

Review & Outlook

SECOND QUARTER 2020



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Review and Outlook

The second quarter of 2020 was the strongest second quarter on record for the S&P 500, which saw the index recover almost all of the ground it lost in the first quarter. This growth is both surprising and perplexing, given the high level of unemployment and other significant issues. Economic forecasts call for unemployment to remain elevated through 2021. A

large number of people

could not pay rent in June, and may not be able to pay in July.

President Trump suspended H-1B and other visas that allow foreigners to work in the U.S.

Florida announced it was closing

popular beaches for the fourth of July due to a recent surge in infections, and Texas announced it was closing bars that had recently reopened. Despite these troubling events, the stock market moved upwards.

The most dramatic increase in stock prices came largely in the first half of the quarter. At that time, it appeared that businesses would reopen and life could start returning to normal. Moreover, the Federal Reserve acted swiftly in March, providing unprecedented support for the economy overall, and credit markets in particular. Optimism was improving in general, and many investors seemed to feel that support from the Federal Reserve meant they could ignore the bad news.

While we are always happy to see the market perform well, we have serious concerns about the disconnect between the stock markets and the broader economy. Alcoa is closing facilities, and permanent layoffs are planned at companies like Boeing and Alaska Airlines. Yet the market moves up. We think this disconnect means more volatility in the future and a potential contraction in stock prices, depending on what happens with the COVID-19 virus.

In April, CNBC reported that investors with \$100,000 or more in investable assets have 32% of their portfolios in cash, which suggests that many people expect another market downturn, or at least want to see what the data reveals before getting fully invested.²

Index Performance Data
Total Return as of 6/30/2020

Indices ¹	Q2 2020	Trailing 12 Months
CRSP U.S. Total Stock Market Index	22.09%	6.44%
MSCI Global ex-U.S. Total Stock Market Index	19.39%	2.63%
Bloomberg Barclays U.S. Aggregate Bond Index	2.90%	8.70%

Many of the emergency benefit programs put in place earlier this year will expire soon. For example, the \$600 supplement Congress added to weekly unemployment benefits expires the week of July 31st. And some mortgage deferral and rent relief programs are set to expire in July, as well. Public agencies could decide to

extend those benefits, but right now it looks like July will be a critical period where we could see a significant change in spending that could ultimately ripple through to stock prices.

In Focus

This quarter's In Focus explores what else might be driving this perplexing rally in the stock market, besides the people investing because they are truly optimistic and think the Federal Reserve will prevent a market correction. We highlight the emergence of the Neo Day Trader; an investor who seems to have no use for any sense of fundamental business valuation. A good example of this is the recent price action of Hertz stock.

Hertz, which also owns other car-rental businesses like Dollar and Thrifty, started missing payments to its lenders in April, and the company filed for bankruptcy on May 22nd. At that time, they had debts of \$18.7 billion, had only \$1 billion in available cash, and demand was near zero for rental cars. Not surprisingly, their stock price fell sharply following the announcement. However, a few days later, the stock price started to increase as investors/gamblers/day traders bet on a recovery. The increase gave Hertz an idea: they asked the bankruptcy judge to allow them to issue \$1 billion in new

shares to raise money to help pay their debts. The judge gave the green light, though the sale was ultimately halted after the SEC objected.

Of interest to us is why anyone would consider buying stock in a company that cannot pay its lenders, and whose secured debt was selling for less than fifty cents on the dollar. If

Hertz cannot pay its debtors, then the stock is essentially worthless. Bond holders and lenders get paid first in bankruptcy proceedings, so its likely there wouldn't be anything left to distribute to shareholders.

One theory of the neo day

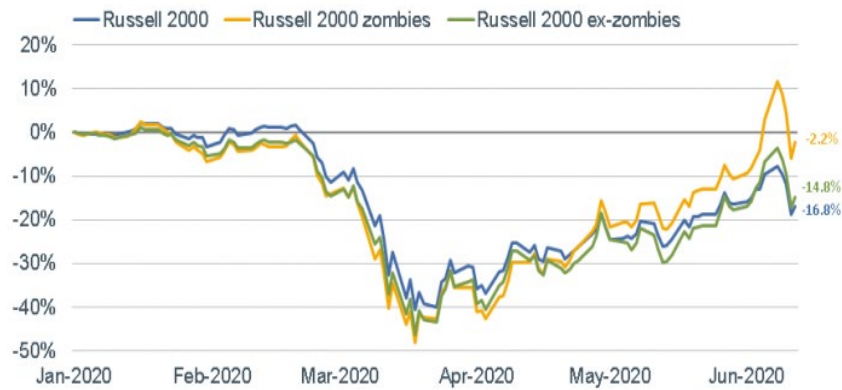
trader is that they are people who normally bet on sports or go to casinos, and who now have no other options. This theory is consistent with the large number of people who opened new accounts and started trading this spring. TD Ameritrade and E-trade saw increases of over 150% in new accounts opened late in the first quarter compared to the same time a year ago.

Neo day traders have been gambling on zombie companies like Hertz; companies that earn just enough money to continue operating, but not enough to pay their debts. Zombies survived by refinancing their debts as interest rates fell. Now many are enjoying an influx of money from these new investors. Figure 1 highlights the strong performance of zombie companies in the Russell 2000 (an index of smaller companies) during the second quarter of 2020.

Whether it is the neo day traders or more seasoned investors feeling newly optimistic, we remain concerned about what is driving the recovery in stock prices. The labor market is

rebounding, but will still take years to recover. For example, dentists and hygienists returning to work to start seeing non-urgent patients again accounted for 10% of the job gains in May, but patient visits are down 30% compared to a year ago. People are afraid, and the economy will not fully recover until people feel safe again.

Figure 1³



Source: Charles Schwab, Bloomberg, as of 6/12/2020. Past performance does not guarantee future results.

The run up in stock prices in the second quarter went higher than we think makes sense, even with support from the Federal Reserve. There's an old saying that investors should never fight the Fed. And it is true that the Fed can support the stock market in different ways.

But the Fed cannot make the coronavirus disappear so that people feel confident again. Nor can the Fed keep many small businesses afloat.

The market is priced for a quick, V-shaped recovery. We are anticipating something slower, so we don't think it makes sense to be fully invested right now. Too little is known about what is really happening with corporate earnings and employment. We need to see what is really happening to be able to make good investment decisions, and new data on corporate earnings comes out mid-summer. We also want to see better news related to the virus. We're watching infection rates, but also what happens to the people who test positive.

We also hope that college and major league sports start back up again soon. We know the stadiums might be empty, but it would allow some of the day traders to go back to gambling on sporting events instead of zombie companies. We think the stock market would behave bit more rationally without their influence.

1. Index price and performance data is provided by Black Diamond Wealth Platform, an SS&C Advent service.

2. Frank, R. (2020, April 20). This is what rich investors were doing with their cash as the market plummeted. Retrieved May 05, 2020, from [Source Link](#)

3. Sonders, L. (2020, June 15). 2020 Mid-Year Outlook: U.S. Stocks and Economy. Retrieved June 16, 2020, from [Source Link](#)

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