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2020 SUMMER INVESTMENT OUTLOOK

The economy and capital markets have experienced notable volatility over the past four months. The record long economic expansion ended abruptly as the National Bureau of Economic Research (NBER) officially deemed a recession began in February. Typically, the NBER waits for two consecutive quarters of negative GDP growth before declaring a recession has begun but, in this case, the unprecedented nature of the current downturn caused the committee to call an end to the 128 month expansion after only one quarter of shrinking output, a 5% decline in the year's first three months. It was the fastest recession declaration since the NBER began officially making such announcements in 1979. The record long string of job gains, lasting 113 months or more than twice the previous record, also ended. March and April saw 22.1 million jobs disappear, approximately equal to all the jobs created since October 2010. The unemployment rate reached 14.7% in April and fell slightly to 13.3% in May. Both figures easily surpassed the post-WWII high of 10.8% achieved in the back to back months of November and December 1982.

The economic disruption caused by the global pandemic negatively impacted the capital markets as well. After achieving a record high level on February 19th, the S&P 500 fell 33.9% over the ensuing five weeks. An extraordinary fiscal and monetary policy response by the federal government, which has had a yet to be determined impact on the real economy, has certainly rekindled investors' enthusiasm. Since reaching a low on March 23rd, the S&P 500 has risen 40.0%. Market participants were buoyed by the government's timely and unprecedented response to the economic crisis as well as by incoming health data which suggested that the COVID-19 crisis had peaked and the outlook was improving.

Another piece of positive news was that oil prices stabilized over the past three months. After briefly turning negative in late April, U.S. benchmark crude prices have since recovered to over $40 per barrel. While low prices are a benefit to consumers, the United States has become the world's largest fossil fuel producer, so the overall impact of low prices is a net negative as the short term impact of lower industry profits and job layoffs more than offset the benefit to consumers.

Meanwhile, the domestic and geopolitical situation remains very unsettled. On the home front, leaders in Washington remain more acrimonious and partisan than at any time in decades. This is unlikely to change before the fall elections. Recent social unrest has magnified the deep divisions embedded in our nation's history and is reminiscent of the late 1960s. While the full significance of these important issues is well beyond the scope of this letter, it is worth noting that the unsettled landscape adds an element of risk to the current environment. At the same time, the U.S. is pulling back from its traditional position of global leadership as historic alliances are rethought, trade deals are renegotiated and allegiances to various intergovernmental organizations are questioned. During such a transition, there is a greater risk of a policy misstep that could negatively impact the capital markets. Nevertheless, the stock market continues to ignore such concerns and has rebounded strongly as noted above. Year to date returns for the popular market benchmarks are shown below.

Equity Markets – 6/23/20

	Index Price Level	2020 YTD Total Return
Dow 30 Industrials	26,156	-7.2%
S&P 500	3,131	-2.1%
NASDAQ Composite	10,131	+13.5%
MSCI All Country World Index ex-USA	272	-8.6%

Outlook

The current economic downturn is unique in that it is perhaps the only recession that has ever been predictable as government mandated shutdowns in response to the COVID-19 pandemic caused the economy to retreat. Several fundamental imbalances existed so the underlying conditions for a recession were already present when stay at home orders proved to be the tipping point. The United States is not alone as more countries will experience simultaneous recessions this year than at any point in the past 150 years including during the Great Depression. The International Monetary Fund predicts that global output will fall by 3.0% in 2020 with advanced economies declining by 6.1% and emerging markets falling by 1.0%. Total global economic activity is expected to rebound slightly in 2021 but 2019's level of output will not likely be surpassed until 2022 at the earliest. The emerging market decline would be the first since such records have been kept going back seventy years. By geographic region, the IMF believes that the U.S. economy will contract by 5.9%, the Euro area by 7.5% and Japan by 5.2%. China and India are the only significant emerging market economies predicted to expand this year but at 1.2% and 1.9%, respectively, those economies will experience their slowest growth in several decades. Globalization has benefited emerging market countries economically, and the relative reversal of that trend has had expected negative consequences. Their economies are less diversified and more dependent on trade than their counterparts in the developed world. Furthermore, with higher debt loads and less stable financing, leaders of many of these countries have fewer policy tools at their disposal to counter economic headwinds. Recent surges of COVID-19 cases in Brazil, India and Russia should be monitored closely as those nations are ill prepared to deal with an escalating health crisis.

The United States did not experience a recession during the decade of the 2010s. The NBER website notes that this is the first decade since at least the 1840s that the U.S. economy did not suffer a growth setback. The first downturn since the Great Financial Crisis (GFC) of 2008-2009 has been swift and powerful with over twenty-two million jobs lost in the months of March and April. In contrast, during the GFC, just under nine million jobs disappeared over a two year span. The nation recovered over 2.5 million jobs in May as local economies slowly began to reopen and various stimulus efforts were enacted. Nevertheless, continuing weekly jobless claims of over twenty million suggest that it will be a long time before those who have been displaced from their workplaces will return to full time employment. Potentially complicating such efforts are signs from those states that have eased restrictions. While still early, there are indications from several states that the number of virus cases is increasing. It remains to be seen how serious these cases may be or how decision makers will respond to renewed outbreaks but, at the very least, investors should pay attention to these ongoing developments.

Regaining our economic prowess will be important as there are clear signs of stress on Americans' personal finances. Credit rating firm TransUnion estimates that over 106 million accounts were enrolled in forbearance, deferment or some other type of debt relief program at the end of May. Over seventy-nine million of those were student loans up from eighteen million in April as the government announced that federally backed student loans do not have to be serviced through September 30th of this year. The number of affected credit card accounts grew 40% to over eleven million while troubled auto loans doubled to over seven million. Meanwhile, problem mortgage loans doubled last month with analytics company Black Knight estimating that 8% of all mortgages were past due or in foreclosure in May.

In reaction to the health crisis and due to the devastating impact that government mandated shutdowns have imposed on the economy, fiscal and monetary authorities responded immediately with unprecedented amounts of stimulus for a peacetime economy. The Federal Reserve acted first by slashing its key short term lending rate by 150 basis points in two unscheduled meetings in early March to its current target range of 0-0.25%. Furthermore, market sentiment was buoyed by forward guidance which indicated that every Fed official believed that rates would be anchored near zero though 2021 while fifteen of seventeen officials thought that rates would stay low through year end 2022. This is reflective of the Fed's dire outlook as their expectation is that the unemployment rate will still be between 9-10% in the year's fourth quarter or nearly triple the rate in February. The Fed's balance sheet has also been employed to cushion the downturn as it has grown from approximately $4 trillion to over $7 trillion in the past four months. Open ended purchases of $80 billion per month of U.S. treasury bonds and $40 billion per month of mortgage backed securities will likely lead to continued balance sheet growth in the coming months. Expanded programs to extend credit to money market funds, corporate and municipal borrowers, banks, securities firms and foreign governments are other tools which the Fed is currently employing. Using unconventional policy tools is a global phenomenon with central banks in Europe, Japan, China and elsewhere enacting similar programs in what is the most synchronized monetary easing cycle since the 2008-2009 downturn.

Fiscal policy is also being aggressively employed by Washington. The federal deficit could exceed $4 trillion this fiscal year which would equal over 19% of GDP or roughly double the percentage achieved during the GFC. This would represent the largest spending gap in our nation's history, aside from 1943-1945 during WWII when the deficit was above 20% in those three consecutive years. The fiscal 2021 deficit is currently projected to decline but only to about 10% which would still be a record high level excluding the war years noted. The federal government acted quickly to get money into the hands of businesses and consumers and, at least in the short term, these efforts have partially blunted the negative impacts of the current recession.

The unintended consequences and intermediate-to-longer term implications of the massive monetary and fiscal stimulus efforts remain to be seen. Fed efforts to control interest rates at unusually low levels have made the basic business of banking less profitable as the yield curve remains historically flat so the spread between where banks can borrow and lend has narrowed. As an important distributor of capital in a dynamic economy, the banking sector's incentive to conduct its business has been negatively impacted by Fed policy. Along these same lines, in a recent Wall Street Journal opinion piece, the long time, independent capital market observer James Grant stated that "interest rates are the critical prices that measure investment risk." He noted that their purpose is to allocate capital and determine investment prices in a capitalist economy. He further opined that "investment valuations don't exist to serve a public policy agenda", a fact lost on current Fed officials who have intentionally targeted higher asset prices. This has allowed investors to avoid short term pain by imposing ever increasing amounts of debt on Americans which increases the ultimate cost to rebalance the system.

Moreover, low rates allow so-called zombie companies to continue to exist. These are businesses that are unable to cover their debt service costs from operating profits. The Bank of International Settlements estimates that such companies doubled from 2007 to 2016 to 6% of all firms in the developed world. As noted in a Financial Times opinion piece earlier this year, this is a troubling trend as these companies crowd out new firms and productive investment and are "associated with lower investment, lower productivity and lower inflation – the opposite of what central bankers aim for." Recent data in the U.S. support this trend as, prior the onset of the current downturn, nearly 40% of listed companies lost money in the past twelve months, the highest such percentage excluding recessionary periods since the late 1990s. Certainly, some of these are zombies companies.

Another likely outcome of current policies are higher future tax rates. The United States is increasingly adopting a European approach to spending and social welfare. While the merits of such programs are certainly worth debating, the fact remains that these initiatives will result in higher taxes. One recent example of a tax law change was the elimination of so-called stretch IRAs which had been official policy for the past thirty years. Higher tax rates on personal and corporate income should be anticipated too, perhaps sooner than many expect. Much like in most European countries with larger social welfare states, tax rates will hit the middle class particularly hard with top marginal rates kicking in at relatively low income levels.

A political change in Washington this fall would almost certainly result in higher corporate tax rates. The broad stock market, which is very fully priced, would become even more expensive should an additional 10-15% of earnings need to be reallocated toward taxes. Even if one assumes no change to corporate tax rates, aggregate corporate profits likely will not surpass 2019's level until 2022. This will limit companies' ability to fund aggressive stock buyback programs and increase dividends, two significant factors that have boosted investors' returns in recent years. In fact, total stock market dividends and buybacks have exceeded free cash flow since 2013 according to Capital Group. Such a tailwind will be difficult to maintain in a slower growth, debt laden future.

Investment Conclusions

The investment outlook is always one that is brimming with opportunity and fraught with risk and now is certainly no exception to that rule. Among our jobs as stewards of our clients' capital is to reflect on those two competing forces as we construct long term investment portfolios designed to achieve their goals and objectives. The current environment is unique in that the capital market recovery underway since late March has occurred at the same that the underlying economic picture has not really improved. If anything, incoming data over the past three months has only confirmed that a quick, v-shaped economic recovery is unlikely. An aggressive fiscal and monetary policy response has improved market sentiment which has lifted asset prices as investors shifted from near panic in March to fear of missing out in June. It remains to be seen if this boost will endure and what additional government support may be forthcoming to support the ongoing recovery, given that the economy and job market and, hence, consumers' bottom lines will remain challenged for some time.

Renowned investor and Warren Buffet mentor Benjamin Graham wrote one of the seminal books on investing called *The Intelligent Investor*. He noted that most investors fail because they "pay too much attention to what the stock market is doing currently." This works at both extremes as investors are often too worried to invest at times of market stress which produces great opportunities and too eager to pile into overpriced markets after stocks have enjoyed a strong run. He further pointed out that intelligence as an investor "consists of patience, independence and self-control."

We agree and note that broad based stock prices are fully valued today so we will remain careful with new purchases. There are select companies which are selling at reasonable prices today and we are pleased to purchase them in portfolios with a long term investment horizon. We will remain nimble and will purchase additional stocks as opportunities present themselves in the coming weeks and months. Similarly, for those clients whose stock ratios have risen above a suitable target range, we are willing to take profits, particularly in shares which have moved well ahead of the underlying business fundamentals. As always, we will take a holistic view and long term perspective as we consider the appropriate course of action to meet our clients' ongoing needs.

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