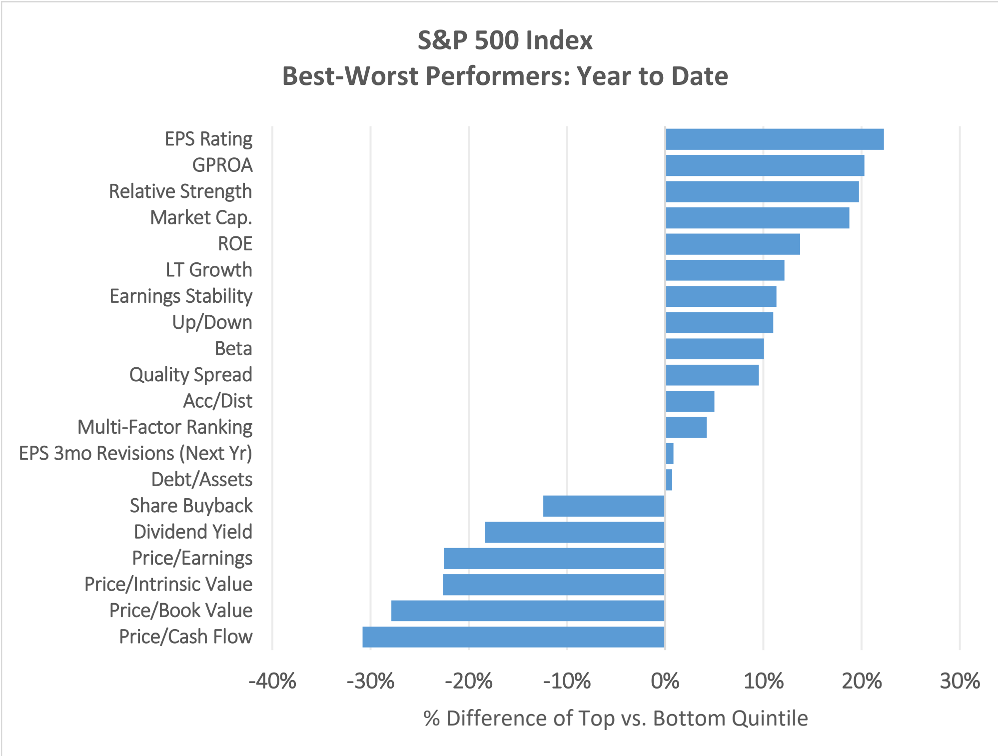
shutdown is likely or even possible at this point. Experts remain optimistic that some remedy should be available in coming quarters.

More challenges will occur before year end. Follow on restructurings and firings are expected. Resurgence of the virus could take on a life of its own. Political discord is almost guaranteed. Some partial shutdowns are occurring and could expand. This is how recoveries begin though, with fitful starts and stops. We are encouraged that long term durable purchases (houses and cars) are doing well with low financing costs, and the past couple of employment reports have seen a strong rebound off the bottom.

The markets have had a significant rebound too, yet 10 year rates remain low on fears of economic weakness. According to the Fed, short term rates are probably stuck at zero for the foreseeable future. Aggressive government income support for consumers, businesses and (probably) local governments in the future, has kept the base of the economy relatively intact to allow for a faster recovery. While more stimulus is going to be needed, we suspect the economy should enter a self-sustaining expansion as the year progresses, especially if there is any good news on the vaccine front. As for the future, we would note that the last five economic expansions lasted an average of eight years.

Bear markets typically result in leadership changes as recessions wipe away excesses of the prior expansion. This episode is different than prior recessions, because the cause of the recession was not correcting an excess but rather dealing with a pandemic. As such, value stocks have remained in the "doghouse" and investors have grown infatuated with the largest 5 stocks in the market. We suspect this bear market is going to result in a rotation, just like others did. The stocks that have suffered the most over the recession (and the years leading up to it) have been the cheaper cyclical stocks. Investors have been preparing for a recession for the past five years by focusing their interest on the largest growth stocks which were perceived as safer bets. Having finally gotten a recession, we believe the decks are cleared for investors to start expanding their interest beyond solely the growth stocks. Normally, this should begin as confidence in the economy grows, which should occur in the coming quarters.

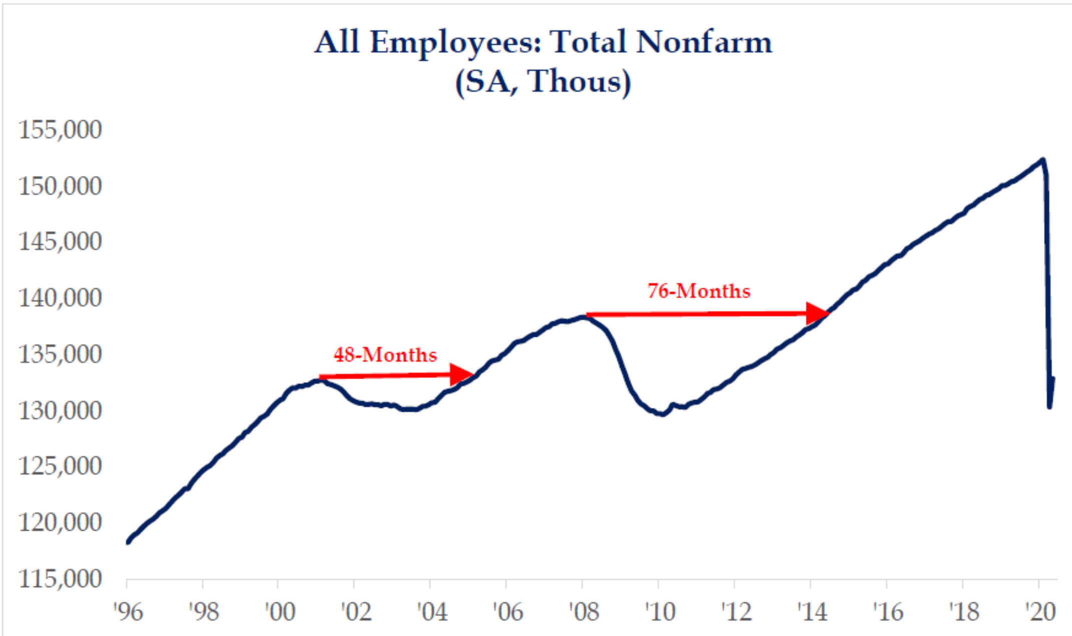
Factor performance



Source: Bloomberg, William O'Neill + Co. And Todd Asset Management

What a difference a quarter makes! We saw a dramatic shift towards value factors working during the quarter (despite value indexes lagging growth). The best performing sectors since the market low have been Consumer Discretionary, Energy and Materials: groups where the average stock has value characteristics.

Interesting Charts we saw This Quarter



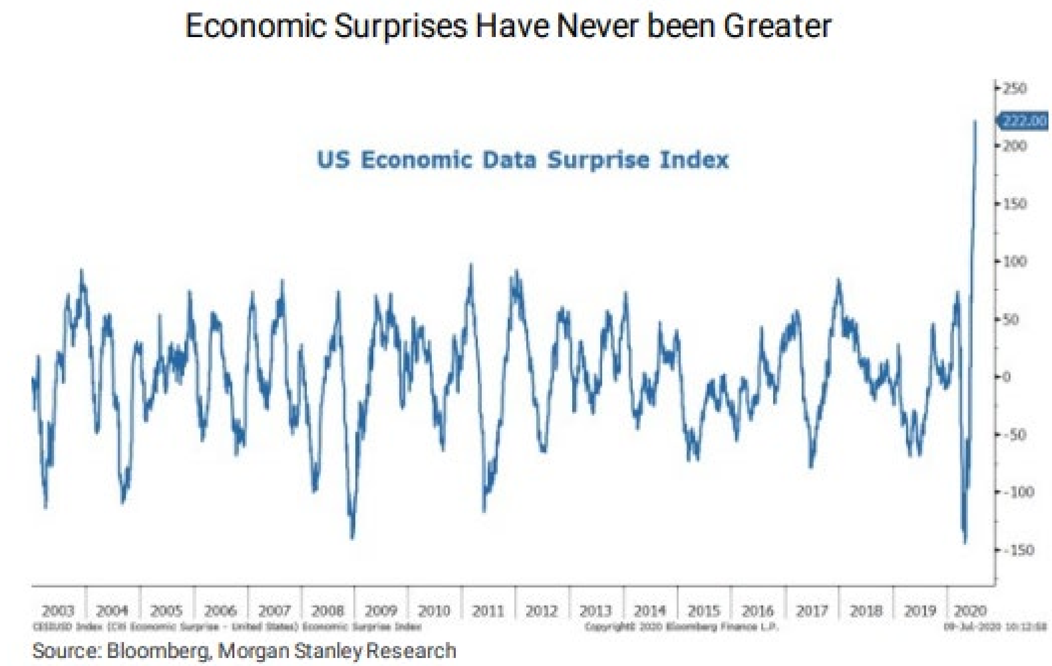
Source: Strategas

This episode was damaging, as non-farm payrolls showed a 22 million job loss between February and April. We have seen May and June recover to add 8 million jobs, and expect further gains. In the last two recoveries it took between 4 and 6 years to make new highs, but the peak to peak period lasted 8 to 12 years. History suggests this recovery has years to go.

Prior S&P Surges Were Followed by Strong Growth

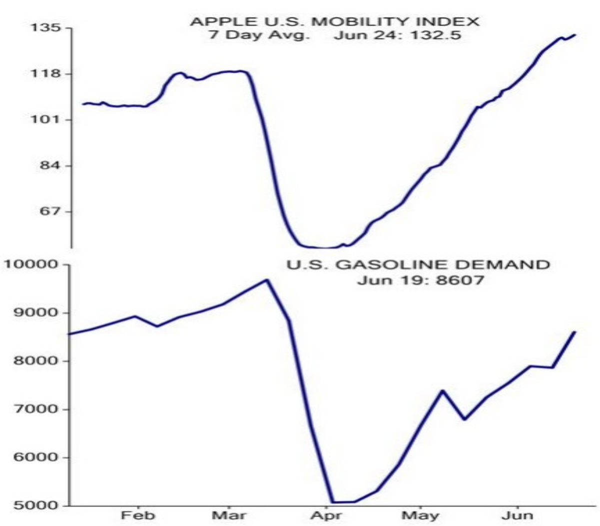
	S&P Q/Q Ch.	U.S. GDP Q/Q A.R.	
1975 Q1	+22%	Q2 +2.9%	Q3 +7.0%
1998 Q4	+21%	Q1 +3.8%	Q2 +3.1%
1987 Q1	+20%	Q2 +4.4%	Q3 +3.5%
✓ 2020 Q2	+19% ✓	Q3 ?	Q4 ?
1997 Q2	+17%	Q3 +5.1%	Q3 +3.5%
1982 Q4	+17%	Q4 +5.4%	Q4 +9.4%
Avg	+19%	+4.3%	+5.3%

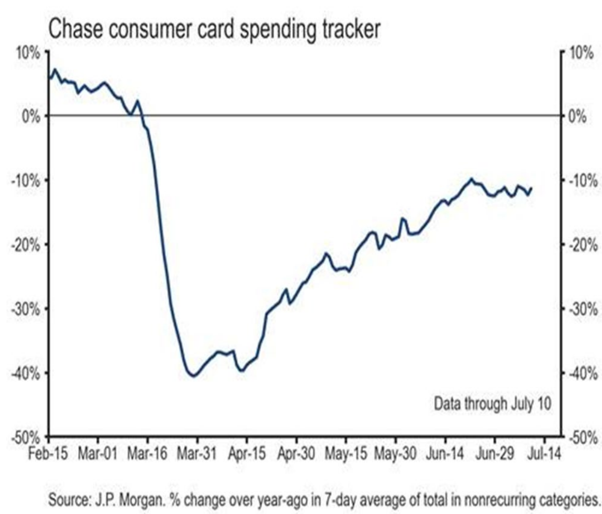
Source: Evercore ISI



Record weakness on the Economic Surprise index has been followed by record strength.

V Shaped Recoveries





Source: Evercore ISI

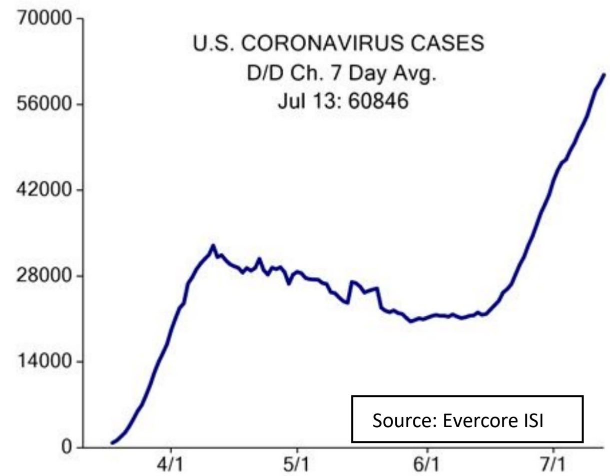
The quarantine is over. Measures of consumer mobility, like Apple's Mobility Index and gasoline demand (chart left, compliments of Evercore ISI) have posted strong recoveries. Consumer credit spending (chart right) is still declining year over year, but is recovering from trough levels.

High Yield Spreads Lead Cyclical Performance

Source: Bloomberg, S&P and Todd Asset Management

High yield bond spreads versus treasuries (yellow line-inverted) are a good gauge of investor confidence in the economy. When spreads decline (i.e. the line rises) confidence is better and cyclicals outperform defensives (blue line rising). Confidence is now increasing on this measure, which we believe will lead to cyclical outperformance.

Apple, Amazon, Microsoft, Google and Facebook account for almost 22% of the S&P 500. Investors have flocked to these names as a safety trade and Covid beneficiaries. While it is impossible to call a turn in this trend, it feels like better economic confidence and positive developments on Covid would work against this concentration.



Covid-19 is a scourge that has not left us yet. New cases continue to rise, though fatalities remain below peak levels. This bears watching as renewed shutdowns mandated by states could delay any economic recovery.

<u>Summary</u>

We believe the economy is entering a new expansion. The pain of the recession is very real, and can be seen in the unemployment rates. Unemployment is likely to remain high especially in the vulnerable services industries. We believe the Government Safety Net has left the economy with a base to recover from. Pent up demand exists, consumers were not overextended going into the recession and government stimulus is forthcoming. Uncertainties surrounding the election and the potential for a second wave of the virus could be headwinds over the summer, but we would not want to fight the Fed and every other central bank on the planet over the next few years. We believe the secular bull market is intact, and we are probably at the beginning of a long economic expansion.

As always, if you need any additional information, please feel free to contact any of us.

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Jack Holden CFA
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07/17/20
S&P 500 – 3,225
Russell 1000 Value – 1,156

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

Disclosure

The indexes are unmanaged, and not available for direct investment; they include reinvestment of dividends; they do not reflect management fees or transaction costs.

S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.