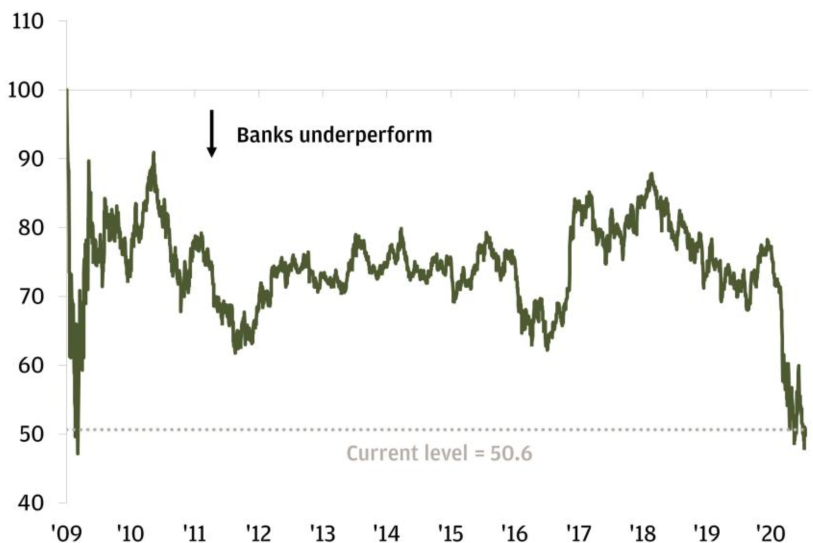
3 Reasons Why the Stock Market Has Shrugged Off the COVID Surge

Market Update
A Mixed Bag

The S&P 500 has been flirting with the top end of its month-long trading range, which also happens to be the level around which we started the year (3,230). The market's rise has been enabled by the surprisingly quick pace of the economic recovery so far, but it seems unlikely that the same pace can hold given the surge in new COVID-19 infections. Nonetheless, from an economic perspective, we continue to believe the worst is behind us and that the recovery will continue – just at a slower clip.

As for the market, it seems like there would need to be another meaningful catalyst (e.g., a surprisingly large fiscal package or medical breakthrough on the upside, or a tragic spike in deaths or second wave in New York City to the downside) to break stocks out of their trading range. The newsworthy data we got this week exemplifies a bit of a mixed bag:

- Scoreboard: the first full week of Q2 earnings results. Of the 42 S&P 500 companies that have reported results through Thursday night, ~74% of them have beaten consensus earnings per share expectations. That's not saying much given how low expectations have been set (on the whole, the index is expected to see Q2 EPS drop by more than 40% year-over-year), but it's obviously better than the alternative. Among the early reporters was Netflix, which managed to add another 10.2 million subscribers in Q2 (bringing year-to-date new subscribers to ~26 million, just 2 million shy of the total added in the entirety of 2019). Nonetheless, the streaming company was one of the companies that missed EPS expectations ($1.59 vs. $1.82 expected). Banks, on the other hand, mostly surpassed EPS expectations. Speaking of…
- Banks have prepared as if we're headed for a credit Armageddon. Six of America's biggest banks collectively marked more than $35 billion for anticipated loan losses in the second quarter (after doing so to the tune of $25 billion in the first quarter). Said another way, banks think there could be a wave of corporate and household defaults on the horizon. Our interpretation is that they're being realistic about the risks; they're prepared and bracing for impact. Markets are reacting in a similarly rational fashion. Relative to the broad S&P 500, Bank industry stock performance is where it was at the depths of the Global Financial Crisis.



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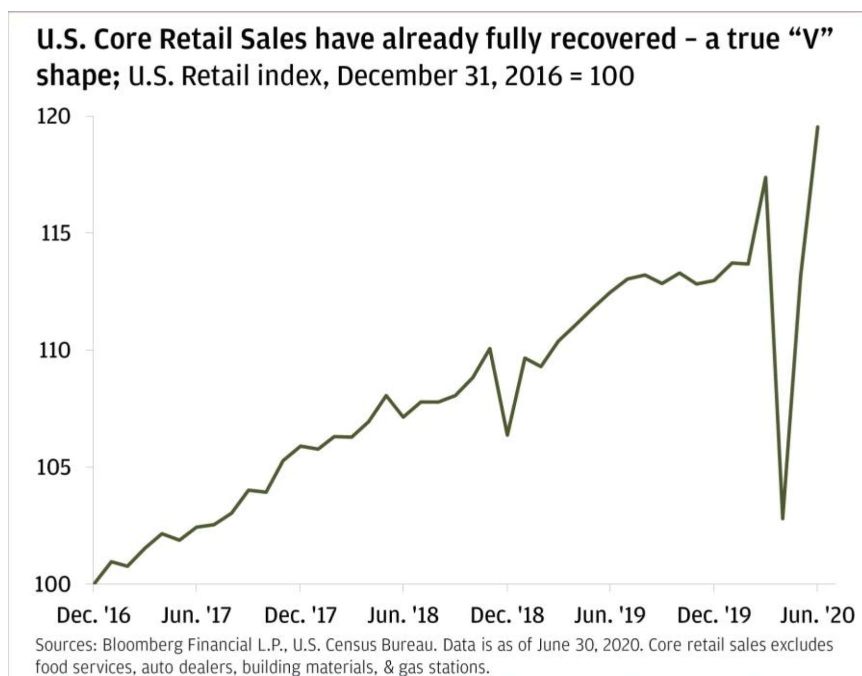
- U.S. jobless claims are still declining, but not as quickly. This week's jobless claims data showed that 1.3 million individuals filed initial claims for unemployment insurance. That's less than last week's 1.31 million and represents the 15th consecutive week of declines (a good thing), although it represents a smaller drop versus recent weeks. Along with the economy more broadly, we think the labor market recovery will continue, even if at a slower pace.

There are obvious challenges and risks facing the economic recovery. Add to them that the United States is nowhere close to containing COVID-19, and the bear's growl gets louder. Still, the S&P 500 headed into Friday up +1.3% on the week. How do we make sense of that?

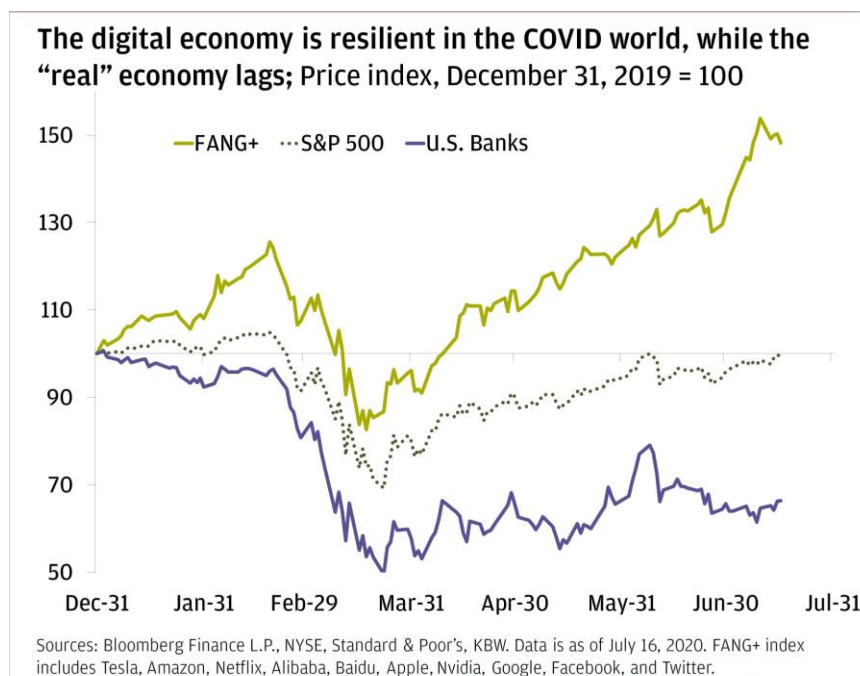
Spotlight
3 reasons why the stock market has shrugged off the COVID surge

Markets seem relatively unfazed by the resurgence of new cases. Since the beginning of June, new COVID-19 cases in the United States have reached new daily highs 11 times. Still, the tech-heavy NASDAQ 100 Index has notched 12 of its own new all-time highs, and the S&P 500 is trading near the highest levels of the COVID crisis era. We see three main reasons why.

1. Despite the surge in cases, the rebound in economic activity has been impressive. Many investors questioned the disconnect between the stock market and the economy, but that argument is becoming harder to make. Production and non-supervisory payrolls declined by around 20 million workers in March and April, but since, the economy has added back almost 7 million jobs. "Control" Retail Sales (which excludes restaurants and autos, among others) have already rebounded past pre-COVID shutdown levels. Indeed, the economic surprise index, which measures the degree to which economic data are beating expectations, has never been higher. To be sure, there are signs of a slowdown in activity in states with more severe current COVID outbreaks (Like Texas, Arizona, Florida, and South Carolina), but there is no indication that economic activity will revert to the early April nadir.



2. **The virus surge is accelerating the adoption of digital technologies.** And the market is taking notice. The production of enterprise software and other information processing technology has almost reached its February levels, and is growing in year-on year terms. Since the beginning of June, popular "stay-at-home" stocks like Peloton, Shopify, and Netflix have all handily outperformed broader markets. Over the same time period, the five largest companies in the S&P 500 (Apple, Microsoft, Amazon, Alphabet, and Facebook; also known as FAAMG) have added $765 billion (!) in market capitalization. That's more than the entire market value of the S&P 500 Energy sector. Meanwhile, companies that are exposed to the tangible economy (e.g. physical interaction, travel, lending to small and medium-sized businesses) have flat-lined.



3. **Markets are going to get over this someday, so they might as well get over it now.** [1] Let's be clear: COVID-19 is a horrific disease that has caused over 500,000 deaths globally and it continues to spread not only in the United States but around the world. But markets are always looking forward. Europe and Asia have been able to contain the virus, which suggests that it is possible to do (if there is individual and political willingness). There is also optimism surrounding an eventual medical solution. Most health experts seem to believe now that treatment and a vaccine are questions of "when" and not "if." Either would present a clean resolution to the current problem. Just this week, we got positive news on two separate vaccine candidates. Finally, the current employment and inflation situation in the United States is unacceptable to the Federal Reserve. They are mandated to ensure full employment and stable prices, and they are highly likely to continue to support the economic recovery until they fulfill their mandate.

Serious investment risks remain. The most concerning to us would be if Congress fails to pass another round of fiscal support that extends unemployment insurance and provides funds for state and local governments. To illustrate how important government support is, personal incomes actually grew during April and May. In most recessions, the opposite occurs.

Clearly, there's a bumpy ride ahead. While the United States and the rest of the world work toward an eventual resolution to this historic coronavirus pandemic, we are staying focused on our key investment themes:

- Navigating volatility
- Finding yield
- Investing in the durable trends that will drive the recovery

Find more insights on our Key Themes here.

[1] Thanks to Logan Ledger for the inspiration. One of my favorite artists I found during quarantine.

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