New Albany
Investment Management

Market Insight

August 2020

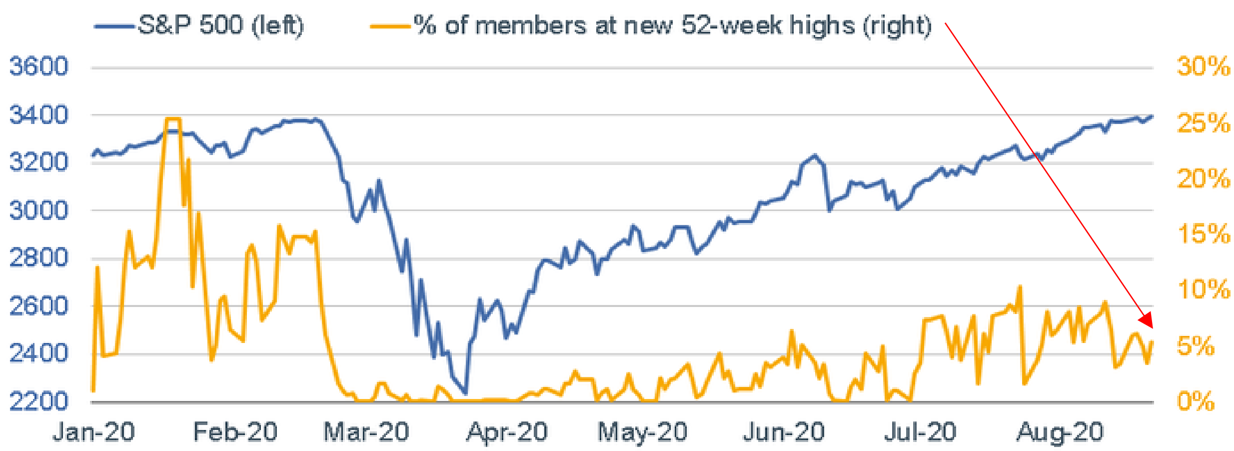
- **NASDAQ and S&P 500 Breaching New Highs**
- **Federal Reserve Announces Historic Shift in Inflation Goals**

New highs were made in the S&P 500 index August 18, 2020, officially ending the bear market that started on February 19, 2020. This is the fifth time in history where new highs were achieved during a recession. The massive downdraft in the market in the first quarter left investors looking at a -34% drop from peak to trough in only 33 days, setting records across the board. Since the 'official' low on March 23rd, the market has rocketed up dramatically,+51.5% rally off the lows in only 148 days – the fastest rebound ever following such a decline. Yes, on the surface the rebound is impressive, but it is very unimpressive when looking at market depth and breath. In other words, only a few mega and momentum stocks are carrying the entire index.

A look under the hood: Though the S&P 500 has 500 stocks, the index is weighted according to capitalization. Thus, a move in the largest companies has the biggest impact on the Index change. A deep dive into the individual holdings reveals a remarkable discovery: only a handful of Mega stocks are leading the charge. A few names probably come to mind: Apple, Amazon, Facebook, Google, Microsoft etc. Though they only represent 1% of the index, on a cap weighted basis they have grown to account for nearly 24% of the S&P 500 index. The chart below shows how the weighting of the top 5 stocks in the S&P has risen dramatically from about 16% in 2019 to over 24%.This is huge!

Source: Charles Schwab 8/21/2020

Narrow Market Participation at New Highs: Another way to look at the Index is by the number of stocks within the index making new highs. The chart below shows how ONLY about 5% of the stocks (Yellow line) in the index have made new highs. This means 95% of the stocks in the Index have NOT made new highs.



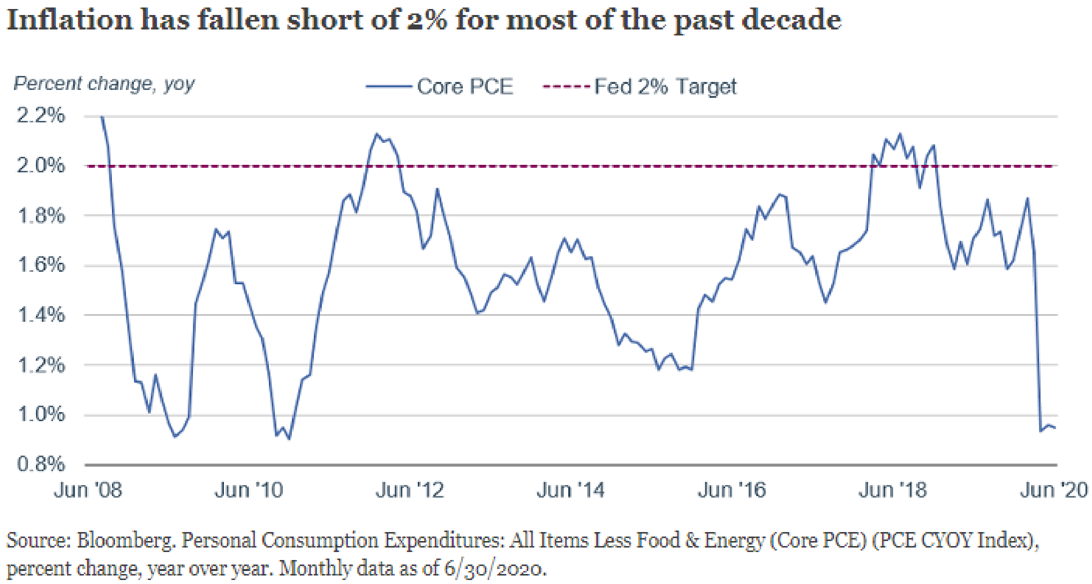
Source: Charles Schwab 8/21/2020

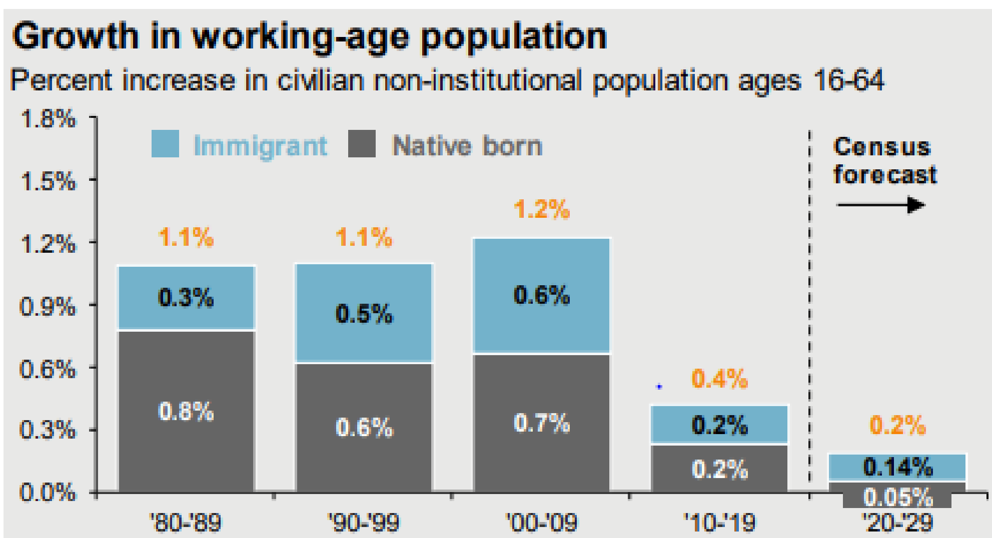
Concentration Risk: The result of these few Mega Cap stocks influencing the index has created an index with a large concentration risk. In other words, if one of these few big stocks were to stumble, it would put significant pressure on the entire index. This over concentration in just a few names in only a few sectors sets the stage for a potential rotation away from our current leaders, and perhaps on to more Value or Cyclical style of stocks.

Bottomline: It would not be surprising to see at least some sort of short-term consolidation/pause in these leading stocks, especially as we head into the final 9 weeks before the 2020 election.

Federal Reserve Policy Shift to Navigate the Next Decade: At the annual August Jackson Hole Fed Symposium, Chairman Powell outlined a new approach of targeting inflation from a precise target of 2% to an 'average' of 2%. This change may seem subtle, however it actually implies a potentially very different operating mandate for monetary policy. The announcement in policy shift is a public confirmation of what the Fed has been wrestling with for many years: inflation trending well below the 2% target and a decline in average GDP. In particular, growth has fallen from 4% at the beginning of this century, to 2.5% in the middle, to only 1.8% today. The reason for these shortfalls is due to two fundamental changes: enhanced technological advancements and an aging workforce population. The rapid and transformative technological changes have put downward pressure on inflation. At the same time, the aging population has put downward pressure on productivity and consumption (GDP).

The charts below show the Inflation rate since 2008 and the slowing growth rate of the working population.:

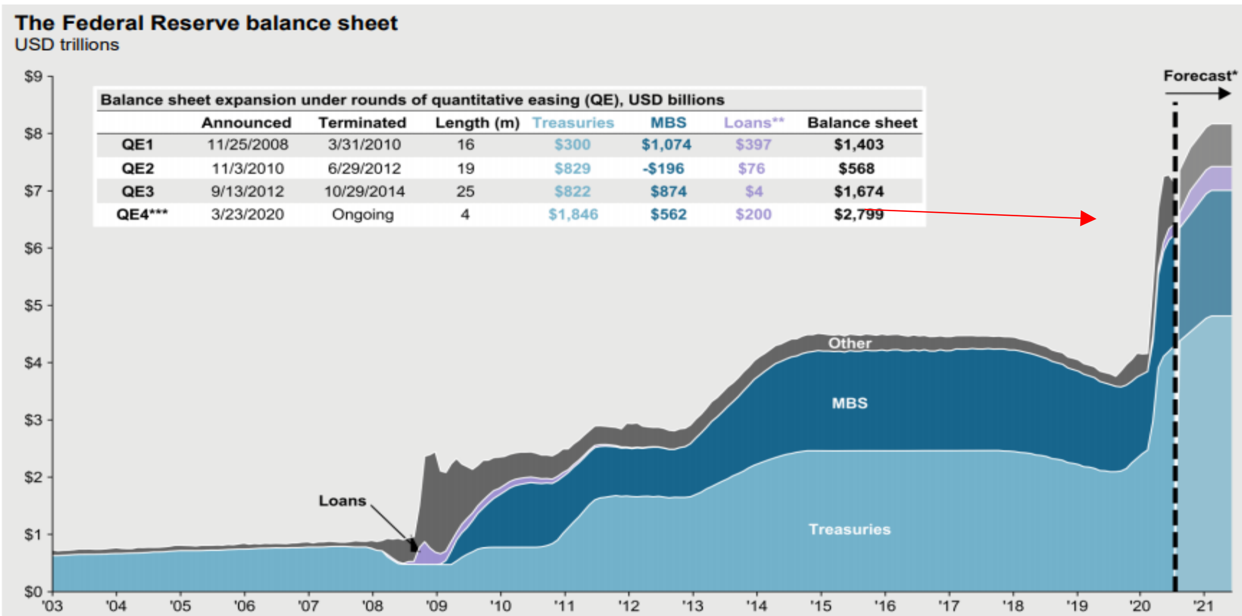




Source: JPMorgan Guide to Markets August 2020

<u>Fragile Economy</u>: The Fed is trying to create an environment that will allow inflation and GDP to increase. The policy change suggests the Fed will keep short term interest rates at zero for much longer (perhaps several years) and allow inflation to run above the 2% level for 'some' period of time until the economy is deemed strong enough to absorb the impact of higher interest rates. Though low rates can be incredibly supportive of financial assets like stocks and real estate and even hard assets like Gold, it also indicates the fragility of the economy. With growth so low, it will not take much to put the economy back into a recession.

$2.7 Trillion Elephant in the room: With interest rates back at zero, the main tool the Fed is using to stimulate growth and inflation is through buying bonds, otherwise known as Quantitative Easing (QE). Without the Fed's continual intervention, the capital markets would be significantly handicapped and economic growth would be much lower. In March the Fed launched another QE program, purchasing over $2.7 trillion in Corporate bonds, nearly 77% of the entire amount done between 2008-2012.



	Announced	Terminated	Length (m)	Treasuries	MBS	Loans**	Balance sheet
QE1	11/25/2008	3/31/2010	16	$300	$1,074	$397	$1,403
QE2	11/3/2010	6/29/2012	19	$829	-$196	$76	$568
QE3	9/13/2012	10/29/2014	25	$822	$874	$4	$1,674
QE4***	3/23/2020	Ongoing	4	$1,846	$562	$200	$2,799

Source: FactSet, Federal Reserve, J.P. Morgan Investment Bank, J.P. Morgan Asset Management.

Bottom Line: For now, zero interest rates and the ongoing huge stimulus programs will be very supportive for all of the capital markets, making a friendly environment for investing. Longer term, the question remains, can the economy grow without Fed support?

Investment Strategy: Risk exposure is targeted to the middle of established risk tolerance bands for each portfolio. Allocation in stocks remains primarily in those Growth sectors that continue to benefit from a dramatic shift in consumer and business spending due to the Covid-19 impact. Bond allocation is spread across both Investment Grade and High Yield areas of which the Federal Reserve continues to support. The portfolio strategy continues to benefit. Please contact me with any questions or concerns.

Best Regards,

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