APRIL 17, 2020

THE LONG AND WINDING ROAD TO RECOVERY - PART 2 - THE US STOCK MARKET

We recently distributed the first in a planned series of papers about the Great Lockdown (a label for the current global health and economic crisis coined by the IMF) that will share a common title and theme, "The Long and Winding Road to Recovery". The US Economy was the focus of Part I . Therein, after summarizing the size and breadth of the economy (its sectors and employment therein; the sources of consumers' incomes and the importance of their spending for the economy), we provided perspectives on the economy in 2020 and beyond. We showed that hypothetical recoveries from the worst economic contraction since the Great Depression could restore GDP to its pre-crisis total by December 2021 (in a V-shaped recovery) or by December 2023 (a U-shaped recovery). Amid current and prospective uncertainties, however, our concluding perspective was that actual outcomes would likely fall somewhere between these two alternative paths to economic recovery.

As reflected in the title of this piece, it focuses on the US stock market. After putting this market in the context of the US economy, we discuss recent (mid-February to mid-April) market outcomes before exploring how current and future earnings trends may affect total stock market returns through December 2022.

The US Stock Market ≠ The US Economy

Starting with a baseline review of the intersection between the US economy and its stock market is a useful preface, we think, before making projections about where the US equities may be headed both near-term and across the next few years:

- Broad benchmarks for the US stock market (e.g., the S&P 500 Index, the Russell 3000 Index) seek to capture the revenues, expenses, and profitability for most or all the stocks whose primary listing is on US stock exchanges. The Russell 3000 currently comprises 2,900 companies whose collective market value (total shares issued x market price per share) was $28 trillion on December 31, 2019 – 33% larger than the $21 trillion US economy.

- Publicly traded companies employ approximately 38 million people (versus total US employment of roughly 150 million). However, some portion of those employees are working for these companies outside the US. Likewise, and most particularly for the market's largest companies and for certain sectors, a large portion of such companies' revenues (about 40% for the S&P 500) and profits are generated outside of the US and, therefore, tied to global as well as US economic growth.

- US equity markets are disproportionately weighted toward certain sectors. For example, Technology stocks have a current market weighting of 25%, in comparison to much lower direct technology sector employment (2%) and spending (the digital economy is approximately 7% of GDP). So, too Financial Services (11% market weighting, 4% of employment, 7% of spending). Conversely, a large portion (16%) of personal consumption goes toward owned or rented housing costs, only a small portion of which are revenues collected by public companies (e.g., utilities, some real estate companies).

- Total profits of US publicly traded companies (an estimated $1.3 trillion in 2019) are substantial, and the cash dividends they pay to shareholders are an important (an average 7% contribution to personal incomes) contributor to the US economy. But the combined profits of all US public and non-public corporations (per the US Bureau of Economic Analysis) are far larger ($2.1 trillion). So too are profits earned by owners of non-corporate business entities ($1.7 trillion, 9% of personal incomes in 2019).

Past economic and equity market history suggests that business profitability (public and private corporations; owner-operated businesses) and dividend payments will all decline by multiples of the shrinking US economy across the next two (or perhaps more) quarters. By way of reference, during the GFC total public and private corporate profits declined -32% (in 2008) and peak-to-trough S&P 500 Index earnings and cash dividends declined -49% and -25% respectively. Non-corporate business' profits (peak-to-trough) declined a comparatively smaller -14%.

Whither the US Equity Market: 2020 and Beyond

As with economists' GDP predictions, analysts' forecasts for the quarterly and annual earnings of public companies are also fraught with uncertainty and rely on sets of assumptions for which there are no relevant historical precedents. Undoubtedly, overall earnings will be substantially lower in aggregate. Some sectors will not only report record losses but likely rising bankruptcies as well. A -60% oil price decline this year, for example, is certain to produce large losses in the energy and MLP sectors. Banks will be affected by lower interest rates and rising credit card and loan losses. And many other market sub-sectors (airlines, hotels, automobile manufacturers, restaurants, brick-and-mortar retail, and REITs, among others) will likely log massive stay-at-home, work-from-home related losses.

Conversely, less severe earnings declines seem a possibility for some market sectors and selected companies such as Consumer Staples (chiefly, food manufacturers and food retailers) Health Care, Communication Services (e.g., Facebook, Google, Netflix), and on-line Retailers (notably, Amazon). Though it may seem inappropriate to declare "winners" and "losers" arising out of the Great Lockdown crisis from a profit perspective, this seems certain to be the case.

The table below summarizes US equity market outcomes for two periods: from the February 19 price peak through the (so far) market bottom on March 23, from March 23 through April 15, and cumulatively. It identifies (in red) those sectors that have lagged the broad market across each of these periods:

Market Sector	Total Returns^ 2/19/2020 to 3/23/20	3/23/2020 to 4/15/20	Full Period
Communication Services	-29.2%	18.0%	-16.5%
Consumer Disretionary	-35.0%	25.6%	-18.3%
Consumer Staples	-24.4%	21.2%	-8.4%
Energy	-56.2%	34.9%	-41.0%
Financials	-43.7%	21.7%	-31.5%
Health Care	-28.4%	28.6%	-8.0%
Industrials	-41.8%	23.6%	-28.4%
Information Technology	-31.6%	23.4%	-15.6%
Materials	-37.5%	26.1%	-21.2%
Real Estate	-41.4%	30.9%	-23.3%
Utilities	-35.6%	29.7%	-16.5%
Overall US Market	**-35.0%**	**24.3%**	**-19.1%**

^ Russell 3000 Index (source: Bloomberg Finance LP)

Observations and take-aways from this (admittedly short-term) data include:

- The speed with which US equity prices collectively recouped over 2/3 of their earlier losses (i.e., in 16 trading days) rivals the pace with which they declined (-35% across 23 trading days).
- By sector, prices for the likely earnings winners have performed, on balance, substantially better than the likely earnings losers. But with the crisis news getting worse since late March, relative returns did not necessarily occur in the sequence that might have been expected (e.g., the Energy and Real Estate sectors had bigger bounce-backs than the rest of the market). This suggests that other factors (valuation considerations) have also been at work more recently.
- A deeper-dive – a review of the biggest individual detractors from market returns across the last two months – show some investor discernment in the short-run. Among the stocks by market weight that have detracted most from the market's total returns: JP Morgan, Bank of America, Citigroup, VISA, and Mastercard (consumer and corporate credit concerns), Boeing (737 Max grounding plus 150 more order cancellations in March), and ExxonMobil and Chevron (plunging oil prices).
- Similarly, just three months into an unprecedented global health crisis the biggest contributors to total returns are not entirely surprising in retrospect. A number of health care companies (some large firms like Eli Lilly and Abbott Laboratories; smaller firms like Teladoc Health, Vertex Pharmaceuticals, Moderna, Gilead Sciences, and Regeneron) whose coronavirus-related work could be a massive source of future profits if not also enduring worldwide

thanks have produced double-digit returns. A varied collection of firms upon which shut-in consumers and working-from-home employees have come to rely (Amazon, Walmart, Netflix, Citrix Systems, Zoom Video, Clorox, and Dominos, to name a recognizable few) have likewise contributed positively to overall returns.

- Shares of smaller ("small cap") companies have materially underperformed their larger brethren, with a total return of -29.8% across this period. On balance, an ever-growing portion of the small cap universe had negative earnings before the pandemic took hold. That, coupled with their greater reliance on debt to fund their growth, subjects them to greater survival risk the longer the crisis persists.

Investors' near-term concerns include how to reconcile divergent economic and equity market trends. Two recent (March 14) sequential "Top Stories" headlines on Bloomberg succinctly captures their dilemma: *Stocks Surge After Signs Coronavirus Outbreak is Easing* and *Worst-Case Fears of 20% plus US Jobless Rate Are Now Realistic* . Net of the recent rally, which leaves US stocks just -19% below their peak and only -15% YTD (Russell 3000 Index), any reasonable guess at current year earnings (i.e., are they down -20%? -30%?) as the denominator in a Price/Earnings calculation works out to market valuations that are now equal to or higher than those before the crisis began.

Earnings Uncertainty and Prospective Future Returns

The only rational way to explain not-so-bad cumulative equity outcomes: the market is already looking past the crisis and its 2020 impact on the US economy and corporate profits, implicitly projecting strong earnings increases thereafter for several years. The table below shows a range of potential annualized US stock market returns between now and December 31, 2022 given combinations of large earnings declines in 2020 and big increases in 2021 and 2022. Each projection assumes that valuations (price/trailing earnings) at the end of the period match the 19.5x average ratio of the past 30 years:

Comparison of Potential Total Returns^

Projected	Projected EPS Growth, 2021 and 2022				
2020 EPS	20%	30%	40%	50%	60%
-20%	9.8%	16.4%	22.8%	29.2%	35.4%
-30%	4.5%	10.7%	16.9%	22.9%	28.9%
-40%	-1.4%	4.6%	10.4%	16.1%	21.7%
-50%	-7.8%	-2.3%	3.2%	8.5%	13.8%

^ as of 4/15/20; annualized, 4/2020 to 12/2022 (assumes terminal 19.5x P/E)

Recognizing that it is impossible to predict with any certainty which, if any, of these sets of outcomes approximates what actually happens, it seems safe to rule out certain combinations (e.g., the table's NE quadrant, with an earnings decline of no more than -30% in 2020 followed by a +50% to +60% annualized earnings growth rate thereafter). More conceivably: a -40% or worse earnings decline in 2020 that is followed by ample (+40% to +60%) gains thereafter (the table's SE quadrant) may be a better model for prospective outcomes across the next few years. [i]

At first glance, the potential for the US stock market to produce annualized returns of +8.5% to +21.7% through 2022 may seem low – if not disappointing – especially relative to the post-GFC crisis rebound (+23.4% annualized returns for the three years ended March 31, 2012). But that rally started with stocks down -56% and a P/E ratio of 11.3x. Substituting the market's March 23 price (-24% lower) into the table's calculations would show prospective returns that are +500 to +700 basis points higher (e.g., a return projection of +22.8% versus +16.1% for the -40%/ +50% combination of earnings changes in 2020 and 2021-2022 respectively). Hence our conclusion that, to some extent, the US equity market has already looked past the crisis to anticipate a better economy and improving corporate earnings across the next few years.

It is too soon – relative to the amount of available data on the economy and on companies' revenues and profits – to declare with any confidence that March 23 was the *market bottom* . Equity markets experienced several strong rallies – in retrospect, head-fakes – during the GFC that created premature optimism on the part of investors. The quick Federal Reserve and Federal Government policy decisions and recent signs of a slowing rate of coronavirus infections have certainly been a positive tonic for the market since late March. Assuming continued positive developments on the virus front, the equity market's direction from here (up or down) will depend on the timing and success of tentative steps to ease the Great Lockdown and, thereafter, a growing sense among investors that falling earnings (and, relatedly, dividend cuts) will soon be history.

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April 17, 2020

[i] In the context of the S&P 500 Index, a -40% earnings decline in 2020 followed by increases averaging +50% in 2021 and 2022 would result in earnings of $250/share by December 31, 2022 (versus $152/share on December 31, 2019, a pre- to post-crisis annualized growth rate of +10.5%).

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