



WOODSTOCK

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A quarterly newsletter offering our views on the market and economic topics of interest to investors.

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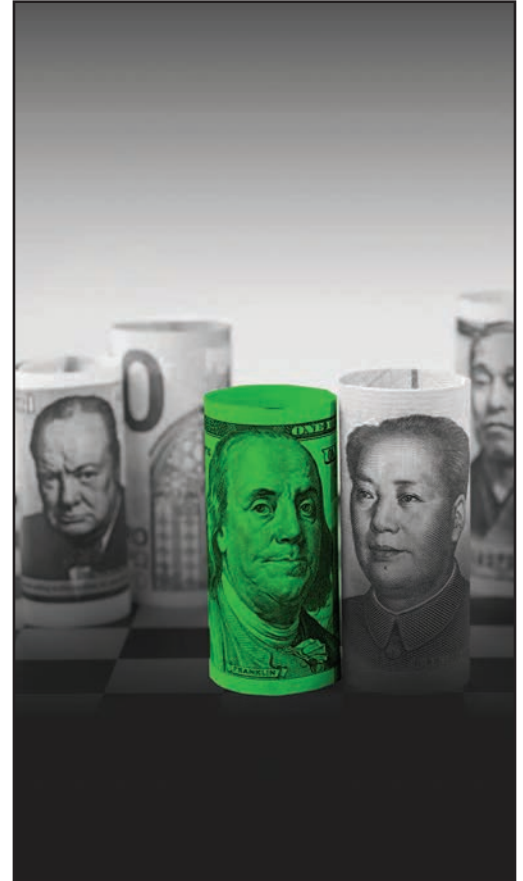
US Shines in Share of World Market Capitalization

William H. Darling, Chairman & CEO

Adrian G. Davies, President

We sometimes start our quarterly letter to you with the smaller, local items and move to the larger, macro ones. However, the US share of world market capitalization is a macro item that has pushed its way to the front.¹ After running at approximately 60% for most of the post-World War II years, the situation changed in the early eighties when valuations for Japanese companies overtook US companies, with Japanese companies accounting for 35% of world market cap, compared to 25% for US companies. Sir John Templeton explained his nervousness about the situation by worrying that if one square mile of Tokyo real estate was worth more than the whole state of California, such valuations were not sustainable. By the year 2000 and the US tech bubble, the US share had climbed up to 50 percent. The bursting of the bubble and interest in emerging country stocks drove the US share down to 40% by 2008.

Since then, the US share of world market cap has climbed back to 50 percent. The next 20% is shared by Japan, the United Kingdom, France, and Germany in approximately equal weights. China, India and Russia hardly register in the rest of the world's remaining 30 percent. Some explanations could credit US advantages and entrepreneurial spirit for this remarkable 80-year run. Others could focus on Chinese government entities being more important than Chinese private sector ones in terms of understanding China's importance in this statistic. But instead, the focus should probably be on what is wrong with the rest of the world. If human capital is the real natural resource, the US is one-third the size of China and equivalent to the European Union. Rather than focus on what we're doing right, perhaps, the focus should be on what they're doing wrong.



As referenced above, after 2000 the institutional investment focus turned to the endowment model and investing in asset classes such as emerging market equities, hedge funds, commodities, real estate and private equity. One of the leaders in this movement was the California Public Employees' Retirement System (CalPERS). The new system seemed to work pretty well from 2000 to 2010, but for the last decade institutions have tried various tweaks to the endowment model to attempt to generate at least a reasonable return compared to the US S&P 500 benchmark return, which has been spectacular. In June 2020, the new chief investment officer for CalPERS announced the latest iteration.² The two-pronged approach that he outlined will focus on "better assets" and "more assets."



“New investment thinking in the US ‘rolls the dice for the next ten years.’”

“Woodstock focuses on growth investment.”

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“Better assets” mean private equities, which are described as having the potential for higher returns and lower volatility than publicly traded assets. As we’ve discussed before in these pages, there is too much money chasing too few good private equity deals. Since they rarely trade, volatility is low, but as we’ve also discussed, volatility doesn’t equal risk. The trading that does occur tends to be between private equity investors themselves for those companies that will never go public, thus sheltering their real valuations from public view.

“More assets” refers to the use of leverage, or borrowing against the assets to increase returns. The best comment on this aspect of the new CalPERS strategy came in a letter to the WSJ editor a week later: “Leverage in a public pension plan? What could possibly go wrong?”³

So here we sit. The whole rest of the world hasn’t been able to get out of its own way for 80 years. New investment thinking in the US “rolls the dice for the next ten years,”⁴ another letter to the WSJ editor commented.

There is a perfectly good investment system that has doubled its investment dollars over the last seven years and may double again over the next decade, provided all this “smart money” never figures it out. We’re there and you’re there. Let’s enjoy the ride.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

We thank you for your support and want you to know that we are dedicated to serving your best interest.



¹ WSJ, James Mackintosh, “Coronavirus Can’t Stop America’s Best Stocks” 4/22/20.

² WSJ, Ben Meng, “CalPERS Preparing for the Long Haul,” 6/15/20.

³ WSJ, 6/22/20.

⁴ WSJ, 6/22/20



One Part of Growth Investing

William H. Darling, Chairman & CEO

Adrian G. Davies, President

Sometimes investment professionals offer this rather generic description of how they work: “we’re not market timers.” The kernel of truth is that it is very hard to make two good decisions regarding first, when to get out of the market and then second, when to get back in. Some stocks in the growth category are secular growth stocks, where “innovation can carry companies to growth almost independently of the economic or business cycle.”¹ On the other hand, value stocks, besides needing those two above-mentioned good decisions, “need an economic outlook conceptual framework over a multi-year forward time period to begin positing economic growth.”²

When Woodstock assumed registered investment advisor status in the 1970s, the company managers at that time viewed their own investment history of trying to make these two good timing decisions and relatedly forecast a multi-year economic outlook. They decided to focus on growth investing. They hired people who love research and told them to put good companies with a growth bias into client portfolios. The company managers did not tell the investment manager which stocks to buy, just to find them. We have satisfied clients over that whole time period and made some clients very happy recently. If this article stirred up any questions about your portfolio, please contact your portfolio manager.



¹ Tom Stakem Memo, 7/15/20.

² Tom Stakem Memo, 7/15/20.



“The National Bureau of Economic Research declared that the country entered a recession in February.”

“We’ve fallen into an economic hole 15 feet deep, and now we’ve climbed 5 feet up from the bottom.”

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What Will the Recovery Look Like?

Adrian G. Davies, President

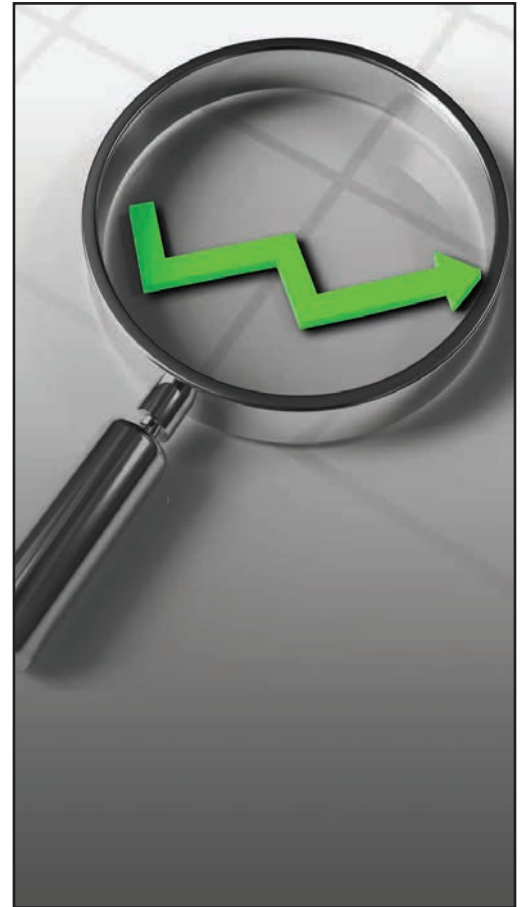
The S&P 500 Index performed a most spectacular “V” in the first half of 2020, first falling 33.9% through its March 23rd low, then rallying 38.6% through mid-year. This performance included the steepest plunge and the fastest rally in 90 years.¹ The wild ride left the market still down 8.4% from its February all-time high and down 4% from the beginning of the year. The index returned 20% in the second quarter. Stocks rallied, anticipating a treatment for COVID-19 and an economic recovery turbocharged by both fiscal and monetary stimulus.

An Economic Blow Like No Other

The National Bureau of Economic Research declared that the country entered a recession in February. US real GDP fell at a 5% annualized rate in the first quarter, and it looks to be down at a 35% annualized rate in the second quarter. Changes in GDP are typically magnified because they are calculated as quarter-over-quarter changes presented as annualized rates, but the economic decline could well be the swiftest in the nation’s history.

Mirroring the sharp fall and rise of the market, the economy has been rebounding in rapid fashion. The US economy added 2.7 million jobs in May, and another 4.8 million in June with shelter-in-place orders lifting and businesses reopening. The unemployment rate stood at 11.1% at the end of June, down from a peak of 14.7% in April. Many furloughed workers were recalled to their jobs. Even with the unemployment rate coming down, the economy still employs 14.7 million fewer workers than in January.² For comparison, unemployment peaked at 10% during the Great Recession, and during the 11 years since, the economy added 22.5 million jobs.

The economy is now expanding month-over-month, as reflected in a consensus forecast for 20% annualized quarter-over-quarter GDP growth for the third quarter. Even so, third-quarter economic activity looks to be down 6.7% over the same quarter a year ago. The worst year-over-year decline of the 2008-2009 recession was 3.9% (in Q1 2009).



We’ve fallen into an economic hole 15 feet deep, and now we’ve climbed 5 feet up from the bottom.

On a day-to-day basis, the stock market rises when there’s positive news of COVID-19 treatments, and falls when there’s news about continued spread of the disease. Investors understand that the direction of this market depends most critically on the development of a vaccine, as we can’t be fully confident about returning to our prior activities until we are immune. With over 140 efforts underway around the world to develop treatments, including 18 in human trials,³ we are confident that a vaccine will be developed, but both the timing and efficacy remain unknowns at this time.

¹ Sarah Ponczek, “History Is a Nightmare From Which Stock Pundits Refuse to Awake,” *Bloomberg Markets*, 7/7/20.

² Total nonfarm payrolls. Source: St. Louis Federal Reserve data series.

³ Dr. Hassel Lee, “Coronavirus vaccine developers to launch phase 3 studies in US,” *abcnews.go.com*, 7/4/2020.

Unemployment Rate Since 2000



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A Slower Grind from Here...

People are travelling much less, and most activities involving crowds have been cancelled. Business offices in Massachusetts, for example, are not allowed to operate at more than 50% of capacity. Public transportation is one bottleneck. Schools and what to do with children are another. Restaurants may or may not be operating at 50% of capacity, helped during the summer months by outdoor seating. It's hard to see these restrictions improving until better treatments for COVID-19 can be found.

The longer we endure this period of waiting for a vaccine, with an economy hobbled by the pandemic and by social distancing measures, the greater the economic fallout and therefore the longer it will take after a vaccine is distributed for the economy to recover. To the extent that many small businesses are operating at 50% of capacity, their cash flows are severely curtailed. Despite the government's best intentions to help, many small businesses were left out or did not receive anywhere near the amount of Payroll Protection Program funds they will need to carry them through this difficult period. Karen Mills, a former head of the Small Business Administration, expected that 20%-30% of small businesses won't reopen.⁴ Larger companies like Brooks Brothers, Neiman Marcus, J.C. Penney, Chesapeake Energy, 24 Hour Fitness, GNC, Sur La Table, and Hertz have declared bankruptcy. Others are likely to follow.

Consumer spending has been supported at least in part by government largess. As part of the CARES Act, people earning less than \$75,000 received one-time \$1,200 stimulus checks. The unemployed have received supplemental unemployment benefits worth \$600 per week (\$2,400 per month). More than two-thirds of beneficiaries are receiving more in unemployment compensation than they received while working. One fifth have doubled their income.⁵ Rushing to put the CARES Act into effect, Congress put few limits on their stimulus plan. According to the Congressional Budget Office, extending the benefits through December 31 would mean 5 out of every 6 claimants would make more money from unemployment insurance than if they returned to the workforce.⁶ With these benefits due to expire by the end of July, it seems likely that Congress will extend federal benefits, albeit at a lower level. At the same time, unemployment insurance is fraught with fraudulent claims, requiring completely overwhelmed unemployment offices to be exceedingly cautious even of legitimate claimants.⁷

⁴ "P&L with Paul Sweeney and Lisa Abramowicz" (Podcast), Bloomberg Markets, 6/10/20.

⁵ Meghan Roos, "Two-thirds of jobless workers make more in unemployment than they did at work," Newsweek, 6/15/20.

⁶ Letter to the Honorable Charles Grassley, "Re: Economic Effects of Additional Unemployment Benefits of \$600 per Week," Congressional Budget Office, 6/4/20.

⁷ Asher Klein, "Mass. Finds Over 58,000 Fake Unemployment Claims," NBC Boston News, Sarah Chaney.

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“A second wave of the pandemic this coming winter is more than a mere possibility.”

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According to Mark Goldwein, Senior Vice President at the Committee for a Responsible Federal Budget, “we will have spent as much money in the first six months of this crisis as we did on stimulus over five years during the Great Recession.”⁸ The summation of four COVID-19 related stimulus laws passed by Congress in March and April amounted to an estimated \$2.7 trillion in additional spending. The Congressional Budget Office expects that 75% of the CARES Act funds will be spent before September.⁹ Across the four bills, 75% of the stimulus works out to about \$400 billion per month. With US GDP at about \$22 trillion before the pandemic, or \$1.8 trillion per month, the government is spending funds equivalent to about 22% of GDP over this five-month period. Clearly, this has gone a long way toward offsetting the economic collapse. Stimulus spending seems destined to fall off before a cure-inspired recovery will gain traction.

The CARES Act provided \$150 billion to state and local governments, but given the fall-off in tax revenue, it’s likely they will need more. Required to balance their budgets, states and municipal governments have already laid off almost 1.5 million employees,¹⁰ and without further stimulus that will continue.

In addition to the fiscal stimulus, the CARES Act and many state governments imposed eviction moratoriums, preventing landlords from evicting tenants behind on their rent. According to US Census data, “about 19% of renters were late or deferred their rent payments in May.”¹¹ Unless extended, most of these moratoriums will be lifted during the summer months, and the backlog of evictions will proceed. According to the COVID-19 Eviction Defense Project, about 20 million Americans are at risk of eviction by the end of September.¹² With many renters not paying, there is a domino effect whereby landlords’ ability to pay mortgages is similarly challenged, as is the ability of many unemployed homeowners. Government-imposed moratoriums on foreclosures are similarly about to expire. A reduction in government stimulus will cause still more people to stop paying their rents and mortgages. A wave of evictions and foreclosures could represent a few steps backwards in our efforts to climb out of the

hole we’re in. Lenders are also forbearing on student loans, auto loans, and credit cards. Even if these moratoriums and forbearance programs are extended, unpaid debts are accumulating. With so many loans in forbearance, it’s hard for the banks to tell who is creditworthy and who isn’t. They’ve tightened their lending standards.

A second wave of the pandemic this coming winter is more than a mere possibility. Previous coronavirus outbreaks, including SARS and MERS, have demonstrated seasonal tendencies. Seasonality is consistent with the idea that the disease is primarily transmitted through the respiratory system and therefore spreads most vigorously when people are in close proximity to each other – indoors. The disease may be spreading this summer most detrimentally in climates where people are staying indoors for air conditioning. Even if a vaccine is discovered before winter, manufacturing and distributing hundreds of millions of doses will still be an incredible challenge.

Monetary Frontier

Stocks fell in the first quarter as earnings expectations were cut. Valuations also fell as uncertainty increased and as anticipated demand for capital overwhelmed supply. To offset the declining availability of funds, the Federal Reserve launched unprecedented levels of monetary stimulus, and this has helped to stave off near-term economic decline. The Federal Reserve started expanding its balance sheet -- buying bonds -- last September to address problems in the “repo” market. Since January, they’ve expanded their balance sheet by \$2.86 trillion, from \$4.15 trillion to \$7.01 trillion as of June 24.¹³ That works out to \$571 billion per month. The most the Fed’s balance sheet increased over any six-month period during the Great Recession averaged

⁸ Ben Werschul, “There is no precedent: Record-breaking U.S. deficits are coming,” Yahoo Finance, 7/1/20.

⁹ Peter Orszag, “The U.S. Economy Will Need Stimulus Well Beyond July,” Bloomberg Opinion, 6/9/20.

¹⁰ Scott Cohn, “Cuts to basic services loom as Coronavirus ravages local economies and sends states into financial crisis,” cnbc.com, 7/7/2020.

¹¹ Associated Press, “Renters face financial cliff ahead as eviction moratorium ends July 25,” on Marketwatch.com, 7/8/20.

¹² Ibid.

¹³ US Federal Reserve, H.4.1 statistical release, Federalreserve.gov.



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\$227 billion per month.¹⁴ The Fed has expanded the types of securities they are willing to buy to include municipal bonds, bond exchange-traded funds, and investment-grade corporate bonds. We’ve written not infrequently about the effect that the Fed’s bond purchases have had on the stock market (see Quarterly Market Perspectives, Winter 2020). The Fed’s actions have lifted bond and stock prices, and are arguably the principal reason why the stock market has been ebullient in the face of such somber economic conditions.

To the Fed, the salutary effects of higher asset prices on the economy – enabling companies that need capital to obtain it – outweigh the risks. Near-term exigencies outweigh the longer-term implications, but the Fed’s actions engender at least two principal risks: generating too much inflation and creating an asset bubble. So far, the deflationary forces at work in the economy have been more powerful than the inflationary implications of the Fed’s bond buying. That was true throughout the recovery from the Great Recession. The Fed’s scaled-up efforts may prove out differently this time, but inflation is unlikely to be impactful in the intermediate term with so many still out of work. Furthermore, the Fed’s actions are creating excess bank reserves. For the monetary policy to create inflation, banks have to have enough confidence to lend against these reserves. It seems unlikely that banks will become confident enough to ramp up lending while pandemic-related economic fears remain pervasive. An effective vaccine and/or treatments for COVID-19 could trigger a sudden rush of economic activity, which could in turn unleash inflationary pressures. Rising inflation and interest rates could very well upset stock prices.

In the meantime, stock prices have been quite responsive to Fed policy. If Fed governors become uncomfortable with the altitude of stock prices, they may stop buying bonds. That doesn’t necessarily mean stocks will fall, but the tailwind would be taken away. The risk scenario is that the Fed continues its aggressive monetary policy and its bond buying generates a stock price bubble. Yes, most investors want stock prices to rise. The risk is not so much that stocks rise, but the likelihood

that a swift and damaging correction would ensue. This is a challenge the Fed is deferring to another day.

Market Internals

The novel coronavirus looks to be something we will have to live with for an extended period, with social distancing measures continuing to limit economic activity. Given the hurdles ahead, we shouldn’t assume either GDP or corporate earnings will continue to rebound rapidly to their prior levels. Stocks are likely to react positively to news of COVID-19 treatments. Even once a vaccine is widely distributed however, it will take time for the economic wounds to heal.

Fed priming has encouraged investors to see through 2020’s depressed earnings to consider what earnings and valuations will look like in a more normal economic environment. S&P 500 Index constituent earnings are expected to decline 22% for the full year, including a partial recovery in the second half, according to FactSet. The index ended the quarter trading at a rather expensive 24.5x 2020 estimates, and 19.0x next year’s very difficult-to-predict earnings. The 2021 earnings consensus forecast happens to be comparable to what index constituents earned in 2019. Stock prices may be justified anticipating an earnings recovery, but the market’s price-to-earnings multiple remains on the high side even then, and the pace of recovery remains in doubt. Investors may still be forced to temper their expectations, with GDP and earnings taking two to three years to recover to their prior levels. The US presidential election and US-China relations are two X-factors which could further complicate the path to recovery.

Although the Fed’s fire hose of liquidity is driving both stock and bond prices higher, its forces aren’t distributed evenly. The effects are unevenly distributed across the economy more broadly – and that’s also true among stocks. Large capitalization technology stocks have continued to do well. Some market commentators have compared this favored group of stocks to the era of the Nifty Fifty stocks in the late 1960s and early 1970s. So far this

¹⁴ For the six months to December 10, 2008. Total Federal Reserve assets, St. Louis Federal Reserve data series.



“When we are freed from our COVID-19 fears, the more economically sensitive stocks are likely to rebound the most.”

“...clients are best served by focusing on high-quality stocks of companies that can maneuver through whatever economic conditions arise to improve their own market positions.”



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year, the five largest companies in the S&P 500 Index by market capitalization – all technology stocks -- were all up in the first half of the year while the index overall was down 4 percent. In the first half of this year, Apple was up 24.9%; Microsoft was up 29.1%; Amazon was up 49.3%; Alphabet was up 5.8%; and Facebook was up 10.6 percent. Three of these companies now have market capitalizations over \$1 trillion (Apple, \$1.58 trillion; Microsoft, \$1.54 trillion; and Amazon, \$1.38 trillion). Since the S&P 500 Index is weighted by market capitalization, these names have been driving the index higher. Excluding these five largest companies, which account for an estimated 22% of the S&P 500's entire market capitalization, the index would have been down about 8% year-to-date (Woodstock estimates). The five largest stocks are more expensive than where they have traded historically and they have lifted the market's overall price-to-earnings ratio. To be sure, sheltering in place has advantaged these stocks over others, accelerating technological adoption trends.

There are other technology highflyers and speculative names that have far exceeded the five largest technology names both in capital appreciation and in achieving very high valuations, but most other stocks have participated much less in the current rally. When we are freed from our COVID-19 fears, the more economically sensitive stocks are likely to rebound the most.

Woodstock's Approach

For the sake of managing through the Federal Reserve's continued involvement in the markets and preparing for whatever comes next, we believe it is important to hold a diversity of stocks, including those that have underperformed during the market's V-shaped recovery. Even if the market capitalization-weighted index struggles to make further headway in the near term, the stock market still presents many opportunities which we endeavor to find for you.

We know that over the long term the market has gone up, if not steadily, then in unpredictable fits and starts. As discussed in the accompanying article *One Part of Growth Investing* (see page 2), jumping in and out of the market – market timing -- is a treacherous business. Not knowing what the short term will bring, we believe clients are best served by focusing on the long term. We further believe that clients are best served by focusing on high-quality stocks of companies that can maneuver through whatever economic conditions arise to improve their own market positions. Clients can have confidence holding high-quality stocks through the worst of market conditions, keeping portfolio turnover low, and assuring they will be well positioned for the next bull market. Our low portfolio turnover approach further serves to be tax efficient, so clients keep more of the returns generated by their portfolios. These core tenets of our investment philosophy have served clients well through the harrowing “V”-shaped market plunge and recovery, and we are confident they will continue to do so.





Tax Update

William H. Darling, CPA – Chairman & CEO
Jeanne M. FitzGerald, CPA – Tax Manager

Remote Work and “Domicile”

If you and your family are handling estate tax planning by living in a low-tax state, then you’re familiar with “domicile,” the determination of a taxpayer’s true “home.” If your business operates in more than one state, then you are familiar with the term “nexus,” which can trigger state taxes depending on an evaluation of sales, physical location of offices, or even location of employees (“payroll”).

Now comes the pandemic with workers choosing or being forced to work remotely. Over two dozen states have announced that they expect workers and their employers to follow their states’ rules on domicile and nexus.¹ As a Wall Street Journal article points out, “these rules are famous for taxing out-of-state entertainers and professional athletes.” The most aggressive states shouldn’t be a surprise: New York and California. Because every state has a slightly different approach, the suggestion is to first understand what the rules are for the situation you’re in, then coordinate, if possible, with your employer to get the paperwork correctly done.

Intra-Family Loans: Tread Carefully

On another matter, we’ve had a recent request from a client concerning intra-family loans. The request was actually about helping a family member with a personal financial transaction. Of course, the first step is to make sure to do no harm. An offer of financial support into an angry situation or to someone irresponsible with funds might not be a good idea. Once you are satisfied on that score, then funds can be gifted or loaned. Gifting re-



lates generally with estate and gift planning, now unified. Loans take a great variety of forms, with varying security and payment terms. From a tax point of view, the interest rate and documentation are key. Another Wall Street Journal article pointed out that the IRS-mandated rates of interest on intra-family loans for both long-term and short-term loans are now at their lowest levels in many, many years: 1.15% and .25%, respectively.² Creating documentation covering the term, repayment schedule, and other provisions, as well as charging at least the mandated rate, makes the loan real.

The main point is that gifting, loaning or a combination of the two can be designed to meet a variety of goals.

If you or any of your other advisors have questions about the issues raised here, please contact your investment manager or one of us.

¹ WSJ, Laura Saunders, “Remote Working From a Different State?” 5/30-31/20.

² WSJ, Laura Saunders, “Thinking About Lending Money to Family?” 5/9-10/20.

“Over two dozen states have announced that they expect workers and their employers to follow their states’ rules on domicile and nexus.”

“...gifting, loaning or a combination of the two can be designed to meet a variety of goals.”



Your ideas and questions are important to us. What would you like to see in our Quarterly Market Perspectives? Please contact your portfolio manager, or anyone from Woodstock’s team of professionals, and let us know.

We want to hear from you!

If you’re new to Woodstock, you can reach us at info@woodstockcorp.com.