Second Quarter 2020 Bounce

"The only reason for time is so that everything doesn't happen at once." - Albert Einstein

This year has brought unprecedented change and upheaval. To start, we have dealt with:

- Natural disasters
- Geopolitical stress
- Growing divisiveness about race and socioeconomics, and
- Continued wide gaps in economic growth and opportunity

Any one of these is more than enough to make investors take pause and that's without the enormous impacts of the COVID-19 pandemic on markets, economies, and people. It has been quite a year and it is only half over.

Market Update
In Mid-March the markets began to climb back from its precipitous fall. The strong bounce back of the S&P 500 continued in the Second Quarter. The U.S. markets response was due to measures taken by the governments and central banks to combat the effects of the virus and to country beginning to reopen. The market rally has held and over the last few weeks hovered at its previous highs. However, there are enough big questions lingering that this optimism is cautious at best. There are many reasons to be skeptical of the market's resilience.

Market breadth in particular turned quite weak in early June. One concern, the number of stocks in the S&P 500 trading above their 50- and 200-day moving average is declining. Another concern is the top five stocks in the S&P500 have grown to encompass more than 22% of the index. The composition of the index is determined by each company's market capitalization (equal to the number of shares outstanding times the share price). So as the share price increases compared to the other stocks, a company's capitalization increases and it becomes a bigger percentage of the S&P 500. The stock market is being driven higher by just a handful of stocks. The graph below shows how unusual it is that the top five stocks make up 22% of the S&P 500. These top five are the large technology stocks (Microsoft, Apple, Amazon, Facebook, and Alphabet Inc. which is Google). A lack of market breadth shows weakness.

So here is the concern: Will these few U.S. growth stocks be able to continue to drive overall market performance? Will there be a point at which valuations become too stretched without fundamental support, leading to a sell-off that brings down the broader market? It is hard to know.

Chart Source: Charles Schwab, Bloomberg, as of 6/30/2020. **Past performance is no guarantee of future results**.

The Economy

As the U.S. economy has begun reopening, it led to a surge in economic data. The growth of the Leading Economic Indicators is amazingly strong but it's because they are percentage which only capture the change. For example, if there is one person employed and you hire another person then there is 100% increase in employment. The rate of growth when you start from such a low point can be misleading. You can see the robust growth in the Leading Economic Indicators on the right side of the graph

As mentioned above the level of the index of Leading Economic Indicators is important because of the current low level of economic activity. When you look at the level you can see that economic activity is still well below pre-pandemic levels. This graph on the left shows that the U.S. economy has a long way to go.

Chart Source: Charles Schwab, Bloomberg, The Conference Board, as of 5/31/2020.

The worry now is that a surge in covid-19 cases could lead to broad lockdowns across the U.S. and the rest of the world and a recession. Much of the equity market recovery was driven by optimism that the curve had been flattened and progress was being made on vaccines. As observed in June, equity markets reacted negatively to indications that infections were on the rise or that early vaccine studies showed lower efficacy levels than anticipated. This optimistic/pessimistic cycle will probably persist throughout the rest of 2020.

Many forecasters started to predict a more rapid economic recovery as a result of the stimulus and other positive signs. The equity markets are still optimistic and showing a V-shaped rebound. However, conflicting signals from a variety of economic indicators point to a slower, more prolonged period of no/slower growth that may not return the economy to levels prior to Covid-19 for many quarters.