## MARGINS OF ERROR

We are all awash in data. But not necessarily in possession of good information. There are daily counts of US and global COVID-19 cases and deaths. Weekly reporting on newly filed and continuing unemployment claims. Data on comparatively how far people are traveling from home, traffic on highways and on usages of public transit, on what portion of retail sales are occurring on-line versus in stores. Periodic updates on which geographies have gone "green" and which remain "yellow"; where mask-wearing is mandated and where it is discretionary. But like political polling that seeks to divine the outcome of a presidential election now only four months hence, placing too much confidence in the raw data may be ill-advised since much of it is drawn from small sample sizes, differing or untested methodologies, or suspect surveys. And especially – and perhaps most evidently with respect to COVID-19 – actual trends can defy even data-based predictions. In short, there are wide "margins of error" to some of the most critical data relevant to assessing public health, world economies, and global capital markets.

### First, Good News

Although we are not, by any stretch of the imagination, "home free" with respect to getting full control over the COVID-19 crisis in the US, better outcomes are occurring elsewhere in the world. And markets' tendency to act as leading indicators (i.e., risk asset prices often begin to recover well-before an economic cycle troughs and corporate profitability hits bottom) contributed to unexpectedly strong quarterly investment returns for the period ended June 30, 2020:

- US equities achieved a total return of +22.0% (Russell 3000 Index) for the quarter, leaving them just -3.5% YTD. Growth stocks continued to outpace their value stock counterparts by a wide margin. Small cap stocks – pummeled during the market's sell-off amid concerns about these companies' viability in a deep recession –excelled with gains of +25.0%.

- Non-US equities (+16.3%) rebounded as well, with emerging market equities (+18.1%) outpacing equities in other developed markets (+15.6%). US investors' gains in these markets were abetted partly by a somewhat weaker USD against many (but not all) major currencies.

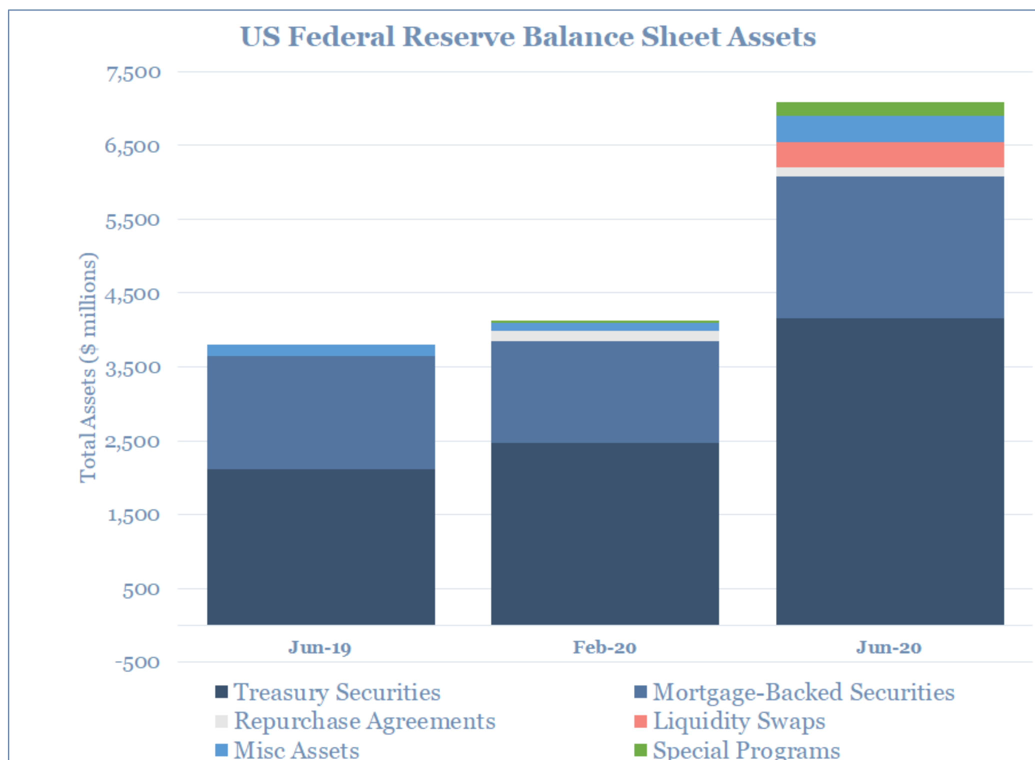
- Credit concerns – which had caused corporate and municipal bonds alike to substantially underperform investor expectations and ultra-safe Treasury bonds during the first quarter – abated. The Federal Reserve's deployment of capital into markets (in short order it has become one of the largest owners in several major bond ETFs) and wholesale purchases by large pools of opportunistic capital (hedge and private equity funds) tightened spreads and narrowed bond

discounts. The result was strong quarterly returns for taxable (+2.9%) and tax-exempt bonds (+2.7%).

On balance, therefore, and taking into consideration the worst-in-generations economic environment, investors' YTD investment returns have exceeded what might otherwise have been anticipated.

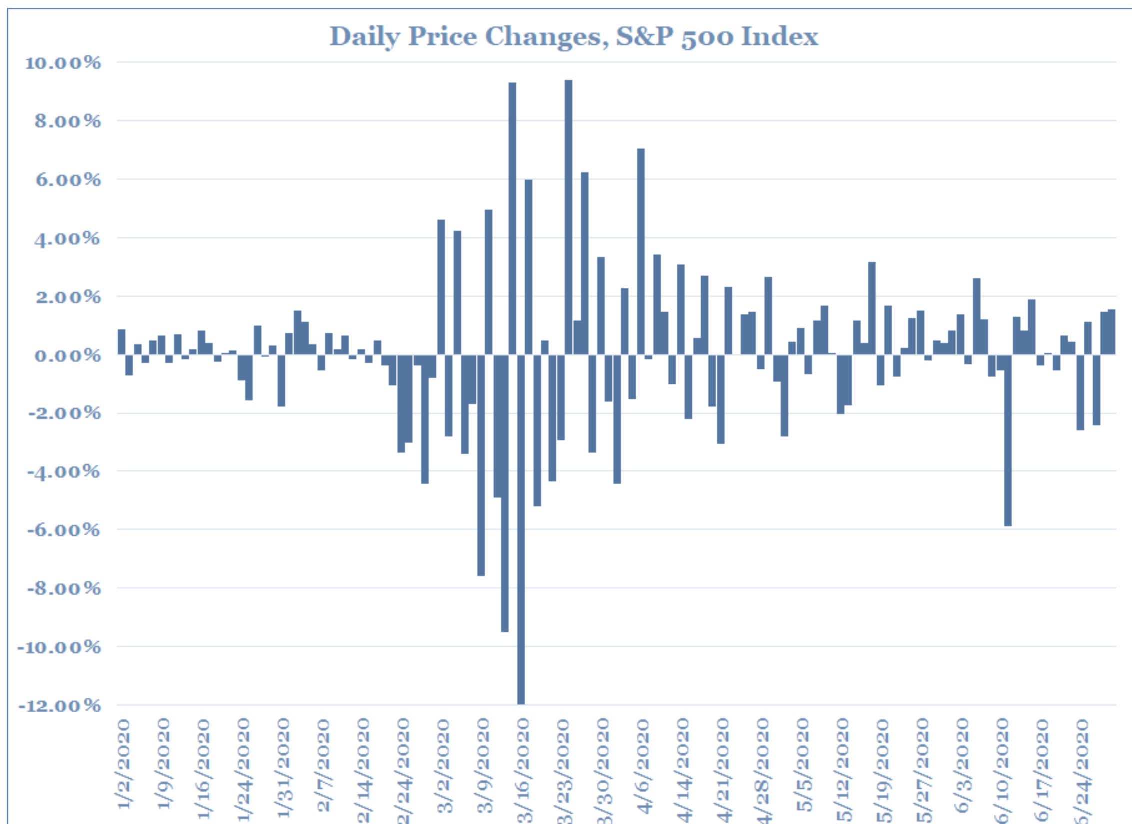
## New Heights for Quantitative Easing

For investors, insights into what is supporting recent positive price trends in capital markets can be gleaned from data contained in weekly Federal Reserve balance sheet statistics. The Fed, which responded extremely quickly in March with promises to "do whatever it takes" to support markets, has gone to great and novel lengths to pump money into the US economy and its financial system. It has grown its balance sheet (largely, the total liquidity it has injected into the economy through the capital markets) from a pre-crisis total of $4.1 trillion to $7.1 trillion currently. Notably, the Fed's balance sheet includes commitments of more than $180 billion in support of specific initiatives including the Payroll Protection Program, the Main Street Lending Program, purchases of corporate and municipal bonds, and money market fund liquidity.



## Gravity Defied: Lower Earnings, Higher Prices

The quarter's nearly uninterrupted upward trend in US equity markets – and markedly less day-to-day price variability in comparison to February and March – was achieved despite data that suggested that the worst impacts of the COVID-19 crisis may not be entirely behind us. Broad market earnings estimates for all of 2020, which were adjusted only minimally as the crisis got underway, were progressively adjusted downward across the last three months as more economic and company-specific statistics became available. Net of estimated poor 2Q profits (e.g., S&P 500 EPS are projected to be -40% below the same period in 2019), trailing earnings are projected to have fallen -28% YTD through mid-year. Not surprisingly, certain market sectors (i.e., Energy, Consumer Discretionary, Financials) are expected to absorb more of the economic fallout than others. Year-to-date, however, companies have been less prone to cut cash dividends (S&P 500 Index cash payouts have actually risen +5%) than was the case during the early months of the Global Financial Crisis (dividends were trimmed -20% across the first half of 2009). Instead, many corporations have taken advantage of record-low interest rates to borrow in the bond market; investment grade companies sold nearly $1.3 trillion worth of debt during the first half of the year, nearly double the previous high set in 2017.



An unavoidable consequence of this combination of higher equity prices/lower earnings combined are valuations that are high relative to historic norms. Based on its closing price of $3,100 on June 30, for example, the S&P 500 Index was trading at a multiple of trailing earnings (21.8x) that was just shy of the ample valuations (22.1x) at the market's February 19 all-time high. Although economic and corporate profitability risks are dramatically different now than they were then, the market appears to be looking past lower full-year 2020 earnings (valuing them at 24.8x). Investors are assuming that generous increases in profits during 2021 will legitimize the above-average valuation (19.3x) being applied to those estimated earnings currently.

**Actual and Estimated Earnings, S&P 500 Index**

| | Trailing EPS | 2020 Forecast | 2021 Forecast |
|---|---|---|---|
| 12/31/2019 | $ 152 | $ 164 | $ 180 |
| 1/31/2020 | $ 153 | $ 175 | $ 194 |
| 2/29/2020 | $ 153 | $ 173 | $ 193 |
| 3/31/2020 | $ 144 | $ 151 | $ 178 |
| 4/30/2020 | $ 144 | $ 129 | $ 164 |
| 5/31/2020 | $ 143 | $ 125 | $ 161 |
| 6/30/2020 | $ 142 | $ 124 | $ 160 |

*source: Bloomberg*

## The Economy: Crossed Wires or Crossed Fingers

Virus uncertainty notwithstanding, a mix of lockdown fatigue and state/local government decisions to allow somewhat limited business re-openings did result in an improved pace of US economic activity starting in April. Unemployment statistics (though methodologically flawed) beat expectations in May and June. Instead of rising toward a projected post-Great Depression high approaching 20%, the rate declined somewhat to "only" 11.1% (compared to a peak of 10% during the Global Financial Crisis). And retail sales, after experiencing an all-time decline of -14.7% (annualized) in April, surged a record +17.7% in May. Consumers' disposable incomes, curtailed by joblessness, received a boost from temporary increases to unemployment benefits and one-time US government cash payments to most households.

An uptick in spending during May and June, however, was not enough to rescue an already weakened economy last quarter. Whole sectors of the economy (retail stores; restaurants; travel-related) remain largely moribund and the pace of job gains is anticipated to slow as the virus lingers. And, after a flurry of bi-partisan Congressional efforts in March to keep the economy afloat, the recent quarter was marked by disagreements as to whether additional fiscal stimulus was needed. There is a possibility, but by no means a certainty, that an additional stimulus package will be approved by Congress in July.

## The Great Lockdown Unlocked?

Current consensus estimates for the US economy predict a -35% annualized decline across the period ended June 30, 2020. But as we discussed in our May Market Perspective ( *Control-Alt-Delete* ), the evolving view is that a pandemic-induced contraction is different than a typical recession. The latter "comes on little cat feet" (economic activity slows, businesses cut back spending, unemployment gradually rises, economic activity slows further). In the current situation, a quick and sharp collapse precipitated by policy decisions (the state-by-state business lockdowns of March-May) could be followed in short order by an impressively strong rebound in economic activity as consumer spending rebounds and joblessness declines. Following this logic, the current median outlook for the US economy is that growth will accelerate at annualized rates of +20% and +8%, respectively across 2020's final two quarters. Were such predictions to pan out, US GDP would experience a net -5.6% contraction for all of 2020 (versus a shallower but longer peak-to-trough recession of -4.0% from 2007-2009).

While we do not know how to best assign probabilities to the strong rebound scenario, we think that there is a wide margin of error (likely skewed toward outcomes that fall short of consensus expectations) to such a prediction. Rising COVID-19 cases – and, worst case, a resurgence of infections in earlier hot-spot areas (e.g., the Northeast) – could dampen and/or lengthen the pace of recovery. From a capital markets perspective, we think that such an eventuality would create rising uncertainty for risk assets (i.e., already fully valued US equities; tightened credit spreads on low-quality corporate bonds) and the cash flows that underpin their prices. Although the Fed's most recent quantitative easing programs and low rates of current and expected inflation should keep US bond market yields at record-lows (1.3% and 1.1%, respectively in the taxable and tax-exempt bond markets) for the foreseeable future, now is not an opportune time to trim safe-haven (taxable and tax-exempt bonds) portfolio assets in pursuit of potentially higher returns.

## Staying Safe

Just six months ago, the challenging and altered world in which we all are living now was perhaps imaginable but not anticipated. It was certainly unfathomable that we would be discussing ad nauseum the various COVID-19 and related economic data discussed above. An abundance of caution – from personal health, business, and investment portfolio perspectives alike – still seems like the best course of action across the second half of 2020.

**Investment Strategy Team**
**Mill Creek Capital Advisors**
**July 2, 2020**

## DISCLOSURE

This publication has been prepared by Mill Creek Capital Advisors, LLC ("MCCA") for information purposes only. The information contained in this publication has been obtained from sources that MCCA believes to be reliable, but MCCA does not represent or warrant that it is accurate or complete. The views in this publication are as of the date indicated, are those of MCCA and are subject to change, and MCCA has no obligation to update its opinions or the information in this publication. While MCCA has obtained information believed to be reliable, MCCA, nor any of their respective officers, partners, or employees accepts any liability whatsoever for any direct or consequential loss arising from any use of this publication or its contents. Please consult with your tax and legal advisers as appropriate in your year-end or other planning.

© 2020 All rights reserved. Trademarks "Mill Creek," "Mill Creek Capital" and "Mill Creek Capital Advisors" are the exclusive property of Mill Creek Capital Advisors, LLC, are registered in the U.S. Patent and Trademark Office, and may not be used without written permission.