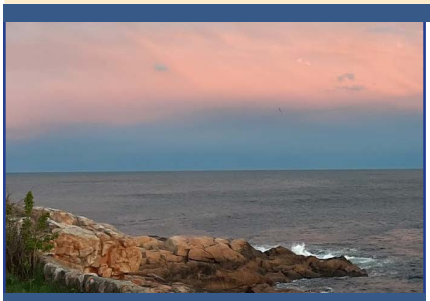
Cabot Quarterly Review

WEALTH MANAGEMENT

2ND QUARTER | 2020



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Blog

Dear Friends, July 14, 2020

As investors, we are conditioned to expect the unexpected. 2020 has certainly filled the bill. The last four months have been a truly unique experience that will forever change our economy. We believe there are many industries that will adapt to the new health safety protocols and they will retain many of these new protocols. Further, the digital sector has been cast into hyperdrive as businesses seek to automate and reduce health risks and protect their hard-working staff. We, in our research work, have always liked efficiency-oriented companies, so we have always been attracted to the software and the technology sector. Today, the technology sector is leading and is the top-performing sector of the economy. We believe this will continue for some time. What are our opinions about equity markets today? Here are a few observations we think are notable. When we think about markets, we usually focus on four separate factors. Here they are with our current thoughts:

1. Monetary Condition: *Extremely bullish.* Today stocks yield more than bonds. Investors will continue to favor stocks as long as central banks keep interest rates on the floor. What is the right valuation level when short-term money instruments are less than 0.25%? Bonds are no competition for stocks today. I am not sure anyone knows what the right valuation is for stocks when interest rates are kept so low for an extended period. I do believe it is much higher than normal periods of time.

2. Earnings: *Positive in 2021.* Earnings have crashed in the second quarter for many sectors like restaurants, entertainment, travel and more. For the digital sector, earnings are strong and rising. Today, markets are looking ahead to earnings that companies will post in Q1 2021 and Q2 2021. This year is being ignored by markets as an outlier. We do believe that it is possible that many companies are able to remove costs from their operations. This may mean earnings in 2021 will be quite strong.

3. Investor Psychology: *Bullish.* Investors in general are still skeptical of markets and continue to remain on the sidelines. This may be changing a bit, but we do not see a highly speculative market.

4. Valuations: *Neutral.* When interest rates are held to extremely low levels, we know valuations can rise to much higher levels than normal. How long will interest rates stay low? Federal Reserve Chairman Jerome Powell tells us it will be for an extended period likely lasting into 2022. I have classified this as neutral, mostly because we are in uncharted territory. We do not have a period of time in history comparable to the current period.

We do believe markets will continue to experience volatile periods and will present us with great opportunities in the coming months and years. We will do our best to take advantage of these opportunities. Thanks for your continued confidence. We are honored to watch over and help you manage your family's wealth.

Sincerely,

Robert T. Lutts
President, Chief Investment Officer

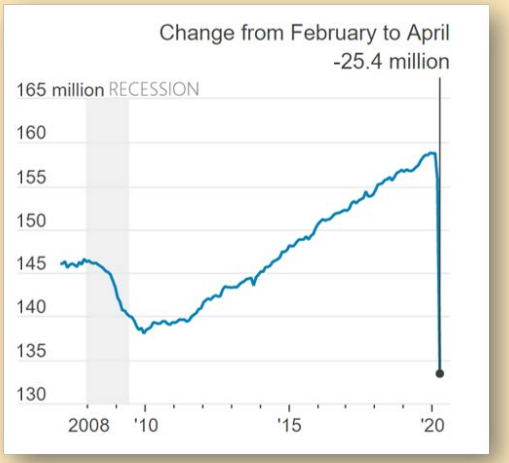
Craig Goryl, CFA
Portfolio Manager

The Great Divergence: Buoyant Markets Amidst a Terrible Economy

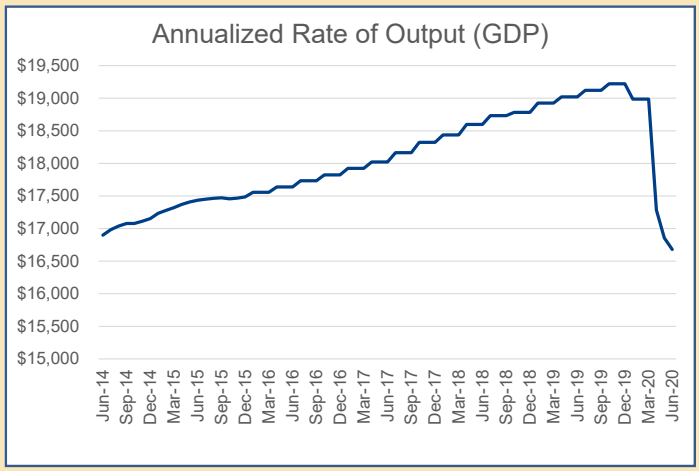
On June 25th Cabot offered an educational online webinar as part of our Speaker Series. Craig Goryl spoke about the state of markets, and Matt Heath discussed the importance of having the correct asset allocation for your goals, horizon, and risk tolerance. Below are some of the key points that Craig covered.

The main issue I would like to address is how Main Street and Wall Street have diverged this year, and what that means for investors. Jobs and Output (as measured by GDP) are among the most important indicators of an economy's health. Both have fallen off a cliff this year:

Number of workers reporting they have a job, monthly.
(Seasonally adjusted).



Source: Labor Department



Source: Bloomberg

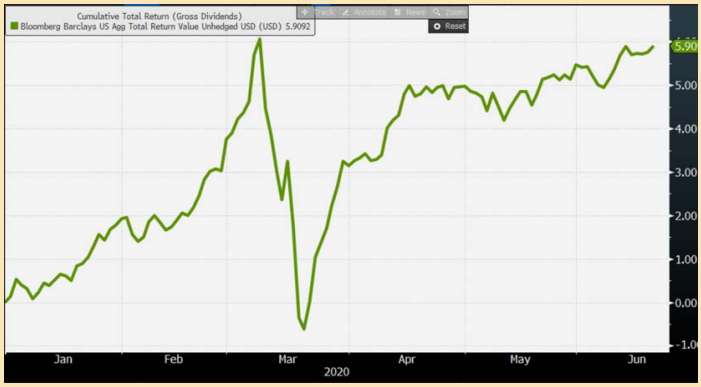
If a crystal ball had shown me those charts at the beginning of the year, I would have guessed they would be accompanied by a market crash. They were, but it was a very short-lived one; markets subsequently recovered most or all of their losses!

The below charts show the returns of stocks and bonds so far this year as represented by the S&P 500 and the Nasdaq Composite. Note the Nasdaq contains many technology companies which have been less hurt, or even helped, by the pandemic.

Total % return, year-to-date

Source: Bloomberg

The Barclays Agg is the most widely cited US bonds index



Source: Bloomberg

That makes this an unusual recession. How does such a bad economy accompany such buoyant markets? First, the market is not the economy. The market tends to look ahead, often 12-18 months, and right now it seems to be looking across a deep valley, and seeing things getting back to normal on the other side. Some of that optimism stems from medical progress toward vaccines and treatments. That shortens the valley. But the main reason is fiscal and monetary stimulus. The government has issued checks, boosted unemployment benefits, offered rescue loans and bailouts. It has borrowed to inject about $4 Trillion into the economy. Separately, the Federal Reserve has been creating money, another $2.5 Trillion, to buy bonds, lower interest rates, and support lending so companies that need a loan can get one.

That amounts to a massive rescue effort. Unfortunately, it comes with costs and risks.

- Interest rates are now so low that safe bonds do not offer enough yield to keep up with inflation, meaning safe savings will lose spending power over time.
- Stock prices are now high compared to earnings. Historically this leads to lower long-term future returns, and/or higher risk of declines.
- A widening gulf of inequality and social inequity. Layoffs, riskier work conditions, and worse health outcomes have fallen disproportionately on lower income, less educated, and people of color. A lot of the benefits of stimulus have helped those already well off. There is a groundswell for policy change. That would be good for society, but there is little agreement on what solutions are needed, and stocks generally loathe policy uncertainty.
- There are signs of speculative excess in the markets, especially among a new generation of day traders. This may be fueled by casino closures, no sports to bet on, stimulus checks, boredom, or some combination, but amateur speculation is not usually a good sign for markets.

So, what is Cabot doing for clients? We advocate maintaining a balanced exposure to stocks and bonds. Both have their drawbacks, but they also offer very different benefits. International stocks have lagged for years and as a result are cheaper than US ones. This may be their time to shine, and we are keeping exposure there. Gold and gold mining stocks historically offer unique protection against inflation and a falling dollar. We avoid speculating, especially among some of the "hot" pandemic stocks. And finally, where we invest in individual stocks, we seek strong balance sheets to weather a storm, trustworthy management teams, and wide competitive moats.

In summary, markets have been fairly benign given the virus-induced recession. That has a lot to do with massive stimulus propping up consumers, businesses, and markets. As a result, risks are elevated, and returns from stocks and bonds from here are likely to be lower than they have been over the past decade. On the bright side, I feel opportunities exist in disciplined stock selection, as well as maintaining exposure to under-owned asset classes like international equities and gold.

ASSET CLASS UPDATE

(2nd Quarter = 3/31/20 to 6/30/20; YTD = 12/31/19 to 6/30/20; 1 Year Return = 6/30/19 to 6/30/20)

INDEX	2nd QTR Return	YTD 2019 Return	1 YEAR Return	3Y ANN Return	5Y ANN Return	DESCRIPTION (What does this Index represent?)
US EQUITIES						
Dow Jones Industrial Average	18.5%	-8.4%	-0.5%	9.1%	10.6%	US Large Cap Stocks (30 select large US corporations)
S&P 500 Index	20.5%	-3.1%	7.5%	10.7%	10.7%	US Large Cap Stocks (Largest 500)
Russell 1000 Index	21.8%	-2.8%	7.5%	10.6%	10.5%	US Large Cap Stocks (Largest 1000)
Russell 2000 Index	25.4%	-13.0%	-6.7%	2.0%	4.3%	US Small Cap Stocks (2000 small public companies)
GLOBAL EQUITIES						
MSCI All Country World Index	19.2%	-6.3%	2.1%	6.1%	6.5%	Combination of major global markets: United States, Foreign Developed, and Emerging Markets
MSCI EAFE (Europe, Australia, Far East)	14.9%	-11.3%	-5.1%	0.8%	2.1%	Large and mid-sized companies in mature foreign markets like Japan, Europe, Australia, etc.
MSCI Emerging Markets	18.1%	-9.8%	-3.4%	1.9%	2.9%	Large and mid-sized companies in developing economies like China, India, Brazil, Russia, South Africa, etc.
MSCI Frontier Markets	14.7%	-15.8%	-11.2%	-1.8%	-0.1%	Large and mid-sized companies in the world's least advanced economies like Kuwait, Argentina, Kenya, etc.
FIXED INCOME						
Bloomberg Barclay's US Intermediate Bonds	2.1%	4.7%	6.6%	4.3%	3.4%	US Bond Market: government, corporate, and mortgage bonds
Bloomberg Barclay's US Aggregate Bonds	2.9%	6.1%	8.7%	5.3%	4.3%	US Bond Market: government, corporate, and mortgage bonds
Bloomberg Barclay's US High Yield	10.2%	-3.8%	0.0%	3.3%	4.8%	Higher risk, higher yield "junk" bonds
"ALTERNATIVE" ASSETS						
GOLD, Dollars/Oz.	12.9%	17.4%	26.3%	12.8%	8.7%	Gold bullion
NYSE Arca Gold Miners Index	55.9%	24.8%	44.5%	20.0%	17.1%	Companies that mine precious metals
Crude Oil, Dollars/Barrel	91.7%	-35.7%	-32.8%	-5.2%	-8.0%	The price of a barrel of oil
Bloomberg Commodity Index	5.0%	-19.7%	-18.4%	-7.7%	-8.7%	Commodities like Gold, copper, natural gas, corn, etc.
Dow Jones REIT Index	13.2%	-13.2%	-6.4%	3.6%	6.7%	An index of Real Estate Investment Trusts
Alerian MLP Infrastructure Index	47.1%	-38.4%	-44.3%	-18.4%	-13.7%	MLPs: Energy infrastructure assets such as pipelines

Pat Creahan
Portfolio Manager

The Fed and Inflation

Once the fear and focus of central bankers and politicians around the globe, inflation has taken a back seat for decades as other risk factors have concerned the average investor. Timid inflation is partly due to the central bank's ability to successfully thwart rising prices as they occur. Over the past ten years, inflation has run puzzlingly low despite a prolonged economic expansion and record low unemployment. This has emboldened central bankers to adopt ultra-accommodative policies to first recover from the 2008 financial crisis and then provide extreme relief in response to Covid-19 economic fallout. The long-term consequences of these actions remain highly uncertain and may take years to play out. The amount of money printing begs the question, will inflation come roaring back?

Traditionally, the Federal Reserve could raise and lower interest rates to combat high or low inflation. With interest rates already at 0%, much of the Covid-19-related stimulus has come in the form of quantitative easing (QE). QE is implemented through the purchase of treasuries, mortgage-backed securities, and more recently, corporate and municipal debt. When the Fed purchases these bonds, they digitally create money in the economy. In isolation, this is an inflationary act to offset the deflationary forces that come with a recession. Each round of easing comes with diminishing effectiveness as the risk premiums for holding debt are pushed lower. As a result, subsequent rounds of easing require larger asset purchases to achieve the same effect. While printed money may cause inflation, the weight of growing debt burdens may be its deflationary counterpart. So how much is too much?

If you have tuned into financial news over the past decade you have probably heard the phrase: "Don't fight the Fed". The market's confidence in the Federal Reserve to combat inflation and provide needed liquidity has long been unwavering. However, this was not always the case. The great inflation of the late 1960s and 1970s wreaked havoc on the economy with high unemployment, muted stock returns, and ever-increasing food and energy prices. To combat inflation meant to raise interest rates, and the Fed continuously re-lowered rates at any sign of economic trouble. After all, the government relied on those low rates to finance their spending which, until 1975, included the Vietnam War. The inconsistent and irresolute Federal Reserve policies damaged credibility, and rising inflation expectations continued to reinforce themselves.

That was until Paul Volcker became the Federal Reserve Chairman in 1980 and set the Fed funds rate over 20%. The move, intended to break the back of inflation, was vilified for inflicting economic pain and causing a recession. In hindsight, Volcker's policies demonstrated the importance of central bank independence and restored the market's confidence in the Fed's ability to take appropriate actions. That confidence reinforced the central bank's effectiveness by lowering the market's expectations about future inflation. Lessons learned from the ensuing economic expansions were that price stability is critically important for economic growth and full employment. More importantly, it showed that the market's confidence in the central bank is at times its most valuable asset.

For fixed-income investors, inflation expectations are a key consideration for longer-term interest rates. A bond or a loan is a promise to receive cash at some future date. If the future cash is expected to be less valuable than it is today, investors will require high rates of return (interest rates) to compensate for the deteriorating value of money. The longer an investor commits to that promise, the more sensitive the bond becomes to changing inflation. A lack of price stability endangers the reliability of bonds as a good storehold of wealth and influences the financing costs of governments and corporations.

Over the past quarter, consumers have experienced the effects of inflation in their increasing grocery bills. However, the broad-based inflation of all goods and services is likely to remain low over the near term as the economy grapples with excess capacity and high unemployment. Over the long term, the impact and interpretations of central bank actions will remain in focus as the country recovers from a truly unique recession.

As always, a diverse and risk-appropriate portfolio is best equipped for investing through these highly uncertain times.

The Economy Post Pandemic: *A Series of Charts*

Rob Lutts
President, CIO

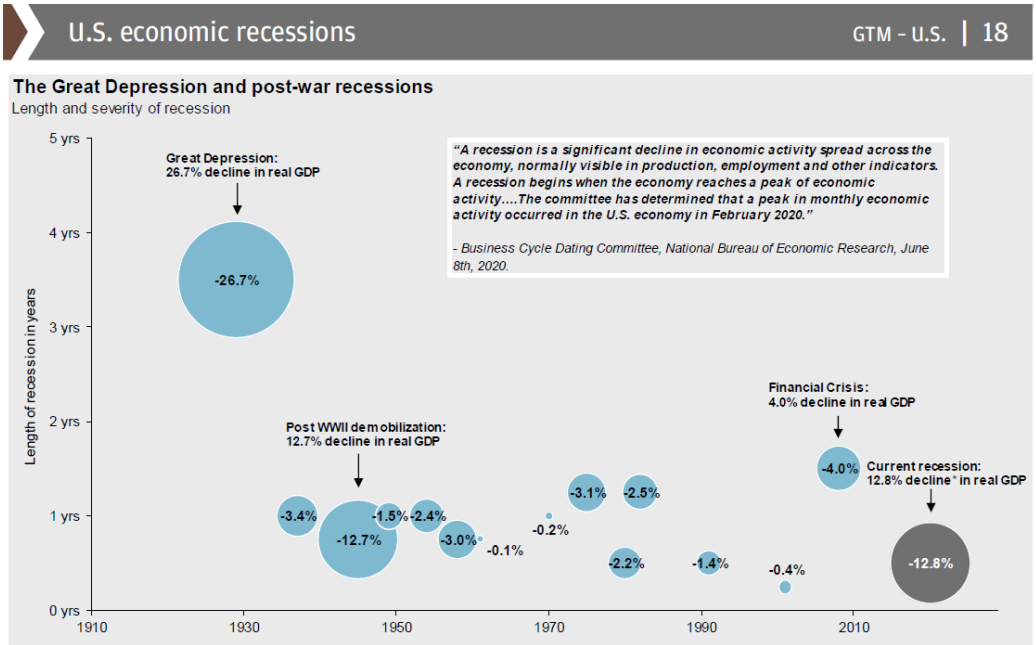
The Economy Earnings Outlook

– a devastating crash (down 20%) in earnings in 2020, then a very strong recovery in 2021 and 2022. Expectations for 2021 and 2022 are high. In fact, both 2021 and 2022 are expected to have record-high earnings levels. Is this possible? Maybe if the health situation improves over the next 3-6 months.

Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Historical EPS levels are based on annual operating earnings per share. Earnings estimates Aggregates. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2020.

The First-Ever Self-Induced Recession

Result: The Second Largest Recession in 100 years! I expect we will never see this again in our lifetimes. Most today expect a V-shaped (sharp, strong) recovery in the economy. A key question is, Will unemployment remain stubbornly high after we return to normal? – Yes, it is likely.



Source: BEA, NBER, J.P. Morgan Asset Management.
Bubble size reflects the severity of the recession, which is calculated as the decline in real GDP from the peak quarter to the trough quarter except in the case of the Great Depression, where it is calculated from the peak year (1929) to the trough year (1933), due to a lack of available quarterly data.
*Current recession reflects JPMAM estimate of peak to trough decline for the recession beginning after February 2020 according to the NBER.
Guide to the Markets – U.S. Data are as of June 30, 2020.

J.P.Morgan
Asset Management

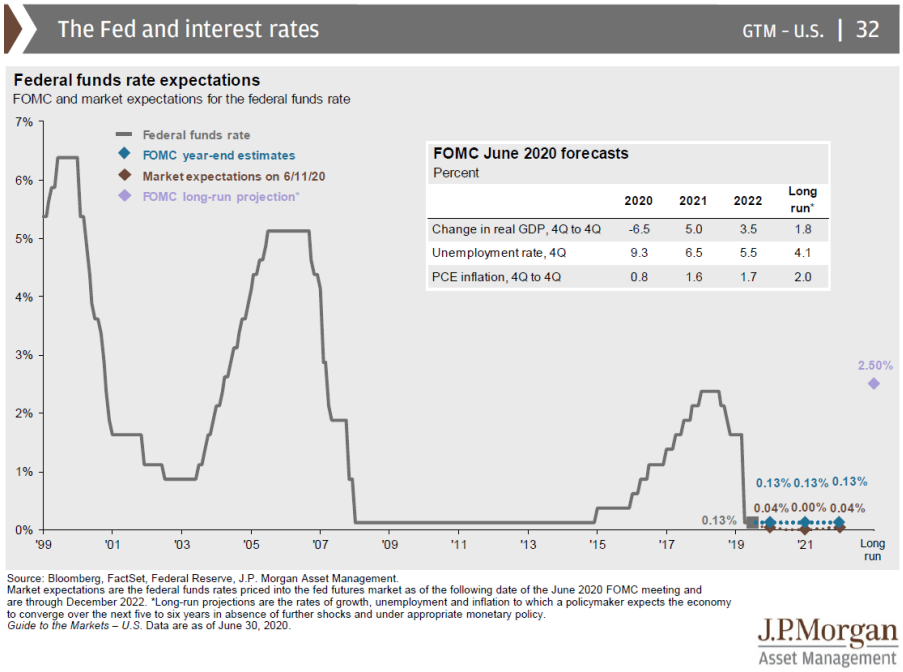
(Continued on next page...)

Rob Lutts
President, CIO

The Economy Post Pandemic: *A Series of Charts Continued....*

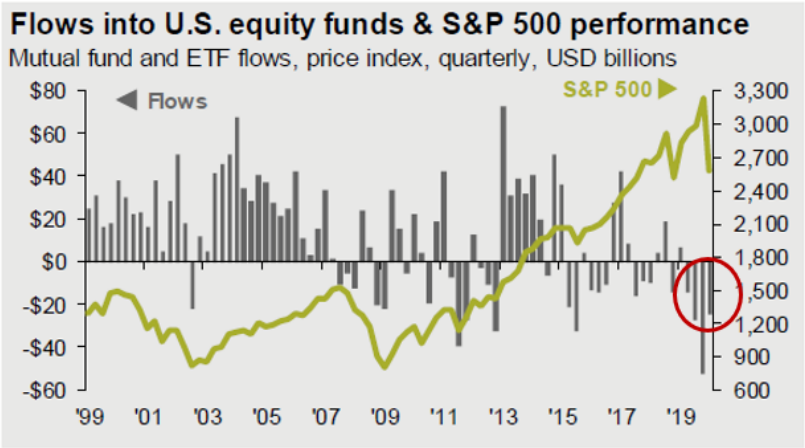
The Fed Reduced Interest Rates to the Floor

They know very well this will support the housing market and the stock market, which should help the economy heal more quickly than normal.



The Wall of Worry

Even though markets have rallied sharply recently, funds continue to move away from equities, which is a very positive situation from a Contrarian Perspective. The old adage, "The market climbs a Wall of Worry" applies. Yes, we still have a Wall of Worry.



Source: JP Morgan and Company June 2020 Chart Book

Mid-Year Tax Planning

Tom Vautin
CPA, CFA®, CFP®
Sr. Financial Planner,
Portfolio Manager

The tax authorities gave everyone a few extra months to file taxes this year, and the July 15th deadline has arrived. While "Tax Day" is always one to circle on the calendar, the task of ongoing tax planning throughout the year can be a much more important and valuable event.

With 2020 being at the halfway point already, now is a good time to start thinking about your income tax situation for the year. Here are some general things to consider:

- How will your marginal tax rate in 2020 compare to future years – lower, similar, or higher? If your income will be lower in 2020 and higher in future years, it might be beneficial to accelerate some income at a lower tax rate and defer deductions when possible. And vice versa if your income will be higher in 2020 than it will be in future years, where it might make sense to defer income and accelerate deductions.

- Be conscious of phaseout limits and additional taxes as your income increases. Certain tax benefits such as education credits, deductible IRA contributions, Roth IRA contributions, and some itemized deductions may be phased out or eliminated as your income increases. Things like the Net Investment Income Tax and higher long-term capital gain rates can apply starting at certain income levels.

- If possible, don't wait until the end of the year to contribute to a retirement plan. By contributing to a retirement account at the beginning of the year or throughout the entire year, you might realize tax-deferred growth of investments sooner. It will also eliminate the stress of dealing with potential paperwork and administrative problems at the eleventh hour.

- Keep track of your receipts and expenses. Spending a few minutes each month doing some simple recordkeeping will help you remember to claim certain deductions and credits when it comes time to file next April.

As always, we recommend seeking the advice of a professional when it comes to tax and financial planning.

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Contact your Cabot Wealth Advisor today with questions or to refer our wealth management services. (800-888-6468)

Around Cabot

Cabot welcomes summer intern Beverly Ge to the Cabot team. Beverly is working with the research team here at Cabot to perform comprehensive research in global climate change to uncover important investment trends that identify winners and losers from an economic perspective resulting from climate change.

Beverly is a Harvard graduate in Environmental Science and Engineering and has considerable classwork experience in the science of climate change. She created and taught a seminar titled "Fundamentals of Climate Change" to Chinese students and has done extensive research at Harvard on the topic.

As the research team reviews technical and scientific studies and their potential success for public companies, Beverly will help to analyze the impact of climate change to consumption and economic trends and provide opinions regarding the likely success of certain technologies and scientific studies.

When Beverly is not deep in scientific research, she might be seen playing her violin! Beverly was a member of the Harvard Bach Society Orchestra while a student there. We are pleased to have her intern with us this summer.

Cabot Sponsorship

Cabot is a proud sponsor of both Hamilton-Wenham and North Reading Little Leagues. Pictured below is Zachary Vautin, son of Tom Vautin, Cabot's Sr. Financial Planner and Portfolio Manager, getting ready for his game with North Reading Little League. This year certainly has brought its challenges to the teams but there's a big smile under that mask! Following the Massachusetts reopening guidelines, the kids are back on the field.

Little League Baseball

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