From: Aequitas Investment Advisors

Re: Reconciliation: The Stock Market vs. The Economy; Our Nation

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In thinking about a title or theme for this quarterly letter and considering the apparent disconnect between the stock market and the state of the economy, as well as the significant economic, social and political divisions in our country, we thought the word *reconciliation* was an appropriate title.

Reconciliation as defined by the Oxford Dictionary:

1. The restoration of friendly relations.
   Synonyms: reuniting, resolving, fence-mending, compromising, understanding. [These words are so powerful and what we sorely need as a nation]
2. The action of making financial accounts consistent; harmonization. [Sooner or later, stock prices must align with economic fundamentals]

How do We Reconcile A Soaring Stock Market and a Depressed Economy?

With unemployment at 11%, the economy in a severe recession, and corporate earnings expected to plunge by more than 40% for the second quarter, why has the stock market been climbing? To confound us further, the market has been rising at the same time the coronavirus curve in the U.S. has turned in the wrong direction. Some pundits suggest stocks are rising due to retail investors pouring money into the market and chasing returns (we know how that usually ends). Others suggest that investors are counting on another government stimulus package which will further buoy the economy and lead to a faster recovery. The primary reason, most believe, is that the Federal Reserve and Congress have pumped vast amounts of liquidity into the system to keep the economy afloat and prevent a more severe downturn (their actions have been successful thus far). As a result, interest rates are now at record-low levels which have effectively turned most high-quality fixed income instruments into low-yielding investments making riskier assets look more attractive. With money market funds yielding close to zero and the 5-Year Treasury Note yielding just 0.30%, investors see stocks as an attractive alternative, especially when the dividend yield on the S&P 500 Index is close to 2%. Of course, investors who are jumping from bonds to stocks are likely ignoring the fact that stock prices can fall sharply which is why high-quality bonds remain an important risk-reducing component in a well-balanced portfolio.

Is the "Stock Market" Really Soaring?

The answer is yes, some stocks are soaring, and no, many more stocks remain depressed. The chart to the right indicates the performance of the *entire* U.S. stock market which is comprised of more than 3,800 publicly traded companies. You will note that only one-third of the asset class style boxes are in green with the majority still in negative territory. The *average* stock in the U.S. market is down more than 8% for the year-to-date through June 30th, with stocks of companies hardest hit by the coronavirus down between 16% and 27%. Stocks on the right side of the table (Growth Stocks) represent companies which have fared better during the crisis and include many stocks in the technology sector. Bear in mind that all of the stock asset classes have rebounded significantly since the depths of March. However, the greatest gains were generated by a relatively small number of stocks led by the largest five companies which now comprise about 40% of the entire NASDAQ Index as of June 30th: Apple (11.6%), Microsoft (10.7%), Google/Alphabet (8.2%), Amazon (8.1%) and Facebook (4.4%). These five largest stocks ("the top five") also comprise close to 23% of the broader S&P 500 Index which represents a record-high concentration of stock market capitalization in so few companies (even exceeding the concentration of the tech bubble of the late 90s).

YTD Return as of 6-30-2020

	Value	Blend	Growth
Large	-15.8%	-4.5%	12.0%
Mid	-23.4%	-11.4%	11.8%
Small	-26.5%	-19.3%	4.4%

A recent article from *MarketWatch* notes that 74% of fund managers surveyed see the bet on technology stocks as the "most crowded trade ever," despite that fact these same managers remain overweight in the technology sector. While we

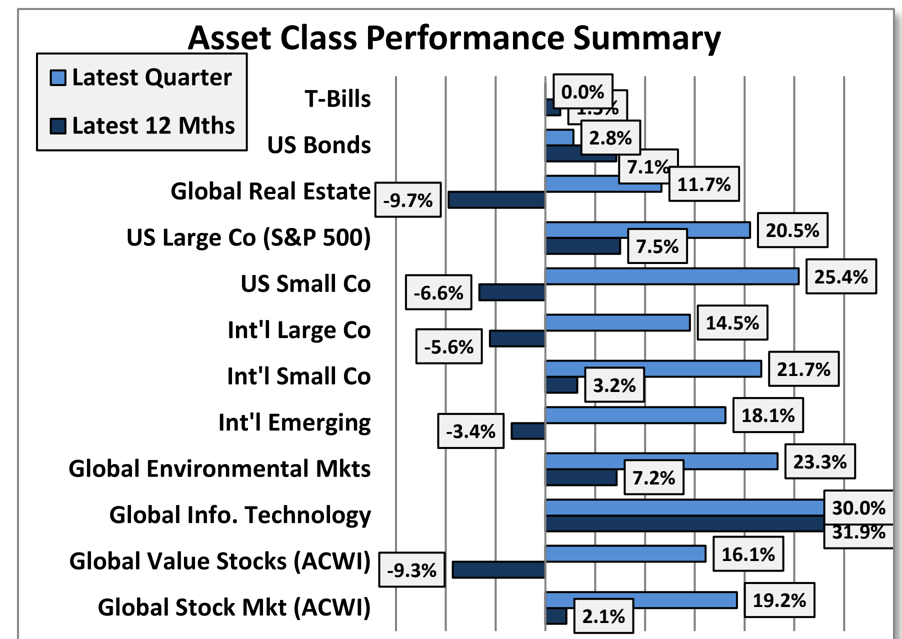
are all familiar with names of the top five companies, what are five largest laggards in the red box in the upper left of the style box table on the previous page? Answer: Intel, AT&T, Pfizer, Comcast and JPMorgan Chase which are considered Value Stocks and were trading for a down-to-earth average Price-to-Earnings Ratio of 13.8 as of May 31st compared to a whopping 54.5 PE Ratio for the top five stocks (based upon forward earnings estimates). However, despite the lofty prices, only a few strategists are calling this another technology stock bubble given that the PE Ratio of tech stocks in 2000 was more than 100 times forward earnings. Furthermore, unlike many of the dot.com stocks in the late 90s, the top five companies are less speculative given their proven track records, solid balance sheets and strong earnings growth potential. Yet, even great companies can become over-valued and disappoint investors with sub-par relative returns for extended periods of time. For example, the technology sector was so overvalued in March of 2000 that it had a *zero percent gain* over the subsequent 16+ year period between March 2000 and September 2016!

Given the evolution of the global economy toward greater use of technological solutions as part of the Fourth Industrial Revolution, we recognize the growing importance of the technology sector which is why we raised our model portfolio's tech sector allocation to neutral weight compared to the MSCI ACWI Index in March (when prices were much more attractive). The fund we added is the Vanguard Information Technology Index fund which has a current PE Ratio of 27 which is about one-half of the average PE of the largest five stocks and remains fairly valued for stocks in this sector, in our opinion. Currently, we are recommending that clients maintain a neutral weight to the technology sector which is now close to 19% of the MSCI All Country World Index.

Asset Class Performance Review

What a remarkable turnaround for stocks following one of the worst quarters in history. For the quarter ending June 30th, the Global Stock Market gained 19.2% and all major stock asset classes were in positive territory. The best gain, unsurprisingly, was the Global Information Technology Index which rose by 30% (note that most of the 12-month gain occurred in the latest quarter). The other stock asset classes posted robust recoveries led by U.S. Small Co's (+25.4%), Environmental Markets (+23.3%), Int'l Small Co's (+21.7%), U.S. Large Co's (+20.5%), Int'l Emerging Mkts (+18.1%), Global Value Stocks (+16.1%), Int'l Large Co's (+14.5%) and finally Global Real Estate (+11.7%). U.S. Bonds gained 2.8% while U.S. T-Bills remained flat due to the recent monetary stimulus.

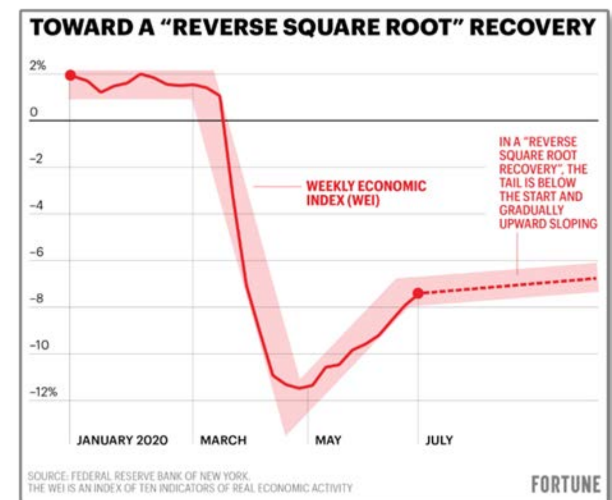
For the trailing 12-months ending June 30th, the picture was mixed, as we would



expect, with five of the stock asset classes on the list in negative territory and five in positive territory. The Global Stock Market gained 2.1%. The Global Information Technology Index (+31.9%) was the big winner followed by three asset classes in a virtual tie for second place: U.S. Large Co's (+7.5%), Environmental Markets (+7.2%) and U.S. Bonds (+7.1%). U.S. T-Bills gained 1.5%, but the other five asset classes lost ground.

The Potential Shape of the Economic Recovery

In our last quarterly letter, we presented several economic recovery scenarios represented by various shapes with the most optimistic (and least likely) being a "V" shaped recovery, a more pessimistic "U" shape, and what we believed to be the more likely scenario, a "reverse square root" shaped recovery represented by the illustration to the right. The solid red line indicates the economy has

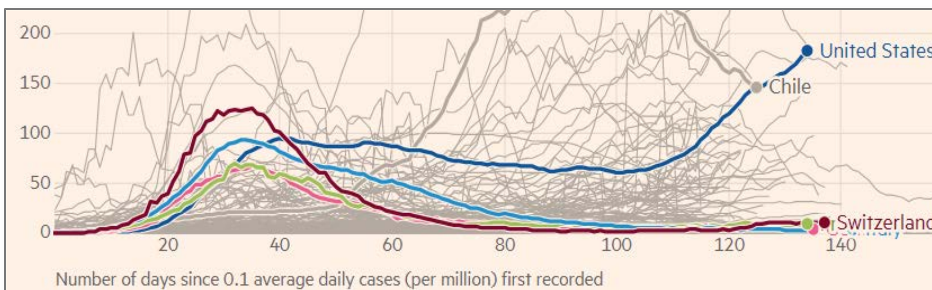


recovered somewhat through the end of June; the dotted red line is a forecast suggesting that the recovery from this point may be disappointing, at least until a vaccine is widely available and consumer confidence is restored. Recently, however, economists are becoming concerned the recovery may be "W" shaped given the resurgence of coronavirus outbreaks in much of the country. Were this to be the case, we may face another economic contraction later this year.

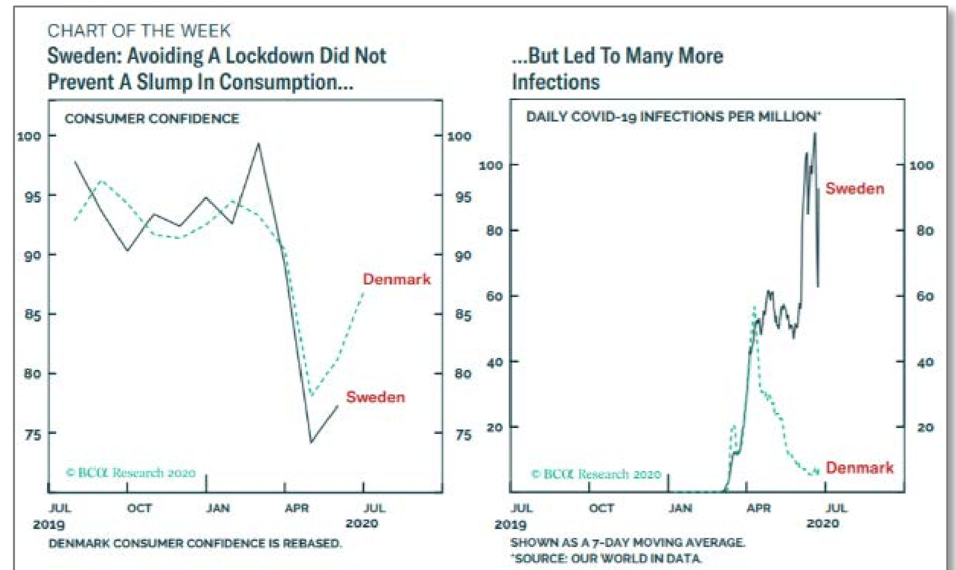
The primary driver in determining the future shape of the recovery, of course, is our steadfastness in fighting the pandemic while at the same time re-opening the economy in a careful, data-dependent manner. Unfortunately, what we've seen so far is a lack of uniformity across the country in that some states are successfully clamping down on the number of new coronavirus cases while others re-opened prematurely only to find themselves moving backwards toward stricter controls. This whipsawing does little to restore confidence and will only prolong the economic pain.

Strict Actions Save Lives and May Boost Consumer Confidence

Europe appears to be much further along in controlling the pandemic as evidenced by the line graph below from the *Financial Times* illustrating the seven-day rolling average in number of new cases per day per million people. As of July 15th, the U.S. is heading in the wrong direction averaging 188 new cases per day per million compared to Switzerland, Germany, France and Italy whose lines have merged at the bottom with a combined average of less than 7 new cases per day (major economies in Asia are averaging about 9 new cases per day per million). Recent data suggest that economic activity is picking up in Europe, Asia as well as in the U.S., although the fact that the curve in the U.S. is rising is cause for concern about the durability of our recovery.



A good case study in contrasting approaches to dealing with the virus is to compare the policy responses in Sweden and Denmark, two countries which have similar demographics, but which took two entirely different approaches to combating the virus. Sweden gambled that the "cure", i.e., locking down the economy, would be worse than simply keeping the economy open and letting the virus run its course. Sweden allowed their bars, restaurants, gyms and hairdressers to remain open. Denmark, on the other hand, implemented some of the strictest lockdowns to fight the virus. As the two graphs below indicate (*MarketWatch*, June 25, 2020), Sweden has paid a heavy price for its laissez-fare approach in that its infection rate has been far worse than Denmark's and its death rate has been



almost five times greater. Yet in exchange for that heavy human toll, Sweden's economy has so far underperformed that of Denmark and Sweden's consumer confidence slumped even further.

The bottom-line in fighting the pandemic, according to Epidemiologist Gabriel Leung of the University of Hong Kong (reported in STAT, May 1, 2020), is that society must referee a "three way tug of war" between three competing interests: (1) keeping the cases and deaths low, (2) preserving jobs and the economy and (3) preserving people's emotional well-being. According to Leung, "It's a battle between what we need to do for public health and what we need to do for the economy and for social well-being." *Leung believes that if the public health side of the tug-of-war weakens, there will then be additional coronavirus outbreak waves into 2021 and possibly 2022.*

Considering the Impact of National Debts Relative to Economic Growth

By Tim Nash

As individuals approach retirement, they typically strive to reduce debt levels as their ability to generate earnings to pay down debt is reduced. Global economies can be viewed in a similar manner as emerging economies like China, Brazil and India often rely on their economic growth to attract international investment which finances more growth, while more mature economies such as Western Europe and the U.S. often use the combination of taxation and lower cost debt to finance their continued growth – as long as it doesn't cripple their economies.

The chart to the right, World Debt by Country, indicates the degree by which some of the largest economies in the world are using debt to finance their growth. As an example, in October of 2019, Japan had one of the highest Debt to GDP ratios in the world at 237%, coupled with slow economic growth and a need to pay down its debt. China, as a very different example, had a much lower Debt to GDP ratio at 51%, with the U.S. somewhere in between at 104%.

Since these numbers were published, the world has experienced a devastating pandemic which has crippled global GDP, while the U.S. Government has committed trillions of dollars to help offset the adverse effects of the pandemic on the economy. In other words, since January, the numerator (Government debt) has increased, while the denominator (GDP) has decreased, thereby dramatically increasing the debt to GDP ratio in a short six-month period.

In the chart below are a few of the most recent Federal acts which have led to this historic challenge. Certainly, other global economies are facing similar challenges, but not to the extent that we are here in the U.S., so we are watching this situation very carefully as we approach the fall election. Eventually, this tremendous debt burden will need to be addressed, and with more than a quarter of the global pandemic cases here in the U.S., we do not see this happening anytime soon. In fact, given that many of the unemployment benefits are expiring at the end of July, there is growing bi-partisan support for additional stimulus measures with estimated price tags ranging from $1 to $2 trillion. As a result of this increased debt burden, we foresee slower economic growth and an extended period of low interest rates as we navigate through the pandemic. Longer-term, we could end up like Japan with an extremely high level of government debt and a relatively stagnant economy.

Federal Acts to Offset Impact of Coronavirus Recession

Amount In Billions	Measure
$293	One-time recovery rebates checks amounting to $1,200 per adult and $500 per child
$268	Boost to unemployment benefits from 26 weeks to 39 weeks until July 31st.
$27	Grants to airlines and businesses deemed important for national security.
$760	Small business relief, mostly "forgivable loans" for spending on payroll, rent and utilities
$150	Direct aid to state and local governments
$425	Health-related spending
$517	Other spending and tax breaks
$2,440	**$2.44 trillion or 12% of GDP**

World Debt by Country

October, 2019 (Pre-Coronavirus) per the IMF

Rank	Country	Debt to GDP	Total Debt In $Trillions	% of World Debt
1	United States	104%	21.5	31.0%
2	Japan	237%	11.8	17.0%
3	China	51%	6.8	9.8%
4	Italy	132%	2.7	4.0%
5	France	98%	2.7	3.9%
6	United Kingdom	87%	2.5	3.5%
7	Germany	62%	2.4	3.5%
8	India	68%	1.9	2.7%
9	Brazil	88%	1.6	2.4%
10	Canada	90%	1.5	2.2%
11	Spain	97%	1.4	2.0%
12	Mexico	54%	0.7	0.9%
13	South Korea	38%	0.7	0.9%
14	Australia	41%	0.6	0.8%
15	Belgium	102%	0.5	0.8%

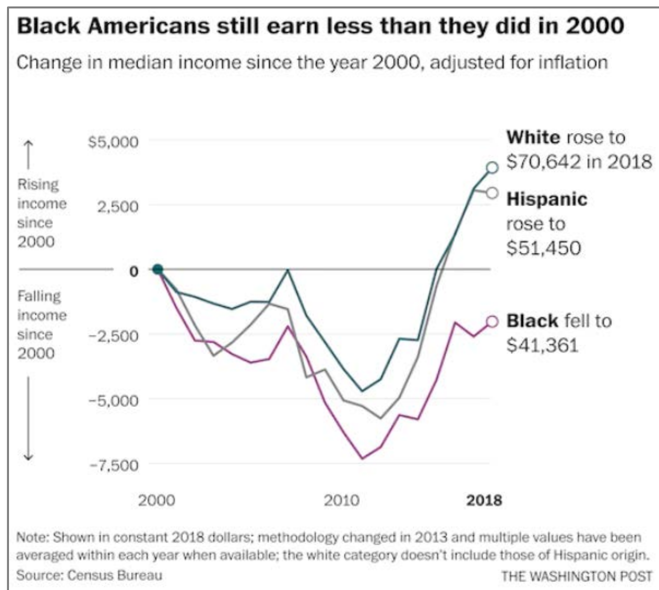
Unfortunately, the current low interest rates will have an immediate impact on our clients' financial plans. We count on high-quality fixed income to serve as a counterbalance in the event of weakness in the global equity markets, and we typically recommend increasing the allocation to fixed income as our clients age and progress through retirement. However, with high-quality fixed income securities eking out paltry yields of less than 1%, and with a relatively flat yield curve, there is likely more risk than reward by moving out into longer-term bonds. We advise remaining invested in shorter-term securities to protect against the risk of rising rates and further stock market volatility. This near-term protection allows us to continue to emphasize other investable regions of the world where higher economic growth and lower relative valuations offer greater opportunities for long-term total returns for our clients.

"Why the Widening Wealth Gap is Bad News for Everyone"
Barron's Magazine Headline, June 19, 2020

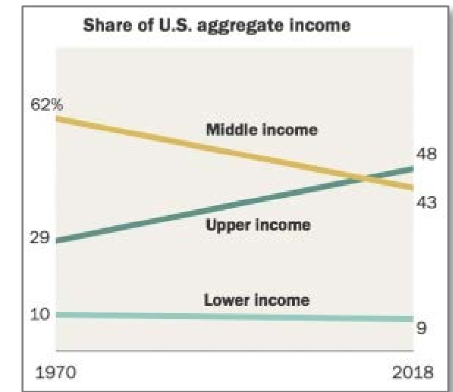
When a venerable Wall Street publication such as Barron's magazine leads with a cover story on the dangers of the widening wealth gap, we know the problem has touched a nerve in the heart of the financial system. According to the Barron's article, "Economic inequality has been building over decades, fueled by structural racism and inequalities in the U.S. educational, financial, and health-care systems."

Two major goals of the civil rights movement of the 1960's were to end racial discrimination against Black Americans and to open doors for greater economic opportunity. While several pieces of landmark legislation were passed as a result of the movement, including the Civil Rights Act of 1965, we know that more than fifty years later racism still exists in our society; and while some economic progress has been made since the 1960s, the reality is that Black households earn just 60% of the income earned by white households and their poverty rate is almost three times greater.

Heading into the coronavirus pandemic, Black Americans were still earning less on an inflation adjusted basis than in 2000 and, along with other Americans who lived from paycheck to paycheck, they were hit particularly hard by the downturn. Federal Reserve Chair Jerome Powell stated on numerous occasions that "that the pandemic is hitting low-income workers the hardest, especially minority females. It is increasing inequality….The pandemic is falling on those least able to bear its burdens. It is low-paid workers in the service industries who are bearing the brunt of this."



Unfortunately, there are no easy answers to resolve the inequities which have been building over the past fifty years, but one important part of the solution will be to look at ways to create a healthier, more equitable economy which would include, among other characteristics, a thriving middle-class and a strong educational system. Based upon the first of those measures, the trends in the U.S. have been heading in the wrong direction as evidenced by the chart to the right created by the Pew Research Center. Note that in 1970, middle income households earned 62% of the aggregate income in the U.S., but by 2018, that share had fallen to just 43%. The income share for lower income households has fallen by 1%. At the other end of the spectrum, the share of income going to the upper income households has risen to 48% representing a 66% increase. The disparities are probably even greater now following the devastating impact of the coronavirus.



If gone unchecked, economists warn that the widening wealth gap may exacerbate distrust in our institutions and lead to greater social instability. Studies show that inequality also depresses economic growth. The Organization for Economic Co-operation and Development found, "The main mechanism through which inequality affects growth is by undermining educational opportunities for children from poor socio-economic backgrounds, lowering social mobility and hampering skills development." Improving the quality of our educational system needs to be a priority to help break the cycle of poverty and help narrow the wealth gap. Unfortunately, the coronavirus pandemic is temporarily disrupting our ability to deliver educational programs to those who need it most.

Closing Thoughts

On a personal note, I vividly remember growing up in the 1960's which was one of the most tumultuous and divisive decades in our nation's history with some strong parallels to what's going on today. As a high school and college student during those years, we were engaged in the political process, participated in marches and protests, and were eager to find ways to build a more peaceful and just world. In looking back, I'm disappointed we didn't accomplish more over the past fifty years, but I'm hopeful that the activism we are witnessing today will spark a new sense of urgency and creativity so that we can better live up to our nation's ideals, heal our social wounds, and begin correcting economic imbalances which must be reconciled if we are to create a flourishing and sustainable economy for all.