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Equity Outlook

FRANKLIN STREET PARTNERS

The Twists and Turns of 2020 Continue

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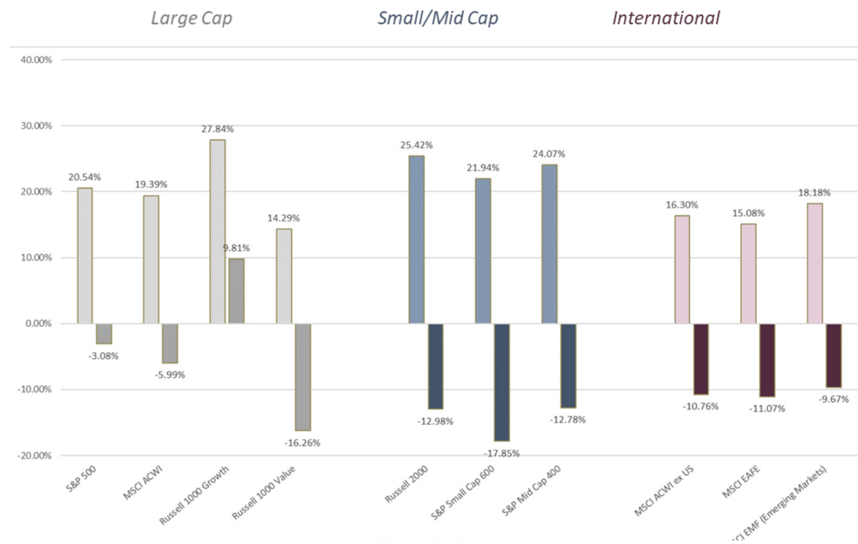
Following the worst first quarter in S&P 500 history, global equities roared back in the second quarter of 2020 with the strongest quarterly performance in decades. Given the ongoing challenges with the Covid-19 pandemic, it is not surprising that concerns have flourished on whether equity markets have moved "too far, too fast," particularly in light of continued reporting of economic data that ranks among the worst in the nation's history. Several theories have been offered on what drove the strong performance of the last three months, ranging from a necessary snapback from oversold conditions, to optimism over reopening the U.S. economy and potential Covid-19 treatments, to the simple idea of "don't fight the Fed" when it appears that both monetary and fiscal policy are committed to supporting the domestic economy through the pandemic and on the path to recovery. As we look to the second half of 2020 and well into 2021, we believe the path to further economic recovery and sustained performance in equity markets will be driven by continued scientific breakthroughs for Covid-19 treatments and vaccine developments, successfully navigating the peaks and valleys of the "reopening" process globally, and sustained monetary and fiscal policy responses from the Federal Reserve and federal and state governments, respectively. The stock market is a forward-looking mechanism that is currently being valued based on fiscal 2021 corporate earnings estimates for the S&P 500 constituents.

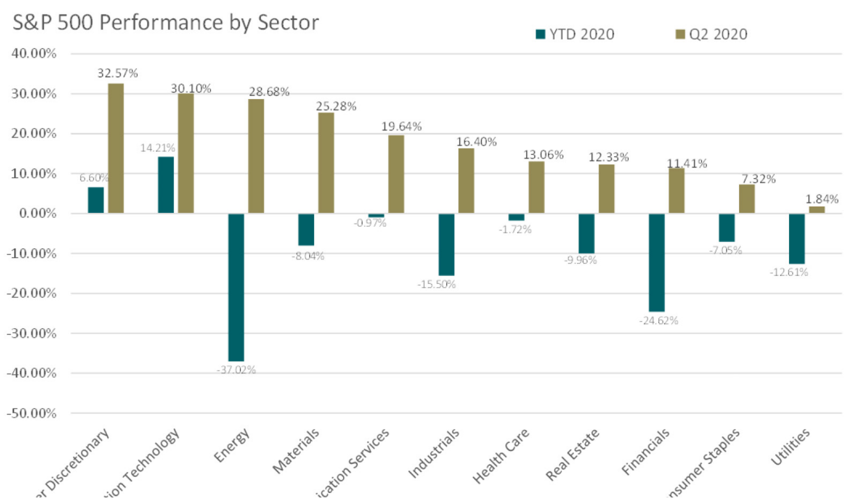
EQUITY MARKET RECAP

For the second quarter of 2020, the benchmark S&P 500 gained +20.5%, the best quarter of performance since the fourth quarter of 1998 and the fourth best calendar quarter since World War II. Following the S&P 500's 2020 closing low on March 23, the index increased +38.6% and stood down only -4.0% on a year-to-date basis. Smaller U.S. stocks enjoyed an even more significant rally, with the mid cap S&P 400 and small cap Russell 2000 advancing +24.1% and +25.4%, respectively. Once again, growth stocks continued their long-running outperformance relative to value counterparts, as the Russell 1000 Growth Index provided a +27.8% gain versus +14.3% for the Russell 1000 Value Index for the June quarter. International stocks also participated in the move higher; the MSCI ACWI ex-U.S. Index gained +14.1% for the second quarter while the MSCI Emerging Market Index was up +16.9%. Every major international equity market moved higher with the German DAX and South Korean KOSPI indices leading for the quarter.

In a reversal of the March quarter, all eleven S&P 500 GICS sectors posted positive performances for the second quarter; once again, performance varied wildly during the period. While traditionally "growth-oriented" sectors such as Technology, Consumer Discretionary, and Communication Services once again outperformed the broader benchmark, economically-cyclical sectors in Energy and Materials also bested the overall index after historically weak performance in the first quarter. Energy's path during the second quarter was particularly interesting; on April 20, the front month West Texas Intermediate (WTI, the benchmark U.S. grade of crude oil) oil futures contract settled at -$37.63 per barrel, a previously unthinkable situation driven by a short-term imbalance of supply and demand. By the end of the second quarter, benchmark WTI had traded back to over $39 per barrel.



When evaluating equity market performance in 2020, an alternative analysis to the common "growth vs. value" debate includes comparing stocks with the highest sensitivity to market movements, or beta, relative to stocks with lower realized volatility.



There has long been a misperception over which stocks are actually higher beta names, with many believing that "high beta" refers largely to fast-growing Technology companies. In 2020, this assumption is mostly incorrect; of the 100 stocks in the S&P 500 Index with the highest beta measurements over the previous year, 30 are in the Financials sector while 15 are in Technology. Also represented in high numbers in the High Beta Index are the Energy (18 companies) and Consumer Discretionary (17) sectors. Perhaps not surprisingly, the S&P 500 Low Volatility Index outperformed the S&P 500 High Beta Index by a wide margin during the peak of the Covid-19 pandemic, as stocks most levered to economic shutdown were the worst performers. The second quarter proved quite different, as the High Beta Index gained +37.0% versus a mere +5.6% for the Low Volatility counterpart.

Regardless of where leadership emerges, increased breadth and depth of stocks in upward trends is a positive development for investors overall.

WHAT TO EXPECT GOING FORWARD

The extraordinary opening six months of 2020 will forever be remembered for the first major global pandemic in over a century and the unique responses to the crisis by economic and political leadership around the world. From an investment perspective, relative responsibility for the factors driving performance have consistently rotated. One rare constant has been the activity of the Federal Reserve and its Chairman, Jay Powell, who have provided timely, substantial levels of liquidity, strongly communicated intentions to maintain activity, and firmly encouraged lawmakers to consider additional fiscal stimulus during the economic slowdown. As of a result of its various stimulus programs, the Fed's balance sheet has grown by approximately 70% year to date (an increase of nearly $3 trillion), and Powell's recent comments that "the passage of time can turn liquidity problems into solvency problems" suggest that the Fed stands ready, willing, and able to provide far more liquidity as needed. On its own, the Fed cannot be the sole factor supporting equity prices, but "fighting the Fed" at the current time seems to be an unwise proposition.

Another key catalyst driving equity performance will continue to be scientific progress toward effectively treating Covid-19 and the eventual development of a vaccine. During the second quarter, multiple studies emerged that offered real optimism over effective treatments for the virus, and broad equity market rallies resulted on nearly every occasion. The global push to develop a successful vaccine has accelerated; according to Bloomberg, the U.S. government has partnered with seven pharmaceutical companies under a program named "Operation Warp Speed" to win such a race. Human trials are currently taking place for proposed vaccines from several domestic and international sources. The importance of medical breakthroughs toward a vaccine should not be underestimated, given its importance to renewed economic growth, and will continue to strongly influence the direction of stocks.

The unprecedented, voluntary halting of economic activity both domestically and internationally was largely uniform in nature. However, the current "reopening" process that began emerging in the second quarter will likely not be as synchronized as the shutdown, leading to substantial debate about which letter or shape that the economic recovery resembles – V, U, W, reverse square root, etc. In the U.S., individual states will pursue reopening policies that differ greatly in timing, and there will be ebbs and flows during the process, as evidenced by the pullback in reopening plans by governors in Texas, Florida, and Arizona at the end of June. The peaks and valleys of reopening will heavily impact market sentiment during the balance of 2020.

Global Monetary And Fiscal Stimulus To Fight COVID-19 Impact
2020 Feb to June (CSM)

	Potential Central Bank Liquidity Injection		Potential Fiscal Stimulus		Central Bank Liquidity Injection and Fiscal Stimulus	
	$ Tln	% GDP	$ Tln	% GDP	$ Tln	% GDP
U.S.***	$6.21	29.0%	$3.30	15.4%	$9.51	44.4%
Eurozone	$1.78	13.3%	$4.02	30.2%	$5.80	43.6%
Japan**	$1.03	20.0%	$2.08	40.3%	$3.11	60.3%
U.K.	$0.37	13.6%	$0.23	8.3%	$0.60	21.8%
China****	$1.33	9.3%	$1.22	8.4%	$2.54	17.7%
Others*	$0.73		$2.67		$3.40	
Global	$11.44	13.2%	$13.52	15.6%	$24.96	28.8%

*incl RoW and ADB, IMF, WB ****China CB stimulus incl injections and other activities, e.g. re-lending, RRR, direct small biz lending, etc.

Source: Cornerstone Macro (CSM), 5.31.20

Corporate earnings reports will regain the spotlight beginning in mid-July, and we expect most companies will maintain the "playbook" introduced during first quarter calls – first and foremost, communicating efforts that prioritize the well-being of employees and customers; the balancing of capital priorities (stock buybacks, cash dividends, capital investment) that emphasize long-term health; and firming up capital coffers with debt and/or equity raises. Questions regarding the tenor of the quarter will also prove popular, as analysts and investors attempt to discern the effects of the reopening process and how it has affected store openings, utilization rates, manufacturing activity, etc., as the quarter progressed from early April to late June. We also expect companies to emphasize there are still more unknowns than knowns, but there are also opportunities. We look for companies to specifically comment on the potential rebound in GDP in the third quarter and share specific metrics relevant to their business (such as consumer spending, recovery in employment data, etc.), and reiterate longer-term, strategic objectives for their business in a return to normal environment. There may also be specific actions that companies have taken to deal with permanent changes resulting from the Covid-19 crisis.

As economic and corporate outlooks remain uncertain, the range of earnings estimates for 2020 and beyond has remained historically wide. Over the course of the second quarter, aggregate estimates for S&P 500 earnings per share in 2020 declined from $158.39 to $125.40 as of June 30. Since most investors acknowledge the impact of the pandemic on current-year profitability, more attention has moved toward 2021 and its potential for a more "normalized" operating environment. For next year, the S&P 500 estimate currently stands at $162.09, implying year-over-year growth of more than +29%. However, the collection of estimates for 2021 is extensive, with estimates ranging from the low $130s to low $170s. As a result, we must consider an earnings scenario analysis that includes several outcomes based on a range of variables. Likewise, in addition to various earnings outcomes, we must contemplate a wider range of valuation considerations. Over the last twenty-five years, the average P/E multiple on next twelve month S&P 500 EPS has been 16.3x. While the current P/E multiple of 2021 estimated earnings currently stands well above average, it is important to consider that stock prices are ultimately a function of future earnings and interest rates, and the absolute low levels of U.S. Treasury bonds suggest a higher P/E multiple may be justified.

In a market environment with significant uncertainty on many important topics, other impactful issues will certainly emerge as 2020 progresses. We are monitoring two in particular – simmering geopolitical tensions between the U.S. and China, the world's two economic superpowers, and the November 2020 election process and its prospective impacts on taxation, regulation, and other policy matters. Both have the potential to meaningfully impact investor expectations for future growth, thereby sustaining an already elevated level of volatility in the market. Volatility can provide opportunities for longer-term investors and active managers, in particular.

ASSET ALLOCATION AND ACTIVELY MANAGED, INTERNAL EQUITY STRATEGIES

Much has been written about the concentration of performance in a relatively small number of stocks, and acronyms like "FANG", "FAANG", or "FAB5" have become important parts of the investment lexicon. Currently, the five largest names in the S&P 500 Index are Apple, Microsoft, Amazon, Alphabet (Google), and Facebook. Collectively, these five companies comprise over 21% of the index's total market value; this compares with 11.6% at the end of 2013 and represents the highest level of concentration in five companies since 1977 (IBM, General Electric, General Motors, AT&T, Exxon). While we are mindful of the dangers of excessively consensus thinking, we are not concerned by the idea of large positions, as by our own design, we actively manage high conviction and/or concentrated equity strategies. Although there are notable differences between the five companies, each shares a number of similarities; namely, asset-light business models, with a large installed customer and/or user base that has a significant component of sticky, service-oriented revenues, strong balance sheets, and high switching costs. In our judgment, these characteristics are often indicative of advantaged business models.

As we've previously discussed, several client portfolios have deviated from longer-term strategic weightings due to the extreme volatility in investment markets and performance deviations in various asset classes. In these instances, we continue to prudently rebalance, which involves selling asset classes that have outperformed and buying those that have underperformed. In terms of asset allocation, we made one change during May to reduce emerging market and passive U.S. large cap exposure in favor of increasing exposure to growth-oriented technology companies, where we have higher conviction. To accomplish this, we moved available funds into a passive position that corresponds to the NASDAQ 100 Index to gain further exposure to select technology themes.

Within FSP, we actively manage five primary large cap equity strategies with a range of return and risk objectives that represent style tilts to the S&P 500 benchmark – Strategic Growth, Partners Advantaged, Equity Income, Growth & Income, and Sustainable, Responsible Equity. Growth & Income uses a barbell approach, combining stocks from our core growth-oriented strategy (Strategic Growth) with our core value conservative strategy (Equity Income); and Sustainable, Responsible strategy is a thematic ESG approach to our Partners strategy.

In the actively managed, internal equity strategies, we continue to focus on companies with distinct advantaged business models and longer-term secular opportunities, making changes in accordance with the style, risk, and reward objectives for each individual strategy. We continue to favor advantaged companies with strong balance sheets, high free cash flow generation, and capital flexibility. Advantaged businesses are uniquely positioned to emerge as stronger competitors over the longer term as well as weather severe economic challenges. We also reiterate two opinions that we discussed at length in our prior letter; first, history illustrates that equity markets bottom before recessions end, and secondly, market timing is not a strategy worth pursuing. Additionally, we believe success is a result of maintaining a long-term investment horizon; staying philosophically consistent with a proven investment process and approach that reinforces consistency in portfolio decisions. Equity performance in the second quarter of 2020 reinforces these sentiments.

The first half of 2020 has been truly historic with unprecedented economic and investment volatility, and we understand the impact that such activity can place on investor anxiety. We are always available for questions and concerns and thank you for your continued confidence.

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