AF CAPITAL MANAGEMENT
Registered Investment Advisor

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This time might be different because the cause of the recession is different.

Perspectives

In my previous two quarterly newsletters, I was able to point out the obvious direction the market was likely to take. In January, stocks were overbought and I could not foresee a catalyst that would make the large downside risk worth the potentially small upside reward. I didn't see COVID-19 overwhelming the world at that point, but the analysis proved timely. In April, I could see we had reached a point of panic selling and stocks were oversold. I pointed out that those who rebalanced from bonds or cash into stocks could earn fantastic gains. The second quarter ended up being the best quarter for stocks in 20 years.

The easy predictions are now over. The economic fundamentals analysts use to make predictions are outdated by the time the data are released due to the quickly changing economy. The momentum that pushes stock prices in either direction shifts with very little changes to reality. We know three key points that have not changed: (1) COVID-19 continues to spread at an increasingly higher rate as businesses reopen; (2) the current unemployment stimulus efforts are scheduled to end later this month; and (3) many pharmaceutical companies are working on vaccines and treatments to prevent and reduce the severity of symptoms related to COVID-19.

We do not know the effect each of these points will have on earnings over the next year. Earnings are what ultimately drive stock prices. Businesses that can allow employees to work remotely can remain profitable. Businesses that require face-to-face interactions must open to keep the companies from shutting down permanently. Since their openings create opportunities for the virus to spread further, the overall counts increase and fewer people want to go out in public, which hurts the businesses for a longer period. This creates a lose-lose situation for restaurants, bars, theaters, cruise ships, amusement parks, gyms, airlines, sports venues, and many more. Even if these industries open with every safety precaution possible, the amount of revenue they can produce is capped at a much lower level than if they could operate at full capacity. The longer the virus persists, the more likely the companies that were struggling before this year will be forced out of business. This wave of closures has already begun.

The $600 per week addition to unemployment benefits that are part of the stimulus package are scheduled to end on the final weekend in July. We don't know if this will encourage those who are unemployed to go back to work or if, by then, the COVID-19 spread will be too large to risk infection. Even if those who are unemployed want to rejoin the workforce, will jobs be available for them? If not, how big of an impact will it be to landlords, mortgage lenders, and service providers who do not provide essential needs? Additionally, if schools and daycares do not open up full-time or remain open after infections begin to spread among teachers and staff, how do parents of younger children manage going to work with children at home?

Every week we see news reports on the progress of vaccines or therapeutics. None are scheduled to be in mass production in 2020, even if they make it through trials and work for more than six months. So far, remdesivir is the only drug treatment approved by the FDA. Last week, reports came out that Florida hospitals are running out of remdesivir, which could severely change the outcome for those who are hospitalized.

That brings us to the big question. Why do stock prices continue to climb if so much is unknown and a lot of what is known is getting worse? The answer is hope and greed. Investors hope things will change soon and want to have exposure to stocks during a recovery. The fear of missing out is a powerful emotion. We have been recovering from the worst of the shutdown for three months and the recent jobs report shows a further drop in unemployment, even if weekly initial jobless claims are rising at the same time.

In most business cycles, investing heavily in stocks when the economy shows the first signs of expanding again is a smart move. This time might be different because the cause of the recession is different, and the limit of expansion is set at a lower level than usual.

After falling more than 35% by late in the first quarter, stocks are now only 7% below their record highs as of Thursday’s close. That’s a gain of 43% from the intraday bottom hit just a few months ago. If the economy was where it was at the beginning of the year, this might be a fair valuation. A decline of 7% in the first quarter, without a pandemic, would have made the risk/reward balance more palatable. The difference is that the US economy is a slimmed down version of what it used to be. The reasonable price for stocks in January is irrelevant now. Investors need to focus on what the new reality is versus what they wish it were.

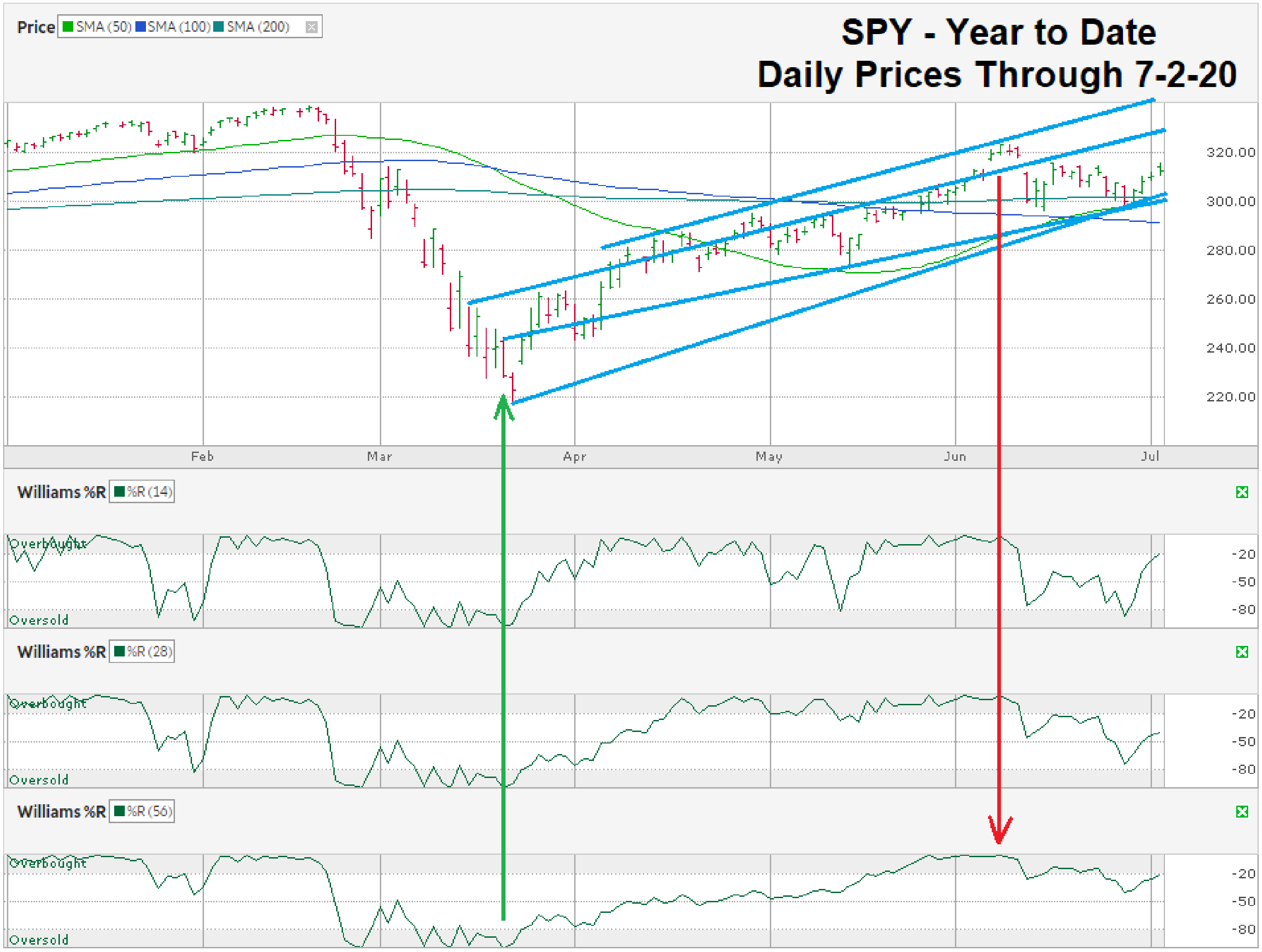
The reality is that most companies are earning less than they used to (forcing pay cuts and furloughs) and will earn less for many months to come. More and more consumers are going out to restaurants and retail stores, but entertainment, sports, and tourism industries have no path to reopening yet beyond what we can watch on television. With those industries being cut out of the national economy, almost in full, the current stock valuations are already ahead of themselves again. Selling stocks at this point might cause investors to miss out on near-term gains as we continue to overshoot historical valuations, but investing is more about balancing risks than capturing short-term rewards.

Summary of Indexes

Courtesy of Morningstar.com

Name	As of Date	YTD	1 Year	3 Years	5 Years
US Stock Indexes					
DJ Industrial Average	7/2/20	-9.50%	-3.58%	+6.55%	+7.81%
S&P 500	7/2/20	-3.12%	+5.28%	+8.90%	+8.55%
Small-Cap	7/2/20	-15.26%	-10.30%	-0.35%	+2.11%
S&P MidCap 400	7/2/20	-8.13%	-2.73%	+5.37%	+5.83%
NASDAQ Composite	7/2/20	+13.76%	+25.88%	+18.46%	+15.30%

Index Chart & Analysis



The above chart shows the daily prices for SPY, an ETF that tracks the S&P 500 Index, after closing the week at $312.23 on July 2, 2020. SPY is up more than 43% from its intraday low on March 23, but has struggled since hitting a three-month high on June 8, nearly a month ago.

The Williams %R technical indicator gave a false positive buy signal at the beginning of March, but was accurate on the second signal. This misleading signal is common when a stock or index falls deeply over a short period. In Wall Street's unique jargon, this is called a "dead cat bounce" and most market veterans know to look for it before buying.

On June 8, Williams %R gave the reverse signal and buyers backed off, but didn't completely abandon stocks again. Instead, they let prices correct a little before beginning the push higher last week. This pattern usually forms a second top that becomes a better selling point. As coincidence would have it, we are at the halfway point for two of the historically best weeks of the year on both sides of July 4.

Another week of positive movement for the large-cap index could drive prices close to the upper side of the ascending trading channel, shown in blue straight lines on the chart. After bouncing off of the trend lines of higher lows, the next area of resistance is more than 3% higher, with a possible extended ceiling more than 6% higher, closer to $330.

In my chart analysis last quarter, I said the small-cap index would act like a rubber band being pulled back to its 200-day moving average. This massive reversion to the mean is exactly what we saw in small and large-cap stocks. SPY is trading above its 200-day moving average now and the rubber band effect has lost its influence, but the 200-day moving average has continued to play an important role for technicians. Since trading above the 200-day moving average on April 27, SPY hasn't fallen below it since.

The key technical indicators to keep an eye on are: (1) another sell signal on the Williams %R indicator; (2) a retest of the trend line of higher highs; and (3) a break below the 200-day moving average, as a signal the easy money is over. Without clear trendlines to the downside, the next area of support, after a break in upward momentum, could be at the May 14 intraday low of $272.99.

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