WELLINGTON SHIELDS & CO. LLC
Quarterly Market Strategy Report

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MARKET PERFORMANCE AND LIQUIDITY

The first half of 2020 was extraordinary in many ways. The S&P 500 fell 20% in the first three months of the year -- the worst performance since the fourth quarter of 2008, or the core of the financial crisis. The second quarter followed with a 20% gain -- the best 3-month advance since the fourth quarter of 1998, or during the heart of a major technology boom. GDP surged over 6% in the last quarter of 1998. Looking forward, it would not be a great shock if the second half of 2020 held its own surprises and if markets became even more volatile. Many things are known. Countries still struggle with COVID-19. Brexit is scheduled for the end of the year and it could be messy. Political relations with China have been tense due to a lack of transparency regarding the pandemic, China's aggressive actions in the South China Sea and a backtracking on the promises of political and economic independence for Hong Kong. And finally, November's presidential election could be another nail biter. But those are only the risks that are known.

However, despite all the hurdles facing equities since the March low the market has steadily outperformed expectations. There is a list of reasons for this. First, to counter the drag of the pandemic, the US and many countries around the world have implemented unprecedented fiscal and monetary stimulus. Second, US corporations are demonstrating impressive creativity, flexibility, and the ability to adopt to a new post-COVID-19 environment. Third, an historic private/public partnership has been put in place to develop, fast-track, and deliver a US vaccine for the virus. Last, but far from least, the US economy and many Americans have demonstrated surprising resilience to weather this historic economic shutdown. As a result, unemployment never reached the 25% level forecasted by many economists, including Secretary of the Treasury Stephen Mnuchin. To date the unemployment rate appears to have peaked at 14.7% in April and dropped to 11.1% in June.

Massive liquidity programs have been a major factor supporting global markets. European Union leaders agreed on a record COVID-19 stimulus package worth $857 billion. The US government implemented three separate stimulus packages in the second quarter that totaled nearly $3 trillion. And though Phase Three of the stimulus package has not been fully disbursed, the Senate GOP is unveiling another stimulus plan of at least $1 trillion. This new Senate plan would include another round of direct payments to Americans, $105 billion for schools and universities, supplementary assistance for small businesses, $16 billion for testing and contact tracing in states, and $26 billion more to develop and distribute a vaccine. The proposal would extend unemployment benefits, although it would cut the current federal $600 weekly supplement to $200 a week through September. It also provides liability protections for schools, businesses, and health-care providers. To put this into a larger perspective, the combination of the $3 trillion fiscal stimulus already in place,

the $1 trillion proposed fiscal plan and the $2 trillion of monetary ease, this $6 trillion equates to 28% of first quarter nominal GDP. In short, the government has "funded" over three months of economic activity!

But more importantly, much of this money is yet to enter the real economy. For example, of the $600 billion authorized for the Fed's various Main Street Loan Facilities, we estimate only 28% has been tapped by businesses and organizations. The CARES Act was a $1.6 trillion program of direct aid to taxpayers, $600 in supplemental unemployment payments and forgivable loans to small businesses. While this direct fiscal aid has been disbursed, it remains mostly unspent by consumers. This view is based upon the $4.2 trillion increase seen in MZM this year. MZM is one of the broadest of the Federal Reserve's money supply benchmarks and it monitors all forms of liquidity within and outside the banking system, including coins and notes in distribution, bank deposits, all checkable deposits, short and long-term time deposits, retail money market funds and institutional money market funds. May's personal savings rate was a stunning 23% and total personal savings hit a record $4.1 trillion, an increase of $2.8 trillion since year end. This explains the record increase in MZM in 2020. Some equity strategists have been bearish on equities on the belief that many individuals are buying stocks with their $1200 COVID-19 checks and comparing the current environment with the speculation seen in 1999. However, the data suggests something quite different. It appears that individuals have actually saved their money, are sitting on large cash piles and could invest much money into equities if they chose. All in all, this sidelined cash represents potential for an extraordinarily strong economy and an even stronger stock market. But questions remain. Can the virus be controlled? When can children get back to school? And when can people get back to work? We believe these questions may be answered soon and if so, confidence will rise, and the economy can look forward to a great second half.

PRESIDENTIAL ELECTION NEARS

The third quarter of the year will bring the November election into focus. The traditional political polls currently have President Trump lagging behind Vice President Biden, but if there is a lesson to be learned from the 2016 election it is that polls have become irrelevant. It may be wiser to put your faith in the stock market rather than in political pollsters. There tends to be a unique seasonality in election years, and it usually begins with a weak opening, a rally in March and July and a third rally at year end. But monthly seasonality in an election year can also be broken down by incumbent wins or losses. When the incumbent party wins the White House, normal seasonality is upended, and equities tend to advance in March, June, August, and October. COVID-19 wreaked havoc in March of this year so the market has been trading more in line with a typical incumbent loss. But what is noteworthy about the equity market's presidential prediction pattern is that the risk of a Trump loss increases if equities are weak in September and October. However, it could also reverse and predict a Trump win if equity prices rally in August and October. This would make August's performance an important political indicator.

Nevertheless, if Vice President Biden wins and Democrats sweep Congress it is almost assured that personal and corporate taxes will rise considerably. The New Green Deal may not get fully implemented but corporate regulations are expected to increase substantively. These two factors alone, coupled with the hit that COVID-19 has dealt to the US economy is a recipe for major economic weakness in 2021. In sum, the major risk of 2020 could be the election. The first presidential debate is scheduled for September 29 and it could be a market moving event. It may be wise for investors to approach the end of September cautiously.

FUNDAMENTALS ALWAYS RULE

August will also give us greater insight into how well or poorly corporate America coped in the midst of the economic shutdown. Second quarter earnings are predicted to be the nadir of earnings growth in 2020 and for that reason second quarter earnings season is crucial. Expectations were grim as reporting season began but to date results have been better than expected. Of the 312 companies in the S&P 500 that have reported earnings to date, 82% have beaten consensus expectations. This is well above the 65% seen in the typical quarter. But with over a third of companies reporting, the IBES consensus second quarter earnings estimate has recovered from a decline of 43.1% YOY to 33.8% YOY. For the full year, IBES is forecasting S&P 500 earnings to decline 21.5% YOY. Although this is a significant decline, we believe a 25% decline in calendar 2020 earnings was fully discounted when the SPX fell to an intra-day low of 2191 on March 23 (closing price SPX 2237.40). A main driver of equity prices in the second half of 2020 will be expectations of how quickly and how far corporate earnings can recover in 2021. Obviously, the longer the economic shutdown persists in 2020, the more elusive the 2021 forecast becomes. Still, consensus earnings for 2021 are consolidating at the $160 level and given the low level of interest rates and inflation, a PE multiple of 20 times would be appropriate for next year. This combination generates a target of SPX 3200. In sum, we believe SPX 3200 could become a base level for stock prices over the next six months, or until news of a vaccine or presidential election results become known.

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