How Sustainable Is the Market & Economic Recovery?

July 27, 2020

Since the S&P 500's low on March 23, the markets have had an incredible rebound. The rising tide of *unprecedented* Fed liquidity—along with fiscal policy support and generally better news on the coronavirus, at least until more recently—has lifted all boats, across all risk-asset markets. The question is, how sustainable is the market and economic recovery?

The S&P 500 just had its best return *ever* over a 50-day period, gaining nearly 40% off the March low. This is another vivid example of how difficult it is to time market inflection points. And how easy it can be to get whipsawed and miss the market's best days if you are trying to "sit out" a bear market and waiting to get back in "when the smoke clears." By the time the coast is clear you've usually missed a lot of the market gains.

Looking Under the Hood

Several other things stand out about the rebound. Within equities, the market continues to favor growth stocks over value. Not only did growth hold up better than value during the market's plunge from February 19 to March 23—growth beat value by about several percentage points on the downside—but growth also outperformed value in the rebound. Looking at returns from March 24 through July 15, the large-cap growth index gained 54%, while large value was up merely 39%—a 15-percentage-point gap. That's huge.

	Value	Blend	Growth
Large	-12.20	3.99	16.95
Mid	-15.14	-5.85	7.94
Small	-22.16	-10.72	0.23

The year-to-date numbers are striking: Large growth is up 17%. Large value is *down* 12%. That's an incredible 29-percentage-point performance gap in just 6½ months! These are mind-boggling numbers, especially considering growth had been crushing value over the *last* 13 years. Small-cap value has been demolished, still down 22% on the year. Meanwhile, small-cap growth wins by just being flat.

Trailing returns as of 07-15-2020	YTD	2/20/20 to 3/23/20	3/24/20 to 7/15/20
Broad Market Indexes			
Domestic Indexes			
S&P 500 TR USD	0.94	-33.79	45.08
S&P 500 Sec/Commun Services TR US	6.01	-28.59	39.37
S&P 500 Sec/Cons Disc TR USD	14.05	-31.73	57.00
S&P 500 Sec/Cons Staples TR USD	-1.53	-24.03	26.38
S&P 500 Sec/Energy TR USD	-36.11	-55.92	59.15
S&P 500 Sec/Financials TR USD	-20.35	-42.92	37.98
S&P 500 Sec/Health Care TR USD	3.66	-27.91	40.82
S&P 500 Sec/Industrials TR USD	-11.14	-41.69	47.60
S&P 500 Sec/Information Technology	18.32	-31.15	53.34
S&P 500 Sec/Materials TR USD	-0.23	-36.09	58.46
S&P 500 Sec/Real Estate TR USD	-8.22	-37.71	38.22
S&P 500 Sec/Utilities TR USD	-8.52	-35.64	30.89
NASDAQ Composite TR USD	18.20	-30.04	54.21
DJ Industrial Average TR USD	-4.62	-36.48	45.52
Russell 2000 TR USD	-10.72	-40.66	48.13

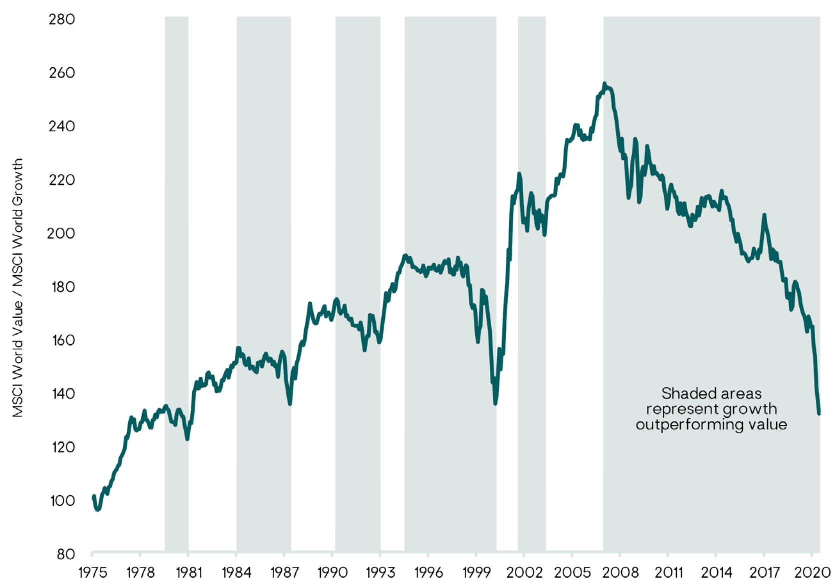
Source: Morningstar

Looking further under the hood at the returns of S&P 500 sectors, you see that the tech sector is up 18% year to date and consumer discretionary is up 14%. By the way, **Amazon.com** is currently about 45% of the consumer discretionary sector. Meanwhile energy is down 36% and financials are down 20%. Quite a disparity.

Looking geographically, it's a similar pattern, with international (EAFE) growth beating value by five percentage points during the rebound, after beating it by seven percentage points during the February–March decline. Year to date there is a 17-percentage-point gap between EAFE growth and value.

Another trend that has continued this year is the outperformance of U.S. stocks vs. international and emerging-market (EM) stocks. Foreign stocks actually performed similarly to the U.S. market during the February–March selloff, but they've trailed the S&P 500 by a few percentage points on the upswing and trail by several percentage points for the year-to-date period.

Growth Has Dominated for 13 Years: One Day the Tide Will Turn



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Growth outperforming value goes a long way toward explaining the relative performance of our portfolios over the past five to 10 years. We firmly believe this 13-year trend of growth dominating value globally is *not* sustainable. But we'll also admit we've been surprised by how long it has gone on—with several false starts for value along the way that haven't been sustained.

So we aren't holding our breath or betting on the *timing* of the eventual reversal. It may take a full-on recessionary bear market to be the catalyst enabling value to outperform coming out of it, as has historically been the case. Or, we may see value and foreign stocks start to outperform growth and the United States if it is clear the coronavirus is under control and a sustainable global economic rebound is underway. In any case, we remain pretty balanced in our active manager exposures across the growth-value spectrum.

The Sustainable Recovery Scenario

We think about the future in terms of a range of scenarios that we believe have some reasonable likelihood of happening. And then we analyze the expected asset class and portfolio returns and risks that are consistent with those scenarios.

So, is this market recovery from the March low sustainable? We think it is one likely scenario. We think there is a reasonable case to be made that it *is* broadly sustainable, and that—supported by tremendous monetary and fiscal policy stimulus in the United States and across the globe—the U.S. and global economies will dig their way out of the severe recession caused by the coronavirus lockdowns.

It may be in fits and starts, depending on the course of the virus and the impact of subsequent responses to its spread or containment. But the general path will be upward and recovery.

That said, the near-term economic outcome remains hugely dependent on the course of the coronavirus. It is still the key variable for the economy, in our opinion, and therefore for corporate earnings and the financial markets. Monetary and fiscal policy/stimulus are second-most important. And as we all know, the medical side of the equation remains highly uncertain. For example, on the one hand we are seeing new surges in infections and hospitalizations in several U.S. states. On the other hand, it appears that substantial progress is being made toward developing an effective vaccine (or vaccines), and many countries appear to have the virus spread under control.

Even a moderate economic recovery would likely be positive for risk assets like stocks and credit. The Fed is very likely continue to keep rates near zero as long as inflation remains subdued and unemployment is elevated above the lows reached earlier this year. The Fed is currently not expecting to raise the federal funds rate until at least 2023. And fiscal policy could remain accommodative in this scenario as well.

If that scenario plays out, our portfolios should perform quite well given our exposure to flexible credit-oriented funds and our global equity exposure. To the extent a global growth recovery scenario corresponds to a depreciating U.S. dollar, that will boost foreign stock returns even further.

Cautiously Optimistic

We would say we are "cautiously optimistic" about a sustainable recovery, which we'd put a couple notches down from "pretty bullish." As we all know, there are still plenty of risks that could play out to derail the nascent economic recovery we've seen over the past couple months. Again, we'd say the coronavirus is the biggest "known unknown" risk. But there are plenty of others out there. For one, we are in an election year—so watch out for an October surprise. A Joe Biden victory probably means higher tax rates for businesses, which would crimp corporate earnings, and creates the potential for earnings disappointments that could drag the market lower. But that damage is quantifiable and manageable. For example, BCA estimates it would reduce S&P 500 EPS by about 6%. Ned Davis Research and Goldman Sachs both estimate roughly a 12% hit to 2021 EPS.

Beyond the election, the potential for an escalation in U.S.-China tensions or any number of other geopolitical conflicts are unfortunately always on the table as potential shocks.

Because of the potential for a double-dip recession, we continue to hold meaningful positions in core bonds. And we remain underweight to U.S. stocks due to their very low expected returns in our baseline scenario. The cash from our underweight to U.S. stocks is invested in an overweight to EM stocks and in lower-risk flexible bond funds and diversifying alternative strategies.

Overall, we believe our portfolios have a nice balance between defense and offense. And if market volatility returns and gives us the opportunity to improve the portfolios' overall risk/reward profile, we are ready to take advantage of it, just as we did in mid-March as stocks were plunging.

—Litman Gregory Investment Team