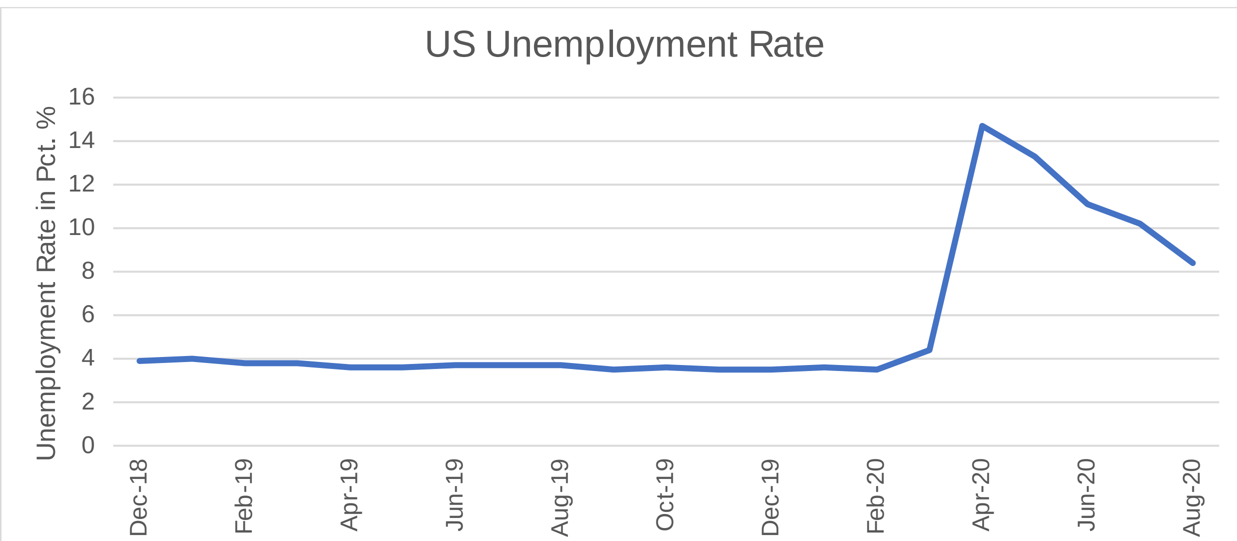
AndCo's Monthly Market Update

September 2020

THE ECONOMY

The basic concept of momentum is that an object with mass can gain velocity until it meets resistance and then begins to slow or stop. Prior to the onset of the pandemic, the US economy was humming along until it met the proverbial wall in COVID-19 in the first quarter. As we have observed in our previous market updates, the US economy bottomed in April and began showing signs of recovery and gathering momentum shortly thereafter. While there are numerous statistics that corroborate this viewpoint, none is more important than the unemployment rate. In August, the US economy added more than 1.3 million jobs which resulted in the unemployment rate falling to 8.4%, down from 10.2% in July.[1] Some of the gains were in seasonal jobs associated with the census that will most likely be lost later in the year. Despite this, the trend is positive and should continue as restrictions related to the pandemic are eased and businesses begin to re-open.

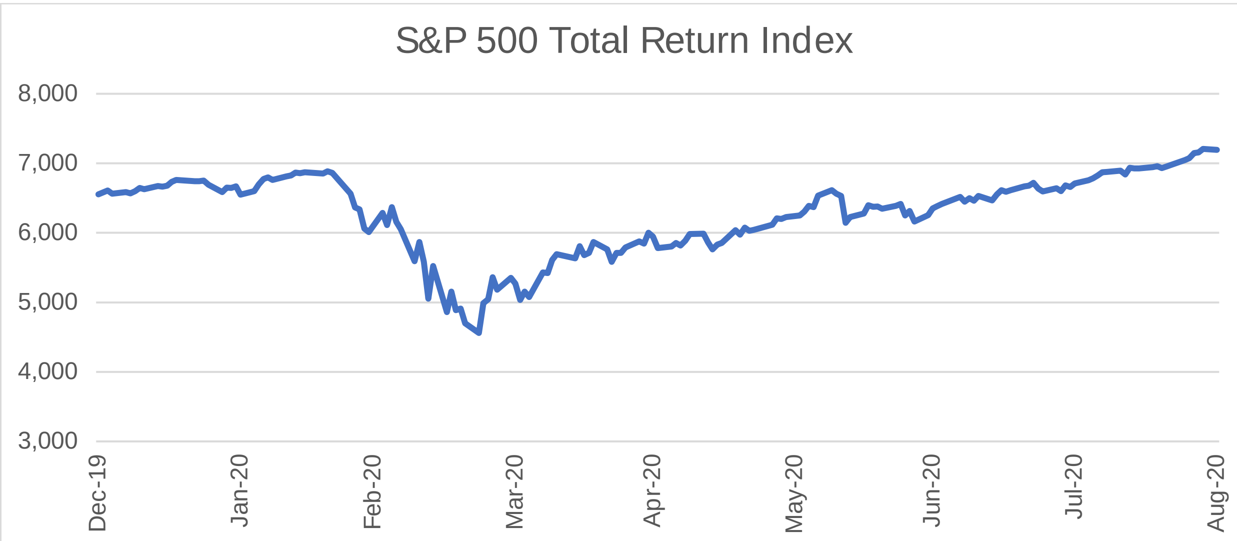


Source: Bloomberg as of August 31, 2020

While the labor market has shown signs of continued improvement, it appears Americans are also slowly beginning to feel better about their prospects. In August, the University of Michigan Consumer Sentiment Index rose to 74.1, up from 72.8 in July.[2] In the report, it was noted that "half of all consumers anticipated the economy would improve in the year ahead."[3] Positive consumer sentiment is closely linked to personal income which rose 0.4% in July, resulting in an increase of personal consumption by 1.9% during the same period.[4] The real benefactor to the improving economic environment was the housing market which saw pending home sales surge ahead, rising 15.4% in July from the same period last year.[5] Housing continues to be a source of strength in the economy, aided by low interest rates, pent up demand and a shift away from urban centers to the suburbs. Finally, the manufacturing sector continues to improve with the ISM Manufacturing Index rising to 56.0 in August, up from 54.2 in July.[6] While the economy remains far below where it was pre-pandemic, momentum is clearly building and we believe could result in continued growth and improving conditions.

EQUITIES

Speaking of momentum, the factor absolutely dominated during the month of August as evidenced by the fact the S&P 500 Price Index closed at an all-time record high of 3500.31.[7] For the month, the S&P 500 produced a total return of 7.2%, while the small cap Russell 2000 returned 5.6%.[8] Ignoring the drawdown beginning in February, the S&P 500 has returned 4.4% since the index's previous peak on February 19th, and 9.7% year-to-date for 2020.[9]



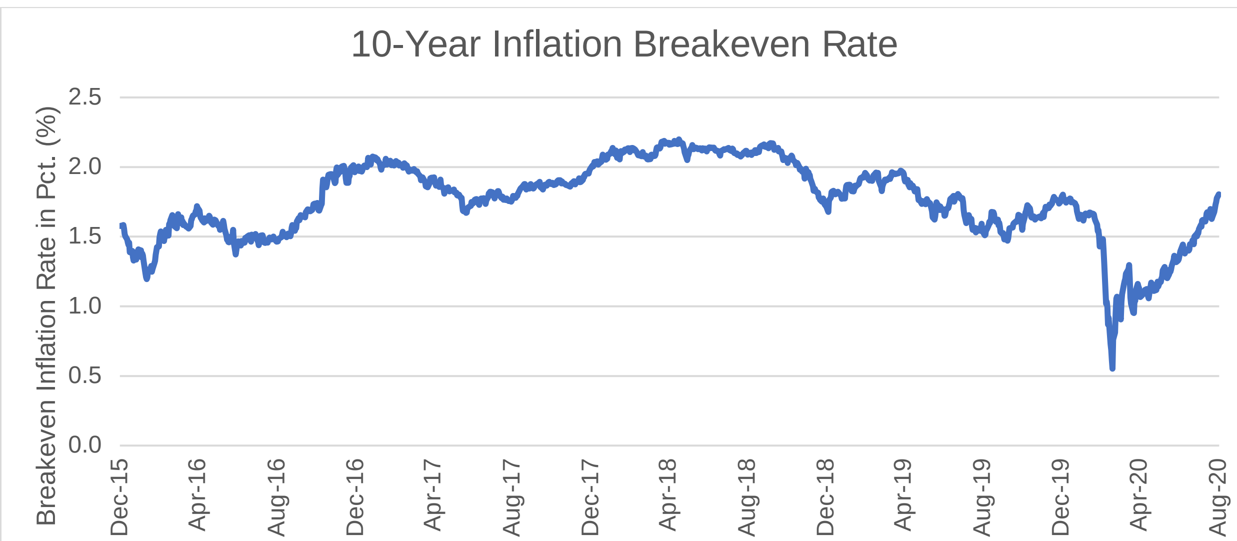
Source: Bloomberg as of August 31, 2020

The US equity market continues to be driven higher primarily by large technology companies. Two stocks were significant contributors to the move higher during August: Apple (AAPL) and Tesla (TSLA). During August, both companies declared 4-1 stock splits and saw their shares appreciate substantially following the news. The move higher in Apple was so dramatic during the month, it became the first public company in the US to trade with a market capitalization more than $2 trillion.[10] While shareholders of Apple may applaud, it is worth noting that the S&P 500 Index is now trading at a P/E multiple of slightly more than 26x, which is the highest level on a quarterly basis since March 2002.[11] For context on how elevated markets are at current levels, since December 2000, the S&P 500 has traded at a roughly 19x trailing P/E.[12] Importantly, as market breadth narrows, underlying volatility can increase despite indices moving higher. This will be important to watch moving forward should investors seek to rotate out of expensive technology-related names into cheaper value-oriented companies.

FIXED INCOME

Fixed income markets were broadly mixed in August with lower quality corporate bonds leading higher quality US Treasury bonds. For the month, the Bloomberg Barclays US Aggregate Index was down -0.8% while the Bloomberg Barclays US Corporate High Yield Index returned 1.0%.[13]

US interest rates, as measured by the US Treasury 10-Year bond, rose during August, settling at 0.71%, up from 0.53% in July.[14] In a speech delivered at the recent Jackson Hole Conference, Federal Reserve Chairman Jerome Powell stated that the Federal Reserve (Fed) would look to average the US inflation rate near 2%, allowing prices to increase faster than the stated 2% target to make up for recent periods of below-level inflation. Seeing as how the Fed has failed to achieve their inflation targeting goals, the idea that it will now allow inflation to run hotter for longer has potentially negative implications for both the broader economy and the bond market. Specifically, given Powell's statement and the Fed's intent to increase inflation, it should be assumed that US interest rates will remain lower for longer. This will be a negative for bond investors as coupons will remain low. The knock-on effect here will be that either investors chose to; a) invest in lower quality bonds with higher coupons to generate sufficient cash flows, or b) seek out other, more risky alternatives such as equities or private investments. Regardless of choice, should investors choose to reallocate, the result will likely be a higher overall risk profile in their portfolios. Finally, while inflation in the US remains low due to the deflationary wave that hit the economy from the pandemic and the subsequent lockdown of the economy, future inflation expectations are rising. Rising inflation erodes cash flows from bonds over time. More importantly, should the momentum of all of the money the Fed has injected into the economy begin to increase and result in inflation remaining above the Fed's comfort level, it may be forced to raise interest rates. An upward move in rates creates a general headwind for fixed income investors. While we do not expect this scenario to play out in the near-term, it would be prudent for fixed income investors to consider the implications and plan accordingly.



Source: Bloomberg as of August 31, 2020

REAL ESTATE

Given the dramatic responses to the COVID-19 pandemic including social distancing, extended scenarios of working from home, and the shuttering of retail and hospitality businesses, the second quarter of 2020 began with significant uncertainty across the real estate sector. While all property-types were impacted, we observed that the brunt of the disruptions were felt in those sectors with significant exposure to consumers such as the Retail and Hospitality sectors. Other more economically sensitive sectors such as Industrial, Office, Apartment, and Health Care properties suffered as rent collection periods were extended in response to the pandemic. However, when we recently reviewed those ratios, it appears rent collections generally bottomed in May and have recovered to pre-COVID levels for many sectors. Importantly, in light of the continued response to the pandemic, property managers are continuing to have conversations with tenants to understand their immediate needs.[15] Fortunately, as the economy has shown signs of recovering, sectors such as Office and Industrial have shown signs of recovering due to their longer lease terms and significant increases in consumer utilization of e-commerce options. Although, in speaking with managers, we understand that the leasing of properties has significantly slowed year-over-year and that property managers are reporting a limited number of new leases and extensions being signed in Office and Industrial assets. Property managers have also reported that leasing foot traffic for Apartments has increased due to the implementation of virtual property tours and increased adherence to CDC protocols by leasing staff. Overall, property prices have held steady despite the drawdown seen in the first quarter in risk assets.[16] Any variation in property values can most likely be attributed to changes in an asset's pro forma cash flows resulting from actual and assumed rent collection rates. Finally, managers are anticipating only marginal impacts to property prices despite recent changes in capital market assumptions given that the spread between the US Treasury 10-year bond and the discount rates and capitalization rates used in valuations are already near all-time highs.

Appendix

1. Bloomberg as of August 25th, 2020
2. Bloomberg as of August 31st, 2020
3. The University of Michigan, August 2020
4. Bloomberg as of August 28th, 2020
5. Bloomberg as of August 27th, 2020
6. Bloomberg as of September 1st, 2020
7. Bloomberg as of August 31st, 2020
8. Morningstar as of August 31st, 2020
9. Morningstar as of August 31st, 2020
10. https://www.wsj.com/articles/apple-surges-to-2-trillion-market-value-11597848808
11. Bloomberg as of August 31st, 2020
12. Bloomberg as of August 31st, 2020
13. Morningstar as of August 31st, 2020
14. Bloomberg as of August 31st, 2020
15. https://www.ccim.com/cre-tenant-landlord-guidance/
16. https://www.statista.com/statistics/936975/commercial-property-index-usa/

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