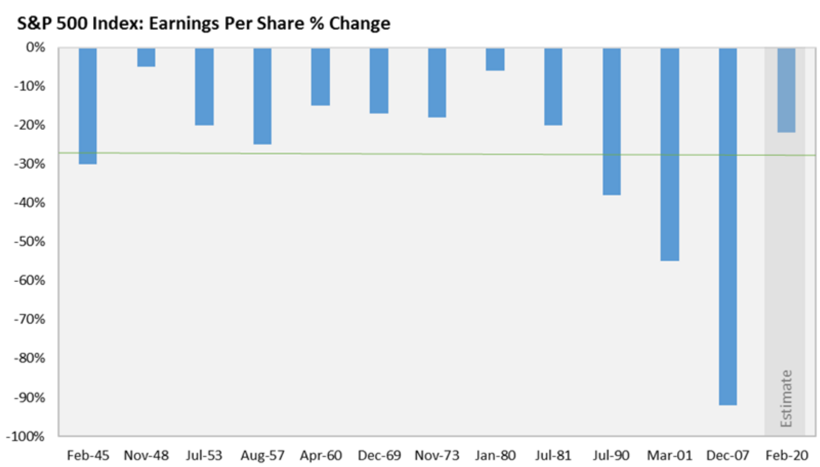
Market Review and Outlook

Global equity markets extended their late-March rally through the second quarter, fueled by central banks' aggressive support for financial markets and signs of an early recovery in economic activity. Domestic stocks reported their best quarter in more than twenty years, with the S&P 500 returning 20.5% during the second quarter—trimming its year-to-date loss to just 3.1%. International equities reported similar strength, as developed international equities (EAFE) posted a second-quarter gain of 15.1% (-11.1% YTD) and emerging markets (EM) climbed 18.2% (-9.7% YTD).

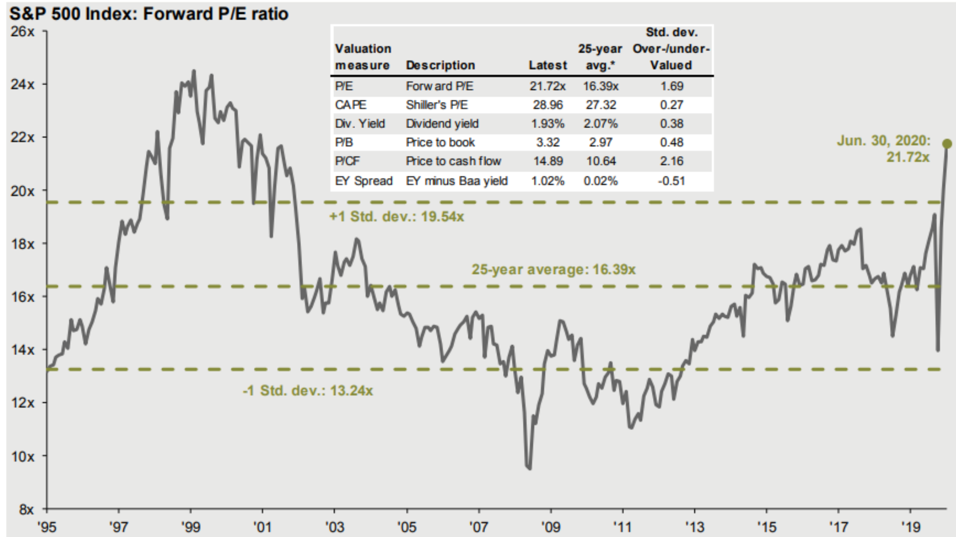
On one hand, the strong equity gains in the quarter appear appropriate based on the likelihood that the pandemic-fueled recession—which officially began in February—may prove be the shortest ever, thanks to the massive stimulus response by policymakers and initial progress toward a vaccine. On the other hand, a second wave of COVID-19 remains a risk to the recovery, particularly as several southern and western states have seen dramatic spikes in infections and hospitalizations. In addition, some of the 20 million jobs lost in March and April will take a while to come back. The economy quickly recovered 7.5 million jobs in May and June as states began to reopen, but the U.S. unemployment rate remains above 11% and the millions of remaining jobless individuals may find it harder to re-enter the labor force due to social distancing constraints and potentially lasting changes in consumer behavior. Jobless claims could also remain stubbornly high if employers terminate employees once the government pulls back Paycheck Protection Plan (PPP) funding and/or if higher earning cohorts of the labor force (who have been less impacted by layoffs to date) start to see an increase in terminations. While the rollout of an effective COVID-19 drug therapy or vaccine would greatly improve the employment outlook and accelerate the economic recovery, widespread availability of such medical breakthroughs are not anticipated for at least the next six months (and possibly longer).

Against this uncertain economic backdrop, the outlook for corporate earnings remains challenged. The estimated earnings decline for the S&P 500 during the second quarter is -44%, while full-year 2020 earnings are expected to decline -22%—which is roughly in line with the average historical earnings decline in past recessions.



Source: LPL Research, FactSet

At the same time 2020 earnings expectations continued to decline, the nearly 40% rally in equities off the March 23rd lows produced inflated stock valuations. The forward (next 12 months) price-to-earnings multiple for the S&P 500 Index was 22x at the end of the second quarter—the highest level since the technology bubble in the late 1990s and early 2000s.



Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

While the current P/E ratio is arguably misleading since it reflects depressed earnings during a period of temporary turmoil, the S&P 500 ended the second quarter at the same baseline level (3,100) it was in mid-November. At that time, however, the unemployment rate of 3.7% was at a 50-year low, GDP growth was stable (albeit modest at <2%), and 2020 corporate earnings were slated to increase 10% (vs. -22% currently). Today's elevated unemployment levels and weak GDP outlook make the market's current level and premium valuation seemingly much more prone to downside risk in the event that near-term economic data and earnings results disappoint.

While stocks historically lead the economy out of financial downturns, there could be a disconnect in what is currently priced into the market and the actual economic recovery trajectory that ensues. Although we remain bullish on equities over the medium to longer term relative to fixed income and cash, we are particularly cautious over the next 6-12 months due to the significant economic impact of massive unemployment levels. We can't rule out the possibility that additional Congressional stimulus could temporarily bridge the economy and extend the recent market rally. That said, with the uncertain economic impact of COVID-19 over the coming months, equity returns during the second half of the year could remain choppy (though less extreme in magnitude than the first half of 2020—hopefully!). As we have done in the past, we will likely use periods of near-term market weakness as an opportunity to purchase select investments with attractive long-term prospects.

Core Portfolio

During the second quarter, we initiated new positions in Sysco Corporation and the Utilities Select Sector SPDR Fund.

Sysco Corporation distributes food products to restaurants, healthcare and educational facilities, and lodging establishments. It is the largest foodservice distributor in the U.S., boasting 16% market share of the highly fragmented $300 billion foodservice distribution industry. With its high exposure to restaurants (62% of revenue), Sysco's sales were dramatically impacted by the drop in restaurant dining at the outset of the COVID-19 lockdowns. However, Sysco had the unique benefit of being a key supplier to many restaurants that remained open for takeout and delivery, which provided some downside protection as those dining options saw increased demand. It also increased its sales force's focus on providing restaurant cleaning and takeout products, such as to-go containers and utensils. Furthermore, by expanding its services to the grocery sector, Sysco helped grocery stores struggling to meet consumer demand. With restaurants now reopening dine-in service (albeit initially with limited capacity), Sysco should see a strong rebound in its traditional sales channel. Meanwhile, Sysco's expanded reach into other service offerings spurred by the pandemic will create incremental growth opportunities for the company on the other side of this temporary downturn.

The Utilities Select Sector SPDR Fund is an exchange-traded fund invested in a diverse portfolio of 28 individual utility companies that produce, generate, transmit or distribute electricity or natural gas. These businesses typically produce steady cash flows capable of supporting reliable dividend payouts. Utilities' steady dividend streams are particularly attractive during periods of low interest rates and elevated market volatility. Nevertheless, utility stocks declined further than the broad market from its February peak to its March trough and have recovered more slowly since then, as investors worry about reduced electricity use by businesses and missed payments by unemployed workers amid the COVID-19 economic disruption. However, we believe this recent underperformance created an attractive entry point into a sector that should demonstrate earnings and cash flow stability over the medium term.

Fixed Income

Following the substantial decline in interest rates during the first quarter, U.S. Treasury rates stabilized in the second quarter. Still, the benchmark 10-year Treasury yield (0.66%) closed modestly below the 0.70% baseline where it started the quarter, as the markets appeared more focused on escalating coronavirus concerns than generally stronger U.S. economic data.

Today's Treasury rates are near their historic lows across the entire maturity spectrum. Although we don't anticipate interest rates to rise significantly anytime soon, with interest rates so close to zero, we believe the potential "side" benefit of capital appreciation in bonds does not exist unless we see negative interest rates (which have been declared as a last option by the Fed). A case can still be made for holding high-quality bonds to maturity as a means of capital protection, but we continue to focus on shorter duration investments as the impact of inflation from massive government stimulus policies pose a significant risk to the real return of longer duration securities.

Final Thoughts

The first six months of 2020 demonstrated how erratic the market can be and how quickly investor sentiment can shift. While we are certainly not immune to short-term gyrations in the market, we have always managed our investors' capital with a long-term perspective that has enabled us to keep the market's sporadic bouts of both trepidation and euphoria in perspective—and opportunistically rebalance our exposure at the extremes.

Lastly, we want to once again express our appreciation for the confidence and trust our clients have instilled in our people for the last 20+ years. We are grateful to have a stable business comprised of a team of individuals who are dedicated to serving our clients, especially during this highly unusual period.

Have a safe summer!

Parkside Investments, LLC

July 13, 2020

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