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Performance Reports

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STRATEGIC CAPITAL MANAGEMENT, LLC

Q3 2020 Newsletter | Jeff Griggs, CFA

Due to the wide range of risk tolerances of our clients, some topics or asset classes may have more, less, or no importance to your portfolio. For a detailed analysis, give us a call, or request a detailed performance review.

Big Picture

2020's wild ride continues. After suffering the fastest ever -30% drop, the market staged a seemingly miraculous recovery. The S&P 500 rose 20.54% in the second quarter, the biggest quarterly gain since 1998. The V-shaped chart for the first six months of the year represents the biggest quarter-to-quarter swing since 1932. In case anyone hasn't noticed, these are not normal times. The stock market has seemingly completely decoupled from the economy. S&P 500 earnings are expected to fall -45% in the second quarter and -21% for the full year. Prior to 2020, the highest week on record for new jobless claims was 695,000 in 1982. That number has been obliterated every week since mid-March (19 weeks and counting), peaking at an astonishing 6.9 million the week ending March 28th.

So far, the market has been largely ignoring these economic realities for two main reasons. First, this recession is not normal, it is almost entirely voluntary. If we miraculously found a vaccine, or somehow beat the virus, much of the destruction could be quickly reversed and the market is forward looking. The market is discounting future economic activity and seems to be pricing in a speedy return to normal. Second, the federal government and the Federal Reserve have been extremely accommodative throughout the pandemic. While no amount of cheap borrowing, or stimulus checks can revive an economy when businesses are closed, the market is apparently expecting these measures to put a big enough band-aid on corporate and personal pocketbooks to avoid disasters like bankruptcy and mortgage foreclosures and provide the fuel necessary to get the economy roaring again as soon as it is safe to do so.

The question is when will that be? States and counties began easing lockdown restrictions throughout the quarter as daily new cases fell and hospital capacity rose, however, we have seen a new surge in infections with many regions (including Oregon) seeing more new daily cases today than ever before. This seriously raises the question as to how quickly we will be able to get the business environment back to normal, let alone how quickly consumer behavior will return to some semblance of normalcy. Not every job will return, and not every consumer will be comfortable jumping back into their pre-COVID lifestyle regardless of government rules and regulations.

Looking Ahead

Earnings are expected to drop -45% in the second quarter and -25% in the third quarter. Sales are expected to fall -11% in Q2 and an additional -5.5% in the third quarter. The forward P/E on the S&P 500 has risen to 22x. Industrial production fell -14.7% in the second quarter, yet the S&P 500 has risen over 40% since its March 23rd lows. With uncertainty as high as it is, and with markets completely decoupling from the economy, diversification is key. If I am not confident in predicting any future outcome, I want my bets spread as wide as can be. With that said, within the stock market there has been a huge distribution of outcomes. From the Tech sector up 15% in the first six months, to the Energy and Financial sectors down -35% and -24%, respectively, the extreme level of uncertainty is creating opportunities for savvy stock-pickers to outperform. 40% of the companies in the S&P 500 have completely suspended guidance, and analyst forecasts are as varied as ever. This environment is in stark contrast to years past when the tide seemed to raise all ships equally and professionals had little opportunity to outperform an index fund.

On the Fridge

US Equities

In a rather shocking reversal, US Stocks bounced off their March 23rd lows and rose 21.8% in the second quarter. Buoyed by fiscal and monetary stimulus and hopes for viral containment and a quick vaccine.

Consumer Discretionary

The Consumer Discretionary sector rose 32.9% in the quarter, beat all others. Many Americans were able to transition to a work-from-home environment to preserve their paychecks, while those less fortunate seem to somehow continue to make ends meet. Although, as a certain mega online retailer now makes up a full quarter of the sector, the performance of the sector may not be a reliable gauge of the health of the US consumer.

In the Dog House

Developed Markets

Despite seeming to have a much better handle on the pandemic, developed market (mainly Europe and Japan) stocks lagged their US counterparts by 6.3% in the second quarter.

Utilities Sector

As investors shrugged off the dismal economic news and pushed stocks to an incredible quarter, the utilities sector rose only 2.7%. Yet, at an 11% loss year-to-date utilities are still handily beating the Energy, Financials, and Industrials sectors.

Links and Articles

No, The Markets Aren't Crazy
Morgan Stanley's Ruchir Sharma lays out a case justifying the market recovery.

Mapping the Outbreak
Bloomberg provides useful data and analysis to map the outbreak across the world.

Economic Lessons from the Pandemic
The Atlantic looks at the economic impact of the pandemic through the lens of war.

The Pandemic Could Get Worse
The New York Times highlights the gravity of the recent surge in new cases.

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Performance

Markets staged an against-all-odds rally with US equities rising 21.8%, bonds achieved fantastic returns as well with investment grade corporates rising 9%. Historically, this should not happen, as government bonds tend to exhibit a negative correlation to equities, but in the post-2008 Fed environment, this is something we have grown accustomed to. Huge monetary stimulus pushes rates lower and risk-assets higher. Interestingly, developed market equities underperformed their US counterparts despite a much more effective reaction to the pandemic. Additionally, high-yield bonds rose 10.2% in the quarter as oil (the energy sector makes up a large part of the high-yield bond market) rose 41% in the quarter. Yet, high-yield bonds remain the only class within fixed income that remains down year-to-date (-3.8%). During the quarter, the forward P/E on the S&P 500 rose 44.5% to finish the quarter at a whopping 21.94x. Perhaps one of the only things that is in line with the economic reality of the pandemic, is the notable outperformance of the tech-heavy NASDAQ composite versus the broader S&P 500. Stay at home orders, and the subsequent shift to work-from-home policies, have benefitted many tech firms as companies and individuals invest in their home office and remote work infrastructures. Many consumers stuck at home observing shelter-in-place policies shifted their spending online for everything from entertainment to necessities. The NASDAQ actually finished the second quarter at all-time highs up 12.7%, while the S&P 500 finished the quarter -3% on the year.

	2020 Q2	YTD	LTM	3yr	5yr	10yr
Cash	0.0%	0.5%	1.5%	0.5%	1.1%	0.6%
Fixed Income	3.3%	3.0%	4.2%	3.8%	3.6%	2.8%
Fixed Income Blend	3.3%	3.0%	4.2%	3.8%	3.6%	2.8%
Government	0.5%	8.6%	10.3%	5.5%	4.0%	3.3%
Inflation Protected	4.2%	6.0%	8.3%	5.0%	3.7%	3.5%
Municipal	2.7%	2.1%	4.4%	4.2%	3.9%	4.2%
Floating Rate	0.1%	0.5%	1.5%	1.8%	1.3%	0.0%
Corporate	9.0%	5.0%	9.5%	6.3%	5.8%	5.5%
High Yield	10.2%	-3.8%	0.0%	3.3%	4.8%	6.7%
International Bond	3.4%	0.6%	0.7%	2.5%	2.9%	2.0%
Equity	19.4%	-6.0%	2.6%	6.7%	7.0%	9.7%
Equity Blend	19.4%	-6.0%	2.6%	6.7%	7.0%	9.7%
US Equity	21.8%	-2.2%	8.4%	11.0%	10.8%	14.1%
Developed Markets	15.5%	-11.2%	-5.0%	1.4%	2.5%	6.0%
Emerging/Frontier	18.2%	-9.7%	-3.0%	2.3%	3.2%	3.6%
Alternatives	5.6%	-3.4%	-1.5%	0.5%	0.5%	1.6%
Alternatives Blend	5.6%	-3.4%	-1.5%	0.5%	0.5%	1.6%

	2020 Q2	6mo	1yr	3yr	5yr	10yr
Information Technology	30.5%	15.0%	35.8%	26.8%	23.4%	20.5%
Financials	12.2%	-23.6%	-13.9%	0.1%	5.4%	9.7%
Health Care	13.6%	-0.8%	10.9%	10.3%	8.1%	15.7%
Consumer Discretionary	32.9%	7.2%	12.6%	15.3%	13.2%	18.2%
Consumer Staples	8.1%	-5.7%	3.6%	5.0%	7.2%	11.8%
Industrials	17.0%	-14.6%	-9.0%	1.9%	6.7%	11.8%
Energy	30.5%	-35.3%	-36.0%	-12.5%	-9.2%	0.2%
Utilities	2.7%	-11.1%	-2.1%	6.4%	10.2%	11.3%
Materials	26.0%	-6.9%	-1.1%	3.9%	5.4%	9.9%
Communication Services	20.0%	-0.3%	11.1%	8.6%	7.2%	10.6%
Real Estate	13.2%	-8.5%	-2.0%	6.3%	8.0%	11.8%

Source: Morningstar; The 1,3,5, and 10 year performance is annualized.

The consumer discretionary sector performed the best, rising 33% in the quarter, however, the sector was largely carried by Amazon, which rose 44.6% in the quarter. Whether you want to call it a tech, logistics, or consumer discretionary company, it's important to realize the impact Amazon has on the sector and not make broad assumptions about the overall consumer environment based on the returns of what is also the world's most profitable cloud computing company. The Tech and the Energy sectors tied for second place, returning 30.5% each. On the year, this performance furthered Tech's lead as it is now up 15% in 2020, while Energy was the hardest hit sector coming into the quarter and remains down -35% despite the recovery. The worst performing sectors were Utilities (+2.7%) and Consumer Staples (+8.1%). While a low return from the least volatile sector may not be surprising, it is notable that utilities remain down -11.1% on the year, underperforming the broader market and failing to offer the relative safety they are known for.

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Asset Class	Benchmark	Description
Cash	BBgBarc US Treasury Bill 1-3 Mon TR USD	Measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.
Fixed Income	BBgBarc Global Aggregate TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers.
Government Bonds	BBgBarc US Government TR USD	The Bloomberg Barclays US Government Bond Index comprises the US Treasury and US Agency indices. The index includes US Dollar-denominated, fixed-rate, nominal US Treasuries and US agency debentures (securities issued by US government owned or government sponsored entities, and debt explicitly guaranteed by the US government).
Inflation Protected	BBgBarc US Treasury US TIPS TR USD	The Bloomberg Barclays US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market.
Municipal	BBgBarc Municipal TR USD	The Bloomberg Barclays U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.
Floating Rate	BBgBarc US Trsy Floating Rate TR USD	The Bloomberg Barclays US Treasury Floating Rate Index measures the performance of floating rate bonds issued by the US Treasury.
Corporate Bonds	BBgBarc US Corp IG TR USD	The Bloomberg Barclays US Corporate Bond index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers.
High Yield Bonds	BBgBarc US Corporate High Yield TR USD	The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.
International Bonds	BBgBarc Gbl Agg Ex USD TR Hdg USD	The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging market issuers. This version excludes USD-denominated debt.
Equity	MSCI ACWI GR USD	The MSCI ACWI captures large and mid cap representation across 23 Developed Markets and 23 Emerging Markets countries. With 2,477 constituents, the index covers approximately 85% of the global investable equity opportunity set.
US Equity	MSCI USA GR USD	Captures broad US equity coverage. The index includes 3,108 constituents across large, mid, small, and micro capitalizations, representing about 99% of the US equity universe.
Developed Market Equity	MSCI World ex USA GR USD	Captures large and mid cap representation across 22 of 23 Developed Market countries, excluding the United States. With 1,023 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Emerging Market Equity	MSCI EM GR USD	The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 829 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.
Alternatives	Wilshire Liquid Alternatives TR USD	Measures the collective performance of the five Wilshire Liquid Alternative strategies that make up the Wilshire Liquid Alternative Universe, including the Wilshire Liquid Alternative Equity Hedge, Global Macro, Relative Value, Multi-Strategy, and Event Driven indices. This index is meant to provide a representative baseline for how the liquid alternative investment category performed as a whole. Constituents comprised of '40 Act mutual funds.
US Large Cap Equity	S&P 500	Widely regarded as the best gauge of large-cap US Equities. The S&P 500 is a market-weighted index that includes 500 leading companies and captures approximately 80% coverage of available market capitalization.