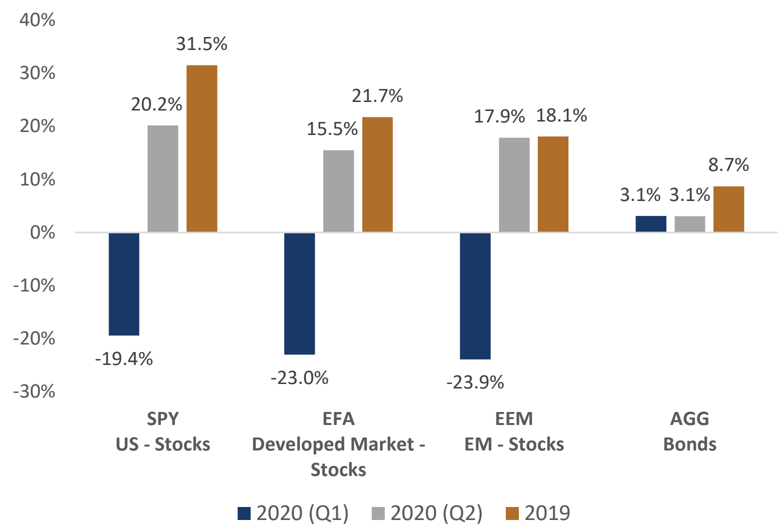
Don't Fight the Fed

"Whoever controls the volume of money in any country is absolute master of all industry and commerce."– ***James A Garfield***

After the S&P 500's worst first quarter on record, the stock market made history with an unprecedented recovery, taking many investors and prognosticators by surprise. Following the market lows reached on March 23rd, the S&P 500 was up 38% through the end of the 2nd quarter, marking one of the sharpest rallies over the past 100 years. The rally was not only monumental given the total return in just 3 months, but there was also 29 trading days (out of 70) that were up over 1%.



Where Are We Now?

The Federal Reserve stepped in with a broad array of actions to limit the economic damage from the COVID-19 pandemic by lending support to households, employers, financial markets, and state & local governments. In April, Jerome H. Powell, Chair of the Federal Reserve Board of Governors said "We are deploying these lending powers to an unprecedented extent [and] … will continue to use these powers forcefully, proactively, and aggressively until we are confident that we are solidly on the road to recovery". However, the Fed's tools alone were not sufficient to cope with the economic impact of the COVID-19 crisis. Congress and the President provided a historical fiscal response which included, stimulus checks to individuals/families, increased unemployment benefits and stimulus to small businesses through the Payroll Protection Program (PPP).

With the assurance from Chairman Powell that "we will not run out of ammunition", along with optimism that coordinated and focused scientific research would eventually lead to a vaccine (World Health Organization reported there are more than 100 vaccines candidates and over 20 in clinical trials), investors have started to look past the pandemic and forward to an economic recovery. In addition, as the lockdowns started to ease, data pointed to a rebound in consumer spending. Household spending rose a record 8.2% in May, which is more than double the prior all-time high, indicating consumers are eager to spend despite historically high unemployment.

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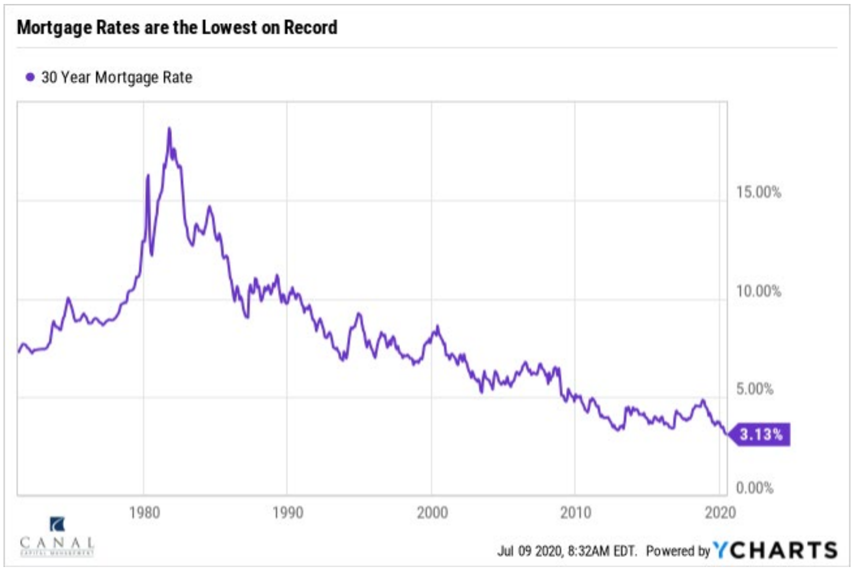
Where Do We Go from Here?

One major question we continue to struggle with is how the market is back to levels where we started the year, while so many Americans are still grappling with COVID challenges?

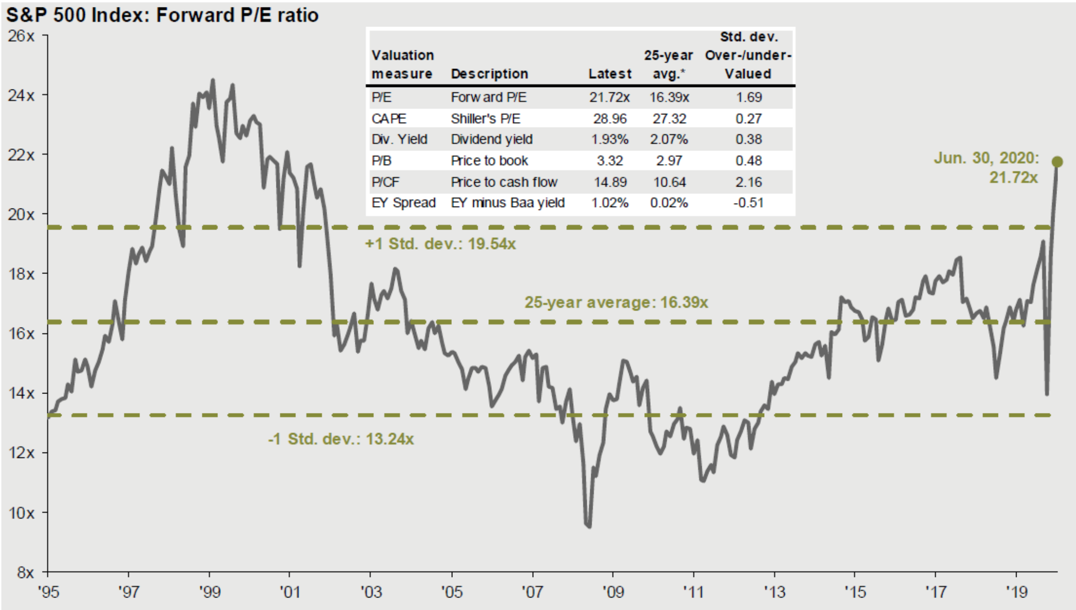
What makes us optimistic? *There is good reason to be optimistic. And that's important because optimism is necessary for traction in an economic recovery. On a basic level, our economy is the combination of hundreds of millions of households making decisions about whether to spend or save.*

- Consumer Confidence & Spending – Consumer spending accounts for approximately 70% of the U.S. GDP and a healthy consumer that is willing and able to spend drives the economy. Supplemental unemployment benefits have cushioned consumers, offsetting some of the decline in wages/salaries. We believe consumer confidence is building and it does appear that consumers are still willing to spend on non-essential items. As vacation options have dwindled this summer, RV and boat dealerships across the country are reporting a significant uptick in sales. Relative to the last recession, consumer confidence remains amazingly high – a function of the assumed temporary nature of job losses.

- Monetary and Fiscal Actions – The Federal Reserve and Treasury demonstrated their dedication to doing anything necessary to support the market through swift policy action. It became clear that the Federal Reserve would manipulate interest rates to stimulate businesses, and investors are convinced that interest rates will be lower for longer. Lower interest rates, at least in the short term, are a clear positive for the consumer and for businesses. As shown in this chart, mortgage rates are at all time lows, which has created a refinancing boom.



- The Stock Market is Always Forward Looking – As stock market investors, we are always looking forward and trying to predict the future economic potential of the economy. This is even more important today as we are trying to look past the near-term issues and to a post-COVID world. In our opinion, Wall Street is currently priced as if we are on a near-linear path back to pre-COVID levels, with valuations being stretched and based on *"potential"* future earnings streams, that are still very uncertain at this point. As noted in the chart below, the forward price to earnings for the S&P 500 is well above its 25-year average, levels not seen since the tech bubble.



Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

What makes us cautious? *Despite the historic recovery, the overall underlying economy faces significant challenges.*

- Historically High Unemployment – At the end of July, supplemental unemployment benefits will run out, and if a significant number of jobs have not returned or another round of stimulus isn't passed, the decline in wages/salaries could become severe. At the end of June, the unemployment rate was still 11.1%. While we anticipate another round of stimulus to help small businesses and individuals, the amount of the benefit and the timing are uncertain at this point. Although many ideas are being discussed, there is a race against time as the PPP funds that helped small businesses retain workers are ending. Businesses with less than 100 workers account for 1/3rd of all employment in this country and it is still unknown how many of those small businesses will survive.

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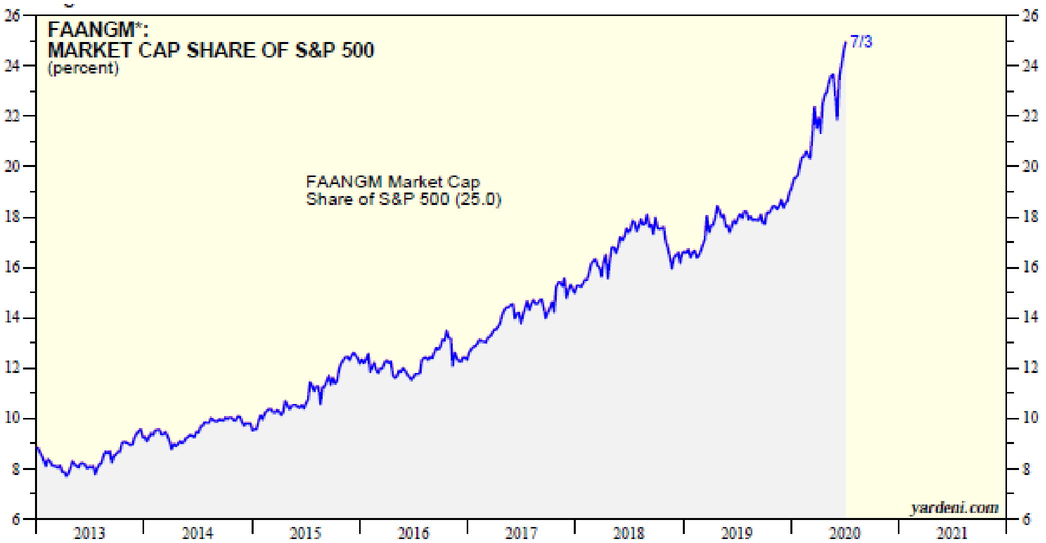
- "V-Shaped" Stock Market Recovery – The equity market recovery has been historic, giving many investors the illusion of "*being back to where they started*". But this is a false sense of security in our opinion. Market gains have been dominated by the FAANGM stocks, which have the best growth stories (Facebook, Amazon, Apple, Netflix, Google & Microsoft). These 6 stocks make up 25% of the S&P 500 (below) and are valued at $6 trillion dollars. For a permanent recovery to take place, there needs to be much broader participation, which would include beaten up sectors, such as the airlines, energy companies and retailers. History also suggest that V shaped market recoveries are rare and there are typically several peaks and troughs as markets consolidate for the next leg higher. It would not be unusual for this consolidation to last another 6-12 months.



* FAANGM stocks include Facebook, Amazon, Apple, Netflix, Google (Alphabet), and Microsoft. Both classes of Alphabet are included.
Source: Standard & Poor's and I/B/E/S data by Refinitiv.

- Irrational Exuberance in Some Areas of the Stock Market – With the swift rebound, retail investors "playing the market" have increased significantly and has led to some wild speculation. Hertz, the auto rental company, filled in June to offer up to $500 million in additional shares, aiming to cash in on a surge in investor's interest on its rallying stock despite having filed for bankruptcy on May 22. In the offering documents, Hertz *repeatedly* warned potential investors its shares could end up being "worthless" amid bankruptcy. Often this type of euphoria for *"low quality"* stocks such as Hertz is a sign of an over-extended market. As a famous economist John Maynard Keynes said, "the markets can remain irrational longer than you can remain solvent.".

- Uncertainty in November's Presidential Election – As we entered 2020, one of the biggest question marks for investors was the upcoming Presidential election. The COVID pandemic has taken all the headlines (for good reason) but we expect focus will shift to the election again as we move closer to November. Importantly, we believe the stock market performance over the next few months will be an important political gauge as politicians will use the stock market instead of GDP growth as a score card for the US recovery from COVID.

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Conclusion:

First and foremost, we hope everyone is safe and healthy. Overall, we remain cautious as we believe market sentiment has become euphoric and equity markets are disconnected from the real economy. In our view, there are still a myriad of uncertainties that are very difficult to handicap:

- Will COVID cases and deaths decline?
- Will COVID have a 2nd or even 3rd round of cases (like most other pandemics)?
- Will there be a vaccine? How quickly can it be distributed to the world?
- Will there be another round of fiscal stimulus? Will it be timely, or will it be slowed by political dissention?
- Will the election have an impact on the next stimulus?
- The market likes Trump, but what if he goes after China, which has been a negative to markets.
- The market hates taxes and Biden will immediately try to increase corporate tax rates.

What we do know is that it is a long road ahead to get to a pre-COVID level of U.S. GDP. While the longer-term outlook might be positive, we believe it is prudent to be a bit more conservative in this market. With that backdrop, we are focused on finding investments that, not only will survive the COVID pandemic disruption, but are likely to gain market share in a post-COVID world. We still see opportunities in Technology, Healthcare and Real Estate to note a few, and will continue to refine investment portfolios to align with our views on future economic opportunities. We think it is important for investors to maintain diversification in portfolios and in these uncertain times, we believe having a cash position is prudent.

As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance.

Sincerely,

Canal Capital Management

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