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Second Quarter 2020 Commentary

Stock investors have been on quite a roller-coaster ride this year. After hitting an all-time high on February 19, the S&P 500 Index plunged a gut-wrenching 34% over the next month, marking the quickest bear market in U.S. history. Smaller company stocks did even worse during that period, losing more than 40%. Investors who remained steadfast then experienced an equally surprising and gravity-defying upturn. From the March 23 low, the market soared nearly 40%, notching its best return ever over any 50-day period. For the full second quarter, larger-cap U.S. stocks gained 21% and smaller-cap stocks climbed 25%. Despite the medical, economic, and social turmoil all around, the U.S. market is down just 3% year to date and is 8% below its all-time high.

However, there is a major divergence beneath the surface. The Russell 1000 Growth Index is up 10% on the year, but its Value counterpart is down 16%. That's a stunning 26-percentage-point difference in only six months. Viewed from another angle, the tech-heavy Nasdaq Index is up 13%, while the Dow Jones Industrial Average languishes, down 8%.

Looking overseas, developed international stocks rose 16% and emerging markets stocks gained 19% in the second quarter. For the year, they are still down 11% and 10%, respectively. The U.S. dollar depreciated slightly during the quarter, providing a modest tailwind to foreign market returns for dollar-based investors. Moving on to the bond markets, core bonds gained almost 3% for the quarter as Treasury yields dropped slightly and investment-grade corporate bond spreads narrowed, rallying along with the stock markets.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	20.8%	10.1%	11.6%
US Mid Cap Stocks	25.0%	-0.2%	7.0%
US Small Cap Stocks	26.7%	-5.6%	5.4%
International Developed Stocks	16.0%	-4.2%	2.8%
Emerging Market Stocks	18.5%	-3.3%	2.9%
US Bonds	2.9%	8.7%	4.3%
Global Bonds	3.4%	0.7%	2.9%
US REITs	11.4%	-13.9%	2.7%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
International Developed Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

As always, we see a range of potential economic and financial market outcomes looking ahead over the next six to twelve months and beyond. What's unique about the current environment is how dependent the outcomes are on the course of COVID-19. Significant uncertainty remains as to the virus's progression and any subsequent economic recovery, though financial markets seem to have priced in an optimistic scenario. Of course one key risk to the economy is the potential for a widespread second wave of COVID-19 infections, hospitalizetions, and deaths that force another large-scale economic shutdown. In that event, stocks would likely give up at least some of recent gains and potentially retest their March lows. But absent a severe second wave (or some other major exogenous shock), and even assuming there are smaller localized outbreaks, the financial markets have priced in an uneven but persistent economic recovery.

While we view the progression of COVID-19 as the most important driver of the near-term economic and market outlook, monetary and fiscal policy are close behind in their potential impact. After the Federal Open Market Committee (FOMC) meeting in June, Fed chair Jerome Powell made it very clear the Fed intends to keep monetary policy extremely accommodative for the foreseeable future. Powell said, "We are strongly committed to using our tools to do whatever we can, and for as long as it takes … We are not thinking about raising rates. We are not even thinking about thinking about raising rates." To this end, most analysts expect the federal funds policy rate to remain near-zero at least through the end of 2022.

On the fiscal policy side, global fiscal stimulus and support programs have also been unprecedented, much larger than during the financial crisis of 2008 – 09, and the long term impact of these remains to be judged. Another trillion-ish dollar fiscal stimulus package in the U.S. seems likely later this summer as both the White House and Democrats (if not yet congressional Republicans) favor additional government spending to support households and business to get through the medical crisis.

Besides a resurgence in the pandemic, the approaching November elections will likely highlight several other macro risks:

- An escalation in U.S.-China geopolitical tensions and/or a re-ignition of their trade war

- Future fiscal policy-related uncertainty (for example, a repeal of the Trump corporate tax cuts if the incumbent party loses)

- Sustained social and political unrest made manifest in marches and other forms of protest

Macro risks such as these always exist for long term investors, but sometimes we are made more acutely aware of them (for example, the risk of a pandemic existed before it became a global reality). With the expected traditional increase in media volume ahead of the elections, it is important that your investment portfolio be aligned with your risk tolerance and financial goals. This should enable you to keep a healthy long-term perspective and to remain disciplined and "stay the course" through what will likely be a second half of the year filled with many dramatic (political) sound bites.

Thank you for your continued trust and confidence.

Timothy S. Healey
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