MARKET COMMENTARY

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Wildermuth ADVISORY

Market Recovers But Underlying Strength is Questionable

More signs of a burgeoning economic recovery are showing as government lockdowns ease across the nation. Air travel and hotel bookings are up sharply, and truck and train travel are growing. Mortgage applications are rising. Amazingly, more people are applying to open new businesses, revealing the strength of the American spirit. By the end of May, much of the economy seems to be slowly improving rather than falling further into the abyss.

Yet, while the U.S. economy appears to be slowly creeping back to life, activity in many sectors remains dismal. Travelers passing through TSA security screening checkpoints tripled from 87,534 on April 14th to 267,451 on May 24th, but numbers were still down 87% from the same day a year earlier. Current economic projections forecast a contraction of 6-7% this year with unemployment remaining in double-digit percentages, surpassing all marks since the Great Depression.

Job losses are still staggering. For the week ending May 23, U.S. workers filed a bit over 2.1 million jobless claims. Amazingly, the stock market reacted favorably to the news as the weekly trend continued lower, but the weekly loss remained over 10 times higher than pre-COVID levels. Lay-offs of 20.5 million workers in April drove the unemployment rate, calculated by the Bureau of Labor Statistics, to 14.7%. By the end of May, it will likely reach nearly 20% with effective numbers higher because official tallies exclude people who have dropped out of the labor force as well as millions more that the agency itself said may have been misclassified as temporary layoffs rather than unemployed.

Not surprisingly, consumer sentiment has dropped sharply. Richard Curtin, the chief economist of the University of Michigan's sentiment surveys, noted that consumer sentiment is about as bad as they have ever recorded.

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> *"...investors have flocked to the big tech stocks while shunning most value stocks..."*

Yet, the stock market has performed amazingly well over the past couple months with the broad-based S&P 500 rising back to within about 5% of beginning of the year numbers and less than 10% shy of its February 19 record high. The tech heavy NASDAQ index is up almost 10% above end of year marks and has climbed back to within a few percentage points of its all-time highs.

Investors are increasingly discounting the Covid-19 hit to earnings this year and are looking forward to a 2021 recovery. Furthermore, strong actions by the Federal Reserve and the Fed's promises to continue to buoy the economy have provided the market a sizable tailwind. As has been noted by many, there is a lot of policy under the stock market, or as the old saying goes, "Don't fight the Fed".

The market is also experiencing some exceedingly unique dynamics. Five big tech stocks – Microsoft, Amazon, Apple, Alphabet (Google), and Facebook – make up about 20% of the S&P 500. These companies have benefited tremendously during America's sheltering at home mandate, and all have enjoyed gains on the year. Amazon alone is up over 30% in 2020.

The performance of the big tech stocks continues a trend that began after the 2008 market meltdown. Historically, dividend-focused, value-based strategies have outperformed the general market and suffered less volatility, particularly during volatile times. Yet, the rapid growth of tech stocks since the last downturn has produced the first example of growth stocks outperforming value stocks over a full-market cycle since stock performance has been recorded.

The performance difference during this cycle resulted from investors bidding up the price of growth stocks, generally at the expense of value stocks. Over the past 13.3 years – the time-period incorporating the 2007-2008 crash – over 100% of value's underperformance relative to growth appears to be due to falling relative valuations. In 2020, the trend has continued as investors have flocked to the big tech stocks while shunning most value stocks with already depressed relative valuations.

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This pattern is notably different from past economic disruptions during which value stocks and dividend paying stocks outperformed the general market. Much of this has been driven by the unique circumstances of the government mandated shutdowns that generally rewarded technology-focused companies while inflicting greater damage on companies more likely to be categorized as value.

The performance differences are dramatic. Since the beginning of the year, the Russell 3000 Value index had lost 17.64% through May 26th, while the Russell 3000 Growth Index had gained 2.63%, yielding an unprecedented 20% performance spread. By comparison, the difference in the indices during 2008 was only about 3%, with value outperforming growth. In 2020, the performance of more dividend-oriented stocks, a category that has historically performed well relative to other strategies during market downturns, performed even worse than value, losing 22.38% year to date through May 26th using iShares Select Dividend ETF (DVY) as a proxy.

As a result of both recent and longer-term market dynamics strongly favoring growth stocks, current relative valuations for value stocks are in the far tail (100th percentile) of the historical distribution. Simply, there has never been a bigger spread in relative valuations between growth and value.

The phenomenon partly derives from currently high prices for growth stocks. Amazon trades at nearly 120 times trailing 12-month earnings versus the S&P 500 average of about 22. Netflix's PE ratio is over 80. Some would argue that their high growth potential justifies their lofty prices, but history suggests that valuations do not stay elevated indefinitely. It also seems quite possible that recent events have disproportionately rewarded many growth stocks while punishing value stocks, at least on a relative basis.

Against this market background, circumstances remain highly uncertain. Investors are assuming that much will go well in a recovery that has barely started. Moreover, it appears that many investors are optimistically assuming that the economy and business will quickly return to pre-COVID levels – an occurrence that seems unlikely.

Instead, it seems highly possible that the U.S. and global economy will require a significantly longer time to heal than seemingly assumed, revealing current stock market levels as somewhat optimistic, and even this assumes no significant second and third waves of the virus.

Also, it seems unlikely that the unusual pattern of growth stocks outperforming value stocks will continue indefinitely, implying that value stocks offer higher future expected returns even if accurately predicting a reversal is not possible. The combination of events seems likely to introduce unusual market gyrations in the coming months as investors struggle to decipher a continuous stream of unique and unprecedented data both in the economy and within the market itself given the highly atypical pricing of different investment sectors.