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Quarterly
3RD QUARTER | 2020

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In The Spotlight

Reid E. Thompson, AIF® - *Vice President & Corporate Retirement Plan Specialist*

Colonial Trust has long serviced corporate retirement plans for our existing clients. Over the past several years, we have seen the industry evolve with improved technologic efficiencies offset by increasingly complex regulations. To that end, we have invested in our capabilities and have added to our depth and expertise in this area. In January, Reid Thompson joined our firm to focus on serving our 401(k) clients. He has over 16 years of experience in the retirement plan industry. Reid has developed a disciplined model to this market that focuses on transparency and process to serve and grow Colonial Trusts' retirement plans business. He received the Accredited Investment Fiduciary (AIF®) in 2019, the leading designation of retirement plan professionals.

Reid moved back to Greenville in 2017 after graduating from Furman University in 1998. He and his wife, Sharon, have two boys, Montford (2 ½) and Myers (7 months). They enjoy walking around the neighborhood with the boys and just adopted a stray Doberman mix puppy. They also have a cat named Bailey that doesn't get as much attention as she would like. With any time left over, Reid likes to play golf and work in the yard.

Market Commentary

REVIEW OF THE QUARTER

The second quarter was one for the record books. With the S&P 500 returning 20.5%, it was the best quarter since 1998, bringing the year-to-date market decline to only -3.1%. The tech-heavy Nasdaq beat the S&P, returning 30.9% for the quarter. Domestic markets fared better than international markets, with the MSCI EFAE index returning 15.5% and the MSCI Emerging Markets index up 17.9% in dollar terms. Dissecting the performance by S&P sectors shows market leadership from consumer discretionary, technology, energy, and materials – returning 32.9%, 30.5%, 30.5%, and 26.0%, respectively. The laggards were stable sectors like utilities and staples, up 2.7% and 8.1%, respectively. Cyclicals outperformed on optimism about economic reopenings, support from Congress and the Fed, and the acceleration of digitization of our economy forced by the pandemic.

Individual stock performance can be categorized into two buckets. First, the companies benefiting from the lockdowns, many of whom were technology companies like Amazon, Apple, or Microsoft. The other group was companies whose first-quarter performance made them ripe for a reopening bounce, like airlines and travel stocks.

The bond market offered positive returns for the quarter, with the US Aggregate Bond Index returning 2.9%. The bond market volatility of the first quarter was quelled as the Fed's balance sheet expanded by $1.3 trillion through purchases of treasury and mortgage debt. Additionally, the Fed began to deploy $2.3 trillion in lending to support households, employers, financial markets, and municipal governments. This wave of liquidity resulted in record bond issuances by corporations to provide the liquidity to manage through this recession.

We will spend the remainder of our market commentary explaining the divergent paths between Wall Street and Main Street and provide our expectations on where we go from here. Many are puzzled to see headlines regarding the best quarter in decades juxtaposed to headlines about record COVID cases and reclosing of businesses. The market's ability to shrug off negative headlines since the March 23rd lows has bewildered even Wall Street veterans.

We believe there are several factors driving market gains even while news of the virus, protests, and economic data has been grim. Perhaps the correct explanation is the simplest, the market is a forward-looking mechanism. The current economic data is poor, with 1st quarter GDP falling 5.0% and Bloomberg estimates for second quarter currently -34.5%. According to S&P, 1st quarter earnings fell 48.7% and second quarter earnings are projected to fall 42.9%. Earnings are projected to recover sharply in 2021 and reach all-time highs. The market is looking beyond the 2020 COVID depressed earnings and towards better days when the pandemic is behind us.

We put a great deal of credence in the forward-looking explanations, but there are other factors at play. There have been news stories over the last quarter with the headline, "The Market is not the Economy". That statement has never been truer than during this pandemic. The average value (market capitalization) of the 500 companies in the S&P 500 is $55 billion and there are four companies valued at more than $1 trillion in Apple, Microsoft, Amazon, and Google. The largest sector in the S&P 500 is technology at 27.5% and if Google, Facebook, and Amazon were categorized as technology stocks, this weighting would be 38.8%. The large, well-capitalized tech-oriented companies are not facing the same challenges as Main Street and in many cases are benefiting from the accelerated digitization of the economy caused by the virus. Publicly traded companies facing difficulty in this environment don't face the same circumstances as small and medium-sized businesses because they have access to capital through the equity and bond markets, aided by the actions of the Fed. Many Main Street businesses are harmed by the economic impacts of COVID and don't have access to capital to manage through these challenging times. When we reach the other side of this pandemic, we expect publicly traded companies with access to capital to take market share from smaller competitors, benefiting their shareholders.

Another reason for the disconnect between Wall Street and Main Street is that Main Street tends to focus on the level of activity and Wall Street focuses on the trend. By every measure the economy is functioning well below capacity. We will highlight two data points to explain this concept. Retail sales for May were down 6.1% from the prior year. Consumer spending is 68% of our economy and a 6.1% drop in retail sales is dreadful. However, retail sales increased 17.7% in May over April. For June the unemployment rate was 11.1% and we have 14.7 million fewer workers than we did in February. However, we have 7.5 million more people working than we did in April. The markets are concerned about the level of these measures but are more concerned if they are improving or worsening. Most of the economic data we examine is concerning when examined in isolation, but the trends on this data show improvement. This provides market participants confidence that the worst is behind us.

The final factor that explains the divergence between the fortunes of Wall Street and Main Street are the policies employed by the Fed. Jay Powell has pulled out all the stops to support market functioning and liquidity since late March. The Fed Fund's rate was cut to 0.0% and their balance sheet has expanded at a rapid pace. They have invented new facilities to support credit market through the purchase of corporate and municipal bonds. They are standing up a Main Street lending facility to provide capital to smaller businesses through the banking system. These efforts have yielded two results. First, public companies have ample access to capital which will allow them to manage through this time. Second, it has taken bond yields to very low levels with the 10yr US treasury yielding 0.70%. This low yield environment makes stocks more attractive compared to lower yielding bonds and increased the value of stocks through valuation models. Interest rates are a key input in discounting models and low rates make future cash flow worth more.

We believe each of these explanations has validity in explaining the divergence between the performance of the equity markets and the situation we see in the news daily. Consider this, the five largest stocks in the S&P 500 are Apple, Microsoft, Amazon, Google, and Facebook. They represent 22.7% of the value of the index and their average return was 34.6% for the quarter. Their business models have either been minimally impacted by the virus or have benefited from what has happened. Like many other companies, the benefits will likely remain after the virus is gone.

This has been a challenging quarter for the US and the world. We have seen mounting cases and deaths from the virus that were unimaginable only three months ago. But we have also seen nimble businesses transform how they serve customers and new ideas emerge about how we will work and live in the future. There will be winners and losers going through this process, but the market believes the innovation and changing dynamics coming from this challenge will bear fruit. The market is looking toward better times ahead and already pricing in those improvements.

WHERE WE GO FROM HERE

Economists and Wall Street analysts are optimistic about the future post-COVID, but there is anxiety about the duration and challenges we face getting there. This creates uncertainty for the rest of the year, where we also face rising China tensions, social unrest, and an election. Forecasting the pace of recovery with this backdrop requires considering variables that are difficult to gauge.

The most important driver for the performance of the economy for the rest of the year is the path of the virus. We have seen a dramatic uptick in new cases, with the 7-day moving average doubling from 22,269 on June 1st to 44,814 on July 1st. The uptick has been largely in the South and Sunbelt which had little early spread and reopened earlier than the hard-hit Northeast. During the last week of the quarter, Texas, Florida, and Arizona tapped the breaks or reversed reopening plans by closing bars and beaches and limiting restaurant capacity. The increase in cases has yet to result in a commensurate increase in deaths. This may be the result of younger people accounting for a larger share of cases and advances in treatments. Hospitalizations are increasing in certain states, which could result in higher death rates if hospital resources are stretched.

As mentioned above, there has been a bounce in economic activity, with many economic measures moving higher in the last month, although lower than a year ago. This improvement has not been uniform for areas of the economy or individual companies. We mentioned certain companies benefiting in this environment above, but there are others whose prospects are dim. There remains weakness in the energy sector where low oil prices and heavy debt load have led to several failures, with Diamond Offshore and Chesapeake Energy filing for bankruptcy. There have also been other high-profile bankruptcy filings, with Hertz, J.C. Penney, and Neiman Marcus all filing for bankruptcy. Over the remainder of 2020, we expect to see weak and indebted companies continue to struggle, with more bankruptcies. While tragic, this is a function of capitalism and after this disruption the capital and employees of firms will be redirected to more fruitful endeavors.

We believe the economy will continue to recover; however, it will be two steps forward with one step back while the virus continues to circulate until we have a vaccine, effective therapies, or reach herd immunity. We don't expect the more universal economic shutdowns employed in March and April. Rather, policy makers will use targeted shutdowns of high-risk activities, like bars and sporting events, while other activities continue with the appropriate safety measures. The number and durations of targeted shutdowns will be dependent on the level of spread in individual communities. More is learned about the virus daily and policy makers will be more judicious in their use of blunt tools to control the spread.

This uneven recovery will necessitate fiscal support to cushion the impacts on the most affected. The first rounds of stimulus were massive, but in many cases could be characterized as "ready, fire, aim". The rules of the Paycheck Protection Plan continue to evolve creating uncertainty for businesses as to if they have a grant or a loan. The expanded unemployment insurance program provided an extra $600/wk. to recipients in addition to the state benefits. This generous level of benefit may disincentivize work and is set to expire at the end of July. While the labor market is improving, it will not return to normal by July 31st. In the June employment report, the number of people categorized as temporarily unemployed fell from 18 million in April to 11 million. However, those categorized as permanently unemployed has increased from 5 million to 8 million. Congress will have to reach an agreement to bridge those temporarily unemployed and to retrain and support those permanently unemployed. The House passed the HEROES act, which was dead on arrival in the Senate as it continued the $600/wk. through year-end and came with a $3 trillion price tag. We believe Sen. McConnell will introduce a slimmer package that encourages work and supports those in need. Both Houses are incentivized to reach a bargain before the election, but it may be an 11th hour deal on July 31st.

We expect fiscal support to create a bridge for those who continue to struggle and allow the economy to continue to recover from the broadscale shutdowns in March/April/May. As the economy deals with targeted shutdowns and government support, the final piece necessary for recovery is confidence. Consumer Confidence fell sharply from February through May but ticked higher in June. Consumers need to feel confident and safe to engage in economic activity. Given our economy's reliance on consumer spending, confidence needs to continue improving to have a robust recovery. The consumer is inundated with virus information, which is often contradictory and changing. This can paralyze consumers who are understandably fearful and overwhelmed. We believe the consumer will begin to digest this information more rationally as we become more accustomed to living with the virus. They will make decisions to engage in certain activities and avoid others. Virus fatigue will force many to discount risks and consider necessary precautions as they re-engage in the economy. However, restoring confidence to pre-pandemic levels will require a vaccine, therapeutics, or herd immunity, and all of those will take time. That time will result in slower earnings growth for the near-term. Wall Street is optimistic about an earnings recovery in 2021 and beyond, but pessimistic about earnings in 2020. According to S&P, analysts have reduced expectations for 2020 earnings by 37.9% since the beginning of the year and are calling for a 30.6% decline in fiscal year earnings. Expectations for 2021 earnings have fallen by 12.1% in the last month but continue to forecast a strong rebound in 2021 with 48.0% earnings growth. Earnings in 2021 are projected to reach new highs, surpassing 2019 earnings by 2.6%. The most pain in 2020 is expected in the energy, consumer discretionary, and financial sectors, which are also expected to have the strongest rebounds in 2021.

We are advising our clients to expect continued volatility for the remainder of 2020. The market reaction to news flow will differ from February and March, when news of the virus and shutdowns brought the entire market down in the fastest bear market in history. Investors have learned a great deal in this process, including that not all companies are impacted equally by this pandemic. During setbacks, we expect the markets to reward those businesses that can manage through these difficult times and punish those who rely on in-person consumer engagement to flourish. Conversely, we will see days when news of vaccine and therapies drive beleaguered travels stocks much higher in a single day. In this environment, it is important to be well diversified with investments in companies that excel in this lockdown environment and high-quality companies that will benefit when normal arrives. We are focusing on the quality of balance sheets and management teams in both areas to position clients to both get through this difficult time and be able to prosper when we can put this time behind us.

We would be remiss if we did not acknowledge the country is dealing with social unrest not seen since the late 1960s. The protests and riots sparked by the death of George Floyd have exacerbated political divisions that have been worsening in our country for decades. There has been vigorous and often bitter debate on how to move forward on issues related to race in the United States. We can each choose how to react to this issue, on an individual basis, in how we treat one another. It is our hope that America continues her long march towards her ideals of a country where all people can achieve their God given potential and where each of us is judged by the contents of our character. Our country, our economy, and our souls all benefit when we all reach our potential and are treated with respect.

We sincerely wish all of our clients and friends good health and safety in this time. The events over the last six months have been tumultuous and unprecedented. We have seen acts of bravery and heroism that heartens us from individual citizens and the private sector. While none of us can choose the times in which we live, we can choose how we react to what life brings us. To that end, we ask our clients and friends to remember that small businesses are the fabric of our community and are not faring as well as Wall Street during this time. If you can support a local business, please take that opportunity. We wish you all wisdom in your choices and hope that each of you stays well and safe. And please don't forget to love your neighbor, wash your hands and wear a mask in public.