WAYPOINT ADVISORS
A CARY STREET PARTNERS COMPANY

**Second Quarter 2020**

**Contradictions Abound…**

US and international equities rebounded sharply in Q2 of 2020 from significantly depressed levels in Q1. All major equity indices had double digit growth for the quarter[1]. Though bond values typically go down when equities go up, U.S. bond indices were also up as investors continued to hedge their bets on the effects of the COVID-19 pandemic. Meanwhile, the economy continued to struggle. What gives? Let's take a deeper look.

**In the stock market**

We saw a sharp recovery in equity markets around the world in the second quarter, but keep in mind that, for the S&P 500, the second quarter recovery can be attributed mainly to 5 tech stocks[2]. In past recessions, value stocks have been the first to recover. Our current recovery is much different, with growth stocks significantly outperforming value stocks as the chart below shows.

| Index | Q1 2020 | | Q2 2020 | | 1 Year | |
|---|---|---|---|---|---|---|
| | Growth | Value | Growth | Value | Growth | Value |
| Russell 1000 | -14.1 | -26.7 | 27.8 | 14.3 | 9.8 | -8.8 |
| Russell Mid Cap | 20.0 | -31.7 | 30.3 | 20.0 | 11.9 | -11.8 |
| Russell 2000 | 25.8 | -35.7 | 30.6 | 18.9 | 3.5 | -17.5 |

*Source: Morningstar, Waypoint Advisors, a Cary Street Partners Company.*

While it is not unusual for different parts of the equity markets to diverge especially over short time periods, the number of extreme divergences between indices is worth noting. When comparing large versus small stocks there is a similar disconnect from history. Over the past year Large Cap stocks (Russell 1000) returned 7.5% vs Small Cap (Russell 2000) at -6.6%[3].

**The economy tells another story.**

On the economic front, U.S. unemployment numbers, though somewhat improved since the end of April, remain high at 11.1% and with a possible undercount of those unemployed.[4] This unemployment level is three times higher than prior to the pandemic. To provide some perspective, almost half of the working-age population (47.2%)[5] of the U.S. did not work in the month of May. This is to say that we have an economy in its worst recession since the Great Depression. Over a hundred bankruptcies have occurred since February; among those are household names such as JC Penney, Hertz and Brooks Brothers. The apparent contradiction in the behavior

[1] Source: Morningstar, Waypoint Advisors, a Cary Street Partners company. Major indices: S&P 500, Russell 1000, Russell 2000, MSCI EAFE GR, MSCI EM GR.

[2] Facebook, Alphabet, Amazon, Apple, Microsoft.

[3] Source: Morningstar, Waypoint Advisors, a Cary Street Partners company.

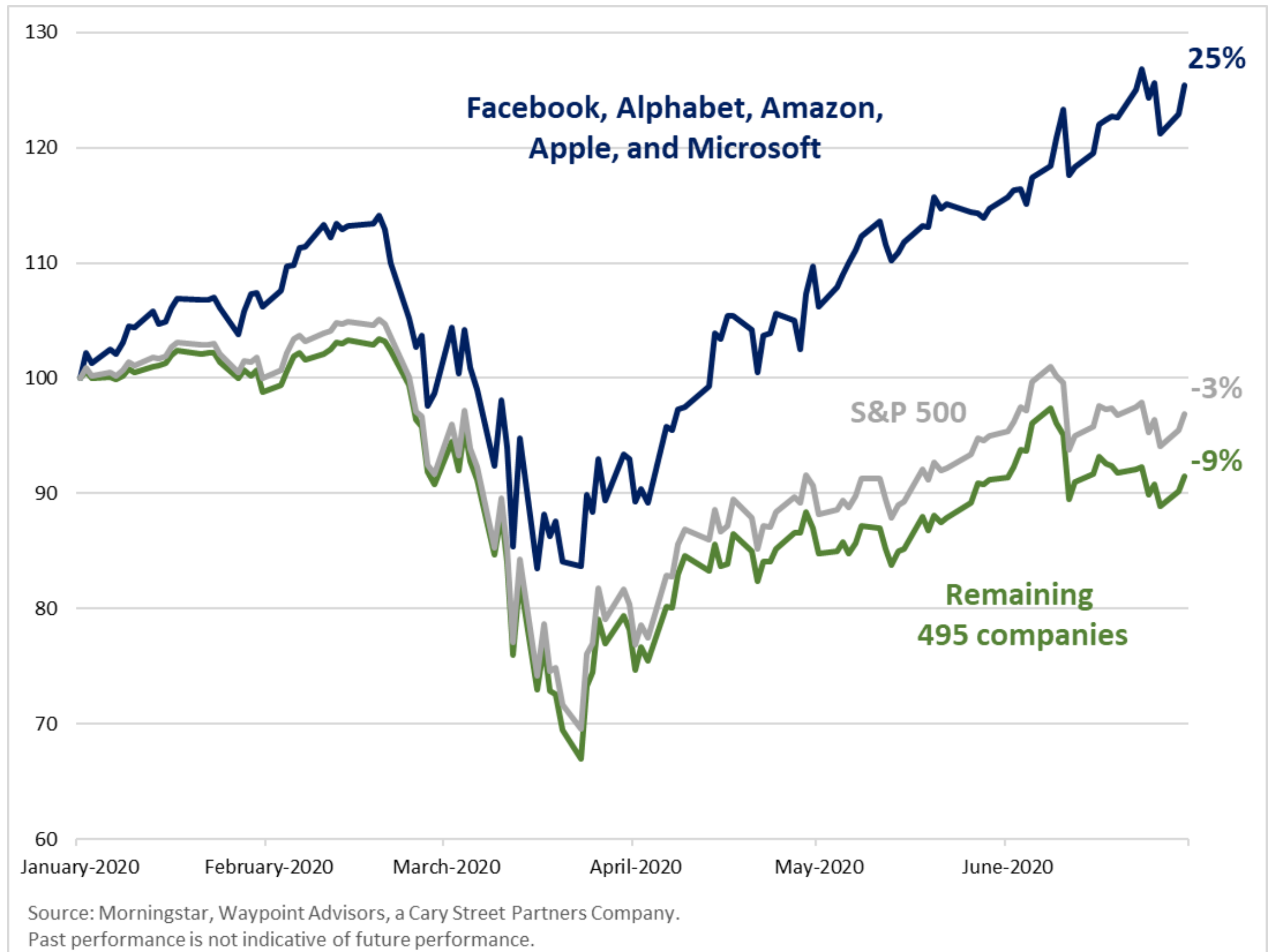
[4] By some measures the actual unemployment rate is 18.3% or 31 million unemployed people. Source: https://californiaforecast.com/covid-19-economic-analysis/

[5] Source: Bureau of Labor Statistics.

of the U.S. stock market becomes more understandable when one considers the monetary and fiscal stimulus that the government has provided.

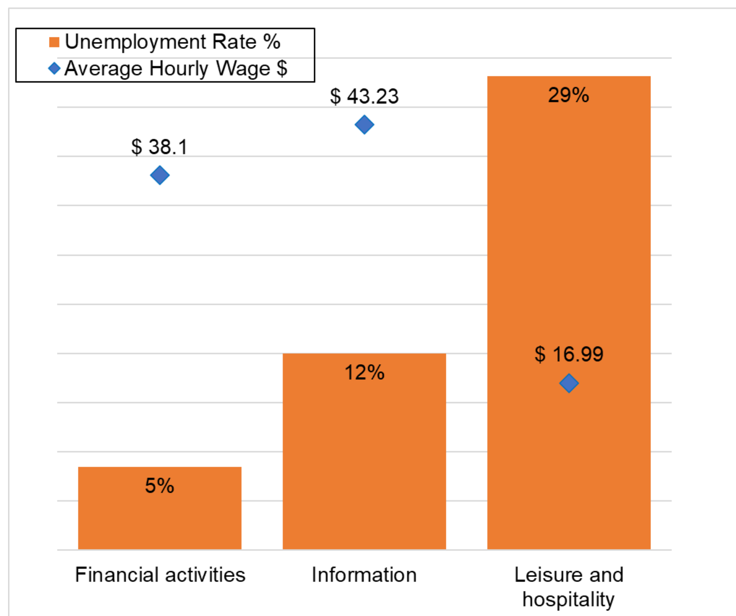
**How can the stock market recover while the economy is still in the doldrums?**

There are a number of factors. First, we often use the S&P 500 to represent the market. This is a cap weighted index, meaning the largest companies have the highest weighting. In fact, only 5 stocks, Facebook, Alphabet, Apple, Microsoft and Amazon, make up about 20% of the S&P 500. The heavy weight of these 5 tech companies drove the performance of the S&P 500 since the beginning of this year as shown in the graph below. The remaining 495 stocks lost money. It is fair to say that, in this time period, the S&P 500 index didn't truly represent "the market."



Source: Morningstar, Waypoint Advisors, a Cary Street Partners Company.
Past performance is not indicative of future performance.

The economic impact of the coronavirus has also disproportionately impacted workers in the Leisure and Hospitality industry. These workers are paid much lower wages when compared to other sectors of the economy as shown with the blue diamonds in the chart on the next page. The Leisure and Hospitality sector has the highest unemployment at 29%. These workers are the most hurt by this recession. However, while they make up 20% of US payroll and 19% of GDP, the companies only contribute 7% of the S&P 500's earnings. Thus, the economy is hurt more than the market (S&P 500), and these low-income workers, who often do not have benefits or other safety nets, are hurt the most. This contrasts with what happened in The Great Recession, which mostly affected those who owned financial assets.




*Source: Bureau of Labor Statistics, Waypoint Advisors, a Cary Street Partners Company as of June 30, 2020.*

Furthermore, the fear that one usually sees in equity markets during such economic times was snuffed out by the Federal Reserve when it injected liquidity into a number of credit markets at the end of Q1. Additionally, when the Fed announced that it was going to become the purchaser of last resort in the investment grade bond market, investors had confidence that large firms with good balance sheets could refinance or take on additional debt in order to weather the COVID-19 storm. The fact that a record level of fiscal stimulus was injected into the economy also gave investors confidence to reenter the equity market, especially in areas that were benefitting from the effects of the pandemic – online retailers, food delivery services, and video conferencing services.

In short, a record setting equity rebound was born in the midst of a global economic Armageddon. The rapidity of the response to the pandemic by the Federal Reserve and the spending by both the Fed and Congress reduced the actual economic impact of the coronavirus-induced shutdowns to both families and businesses. While these same actions precipitated the equity rebound we have seen to date, they have also caused growth equities to become very expensive and do not alleviate the uncertainties around the pandemic.

**Will these contradictions persist?**

Whether the divergences discussed above can continue depends on continued support by the Federal Reserve and Congress until the pandemic is under control and effective treatments for the coronavirus are discovered and deployed. The Fed has indicated that it will continue to do whatever it takes to lower unemployment and manage inflation. Congress, being a deliberative body, is not providing signals as to its future actions. The congressional programs that were put in place to mitigate the loss of income for individuals and businesses will end within a month. Consumer spending accounts for 68% of GDP. In light of the resurgence of the coronavirus in the U.S. and the rollback of some state openings, additional stimulus will be needed if we want to forestall a drastic decline in consumer spending. In fact, many economists have warned of an “income cliff” if the $600/week additional unemployment benefit that was part of the CARES Act is not extended at least partially. While the House of Representatives has passed an extension of the enhanced unemployment benefits, the Senate has recessed until July 19th and indications are that Senate Republicans are disinclined to extend unemployment benefits in their current form. The Executive branch currently supports an additional one-time COVID payment to low income families but has not indicated whether it would support extending enhanced unemployment benefits.

**Waypoints You Can Follow**

Given the devastating nature of the coronavirus, the unprecedented governmental response, and the contradictions we see all around us, it would be surprising if investors did **not** feel uncertain. With U.S. equities having high valuations and bonds not paying enough interest to keep up with inflation, where does one turn in order to achieve one's financial goals? Waypoint 1: Investing in equities is a long-term proposition. Do not get too caught up in the short-term hype. Continually following the news media can magnify one's concern about the short-term, blur the long-term and keep one in a frightened state. Acting on emotion can cause one to make the wrong moves. Remember the mantra of the famed investor, Warren Buffett: "I buy when people are fearful and sell when people are greedy." Waypoint 2: Have patience. Understand that there will be periods of time when certain investment strategies will be out of favor and perform poorly (as value and small cap strategies have done over the past several years) only to recover and take the lead in a different market environment. Waypoint 3: Maintaining a diversified investment portfolio smooths out the ride and has historically provided the best risk-adjusted return in the long run. As always, we are here to help you and your family navigate these uncertain times.