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SECOND QUARTER 2020 MARKET RECAP

How Will the Economy (And the Financial Markets) Recover?

"V-Shaped," "Checkmark-Shaped," or a "V-Check?"

Stocks Will Adjust to a "V-Check" Economic Recovery

The financial markets experienced a sharp recovery during the second quarter. Declining COVID-19 mortality rates coupled with the reopening of the U.S. economy and other economies around the world, provided the impetus for investors to invest back into stocks. Meanwhile, massive monetary policy support by the U.S. Federal Reserve ("Fed") and other central banks provided a liquidity backstop to most bond markets. The U.S. economy is entering into the early phase of a new growth cycle, which will be supportive to stocks. However, the recovery in U.S. stock valuations imply the U.S. economy will experience a "V-Shaped" recovery. We expect more of a "V-Check" recovery (depicted in the figure on the right side of the image above) due to intermittent resurgences of COVID-19 and lingering high unemployment. U.S. stocks will unlikely retest their lows in March but rather we anticipate more of an upward but choppy road forward as the markets capitulate towards the reality of a "V-Check" recovery. While a low interest rate environment limits the upside potential for bonds, they remain an important "stabilizer" to client portfolios.

U.S. Stocks

The Standard & Poor's 500 Index ("S&P 500"), which measures the performance of the 500 largest publicly traded companies in the U.S., rose 20.5% during second quarter 2020. U.S. stocks posted their best quarterly performance since fourth quarter 1998 in response to continued fiscal and monetary policy support, the reopening of American businesses, and a declining COVID-19 daily death rate. For the six months ending 06/30/20, the S&P 500 was down 3.1%.

Within the S&P 500, consumer discretionary (+32.9%), technology (+30.5%), and energy (+30.5%) were the best sectors in the second quarter while utilities (+2.7%), consumer staples (+8.1%), and financials (+12.2%) were the sectors with the poorest results. Year-to-date through 06/30/20 ("YTD"), technology (+15.0), consumer discretionary (+7.2%), and communication services (-0.3%) led all sectors while energy (-35.3%), financials (-23.6%), and industrials (-14.6%) were the worst performing sectors.

During 2Q 2020, value stocks, or shares of defensively oriented companies that generally have slower growth and higher dividend payouts, rose 13.2% while growth stocks, or shares of companies growing sales and profits faster than the broader market, increased 26.2%. Over the first six months of 2020, growth stocks increased 7.9% while value stocks declined 15.5%. The Russell 2500 Index, a measure of domestic small and mid-capitalization stocks (U.S. companies with a market capitalization lower than $10 billion) increased 26.6% in 2Q 2020. YTD, the Russell 2500 Index is down 11.1%.

A "V-Check" U.S. Economic Recovery

The reopening of the U.S. economy over the course of June effectively triggered the start of a new business cycle. The course of the current economic recovery (i.e. early phase of the current business cycle) has resembled a "V" given the sharp rebound in economic activity. This is simply due to temporarily laid off staff or furloughed employees going back to work and individuals/entities following through with purchases or other activities that were put off due to the lockdowns. We do not expect U.S. economic activity to return to pre-COVID levels (thus experience a true "V-shaped" recovery) over the next 12-18 months due an extended period of high unemployment. As such, we expect the pace of economic growth to begin to moderate into more of a "checkmark-shaped" trajectory as fiscal rescue programs such as Federal Pandemic Unemployment Compensation and the Paycheck Protection Program ("PPP") begin to wind down in July and August respectively.

As illustrated on the first page of this newsletter, we do not anticipate the U.S. economic recovery will proceed on a smooth upward trajectory. Instead, the recovery will likely experience a "bumpy" upward rise due to resurging COVID-19 infections, especially in states with less stringent quarantining efforts. The economists we speak with do not expect another nationwide lockdown due to the economic pain and social consequences caused by the first national lockdown. Instead, these economists expect future lockdowns to occur on a more regional basis where COVID-19 breakouts occur. These localized lockdowns will probably persist until a COVID-19 vaccine becomes broadly available or a larger percentage of the U.S. population take wearing face coverings and social distancing more seriously. Economic growth should also persist, albeit at a choppy pace, as certain parts of the country maintain commerce while other areas implement differing quarantining guidelines based upon the severity of the outbreak.

Generally, we are maintaining client weightings to U.S. stocks given the positive backdrop of the U.S. economy entering the early phase of new business cycle. We remain cautious, however, due to lingering high unemployment and the likelihood for a significant increase in small-to-mid sized business closures as federal support wanes and intermittent (localized) lockdowns persist. We are also cognizant of the potential for higher volatility headed into the presidential elections in November. As such, we continue to orient our clients' U.S. stock holdings towards higher quality large capitalization companies with strong business models and durable cash flows. We are also maintaining our tactical emphasis on industry sectors that have the potential to grow earnings in midst of the current pandemic. These include communication services/technology, health care/biotechnology, and consumer staples.

Foreign Stocks

The rebound in foreign stocks, both international developed markets and emerging markets, trailed U.S. stocks during 2Q 2020. The MSCI EAFE Index ("Europe, Australia-Asia, and Far East"), which measures the U.S. dollar-denominated ("USD") return of medium-to-large company stocks in developed markets outside of the US and Canada, increased 14.9% during the second quarter. Developed market stocks underperformed U.S. stocks during the quarter primarily due to their greater exposure to "old economy" businesses (e.g. travel/leisure, financials, and industrials). Stocks within these industries have lagged the recovery in more dynamic sectors such as technology and communication services, due to their higher sensitivity to economic conditions and global export demand. During the first six months of 2020, the MSCI EAFE Index declined 11.3%.

Developed international small-to-mid ("smid") capitalization ("cap") stocks, as measured by the MSCI EAFE SMID Cap (U.S. dollar) Index, rose 18.9% in 2Q 2020. Like their U.S. counterparts, the recovery in developed international smid cap stock prices in the second quarter was more pronounced relative to large caps. The reopening of global economies was perceived to disproportionately benefit smaller cap companies just has the lockdowns during the early phase of the COVID-19 pandemic was more detrimental to these companies. The MSCI EAFE SMID Cap Index declined 12.5% during the first half ("1H") of 2020.

Emerging market stocks (countries with less than a $25,000 per capita income), as measured by the MSCI Emerging Markets USD Index, rose 18.1% (on a U.S. dollar-denominated basis) in 2Q 2020. Emerging market stocks benefited from a higher appetite for riskier assets and a declining U.S. dollar. Stocks within emerging market oil producing countries were further supported by the 81.0% rise in Brent crude oil prices during the quarter. YTD through June 30, 2020, emerging market stocks dropped 9.8%.

The MSCI China (U.S. dollar) Index was up 15.3% during second quarter 2020. Chinese stocks, which account for 33% of the value of the MSCI Emerging Markets USD Index[1], experienced a steady rise in valuation over the course of the quarter in response to central governments successful efforts to contain COVID-19. China is also experiencing a stronger recovery relative to rest of the world with its economy operating at 90% of pre-COVID levels[2]. Chinese stocks rose 3.5% over the first six months of 2020.

We Continue to Prefer Foreign Stocks Over U.S. Stocks

International developed markets are attractive both from a fundamental and valuation standpoint. Trailing returns over the past decade for both developed international and emerging markets stocks are nearly 50% below their respective long-term average. Fundamentally, the COVID-19 pandemic has forced major international developed market countries to implement long-overdue policy measures that have the potential to create lasting benefits to the regions' economies and asset markets. For example, the European Commission established an $841 billion fiscal stimulus program that will fund "green deal" oriented infrastructure projects like high-speed rail while also moving the 27-member trading block closer towards a true fiscal union, an important factor of stability going forward. Strong public health measures controlling the spread of Covid-19 in Europe, Japan, and South Korea have also allowed for a more rapid "normalization" of economic activity as compared to the U.S. Key international developed markets, including Europe and Japan, continue to trade at a significant discount to U.S. stocks.

Emerging markets stocks also provide a compelling investment opportunity relative to U.S. stocks. Valuations remain cheap and the long-term growth prospects for emerging market economies still look better than for the U.S. and other developed markets. We maintain a tactical emphasis on China/Asia-Pacific especially since these countries have handled the COVID-19 outbreak most effectively and are on the forefront of the global economic rebound.

Real Assets

The S&P Real Asset Index rose 10.8% in second quarter 2020. The S&P Real Asset Index measures the results of securities tied to physical assets including those that can produce relatively stable income streams, such as real estate and infrastructure assets, and inflation-sensitive real assets (e.g. hard commodities and inflation-linked bonds). Falling bond rates increased demand for higher yielding, income generating global real estate and infrastructure assets last quarter. During 1H 2020, the S&P Real Asset Index declined 10.8%.

U.S. midstream energy sector returns significantly outpaced other infrastructure categories during 2Q 2020. The Alerian US Midstream Energy Index, which measures the results of U.S. companies that gather, process, transport, and store oil and gas, increased 45.3% during the quarter. The OPEC+ production cuts beginning on May 1 combined with a pickup in global oil demand led to a sharp rebound in U.S. midstream energy valuations. However, the U.S. midstream energy sector is still down 33.3% over the first six months of 2020.

Real assets remain an import portfolio “diversifier” since their relatively defensive income streams serve as a viable substitute to holding more fixed income or higher concentrated positions in defensive stock sectors (e.g. consumer staples, healthcare). Midstream energy companies offer an especially attractive opportunity to capture current income considering the current yield of the Alerian US Midstream Energy Index is approximately 10% (vs. 2% for the S&P 500). We anticipate US midstream energy company valuations will continue to recover as the macro factors that impacted the energy sector in 1H 2020 (declining energy demand and global oil oversupply) are expected to turn around over the coming quarters. Warren Buffet’s recent purchase of a utility company’s natural gas transmission and storage assets highlights this opportunity. It also highlights the importance of natural gas and natural gas transmission as the world consumes more energy yet demands less carbon.

We continue to recommend caution in the real estate sector, particularly in light of the companies that have failed and the anticipation that more companies will fail in the coming months. Demand for commercial space, especially restaurant locations, should minimize the normal benefits of owning commercial real estate. Once real estate values adjust to reflect the new reality in the commercial real estate sector, we may consider the benefits at that time.

Alternatives

The Credit Suisse Liquid Alternatives Index, which measures the returns of investment assets/strategies that have very low correlation (i.e. relationship) to traditional stocks and bonds (i.e. “alternatives”), rose 5.1% in second quarter 2020. For the first half of 2020, alternatives were down 1.0%. Alternatives continue to mitigate portfolio volatility by not falling as much as traditional equities during the 1Q 2020 and generating a higher-than-traditional bond return in 2Q 2020.

We are replacing an existing managed futures (“trend following”) strategy we have used in some client portfolios with another manager focused on “event driven” investing. Unfortunately, the previous fund manager did not provide competitive results compared to other trend following managers during the most recent financial market downturn. The new alternative fund manager invests in worldwide publicly announced mergers, acquisitions, takeovers, and other corporate reorganizations. We see an opportunity in event driven strategies given the disruption experienced in practically every industry as a result of COVID-19. The frequency of mergers, acquisitions, corporate divestitures, etc. will likely increase thus provide opportunities for solid results.

U.S. Fixed Income (U.S. Bonds)

The Bloomberg Barclays US Aggregate Bond Index (“Barclays Agg”), a measure of high-quality U.S. bonds of all types (i.e. “core bonds”), rose 2.9% in 2Q 2020. Investment grade corporate bonds, as measured by the Bank of America Merrill Lynch U.S. Corporate Bond Index significantly outpaced other investment grade bond sectors (namely U.S. Treasury bonds and agency mortgage backed securities) rising 9.3%

during the quarter. The phased reopening of the U.S. economy over the course of 2Q 2020 coupled with unprecedented Fed policy support, spurred investor optimism and drove investment grade corporate bond spreads tighter. (A spread is the difference between a U.S. Treasury bond yield and the yield of a non-U.S. Treasury bond, such as a corporate bond, of the same maturity.)

The S&P National Municipal Bond Index, which is designed to measure the returns of the investment grade, tax-exempt bond market, increased 2.4% in the 2Q 2020. After experiencing their worst month ever in March (in terms of monthly outflows)[3], investor sentiment has improved in response to Fed policy support and federal assistance to state and local municipalities throughout the course of the quarter. The S&P National Municipal Bond Index has risen 2.0% during the first six months of 2020.

International Fixed Income (Bonds)

Outside of the U.S., the Bloomberg Barclays International Aggregate Bond USD ("U.S. Dollar") Index, a measure of international developed markets investment grade bonds of all types, rose (in US dollar terms) 3.4% in 2Q 2020. Developed markets investment grade corporate bonds were a key driver of returns during the quarter. The S&P International Corporate Bond Index rose 10.1% during the quarter spurred on by foreign central bank bond purchases, especially the European Central Bank's ("ECB") $700 billion Pandemic Emergency Purchase Program. YTD, the Bloomberg Barclays International Bond USD Index is up 0.6%.

The Bloomberg Barclays Emerging Markets Aggregate Bond Index, which measures the results of U.S. dollar-denominated debt of emerging market government and corporate issuers, increased 10.0% in the second quarter 2020. USD-denominated emerging market debt performance was spurred on by an increased appetite for higher yielding debt by foreign investors due to low developed market interest rates. Aggressive central bank monetary policy support, the strengthening economic recovery in China, and the OPEC+ production cuts further helped drive USD-denominated emerging market debt higher during the quarter. For 1H 2020, the Bloomberg Barclays Emerging Markets Aggregate Bond Index is down 0.4%.

The Fed Will Remain Highly Accommodative for Years to Come

The Fed's latest monetary and economic projections show that it intends to keep short-term rates near zero into 2022. Underpinning this expectation are its forecasts for a lingering high unemployment rate at the end of this year (9.0%-10.0%) and 2021 (5.9%-7.5%) and inflation below 2% through 2022. To keep longer term rates low to promote economic growth and safeguard market liquidity, the Fed is expected to expand its balance sheet (to fund bond purchases and its various lending programs) from $4.2 trillion at the end of February to $10.3 trillion by the end of 2021[4].

Given our expectation for low interest rates at least through 2021, we view fixed income as providing a ballast to client portfolios rather than a primary source of returns.

Maintaining a globally diversified portfolio of predominately investment grade bonds will help to offset equity market volatility associated with the progression of COVID-19 infections and the economic impact of the virus. Renewed trade tensions between the U.S. and China, rising geopolitical risks (North Korea, China-India), and the upcoming U.S. presidential elections are additional reasons we advocate staying defensively positioned to offset future equity market volatility.

Due to the potential for an extended period of stress within the commercial mortgage market (40% of commercial mortgage backed deals are tied to the retail and lodging/hotel debt[5]), we are eliminating our tactical emphasis on mortgage-backed securities ("MBS"). While low supply and low mortgage rates is expected to provide support to the residential real estate market, exceptionally high unemployment due to COVID-19 increases the risk profile of residential MBS. For most clients, we will use proceeds from the sale of MBS funds to purchase "core-plus" bond funds that own intermediate-term bonds across all U.S. investment grade sectors. These funds can also opportunistically invest up to 20-30% of fund assets in foreign securities, high yield (i.e. below investment grade corporate bonds), and other high-income securities (e.g. preferred securities, convertible bonds).

Generally, we continue to advocate replacing a portion of high-quality bond exposure with national municipal bond strategies for clients in high income tax brackets. Municipal bonds offer attractive tax-equivalent yields as compared to U.S. Treasury bonds and investment grade corporate debt. In addition to continued Fed policy support, future fiscal stimulus measures are expected to provide more direct financial support for state and local governments, which will further stabilize the municipal bond markets.

For most clients, we continue to recommend owning emerging market bonds for their attractive yields and long-term growth potential. We are cognizant of the near-parabolic rise in COVID-19 cases in the emerging markets. The managers we use to gain access to these markets focus investment on countries with relatively strong balance sheets and the policy capacity to weather the pandemic. These managers also have the flexibility to take advantage of price dislocations within affected countries to pick up high-quality debt issues at deep discounts.

To "V" or Not to "V?"

The U.S. economy is opening back up, albeit in fits and starts, which is positive for stocks over the intermediate term. The market recovery, however, implies a much quicker path to full recovery than what COVID infection rates and unemployment trends dictate. We expect stock volatility to increase as the financial markets adjust to the reality of a "V-Check" recovery. Renewed trade tensions, rising geopolitical risks (North Korea, China-India), and the U.S. presidential elections may further heighten stock volatility. Owning high quality bonds, real assets, and alternative assets will help to reduce this volatility while allowing portfolios to more efficiently compound returns over time.

We Want to Help You Attain Your Financial and Personal Goals!

The general information in this report is not intended to reflect our specific recommendations for any client portfolio. Please contact us with any questions to discuss your personal goals and your investment portfolio.

We invite you to visit our new website at www.ginsburgadvisors.com. Here you will learn more about our services, client value proposition, and our team. The site also has a useful “Resources” section where you can access our previous market commentaries, watch informative videos, download our latest staff contact list, and access useful financial calculators and web links. Please be sure to check our website periodically, as we will be updating the functionality of the site to include a client portal and other useful applications.

We welcome the opportunity to discuss your goals and the most appropriate strategy to attain them. We are also honored to speak to any of your friends, associates, or relatives should they have an interest in our financial planning or investment management services.

Please stay healthy and safe!

References:
[1] MSCI Emerging Markets Index website; https://www.msci.com/emerging-markets
[2] Fidelity Advisor webinar with Mahernosh Engineer, Capital Markets Strategist; 06/15/20
[3] MarketWatch.com article: “Investor fund flows just smash all kinds of records, as seen in these charts;” 04/17/20
[4] 2Q 2020 MetWest Fixed Income Review; 06/30/20
[5] Bloomberg TV interview with Tad Rivelle, CIO for Fixed Income at TCW; 06/24/20

The return and principal value of bonds fluctuate with changes in market conditions. If bonds are not held to maturity, they may be worth more or less than their original value.

Index descriptions:

-Alerian Midstream Energy Index. The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMNA) and on a total-return basis (AMNAX).

-Bank of America Merrill Lynch U.S. Corporate Bond Index- BofA Merrill Lynch US Corporate Index – ETF Tracker. The Index is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with at least one-year remaining term to final maturity.

-Bloomberg Barclays Emerging Markets Aggregate Bond Index- The emerging markets bond index (EMBI) is a benchmark index for measuring the total return performance of international government and corporate bonds issued by emerging market countries that meet specific liquidity and structural requirements. Despite their increased riskiness relative to developed markets, emerging market bonds offer several potential benefits such as portfolio diversity as their returns are not closely correlated to traditional asset classes.

-Bloomberg Barclays International Aggregate Bond USD ("U.S. Dollar") Index- The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

-Bloomberg Barclays US Aggregate Bond Index, or the Agg, is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

-Credit Suisse Liquid Alternatives Index- The Credit Suisse Liquid Alternative Beta Index (CSLAB), which aims to reflect the performance of the global hedge fund industry, finished up 0.58% in August. The Event Driven strategy was the strongest performer for the month, and finished up 1.39% in August, and up 7.87% year-to-date

-MSCI China (U.S. dollar) Index- The MSCI China Index captures large and mid-cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). With 711 constituents, the index covers about 85% of this China equity universe.

-MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. & Canada.

-MSCI EAFE SMID Cap Index captures mid and small cap representation across Developed Markets countries around the world, excluding the US and Canada. With 2,865 constituents, the index covers approximately 28% of the free float-adjusted market capitalization in each country*

-MSCI Emerging Markets Index stands for Morgan Stanley Capital International (MSCI), and is an index used to measure equity market performance in global emerging markets.

-Russell 2500 Index is a broad index, featuring 2,500 stocks that cover the small- and mid-cap market capitalizations.

-S&P (Standard & Poor's) 500. A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the US stock market. It measures the movement of the largest issues. Standard and Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied.

-S&P International Corporate Bond Index- S&P International Corporate Bond Index is an investable index of non-U.S. Dollar corporate bonds issued by non-U.S. investment grade issuers. The index seeks to measure the performance of corporate bonds issued in the non-U.S. Dollar G10 currencies

-S&P National AMT-Free Municipal Bond Index is a broad, comprehensive, market value-weighted index designed to measure the performance of the investment-grade tax-exempt U.S. municipal bond market. Bonds issued by U.S. territories, including Puerto Rico, are excluded from this index.

-S&P Real Assets Index is the first index of its kind designed to measure global property, infrastructure, commodities, and inflation-linked bonds using liquid and investable component indices that track public equities, fixed income, and futures.