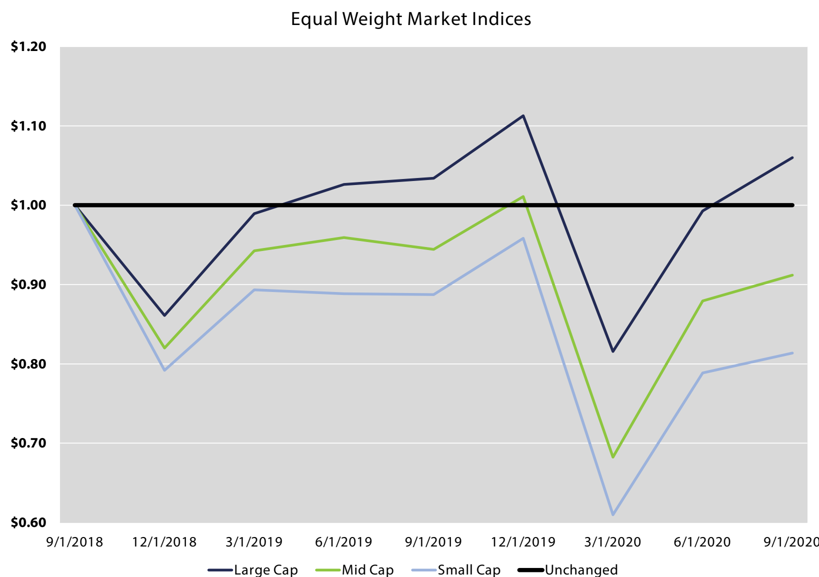
A Market of Stocks

The last twenty-four months seems like an eternity or like a flash in time, depending on how changes have or have not impacted your life. The most significant changes in our society and economy have occurred in just the last seven months, but the last two years have been a slog for portfolio managers.

We have apologized for repeatedly including our chart of corporate earnings dating back to the high-water mark in September, 2018, so we will spare you by omitting it this quarter. Suffice it to say that operating earnings for all segments of the market for stocks have suffered earnings declines. Comparing the last twelve months of earnings to the twelve months ended two years ago:

Index	**Earnings Decline**
S&P Large Cap	-21.9%
S&P Mid Cap	-30.5%
S&P Small Cap	*-137.8%*

(And yes, a 138% decline for the small cap index means a 12 month loss compared to positive earnings two years ago). The positive news is that earnings have stabilized and are forecast to improve over the next year to the point of recovering the entire decline. Maybe that is why the market of stocks has recovered nearly all pandemic-panic losses. Or has it?



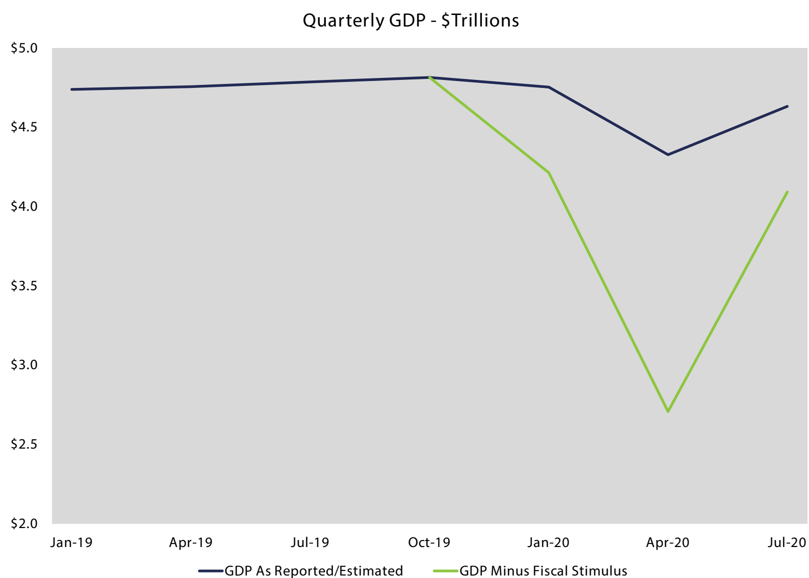
Imagine for a moment, a world with only ten public companies…one company in each economic sector…technology, health care, energy, banking, etc. Following these ten companies would give you a very simple pulse of the economy and of the market of the stocks of these companies. In some respects, today's sector index funds offer something close to this imaginary world. Now we step back to September 2018 and imagine the 'average' portfolio manager picking the 'average' stocks. If she had picked the average stock in small, mid and large cap universes her performance from each would have been significantly lower than the overall index in each case: S&P Large Cap +6.0%, Mid Cap -8.8%, Small Cap -18.6% (based on equal-weighted averages published by Morningstar).

While it is true that the S&P 500 was up 20% over the last two year period, it is a capitalization weighted index where the larger companies have a larger impact on the performance. Essentially, the big have gotten bigger and have hidden the true lack of performance in the market of stocks. Recently, the largest 10 companies represented over 28% of the S&P 500 – the largest concentration in at least 40 years. Will the leaders fall, or will the rest of the troops rally? That depends on…

The Economy

In the second quarter, the economy contracted at the fastest pace in the post-war period, declining by 9% (government reports always annualize this number but we are not). The forecast for the third quarter rebound is a gain of around 7%. This would leave the U.S. economy nearly 4% smaller than the peak reached late last year. If growth moderates to a 1% quarterly gain, the economy will regain its prior peak by mid next year (about the same time as corporate profits are forecast to make new highs). However, we expect future growth to be nonuniform. Travel and leisure will lag the recovery until people are comfortable traveling again. Corporate liability protections would help this segment of the economy. Home remodeling, treadmill sales and food delivery services will continue in demand and fill in some of the slack. There are a lot of moving parts and changing allocations within the economy. Maybe a good way to benchmark overall progress is the rate of employment. Some businesses will be closed permanently and some jobs will never come back.

Government fiscal support for the economy has been a cushion for everything, with fiscal measures equal to 13% of GDP (nearly $3 Trillion) and monetary support of 25% (over $5 Trillion) of GDP. Congress is currently debating another fiscal package that would be equivalent to somewhere between 5-10% of GDP, if passed. Fiscal support has included direct payments to individuals, enhanced unemployment benefits, direct payments to companies, health care efforts, schools and state and local governments. Monetary support has included loans to foreign central banks, the U.S. Treasury and corporations. It is difficult to precisely calculate the impact fiscal support has had on GDP. However, it you assume every dollar went into some measure of GDP over the last 6 months, GDP would have fallen by 40% without it, and the estimated recovery would be 15% below the year ago peak instead of 4%. The current debate surrounding further fiscal stimulus may be impactful.



Ultimately though, government support cannot continue indefinitely; at least not without consequences. At some point the permanently lost resources and jobs will need to be replaced by new ones – a process that can take years. How fast the evolution occurs will be a key component in regaining the prior high level of economic activity. Achieving this economic activity will be paramount in the effort to return fiscal and monetary stimulus levels closer to their "old" normals, as well as improving corporate earnings and supporting broader stock market growth. The volatility that we expect in this recovery, both economic and earnings, reminds us to remain diligent and unemotional when applying our investment disciplines.

Your AAMA Team

The information and opinions in this report have been prepared by the investment staff of Advanced Asset Management Advisors (AAMA). This report is based upon information available to the public. The information herein is believed to be reliable and has been obtained from sources believed to be reliable, but AAMA makes no representation as to the accuracy or completeness of such information. Opinions, estimates and projections in this report constitute AAMA's judgment and are subject to change without notice. This report is provided for informational purposes only. It is not to be construed as a recommendation to buy or sell or a solicitation of an offer to buy or sell any financial instruments or to participate in any particular trading strategy in any jurisdiction in which such an offer or solicitation would violate applicable laws or regulations.