STONE INVESTMENT PARTNERS LLC

Weekly Market Guide | July 6, 2020

CHART OF THE WEEK

Source: Stone Investment Partners, Bloomberg as of 7/5/2020

Financial market performance for the first half of 2020 provided some interesting divergences. After falling -20% in 1Q, the S&P 500 forecasted the V-shaped recovery in the economy so far with a gain of 20% in 2Q leaving it down only -4% year-to-date (YTD). Growth stocks again dominated in 2Q after outperforming in 1Q as well and are now 9% higher in 2020. It is worth noting that the valuation differential between growth and value is historically wide as we wrote about here. Small capitalization stocks outperformed in 2Q with the Russell 2000 rising by 25%, but the underperformance in 1Q still leaves them lower by about -14% YTD. Though not shown on the chart, dividend strategies generally continued their underperformance in 2Q with high dividend yield strategies lagging particularly badly both in 2Q and YTD. We wrote in more depth about what was ailing these high dividend strategies here and here. In addition, high dividend strategies typically have large allocations to financial companies which underperformed significantly in both quarters and our recent update regarding uncertainty around the future of bank dividends is here. A 60% U.S. stocks and 40% bonds portfolio (60/40) more than made up its 1Q losses in 2Q and now stands about 2% higher YTD. While it will be tough for bonds to provide as much cushion to 60/40 portfolios going forward given the exceptionally low yields currently, this year has illustrated the risk reduction value of fixed income as part of a diversified portfolio.

WEEK IN PREVIEW

- Geopolitical: The global economic calendar is light this week with no data that is likely to change any views on the trajectory of the economic recovery. 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. The relationship between the U.S. and China remains fragile and will be watched since it is a risk to the economic outlook.
- U.S.: Economic data last week reinforced the V-shaped recovery narrative with a strong rebound for the June ISM manufacturing reading and another strong jump in jobs from the June monthly payrolls report. According to the June payrolls report about one third of the 22 million jobs lost during March and April have now been recovered, but even the strong additions leave us with a deep hole yet to be filled. The June payrolls report data covered a period prior to the recent increase in COVID-19 cases which caused a pause in re-openings, so initial jobless claims will be watched closely this week to judge the impact on employment. Readings for our U.S. Reopening Monitor improved last week, but new COVID-19 cases in the U.S. rose again on a week-over-week (W/W) basis. Though not yet a part of our monitor, COVID-19 deaths declined on a W/W basis which was good news after the previous week showed the first W/W increase in deaths since mid-April. Underlying high frequency economic indicators remained in a positive trend, but OpenTable diners, transit demand and TSA travelers improved by only a small amount likely indicating the impact of increased infections and the pause in some re-openings. Please see our weekly **U.S. Reopening Monitor** and our ***Guide to the U.S. Reopening Monitor*** for more details.
- S&P 500 Earnings Estimates: Consensus estimates for 2Q remain around -43.8% year-over-year (Y/Y). More attention should be paid to forward estimates with 2020 earnings essentially unchanged last week at -21.5% Y/Y. 2021 earnings estimates stabilized at about +28% Y/Y. Judging future estimates is complicated with many companies removing earnings guidance due to the unknown depth and length of the shutdown related economic weakness. Three S&P 500 companies report earnings this week with 2Q earnings season really beginning in earnest with the big banks next week.
- Europe: Eurozone Sentix investor confidence for July followed the positive path of most confidence readings in Europe and improved to -18.2 from -25.8. The U.K. June construction PMI is expected to rebound to 46.0 from 28.9.
- Asia: China reports June consumer and producer inflation with CPI forecast to increase to 2.5% Y/Y from 2.4% and PPI at -3.2% Y/Y from -3.7%. Consensus expects Japan household spending for May to decline to -11.8% Y/Y from -11.1% but the range of estimates is fairly wide, and some analysts are calling for some relative improvement.
- Central Banks: The central banks of Israel, Australia, Malaysia, Sri Lanka, Serbia and Peru are scheduled to meet with Malaysia and Sri Lanka expected to lower their policy rates.

WEEK IN REVIEW

- Stocks rose by 4.0% for the S&P 500 with all eleven sectors higher for the week. U.S. economic data was constructive with the better than expected June ISM and jobs report, but rising coronavirus infections continued. Communication services (5.6%), real estate (5.6%) and materials (5.5%) outperformed the S&P 500, while financials (1.6%), energy (2.2%) and consumer staples (3.2%) were the biggest laggards. WTI (5.6%) and Brent (4.3%) oil rose with MLPs (-0.1%) and the energy sector (2.2%) underperforming. Small cap stocks narrowly underperformed the S&P 500 with the Russell 2000 higher by 3.9% but small cap value stocks lagged at 3.4%. The 10-year and 30-year U.S. Treasury yield were higher at 0.67% and 1.43% respectively.
- High yield credit spreads narrowed reflecting increased risk appetite. AAA municipal bond yields as a percentage of Treasuries decreased, 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 to the states.
- 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 (1.4%) and on a hedged-currency basis (1.1%). Emerging market stocks underperformed the S&P 500 with the non-hedged return of 3.4% for MSCI EM.
- The 10-2 yield curve widened to +52 basis points. Another curve measure of three-month yield six quarters forward minus the current three-month yield fell to +2 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 and external shocks like the current coronavirus outbreak might not be accompanied by one. Stocks have historically had significant advances post-inversion.

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Disclosures

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