



The Fed vs. the Pandemic July 2020

My Dear Client:

I hope that you and your family are in good health and spirits. I also hope you did not get whiplash during the first half of 2020, which saw two distinct markets reflecting two entirely different realities.

The first quarter culminated in the fastest peak-to-bear market in Standard & Poor's 500 history, as volatility spiked to unprecedented levels and the coronavirus pandemic raged. However, the second quarter of 2020 with its 21% rally, was the best S&P 500 quarter since 1998. Aggressive stimulus policy, optimism over potential vaccines and treatments and a faster-than-expected bottoming/rebound in some economic data contributed to the strong performance.



Growth stocks outpaced Value while Technology, Consumer Discretionary, and Energy fared best among sectors. Yet despite the strong stock market performance, the state of the economy remains mixed at best. Unemployment has been in the double digits (though declining) for three months and the economy shed roughly 13 million jobs over the course of 2Q20. Unemployment insurance claims have flattened out, but at a very concerning level before including those receiving Pandemic Unemployment Assistance who do not qualify for unemployment. Still, several data points indicate a more V-shaped recovery while others point to a W or square-root recovery. Manufacturing and service PMI data have rebounded strongly, while the purchasing of housing has remained shockingly resilient. Almost a third (31%) of renters did not make their May payment and 8.5% (4.2 million) of U.S. mortgage holders are now in forbearance. I suggest another quarter or two to discern if housing has rebounded... or if lockdown demand from March- May was simply unleashed?

All eyes look to Washington, as another coronavirus stimulus bill will seem key to the continued recovery, particularly given the dire unemployment. The Federal Reserve, led by Chair Jerome Powell, pledges to use its "full range of tools to support the economy in this challenging time." Following their landmark 1Q20 actions, the Fed has implemented and expanded several lending facilities aimed at both corporate America and Main Street. Despite this support, Powell has also continued to use his platform to advocate for additional Congressional fiscal stimulus to battle the longer-term effects of pandemic lockdowns, especially job losses.

History will decide if this unprecedented aid – much of it tax-free – can keep citizens, business, and the country solvent to re-emerge and restart normal economic activity.

Domestic Equity Market



Growth continued to trounce Value this quarter with a 28% rebound for the Russell 3000 Growth and a 15% gain for the Russell 3000 Value. On the year, Growth now leads Value more than 25%, the widest margin for a 6-month period since 1999.

From a market cap standpoint, trends shifted in the second quarter. Investors showed their appetite for risk by favoring Small-Cap (+25%) over Large-Cap (+22%). For the first half of 2020, Small-Cap still trails Large-Cap more than 10%, as larger companies experienced greater investment inflows and protected more on the downside in the freefall of the first quarter. A paradox could be forming as some suggest this is the early start of a rotation towards Small-Cap stocks. Yet, strengthening Q2 gold prices could be a harbinger of debt related economic challenges.

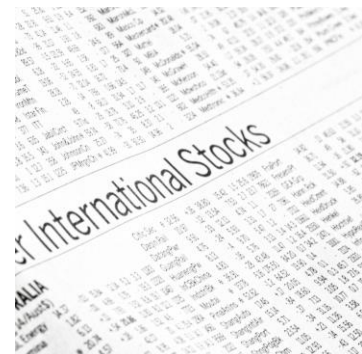
Leading the rally during this recent quarter were surging sectors Consumer Discretionary (+32.9%), Information Technology (+30.5%) and Energy (+30.5%). Defensive sectors Utilities (+2.7%) and Consumer Staples (+8.1%) lagged in a market eager for “risk-on” and speculation. Real Estate (+26%) led the economy-sensitive cyclical sectors, followed by Industrials (+17%), Materials (+13.2%), and Financials (+12.2%). Communication Services (+20%) and Health Care (+13.6%) had gains that basically offset their first-quarter declines. Information Technology has been the leader for the first half of the year with a 15% YTD return. Energy (-35.3%) and Financials (-23.6%) remain in negative territory.

The Fed-induced risk on trade that is propelling this rally is beginning to show areas of froth and surrealism. As happened during the quarter, mania-like trading action at multiple points saw “speculators” push up shares of bankrupt Hertz auto. Information Technology includes the powerhouse stocks Apple, Microsoft, Google, Facebook and Amazon that collectively now represent 22% of the S&P 500 (*this is eerily similar to 2000, when Cisco, Microsoft, General Electric, Intel and Exxon were 19% of the S&P 500*). These companies powered the Tech laden NASDAQ 100 index to a pandemic ignoring +16.9% return (thru Q2).

International Markets

No part of the world has been immune to COVID-19 but the timing and pace of the recovery varies by sector and region.

International equities underperformed compared with those of the U.S. Within international, Emerging Markets (+18%) outperformed Developed International (+15%). The U.S. dollar weakened somewhat this quarter, which was a tailwind for foreign stocks. The best performers were Australia, South Africa and Germany, which rallied more than 25% in the second quarter of the year. Laggards included Hong Kong and the U.K., which posted single-digit returns. Note that International markets outperformed domestic for the month of June, a first- in multiple quarters.



China is one of the only countries with a positive YTD return (3.5%). The Netherlands, Switzerland and Taiwan are down less than 2% YTD. The two largest economies in Latin America – Brazil and Mexico – struggled this



year, down 39% and 28%, respectively. Both countries face surging COVID-19 (Brazil is second to the U.S. in total cases) and are hurting from low commodity prices, as slow demand continues to hold oil prices at bay.

More volatile emerging-market equities (as measured by the MSCI Emerging Markets Index) fell 23.6%. Developed international equities as measured by the MSCI EAFE Index (net of taxes) fell 22.8%.

As in the U.S., Growth stocks held up better than Value across international markets.

Bond Markets



As measured by the Bloomberg Barclays Aggregate, the U.S. bond market delivered positive returns in Q2, increasing 2.9%. Risk sentiment experienced a nice bounce back as investors adjusted to the new reality of COVID-19. Economic data and virus-related news during the second quarter were not as dire as initially forecasted, prompting a bid for risk assets and spread product. Policy remains accommodative, creating incentive for liquidity-driven increases across markets.

The second quarter saw rates stay relatively range-bound, while credit spreads snapped back as fundamental concerns were pushed aside and demand for yield took over. Sectors hit hardest in the first quarter experienced the biggest rebound in the second, with High-Yield returning 9.7%, Leveraged Loans 9.6% and Investment Grade Credit 9%.

Investment Grade spreads tightened despite the high degree of economic uncertainty and record corporate debt issuance (\$1.6 trillion YTD). A broad, not-so-dire growth outlook and a weaker U.S. Dollar served as support for Emerging Market debt, which saw a 10% increase in 2Q20. Laggards included U.S. Treasuries (0.5%) and Mortgage Backed Securities (MBS) (0.7%). Due to their low-yield profile, returns for these high-quality sectors are driven more by rates than by income. The 10-year Treasury ended the second quarter at 0.67%.

Munis returned 2.7% in the second quarter, trailing their taxable counterparts by 20 bps. With assistance from the Federal Reserve and policy intervention, order was restored to the muni market: Sector dispersion continues to be elevated; COVID-impacted areas such as transportation, education, healthcare, sales tax-backed, airports and convention centers are still trading at wide levels versus historical averages (though tighter than the horrendous first quarter). Risk sentiment also returned to the muni market during 2Q20, leading to strong performance for high-yield (+4.6%) and taxable municipals (+5.9%).

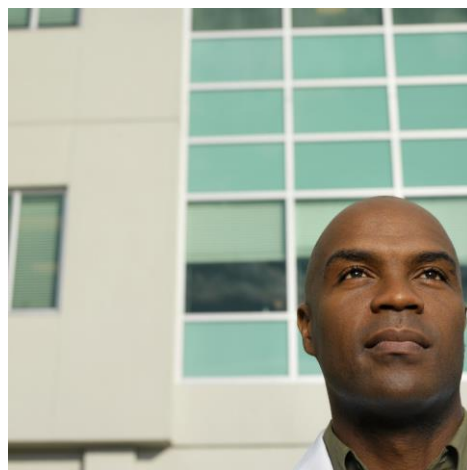
The Fed's declaration and willingness to support the lower bound of the investment-grade bond market served first as a floor and now as prop to the entire bond market. Not only were high-yield debt securities increasing in strength but challenged companies such as Carnival Cruise were able to raise significant debt using their ships as collateral even though the company will have zero revenues thru Sept. 30.

A Look Ahead

We know a bit more than we did at this time last quarter, but we still don't know many things.

We now know how the virus is spread and can be significantly halted by wearing masks. We know that cases are rising, particularly in the U.S., Brazil, India, Mexico, Russia, and South Africa. We know that many promising treatments and vaccines are working their way through trials at breakneck speed and the death rate has measurably decreased from earlier this year.

We know that peak-to-trough decline in the GDP (-12.8%) for this recession is second only to the Great Depression's decline of -26.7% – and this recession's GDP decline is *three times* as severe as that of the 2008 recession. Its peak-to-trough move was even quicker than the Great Depression's: 22 days versus 42 days, in 1929.



We know that policymakers here and abroad responded with massive monetary and fiscal stimulus unimaginable before now, and delivered to the markets in a fraction of the time it took in 2008-2009. As a result, stock markets, especially the NASDAQ and S&P 500, continue to achieve or flirt with new highs.

This rapid rebound in the stock market has been led by a narrow group primarily in the Information Technology sector, with some additional contribution from Biotech and similar health-based companies. As mentioned earlier, the new big five of Apple, Microsoft, Google, Facebook, and Amazon are 22% of the S&P 500 while the bottom 350 stocks represent 20.8% of the S&P. Today in addition to the big five we also have Tesla and Netflix helping to drive market action much like Oracle, Cisco, Sun Microsystems and EMC were drivers back in 1998-2000. Today the top 15 companies represent \$9.5 trillion of market cap, or 34.3% of the S&P 500, which is exactly the same level of market cap and percentage weighting as the bottom 420 S&P 500 companies. The top three of the big five are 16.6% of the S&P at \$4.6 trillion of market cap, equal to the bottom 300 companies in the S&P.

The old adage is, "Don't fight the Fed and don't fight the tape," meaning that if the Fed is feeding the market don't try to fight it. It appears the Fed is even able to beat a global pandemic – so far. The U.S. bull market has ended yet now many say a new one has restarted, led by near-monopoly companies and the impact of the Fed and fiscal stimulus.

But the cheapest markets by far are value stocks and non-U.S. stocks, and even this guy in Nebraska named Buffet (who's done pretty well with investments) is decreasing, not increasing, his U.S. stock investments. Other legendary investors Stan Druckenmiller, David Tepper, and Howard Marks all see this as an extremely overvalued equity market.



My portfolio considerations remain consistent with those of the past few quarters. Maintain a focus on a risk-balanced, multi-asset class approach, and evaluate opportunities when larger short-term declines occur.

Consider:

- Maintaining overall U.S. equity allocation to portfolio targets and below maximum range;
- Using cash raised from Large-Cap growth stocks and other U.S. equity sales for new investments in select Emerging and International stocks and some Small Cap;
- Directing fixed-income portfolio allocations to high-quality bonds and proven opportunistic credit strategies;
- Seeking niche and opportunistic illiquid private investments; and avoid Real Estate for now as opportunities will be plentiful next year
- Reviewing prior asset allocation adjustments in public equity assets preparing for further corrections.

Great questions to ask yourself is if the S&P 500 was at an all-time high in mid-February with record low unemployment, super low interest rates, modest future inflation expectations, positive expected earnings/earnings growth, and of course no global health crisis- Why is the market doing almost as well today? Why haven't credit spreads decreased to 2020 lows?

Use disciplined, pragmatic, and patient caution during this and subsequent quarters to strategically deploy capital, riding the Fed's wave without creating undue risk to your portfolio.

Our firm is fully operational, and I will continue to discuss any concerns or changes of plan to assure that your current strategy is on target to achieve your objectives. As always, it is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

Appreciatively,

A handwritten signature in black ink that reads 'Walid L. Petiri'.

Walid L. Petiri

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, JP Morgan.