July 31, 2020

Economy and Stock Market Disconnect

Coming off of the worst quarterly contraction of GDP in History (-9.9%) and record unemployment, many investors find it difficult to understand why stock prices of some companies continue to advance strongly while others have been decimated. (Note: Most media outlets reported the GDP decline as -33%, which is not the true drop but rather an annualized figure and quite misleading).

For example, Healthcare Software Company, Veeva Systems is up +87% this year while Berkshire Hathaway is down -14%.

Many spectators believe that markets appear to be ignoring the deep damage to employment by Covid and believe that this will ultimately impact earnings for most, if not all companies.

Will Amazon hire a sufficient number of drivers and warehouse workers to absorb the losses from 60% of restaurants that have announced they will not reopen?

Our Thoughts

New Jobs are being created to serve the stay at home, work from home, and entertain at home economy and over the next 24 to 36 months, will more than offset the jobs lost.

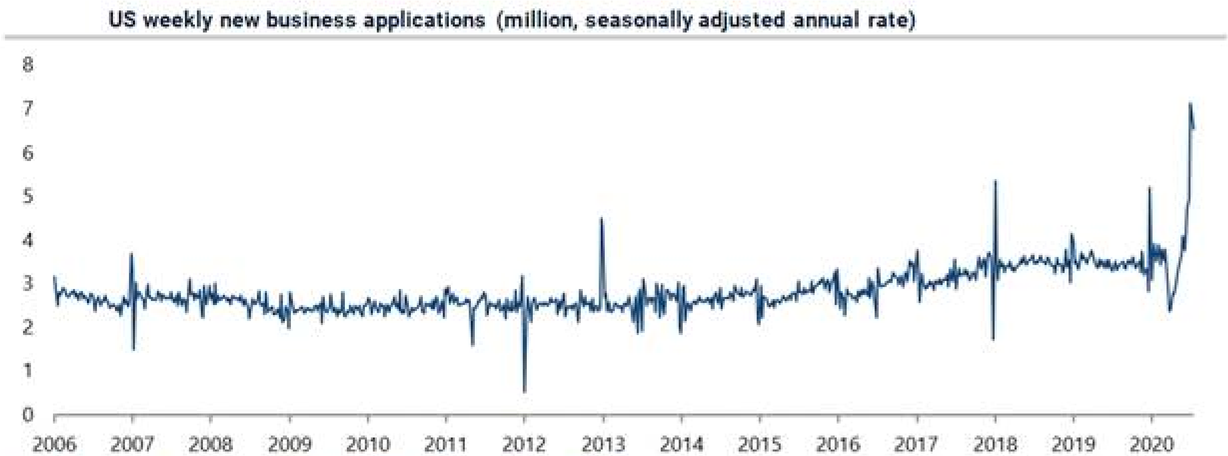
For example, suburban new home sales are the strongest they have been in over a decade as former city dwellers are now flocking in large numbers to surrounding suburbs to escape densely populated and overcrowded urban hot-spots.

Home improvement, home computing, e-commerce, and home entertainment will continue to thrive as we spend more time working, dining and entertaining remotely.

For example, Cadence Design, a design automation software company, is benefiting from exceptionally strong semiconductor demand for Data Centers (cloud computing), Laptops/PCs (work-from-home), and Video Gaming (high resolution chips). All of these themes reflect both the behavioral impact of Covid and long-term trends towards an increasingly digital society.

The Stock Market has, and will continue to reward companies in the right space that execute and will punish those in the wrong spot. The growth premium garnered by “disruptors” will increase as the chasm between the “haves” and “have-nots” will continue to widen. Consequently, the disparity in return (and valuations) will not only continue but also accelerate.

In addition, the “creative destruction” trends accelerated by Covid-19 will be positive for productivity and growth in the long run, as new businesses emerge to fill the gaps and provide supporting products and services. New business applications are about 80% above the average level in January-February.



Note: Data up to the week ended 18 July 2020. Source: Haver, JEF Economics

Sub-Par Returns for Index Investors

This disparity in returns will hit Index investors and those with over-concentrations in "Dead-Zones" particularly hard.

An Index must hold the good, bad and ugly within their respective spaces. This causes mediocre returns during this period of highly disparate performance. Year-to-date, only 186 of the 500 stocks in the S&P 500 have positive returns. In short, avoid index investing.

Index/Portfolio	**2020 Return**
S&P 500	1.25%
Dow Jones	-7.39%
SLG High Growth	**16.56%**

Net Returns for period 12/31/2019 – 07/31/2020

All Will Not Be Forgotten

Although an effective treatment or vaccine will revive many of the currently near-dead industries and companies, the impact of the current dynamics will be long-lasting. The impairment to the capital of these companies might takes years to repair.

For example, will Shopping Malls once again be packed with people or has their behavior switched by necessity, to Amazon and Walmart's Home delivery services? Will families fly across the country to visit Disney World or drive to the beach, lake or mountains for vacations?

Given the uncertainties, we continue to:

- Buy high quality growth companies with strong balance sheets
- Avoid speculating on the return of beaten down industries and companies despite the trader-induced bounces along the way.

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