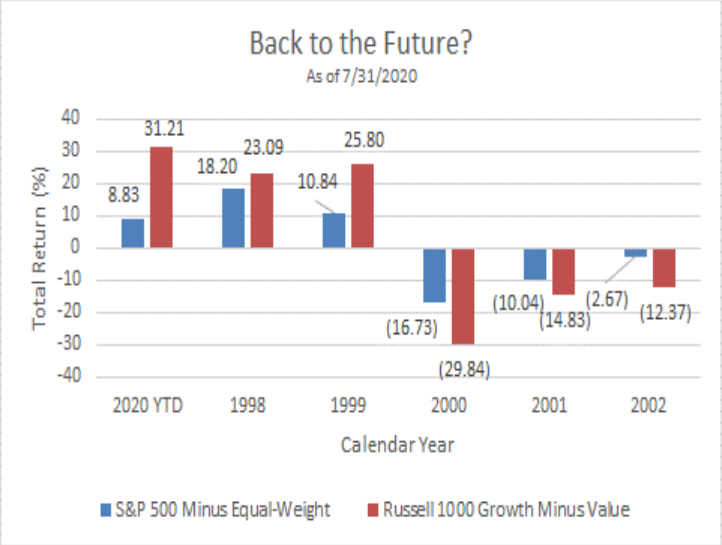
STONE INVESTMENT PARTNERS LLC

Weekly Market Guide | August 3, 2020

CHART OF THE WEEK



Source: Stone Investment Partners, Bloomberg as of 8/3/2020

Last week provided another example of growth stocks trouncing value and the larger capitalization stocks outperforming the smaller, so it is a good time to look at these moves relative to history. The capitalization-weighted S&P 500 (the widely quoted index) is outperforming the equal-weighted (S&P 500 companies equally-weighted in a portfolio) by almost 9 percentage points year-to-date (YTD) which reflects the outperformance of the largest companies (see chart). If the outperformance continues at this pace, it would be the second largest relative outperformance on record after the 1998 calendar year. If the calendar year 2020 was over today, growth stocks (Russell 1000 Growth) would have outperformed value (Russell 1000 Value) by the largest amount on record with second place going to 1999. As Mark Twain is reported to have said, "History doesn't repeat itself, but it often rhymes." The analogy between the current situation and the technology, media and telecommunications (TMT) bubble of the late-1990s is imperfect, but likely holds some valuable lessons for investors today. First, the divergences noted in 2020 are large but 1998 and 1999 illustrate that they can continue. Second, the current period is more difficult to judge in some respects because most of the growth companies doing well are fundamentally strong and profitable companies compared to the bubble period with a large number of money-losing dot-com companies with questionable business models. For example, Apple (AAPL), which has risen almost 45% YTD, posted record earnings for the quarter last week despite the pandemic. Third, every large divergence has some element of truth. The idea behind the TMT bubble was correct in that the internet did change the world. Similarly, the pandemic has clearly impacted the fortunes of some companies. Finally, the large divergence likely closes at some point as too much good news is priced into these winners versus the underperformers because valuation matters in the long-term. Please see my previous notes about valuation here and small-cap stocks here. Strategas Research Partners also notes that concentration risk has risen with the largest 1% of the NASDAQ and Russell 1000 Growth indexes now accounting for 45.3% and 21.6% of the market-cap weight, respectively. This compares to 31.9% and 14.1% for the S&P 500 and Russell 1000 Value indexes. While the timing is unclear, maintaining and perhaps rebalancing some exposure to value and non-mega capitalization stocks will likely serve investors well when the future again rhymes with the past.

WEEK IN PREVIEW

- Geopolitical: With lockdown measures being re-introduced in parts of the U.S. and globe to combat a resurgence in COVID-19 infections, the impact on economic activity will be closely monitored. Tensions between the U.S. and China continue with TikTok the latest target of animosity between the two countries.
- U.S.: Primary attention will be on negotiations over the next fiscal stimulus package and the July jobs report. The additional $600 per week unemployment benefit expired at the end of July and the Congressional August recess adds to the urgency of reaching an agreement. While there is wide disparity in estimates including some economists expecting a decline, our expectation is that job growth will continue but at a slower pace than June with the increase in infections weighing on the gains. The infection drag has been seen in initial jobless claims which rose again last week and will again be watched to judge the impact on future employment. 2Q GDP posted a record annualized decline at -32.9% but 3Q should rebound with the Atlanta and NY Fed estimating 11.9% and 16.9%, respectively. Readings for our U.S. Reopening Monitor were deteriorated last week with the uptick in infections slowing the momentum of the economic recovery and showing up in the underlying high frequency economic data for dining, airplane travel and public transit usage. Of positive note looking forward, initial readings on new COVID-19 cases have fallen on a week-over-week (W/W) basis for two weeks in a row now after starting to rise in early June. Please see our weekly **U.S. Reopening Monitor** and our ***Guide to the U.S. Reopening Monitor*** for more details.
- S&P 500 2Q Earnings Season: The heart of 2Q earnings season continues with 129 S&P 500 companies reporting. According to FactSet, 84% and 69% have beaten consensus earnings and revenue estimates respectively with 63% of companies reporting. If it holds, the reading of 84% beating earnings would be the highest since FactSet started tracking the metric in 2008. The 2Q blended (actual and estimates) earnings decline improved to -35.7% year-over-year (Y/Y) from -42.4% due to positive surprises from multiple sectors led by consumer discretionary and technology. As we forecasted, some companies have reinstated earnings guidance which is a positive in removing some unknowns. The calendar year 2020 earnings estimates improved to -19.4% Y/Y with 2021 estimates at +29.2% Y/Y.
- Europe: Eurozone calendar is quieter this week, but June factory orders and trade for Germany will be of interest. The E.U. and U.K. held trade deal negotiations last week before the summer break and reports give reason for some optimism that the sides might reach a deal this year. The Bank of England (BOE) meets and is widely expected to keep the policy rate and asset purchases unchanged.
- Asia: The July China Caixin manufacturing PMI reading improved to 52.8 from 51.2 with the services PMI expected to remain strong at 57.9 and continue to reflect expansion. China also reports July trade data which will give a reading on the state of global trade and economic recovery. Japan June retail sales should improve to -7.8% Y/Y from -16.2%.
- Central Banks: In addition to the BOE, the central banks of Australia, Thailand, Brazil, Georgia, India and Czech Republic are scheduled to meet with Brazil and India expected to lower their policy rates.

WEEK IN REVIEW

- Stocks rose by 1.7% for the S&P 500 with seven out of eleven sectors higher for the week. U.S. economic data posted a record decline in 2Q annualized GDP at -32.9% and initial jobless claims rose, but 2Q earning outperformed expectations. Technology (5.0%), real estate (4.1%) and consumer discretionary (2.1%) outperformed the S&P 500, while energy (-4.2%), materials (-1.8%) and financials (-0.9%) were the biggest laggards. WTI (-2.5%) and Brent (-0.1%) oil were lower with MLPs (-2.1%) and the energy sector (-4.2%) underperforming. Small cap stocks underperformed the S&P 500 with the Russell 2000 higher by 0.9% but small cap value stocks gained 0.3%. The 10-year and 30-year U.S. Treasury yield were lower at 0.53% and 1.19% respectively.
- High yield credit spreads narrowed reflecting increased risk appetite. AAA municipal bond yields as a percentage of Treasuries decreased slightly, causing municipal bonds to outperform. The negative revenue impacts of the economic lockdown on local governments and talk of state bankruptcy have driven municipal bond valuations to low levels relative to Treasuries. Allowing states to declare bankruptcy should remain an unlikely outcome with the heart of the issue really about the size and distribution of Federal government aid. Additional support for the states is likely to come in the next stimulus bill.
- The U.S. dollar was weaker against developed and emerging market currencies. Developed international stocks as measured by MSCI EAFE underperformed the S&P 500 returns in U.S. dollar terms (-2.1%) and on a hedged-currency basis (-3.4%). Emerging market stocks performed similarly to the S&P 500 with the non-hedged return of 1.7% for MSCI EM.
- The 10-2 yield curve narrowed to +42 basis points. Another curve measure of three-month yield six quarters forward minus the current three-month yield narrowed to +3 basis points. The yield curve has historically provided an accurate forecast of future recessions when the difference in these measures turns negative, also known as inversion. Yield curves are one of the major indicators that we monitor to judge recession risk, but these inversions typically happen more than a year in advance of an economic recession but external shocks like the current coronavirus-induced recession might not be accompanied by one. Stocks have historically had significant advances post-inversion.

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Disclosures

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