

July 23, 2020

**Key Points**

- The warp-speed nature of the pandemic and economic crisis helps explain the equally warp-speed nature of the stock market's behavior
- Although the stock market was suggesting a V-shaped recovery, the more likely scenario is rolling "Ws"
- Rampant speculation, especially in options trading, represents the biggest short-term risk for stocks

Lately, the number one question we've been fielding is about the disconnect between the stock market and the economy. As the rain bears down on Main Street, Wall Street has been singing a much sunnier tune; but can it last? What we believe we will continue to see is a real heavyweight battle between poor economic numbers and massive stimulus. Which one of those wins out long term? Remember stock market recovery is 100%, it happens every single time. The keys are to be invested in high quality companies and stick to the plan. We don't ever trade on emotion; we don't buy on excitement and certainly don't sell on fear. As we dive into the details we'll share some thoughts from Liz Ann Sonders, Chief Investment Strategist of Charles Schwab & Co.

**Warp-speed**

I will not suggest there is anything normal about the nature of this cycle—we have never seen a health crisis morph into an economic crisis by virtue of a government-mandated full-stop shutdown. That helps explain the speed with which stocks reacted from February to March. Although it's confounding to connect the equally-speedy stock market recovery to today's economic reality, one could argue that when the S&P 500 was down 34% on March 23 (from the February 19 all-time high) it was discounting the fairly dire economic scenario which quickly unfolded.

In keeping with the high-speed nature of this crisis, the National Bureau of Economic Research (NBER)—the official arbiters of recessions—declared one as having started at the peak in economic activity in February. It was the fastest decision in the 40-year history of the NBER's recession declarations. The stock market has a fairly consistent history of peaks and troughs coming at or before the peaks and troughs in the economy—after all, the stock market is a leading economic indicator.

**Looking ahead**

As we look ahead to the second half of the year, we will begin to get clarity on the depth of the economic contraction via both second quarter earnings season, which has begun; and the initial read on second quarter real gross domestic product (GDP) toward the end of July. One of the most-watched GDP forecasts comes from the Federal Reserve Bank of Atlanta—its GDPNow forecast is for a -48.5%

quarter/quarter annualized plunge. The Bloomberg consensus for the third quarter is a rebound of nearly +20%. But if GDPNow is anywhere near correct, it will take many strong quarters before the economy is back to its previous level.

The Federal Open Market Committee (FOMC) of the Federal Reserve recently updated its economic projections, and most members don't expect GDP to return to pre-pandemic levels until 2022; with the unemployment rate at 5.5% by the end of that year. Even with the economy largely reopened, social distancing is likely to prevent millions of workers from returning to work; suggesting long-lasting damage to the economy.

### **"Stimulus" = inflation risk?**

The speed with which the economy sank into a recession was matched by the speed with which the Federal Reserve and Congress acted to provide liquidity and fiscal relief/income replacement (distinct from "stimulus"). Probably the second-most asked question I've fielded on client webcasts has been about inflation implications. In sum, we do not think inflation is a near-term risk—although it could be a longer-term risk. For now, the pandemic and its impact on the economy is disinflationary.

As mentioned earlier, this is not a normal recession. Historically, as government debt rose, private sector debt eased; with the latter typically more than offsetting the former. In this cycle, there is likely to be a troubling increase in non-financial corporate debt, which was already at an all-time high prior to the pandemic. The good news is that household debt came down dramatically post-financial crisis and remains on sounder footing.

### **Trend matters, but sometimes levels do, too**

I am a market optimist at heart; and I believe that "better or worse tends to matter more than good or bad" when it comes to the relationship between economic data and stocks. I also believe in the power of ingenuity, creativity and drive when it comes to our country's ability to pull itself out of dire crises. But the stock market probably got a bit ahead of itself in pricing in a V-shaped recovery. The latest pullback and increase in volatility has been related to the emergence of a second wave in the virus among a number of early-opener states (I'm not sure we ever exited the first wave). Like was the case in April and May, when there were positive headlines on both therapeutics and vaccines, stocks may continue to be at the mercy of virus-related news—in both directions.

In terms of the economy's recovery shape, I think the reality for the remainder of this year is likely to be more "rolling Ws" as opposed to a clean "V" (the first part of a W is a V). The reason why a lot of the data improvement looks like a V, it's mainly a function of opening back up the economy. It will take at least a few months before we see what the post-pandemic "normal" looks like.

Even if federal/state governments opt not to shut down the economy amid second wave concerns, a slowdown in the recovery should be expected based on the impact of weaker demand and constrained supply. Second quarter earnings season may be an eye-opener—not just what's reported for earnings in the quarter; but what companies say about their second half outlooks. Given that one-third of S&P 500 companies have withdrawn earnings-per-share guidance for 2020, any color will be helpful in shaping views about the shape of the recovery.

Longer-term I believe our economy is starting a shift from services/consumer-led growth toward more investment-led growth (in areas like health care, technology and supply-chain manufacturing). The



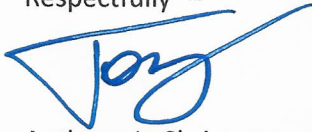
transition is likely to be bumpy and uneven—especially for workers displaced by the havoc wreaked by the pandemic.

### So what?

The sharp downturn in the first quarter of 2020 gave way to an equally impressive rally in the second quarter of 2020, despite ongoing uncertainty around the COVID-19 pandemic and its effect on the global economy. Our unwavering focus continues to be on owning the best businesses over the long term, not making market predictions. We believe the companies we own are competitively advantaged and can use difficult periods to strengthen those advantages. We also think companies that exhibit strong balance sheets are clearly better positioned to weather near-term challenges.

Volatility presents opportunities and we have used the cash in our portfolios to take advantage of opportunities that have arisen. As famed value investor Shelby Davis observed: “You make most of your money in a bear market; you just don't realize it at the time.” Long-term investment success does not require picking market tops and bottoms. That’s attempting to gamble on moments in time; while investing should always be a process over time. We like to make safe bets on the safest economy in the world, and we will continue to do exactly that for you.

Respectfully —



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