



2ND QUARTER REVIEW AND OUTLOOK

The mass media routinely paints a very dire picture of the global economic situation. It's important to realize that journalists are not capital market strategists, however, and are incited to create hyperbole and sensationalism. We strive to examine fact patterns and rely upon as holistic a perspective, as possible, drawing the most sensible "weight of the evidence" conclusions we can.

While cognizant of the widespread dislocations, we remain confident that smart investors are best suited by a renewed commitment to their strategic asset allocation policies. Having navigated several sharp bear markets, we remind ourselves that investors face two very fundamental risks in times like these. The first is a failure to maintain your core portfolio through to the other side, like a metaphorical beachcomber, although we might be drawn to fixate on the waves (or headlines du jour) lapping at our ankles, it is more productive and profitable to focus on the horizon, in the distance. The second is that components of your portfolio become permanently impaired as a result of the dislocation. As of this writing, this second risk (solvency) remains a tangible concern to which policy responses and consumer behaviors will ultimately dictate the outcome.

Due to the wide range of potential outcomes caused by the virus and policy makers, economic forecasting has arguably reached the apex of uncertainty in the short term. The observations highlighted below are contingent upon the path of a virus and policymaker's reaction to said virus (to complicate things further, these policy decisions come four months prior to a contentious Presidential election). As Mark Twain famously noted "It ain't what you don't know that gets you in to trouble; it's what you know for certain that just ain't so." It would be foolish to make overly confident predictions (either bullish or bearish) in this highly abnormal slice of U.S. history. As a result, we are keeping allocations close to targets until the historic levels of uncertainty recede.

Cautious Observations

- The timing and pace of reopening the economy will have significant ramifications on the level of defaults and bankruptcies that ensue. The threat of a second wave of infections arising this fall further complicates any attempt at prognosticating near-term developments.
- Second and third-order ancillary effects of the pandemic remain elusive, particularly consumer behaviors and return to 'normalcy'. We expect the recovery process to be slow and choppy as there remains considerable uncertainty associated with how cautious households and businesses will be in the upcoming months and years. The initial economic shock is disinflationary, but the aggressive policy response to offset it will gradually tilt the balance in an inflationary direction.
- Many corporations have suspended guidance on their near-term operating results, given limited visibility to revenue and earnings trends. As a result, stock prices are primarily a function of near-term sentiment and whipsaw with the daily headlines and other high frequency data items (retail sales, reported CoVid-19 cases, etc.).

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- Despite the strong financial market recovery in the second quarter, this cycle is highly unpredictable, and sentiment/markets are expected to remain volatile.
- The degree to which temporary layoffs become permanent will be widely scrutinized in the weeks and months ahead. Although the labor market is healing and unemployment has fallen down to 11% in June, those identifying as temporarily unemployed (furloughed) has fallen from 82% to 60%. A continuation of that trend would put a damper on the V-shaped recovery for consumer spending baked in current market prices.
- Given the proximity of the U.S. presidential election in 4 months, there is no shortage of political posturing by federal and state officials, creating heightened sensitivity around the pace and form of re-opening regional and local economies around the country.
- Absent the Federal Cares Act, disposable incomes in the US would have fallen by 6% during the CoVid-19 crisis. Instead, income surged by 8% year over year. The \$600 per week unemployment supplement expires July 31st. Further, state and local government rescue funds are mostly depleted. July and August recesses combined with election year politics could create mid-summer volatility.
- As rhetoric increases regarding China's culpability in facilitating the global spread of the pandemic, protectionism trends may threaten already precarious global trade relationships.

Constructive Observations

- Unprecedented global stimulus measures, both size and scope, should be very supportive to financial markets in the near term. U.S. total monetary/fiscal stimulus is \$10T already (6 months of GDP). The Fed's willingness to purchase a myriad of instruments, including corporate and municipal bonds and ETFs minimizes liquidity risks. To put this in perspective, the more dire GDP forecasts log in at a 10% contraction for the year while Bloomberg's average of 70 economists registers a 6% contraction. On a \$20 trillion dollar economy, that is a drag of somewhere between \$1.2T and \$2T. The fiscal response alone is near \$3T.
- The recovery rally in April suggests the economic decline will be sharp but relatively short lived. Risk-seeking market internals are also encouraging.
- Rapid ramp in testing and data collection are fortunately illustrating actual CoVid-19 outcomes notably less dire than modeled outcomes.
- We expect the global 'Manhattan Project' style race across bio-innovation industries for testing, treatments and vaccination should yield results. Seventeen drugs are in human trial stages with an additional 130 in development.
- Historical analysis of bear markets and recessions suggest the stock market bottoms well before corporate earnings, implying the market's forward-looking perspective discounts the near-term and anticipates longer-term trends in advance of their manifestation (Note the S&P 500 is up +40% from its March 23rd closing level.) There is a cost to waiting for the proverbial bell (earnings or economic data turning).

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Over the intermediate horizon (1-3 years), the weight of the evidence tells us that unprecedented levels of monetary and fiscal stimulus will provide a tailwind to risk assets. However, expiration of the CARES Act unemployment supplement (July 31st), the path of the virus in the fall, and election year uncertainty are tangible reasons to prudently rebalance into market rallies.

ECONOMIC OVERVIEW

In early June, the National Bureau of Economic Research (NBER) determined U.S. economic activity peaked in February 2020, marking the end of the expansion that began in June 2009 and the beginning of a recession. The expansion lasted 10 years and 8 months, the longest in the history of U.S. business cycles dating back to 1854. The previous record was held by the expansion that lasted 10 years from March 1991 to March 2001. The Federal Reserve Bank of Atlanta's GDPNow model is currently forecasting real GDP growth (seasonally-adjusted annual rate) of -34.7% for the second quarter. This estimate mostly contains data from the first two months of the quarter, so it doesn't capture some of the recovery in June. Economic activity is difficult to interpret due to the dramatic declines in March and April that have been followed by a bounce-back in May and June as economies have gradually reopened.

The U.S. Consumer

The unemployment rate peaked in April at 14.7% and fell to 11.1% in June. April showed dramatic job losses of 20.8 million, but gains materialized in May (+2.7mm) and June (+4.8mm) as the partial resumption of economic activity unfolded in some states. The gains in June occurred in some of the hardest hit industries including Leisure and Hospitality (+2mm jobs) and Retail (+740k jobs). Although unemployment fell in May and June, the jobless rate and the number of unemployed are up by 7.6% and 12.0 million, respectively, since February. Despite high levels of unemployment, disposable income remained high as unemployment checks from both state and federal governments kept incomes supported. The savings rate, which had been hovering between 7.4% - 8.4% from early 2019 to February 2020, increased to 32% in April and registered 23% in May as a result of lockdowns that forced consumers to stay home. Higher income consumers have been under less pressure as they tend to have jobs that allow them to continue working from home. The net result is an increase in pent up demand. According to estimates from the Bureau of Economic Analysis (BEA), consumer spending increased 8.2% in May. As states reopen further, spending should increase, and the savings rate will likely decline toward more normal levels. Despite sharp drops in recent activity due to the coronavirus pandemic, the domestic housing market appears to be strengthening, driven by growing demand, limited supplies and multi-decade low mortgage rates. House prices in May were 4.3% higher than a year ago. Housing starts in June were up over 17% (seasonally-adjusted annual rate) and permits rose 2.1%. According to Freddie Mac the average rate on a 30-year fixed mortgage fell below 3.0%, representing the lowest level in almost 50 years of record keeping.

The Federal Reserve

In recent months, the Federal Reserve has deployed various tools to promote the smooth functioning of financial markets and the flow of credit. The Fed has purchased Treasury securities, agency residential and commercial mortgage-backed securities (MBS), expanded repurchase agreement (repo) operations, and introduced several credit and liquidity facilities aimed at both corporate America and Main Street. As a result,

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the Fed's balance sheet has increased from \$4.2 trillion at the beginning of 2020 (representing about 19% of U.S. GDP) to \$7.2 trillion in June (about 33% of U.S. GDP). Interest rates are likely to be held steady at near-zero levels for the foreseeable future. Most economists do not anticipate interest rate increases until 2022 at the earliest due to the lack of inflationary pressures.

EQUITY MARKETS

U.S. Equity

Second quarter 2020 was the strongest-performing quarter for the S&P 500 (+20.5%) in over 20 years. The quarter was the second highest returning quarter since Q4 1998's return of +21.3% and the 6th best quarter since 1936. Given the -19.6% decline of the index in Q1 of this year, the only other time in history when a more dramatic swing in consecutive quarterly performance was observable was in 1938 when the market declined -19.0% in Q1 of that year, followed by a +38.6% return in the following quarter. Mid-cap stocks (+24.1%) and small-cap stocks (+21.9%) both out-performed large-cap stocks in Q2. Growth stocks continued to out-perform value stocks in Q2 with the divergence most dramatically seen in the large-cap realm where large growth (+26.2%) delivered almost twice that of large value (+13.2%). On a year-to-date basis, although the S&P 500 is down a relatively modest -3.1%, this masks the dramatic divergence among sectors with Energy down -35.3% for the year and Information Technology up +15.0% through 6/30.

International and Emerging Market Equity

International equity markets underperformed the U.S. in the second quarter. Emerging markets (+18%) out-performed developed markets (+15%). Within developed markets, Europe (+16%) out-performed Asia-Pacific (+14%). The weakening of the U.S. dollar this quarter served as a tailwind for foreign stocks. Australia, South Africa and Germany rallied more than 25% over the quarter; laggards included Hong Kong and the U.K., which posted single digit returns in Q2. China is one of the few countries with a positive year-to-date increase of +3.5%. The Netherlands, Switzerland and Taiwan are down less than -2% year-to-date. Brazil and Mexico have struggled with surging counts of COVID-19 cases and are down -39% and -28%, respectively, year-to-date.

FIXED INCOME MARKETS

U.S. Treasury prices did not move very much over the quarter after experiencing dramatic increases earlier in the year due to the flight to quality. Investors were more focused on buying credit and equities and less on the safety of Treasuries. Credit spreads widened dramatically from mid-February until the peak on March 23rd and began tightening when the Fed announced several programs to support fixed income markets, including the purchase of corporate and high yield bonds. As a result, Investment Grade corporate bonds (+8.2%) and High Yield bonds (+10.2%) outperformed Treasuries (+0.5%) for the quarter. The Bloomberg Barclays Aggregate Bond Index returned just under 3.0% for the quarter. Corporate bond issuance set a record for the quarter at \$692 billion. 2020 will likely top the previous record set in 2017. It appears that the corporate bond market is functioning well, providing companies with the necessary capital to weather what could be several quarters of difficult operating conditions. Companies in some of the hardest hit industries like airlines, lodging, casinos, retail and energy were able to access the debt market to secure much-needed capital for the foreseeable future.

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