The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets July 2020

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***The Global Economic Recovery Will be Slow and Uneven During the Final Six Months of 2020.*** *There should be a gradual easing of lockdowns and a gradual return to normal consumer behavior.*
- ***U.S. Domestic Policy Will Continue to Support Growth, Recognizing that Some Parts of the Economy Will Remain Weak.*** *In general, however, employment will return in the hardest hit areas of business.*
- ***Monetary and Fiscal Maneuvers Will Further Support the Return of Business to Normalcy.*** *The Fed's announcement of its main street lending program targets firms too large to benefit from the Paycheck Protection Program but too small to issue bonds.*
- ***The Equity and Fixed Income Markets Will Continue Their Erratic Behavior as a Result of News Here and Abroad.*** *The equity markets should continue to move higher as better economic data is released, while the fixed markets will, as well, stabilize as business continues to get back to normal.*

THE ECONOMY

Jobless claims are as good a measure as there is in getting a handle on the state of the U.S. economy. Jobless numbers continue to fall while those receiving benefits are appearing to plateau. Though states continue to work through a backlog of claims, new applications for unemployment benefits have trended down. The U.S. economy added a more-than-expected 4.8 million jobs in June. Yet, nearly 20 million Americans remain out of work. The economy is far from normal, and it will take a long time to absorb the millions of unemployed workers who will hold down consumer spending, straining corporate profits and state and local budgets. We all read about both bear and bull cases for the economy throughout the second half of this year and into 2021. Our preference is to look at the trendline, which is up, and not get too pessimistic.

Our base case scenario is as follows: First, since we are all going to have to live with the coronavirus for an extended period of time, the path to full recovery in the economy will be ragged, at best. Second, the Federal Reserve will continue to support the economy and react as necessary to see that we do not go backwards with our now forward business momentum. And third, Congress will, likewise, continue to support households and businesses, both large and small. Because of the accommodative policy from the Fed and Congress, we hear concerns regarding a pick-up in inflation. Our view on this argument is that fiscal and monetary relief is only partially filling the gap of lost wages and income for households and businesses.

FINANCIAL MARKETS

EQUITIES

Over the past quarter, the equity market has swung between enthusiasm and caution. During the past three months, markets have struggled to reconcile the sharpest-ever quarter-over-quarter decline in economic activity with the announcement of the largest stimulus package in history. In spite of ongoing volatility and considerable economic anxiety, stocks behaved in a fashion consistent with historical rebounds in recessionary periods.

The following chart shows the impressive recovery in all major indexes in the second quarter. As of the end of the quarter, the S&P 500 had risen 39% from its March 23rd low, to end the quarter ahead 20.54%. The NASDAQ, with its approximate 49% weight in Information Technology, was, by far, the winner for the period with a return of 30.63%, followed by 25.42% for the Russell 2000 Index of small capitalization companies.

	Equity Returns*		
Index	**2nd Qtr**	**1st Qtr**	**YTD**
S&P 500	20.54%	-19.60%	-3.08%
Dow	18.51%	-22.73%	-8.43%
NASDAQ	30.63%	-14.18%	12.11%
Russell 2000	25.42%	-30.61%	-12.98%

*Total: price change + reinvested dividends

The global health crisis was undoubtedly an unprecedented cause of the market decline and, as such, investors were completely confused as to the future direction of the stock market after this painful correction. The bears came out in force, citing that the unusual degree of uncertainty confronting consumers would inflict ongoing retreat with equities prices. Further, a resurgence in coronavirus cases would put a lid on any thought of recovery in the markets. All one had to do was look at the rest of the world's dilemma to understand that governments would come to the rescue of failing economies and get people and business back to work as soon as possible.

Were we surprised by the magnitude of the recovery in equity prices? We would be reporting incorrectly if we said we were not surprised. However, with both the Federal Reserve and Congress joining together to get the country moving again in an upward path had to cause a lift to stock prices from their depressed levels.

For the second quarter, all sectors of the S&P 500 stock index were positive, with all but two areas achieving double-digit returns, as reflected in the table below. Consumer Discretionary was the best performer for the period. As states continue to lift mandatory lockdowns, this area should perform well, albeit choppy at times. Information Technology and Energy followed, achieving returns above 30%, with Utilities coming in last, lagging the overall market since April and missing out on much of the market's rally. Although one of the top performers for the quarter, Energy had the lowest return year to date through June 30th, while Information Technology had the highest.

S&P 500

		Returns*		
Sector	**Weight**	**2nd Qtr**	**1st Qtr**	**YTD**
• Energy	2.8%	30.51%	-50.45%	-35.34%
• Materials	2.5%	26.01%	-26.14%	-6.92%
• Industrials	8.0%	17.01%	-27.05%	-14.64%
• Cons. Discretionary	10.8%	32.86%	-19.29%	7.23%
• Consumer Staples	7.0%	8.12%	-12.74%	-5.66%
• Health Care	14.6%	13.59%	-12.67%	-0.81%
• Financials	10.1%	12.20%	-31.92%	-23.62%
• Info Technology	27.5%	30.53%	-11.93%	14.95%
• Communication Svcs	10.8%	20.04%	-16.95%	-0.31%
• Utilities	3.1%	2.73%	-13.50%	-11.14%
• Real Estate	2.8%	13.22%	-19.21%	-8.53%

06/30/20
*Price + income
Source: S&P Dow Jones

Now, as we write this commentary, the S&P 500 is trading at roughly 25 times estimated 2020 earnings, its highest level since the dot-com era, but no one seems to care. The Index is down just 1.4% year-to-date and less than 6% away from an all-time high.

FIXED INCOME

Fixed income returns can be as volatile as movements in the equity markets, particularly during a period when so much confusion is in the air, as shown in the chart below. As the coronavirus spread, bonds with the least risk, such as Treasuries, were posting the strongest returns, while riskier segments of the markets showed slightly negative returns, as reflected in the returns for the first quarter. As states began easing lockdowns, by the end of the second quarter, the fixed income market had reversed, with corporates outperforming Treasuries, which moved to the sidelines in June, and the lower-rated BBB bonds outperforming the higher-rated bonds.

Fixed Income Returns

Index	**2nd Qtr**	**1st Qtr**	**YTD**
Corporate/Govt.	3.57%	3.48%	7.18%
Int. Corporate/Govt.	2.89%	2.12%	5.07%
Long Corporate/Govt.	5.35%	7.24%	12.98%
U.S. Treasury	0.21%	8.80%	9.02%
- Intermediate	0.42%	5.26%	5.70%
- Long	-0.44%	21.28%	20.75%
Corporate	9.27%	-4.05%	4.84%
- Intermediate	7.88%	-3.43%	4.18%
- Long	12.04%	-5.29%	6.11%
- Quality			
- AAA	4.72%	4.49%	9.42%
- AA	5.85%	0.69%	6.58%
- A	7.45%	-1.18%	6.18%
- BBB	11.61%	-7.40%	3.36%
Municipal	2.66%	-0.68%	1.97%
- Intermediate	2.59%	-0.62%	1.95%
- Long	2.70%	-0.72%	1.96%

Source: BofA Merrill Lynch

Yields have swung widely as markets reacted to the sudden halt in economic growth, the Fed's rapid rate cuts and fiscal stimulus, followed by weak signs of recovery. The sum total of the programs put in place is approximately equivalent to about a quarter's worth of Gross Domestic Product growth. Despite the massive relief provided, the outlook still suggests the economy will take time to recover. Consequently, inflation will, most likely, remain low, and the Fed will maintain an easy-money policy stance.

As the economy continues to rebound, we expect longer-term yields to move higher. With an ever-increasing supply of Treasuries, a steeper yield curve can be expected. Inflation, as mentioned, should not be a problem, as the Fed's balance sheet expansion will likely boost asset prices rather than prices of goods and services.

The Fed's lending facilities for business should support both the corporate and municipal markets. Yes, there will continue to be more credit rating downgrades, particularly with the more highly-leveraged companies. And we will also see a strain on municipal budgets by the reduction in tax revenues and increasing costs. Again, below investment grade issues, particularly among retirement facilities, await additional support. A package under consideration, currently estimated at $1 Trillion, with significant funds directed towards state and local governments, will go a long way in shoring up both government and private sector financial statements.

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In conclusion, we remain confident for the successful recovery from the pains of the coronavirus pandemic. While the shape of the recovery will be ragged, with various business sectors responding at different times to the support given by both monetary and fiscal policy, an eventual return to normal life is in the cards for the future. In terms of our investment judgment and guideline for clients, we expect modest, continued improvement in the capital markets. There will be "backing and filling," but the trendline is for continued improvement.

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