TURTLE CREEK

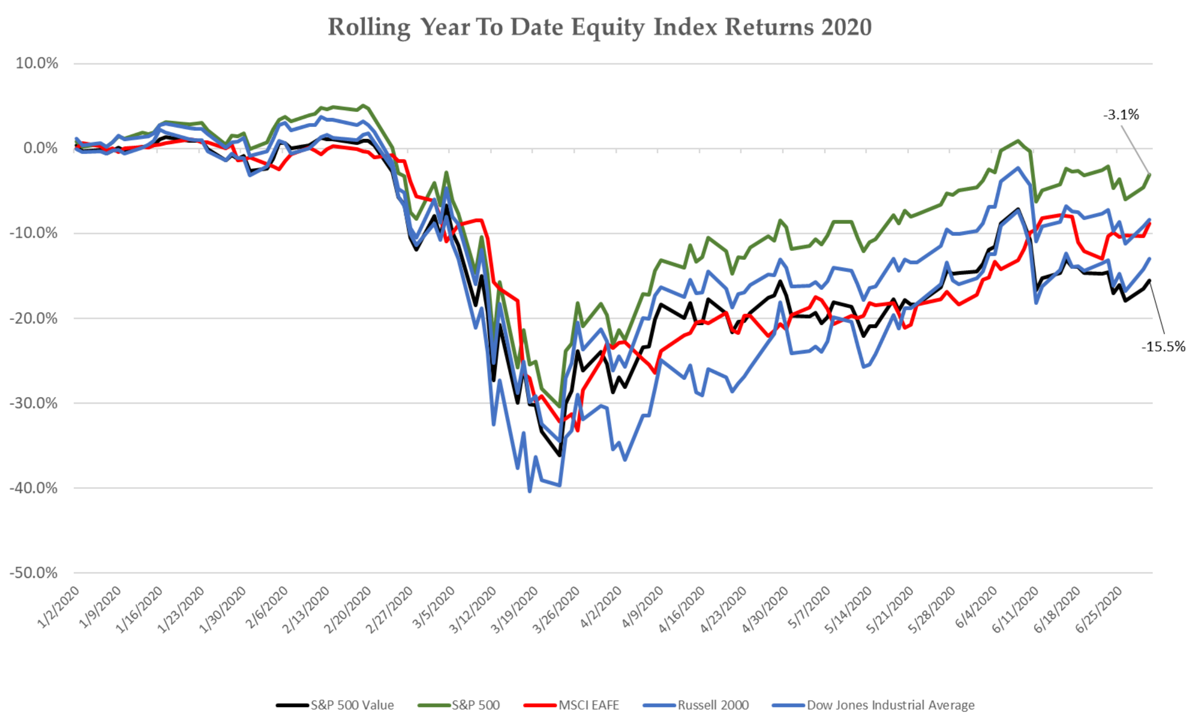
July 24th, 2020

Dear Turtle Creek Client,

What a difference a quarter makes. The stock market bounced back from one of the fastest and deepest bear markets in history to post its best quarterly performance in several decades. Malfunctioning credit markets returned to a normal rhythm and the historic day-to-day swings in investment prices finally ebbed into more typical trading patterns.

On their surface investment markets appear to be sending an all-clear signal regarding further economic damage from the COVID-19 virus and over the longer-term it does appear likely that the very worst has passed regarding the current economic down-turn. The significant emergency stimulus measures enacted by Congress had a meaningful impact on preserving consumer financial health and the Federal Reserve's historic intervention in markets allowed for corporations to maintain liquidity and operate normally.

Digging deeper into market performance, however, merits a note of caution. Investor optimism has yet to be matched by a robust recovery in economic output and corporate profits. Economic indicators do exhibit a bottoming and nascent recovery in economic activity, but most gauges remain far below their pre-COVID levels. The stock market has posted a very narrow performance with a small handful of mega-capitalization technology companies driving most of its recovery. The attractive market valuations we highlighted in our first quarter communications have now swelled to premium levels. Most importantly, the COVID virus is still expanding throughout the world and the timing of a sustained resumption of "normal" economic activity is still very much up in the air. Until corporate fundamentals better justify market advances, investors are wise to exhibit some caution.




*Source: Bloomberg*

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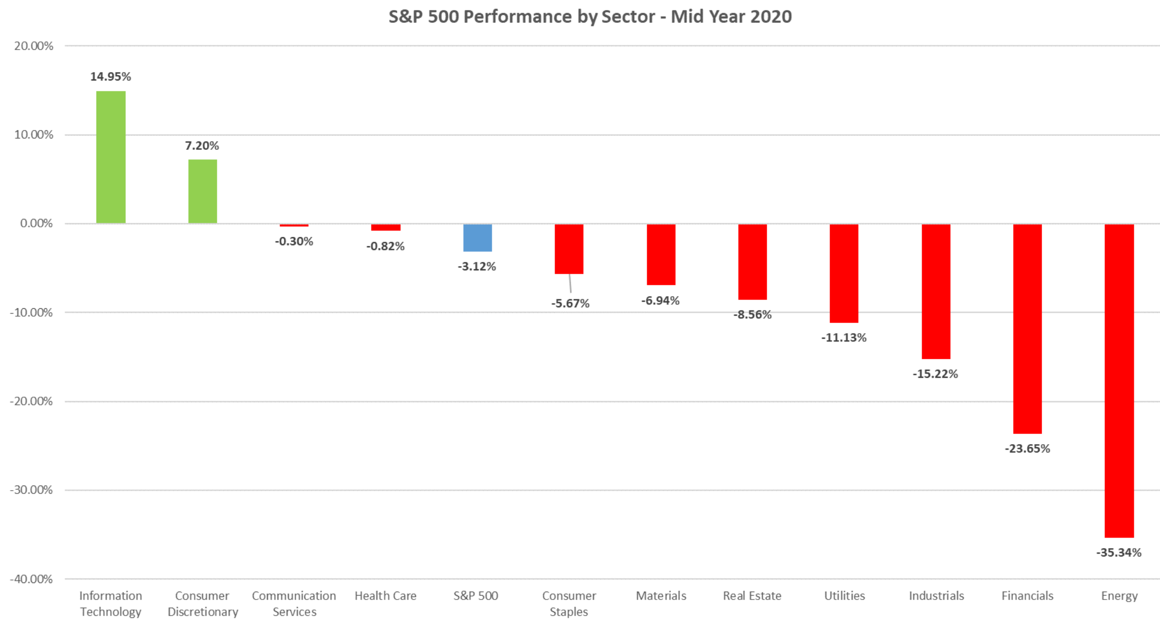
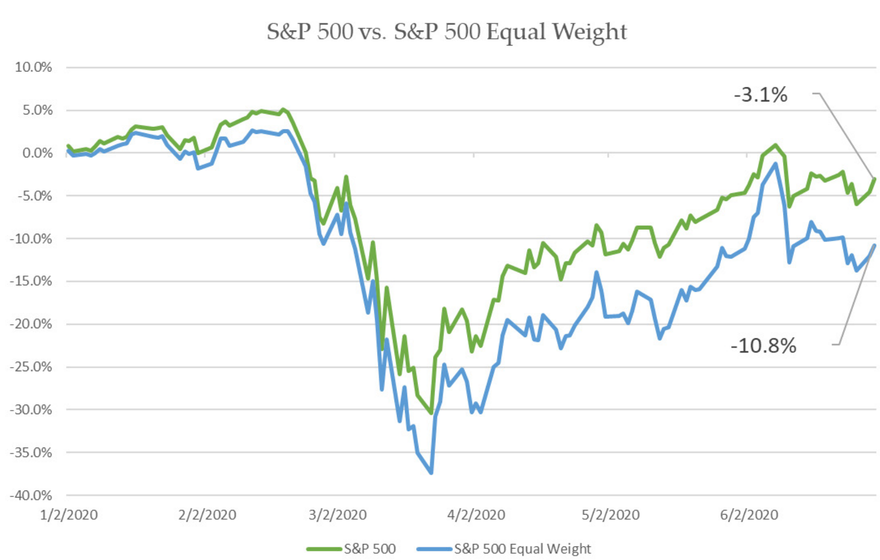
<u>**Elements of Stock Market Performance**</u>

Broad stock market indices such as the S&P 500 recouped the majority of their losses by quarter end but did so on the back of a select group of large technology, communications, and health care firms. Most S&P sectors remain underwater for the year and economically sensitive sectors such as financial services, energy, and industrial firms still feature significant losses.




*Source: Bloomberg*

This narrow market leadership does not signal a quick economic recovery. A typical bear market recovery features the most downtrodden of stocks benefitting from a sudden resurgence in economic activity. Market leaders today reflect a sudden and large shift in demand. Online shopping has surged in place of shuttered physical retail stores. Technology firms have enjoyed elevated demand as the global workforce has switched to remote locations. Consumer spending normally dedicated to restaurant dining, travel, and other suddenly shuttered pursuits has been redirected.




*Source: Bloomberg*

The capitalization-weighted nature of indices like the S&P 500 also obscure ongoing market headwinds. The biggest of companies happened to do the best this quarter. Comparing the market-capitalization weighted S&P 500 Index (loss of 3.1% year to date) against the S&P 500 equal weight index – where each stock is weighted equally for performance calculations–shows that the average stock did much worse than index headline would indicate. The equal weight index features a year-to date loss of nearly 11%.

**Gauging the Recession and Recovery**

Traditional economic techniques have unfortunately proven useless for tracking the near immediate halt to economic activity brought on by government mandated health measures. Backward-looking indicators such as GDP growth, Industrial Production, and other data-points take weeks to compile and have been rendered meaningless by the fast-moving nature of this recession. Despite this fact, a consensus is building that we entered into and have already emerged from a recession during second quarter of 2020.

The National Bureau of Economic Research (NBER) is the final word on dating recessions and it recently confirmed the obvious fact that the U.S. had entered a recession sometime in late February. The depth of this recession is truly staggering, with an estimated 22 Million Americans losing their jobs and Gross Domestic Product shrinking 40% year over year per the NBER.

Subsequent datapoints beginning in June showed a surprisingly quick bottoming and recovery, however. The May jobs report was expected to show another 7 Million Americans out of work and the unemployment rate soaring to 20%. It instead shocked market watchers by recording a gain of 2.5 Million jobs. It was, according to one economist, "The biggest payroll surprise in history by a gigantic margin." Subsequent datapoints confirmed the rapidly changing economic momentum. Retails sales grew much faster than forecast. Business inventories declined. Industrial production jumped faster than predicted.

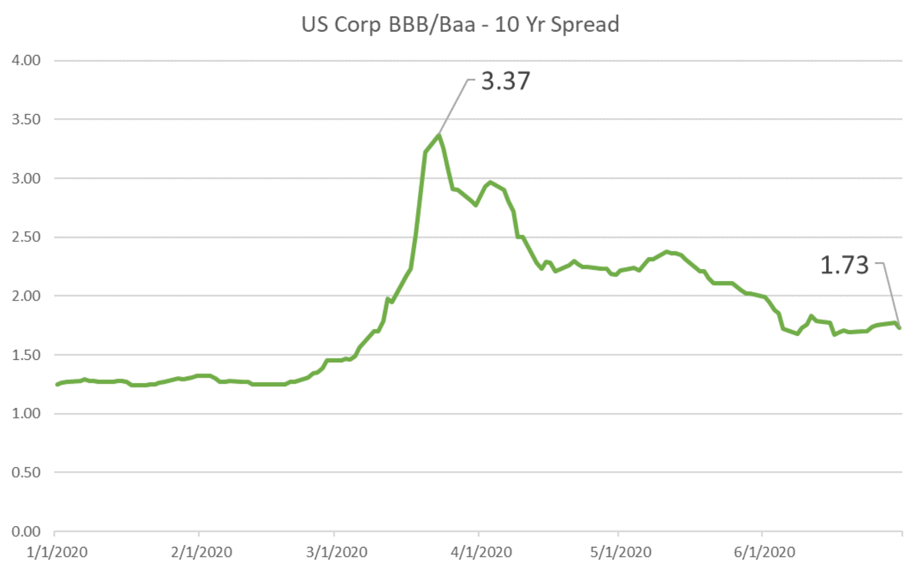
The Atlanta Fed GDP Now model, which attempts to predict daily year-over-year GDP growth using a variety of datapoints, captured the steadily improving outlook for the economy through the last weeks of June. Should the trend continue, the economy will enjoy the best-case scenario of a "V-shaped" recovery.


*Source: Bloomberg*

Even with this sudden rebound, economic activity remains far below pre-COVID levels and the continued easing of health-related business restrictions that supported the recent economic snap-back could be challenged by the continued growth of the COVID virus. In that case, the economic recovery would take longer and more meandering paths. The economy is not out of the woods yet, but worst-case scenarios seem to have been avoided.

## Fixed Income

At quarter-end, yields on Treasury bonds still hovered near zero for most maturities going out to five years. The once enticing spread, or additional yield, on riskier corporate bonds shrank noticeably during the quarter. The Federal Reserve extended its emergency stimulus through the unprecedented step of buying corporate bonds directly in the open market, stepping in as a buyer of last resort when traditional investors found a bond's price unpalatable. It took this measure to ensure corporations could finance their business and avoid disruption during the recession. A side effect is a growing mismatch between credit risk and reward. Yield focused investors are more willing to purchase bonds of poor-quality companies knowing the Fed stands ready to save them. The "Fed Put", or belief that the Fed would always intervene to save the stock market, has now extended to bonds.




*Source: Bloomberg*

## Investment Strategy

With the absolute level of bond yields near zero and the compensation for credit risk seemingly out of step with the economic backdrop, we have not changed our view that the equity allocation of your portfolio will be the primary driver of returns over medium and long-term. The strong rally in stocks has discounted much the potential recovery in economic growth and corporate profits over the next few years, however, and there remains uncertainty regarding the sustainability of the recent economic rebound.

In light of this, we have been taking some profits in the mega-cap technology winners and maintain a focus on quality investments. Given the shrinking margin of error implied by current stock valuations, we have been more selective in our portfolio additions. Should the market experience a pull back during the third quarter, we will take advantage of any compelling risk/reward scenario that presents itself. Until then, caution is the order of the day.

TURTLE CREEK MANAGEMENT, LLC
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