ATLANTA CAPITAL

Bill Hackney, CFA

July 13, 2020

There's an important question on the minds of most investors at the moment: What is the likely contour of the budding US economic recovery? Will it be a U-shaped recovery? Will it be a W-shaped recovery where the economy lurches forward, only to fall back when struck by another wave of Covid-19? Will the recovery be more like Nike's iconic swoosh—an elongated and gradual increase following the steep decline that began last February?

So far, the US stock market has traced out what appears to be a V-shaped recovery. During the second quarter, the S&P 500 racked up a total return of 21%, its best showing in over two decades. This sharp rebound erased most of the pandemic-induced losses of the first quarter of 2020.

Many investors believe . . . or at least hope . . . the late 2020 economic recovery will also be V- shaped. Otherwise, the recent recovery in stock prices would appear to be out of sync with underlying economic fundamentals. (Or as Shakespeare's Hamlet would say, "The time is out of joint: O cursed spite that I was ever born to make it right.")

June's strong economic data suggests that the timing of the stock market rebound and the economic recovery is not "out of joint." Stock prices typically bottom and begin to rise in advance of an economy. What gets stocks moving higher is usually a combination of depressed prices and massive government stimulus. By late March we had both and the stock market took off.

A few months later the economy began to improve. Economically sensitive commodity prices like copper and lumber are now rising sharply. In June the closely watched ISM Purchasing Managers Index (PMI) for manufacturing surged to 52.6%, a 14-month high. The new orders component showed surprising strength, suggesting the recovery in factory output has legs.

US job growth began to improve in May and then jumped a record 4.8 million in June due to impressive gains in leisure and hospitality, and retail trade. (Nevertheless, total US employment in June was 15 million below February and the current unemployment rate is 11.1% vs February's 3.5%.) Despite continued weakness in the job market, mortgage applications for new homes have recently rebounded to pre-pandemic levels. Housing, like manufacturing, is a bright spot in an improving economic picture.

What about the recent resurgence of Covid-19 cases in Texas, California, Arizona, Florida and other southern states? Governors and mayors are responding by again shutting down bars, restaurants and other facilities. Won't this eventually snuff out the emerging V-shaped economic recovery?

The resurgence of Covid-19 cases that began in mid-June is unlikely to derail the recovery. Economists may quibble about whether the recovery is V-shaped, more gradual like the Nike swoosh or perhaps a little wavy like a W. The key point to keep in mind is that a solid economic recovery is unfolding for the following reasons.

1) Massive fiscal and monetary stimulus has been applied to our economy. The Congress and the Federal Reserve together injected funds into the US economy equal to about 45% of GDP. Never before has so much money been injected into the economy in such a short period of time. When the economy shut down in the wake of the coronavirus, credit markets virtually ceased to function. Action by the Fed quickly restored them. The CARES Act put so much money in people's pockets that personal incomes actually rose as economic activity nosedived in February, March and April. The massive stimulus provided by the federal government in March underwrote the economic recovery we are now beginning to see.

2) Covid-19 has morphed from an economic uncertainty into a manageable risk. There's a big difference between uncertainty and risk. With uncertainty, you are dealing with events that are unpredictable, where the risk isn't knowable. Uncertainty is bad for the economy and the capital markets. In the first quarter, the coronavirus represented uncertainty: We didn't know its lethality or its contagion. We were unsure about countermeasures. Very scary. By the end of the second quarter, we had gathered enough data to assess who was most at risk and who was least affected. We learned how the virus spread and developed countermeasures. Our health care, political and business institutions adjusted to manage the risk posed by the virus. An important milestone was reached for getting on with our lives.

3) Areas of economy most affected by the Covid-19 resurgence are not that large. The industries most vulnerable to a renewed economic shutdown are air transport, leisure and hospitality, travel services and segments of brick and mortar retail trade. Collectively these segments account for about 12% of total employment according to my calculations. They account for even a smaller portion of GDP. This recovery is being driven by technology, health care, manufacturing and residential construction.

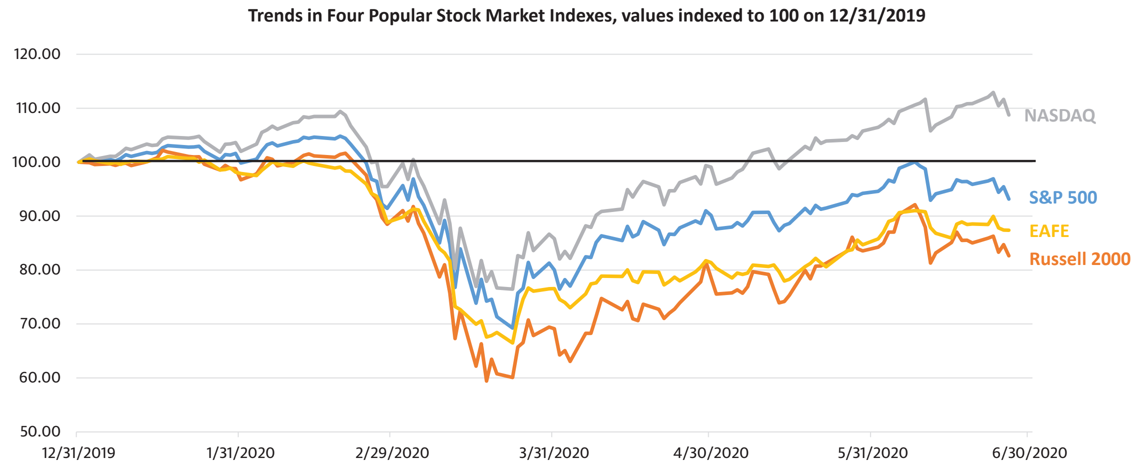
4) A global economic recovery is underway which should boost US economic prospects. China was hit first by the virus and appears to be among the first to recover. Like the US, Europe and Japan applied massive stimulus to their economies and now appear to be entering a recovery mode. Manufacturing PMIs have recently turned sharply higher in both Asia and Europe. With many focused on our large trade deficit, Americans tend to forget that exports account for about 13% of US GDP. The US leads the world in a wide array of software and hardware information technology and pharmaceutical/biomedical products. These products are what the rest of the world needs to coexist with Covid-19.

Pockets of pain

While an economic recovery is underway, it will not be a normal recovery. Don't get fooled by the aggregate economic data. GDP crashed in the first half of 2020 and will likely grow by double digits in the second half. Amidst the rebound in economic activity, however, there will be pockets of pain. Because of the lingering impact of the virus, many industries will experience little or no recovery: airlines, aerospace, brick and mortar retailing, apparel, commercial real estate (office buildings), hotel/motel, bars and restaurants.

These pockets of pain are showing up in the labor market. Despite June's gain in job creation, initial claims for unemployment were 1.3 million last week, twice as high as the worst week of the Great Recession of 2008-2009. There's a lot of churn in the labor market. Corporate bankruptcies are likely to rise in the months ahead as debt

Exhibit 1: A V-shaped recovery pattern is most apparent in the tech-dominated NASDAQ index. Small cap US stocks, represented by the Russell 2000, and foreign stocks, represented by the EAFE, were notable laggards during the last six months and may represent good investment opportunities.



Sources: Bloomberg and Atlanta Capital calculations as of June 30, 2020.

burdened firms eventually succumb to the effects of the virus. The aggregate economy is on the mend, but it will probably be 2022 before real GDP surpasses 2019 levels.

Exhibit 1 shows the performance of four popular stock market indexes during the first six months. Large capitalization US tech-related stocks were the big winners. Of the 11 sectors within the S&P 500, only two produced positive price returns—Information Technology and Consumer Discretionary. The positive return from Consumer Discretionary was largely explained by the sharp rise in Amazon. America's "big five" tech-related stocks—Microsoft, Apple, Amazon, Alphabet (Google) and Facebook—represent about 20% of the S&P 500 index and about 45% of the NASDAQ index.

Without the big tech-related stocks, stock market performance during the first half looks much more lackluster: not the V-shaped recovery pattern many investors expect. In fact, the price of the equal-weighted S&P 500 (a proxy for how the average stock performed) fell 13% during the first six months compared to the 4% decline in the capitalization-weighted S&P 500 index. The economically sensitive (cyclical) sectors of Energy, Industrials and Financials suffered the biggest declines.

Lately, a popular argument for avoiding the equity market has been that stock prices have advanced too far ahead of underlying economic fundamentals. This argument doesn't appear valid if you dissect the market averages. The stocks that have done the best this year are the ones least affected by the coronavirus or are, in fact, pandemic beneficiaries—Internet marketing, household products, biotechnology, life science tools, interactive media and, of course, technology. These stocks, many of which are heavyweights in the indexes, have propped up the market. The majority of US stocks have declined 13% or more, reflecting the dismal performance of the economy. To me, stock prices appear correctly aligned with prevailing economic fundamentals.

Exhibit 2 shows my five stock market indicators which I rate as moderately constructive. The early stage of an economic recovery, characterized by easy money and low interest rates, is typically not the time to abandon the equity market, even one that appears to be fully valued. Clearly the most fully valued names are found in the tech-related issues. The cheapest valuations are found among smaller capitalization and international stocks as well as the cyclical sectors of the economy. Eventually these stocks should play catch-up, but it hasn't happened yet.

Political climate poses near term risks

The biggest uncertainty facing the stock market in my view is not Covid-19 or the economy, but the election. So far, investors haven't paid too much attention, but this is

Exhibit 2: The pandemic ambushed the economy, so the five indicators provided no early warning signal. I rate the current indicators as mildly positive. With interest rates near record lows, stocks have little competition from the bond market. High P/E ratios remain a concern, but this issue is mainly concentrated in tech-related issues.

Indicator	Rationale	December 31, 2019		June 30, 2020	
The yield curve: short vs. long-term interest rates	When short-term interest rates rise to meet or exceed long-term rates, monetary policy is usually tight enough to eventually cause a recession.	Curve has steepened as Fed cut rates three times in 2019. Curve still relatively flat	Yellow flag	Short rates near zero. Curve relatively steep	Green flag
Widening spread between high- and low-quality bond yields	A widening spread between junk bond yields and Treasuries indicates deteriorating credit market conditions.	Credit spreads are still narrow	Green flag	Credit spreads down from recent peak, but wider than six months ago	Yellow flag
Rising wage inflation	When wages rise at a 4% annual rate, it is difficult for the Fed to keep core inflation near its 2% goal. So the Fed usually tightens policy aggressively.	Wage growth still well contained at about 3.1%	Green flag	Wage pressures subdued due to high unemployment	Green flag
S&P 500 P/E ratio over 20 times	Price/earnings ratios over 20 times trailing four quarter earnings makes stocks vulnerable to rising interest rates and inflation.	Rising stock prices and lackluster earnings push P/E up to 19.9 times	Yellow flag	P/E on trailing earnings at 19.5 times. Earnings depressed due to pandemic	Yellow flag
Downturn in Leading Economic Index®	The Conference Board's LEI has peaked and turned down in advance of each recession since 1960. Average lead time is 13 months.	Still relatively flat over last six months	Yellow flag	Turning up from very low level	Yellow flag

Source: Atlanta Capital as of June 30, 2020.

likely to change in August. The President's poll numbers are poor and there is an increasing chance of a sweep by the Democrats. Such an event would open up the possibility of major adverse tax legislation for investors.

Joe Biden has vowed to repeal much of the 2017 corporate tax cut, which lowered the US tax rate from nearly the highest in the world to the middle-of-the-pack. Besides reducing the competitiveness of US-based manufacturing, Biden's proposal could reduce S&P 500 earnings by 5 to 10%.

In addition, Mr. Biden has proposed a big increase in the capital gains tax rate. Relatively low rates of taxation on capital gains has underpinned a boom in US technological innovation. US-based technology and health care companies are now the envy of the world. Moreover, their strong stock price performance has been a key reason that the US market has outperformed most foreign markets in recent years. If you are wondering what might cause a change in US stock market leadership from the tech stocks to something else, we might find out in November.

Of course, it is always risky, some say foolish, to inject political judgments into investment decision-making. After all, for over 150 years, the US stock market has generally flourished through a variety of different political and tax regimes. Nevertheless, today's crazy political climate poses some significant near-term risks for investors in my view. Perhaps the character Polonius in Hamlet said it best, "Though this be madness, yet there is method to it."

Atlanta Capital Management Co., LLC | 1075 Peachtree Street NE, Suite 2100, Atlanta, Georgia 30309 | Tel: 404.876.9411 | atlcap.com