Q2 – 2020: Morgan Dempsey Large Cap Value Commentary

Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning.

Winston Churchill, Speech at the Lord Mayor's Day Luncheon, London, November 10, 1942

Market Commentary

Equity investors appeared to be more than willing to dismiss the impact of Covid-19 as a short-term phenomenon during the second quarter. After a stomach-wrenching decline during late February and most of March, the S&P 500 rapidly rebounded. While the index's +20.5% return during the quarter was not particularly broad-based and heavily skewed by the stellar performance of a small number of Mega-cap technology stocks, it was still impressive.

The rationale for the effusive market rally that began in late March is somewhat mystifying if it is viewed through the lens of individual company fundamentals. According to Factset Research, stock market analysts in late June expected S&P 500 earnings-per-share to generate year-over-year declines of -43.9% in the second quarter of 2020, -25.4% in the third and -12.8% in the fourth. While these numbers are probably much closer to guesstimates than estimates, they do reflect Wall Street's expectations for improving, but still significantly negative, earnings declines for the rest of the year. The catalyst for the equity market's breathtaking rally comes into clearer focus when Federal Reserve monetary policy and Federal government fiscal policy are factored into the equation.

The Federal Reserve leapt into action as the stock market rapidly declined. Its first actions were to initiate a significant expansion of both Quantitative Easing and its overnight and term repurchase agreement operations. The Fed's actions expanded into other areas of the Fixed Income markets, eventually directly purchasing both individual corporate bonds and bond market ETFs . This compressed credit spreads, making it cheaper for corporations to borrow money. Primarily as a result of these policies, the Fed's balance sheet grew by about $1.2 Trillion during the quarter. We suspect that much of the money used by the Fed to purchase bonds and ETFs found its way into the stock market.

The Fed's aggressive monetary policy was accompanied by $2 Trillion in stimulus measures from the U.S. government. These included direct payments to individuals, enhanced unemployment benefits, a suspension of student loan payments, federally guaranteed loans for small businesses and a government lending program for larger companies such as airlines that were severely impacted by the pandemic. These actions helped to stabilize some of the worst hit segments of the economy while helping to support consumer spending through direct payments to individuals directly impacted by the pandemic.

We believe that the combined firepower of the Federal Reserve and the U.S. government provided the primary catalysts for the markets miraculous rebound. They reassured investors that the government and, particularly, the Fed, were prepared to do whatever necessary to support the unemployed, individual companies and the equity market from the impact of policies that were implemented to combat Covid-19. Investors responded by bidding stock prices significantly higher in the face of a pandemic of indeterminate length and unknown long-term impact.

While we are always pleased when we can make money for our clients, the extent of the rally seemed excessive. There is no question that the Federal government can provide a temporary backstop for lost income and that the Federal Reserve (apparently) has an unlimited capacity to purchase fixed income securities and ETFs. However, they have limited ability to generate revenue and earnings for most individual businesses. We suspect that It will be difficult for the equity market to either retain its gains or rally much further until companies show that they can return to growth in this new and unpredictable environment.

Large Cap Value Strategy

The Strategy did not perform well on a relative basis during the quarter. Although there were changes in the portfolio, the overall structure and positioning that protected our clients at the beginning of the year failed to keep up with the dynamic rally that followed. While we were disappointed by our limited participation in the market's rather manic ascent, we are pleased that the Strategy is still significantly outperforming its benchmark for the year.

Neither our sector allocation nor stock selection helped our relative performance during the second quarter. From a sector standpoint, the positive impact of our underweight in both Financials and Utilities was more than offset by our overweight in Consumer Staples and our underweight in both Materials and Energy. Our cash position was a significant detriment during the period. Unfortunately, our stock selection was weak across the board, with the Strategy's holdings in Healthcare and Consumer Discretionary providing the most relative drag. While the performance of our stock holdings was particularly disappointing, it is important to remember that we expect to own our individual names for a long time. Their performance occasionally can be out of sync with short term market action and fail to positively impact the relative returns of the Strategy during any individual quarter.

There is no question that we are in a unique environment. We have experienced a pandemic induced market collapse followed by a nearly as dramatic rally. Yet we still don't have a firm grasp on Covid-19's short or long-term impact on either the economy or individual companies. This has introduced an additional level of complexity into the Strategy's stock selection process. A company's ability to currently generate enough free cash flow to cover its dividend amidst a virus disrupted economy is just as important as its long-term potential. With visibility extremely low for most company managements, particularly those in the most cyclical companies, we believe that it is essential to become even more selective about new positions at this point in time. While Fed policy may be able to encourage higher stock prices through multiple expansion, it cannot generate cash flow for individual companies.

The dramatic recovery of the equity market was a welcome relief for investors. However, we believe that it is too soon to declare economic victory. It is important to note that the U.S. economy had already entered into a recession in February. The Covid-19 shutdown rapidly accelerated the natural progress of a business cycle slowdown. The Federal Reserve's ultra-loose monetary policy and the U.S.

government's fiscal stimulus (with more to come) probably can continue to support equity prices as long as Congress is willing and able to continue to run multi-Trillion-dollar deficits. We will be surprised if it can produce the V-shaped recovery in profits and revenues that are an important component of the bull-market scenario.

We continue to deploy the Strategy's excess cash into companies that we believe have the willingness and capability to maintain their dividend and trim or eliminate those that we believe will have difficulty navigating this new economic environment. We believe that dividends will play a more prominent role in equity total returns for the foreseeable future as investors slowly reconcile prices with earnings.

FOR ADDITIONAL INFORMATION

Dave Isaacson
Portfolio Specialist
disaacson@morgandempsey.com
Office: 414.928.8702
Mobile: 760.822.1083

MORGAN-DEMPSEY
CAPITAL MANAGEMENT, LLC

111 Heritage Reserve, Suite 200
Menomonee Falls, WI 53051

Main Office: 414.319.1080