Morris Capital Advisors, LLC

Investment Commentary
June 30, 2020

It's either Sadness or Euphoria

Billy Joel spent much of the summer of 1975 in upstate New York as he worked on his third album, "Turnstiles". While he was inspired by the beauty of that area, the music on that album reflected the pressures and frustrations of his nascent music career. One of the tracks from that album, "Summer, Highland Falls", described his feelings of "sadness or euphoria" accompanied by an upbeat piano that ebbs and flows in the background.

During the first half of 2020 the economy and financial markets certainly swung between sadness and euphoria. The onslaught of the novel corona virus and the economic shutdowns imposed to stop its spread disrupted a strong economy, ending the longest expansion on record. Stocks dropped 34% in just 23 trading days (the fastest decline of this magnitude ever). Yields dropped dramatically as the 10-year US Treasury yield dropped from 1.92% at year end to 0.67% by the end of March, while the 2-year US Treasury yield dropped from 1.58% to 0.26% over the same time period. The selloff reflected the severe damage inflicted by the virus and resulting lockdowns. More than 20 million jobs were lost during the early days of the lockdown , pushing the unemployment rate to almost 15%. Housing starts and permits dropped, industrial production collapsed, and consumer spending and confidence plunged. Gross Domestic Product (GDP) fell 4.8% in the first quarter and could decline by as much as 40.0% in the second quarter.

In response, the Federal Reserve implemented a series of policy initiatives, rolling out their entire playbook from the financial crisis of 2008-09, and then some. They slashed short term rates, announced the open-ended purchase of US Treasury and mortgage-backed securities, extended lending facilities to securities firms and banks, and for the first time extended the facilities to high yield (junk) ETF's as well. In less than two short months the Fed balance sheet grew from $3.9 to $6.1 trillion.

Countries around the world rushed to implement emergency measures. In the US both Democrats and Republicans raced to implement stimulus packages that would benefit their individual constituents. The legislation, now referred to as the CARES Act, started as a $1 trillion aid package, but grew to more than $2 trillion by the time it was enacted, amounting to almost 10% of total GDP. The bill had something for everyone; payments to households, payments to state and local governments, unemployment benefits, aid to small business and large corporations, Payroll Protection loans, cash grants to college students, student loan deferrals, as well as rent and mortgage forbearance. In the rush to implement the legislation secondary effects were often overlooked. For example, the emergency unemployment benefits paid many claimants more than they made working. This perverse benefit created a disincentive for many to rejoin the workforce when opportunities arose. Unions representing municipal workers and teachers gamed the system by furloughing members one day per week so they could collect both a paycheck and receive unemployment compensation. All of this spending was fueled on borrowed money.

We were reminded often as children that "money does not grow on trees", but for some reason Central Bankers and legislators seem to believe that money can grow magically with "digital entries". This cannot go on forever, and when it finally ends it will not end well. My greatest concern is that the ill effects will be borne not by us or our children, but by our children's children.

The market decline of the first quarter was followed by an equally stunning rebound. Stocks rose 40% from the lows set in the last week of March through early June (the fastest rally of that magnitude over a 50-day period). The rebound lifted the S&P 500 index above the year-end close and just 4.5% below the peak set in February. The move seemed completely disconnected from economic reality. While some sections of the economy reopened quickly, airlines, restaurants, and retail businesses were operating at limited (and unprofitable) levels. The disconnect was apparent in the bond markets as longer-term yields remained stable, or drifted lower, indicating that bond investors did not foresee a sustained rebound in economic activity or inflation.

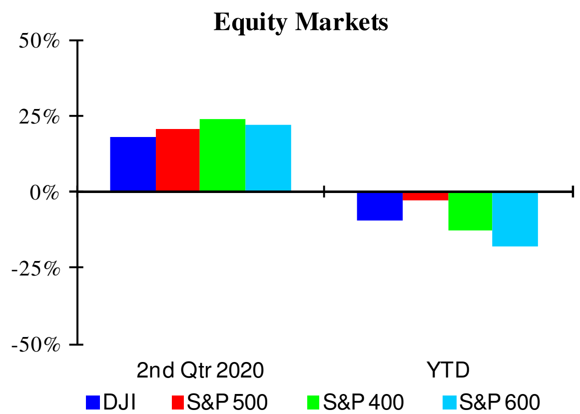
Market volatility of the magnitude recently experienced is often followed by periods of uncertainty, as investors search for investment opportunities in the absence of reliable information. Since the recent peak inter-day volatility seems much higher as markets react to headline news or sudden reversals of widely followed stocks. In the absence of reliable fundamental information we will exercise caution to avoid getting whipsawed by market swings from sadness to euphoria.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

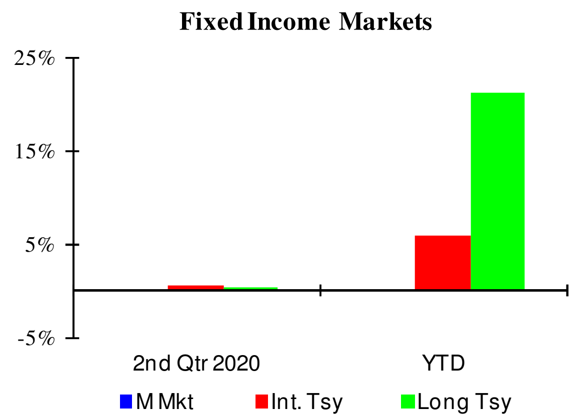
Market Summary
June 30, 2020



Stock markets posted sharp gains throughout the 2020's second quarter, as investors gained confidence that the Federal Reserve would do whatever it took to provide liquidity to asset markets, and the Federal government unleashed an unprecedented amount of countercyclical spending.

Mega-cap growth stocks led the rebound early in the quarter, as it became clear that the tech giants were relatively impervious to the economic downturn and as a result investors were willing to pay large premiums for increasingly scarce earnings growth. By mid quarter, investors began to see some visibility that the collapse in economic activity was bottoming. Moreover, the Federal Reserve loudly reiterated its intention to buy corporate debt securities, which compressed default spreads and encouraged investors to buy more cyclical and smaller cap equities. However, by quarter's end evidence that coronavirus cases were spiking in sunbelt states began to chip away at confidence that the economic rebound would be relatively quick.

By quarter's end most indices posted total returns in excess of 20%. The S&P 500 closed a little more than 3% below its 12/31/19 value, and large cap growth names had returned to pre-COVID levels. Growth names outperformed value names owing to a late quarter retreat in economically cyclical issues, and small cap names kept pace with larger cap indexes.



Trading in US Treasury securities was relatively subdued for most of the second quarter of 2020, trading in a fairly tight spread. Given that the US Treasury issued unprecedented quantities of bills, notes and bonds, this tight trading reflects market confidence that the Federal Reserve will be extraordinarily supportive of burgeoning federal deficits.

The only exception to this pattern occurred in the last week of May through the first week of June, when a "risk-on" rally drove higher-yielding paper and economically sensitive equities higher and treasury prices lower. The selloff in treasury bonds reached its maximum after a surprisingly positive jobs number was announced. In the subsequent week, however, the Federal; Reserve was notably cautious about the outlook, which put the markets into "risk-off" mode and put a bid under treasury prices.

By the end of the quarter, yields had returned to where they had started the quarter, and total turns for US Treasury bonds were modestly positive.