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Q2 2020 Commentary: Expectations are up, will they be met?…

Financial markets bounced back sharply in the 2nd quarter from the 1st quarter Covid-19 swoon. Although the magnitude of the recovery was startling given the uncertainties we face, it was not wholly unexpected. The advance was triggered by anticipated events such as the massive stimulus bill that literally showered money on the economy. Initial attempts to re-open the economy after the shutdown also emboldened investors, although that is now reversing. In the quarter, the S&P 500 rose 20.5%, driven by large moves among the largest growth companies. Meanwhile, many small and value stocks languished. Bond markets also performed very well as interest rates fell and bond prices rose as panicked "sell everything" selling pressure on all financial assets abated. The 10-year US treasury yield fell to 0.65% from 0.70% and the Barclay's US Aggregate bond index gained 2.9%.

Currently, tens of millions of Americans have lost their jobs and more than a million people are filing for unemployment benefits every week. The Covid-19 pandemic continues to be as bad as ever, except, thankfully, for the death rate of those infected due to improved treatment of the disease. Political animosity rages on and demonstrations are daily events. Despite massive political, social, and economic problems, the stock market is not far from the all-time high levels achieved in February, before the Covid-19 pandemic surged. It is fair to wonder why.

There is a logic to the stock market recovery. First and foremost, the prospects for a treatment of covid-19 are encouraging. Already Gilead Science's Remdesivir is being used in hospitals with some success. In recent weeks National Institute of Health Director Dr. Anthony Fauci has repeated that his examination of the research data leads him to believe promising treatment and vaccine candidates are likely to be identified in the fall and that a treatment, or treatments, will become available around the new year. Over the most recent weekend there were further encouraging reports of progress made in the research effort.

If a Covid-19 treatment is coming, all that needs to be done is to support the economy between now and then. If we can bridge that period by minimizing the damage to the economy, a substantial recovery can begin that will support the stock market. The government, in a rare act of bipartisanship, has demonstrated its willingness to do whatever it takes with the passage of the three trillion-dollar Cares Act aid program. This week it looks like there is further consensus in Congress to continue with more aid. Given these circumstances, we will be staying the course with our equity portfolios as we have throughout the pandemic.

A characteristic of the current stock market is the chasm between the performance of growth stocks and value stocks. This is a trend that has been in place for years and it continued in the 2nd quarter. The S&P 500's growth stocks were up 26% while its value stocks rose only 13%. We know this performance divergence cannot last forever. At some point the growth stock valuations will rise to unsustainable heights. Conversely, value stocks are heading toward valuations that are too cheap to ignore. Our portfolios contain a fair number of high-quality growth companies. The most likely portfolio activity going forward would be a migration from growth stocks back to more traditional value stocks. Ultimately, those decisions will be based on valuation and where we see the greatest appreciation potential over the long term.

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