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Q3 2020 Market Outlook

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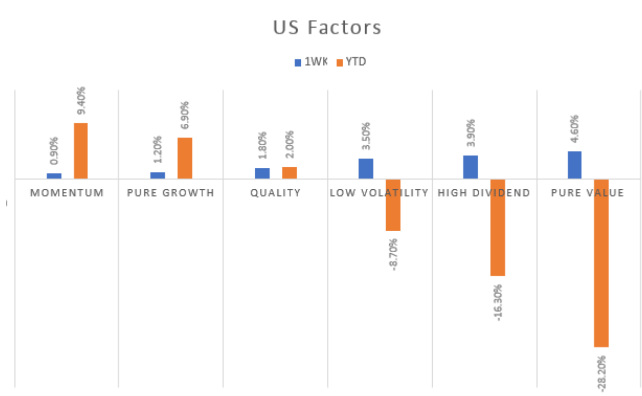
July 23rd, 2020 Letter to Clients

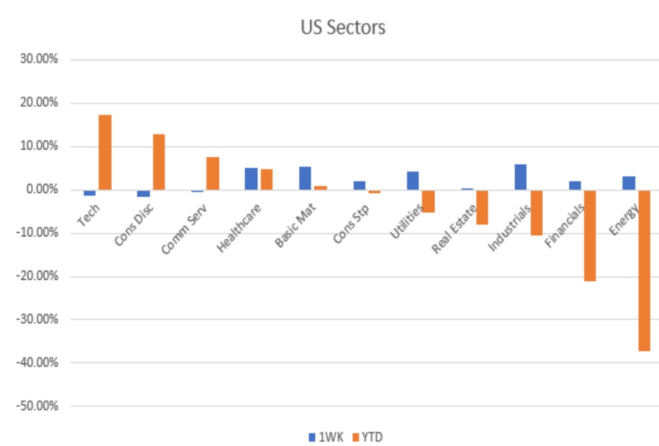
YTD Recap – Roller Coaster Ride

After an unusually profitable 2019, the market became overvalued.[1] At the start of 2020, the market's overvaluation raised several unique considerations. The bull market was at record length, election years tend to be volatile, and the coronavirus pandemic was beginning. EAM believed any combination of these considerations could be the catalyst that begins a recession many analysts believed to be long overdue. As a result, EAM decided to de-risk client portfolios on February 1st, 2020.

De-risking proved prescient, as COVID-19 triggered an unprecedentedly rapid decline into bear market territory. The decline was so severe that many segments of the market saw indiscriminate selling.[2] In the midst of the unprecedented market decline, EAM identified significant market discounts and seized the opportunity. On March 9th, EAM decided to buy back into the equity markets. Simply put, even if a further decline materialized, the potential return for equity holdings became too good to remain on the sidelines.[3]

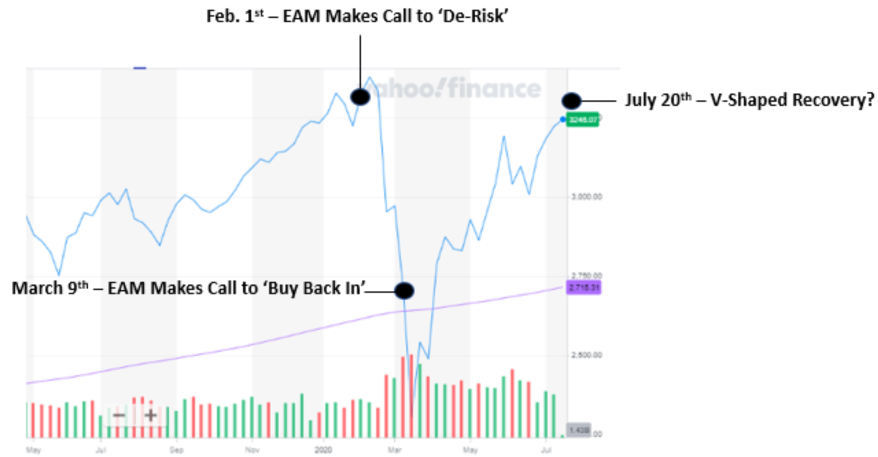
Highlights of the March 9th model changes included **<u>new positions in a technology sector ETF, resulting in a significant overweight to the technology sector, and a momentum factor ETF</u>**:





Looking Forward –

V Does Not Stand for Victory



SP500 Chart as of July 20th Source: Yahoo! Finance

After buying back into the equity markets on March 9th, EAM has 'let it ride' – clients have enjoyed a recovery as swift as was the decline.

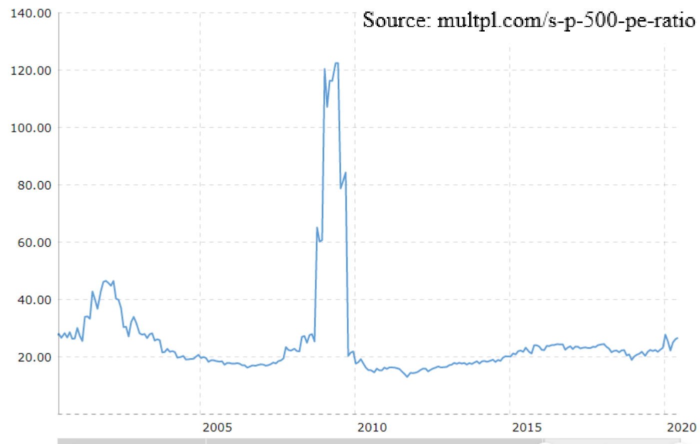
The functional definition of a V-Recovery is when market's erase the losses associated with a rapid decline and quickly go to new highs[3]. Although the markets have seen a nice reversal from the March 23rd bottom, the retracement of 80% (as of June 20th) does not yet fit the definition of a V-Recovery. As mentioned earlier, EAM is currently exposed to the markets. The best-case scenario for everyone would be further market gains, on the back of further government and Fed intervention, until earnings can accelerate toward pre-Covid levels. However, our theories of market value show that this scenario is based on hope rather than a thoughtful analysis of economic realities. Here comes the nerd talk – skip to the conclusion if you simply want our recommendation.

What makes the markets selloff at certain prices? The S&P 500, for example, has a two-factor model that determines pricing:

1. Total earnings of all stocks in the index and,
2. The level market participants are willing to pay for those earnings.

These two factors are combined into the 'index price to earnings' ratio (PE). Over the past 30 years, the PE has been in a range of 16 to pre-pandemic all time high of 22 (for the number geeks out there, our analysis smooths out moves above two standard deviations):

S&P 500 PE Ratio – 30 Year Chart



As visualized in the chart above, PE levels have been in a tight range (with the tech bubble and financial crisis as outliers, of course). What this shows us is that for markets to reach new highs, earnings either need to look like January 2020 OR we need to see new highs in the earning ratio. For those who expect the market rally to continue indefinitely, this is a big problem.

It is obvious that COVID has and will negatively affect earnings in the short run. Most analysts expect terrible earnings for several quarters and then flatten. EAM has analyzed the demand for goods and services in the USA and our resulting belief is that a collapse in demand will accelerate, not flatten, for quite a long time. Currently, consumer demand is being artificially propped up by government distributions, while the collapse in corporate demand is braced by new debt and cash on balance sheets.

Worst U.S. Job Losses on Record *(Four Week Period)*

Year	Description	Peak Jobless claims (4-wk total)	% of U.S. Population
1975	Stagflation	2.24 million	1.0%
1980	Fed tightening (Volcker)	2.52 million	1.1%
1982	Double-dip recession	2.70 million	1.2%
1991	Early 1990s recession	2.00 million	0.8%
2001	Dotcom Bust	1.96 million	0.7%
2009	Great Recession	2.64 million	0.9%
2020	The Great Lockdown	22.03 million	6.7%

Source: FT

A weakening consumer will, of course, lead to a decrease in consumption at all levels. Large and small companies alike will not be spared, leading to a sustained downturn in earnings across the board. There is plenty of evidence out there to support our prediction. Using a specific example, look at Boeing and its suppliers cutting huge amounts of jobs.[4] From a high level, look at the loss of jobs in the movie theater and vacation industries.[5] We could continue with many more examples.

At a lower level, look around in your own communities. Are some restaurants, salons, bars, etc. shutting down <u>for good?</u> PE analysis justifies our bearish stance, but one can ignore our analysis and simply look around to see that we are not back to normal – far from it, in fact. Consumption disruption of this magnitude will take substantial time to bottom, and we believe the recovery from the bottom will be slow.

All analysts expected Covid to negatively impact earnings. It will only be possible for earnings to return to normal levels if we get a substantial PE expansion. This brings us to our final point. Let us refer to our discussion of the PE ratio at the beginning of our letter. The PE ratio is a value that the market will pay for a certain asset given current earnings and growth. Good times and good growth equal high earnings multiples for stocks because the earnings **base** can grow into the higher multiple. The keyword here is base. Even though we are going to have a recovery in earnings growth, it will come from a much lower base. Therefore, in the simple two-factor model described above, something must give.

Conclusion

Our previous writeup, dated March 24th, discussed a market that had been indiscriminately sold. EAM thought the markets were close to the bottom, and investors buying in at those levels could expect a higher than average 12% annualized return over the next five years. Now, as the current rally continues, we believe that those who have remained on the sideline will benefit from continued patience. At some point the stock market will hit new highs. It always does. The S&P 500 chart, from inception, looks like a hiker's worst nightmare, despite intermittent bear markets.

However, based on our analysis we conclude that the current market levels are unjustified. We do not see a V-shaped recovery taking form. Rather, we use the letter V for volatility. Prudent investors take advantage of volatility by selling highs and buying dips. We believe the markets are at highs and buying opportunities will present themselves. JHH is moving to de-risk portfolios.

On behalf of JHH Wealth, thank you for your continued business and we wish you a prosperous 2nd half of 2020.

Eric Hines, MSF
Portfolio Manager

Jeff Hines, CFA®
Portfolio Manager

David W. Jackson III
Analyst

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[1] Mislinski, Jill. "Market Remains Overvalued." Advisor Perspectives, 3 March 2020, https://www.advisorperspectives.com/dshort/updates/2020/03/03/market-remains-overvalued

[2] Doorn, Philip van. "You Can Be 'Practically Stealing' Quality Stocks Now, According to Jefferies." Market Watch, 24 March 2020 https://www.marketwatch.com/story/you-can-be-practically-stealing-quality-stocks-nowaccording-to-jefferies-2020-03-23

[3] https://www.investopedia.com/terms/v/v-shaped-recovery.asp#:~:text=A%20V%2Dshaped%20recovery%20is,case%20scenario%20given%20the%20recession.

[4] https://www.cnn.com/2020/04/29/business/boeing-loss-staff-cuts/index.html#:~:text=The%20company%20announced%20it%20would,lose%20about%2015%25%20of%20jobs.

[5] https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/us-motion-picture-sound-recording-workers-hit-hard-by-job-losses-in-april-58565221