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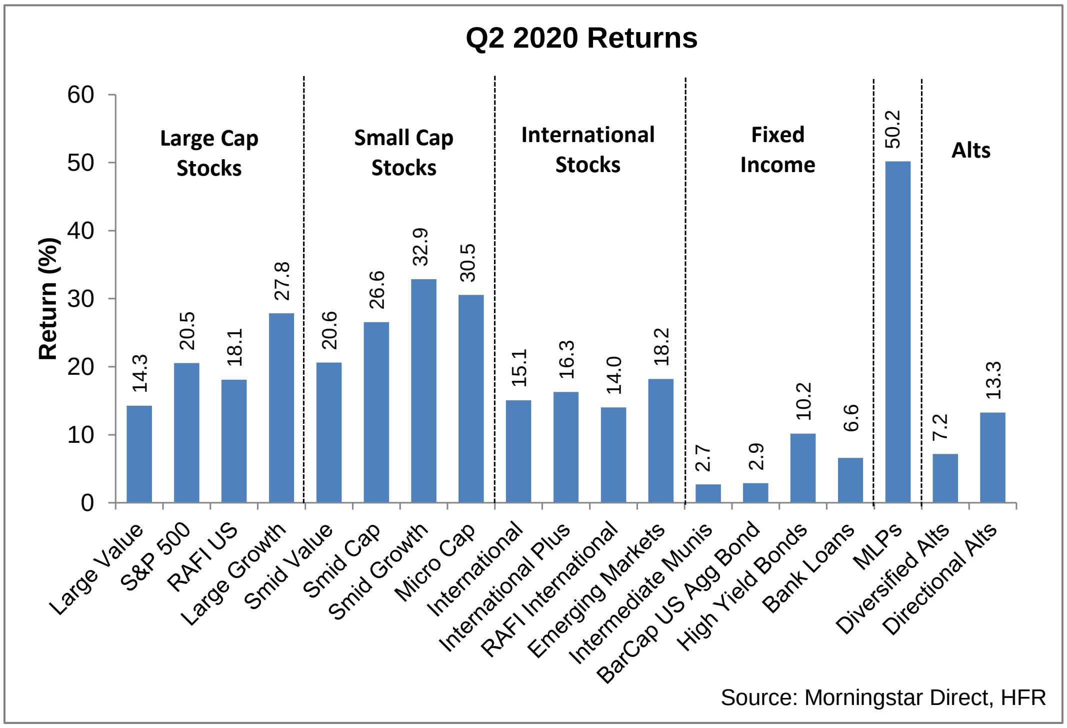
Second Quarter 2020 Investment Review & Outlook



EXECUTIVE SUMMARY

Q2 2020 Recap:

- Virtually all asset classes rebounded in the wake of the coronavirus crisis. The S&P 500 posted its best quarter in more than 20 years, climbing 20%
- Market performance has been driven by a combination of massive government stimulus and a concentration in outperforming mega-cap tech names
- The fundamental damage from Covid-19 has been acute, with US GDP falling 35% and corporate profits declining 40% in the second quarter alone

NEXT Outlook:

- We believe the fundamentals will take longer to recover than the market currently expects. This could be further hindered by any additional deterioration in US-China relations and/or a potential corporate tax hike under a new administration
- This will make it harder to justify historically high valuations for the stock market, which are currently 22.0x next year's expected earnings
- These concerns must be balanced against the tremendous support from Congress and the Federal Reserve, which are enough to propel the market rally in the near-term

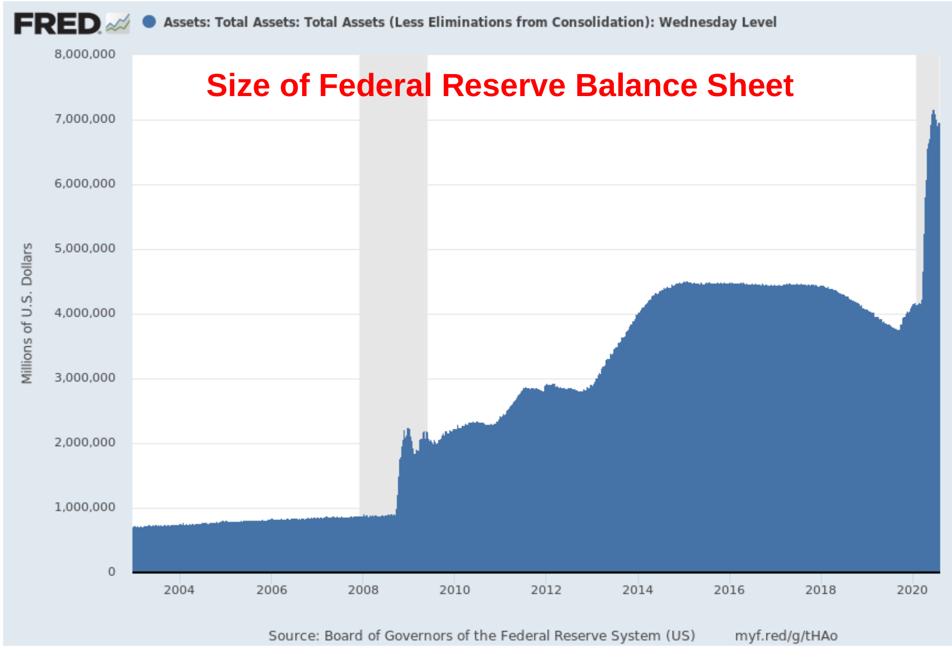
To Our Clients and Friends,

The second quarter proved to be a historic one for the stock market, as the S&P 500 jumped 20% in the aftermath of the coronavirus crisis. It was the best quarter for the index since 1998 and represented a sharp reversal from the 20% decline in the first three months of the year. This left the US market down just 3% through June 30th – a stunning achievement considering the depth of the economic damage facing this country.

The economic toll of Covid-19 has, indeed, been acute. US GDP fell 35% in the second quarter, the largest decline on record since we started tracking quarterly data in the 1940s. Approximately 20 million jobs were lost, while corporate profits shrank 40% in Q2. Business failures are accumulating, with several high-profile bankruptcies announced in the last few weeks. And yet, as we write this commentary in the third quarter, stock markets are back near all-time highs. How do we reconcile this?

1. Unprecedented Government Support

First, and most importantly, our government has thrown an immense level of stimulus at the coronavirus in a way that we have not seen before. Whereas the Federal Reserve took nearly a year to act during the 2008 Financial Crisis, the "Fed" moved in a matter of weeks this time to support financial markets. This included cutting short-term interest rates to zero, expanding their balance sheet by more than 70% (an increase of $3 trillion dollars, so far), and directly purchasing securities in a range of markets. Our central bank has gone as far as buying "junk" bonds – something once considered unimaginable. These actions have encouraged investors to take financial risk again, regardless of the breakdown in fundamentals that threaten corporate earnings and solvency.



Congress provided nearly $3 trillion of its own support through the CARES Act and other legislation, which directly supported consumers and businesses. With an additional $1-2 trillion spending package expected from Congress before the election, the total dollar amount of government support will realistically total $8 trillion in a mere six months since the pandemic started. By comparison, the entire US economy totaled just under $22 trillion at the end of 2019.

The speed and magnitude of this support cannot be overstated. We have collectively substituted more than a third of our national economy with dollars from the US Treasury and Federal Reserve. Financial markets would look far different if the government's response had looked more like 2008 – a period when the S&P 500 fell 57%.

2. This is a Natural Disaster, Not a Bubble

It is also important to understand that many investors do not view the current pandemic as a "normal" recession. Traditionally, recessions are brought on by excesses that build up in a certain part of the economy – so-called "bubbles" – that burst and require a long and difficult recovery. In 2000 it was the internet bubble and in 2008 it was the overextended housing market. This time around, many investors view our situation as more akin to a natural disaster like a hurricane or flood: in other words, we are experiencing a temporary disruption to economic activity that will be quickly reversed once that disruption ceases.

So far, that view has proved mostly correct, as employment and growth levels have rebounded sharply since national lockdowns have been lifted. But while economic activity is improved from trough levels, aggregate output and employment remain significantly below pre-covid levels. Time will tell whether a swift recovery is in store for us or if a much longer period of healing is necessary. We would venture that the latter is not adequately priced into the markets and poses a risk as we head into 2021.

3. The Stock Market is Not the Economy (Especially the S&P 500)

Lastly, we would note that the composition of our stock market has evolved to look very different than the broader economy – and frankly, look very different from other stock markets around the world. Today a record 23% of the S&P 500 is concentrated in just five companies – Apple, Microsoft, Amazon, Alphabet (Google), and Facebook. All five are technology-oriented companies that have been comparatively less impacted by the pandemic. Through June 30th, the average performance of those five names was +23.8%, about 30% better than the performance of the other 495 stocks in the index!

This performance at the top of the S&P has masked what is an otherwise poor year for markets. International stocks, small cap companies, and "value" stocks (banks, industrials, etc.) have all posted double-digit losses this year. We had seen a trend of outperformance by technology stocks in recent years, but the pandemic has accelerated the dominance of the sector over the rest of the stock market.

What We See Moving Forward…

Absent an effective and rapidly available vaccine, it is difficult to see the status quo changing. Social distancing and the adoption of new technologies will continue to dominate our personal and professional lives. This has been a favorable tailwind for the S&P, as the index is increasingly concentrated in cloud computing, e-commerce, and communication companies. We believe that behaviors are permanently altered moving forward, even after a vaccine has been created.

The key question though is how much of that benefit has already been priced in. Today, the S&P 500 trades at 22.0x next year's earnings, which is a tremendous premium to historic market multiples. The only comparable period we have to these levels was in the late 1990s during the so-called tech bubble.

Typically, valuations are reset lower in the wake of a bear market; but with markets virtually back to all-time highs – and earnings a long way from their 2019 peak – we are concerned that we are navigating unsustainable valuation levels.

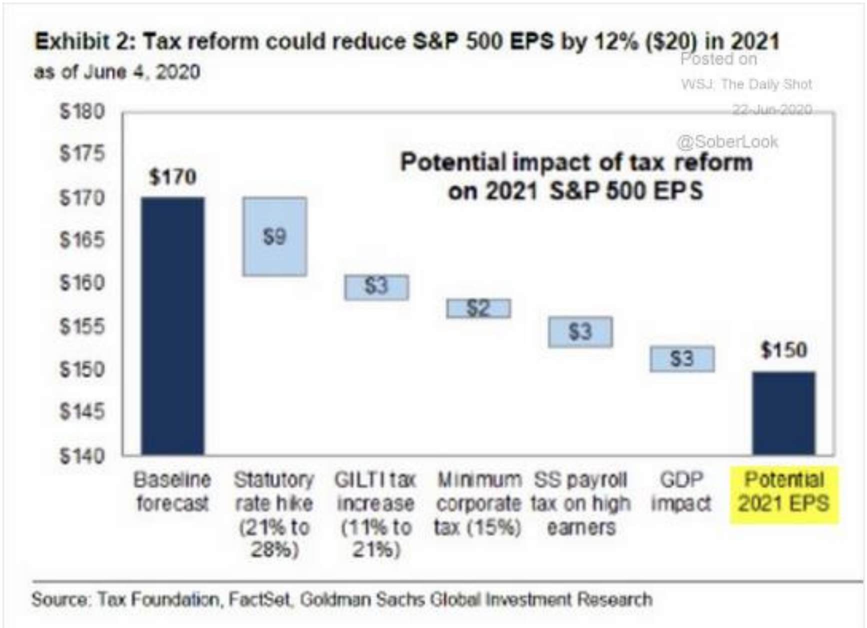
In the near term, this frankly probably does not matter much. The massive level of liquidity injected into markets and our economy is inflating asset prices. In a world where interest rates are virtually zero, and the government has effectively promised to paper over any further bad developments in the economy or markets, the current momentum in stocks can easily continue. Anecdotal reports of the so-called Robinhood generation of day traders is indicative of the swelling enthusiasm from retail investors. The episodic declines that have occurred since March have been quickly bid up as cash flows in from the sidelines.

At some point, though, fundamentals will have to matter again. The risks to many individual businesses have been blunted by the sheer amount of spending by the Federal government, but ultimately companies must justify their share prices with earnings and revenue growth. As long as companies can recover and surpass their pre-covid earnings, then one can argue that the current rally is logical. Any major disruption to the recovery story could leave us on fragile footing.

To that end, we are keeping an eye on two key geopolitical developments that could derail our momentum: (1) deteriorating relations between the US and China; and (2) a potential reversal of the corporate tax cut.

It was not long ago that alternating tariffs and public sniping between the US and China triggered a bear market in most stock indices around the world. More recently, tensions have largely been ignored by stock markets, despite having crossed into new territory with the outright ban of a successful Chinese social media company. An escalating series of retaliatory actions could take us to a new phase of this modern day "cold war" that markets must acknowledge.

Regarding corporate taxes, we are already concerned that analysts' estimates for 2021 earnings are too aggressive. Thus, any reversal of 2017's Tax Cut & Jobs Act would present an even greater challenge to meeting those expectations. Joe Biden's economic platform includes a series of tax reform items, including a rollback of the corporate tax from 21% to 28%. With a realistic possibility that Democrats sweep both the White House and Congress, November's election could have explicit implications for stock markets if a new administration were to move forward with this plan.



What It Means for Portfolios…

Given the backdrop we face today, we are managing portfolios with the following principles in mind:

- **Take Prudent Risk** – Investors face a balancing act in the markets today: the powerful effects of liquidity from our government versus weak underlying fundamentals. One should not ignore the former, as it can fuel an extended rally and the Fed has essentially backstopped financial markets. At some point, though, the market will pivot its attention back towards the precarious nature of our economy, earnings, and valuations.
- **Greater Emphasis on Active Management** – We believe it will be more important for portfolios to be actively managed given the extreme divergence in corporate fortunes and valuations amid this pandemic. We have seen our active managers significantly outperform in this environment and expect that to continue.
- **Diversifying Exposures Remain Important** – Equity investments in small cap, value, and international markets have sharply underperformed mega-cap tech and S&P 500 this year. However, valuations are much more attractive in those segments and we will likely see a dramatic "catch up" when the world normalizes.
- **Fixed Income Demands Creativity** – An unfortunate side effect of the pandemic for bond investors is that interest rates have been pushed to record lows in the US. It will be even more difficult moving forward to generate adequate yield and return from high quality fixed income investments. Thus, bond allocations will require more dynamic management, exposure to unique sectors, and the use of private funds where appropriate.

We understand 2020 has been a difficult year for everyone on a number of fronts. We hope you and your families are safe and have settled in to your own new normal. We remain available at your convenience (via Zoom, of course!) to discuss your portfolio, markets, or your personal situation.

Kindest regards,
Your Investment Team
8/7/2020

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