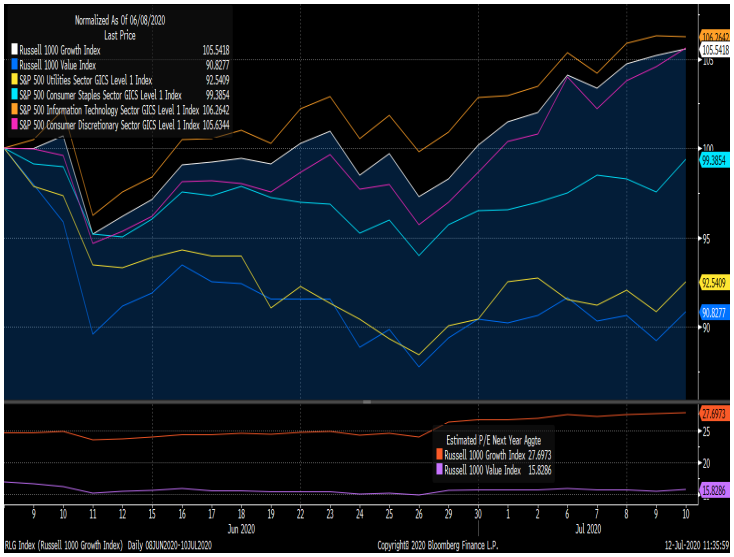
STONE INVESTMENT PARTNERS LLC

Weekly Market Guide | July 13, 2020

CHART OF THE WEEK



Source: Stone Investment Partners, Bloomberg as of 7/12/2020

The divergence in the markets between growth and value has continued to widen since the recent S&P 500 peak on June 8th (see chart). Interestingly, this decline off the S&P 500's June high was not accompanied by outperformance from traditionally defensive sectors like utilities and consumer staples. Amazon.com now accounts for 45% of the consumer discretionary sector's market capitalization according to Strategas Research Partners with discretionary about 16% of the growth index. The market is clearly keying on companies which the consensus thinks can continue to grow earnings with the Russell 1000 Growth index price and valuation based on 2021 estimated earnings rising since early June while both measures have declined for the Russell 1000 Value. Growth companies are generally better companies, but the question is how much more they are worth. Year-to-date, growth is now outperforming value by 32 percentage points! For the brave souls who think it cannot get any worse for value, the years of 1998-1999 provide an even more extreme example with growth outperforming by almost 63 percentage points. Interestingly, the valuations at the end of 1999 were 32x and 16x next year's earnings with interest rates significantly higher (10-year Treasury yield: 6.4%) than today. While it may continue to be painful for some time, this large divergence does argue for at least some exposure to value and perhaps even a slight tilt in that direction. Additional charts of growth versus value and valuation are posted on my weekly blog. More about index construction and long-term performance is here and AQR has some great recent work on value here and here.

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. The relationship between the U.S. and China remains fragile and will be watched with the U.S. rumored to be making a statement about rising tensions in the South China Sea this week. OPEC+ meets on Wednesday to discuss a possible easing in oil production cuts.
- U.S.: Despite little economic data last week, June ISM non-manufacturing reinforced the V-shaped recovery narrative and initial jobless claims fell. June retail sales should retreat from the record rebound pace in May, but still post a 5.0% gain. With rising COVID-19 cases causing a pause in re-openings, initial jobless claims will again be watched closely to judge the impact on employment. Plenty of Fedspeak on tap with the Beige Book on Wednesday and at least eight scheduled speeches. Readings for our U.S. Reopening Monitor deteriorated last week with new COVID-19 cases and deaths in the U.S. rising on a week-over-week (W/W) basis. Rising infections are showing up in the underlying high frequency economic indicators with OpenTable diners and consumer confidence declining. In addition, transit demand and TSA travelers only showed grudging improvement. 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: 2Q earnings season begins in earnest with the big banks this week and a total of 35 S&P 500 companies reporting. According to FactSet, consensus estimates for 2Q are -44.6% year-over-year (Y/Y) with no sector expected to show Y/Y improvement. With many companies removing earnings guidance, there could be some significant earnings surprises in both directions. While the numbers are grim, 2Q actual earnings seem likely to beat estimates with the bar so low and some companies could reinstate guidance which would be a positive in removing some unknowns. 2020 earnings estimates were unchanged last week at -21.5% Y/Y and 2021 estimates at +29.6% Y/Y.
- Europe: European Union (E.U.) leaders hold a summit on Friday to discuss the proposed EUR 750 million recovery fund and the budget. The European Central Bank (ECB) meets and is expected to hold steady. The July reading for the German ZEW expectations survey might post a decline from last month. The U.K. added to fiscal stimulus measures last week and continues to attempt to negotiate a trade agreement with the E.U.
- Asia: China has a busy calendar with June trade numbers expected to improve from May levels. China 2Q GDP is forecast to rebound back into the positive at 2.2% Y/Y from -6.8% in 1Q. In addition, June industrial production, retail sales and fixed assets are scheduled to be reported. The Bank of Japan (BOJ) meets and is widely expected to keep policy unchanged.
- Central Banks: In addition to the BOJ and ECB, the central banks of Poland, Canada, Chile, South Korea, and Indonesia are scheduled to meet with only Indonesia expected to lower its policy rate.

WEEK IN REVIEW

- Stocks rose by 1.8% for the S&P 500 with six out of eleven sectors higher for the week. U.S. economic data was constructive with the better than expected June non-manufacturing ISM and weekly initial jobless claims. Rising coronavirus infections continued, but positive vaccine and drug treatment news helped ease the sting. Consumer discretionary (4.8%), Communication services (4.7%) and technology (2.7%) outperformed the S&P 500, while energy (-4.6%), real estate (-1.8%) and industrials (-1.4%) were the biggest laggards. WTI (-0.2%) and Brent (1.0%) oil were mixed with MLPs (-4.6%) and the energy sector (-4.6%) underperforming. Small cap stocks underperformed the S&P 500 with the Russell 2000 lower by -0.6% with small cap value stocks dragging down the index at -1.4%. The 10-year and 30-year U.S. Treasury yield were lower at 0.65% and 1.34% respectively.
- High yield credit spreads slightly 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 (0.5%) and on a hedged-currency basis (-0.3%). Emerging market stocks outperformed the S&P 500 with the non-hedged return of 3.5% for MSCI EM.
- The 10-2 yield curve narrowed to +49 basis points. Another curve measure of three-month yield six quarters forward minus the current three-month yield rose to +4 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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