Boston Trust Walden
Principled Investing.

# Investment Commentary

June 30, 2020

## Financial Markets

Building on the recovery that began the last week of March, stocks recorded their best calendar quarter in over twenty years. As measured by the S&P 500 Index, stocks gained 20.5% during the three months ended June 30. From the market bottom of March 23, the Index is now up 39.3%. Other equity indices, both domestic and international, also registered gains well into the double digits. US smaller capitalization stocks, as tracked by the Russell 2000®, outpaced their larger cap counterparts by almost five percentage points during the quarter. For the year-to-date period, however, larger cap stocks have fared far better. Despite the quarter's recovery, small cap stocks remain ten percentage points behind large caps thus far in 2020.

| Total Returns through June 30, 2020 | | |
|---|---|---|
| **US Stocks** | **2nd Quarter** | **Year-to-Date** |
| Standard & Poor's 500 | 20.5% | -3.1% |
| Russell 2000® | 25.4% | -13.0% |
| **International Stocks** | | |
| MSCI World Ex-USA | 15.3% | -11.5% |
| MSCI Emerging Markets | 18.1% | -9.8% |
| **US Fixed Income** | | |
| Bloomberg Barclays Gov't/Credit | 3.7% | 7.2% |
| US Treasury Bill | 0.0% | 0.6% |

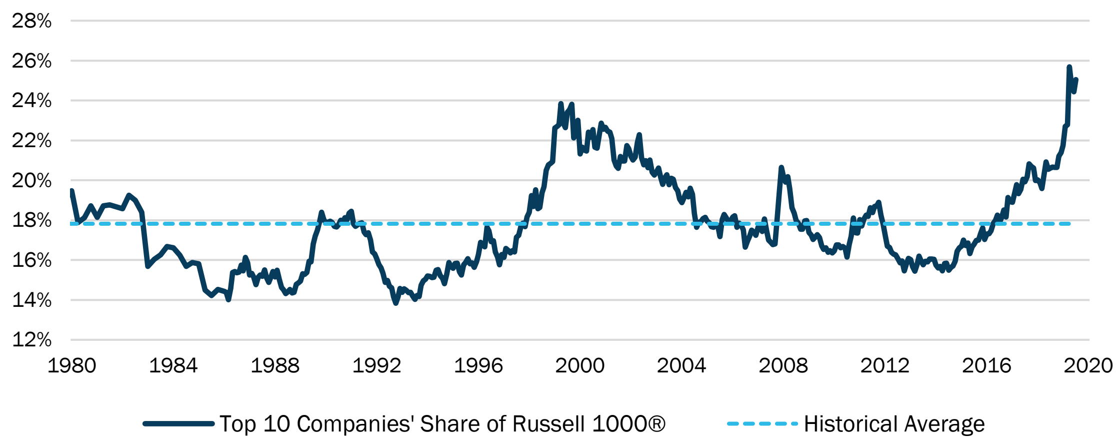
Prices of US government bonds were little changed during the quarter as the yield on the 10-year Treasury note ended the quarter at 0.66%, about where it began. However, as bond investors became less risk averse, corporate credit spreads—especially for lower-rated debt—narrowed, thereby driving prices higher. Though spreads remain wider than prior to the pandemic, this 'repricing' of risk within the corporate segment of the market explains most of the positive returns for bond indices during the quarter.

## Investment Perspectives

### *Follow the Leader*

As the year-to-date returns of the domestic equity indices reveal, capitalization has been a significant determinant of stock performance. That is not just true of large vs. small cap indices, but also within the large cap universe itself. Despite the year's roller coaster ride, the market capitalization weighted S&P 500 Index has lost just 3.1% thus far in 2020. This is in stark contrast to an equal-weighted index of the same 500 companies, which has declined 10.8%. In fact, much of this year's benign year-to-date S&P 500 returns can be attributed to just five companies (all of which are technology-related behemoths) that now account for over 20% of the Index's value. As the chart shows, this degree of market concentration is rare; according to some measures, it has reached its highest level in more than a generation.

Index Concentration




Source: Bloomberg, FTSE Russell

It isn't difficult to understand the extraordinary stock performance of these mega capitalization companies. For instance, Microsoft's prospects might actually have improved during the pandemic as businesses seek to enhance the interconnectedness of global customers and ease the barriers to working from dispersed locations. Similarly, Apple has benefited from ever greater reliance on their easy-to-use devices and access to a growing suite of service offerings. Amazon's rapid growth has only accelerated as shoppers avoid traditional brick and mortar stores. Moreover, these businesses generate prodigious free cash flow. Nonetheless, the stocks of all these companies entail appreciable risk. Valuations of several have risen to multi-year highs as investors seek to participate in these trends. Meanwhile, global regulators are troubled by the concentration of market power they have accumulated. And, of course, the rules of competition, which have trimmed the prospects of previous dominant companies, have not been repealed.

Besides this handful of dominant companies, several newer companies—frequently referred to as COVID-19 beneficiaries—have seen their stocks rise dramatically in 2020. These are companies we have become newly dependent upon, whether for communication, entertainment, e-commerce, or our health. With perhaps lasting secular changes in the economy (e.g., more working from home), some of these companies may indeed demonstrate their business models can be sustained. The success of many, however, we suspect will prove fleeting. Regardless, most of these market darlings now carry valuations that imply long-term growth projections we view as highly speculative.

Though portfolios we manage participated in this quarter's market recovery, the character of the market's performance led to disappointing results relative to equity indices. While portfolios maintain substantial positions in several of the large companies we judge to have both strong business models and reasonable valuations, we have avoided investments in companies whose valuations we believe entail too much risk. Portfolios also have little exposure to those newer companies with unproven business models and largely uncertain growth prospects. Despite the recent challenges, we remain committed to broadly diversified portfolios comprised of reasonably valued companies with strong financial underpinnings and well-conceived business models.

### *What's Driving the Market?*

Any way you slice them, stocks have recovered much ground since the depths of late March. And although the pandemic rages on, there are logical—if debatable—reasons for stocks having regained their levels of late 2019. Chief among these is the extraordinary government response. Most important, the Federal Reserve acted with greater intensity and speed than during the 2008 Financial Crisis. The Fed cut short-term rates to near zero and (re)initiated huge asset purchases (known as quantitative easing) to force longer-term rates lower. For the first time, it also expanded purchases into new asset classes like municipal and corporate bonds. Perhaps most significantly, the Fed has pledged continued support until the economy can stand on its own.

Congress also acted with unprecedented speed and scale. All told, the Federal government has thus far allocated $2.8 trillion to help businesses and individuals weather the storm of government-mandated closures. Though negotiations for another package have stalled, Congress has extended the June 30 deadline for the Paycheck Protection Program (PPP). Taken together, the policy response has effectively staved off a full economic collapse.

What about equity valuations? Finance theory holds that a company's valuation should equal the current value of all its future earnings, not just next year's results as the commonly cited price-to-earnings measure implies. If the economy recovers quickly, even the current deep recession may only reduce earnings briefly. When interest rates are low, long-term earnings power is all the more important. Based on current equity valuations, therefore, it is apparent that investors believe the COVID-19 pandemic will be a short-term event insofar as corporate profits are concerned.

Finance theory aside, the power of low interest rates to support stock prices is obvious. As measured by the S&P 500 Index, equity dividend yields today are higher than those on even 30-year Treasury bonds; money market yields are near zero. Simply put, in a world of historically low interest rates, return-seeking investors are willingly placing a premium on corporate cash yields, accepting the inevitably higher risks.

### *Economic Outlook & Positioning*

The economic reports released after much of the country was sheltering in place in March were dismal. The US economy suffered an historic deterioration with drastic reductions in employment, manufacturing, consumer spending, and virtually every other measure. The only saving grace was the hope that after the government-mandated shutdowns were lifted, economic activity would quickly pick up as people returned to their jobs and spending—a so-called, V-shaped recovery. And while economic indicators improved through much of the second calendar quarter, many have slowed in recent weeks; activity remains well below pre-pandemic levels. This flattening may be due to stimulus checks having been spent, the exhaustion of pent-up demand, or a retrenchment in states where COVID-19 cases have surged and consumers have returned home. Most likely, it's a combination of all three.

As the pandemic continues, we expect Congress will eventually provide more fiscal support. Extending the expanded unemployment benefits beyond their current July expiration seems a reasonable interim step. Though any assistance will probably be welcomed by investors, such measures—while appropriate in our view—simply serve as a bridge loan for the economy. As we emphasized in our first quarter report, the virus will continue to drive the economy in the short term. Indeed, the recent decision by several states to pause or rescind reopening plans is a reminder of how closely the economy's fortunes are tied to shifts in virus-induced public health initiatives. A full return to normal economic conditions will only come with a viable solution to the health crisis, probably with the development and wide distribution of a vaccine. Until that happens, the recovery will depend upon the path of the virus and the degree to which our society finds ways to resume economic activity while taking appropriate measures to limit the virus's transmission.

Today's market valuations leave little room for a public health or economic misstep. Accordingly, we continue to see significant risks to equity markets, particularly in the short term. However, if interest rates stay low as we expect, and the economic recovery does not suffer a large reversal, long-term returns for equities are likely to exceed those for bonds. Substantial equity allocations therefore remain appropriate for investors able to tolerate a high level of near-term uncertainty. In accordance with client circumstances, including ample provisions for liquidity needs, we continue to position multi-asset portfolios near benchmark allocation targets. As has been the case in recent months, we expect markets to remain volatile as investors react to the path of the public health crisis, election news, and other geopolitical events. We believe our long-held emphasis on sustainable business models, financially strong companies, reasonable valuations, and prudent diversification will help protect portfolios in the anticipated environment of continued market volatility.