BUCKHORN
INVESTMENT ADVISORS

Second Quarter Market Review and Comment
July 2020

Updated Market Performance

Returns	2nd Quarter 2020	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**20.54%**	**7.51%**	**10.73%**	**10.73%**	**13.99%**
DJIA	**18.51%**	**-0.54%**	**9.08%**	**10.62%**	**12.99%**

Performance: April picked up the rally/recovery from the end of March notching a return of 12.82%. May continued April's upward trend returning 4.76%. June added 1.99% as the rally continued but appeared to be losing steam.

After a forgettable 1st quarter 2020 with the SP500 down -19.60% the 2nd quarter of 2020 brought some optimism along with a little relief. The 2nd quarter ended up 20.54%. This was the largest quarterly gain since 4th Quarter 1998's gain of 21.3%. The Dow Jones Industrial Average (DJIA) trailed the SP500, posting 18.51% gain over the same period. For the previous twelve months the SP500 has returned 7.51%, handily outpacing the DJIA which returned -0.54% over the same period. The annualized three-year returns are better than the near-term returns with the SP500 posting 10.73%, while the DJIA is lagging at 9.08%. Over the last five years the annualized returns are running slightly above historical norms (around 10%), with the SP500 returning 10.73% and the DJIA posting 10.62%. The ten-year annualized numbers are still running above long-term averages (around 10.00%); the S&P500 posted 13.99% vs the DJIA which turned in 12.99%.

Breaking down the returns for the Q2 2020, we note that there were four outperforming sectors and seven underperformers. **The best sectors were Consumer Discretionary (32.86%), Technology (30.53%) and Energy (30.51%)**. **The losers during the quarter were Utilities (2.73%), Consumer Staples (8.12%) and Financials (12.20%).** The clear winners the last twelve months were Technology (34.06%), Consumer Discretionary (11.19%) and Communication Services (9.53%). Bringing up the rear were Energy (-39.00%), Financials (-16.00%) and Industrials (-10.85%).

Economy: We have gone from a full shutdown to phased reopening's. Daily new cases of Covid-19 for the United States hit a record high on July 17th with ~75,821 new cases. Over ~4.32 million total confirmed cases in the US currently (~16.3 million globally). We have seen hot spots reverse on some reopening plans, as well as some states implementing quarantines for visitors traveling from hot spots. The rise in cases should not be too alarming. An increase in cases was expected. What matters in addition to minimizing deaths is that the spread can be contained and the transmission to others reduced. Continued growth in the economy will return once the economy is fully operational and threats from the virus have subsided either due to a successful treatment, increased immunity, or a vaccine. The economic recovery is going to be path dependent on how long the economy is restricted, how well the virus is contained, and if the transmission can be minimized during reopening phases. The longer the economy remains restricted the more economic damage we will experience extending the length of the recovery.

The third estimate of 1st quarter Gross Domestic Product (GDP) is -5.0% according to the report released at the end of June by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 1st quarter decreased -5.0% from 4th quarter 2019 and was unrevised from the second estimate.

GDP for 2019 came in at 2.3% compared to 2.9% in 2018 and 2.2% in 2017. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted 2020 Q2 GDP growth at negative -14.3% and 2020 Q3 GDP growth at positive 13.2%. By comparison, China says their GDP increased at 3.2% in the 2nd quarter of 2020. Rebounding from 1st quarter 2020 contraction of -6.5%. China became the first major economy to report growth following the coronavirus pandemic. China's 2019 GDP was 6.1%, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were -2.7% and -3.6% respectively in the 1st quarter 2020. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2017. GDP Growth forecasts for the end of the 2nd QTR 2020 are -7.8% for the EU and -3.6% for the Euro Area.

Unemployment is decreasing but is still well above historical norms (~5.75%). Once the restrictions on the economy subside the unemployment rate will decrease back to historical averages. According to the Bureau of Labor Statistics, June unemployment declined to 11.1% a decrease of 2.2% from May's 13.3%. Unemployment for 2019 came in at 3.67%. The number of unemployed fell by 3.2 million to 17.8 million in June. Although the unemployment rate decreased in both May and June, we remained 7.6% lower and 12 million jobs fewer than in February. The labor force participation rate was 61.5% for June an increase of 0.7% from May.

Inflation increased in June after declining three consecutive months. After averaging ~2.10% in the 1st quarter 2020, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 0.33% in the 2nd quarter 2020. The average rate of inflation for 2019 was 1.82% and continues to be subdued by historical standards (~2.50% over last 30 years). If it feels like food prices are increasing even though inflation is low, it is, because the food index increased 4.5 percent over the last 12 months, with the index for food at home rising 5.6 percent.

Consumption is an important driver of the economy as it represented 67.7% of 1st quarter 2020 nominal GDP. The U.S. Census Bureau announced in July that retail sales for June 2020 were up 7.5% compared to May and were up 1.1% above June 2019. Non-store retailers were up 23.5 percent from June 2019, while building material and garden equipment and supplies dealers were up 17.3 percent from last year.

Manufacturing economy grew in June. Economic activity in the **manufacturing sector** expanded for the month of June, with the overall economy notching a second consecutive month of growth after contracting for one month. The Purchasing Managers Index (PMI®) registered 52.6, an increase of 9.5 from May's reading of 43.1. The PMI signaled a rebuilding of economic activity in June after three months below 50. The PMI recorded its largest increase since August 1980, when it increased 9.5. Among the big six industries, three of the industry sectors expanded. New Orders and Production returned to expansion. Supplier Deliveries reached a normal level of balance between supply and demand. The overall economy grew for the 2nd consecutive month, according to the nation's supply executives in the latest Manufacturing ISM® *Report on Business*®. Based on historical relationships between PMI and GDP, a PMI of 52.6 corresponds to a 2.9% increase in real gross domestic profit (GDP) on an annualized basis.

Home prices are holding up well and appear to be remarkably stable. According to the S&P Case-Shiller Home Price Indices home prices rose in April with the S&P CoreLogic Case-Shiller National Home Price Index rising 4.0% over the last 12 months. Phoenix, Seattle, and Minneapolis had the largest year over year increases with 8.8% for Phoenix followed by 7.3% for Seattle and 6.4% for Minneapolis. According to the National Association of Realtors, the year over year change in existing home sales was 2.4% in June for Single family homes above $250,000 and housing supply continued to remain tight in June with 3.7 months of supply.

Markets: As the economy has begun to open, we are already experiencing increases in cases, new hot spots, and even some states tightening restrictions they just relaxed or alternatively delaying moving to the next phase of reopening. We all know the stock market is forward looking and right now it is clearly evident that the stock market is ahead of the economic recovery. The stock market just finished a stellar Quarter, but the economy has not kept up. If the market is right the economy should be in a good spot in

approximately 6 months. If the market is wrong and the economy doesn't follow the same trajectory as the market, we could give back some of our recent gains while the market digests the prospects of a longer recovery.

- **Covid-19 Virus: The market reacted fast and furious as it priced in a worst-case scenario. We have since rebounded and recovered much of our paper losses. We are now closing in on the all-time high for the S&P 500 set on February 19th of 3,386.15.** The immediate impact was felt quick with the closing of most of the global economy. As restrictions are beginning to be rolled back, we are already experiencing setbacks. This is something that we have never done before. Once we get on the other side of the virus and the economy returns to normal capacity equity markets should benefit from ultra-low interest rates and the tail wind of all the economic stimulus we have and will receive. The old acronym TINA (There is no alternative) will come back to fashion.
- **Earnings growth for the SP500 is expected to decline -42.4% for the 2nd quarter 2020. If the actual decline for the quarter is -42.4%, it will mark the largest year-over-year decline in earnings reported by the index since Q4 2008 when the decline was -69.1%.** According to FACTSET, of the SP500 companies that have reported earnings as of 24 July (Approximately 131), 81% reported earnings above the mean estimate and 71% have reported sales above the mean estimate. **A number of companies are having difficulty providing estimates for future earnings due to the uncertainty surrounding the negative impacts of COVID-19**. Looking at future quarters, analysts predict a decline in earnings for the third quarter of -24.0% and fourth quarter -12.3% and a return to growth in the first quarter 2021 of 3.0%.
- **After the recent rally from the low's stocks look a little rich. *It does not look like we will receive any meaningful earnings growth until early 2021.*** The current 12-month forward Price Earnings (PE) multiple on stocks is 21.7. The long term (20 Year Average) PE for stocks is 15.4, so we do not see a lot of room for valuations to move higher without growth. As earnings continue to come in lower, the E in the P/E ratio will get smaller and in turn lower our PE levels a little more (This is as long as prices don't increase at the same time offsetting any decrease in PE). Lower interest rates allow for higher multiples.
- **Interest Rates are still near Zero again and the Fed is still waiting in the shadows ready to do whatever it takes.** The Federal Reserve dropped short term rates 1.50% in March and launched multiple quantitative easing programs. Rates have since been left unchanged at a range between 0.0-.25%. The Fed continues to closely monitor developments and is prepared to adjust plans as appropriate.
- **More fiscal stimulus.** After the Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress and signed into law by President Trump on March 27th, 2020 plans of another round of stimulus began. The next stimulus package might include more stimulus checks, an extension of the eviction moratorium, a reduced unemployment aid benefit as well as other simulative measures. The actual details are currently being debated between the house and senate. They will most likely have an agreement by the end of July.
- **An election that could drag on past election day.** There has been a widespread expansion of vote-by-mail this year in response to the pandemic. We are already seeing local and state elections being contested leading to slower election results. A tight race for the presidency could produce vote recounts in one of more swing states. In an environment of extreme polarization, President Trump or former Vice President Joe Biden would refuse to concede while recounts are underway and their vast army of lawyer's dispute to results in court. In general, our constitution is more effective than the consensus thinks. The market is likely to overact creating a short-term buying opportunity. The US possesses the world's oldest operating constitution. It is very robust. The Supreme Court and Congress will intervene, if necessary, to determine the succession of the presidency.
- **Election Year.** Election years bring policy uncertainty, which usually translates into higher market volatility. Currently the Pandemic is still overshadowing most policy uncertainty. The last 23 election years since 1928 the S&P 500 was only negative 4 times. Historically if the S&P 500 rises between July

31st and October 31st in an election year, the incumbent candidate (current holder of office) wins 80% of the time. On the other hand, if stocks fall, the incumbent loses 88% of the time.

Forecast:

We think the biggest threat to the stock market is the uncertainty presented by the Covid-19 virus and the uncertainty of how and when the economy will return to business as usual. We think the SP500 will end the quarter between 3,100 and 3,200. At this juncture, we venture a guess that stocks will end up somewhere between 0% and 2% for the year.

For the next six to nine months, the Federal Funds rate should remain at its current range of 0%-0.25%. **The 10-year Treasury which is currently priced at ~.60% should remain in a range between .50%-.75% through the end of the 3rd quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

Julian F. Patton, Jr. CFA, CFP®, CAIA
Chief Investment Officer