VICTORIA
Capital Management, Inc.

Financial Markets Perspective

October 2020

A Time of Transition

Nine Months into a Crisis and Counting

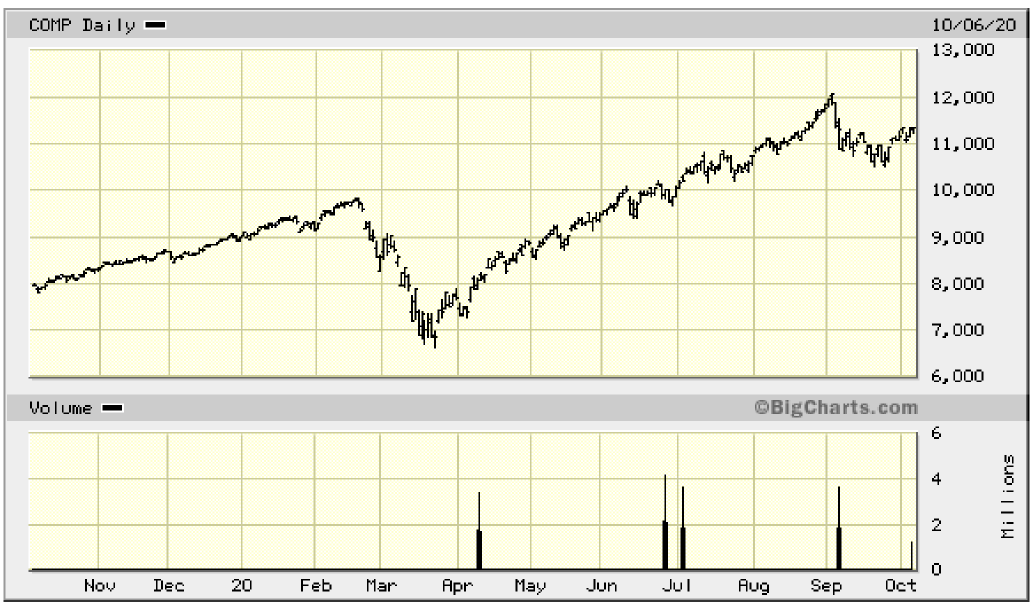
On March 11th, the World Health Organization declared the COVID-19 outbreak a pandemic. Two days later, President Trump declared a national emergency in the United States. Who would have thought the year would experience record swings in economic activity and unemployment and more importantly for us: how have financial markets fared? The stock market is usually a good indicator of what is to come, but no one expected that the Dow Jones Industrial Average (DJIA) would fall from a high of 29,569 on February 12th to a low of 18,214 on March 23rd. The total decline was 11,355 points (38%) and happened in less than six weeks! After the initial shock was over and decisions to reopen parts of the economy intensified, the markets rallied. By the end of September, the DJIA closed at 27,782 a gain of 9,568 points or 53%, in only six months as you can see below in Exhibit #1. This bounce back is impressive, yet the NASDAQ Composite index turned in even more stellar returns that can be seen in Exhibit #2 on the next page.

Exhibit #1

From the February high of 9,838 the index dropped to a low of 6,631 or 33%. Since that low, the Nasdaq Composite has rallied to record highs. Part of the reason for the outperformance of the technology-heavy Nasdaq can be attributed to the forced changes in both work and home lifestyles brought about by the Coronavirus. The shutdown curtailed activities such as eating out and travel, to be replaced by eating at home and canceling vacations to avoid unnecessary human contact. As a result, the most severe hardships are evident in the airline, food & beverage and hotel industries. Conversely, companies that provide consumer staples, such as Clorox and Procter and Gamble, benefitted from the rush to purchase disinfecting wipes and toilet paper.

Education was also hard hit with the suspension of classes on campus forcing teachers, parents, and students to adapt to a completely different learning environment. Corporations across the globe were forced to make employees work from home and to employ videoconferencing technology to not only conduct meetings but to keep businesses running. Countless worldwide manufacturers have retooled to make personal protective equipment for healthcare workers and first responders in their battle against the coronavirus. There are so many examples around the world, but one of the best domestic examples of this is Ford and General Motors, who shut down car production and redeployed their Detroit factories and workers to produce ventilators, respirators, and face shields. As the virus extended its tentacles, working from home gained attractiveness as employees enjoyed the flexibility of their new work schedule and the ability to spend more time with family. Management saw an opportunity to reduce travel costs related to conferences, exhibitions, and seminars. The pandemic has caused many events around the world to be cancelled or postponed. For example, both the 2020 Summer Olympics and Expo 2020 have been postponed to 2021 while the Eurovision Song Contest 2020 was cancelled entirely. Professional baseball and football games are now populated with cardboard people! Other cancellations include military, political, religious and sporting events, to name a few. Unfortunately, these trends will likely continue until a vaccine is discovered.

Exhibit #2

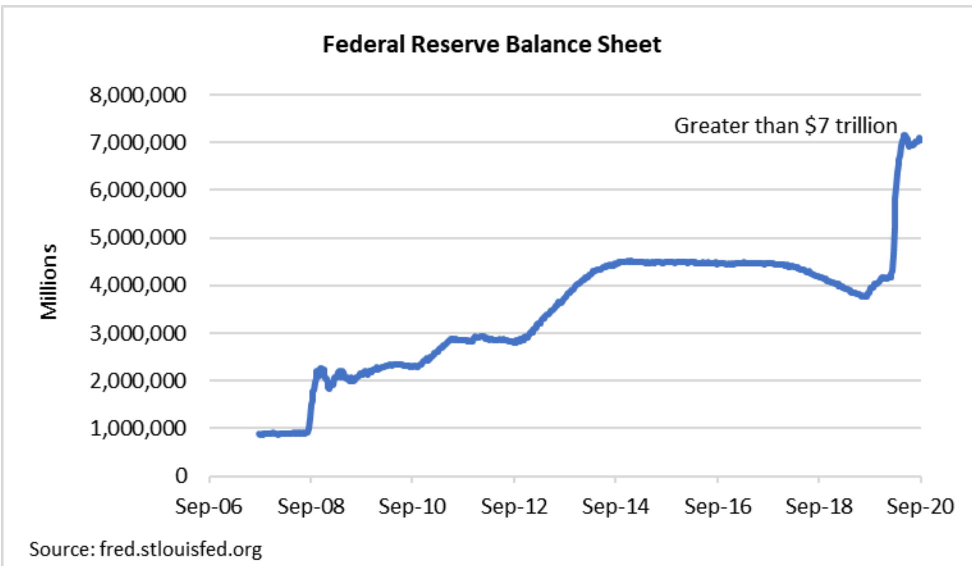


Despite the many negatives associated with forced shutdowns, there are some positives in the form of transitioning. As consumers continue to try to limit their exposure to the virus, many have started using online grocery services like Instacart for the first time. We were early users of this platform back in 2018 to save time. So far this year we have saved 55 hours using Instacart for grocery shopping. Some experts predict that 50% or more of American consumers will be using this service before the end of this year. The same goes for dining, as restaurants had to close for an extended period in response to the pandemic, forcing them to rely on platforms like DoorDash and Uber Eats. To demonstrate the newfound popularity of DoorDash and its subsidiaries, the company earned 46% of U.S. consumers' meal delivery sales in August! There has already been some consolidation in this space as these services are in demand across the globe and we expect to see more.

Monetary and Fiscal Policy

A transition is also taking place due to the sudden government reaction to the Coronavirus. Shutting down the economy to minimize the spread of the virus stopped most economic activity. For the second quarter of this year, real GDP contracted at a 32.9% annualized rate! To offset this response to the shutdown, both monetary and fiscal policies became expansionary. The Federal Reserve quickly reduced its short-term interest rate target to zero and stated that it intended to keep rates at that level until 2022, at the earliest. In addition, the Fed purchased bonds to keep the economy liquid and made a commitment to buy bonds, not only government bonds but also bonds issued by municipalities and corporations. This commitment triggered a strong rally in the bond market, especially in junk bonds, as the risks of bankruptcy were diminished. Exhibit #3 reflects the surge in Federal Reserve bank liabilities this year. Currently, the balance sheet is in excess of $7 trillion!

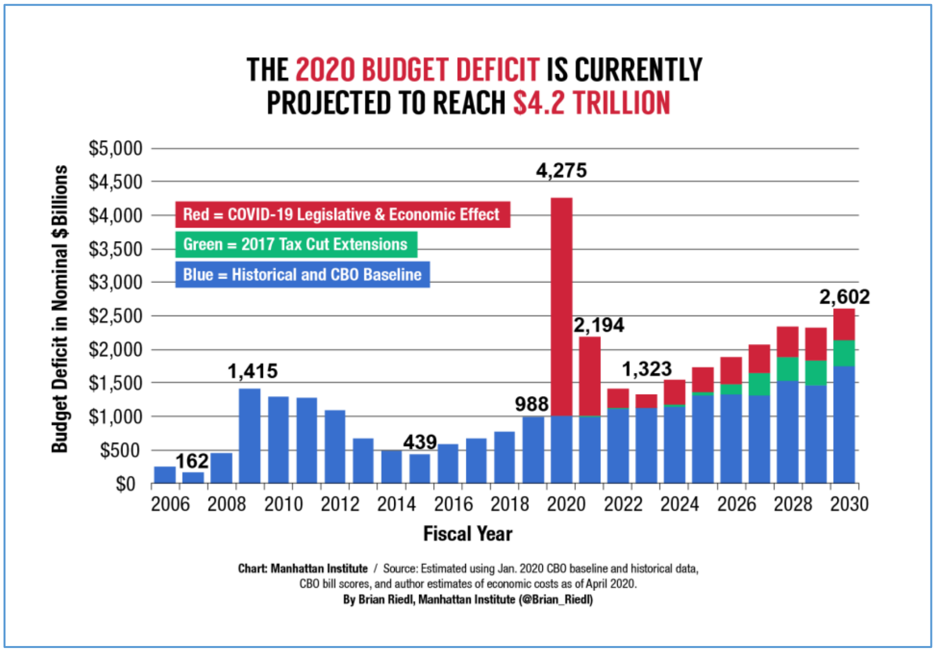
Exhibit #3



The Fed's commitment to low interest rates means that borrowers will continue to benefit at the expense of savers. While bonds appeared to have been a good investment over the years, the problem is that bond returns were temporarily bolstered by the capital return side of the return equation. While historical returns looked good under this metric, the fact is that future returns will be dictated by current interest rates and there is likely to be little, if any, temporary capital gains to augment the attractiveness of bonds. Investors are left with bond returns of 1-3% for the foreseeable future -- not an attractive option for building a retirement nest egg. Once rates begin to rise, bond prices will fall offsetting any benefit from rising rates.

In addition to the Fed's change in policy to extend low interest rates indefinitely, congress and the president worked together to provide an array of support programs for the private sector launching trillions of dollars in payments to the business community that had been throttled due to the shutdown. Even now, congress is debating another support program for the private sector to facilitate a transition to this new way of doing things. As Exhibit #4 on the next page demonstrates, the magnitude of current government spending due to the coronavirus is enormous. Even after the virus is eliminated, there will be needs for continued government support. Recently, over 90% of restaurants in New York City could not pay their August rent. Many of these restaurants rely on outdoor seating so when cooler temperatures arrive in a month, they will be facing another challenge to their existence. Unless there is a change in lockdown policy or another assistance program for these businesses, a disaster is forthcoming. While Federal authorities have made major changes in their policies to keep the economy afloat, many state and local government officials are taking divergent paths to combat the rise in cases. There are states in partial lockdown while others that are fully open are seeing a resurgence in cases.

Exhibit #4



These are truly unique times in American history. The federal government shuts down the economy to sidetrack the virus and then, to mitigate the impact, provides unheard of financial assistance to the private sector to get the economy back on track. The result of this assistance is the fact that more than half of private sector jobs that were lost have been recovered and the unemployment rate has reversed half of its gain in just 5 months! Meanwhile the public sector has been slow to recover, one more sign that the private sector is inherently more dynamic than the public sector.

For economists and market forecasters, relying on recent economic data can be misleading. The collapse in the economy for one quarter and then the subsequent expected snapback, which was almost equal to the collapse, has left forecasters scratching their heads. We have witnessed company earnings' forecasts being revised down and then back up as the strength of the economic recovery has been continually underestimated. On the other hand, we can be sure about the level of interest rates, at least for the next 12-18 months. The Federal Reserve has committed to an effective zero interest rate for short-term securities and near-zero rates for longer term government securities. One benefit of this low interest rate policy is low mortgage rates that have fallen to record lows for a 30-year conventional mortgage. These record low mortgage rates provide buyers with additional purchasing power who would otherwise have to designate a much larger amount of their income to make monthly payments.

Conclusions

The surprise COVID-19 virus "attack" around the globe has permanently changed the way we live and work. The most important change here in the United States has been the federal government's response to the Coronavirus -- providing trillions of dollars of support to the private economy. The silver lining in all the bad news is that there is some good news. The economy is recovering rapidly. The GDP Now forecast for the economic growth in the third quarter is an annualized rate of 35.3%! This jump will not get us back to where we were before the pandemic hit but represents the fastest bounce from a recession low. Remember that this brief recession was forced on the economy – completely unlike the financial crisis of 2008-2009 or the dot.com meltdown in 2000-2002 (both which we also survived). Expect growth to get back to normal levels once we have transitioned to this new way of doing things.

The Coronavirus has also accomplished what neither the government nor private sector could do in advancing the use of technology to change our lives in a positive way. As a result, there are sectors of the economy that are benefiting during these times as there are ones that are suffering – what we refer to is the Have's and Have Not's. Drilling down into asset classes, we see that the beneficiaries are generally large capitalization growth stocks while the poor performers are small capitalization value stocks. Year-to-date through September, the S&P 500 growth stock index is up 20.6% while the S&P 500 Value index is down 11.5%. More generally, the S&P 500 index is up 5.6% while the mid-cap S&P 400 and small-cap S&P 600 are down 8.6% and 15.3%, respectively. Taking the combination of the wide disparity in market sector performance and the changing ways in which we are being forced to live because of the pandemic, we are in an historic transition in both how the economy and financial markets work.

In our July perspective, during the stock market rally, we said the following:

"As we reflect on the economy and stock market condition, we may be reliving the crisis of 1942 just with a different enemy. The rally in stocks in the second quarter where the S&P 500 rose 21% may be the beginning of a similar recovery for the full year. Even though there are continuing uncertainties that can impact financial markets on a day-to-day basis, the clouds over financial markets appear to be clearing and continued improvements in economic metrics could keep us on an upward trend until the economy is off of life support."

While we are not prognosticators of stock market returns, we know that earnings and profits matter. As we have written many times before, profits are the mother's milk of stocks, and for that matter, for business and the entire economy. Wall Street is adjusting to the improving economic outlook. Earnings forecasts are being increased and recent overall profit forecasts have risen even though there are Coronavirus hotspots across the country. As we approach earnings season, we will know who the winners and loser are as earnings return to center stage.

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