2020 - VISIBILITY IS FAR FROM CLEAR

Can you believe we are already halfway through the year? Can you believe we have another half to go?? The answer depends upon your visibility and vantage point. **There is nothing normal about 2020.** Within 6 months, the world changed. A global pandemic blanketed the world. The longest economic expansion in recorded American history came to an end. The price of Oil went below zero. 20 Million Americans are unemployed. There was a 50% increase in bankruptcies. Airline traffic declined by 80% after being nearly grounded completely in March. And Major League Baseball is attempting a 60-game season, the fewest since 1878. That was the year that Thomas Edison patented the phonograph. Rutherford B. Hayes was President.

HALFWAY DONE, ANOTHER HALF TO GO

The second half of 2020 just might be more eventful than the first, if you can believe it. The crowning event will no doubt be the Presidential election in November. There's a lot of time between then and now, but the clock is ticking. I saw a clever quote that said: **"the term 'hindsight is 2020' was some kind of message from a future time traveler that we all misunderstood."** That might be the quote of the year. When you break it down, 2020 has no peer.

The Market crashed. In fact, there were 2 kinds of crashes. It was a crash down followed by a crash up. Stocks free fell in February and March, pretty much indiscriminately. Circuit breakers were triggered for the first time in 2 decades. Bonds, commodities and pretty much every other asset class felt the pressure. It didn't last long. **The Fed stepped in with a "whatever it takes" attitude and unprecedented actions backstopped the declines and sent asset prices soaring in April and May.** It was the best 2-month stretch for stocks in over a decade. June brought sideways price action with increased volatility. Q2 was the best Qtr. for stocks since 1998 which followed the worst Qtr. since 2008. The Tech-heavy NASDAQ finished the first half positive on the year, while the Dow and S&P finished down. That's only happened twice, ever. It's been quite the run. That's where we stand today.

Under normal circumstances, seeing the S&P 500 down 4% and the Dow down 9.5% halfway through the year would have people asking, "What went wrong?" rather than "Why isn't it down a lot more?" But it's a common and logical question. 2020 has been anything but normal. **Why is the Stock Market back this high already with so many problems and so much uncertainty?** We attempt to explain and prognosticate below. It basically starts and ends with the Fed, but there's so much in between. One thing we do know: The whipsaw price action has been gut-wrenching. And it's going to continue.

SLOWING GROWTH

Something is important to establish upfront: Growth was already slowing around the globe before the virus outbreak. Most major economies were on the edge of a recession before the lockdowns tied to Covid-19 hit. Five of the major Group of Seven (G7) countries ended the fourth quarter of last year with negative or zero GDP growth: Japan (-1.9%), Germany (-0.1%), France (-0.1%), Italy (-0.2%),

and the United Kingdom (0.0%). China reported its slowest growth in decades. The United States Economy had clearly been the strongest of the bunch, but even its pace of growth was slowing.

Eleven years of economic expansion was showing signs of fatigue. The tax cuts in 2017 helped provide the stimulus for another couple years, with its primary beneficiaries residing in the S&P 500. Asset prices soared. **The Stock Market entered 2020 at valuations that rivaled the 1990s,** and its Tech dominance did too. It reached fresh, all-time highs in February. It didn't last long. Covid-19 spread. The health crisis became an economic crisis. The Fed prevented its spread from becoming a financial crisis.

The reopening narrative is what the Bulls have embraced. This is supported by the recovering global economic activity and sequential improvement in corporate demand. This has all helped to put some traction behind a possible V-shaped economic and earnings recovery. There has also been a good deal of optimism about the potential for coronavirus vaccines and treatments. In addition, depressed sentiment and defensive positioning have increasingly been viewed as contrarian indicators for stocks. It seems overly optimistic to us. That said, **the "pain trade" has been higher on Wall Street amidst the fear of missing out (FOMO)**. However, the recent surge in virus cases around the country could reverse the Stock Market rally; in an instant. Stay nimble, we say. Stay nimble, we do.

WHATEVER IT TAKES

The Federal Reserve jumped in quickly and put a backstop against a seizing Credit Market early on in the crisis. The Fed took interest rates to zero. It bought Treasuries. It bought Mortgage-backed securities. It bought Muni bonds. It bought Corporate Bonds. It bought pretty much everything but stocks. It is showing no signs of being done yet.

There is now $7 Trillion in asset purchases on the Fed balance sheet, a level never before seen. It's nearly double the peak levels from the Financial Crisis a decade ago. The Fed owns $4 Trillion in Treasuries, $2 Trillion in Mortgage Backed Securities and the rest Corporate and Municipal Bonds. It is going to stay that way for a while. The Fed has no plans to abandon support and raise interest rates. Fed Chair Powell said the Fed "is not even thinking about thinking about raising rates."

The Fed's shock-and-awe campaign worked really well. The Stock Market soared. This raises the question of whether the Fed really needs to do much more. The goal was to restore liquidity to the credit markets. They are clearly functioning well again. If the Fed persists in flooding the markets with liquidity, **the risk is that the central bank will create the mother of all financial bubbles.**

Government and central bank stimulus is intended to be a temporary support for businesses as the economy slowly reopens, not a life preserver. Yet, the amount of global stimulus is massive, many times the size of the stimulus applied in the aftermath of the Great Financial Crisis in 2008-09. The global stimulus amounts to nearly 30% of world GDP. That is a very big number. At some point, the mountain of debt is going to matter. Nobody seems to care now. We do.

In America, the Congressional Budget Office projects a $3.7 Trillion Federal budget deficit during this current fiscal year. The Fed has already financed more than half of it since the start of the current fiscal year! The result: A Fed-induced Market rally from the March lows. The 35% decline reversed course, which led to a 40% linear rise, with the S&P actually turning positive for the year at one-point in June. The fast recovery is quite unusual. It typically takes about a year and a half to recover from a 20% drop. Instead, the S&P 500 rose 40% in just 50 trading days, the fastest rebound ever.

THE RALLY HIT A WALL

After such a massive move in such little time, fatigue seems to be setting in for stocks. This is to be expected after the best 11-week run in Market history. The thing is, the Stock Market seems to have priced in a lot of good, while the winds have changed with the Coronavirus, suggesting a less than good outcome in the short-term.

The V-shaped economic recovery is getting pulled down by a surge in new coronavirus cases. **The recovery is looking more like a W, at best.** Many small businesses may struggle to survive if they reopen with their revenues remaining well below what they need to stay in business. If the number of cases continue to expand at the current rate, it could be devastating. America is still in wave 1 of Covid.

Stocks never got cheap. Balance sheets never got cleansed. The Fed prevented it before it could naturally happen. True price discovery has been skewed. The aggressive Fed action has enabled bad and reckless behavior. There was a classic speculative mania at play as stocks continued their near unabated ascent. It has basically gone straight up since the March lows. Studies showed that a disproportionate amount of money from the Paycheck Protection Package, designed by Congress to provide support for the newly unemployed, found its way directly in the Stock Market. **A new generation of Day traders was born.** Bored at home with no live sports to gamble on, they set their sights on the Stock Market. Speculation took off. Even bankrupt company stocks rallied. One of the leaders of the movement ignited the base saying, "stocks only go up!" We've seen this before. It did not end well.

NEW CYCLE OR SAME CYCLE PAUSE?

New economic cycles tend to bring new Market leadership. Factors (such as Growth and Value) and Geography (US and International) tend to switch places at the start of a new cycle. The US has dominated the past 12 years, driven by Technology and Growth. Large Cap Tech has been holding the Stock Market up for months. The question is how long that can last. Long-term, we love Tech. Shorter-term, it's showing signs of fatigue.

Equity valuations continue to be high. The S&P 500 P/E soared from 12X earnings in March to a multi-year high of 22.5X in June. That's the highest since September 2000. For reference,

the historical average is 15.5X. To put that in perspective, the S&P 500 would be trading around 2100 if it was trading at the average historical multiple, we are at 3100. On the Dow, that would be 18,000 and we closed the quarter at 25,800. Other measurements like Price-to-Sales and Market Cap to GDP show excessive value too. **The Market is pricing in a substantial recovery in earnings growth, betting this rough patch is only temporary. We will get a better understanding of the situation when Earnings Season begins in July.** Leadership remains in the Large Cap Tech arena. They were strong before Covid. They're even stronger now.

The explanation for these developments is simple: **The Tech Titans, led by Apple, Microsoft, Amazon and Google** are benefiting from the consequences of the virus spread and the shelter-in-place initiative. **They're disruptors. Their business models are geared for it.** This is the theme for Tech as a whole. This has been a major catalyst for digital usage and the revenue and earnings growth has soared. Technology companies are growing far faster than the rest of the S&P 500 pack. It's been the case for quite some time, even before the virus hit. Investors have been willing to pay a lot for that growth. The US Stock Market is much more exposed to technology, which is why it continues to outperform the rest of the world.

REOPENING AND RECOVERY

Responses have varied from city to city and state to state, and across the globe. The one thing that appears to be increasingly clear is that the process of reopening an economy is not as easy as flipping a switch. It's more like traversing a landscape of hurdles across the globe.

The US Economy has made a good deal of progress since early Spring, but that does not mean the outlook is without any potential pitfalls. The virus remains at the top of that list. The early hit states like New York and New Jersey have shown much improvement and continue to move ahead with reopening plans. Unfortunately, a number of states spared by the worst of the pandemic in April and May are seeing case counts and infection rates surge. Arizona, Texas and Florida have become epicenters for the virus spread. They have paused their reopening. California is experiencing it too.

Many have argued that despite the rise in cases, another economic lockdown is unlikely. That may well be true, but consumers and businesses may also take matters into their own hands. Many Americans seem to be voluntarily avoiding bars and restaurants. Disney delayed its theme park openings. Apple re-closed some of its stores. Dr. Fauci was prescient when he said back in March: **"you don't make the timeline; the virus makes the timeline."**

FISCAL CLIFF OF UNEMPLOYMENT BENEFITS

The end of July will bring with it the expiration of enhanced unemployment insurance. This program, activated in April, tacked an additional $600 per week to weekly jobless benefits. For many workers, especially those in leisure & hospitality and retail, this amounted to a greater than one-for-one income replacement. In other words, they made more money by not working. That's not sustainable.

Unless Congress extends the program beyond July, something that does not currently have bipartisan support, there will be a significant loss of income support. Given how high unemployment claims are right now, it seems politically unthinkable ahead of

an election for both Democrats and Republicans in Congress not to extend support. That said, if we've learned anything about Congress, it's that everything is political, and negotiation is all about politics. Our sense is a compromise will likely be struck but only in the final hour, which will likely cause some Market stress. Consumers will likely cut back on spending in advance, compounding the economic angst.

INVESTING IN THE DIGITAL AGE

The Coronavirus jumpstarted what were already growing, irreversible trends. In some ways, it launched the **Digital Age 2.0.** We continue to invest in the physical and the digital. **Companies that embrace digital solutions for the distribution of physical items will continue to succeed.** The emphasis is on freshness and convenience. It's showing up nearly everywhere. We see it in food and beverages. It's driving health care and medicine. It's in the workplace. It's in the home. Software that helps working from home or working remotely will continue to take share.

The future of medicine is evolving. **24/7 Digital Health Care is here.** Clinics are popping up at the local pharmacy. **Digital interaction with your doctor** is providing a quicker and more efficient experience when in-person is not necessary. **Health and wearables continue to be a major growth opportunity for investment.** Devices that measure vital signs are providing a significant improvement in managing health.

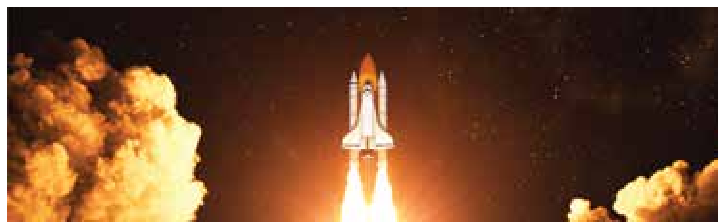
Biotechnology is clearly the solution to the pandemic. Until there's a vaccine, treatment is essential and Biotech companies around the globe are working feverishly for solutions. Modern medicine is bringing all sorts of innovative therapies to disease and increasing quality of life. **Gene sequencing has improved targeted therapies.** Science is where it starts. It's definitely investable.

Digital car keys are coming. They will allow drivers to unlock their cars wirelessly with their phones. It won't stop there. Users will be able to create new virtual keys for friends and family members and share them via iMessage. For security purposes, keys can be deactivated remotely if a phone is lost or stolen. They're coming this Summer.

We have made investments in **online education.** The web will certainly not replace the value of the classroom and hands-on learning with the relationship between student and teacher. But it is certainly playing a role during the pandemic and will help expand the reach of quality learning and help reduce costs. We see major opportunities from K-12, all the way to continuing education for professionals already in the workforce. Enhancing and maintaining sharp skills will continue to be essential in the ever-evolving digital economy.

We see **supply chains returning to America,** as the Coronavirus exposed our vulnerabilities. The internet of things is expanding. **3D printing and Artificial Intelligence** will likely be the backbone of this new American infrastructure. **Robots** and people will operate assembly lines, producing goods Americans need. Costs will likely increase a bit, but the price of security and independence from foreign sources will be worth it. **Autonomous vehicles** are coming to help improve distribution and transportation in the post-Covid environment. **Smart cities and 5G are emerging.**

Americans returned to space from American soil. That was huge. The SpaceX launch ushered in **the new space race, combining government resources with private capital and ingenuity.** It's innovation in its greatest form. This is just the beginning and we are investing in the future of space travel.



THE BOND MARKET

A year ago, there was over $2.5 Trillion in BBB-rated corporate bonds, representing 43.5% of investment-grade corporate bonds and 35% of all corporate bonds. Bonds rated BBB are just one downgrade away from being ejected from the investment-grade universe to the junkyard.

Many of these BBB-rated bonds got downgraded to junk in the wake of the crisis. Everyone knew this could happen once the next recession came along, though no one expected that it would be caused by a viral pandemic. The Fed established a plan to rescue these "fallen angels" by purchasing some of their debt. They didn't stop there.

The Fed bought investment-grade corporate bonds too. The list it released included nearly 800 different companies. Some of them were foreign. The Fed bought bonds from Apple, Verizon, Berkshire Hathaway and AT&T. They also bought bonds from the US divisions of Toyota, Volkswagen, and Daimler, making up approximately 10% of the amount spent. Fed officials have said the goal of the purchases is to maintain liquidity in the Market for corporate debt, so that issuers are able to access capital despite the economic downturn created by the Covid-19 pandemic.

It's hard enough to understand why the Fed feels the necessity to support both the buyers and the sellers of these lower quality bonds since all participants understood the risks of owning and issuing BBB-rated debt. But buying bonds from Apple and Coca Cola which are A-rated companies which need no assistance seems beyond excessive. These companies don't need the government's support. **We just think the Fed is stoking moral hazard. Where does it end? At some point, failure has to be an option in the Free Market.**

WARNING SIGNS

The Bond Market is the smartest of the overall Market. It's about risk. It's about math. The Bond Market continues to signal trouble brewing. Even though an economic recovery has taken hold and the Stock Market exploded higher, **the Bond Market has been consistently cautious.** The yield on the 10-Year Treasury closed out June at 0.65%. It remains stubbornly down near all-time lows. The Fed controls the front-end of the curve, which is basically at zero. But the back-end of the curve keeps falling, rather than rising with the Stock Market. The Bond Market senses something.

We still like Gold. With low rates at home and negative rates abroad, and mountains of debt, we see a really bright future for precious metals. It's a diversification position. It's a tactical asset allocation. After 6 years of basing, we think it's going to be a good decade for Gold.

NOVEMBER AHEAD

The election is in 18 weeks. In some respects, that is so little time. But these days, it seems like an eternity. When you consider all that has happened in the last 18 weeks: The world changed. The unemployment rate was 3.5% 18 weeks ago. Only 53 Americans were infected by the virus. There were zero known American deaths related to the virus at the time. The impeachment trial had just been completed. The 49ers were in the Super Bowl. That was 18 weeks ago.

I will no doubt be covering the election prospects 12 weeks from now, in our Fall Newsletter. A lot will happen between then and now. America stands divided. Our nation is at another crossroads. The future hangs in the balance until we head to the ballots. The economy is fragile but recovering.

Trade tensions are on the rise. China has been a bipartisan issue. Both Presidential candidates are going to campaign tough on China. The Trade Deal is at risk, daily. Tensions on trade are increasing with Europe too. Global alliances have frayed while geopolitical issues rise. These are all issues that will move markets. We expect a whole lot of volatility ahead.

The bigger the drop, the bigger the pop. That's often been the case for the Stock Market over the many decades. That sure has been the case in 2020. It's only halfway through. **This Boom-Bust cycle has been gut-wrenching since it began in 2016.** It's showing no signs of ending. They say the easy money has been made. That pertains to the massive rally since March. I hate that phrase. There has been nothing easy about this Market. Zero. People who say that have no clue what's involved and what's at stake. We are long-term investors. We see many exciting investment opportunities in this Digital Age. We are also mindful of short-term risks. **Stay nimble, we say. Stay nimble, we do.** We are in it to the end.