Bell
Institutional Investment Management

EQUITY & FIXED INCOME OUTLOOK SEPTEMBER 2020

From record high, to 35% sell-off, to record high again – in a matter of six months. Yes, this is a recap of the S&P 500 from February 19 to August 19, 2020. Since 1945, 35% of U.S. market corrections have had a recovery period averaging 42 months. Not this one.

As it currently stands, about 15 million people who previously had jobs remain jobless. Personal consumption expenditures are about $700 million below the February peak. The most recent gross domestic product (GDP) reading as of June 30 sat $2.1 trillion below the March 30, 2020, level. Consumption that did occur was supported by stimulus checks, federal supplemental unemployment payments and the Payroll Protection Program (PPP). These programs ran up $3 trillion in additional federal debt, and it looks like more is on the way between now and the end of the year. This is not exactly the framework I imagined supporting record-high stock market levels.

"Economy" vs. "Markets"

Why is the market doing so well? From my professional perspective – as an expert reporting on past events! – the $3 trillion added to the economy via federal fiscal programs, plus nearly $3 trillion in monetary policy additions by the Federal Reserve, resulted in a combined stimulus of $6 trillion. In the simplest form, the intended goal was, indeed, to stimulate the economy. However, U.S. GDP actually declined – and is not even expected to fully recover by the next reporting date at the end of the third quarter.

If we turn our focus away from the economy as a whole and toward the stock market, we find something materially different. The market cap (total market value) of the S&P 500 went from $25.4 trillion at the end of February to $30.2 trillion at the end of August. Coincidence? No. Instead of stimulating the economy, those federal programs stimulated the markets.

How long will this last? Here's the bad news: Neither I nor anyone who claims to predict the future has had any sustainable success in doing so. That's a fancy way of saying that future expectations are little better than complete guesses. Today, the Fed is committed to keeping interest rates low for an extended period of time to support the economy (we now know "economy" is really the code word for "market"), while Congress claims to be working its way toward another round of fiscal stimulus. ("Working" may be optimistic; "bickering and blaming," in my opinion, would be more accurate.)

This suggests that market optimism can extend further. In modern times, we recall, valuations were a bit higher back in the tech-stock bubble of the early 2000s. This was on the heels of the Fed injecting a lot of cash to deal with the perceived potential threat of Y2K.

Passive Investing

Now for an additional concept – perhaps beyond the scope of this monthly update, but a very important topic. Prior to about 10 years ago, "passive investing" was a niche approach to investing that let investors ride for free on the coattails of active managers, who bought and sold stocks based on an company's underlying earning and growth prospects. Today, passive investing is the dominant approach to the market, blurring any effect an active manager might have in valuing a stock based on its underlying fundamentals.

To better understand the noticeable portion of dollars now entering the market through passive investing, imagine air blown into a balloon: As the air goes in, the balloon expands, while its latex shell gets thinner and thinner. Today, it is no longer active management that moves the value of stocks, but the flow of passive money. What has changed in the world of passive investing is that it is no longer deteriorating individual stock valuations that lead up to a market sell-off. Instead, it's the money that simply quits flowing in – or rather, starts flowing out of the market (like air being let out of a balloon) – that determines whether the market rises or falls.

As the table shows, the market is also very concentrated at the top, because the S&P 500 is a capitalization-weighted index. For every $1,000 of passive money that comes into the stock market, $72.60 goes into Apple, $59.00 goes into Microsoft, $49.90 goes into Amazon, $24.30 goes into Facebook, and $33.40 goes into the combined Google entity. The remaining $760.80 is shared among the other 495 stocks. Add corporate share buy-backs on top of that, and the number of shares in the universe declines.

Name	% Weighting in S&P 500	YTD Return	Contribution to S&P 500
S&P 500 (SPY)		9.74%	
Microsoft (MSFT)	5.90%	44.15%	2.60%
Apple (AAPL)	7.26%	76.99%	5.59%
Amazon (AMZN)	4.99%	86.76%	4.33%
Facebook (FB)	2.43%	42.85%	1.04%
Alphabet A (GOOGL)	1.69%	21.66%	0.37%
Alphabet C (GOOG)	1.65%	22.23%	0.37%
	23.92%		**14.30%**
S&P 500 return YTD without the top 5			**-4.56%**

Calculation data from Bloomberg for August 31, 2020, returns.

In short, the balloon's latex is getting thinner and thinner. Its bursting point will occur when passive investors decide overall market valuations are not worth the risk – whenever that might be.

Of course, there are passive-investment "superpowers" that can provide reams of researched white papers on why everything I've just said about passive investing's dominance of the market landscape is inaccurate. These papers remind me of an old joke: Analysts use statistics like a drunkard uses a lamppost – more for support than illumination.

Greg Sweeney, CFA
SVP/Chief Investment Officer

Tenure: 09/1992

Years of Investment Experience:
35 years

Education: Greg holds a bachelor's degree in business from the University of North Dakota and is a CFA charter holder.

bell.bank Not FDIC insured | May lose value | Not financial institution guaranteed | Not a deposit | Not insured by any federal government agency

0-27859