Q2 2020 GSIS Commentary - Odd Optimism

What a quarter and what a first half!

To put the second quarter in perspective you really should start on March 23 when the S&P 500 index was in a free fall and down 30% YTD. Pessimism was rampant with unparalleled ambiguity of COVID-19's impact on humanity and the world economy. Then, out of nowhere, in the next three days the markets rallied 17.6%! The below table outlines the return of key asset classes for periods ending June 30, 2020.

Asset Class	Q2 2020	YTD	1 Year	3 Years	5 Years	10 Years
Global Equity	**19.2%**	**-6.3%**	**2.1%**	**6.1%**	**6.5%**	**9.2%**
US Large Cap	20.5%	-3.1%	7.5%	10.7%	10.7%	14.0%
US Large Cap Growth	27.8%	9.8%	23.3%	19.0%	15.9%	17.2%
US Large Cap Value	14.3%	-16.3%	-8.8%	1.8%	4.6%	10.4%
US Small Cap	25.4%	-13.0%	-6.6%	2.0%	4.3%	10.5%
International	14.9%	-11.3%	-5.1%	0.8%	2.1%	5.7%
Emerging Markets	18.1%	-9.8%	-3.4%	1.9%	2.9%	3.3%
Commodities	5.1%	-19.4%	-17.4%	-6.1%	-7.7%	-5.8%
Real Estate	13.1%	-13.0%	-6.3%	3.8%	6.9%	9.7%
Muni Bonds	2.2%	1.8%	3.0%	2.3%	1.9%	1.8%
Taxable Bonds	1.8%	4.0%	5.4%	3.5%	2.6%	2.2%
High Yield Bonds	10.2%	-3.8%	0.0%	3.3%	4.8%	6.7%
Updated 06/30/2020						

Why this reversal and why did it persist through most of the second quarter?

The most important reason was that the Federal Reserve and Treasury quickly announced a series monetary stimulus measures to rapidly increase liquidity, reinforcing the long-held maxim "don't fight the Fed." In 2008 and 2009 both the Fed and Treasury were in uncharted territory and did not have the tools developed to respond to the banking crisis. Their steep learning curve paid off in today's circumstances as they implemented responses quickly. These actions alleviated investor concerns and proved to be a key catalyst for the market rally. Optimism abounded even as commentators and forecasters predicted deep doom and gloom about the pending decline in GDP and near-term collapse of corporate earnings.

Forecasting versus Reality

It has been proven time and again that economic and financial markets forecasting is practically impossible. Current economic statistics releases have proven to be even less reliable because the mechanisms of gathering and collating data have been compromised by COVID-19's impacts in local, state and federal agencies. The recent employment numbers are an excellent example where the initial report was very positive and the market rallied 4%, but a few days later it was discovered that significant (negative) inputs were missing and the market immediately fell 7%.

In the last six months we have swung from optimism (January/February) to abject pessimism (March), to optimism (2Q) again. Howard Marks, of Oaktree Capital Management, recently pointed out on the topic of sentiment:

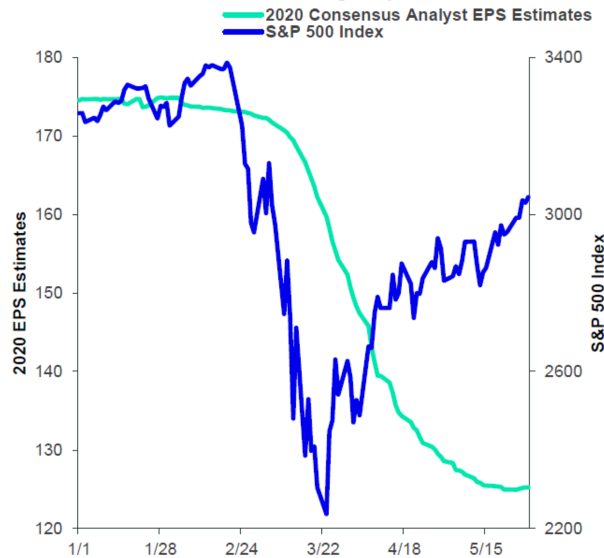
> ***"That's one of the crazy things: in the real world, things generally fluctuate between "pretty good" and "not so good." But in the world of investing, perception often swings from "flawless" to "hopeless."***

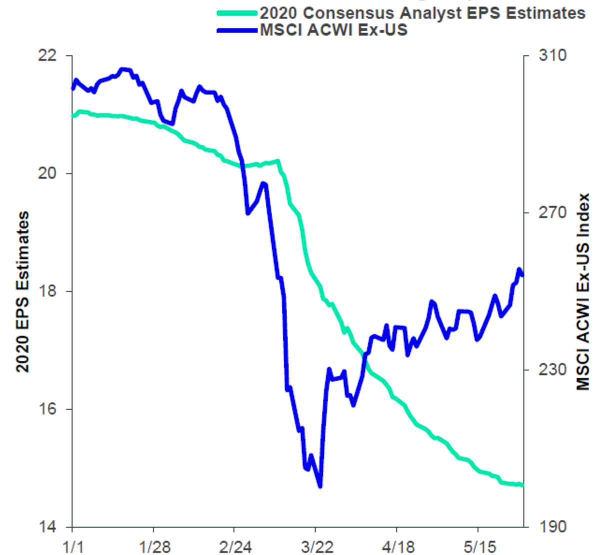
Heads or Tails - What lies ahead?

Fed-driven optimism, combined with "progress" in treatment, vaccines, etc. for COVID-19, have improved investor confidence. US stocks have recovered a significant portion of their losses and the tech-laden NASDAQ is now at an all-time high level. The other side of this coin is the barrage of weak economic and earnings statistics that point to a slow, extended and potentially volatile recovery. Equity valuations are currently above historic levels based on depressed near-term earnings. The markets have already priced in a significant earnings decline in 2020, with expectations that 2021 will see improvement and by 2022 will fully recover to pre-COVID crisis levels. We expect the struggle of optimism and pessimism to persist for several quarters.

The consumer is the key to all economies and in the US accounts for roughly 70% of economic consumption. The consumer savings rate is up dramatically and it is logical to think (or conservatively assume) that this may persist for some time. Economists from Blackstone maintain that for every 1% rise in the consumer savings rate economic output will decline 0.80%. This is one statistic we will be watching carefully, as continued high consumer savings rates will dampen any recovery.

The chart below shows you the disconnect between Earnings and Equities Markets in both the US and the World. Nobody knows how or when these lines will converge to a normalized relationship but the volatility that we have seen will likely persist.





Source: Bloomberg Finance, as of May 31, 2020. Characteristics are as of the date indicated, are subject to change, and should not be relied upon as current thereafter. EPS growth estimates are based on Consensus Analyst Estimates compiled by Bloomberg Finance L.P.

We are cautious but remain vigilant for opportunities.

Thank you for your trust and confidence in us.

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