Q2 MARKET INSIGHTS

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Summer 2020

UNPRECEDENTED TIMES

We sincerely hope that this letter finds you and your loved ones healthy and safe. We also want to thank all the healthcare professionals, first responders, grocery store workers, farmers, truck and delivery drivers, etc. who are making sacrifices to support the coronavirus fight. While only half over, 2020 has proved to be an unprecedented year thus far. The global pandemic seems to have changed our world forever. Simple tasks such as going to a restaurant, attending a crowded sporting event, or even shaking hands with a stranger now seem foreign. In this ever-changing world, where we all try to adjust to the "new normal", one thing has not changed: our commitment to provide you sound, stable advice as we navigate these uncertain times together.

Global financial markets enjoyed a historic rebound in the second quarter, thanks in part to an initial peak in COVID-19 cases, continued government support and a quicker-than-anticipated economic recovery. Like the financial markets, society also made a substantial rebound in the second quarter as global economies partially reopened. Even as the U.S. battled COVID-19, business shutdowns, and limited economic activity during the second quarter, investors looked ahead to better prospects in 2021 and led the S&P 500® Index to its third highest quarterly gain in over 41 years. For the quarter, the S&P 500 finished up 20.54%, and is now only down 3.08% for the year (through June 30). International markets also rallied in the second quarter as European and Asian economies reopened. Emerging markets, whose economies are typically more sensitive to changes in expected global growth, modestly outperformed foreign developed markets thanks to a declining U.S. dollar and rising hopes for a global economic rebound. For the quarter, foreign developed markets, represented by the MSCI EAFE Index were up 15.15% (-11.03% YTD) and the MSCI Emerging Markets Index finished up 18.13% (-9.70% YTD). Switching to fixed income markets, the total return for most bond classes were again positive in the second quarter as the leading benchmark for bonds, the Bloomberg Barclays U.S. Aggregate Bond Index, returned 2.90% (+6.14% YTD). Longer-duration bonds outperformed those with shorter durations as global central bank commentary stated that rates would stay low for years to come, which anchored shorter duration bonds and in turn, increased the appeal of higher yielding, longer-maturity bonds. Corporate bonds, in a sharp reversal from the first quarter, saw positive returns in the second quarter thanks to optimism surrounding the economic reopening process combined with the Federal Reserve (the "Fed") actively buying corporate bonds in an effort to ensure adequate liquidity. Investment-grade bonds outperformed high yield corporate bonds, due in part to active buying from the Fed, as well as lingering worries about how weaker companies would fare over the longer term as the global economy slowly reopens.

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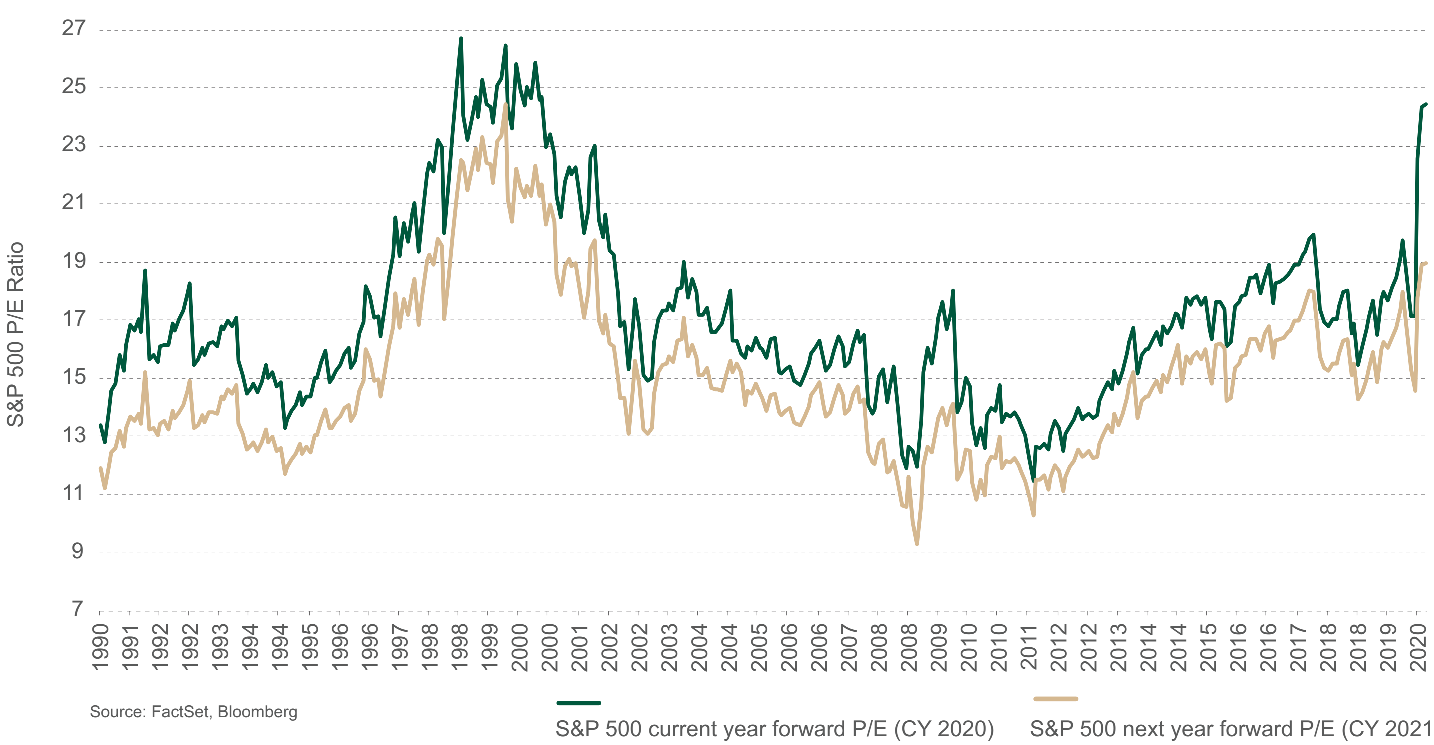
The recovery in equity prices from the March 23, 2020 bottom is nothing short of extraordinary. The speed at which the market collapsed and recovered has been truly historic, with the S&P 500 dropping 34% from February 19th to March 23rd, and then swiftly rebounding 45% to June 8th. There has been nothing normal about the nature of the current economic cycle. Investors have never seen a health crisis morph into an economic crisis by virtue of a government-mandated shutdown. In keeping with the high-speed nature of this crisis, the National Bureau of Economic Research ("NBER") declared that a recession began in February. It was the fastest decision in the 40-year history of the NBER's recession declarations. Many economists are expecting GDP in the U.S. to contract between 6% to 10% for 2020.

As we look ahead, we are seeing a real disconnect between equity valuations and economic fundamentals. The economic data for March and April was quite weak, however, incoming data for May and June suggest that the U.S. economy has bottomed and is coming out of the recession. The Leading Economic Indicators have turned up, and the Institute for Supply Management manufacturing and non-manufacturing indices are back above 50 (suggesting expansion). As such, many investors are expecting a "V-shaped" economic recovery, with a material drop in 2020 corporate earnings that will be fully recovered by 2021. In our opinion, the likelihood of a V-shaped recovery is low. The rate of change in economic activity has improved but is leveling off and the amount of activity remains far from pre-COVID-19 levels. While the U.S. added more jobs in June than expected (4.8 million vs. estimates of 3.2 million), causing the unemployment rate to fall 2.2% to 11.1% (vs. expectations of 12.5%), trends and levels in initial jobless claims portray a labor market rebound that is slowing. Even some of the more optimistic economists do not expect the unemployment rate to drop to previous levels of 4% until 2023. As we write this, there are still some 30 million people collecting unemployment benefits.

Given the recent spikes in COVID-19 cases in Florida, Texas, and Arizona, we believe growth will continue to slow due to the possibility of renewed restrictions or delayed reopenings. Further economic progress will probably depend on the course of the disease and could become more challenged if cases overwhelm the healthcare system. We have a difficult time believing the economy and corporate earnings can reach pre-COVID-19 levels until we get some sort of cure or vaccine.

According to FactSet, earnings per share ("EPS") for the S&P 500 for calendar year 2019 was $163.02. For 2020, analysts are expecting EPS of $126.90, or a drop of 22%. For 2021, analysts are expecting earnings to rebound back to 2019 levels with an estimate of $163.39 in EPS. Given the June 30, 2020 closing price of 3,100 for the S&P 500, this implies a forward price-to-earnings ratio ("P/E") of 24.4X on 2020 calendar year earnings. Assuming investors are looking past near-term earning losses due to shutdowns in 2020, and are valuing equities based on calendar year 2021 earnings, the P/E ratio stands at 19.0X. Such levels of valuations are the highest since the stock market bubble of the early 2000s (see chart below). Even if we were to achieve a V-shaped recovery in 2021, valuations appear to be somewhat high at current levels.

S&P 500 Current Year and Next Year Forward P/E Ratios

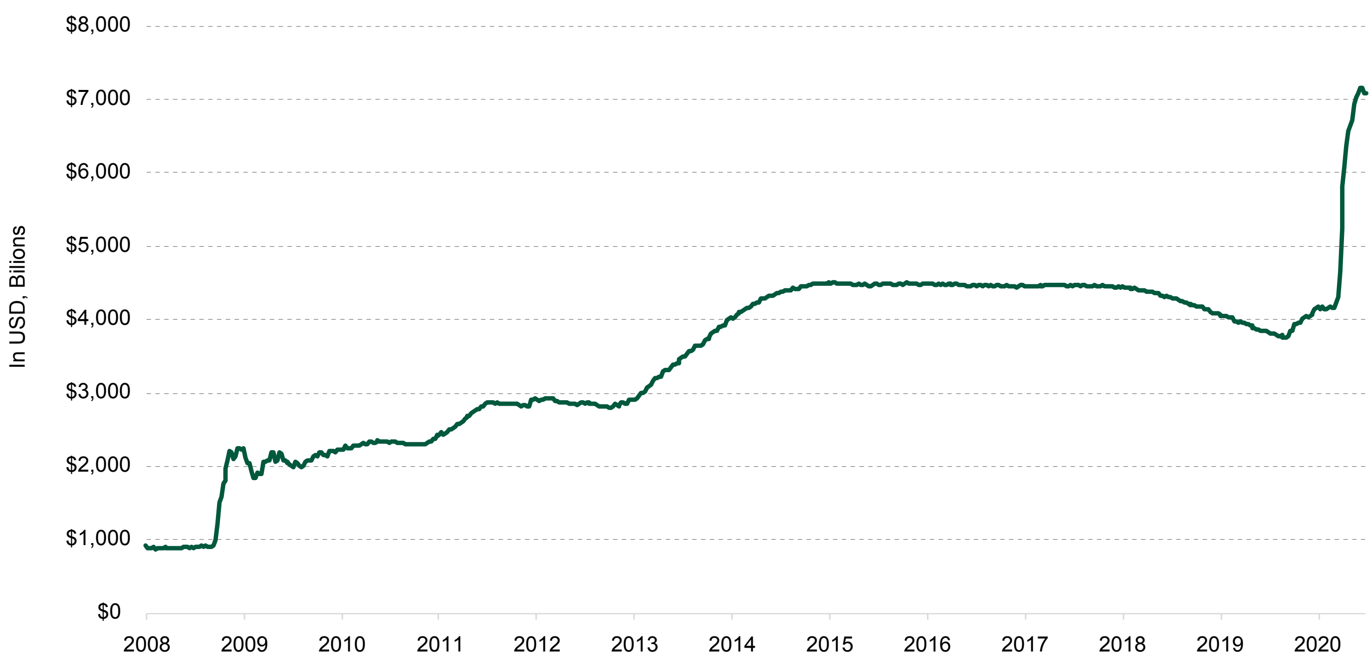


Source: FactSet, Bloomberg

THE RETURN OF QUANTITATIVE EASING

The divergence between the fundamentals and valuations may look wide, however, the rally in equities has been driven by liquidity. In response to the crisis, the Fed continues to rewrite the rules with aggressive policy action. The Fed has taken unprecedented steps in an attempt to bolster the economy and prop-up both the equity and bond markets in the face of the pandemic. In addition to lowering short-term interest rates to zero, it has again implemented asset-purchase programs, known as quantitative easing ("QE"). However, unlike the first QE programs adopted during the 2008 financial crisis, today's QE is far more expansive in the amount of money that can be spent and the type of assets than can be purchased. In this instance, the Fed has expanded its balance sheet to over $7.0 trillion (see chart below) and added capacity to purchase not just government backed securities, but for the first time, both investment grade and high yield corporate bonds. In our view, this creates a meaningful floor for risk assets, like equities and bonds, as the Fed is truly the buyer of last resort for corporate debt. In turn, this opens the high yield issuance market and allows companies to refinance and bolster or repair damaged balance sheets. This has been crucial in supporting markets.

U.S. Federal Reserve Bank Balance Sheet



Source: Federal Reserve, Bloomberg

This influx of cash by the Fed has reduced near-term financial risk, which has been a boon for asset class returns, most notably high yield corporate bonds and by extension, U.S. equities.

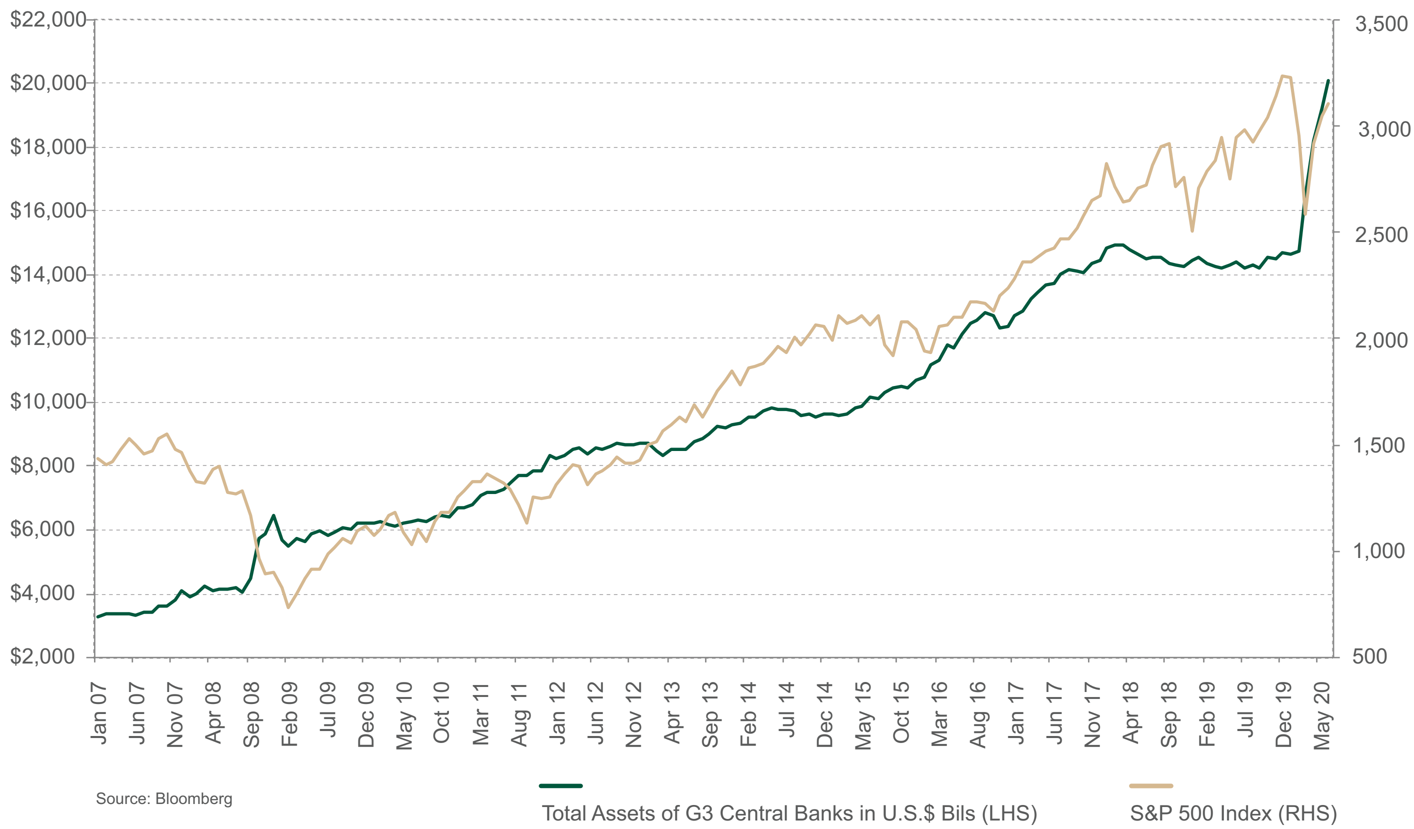
Despite the Fed's good intentions, these newly expanded programs create substantial artificial demand for the assets being purchased and compromise the fair and efficient pricing of financial assets. As a result, fundamentals get forgotten as investors come to expect the federal government to support market prices in times of crisis. However, it is not just the Fed; central banks all over the globe have been pumping liquidity into the financial system. Since the global financial crisis of 2008, the three biggest central banks, the Fed, the European Central Bank, and the Bank of Japan (collectively known as the "G3") have seen their balance sheets expand from $4 trillion to over $20 trillion. In that same timeframe, the price of the S&P 500 has risen over 300%. The chart on the next page, which we have shown several times in the past, highlights this relationship. Notice that when the Fed began its latest round of QE in March, how quickly (and positively) the market reacted. Looking ahead, we believe that the Fed's balance sheet will ultimately grow to over $10 trillion, as the Fed will continue to aggressively try to bolster the economy in the face of the pandemic. In addition, we believe other central banks will follow suit, as they too have exhausted all traditional monetary policy tools, and therefore have no other option than to purchase securities as well.

As such, we believe the gap between valuations and fundamentals will remain wide, or even expand, making the case to continue to own equities despite valuations. For more information on the basics of QE please see our breakout titled "QE and its Impact on Financial Assets".

In addition to the monetary policy response, large cap U.S. equities also appear attractive relative to fixed income assets. We must remember that large pools of money not only invest in equities, but across all asset classes. As we highlighted above, equities may appear expensive relative to their own history, but they seem cheap relative to bonds due to their free cash flow yields.

What is free cash flow? Free cash flow is the amount of cash a company generates on an annual basis after they pay their capital expenditures to maintain and grow their operations. For example, if you run a manufacturing company that is currently in the process of building a new production facility to expand the number of products you offer, free cash flow is the amount of cash you have left from your earnings after you pay the cost of the new facility, plus any maintenance costs on your current facilities. Free cash flow is used as an indicator of how much money is available for the company to return to shareholders via dividends or share buybacks.

Total Assets of G3 Central Banks and S&P 500



Source: Bloomberg

As of the end of the second quarter, the free cash flow yield on the S&P 500 was 4.67% (which is calculated by taking the level of free cash flow generated by all the companies in the S&P 500 divided by the current value of the S&P 500). This yield compares favorably to other fixed income options. See table to the right:

	Yield @ 6/30/2020*
10Yr US Treasury Note	0.66%
30Yr US Treasury Bond	1.41%
IG Corporate Bonds	2.15%
S&P 500	4.67%
High Yield Corp Bonds	7.12%

*Yield quoted for S&P 500 is free cashflow yield   Source: Bloomberg

As you can see, the free cash flow yield on the S&P 500 is much higher than the yields of the 10-year U.S. Treasury note, the 30-year U.S. Treasury bond, as well as investment grade corporate bonds. The yield on high yield corporate bonds is higher, however, high yield bond investors are subject to elevated levels of default risk. We believe this highlights the reason why investors, especially those looking for yield, have been buying large cap U.S. equities, as they offer a better relative value to other fixed income options. Would you rather own a 30-year U.S. Treasury bond paying you 1.41%, or would you rather own a stock that is generating 4.67% in free cash that can be used to pay dividends and has the potential to increase in value over 30 years?

With bond yields at historical lows, the risk-reward trade-off for owning fixed income may not be as robust as it has been in the past. While we do not anticipate interest rates rising anytime soon, which would cause bond prices to fall, there is very little room for price appreciation given that rates are so low. Therefore, within our fixed income allocations, we are managing interest rate risk by seeking to keep portfolio duration close to that of the Bloomberg Barclays U.S. Aggregate Bond Index. We also strive to reduce credit risk by keeping a majority of the portfolio in investment grade bonds.

The value proposition of owning alternative investments relative to traditional investments has become increasingly compelling. However, investing in alternative assets can involve higher risks than traditional investments and are only suitable for investors who meet certain qualifications. For those qualified investors, we will continue to seek out alternative investments that exhibit low correlation to equity and fixed income markets to broaden diversification and reduce portfolio risk in an effort to enhance overall returns.

Continue reading for a review of QE and it's impact on financial assets.

Finally, while essential to the economic recovery so far in 2020, the historic government stimulus unleashed on the U.S. economy has also resulted in an explosion of debt and surging deficits. We all know that over the long-term this trajectory is not sustainable. While the current shutdowns and restrictions are deflationary near-term as demand is weak, we believe the market is underpricing longer-term inflationary risks. Therefore, we think investors can be served well to protect their purchasing power by having an allocation to real assets and precious metals.

IN CLOSING

The first half of the year was a significant roller coaster ride and the second half could provide a few bumps as well. Various uncertainties around the U.S. elections, possible second COVID-19 waves and substantial unemployment levels all suggest that investors may experience meaningful volatility, especially as earnings visibility could remain elusive. Valuations are not very compelling at these levels as stock prices already appear to be discounting a sharp rebound for S&P 500 EPS. Additionally, the fate of the historic fiscal stimulus enacted back in March remains uncertain as of this writing. Paycheck Protection Program loans, which provided critical assistance to small businesses over the past three months, may no longer be available while it remains unclear what will become of the federal unemployment benefits included in the CARES Act, as they are set to expire at the end of July. That fiscal stimulus played a critical role in the better-than-expected economic rebound witnessed in the second quarter, and without it, the economic outlook will become increasingly uncertain. As cases pick up, reopening plans halt, and some of the stimulus wears off, we believe there will be additional rounds of monetary stimulus. While there appears to be a "disconnect" between the fundamentals and equity market valuations, we are subscribing to the mantra "don't fight the Fed" as we expect any future disruptions to be met with more monetary response. The extraordinary size and scope of the Fed's response to this crisis is the differentiator and should support investment markets in the near future. However, we expect that there will be plenty of volatility as we move forward.

The worst thing to do during a panic is to panic, because panic leads to hasty, short-term decisions that can jeopardize your long-term best interests.

The quick rebound in the equity markets off the March lows reminds us the importance of asset allocation. As we highlighted in our last quarterly letter, history has shown that a long-term approach combined with a well-designed and well-executed investment strategy can overcome periods of heightened volatility, market corrections, and even bear markets. The worst thing to do during a panic is to panic, because panic leads to hasty, short-term decisions that can jeopardize your long-term best interests.

Successful investing is a marathon, not a sprint, and even intense volatility like we experienced in the first half of this year is unlikely to alter a diversified approach set up to meet your long-term investment goals.

We thank you for your ongoing confidence and trust. Please know that our entire team will remain dedicated to helping you successfully navigate this challenging market environment.

QE AND ITS IMPACT ON FINANCIAL ASSETS

The origins of QE began during the 2008 financial crisis when the Fed first used it as a means to preserve liquidity in the banking systems and to stabilize the economy. In its simplest form, QE involves the Fed's purchase of Treasury bonds and other government-guaranteed debt from commercial banks in order to pump money into the banking system. The primary goal of QE is to strengthen the financial position of commercial banks in order to stabilize the banking system during times of stress. It also provides commercial banks with additional liquidity so that they can make more loans to consumers and businesses with the objective of jump-starting economic growth.

However, QE also creates substantial artificial demand for the assets being purchased. Under the basic law of supply and demand, Fed-driven securities buying causes a corresponding increase in asset prices. Therefore, when the Fed launches a QE program to buy Treasury bonds and/or government agency debt, the effect is not only to create liquidity in the financial system but also to increase the demand and market price for such debt as well as lower its interest yield. In fact, any QE or central bank asset-purchase program will lead to greater liquidity, more demand and higher market prices for the assets being purchased. This is one of the reasons why QE was viewed as being so controversial when it was first implemented in 2008.

QE programs also indirectly affect the price of financial markets by increasing money flows to commercial banks and other financial institutions who use this additional liquidity to buy financial assets for their own account.

For example, when the Fed buys Treasury bonds and agency debt from commercial banks in exchange for dollars, this increases the amount of cash on each bank's balance sheet. Not all of this cash is used to fund capital reserves or to make additional loans. Rather, a substantial portion of this additional liquidity is used by the banks to buy publicly traded stocks and bonds for their own account. Again, under the law of supply and demand, this increase in capital into publicly traded stocks, bonds and other financial assets causes prices in these markets to increase. QE programs cause artificial price increases in financial markets, which can lead to valuation bubbles over the long-term. This is the main reason why the equity markets fell sharply at the end of 2018, as the Fed was in the process of removing liquidity out of the system. As long as the Fed keeps money flowing into the system, prices of financial assets should continue to rise.

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Definitions:

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corpo¬rate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

Institute for Supply Management (ISM) Manufacturing Index® is a composite index based on the diffusion Indexes of five of the Indexes with equal weights: new orders (seasonally adjusted), production (seasonally adjusted), employment (seasonally adjusted), supplier deliveries (seasonally adjusted), and inventories. The index is used to measure activity in the manufacturing sector of an economy. An index value over 50 indicate expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

Institute for Supply Management (ISM) Non-Manufacturing Index is based on surveys of more than 400 non-manufacturing firms by the Institute for Supply Management. The index is used to measure activity in the services sector. An index value over 50 indicate expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

Leading Economic Indicators (LEIs) are a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association, founded in 1916, working in the public interest to deliver trusted insights for what's ahead.

Gross domestic product (GDP) is calculated by the Bureau of Economic Analysis that serves as a measure of total market value of the goods and services produced (output) in the U.S. GDP is the sum of consumer spending, investments made by industry, the excess of Exports over Imports and Government Spending.

Quantitative easing (QE) is defined as large scale purchases of securities, typically fixed income, by a monetary authority such as the Federal Reserve. In theory, the result is an increase in demand for those securities, putting upward pressure on their prices and pushing yields down. Quantitative easing allows a monetary authority the ability to influence longer duration securities, while traditional monetary tools can only directly influence shorter duration securities.

The price-earnings ratio (P/E) is the ratio of a company's share price to the company's earnings per share. The ratio is used for valuing companies and measures the price you are paying per unit of earnings.

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