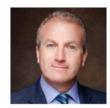
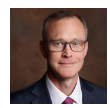
Taking Stock of U.S. Equities Amid the Crisis

A closer look at diverging U.S. equity market and economic performance.

July 2020



Julian Cook
Portfolio Specialist, U.S. Equity



Eric Papesh
Portfolio Specialist, U.S. Equity

KEY INSIGHTS

- U.S. equities have rebounded sharply from the lows reached in March while, at the same time, the economy has declined meaningfully.
- Investors are pricing in an optimistic outlook for U.S. equities, seemingly anticipating a relatively quick postcrisis recovery.
- Our view is that a U.S. recovery may take longer than is currently anticipated. Less "V"-shaped, for example, and potentially more "swoosh"-shaped in nature.

Q1: How has T. Rowe Price adapted to the coronavirus environment?

Eric Papesh (EP): There is no question that the environment over recent months has been very challenging. In relation to how we have responded to the crisis, I would highlight a couple of things. The first is that the level of engagement across the T. Rowe Price organization has been strong during the period, and our research analysts, portfolio managers, and traders have remained in very close contact with each other throughout the isolation period.

The second point—and this was more of an unknown going into the isolation period—has been the level of engagement that we have been able to maintain with company management teams. T. Rowe Price has always placed a premium on close contact with the leaders of companies that we hold in our portfolios, and this has essentially remained unchanged in recent months. To provide some context, in 2019 T. Rowe Price either met, or had conversations with, more than 11,000 company management teams. Obviously, 2019 was a very different environment from today; however, so far in 2020, we have been able to maintain a similar level of company meetings and discussions with management, despite the far more challenging conditions. This, in large part, reflects the strong relationships we have built over time with the companies that we invest in, some of which stretch back over several decades.

Julian Cook (JC): One further comment I would make is about the nature of the discussions we are having with company management teams currently. Obviously, we have seen business activity levels fall precipitously over recent months, so we are not too concerned with how many widgets a company is producing in the current,

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difficult conditions. What we are more interested in knowing is how these companies are adapting to the current environment. So, we are questioning companies on things like their level of cash reserves, what their debt maturity profiles look like, and about their fixed versus variable cost structures.

What we have been particularly impressed by is just how engaged and willing management teams are to speak with us about these topics. It is not unusual for us to speak with the same company two or even three times in a two-week period, for example, in order to fully understand how they are negotiating the crisis and which ones look like they will be well positioned once we eventually emerge from the crisis.

Q2: There appears to be a significant divergence between the performance of the stock market and that of the economy. Do you think this is sustainable?

EP The short answer here is no. U.S. equities have rebounded sharply from the lows reached in March, with the S&P 500 Index rallying 42.9% from the low point.[1] At the same time, the U.S. economy has declined meaningfully. If we think of the equity market as a forward-looking mechanism, then there is clearly a lot of optimism that is currently being priced in, with investors seemingly prepared to look beyond the near term and to a postcrisis recovery.

Our view is that, over the coming months and quarters, the U.S. equity market is likely to experience a higher level of volatility than we have generally been used to over recent years. This will be in line with the information coming through about progress, or lack thereof, in fighting the pandemic. However, longer term, we do not anticipate a continuing and persistent disconnect between the U.S. equity market and the underlying economy.

JC We have certainly been surprised at the level of market resilience in recent months, given there are still many unknowns and a lot of variable outcomes. Another interesting observation has been the unique nature of the sell-off during the pandemic, in that some of the most highly valued companies have also proven to be the most resilient during the downturn and have also recovered in line with the market. So, we have seen some high-performing companies at the very expensive end of the valuation spectrum. Normally in a market downturn, let alone one as severe as that we have just seen, it is these high-valuation, high-beta stocks that lead the market lower, and that has certainly not been the case this time.

The key question that we are asking ourselves currently is not so much when do we expect to return to a normal environment, but when do we think we will return to a normal recessionary environment? With more than 13% of the U.S. population currently unemployed, and many businesses still shuttered, these are key signals that cannot be ignored, and they will have increasingly significant implications the longer this economic hiatus is sustained. As such, we remain cautious about expectations or predictions as to how long the divergence can continue, suffice to say that it is not sustainable longer term.

Q3: In relation to the recession question, do you think the government has done enough to support the economy and that the measures so far will ultimately be enough?

EP The U.S. government and central bank have been very quick to respond to the economic impacts of the

[1] Source: Thomson Reuters, as of July 14, 2020. Based on S&P 500 Index, as of July 14, 2020 for period March 23, 2020 (market low) to July 14, 2020.

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crisis, initiating unprecedented fiscal and monetary support measures. This decisive action in backstopping the economy shows a clear commitment to do "whatever it takes" to get through the crisis and onto a recovery on the other side. This alone is reason for encouragement, and we think that the government and central bank have done a very good job in providing support during this difficult period.

JC If we also look back to the global financial crisis, which was clearly a very negative market and economic event, one positive to come out of it is that it provided a playbook for global governments and central banks on how to respond to a severe financial and economic crisis. And the response to the coronavirus crisis has been textbook in both execution and effect—we have seen decisive action taken, with vast monetary and fiscal support made available to combat the economic impact of the crisis, which has ultimately helped to underpin confidence in markets and a potential recovery.

However, while there does seem to be some early signs of improvement coming through on the consumer side, we remain circumspect about what is driving the pickup in activity. Is it due to real improvement in the underlying economy and company activity, or is it simply a result of the substantial fiscal stimulus finding its way through the economy and boosting consumer confidence?

This is where having close relationships with the companies we invest in can be helpful, in that we can question management about their direct experience. For example, we recently spoke to a leading global payment processing company that we are invested in about the trends in consumer spending it is seeing currently. The company confirmed that it is seeing a pickup in the level of spending activity, but also that it felt the improvement was less reflective of an improving consumer backdrop and more about the short-term stimulus measures. These insights all add to the information that ultimately informs our investment decision-making.

Q4: Has T. Rowe Price been able to take advantage of the heightened market volatility in recent months?

EP Yes, absolutely. As a general comment, we have seen a higher level of trading activity across the firm in recent months, particularly in the early to middle stages of the crisis. From late February through to early April, activity levels progressively increased in order to take advantage of the heightened market volatility. Activity levels have eased back more recently, from around mid-April onward, as markets have rallied back.

In late February and early March, when markets were around their lows, the increased activity was focused toward companies with sound defensive characteristics, such as balance sheet strength, ample liquidity, and good access to capital. However, as confidence improved, encouraged by the vast fiscal and monetary support, the focus shifted more toward companies that could potentially emerge from the crisis in a strong, or even enhanced, position, relative to their competitors.

Importantly, the extent of the correction in late February and early March was such that there was little differentiation shown between companies as markets sold off. This indiscriminate selling provided us with opportunities to make some comparative judgments between companies within certain industries—on valuation and longer-term upside potential—and this also drove increased activity early in the period.

JC After a relatively quiet start to the year, trading activity in the U.S. growth portfolios picked up noticeably during March, as the economic dislocation started to become evident. We used the heightened volatility to buy

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various companies that had been oversold, in our view. While heightened volatility can be uncomfortable, it also offers opportunities to take advantage of that volatility. As an active manager, we are always looking to take advantage of these kinds of market dislocations in order to create potential alpha for our clients.

EP On the value side, the increase in activity in recent months has included dipping into certain companies in industries that are under extreme pressure as a direct result of the pandemic. For example, financials has suffered across the board as a direct result of the coronavirus, and this is creating some interesting opportunities on a longer-term view. While we acknowledge the near-term difficulties the sector faces, with very low interest rates and rising credit costs likely to weigh on returns for some time, identifying early those companies that are likely to emerge from the crisis in a stronger position offers significant long-term upside potential. Similarly, the energy sector is another hard-hit value area, where opportunities to buy oversold companies can be found.

Q5: Broadly speaking, when do you anticipate that companies will start to see a recovery in earnings?

JC Our expectations for a recovery in earnings are relatively modest. We don't anticipate getting back to 2019 earnings levels until well into 2022. Again, there appears to be a disconnect between what are generally modest earnings expectations over the next 12 months and the strong rally that we have seen in the U.S. equity market. Our view is that a recovery may take longer than some are currently anticipating (and that the market rebound seems to suggest). Rather than a possible "V"- or "W"-shaped recovery, for example, we envisage it will be more gradual and potentially "swoosh"-shaped in nature.

Q6: It is a question that is asked time and again, but are you anticipating a rotation from growth to value investments any time soon?

EP It's been a long time since value delivered a meaningful period of outperformance versus growth. Since the end of the global financial crisis in 2008–2009, we have generally seen pronounced outperformance of growth companies relative to value. And this outperformance has been well deserved, as growth stocks have delivered better fundamentals and generated superior profits than their value stock counterparts.

When talking about growth versus value, I try to make the case that investor portfolios should be generally split between both style investments. Currently, the broad U.S. equity market is roughly split between 55% growth and 45% value stocks, so this seems a reasonable allocation to consider replicating in a portfolio.

At a more specific level, there is a case for optimism around some of the larger value areas of the market, for example the financials sector as well as energy and materials. A lot of the difficulties that businesses in these respective sectors face are largely reflected in the current valuations. Within financials, for example, many insurance companies are trading at a fraction of their book value despite having relatively attractive longer-term earnings potential, in our view.

JC Whatever the environment, valuations matter, and we can't ignore some of the extreme valuations that we are seeing in the markets currently—both on the upside where growth stocks are concerned and on the downside for many value-oriented names.

It is worth pointing out that, as a firm, we think about valuation a little differently from most. The standard valuation ratios and measures, while important, are not the be all and

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end all. This is because our investment approach revolves around identifying and investing in companies that we believe are secularly advantaged. It is the unique advantages that these businesses possess that informs our valuation view, and this may differ considerably from the consensus view.

For example, a number of growth-oriented companies have been advantaged by the pandemic, as it has effectively changed the way businesses and employees interact and the way in which consumers engage with goods and services. So, while these companies have risen to seemingly elevated valuations, we believe there are good reasons to be optimistic about further upside potential. That said, valuations cannot continue to rise forever, and if we were to see a cyclical rebound in the economy at some point, then we would expect to see some market rotation and a resurgence in value stocks.

WHAT WE'RE WATCHING NEXT

The coronavirus pandemic has understandably consumed the public's attention in recent months and overshadowed the upcoming U.S. presidential election. However, as November 2020 draws ever closer, the election race has the potential to be a further source of U.S. market and economic uncertainty. Both who wins the presidency and which party ultimately gains control of the Senate will be key influences on the market and economic outlook.

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