Daniel Wildermuth's

MARKETCOMMENTARY

July 2020

- Presented by Wildermuth Asset Management

Volatile Markets Accompany Much Ongoing Uncertainty

Daniel Wildermuth
CEO, Wildermuth Asset Management

> *"Today's market is unique in countless ways with unusual dynamics driving equity markets broadly and also within individual sectors."*

More signs of a burgeoning economy in June has subjected investors to a fair amount of volatility, but broad-based U.S. markets are ending the month in about the same place they started. The recent surge in COVID-19 cases, sparking fears of more economically damaging shutdowns, ended the short but strong rally that launched off the March 23rd 2020 market lows. Ongoing market volatility, with moves often greater than 1% per day, demonstrate that fears remain elevated. Yet, while the rally paused a bit in June, Federal Reserve promises to inject liquidity into the market and keep rates low through 2022 continue to provide strong safety nets under both the bond and equity markets.

Today's market is unique in countless ways with unusual dynamics driving equity markets broadly and also within individual sectors. Through June 25, 218 of the 500 companies in the S&P 500 (43.6%) had pulled their quarterly or annual financial guidance, citing the uncertainly of the COVID pandemic. Not surprisingly, many of these companies have been those more impacted by shutdowns, and their shares in aggregate have fallen 18.2% year to date versus the S&P 500 down 6.9%.

Their plight highlights another prevalent theme in 2020. The divergence in the performance of the major U.S. stock indexes this year, and within sectors of the different indexes, are the widest in decades. Big technology stocks have surged in 2020 carrying the Nasdaq Composite up 12% through June 22, 2020. By comparison, the Dow Jones Industrial Average holding primarily blue-chip stocks is down 8.8%. The broader S&P 500 index lands closer to the middle, off 3.5% for the year.

The Nasdaq's advantage over the Dow and S&P 500 is the biggest in nearly four decades, dating back to 1983. The gap between the S&P 500 and the Dow is the widest since 2002.

The primary drivers of the differences are just a handful of stocks – Apple, Microsoft, Amazon, Google parent Alphabet, and Facebook. These five stocks account for about 40% of the Nasdaq index versus about 20% of the S&P 500 and only 2 of the 30 Dow stocks.

Even these percentages have changed dramatically in 2020, growing from 18% of the S&P 500 at the beginning of the year to 24% by late June.

The three sectors of the S&P 500 that contain at least one of these stocks – information technology (Microsoft and Apple), consumer discretionary (Amazon), and communication services (Alphabet and Facebook) – are the only sectors in positive territory for the year. By contrast, utilities have dropped more than 10%, industrials are down more than 15%, financials have sunk nearly 25%, and energy has plummeted nearly 40%.

The disparities have fractured the market into many different sub-markets. The lack of data and differing economic impacts add to the many challenges facing investors trying to make sense of a dizzying stream of rapidly changing circumstances.

Yet another odd dynamic is also impacting markets. As sports have disappeared in the U.S., millions of former sports betters have turned to trading to satisfy their gambling interests. TD Ameritrade, Schwab, E-Trade all opened record numbers of accounts over the past few months, doubling and tripling levels from last year's pace. In early May, Robinhood, a new commission-free trading platform, reported adding more new accounts this year than all three of the above combined. The new traders introduce a flood of new dollars and

Continued ...

with unique trading styles into the market.

At least some are behaving like aggressive gamblers, and transactions that make little economic sense, such as buying up the nearly valueless shares of bankrupt companies, have skyrocketed. Goldman Sachs noted that that individual investors are a significant proportion of daily volume. Sports gamblers are likely just another factor pushing markets into strange directions driven by odd dynamics.

Against this backdrop, a V-shaped recovery is looking increasingly unlikely. New COVID-19 cases are rising across the country, slowing, and in some cases, reversing reopening plans. Data also indicate that a rapid recovery continues to grow less likely. The last full week of June recorded initial weekly jobless claims of 1.48 million, the 14th consecutive week above 1 million.

Globally, the news does not look better. On June 24th, the IMF said that the global economy will shrink 4.9% this year, compared with its April estimate of 3%. The international lending institution downgraded its 2020 forecast for all major economies, citing April's worse than expected economic data. The U.S. is forecast to shrink 8% this year versus the euro-area economy contraction of 10.2%. Brazil is projected to shrink by 9.1%, Mexico by 10.5%, and the U.K. by 10.2%. China is the only major economy projected to expand in 2020, but by only 1%.

Although current decline appears significantly worse than the world has experienced since the Great Depression that began in 1929, this contraction should not come close to inflicting similar pain. During the Great Depression, the global economy shrunk by 10% over three years compared with this year's 4.9% forecast. The world's leading economies contracted by around 16% then compared with a projected 8% expected for this year. More importantly, global economies struggled throughout all of the 1930s. By contrast, the IMF expects the global economy to grow in 2021, and in most cases, countries have likely already endured the worst of their anticipated economic contraction.

Yet, despite much negative data and high valuations that will almost certainly go higher as generally poor second quarter earnings are released, there are some that argue that valuations could climb further above levels already at their highest since the dot-com bubble. Nearly all financial models discount future earnings and dividends using a discount rate dependent on current interest rates. The value of future earnings increases as the cost of capital declines. Because the cost of capital is at near zero, some argue the value of earnings are worth more than past average levels and therefore justify high, and possibly even higher, valuations.

While this could be true, the market appears to be trading more on pure speculative optimism right now than at any time in modern history. Investors are incorporating unprecedented circumstances, much novel data, and even many new players. Current optimism could be justified by one of many different factors, or one of countless circumstances could change, sending markets plummeting again. We believe downside risk is higher than upside potential but predicting future moves in the face of today's extraordinary uncertainty is hubris at best.