Second Quarter 2020

Quarterly Letter to Clients

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We began 2020 with high hopes for continued prosperity, which were shattered during the first quarter of the year with the onset of the Nouveau Coronavirus (Covid19). We have just completed a quarter that was crushed by the changes required to adapt to the global pandemic. Amidst the background of the reopening of America and new Covid19 hotspots, the country is trying to get back to work, albeit with a mask and a prayer. While this could be considered a summer of discontent, the reality is that the ongoing impacts of the virus could last for a year or two, but the aftermath may change our lives forever.

Most folks, after working either part-time or full-time from home for the past 15 or more weeks, are ready to be done with the COVID19 pandemic. However, the pandemic is not ready to be done with us. For the most part, the shock of the global policy response to the pandemic, coupled with increase social unrest and political uncertainty, have left us all trying to come to grips with what might be a new economic reality. We've heard the impacts described as "unprecedented" till we really can't stand hearing that superlative anymore. We have been forced to deal with multiple fears – the fear of losing a job, the fear of losing money, and the fear of losing our health, with most of us ill-equipped to gauge the probabilities of the potential outcomes for our particular situation.

Our economy experienced a government mandated sudden stop in economic activity to try to forestall the debilitating, and sometimes deadly impacts, of the coronavirus. The rapidity of the change has, at the very least, plunged our economy into a deep recession whose duration will most likely be a function of when either of the following two conditions are met: 1. a vaccine is developed and distributed, or 2. herd immunity is attained. In the interim period, the U.S. Government and its Central Bankers are coordinating (we use that term loosely) a full-fledged assault to try and offset the impacts of the pandemic. Yet, the speed of change has left us all wondering if the government response has really made things better or worse.

At this point in time, the implications of the worldwide shut-down are difficult to decipher. It really did not help that the global economy was already exhibiting

signs of a significant slowdown before the pandemic hit. 2019 ended with consumers and corporations tacking on higher levels of debt, stifled trade, earnings growth faltering, and a manufacturing sector that was already experiencing a profits recession. The National Bureau of Economic Research (NBER) has determined that the record long expansion ended in February 2020. This means that the nationwide shelter-in-place mandate impacted that last third of the first quarter and carried on into the second quarter of the year. As reopening began in late May and early June, the estimates of second quarter Gross Domestic Product (GDP) will be heavily influenced by the shutdown. Reopening will be a process – one that is not very well defined at the present time, but nevertheless, will most likely take place with fits, starts, restarts, and delays as the virus finishes its first wave across the country. The history of pandemic cycles is not encouraging and points to a high probability that we will experience a 2nd, 3rd or more waves as the virus works through the population, unless an effective vaccine is developed and widely distributed.

Physical distancing, while a practical and necessary part of fighting the spread of the disease, translates to a decline in capacity for almost all industries in America. In addition to the question of how long it will take to defeat the pandemic, there is the very real question of what changes in behavior will be temporary and which will be permanent. Either way, companies with excess capacity will most likely have difficulty in sustaining pricing at previous levels while volumes are significantly reduced. It follows then that revenues, net income and cash flows will all be impacted significantly until some semblance of normalcy returns. Businesses across the country have been upended by COVID19, with many permanently shuttering their doors.

This contributes to an already ugly employment outlook. Unemployment is only a partial indicator of what's happening. While the rate of decline has slowed considerably, even with the improvements made over the past few weeks, the data is still painting a bleak picture. Many of the unemployed are currently considered furloughed or temporarily unemployed. However, as things have gone from "really bad" to "not as bad", the reality is that the lag in business reopenings is starting to weigh on the ability of businesses to return to their former level of sales and profitability.

With over 30 million people filing for unemployment and supplemental payments provided for under the CARES Act, the ability to balance the mitigation of virus spread with the ability to get back to work will be difficult in the best of situations. Some industries will need to retrench to survive. Many of those who are temporarily unemployed will be moving into the permanently unemployed camp. Take for instance the airline industry which employed about 750,000 employees

before the pandemic. Most recent estimates of reduced demand are challenging airlines to reduced capacity, and with less planes flying it's estimated that the industry will lose between 175,000 and 225,000 jobs. Many of these jobs may not come back in the near term, which means that former airline employees will need to search for new employment.

The government's attempts to fill the gap through the stimulus bill can only succeed if businesses are able to return to a sustainable level of sales and profitability. Income replacement is not the traditional form of recessionary stimulus. In fact, the current policy response has moved from being a temporary safety net to a substitute for earned income, with many folks earning more through government assistance than from their former jobs. This only complicates the recovery process by making the return to former employment temporarily less attractive. While these actions provide relief in the short-run, the indeterminate time horizon for a solution to the virus means that this may only be the first of many assistance programs.

There is quite frankly a staggering level of stimulus being thrown at the problem of keeping people employed, providing liquidity to businesses so they can survive, and to inject funds into the fixed income markets to reduce uncertainty and to thaw those markets where fear had frozen market participants to the point of not buying or selling securities. The hope is that the huge levels of fiscal and money stimulus will help forestall the devastating impact that came from the sudden stop of businesses and consumers buying goods and services. But the reality is that these policy actions continue to cloud the crystal balls of economists, many of whom have neither the past experience nor the econometric models to provide us a clue of how much stimulus is really enough. As of this writing, over four years of tax receipts have been approved by Congress to provide various forms of relief. In addition, the Federal Reserve has implemented over a dozen programs to target either loans or to provide liquidity to various parts of the fixed income market.

The good news is that the capital markets have responded with enthusiasm to the intervention. Spreads in the corporate and high-yield markets narrowed considerably after the Fed's announcement that they would purchase high-yield Exchange Traded Funds (ETFs) and investment grade corporate bonds. In essence, the market believes that if the Fed is buying, there is less risk and that there is a price floor underneath the credits. Loans made directly to marginal companies, with below average balance sheets, have likewise been cheered by stock market participants. Stocks of near bankrupted companies have seen massive stock price gains as speculators have been buying without abandon.

The bad news is that the Government has stepped into the middle of the market processes, providing loans to marginal companies and intervening in the bond markets by making purchases of high-yield and corporate bonds. These actions do not come without future costs and consequences. Since the U.S. Treasury is charged with funding the huge deficits created to pay for the myriad of stimulus programs, the current stimulus spending really translates into a higher levels of Federal Debt. The already precarious state of the U.S. Debt levels leaves the country vulnerable in a world where there are few safe haven investments. At what point will borrowers deem the United States credit ratings at less than AAA/Aaa? While that question seems rhetorical, it has been debated frequently with no specific answer. What we do know is that the probability of a credit downgrade becomes more certain as the level of debt increases relative to the nation's ability to service the debt. We also know that currently high, and increasingly larger debt creation, leaves future policy makers with limited capabilities to use fiscal and money tools to offset the impacts of the business cycle. Finally, with the Federal Reserve now directly intervening in the capital markets as the "buyer of last resort", there is little question that these actions will directly impact interest rates (the price of money). In essence, the Fed may be artificially influencing the nominal interest rate and inflation dynamics of the bond markets.

The stock market appears to be ignoring the economic chaos in favor of looking past the current earnings season, which will be a disaster, towards a possible brighter future. Nevertheless, earnings estimates are falling hard, with company earnings guidance removed due to the uncertain future. Many companies have adopted a survival strategy. They are conserving cash and trying to delay the tipping point so that reduced liquidity doesn't morph into insolvency. The playbook is similar to a turnaround situation, where the focus is on conserving cash. This means companies are reducing, delaying, or eliminating capital spending, dividends, and share buybacks. If the cash burn is too high, the next step is to retrench and redirect, which translates into reduced headcounts, reduced production, and a focus on productivity to meet soft demand. Finally, if the cash dwindles and funding sources are exhausted, the alternatives dissipate to renegotiating payment terms for rents, interest payments, or debt repayments and, ultimately, insolvency and a bankruptcy declaration.

This process takes time, which is in scarce supply for those companies in industries hardest hit by the sudden stop of our economy, and is a primary reason why it is difficult to gauge the long-term impacts on companies at this stage of the crisis. Meanwhile, as the paradigm of rent, mortgage, and other forbearance measures ripple through the economy, companies without strong

balance sheets, adequate revenue generation, and negative cash flows will have an increasingly difficult time recovering and may have to move further down the retrenchment strategy path.

At this point in time, no one can know for sure whether the depths of this recession have already passed us by or whether the recovery will be as quick as the downdraft. It all hinges on the ingenuity of those working on developing, producing, and distributing a viable and effective vaccine to the world's population.

Bond and Stock Markets

The capital markets spent most of the second quarter focused on the potential therapeutics, vaccines, and progress of the virus. With the Federal Reserve cutting its benchmark interest rate to zero and then pledging that it would do whatever it takes to keep markets functional, the second quarter began with a combination of a shift in sentiment and, what appeared to be, an unlimited government backstop. Investors in just 12 weeks experienced both extremes of fear and greed, something that would usually occur over months or years.

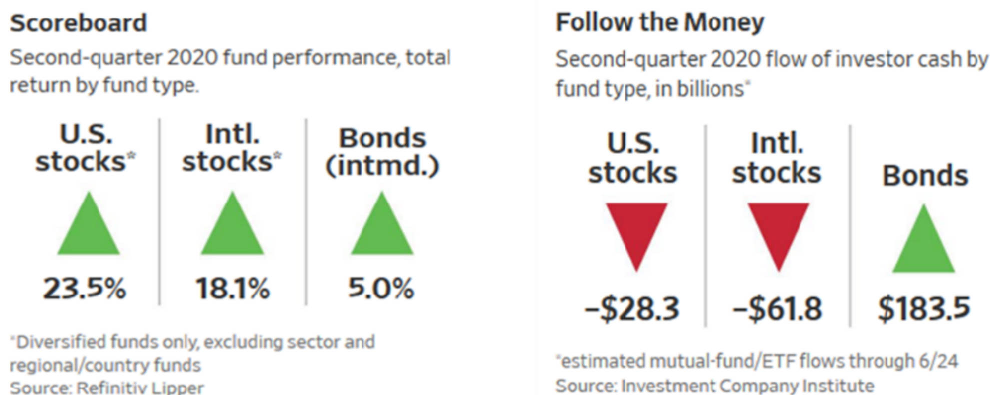
For the quarter, the fixed income market felt the weight of riskier credits lightened by the Fed's intervention, forcing spreads lower as the perceived risks of near-term calamity dissipated. U.S. Government Obligations stabilized with minimal change over the quarter, with U.S. Treasury yields across the maturity spectrum varying only about 10 to 15 basis points. Fixed income investors reversed the trends seen last quarter, with spreads on poor-quality credits narrowing considerably and buyers in the below-investment grade category (aka junk bonds) joining the Fed in buying the fallen angels. The U.S. Treasury 10-year declined only slightly from its March 31, 2020 level of 0.70% to end the second quarter at 0.66%. As the performance table below shows, lower-quality and longer-duration credits outperformed their higher-quality brethren, with stocks outperforming bonds during the quarter.

Time-Weighted Rate of Return Summary *As of 6/30/2020*

Bond Indexes	Quarter	1-Year	3-Year	5-Year
US Treasury Bills	0.0	1.7	1.9	1.3
Barclays US Gov 1-3 Year	0.3	4.5	3.0	2.0
Barclays Intermed Gov/Corp	0.6	7.0	4.1	3.0
Barclays Muni Bond 5 Year	3.3	3.8	3.1	2.8

Stock Market Indexes	Quarter	1-Year	3-Year	5-Year
DJ Industrial Average	18.5	(0.6)	9.0	10.5
Dow Jones TTL Stock Mkt US	21.5	4.4	7.9	7.9
NASDAQ Composite	30.3	26.2	18.1	15.4
S&P 500	20.5	7.5	10.7	10.7
MSCI EAFE (NET DIV)	14.9	(5.1)	0.8	2.1

As the sheltering in place mandates were lifted, reopenings and stimulus money brought the hope of a vigorous rebound in economic activity. Stocks staged a brisk recovery, posting one of the best quarterly gains since 1998. During the past quarter, the S&P 500 soared +20.5%, while the Dow Jones Industrial Average (DJIA) increased +18.5%, and the tech-heavy NASDAQ catapulted +30.3%. Investors reversed their prior quarter aversion to riskier stocks, and bid up prices for mid-capitalization companies and the "stay-at-home" mega cap equities, many of which are in the technology sector. As the Scoreboard graphic below shows, the average diversified U.S. stock fund was up +23.5%. [1] International stock funds continued to lag the broader U.S. Market, climbing a respectable +18.1% during the quarter.



However, while the past quarter's stock performance is welcome given the prior quarter's depressing returns, the year-to-date returns for most funds are still in negative territory. According to a recent Financial Advisor Magazine article, 33% of investors over the age of 65 sold all their stocks this year.[2] Further, the fact that investors pulled out $28.3 billion from U.S. Stock Mutual Funds and ETFs and another $61.8 billion from international funds and invested $183.5 billion into bond funds, does not portray a market that is embracing high levels of risk.

The stock market's reversal of fortune has many pondering the rapidity of the rebound, given the high levels of uncertainty on whether economic activity can be sustained to provide a solid foundation for a subsequent broad-based economic growth. At this juncture, it is nearly impossible to ascertain whether the health and financial influences can be managed well enough to minimize the

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[1] https://www.wsj.com/articles/u-s-stock-funds-rose-23-5-in-the-quarter-11593967861

[2] 33% Of Investors Over 65 Sold All Their Stocks, Ryan Detrick, **FA Magazine,** June 18, 2020.

costs to society, given that we still appear to be in the early stages of understanding the complete makeup of the contagion.

It continues to be a challenge to put capital to work in a wise and thoughtful manner. Our preference continues to be to assemble and maintain a well-diversified portfolio of companies with a history of earnings, dividends, and cash flow growth that can provide exposure to most economic sectors of the economy. Our process focuses on trying to manage risks by implementing a time-tested approach to managing portfolios to meet your goals and objectives. It relies on our judgement and ability to evaluate and assess business attributes and valuations, while operating in a capital market that continues to push stock prices further away from the reality of those same fundamentals. Nevertheless, we continue to search out situations where we believe a company is undervalued in the stock market relative to our estimate of what it is worth, so that we can use it in constructing a custom portfolio to meet your long-term needs.