"There are decades where nothing happens; and there are weeks where decades happen." - Vladimir Lenin

The words of this foremost communist revolutionary seem entirely appropriate in describing the events that have driven – and continue to drive – the capital markets in 2020.

The unemployment rate unexpectedly fell to 13.3% in May, as non-farm payrolls increased by 2.5-million following a 20.7-million decline in April. It is known that some misclassified data made the report look better than it actually was, but it nevertheless represents a stunning turnaround, as no one in the Bloomberg survey had forecast improvement of any amount in either number. The consensus was that the economy would shed an additional 7.5-million jobs, and unemployment would rise to 19%.

More good news has come with reports that personal incomes have actually risen during the economic shutdown, as government stimulus measures were more than enough to offset job losses during this period. When combined with record declines in household spending, the result is a savings rate that is above the previous highs seen during World War II. Pent up demand following months of quarantine, growing money supply, and an improving labor market are necessary requisites for an economic rebound that may come earlier and with more force than many had feared, including us.

There are other, scattered indicators of better times ahead.

Jamie Dimon, Chairman & CEO of JPMorgan Chase, said that one-third of their customers who had requested forbearance on their home loans had not used it. He indicated that his bank would likely need to increase its loan loss reserves in the current quarter by no more than in the first quarter, and possibly not at all in subsequent quarters.

Toll Brothers, a major home builder, reported that deposits for new homes were up 13% over the three week period ending May 27th, versus the same period last year. Construction is critical in getting the economy back on track, and is also one of the first industries to be allowed to resume operating as states implement their re-opening plans.

Manufacturers are beginning to report an increase in new orders. The Kansas City Fed has released data showing that incoming orders in May were 7% above last year's level, after having declined by as much as 35% in March.

Assuming that the economy does, in fact, rebound faster and more strongly than originally expected, we would caution that the overall level of risk remains elevated. Earnings estimates have plummeted as stock prices have moved higher, resulting in an historically high P/E multiple of 22 times forward 12 months earnings. The market is not in a good place technically, as well. While the S&P 500's rise of 43% from its March low is impressive, fewer than half of all stocks are currently trading above their 200-day moving averages. Institutional investors are increasingly chasing returns in the stocks of the largest companies, as evidenced by the fact that the five largest stocks in the S&P 500 are up 15% year-to-date, while the remaining 495 stocks are down 8%. Similarly, a portfolio of the 50 most expensive stocks at the beginning of the year, with a forward P/E of 33X at the time, is up an average of 9% this year. Over the same time, a portfolio of the 50 cheapest stocks, with a forward P/E of less than

9X, is down more than 22%. In other words, this has been a very narrow rally, and most investors have experienced results that have lagged the major market averages.

Beyond a rich overall market valuation and disturbing technical trends, fundamental challenges remain as the economy tries to re-open.

Tensions with China are growing again, a story that would be dominating news headlines were it not for Covid-19 and the civil unrest we are experiencing. The country is getting into full election mode, and a nasty campaign is likely to cause more market volatility than would normally be the case. The future spread of the virus remains unknown as states begin to re-open, though the President has vowed that the economy would not be shut down again in the event of major outbreaks.

Longer term, while the Fed has indicated that its ability to act is essentially unlimited, there is growing reluctance in Congress to further stimulus measures, should they be needed. An extraordinary circumstance elicited an extraordinary policy response, but a period of austerity will inevitably be necessary as the economy returns to normal. But that can remain next year's concern.

It's been said that the stock market exists to make us look foolish. That's because the market is forward looking, while we tend to look backward. Stock prices fell by one-third before the economy shut down. Then, while all of the bad news was backward looking, equities rose because the Treasury and the Fed were pumping trillions of dollars into the economy and scientists were reporting progress in their labs. The stock market will return to its pre-Covid level far sooner than the economy will, though most lack the fortitude to act on that assumption.

We can be reasonably encouraged by recent reports, while remaining mindful of the pitfalls that remain. We reduced our market exposure significantly early in the crisis, and have since experienced a level of appreciation that has brought our equity exposure back closer to normal. Normally, a 40% rise in the market in such a short period would have us looking for the exits, but this is not a normal time. The narrowness of this rally, which we noted earlier, is a bad omen near term. But it also means that there are opportunities in the many sectors of the market that have lagged in this rally, or not participated at all. With the downside pretty well defined and the potential for upside surprises growing, it may soon be time to take advantage of those opportunities.

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