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Market Update

July 28th, 2020

The biggest earnings week of the year has arrived with reports expected from companies that account for $13.5 trillion of market cap over the next five days. Four out of the five largest companies will report quarterly earnings with Facebook reporting on Wednesday while Apple, Alphabet (Google), and Amazon reporting on Thursday. Earnings season has exceeded expectations so far with companies reporting overall sales declines of approximately 9% year-over-year. Earnings declines have been more severe with a decrease of approximately 16% year-over-year. Reported earnings are, by definition, backward-looking and are important for us to review and understand; however, given the current economic environment, we are more interested in what company outlooks are for the rest of the year. We are also paying close attention to comments on demand pickup from the March/April lows and the effects the shutdown has had on supply chains.

Another major storyline to follow this week is the passage of an additional coronavirus relief package. The first bill that was passed in March (The CARES Act) included direct payments to individuals, enhanced unemployment insurance, and aid for businesses and governments. Treasury Secretary Steve Mnuchin announced on Sunday that the Republican plan would be released on Monday. He stated that the plan will include another round of stimulus checks for individuals and a continuation of the enhanced unemployment insurance, although at a reduced rate. White House Economic Advisor Larry Kudlow stated that the new package will include aid for state coronavirus testing and school districts to help them reopen due to the plummet in state and local government tax revenues. Senate and House leaders disagree on many points of this new relief package which could delay passage of the bill. We continue to believe that another round of stimulus is needed to avoid a deeper economic downturn.

One positive that has been noticed recently is the record high in the Citi Economic Surprise Index (teal line in chart below). This index shows how economic data are progressing relative to consensus estimates. This indicates that the recovery is stronger than was predicted. Interlaid within this chart are 10-year Treasury yields (gray line). These yields are normally highly correlated with the Index. Currently, the two data points are widely diverged. This may be due to the Fed forcing lower rates despite the stronger than expected economy. It could also mean that economists are still grappling with how to quantify this volatile economy.

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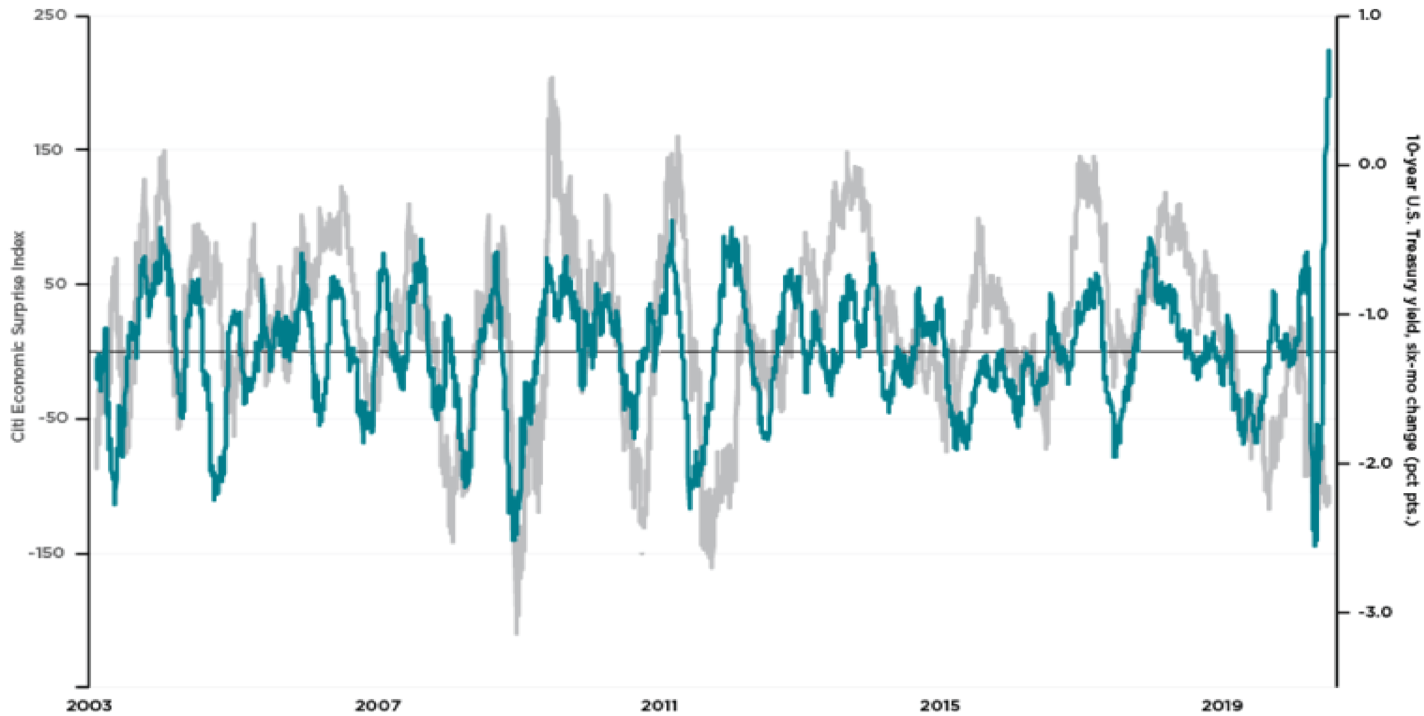
Is it a "head fake" moment for the economic recovery?

Citi Economic Surprise Index vs. Six-month change in 10-year U.S. Treasury yields, 2003 to July 2020



Source for chart data: FactSet Research Services

While there are some other positive areas in the economy – notably housing (which remains strong in large part due to low interest rates) – there are many economic overhangs to overcome from this recession. Both small businesses and large corporations are shedding labor costs to try to survive. Even with government aid, these job reductions have led to over 20 million people out of work and many businesses permanently unable to recover. With 2020 being an election year, the political situation is as polarized as ever and diplomatic relations between the U.S. and China are deteriorating. COVID-19 cases continue to remain elevated throughout the U.S., with other parts of the world seeing new cases surge.

In this environment, we continue to believe patience is our best strategy. The S&P 500 Index has rallied more than 50% from the March 23rd lows. We believe the market over shot to the downside during the crash earlier this year, but we also believe prices are currently elevated in some sectors. The five largest companies now make up 22% of the S&P 500 and are trading at multiples we have not seen in two decades.

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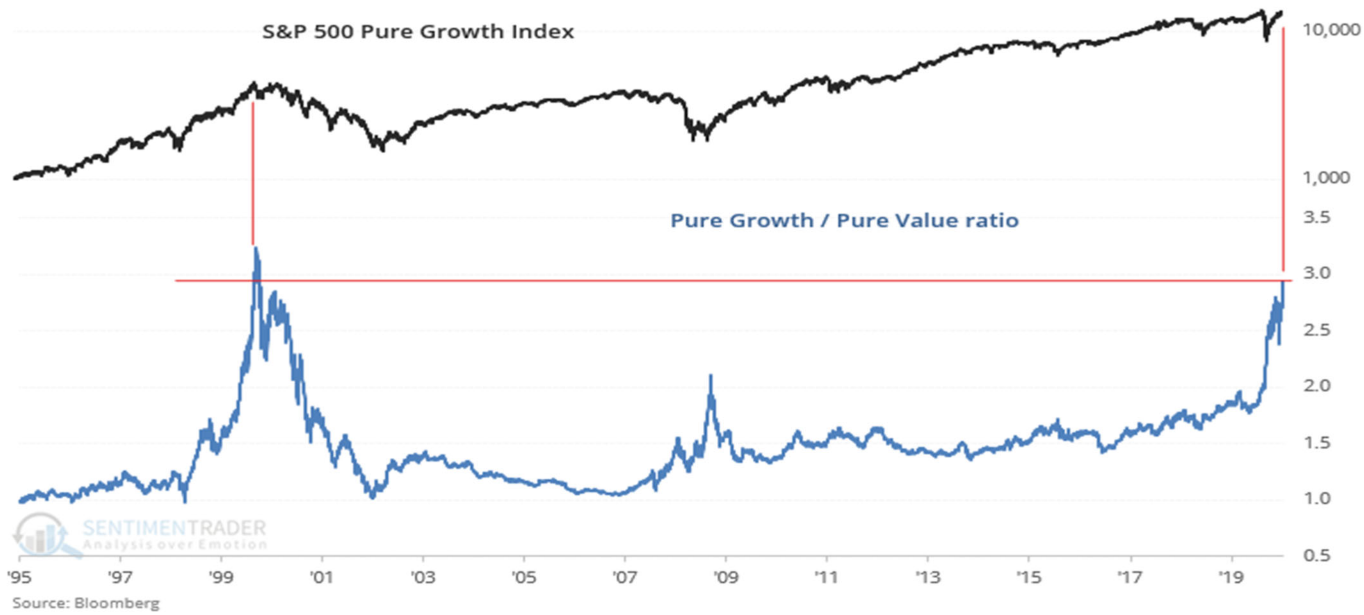

We are fundamental investors at AMB. We look to invest in sustainable companies with strong balance sheets and predictable cash flows that are trading below what we perceive to be their intrinsic value; however, this strategy has fallen to the wayside in favor of companies that have unreliable earnings, suspect balance sheets, and large debt burdens. A similar environment has been seen before as illustrated in the chart above comparing the performance of growth and value stocks. We do expect a reversion to the mean with a resurgence of quality and value but trying to pinpoint when that will occur is a fool's errand. We will continue to be patient in the face of today's environment and look for opportunities when they present themselves.

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