Insights: July 2020

Market Overview and Performance

Without question, it has been a remarkable period for investors since our last Insights in March. The S&P 500 collapsed -34% from it's February high, however much of the media attention has been focused on the rally off of those lows despite increasing evidence that the macro trends continue to deteriorate at a rapid pace. While it seems heartening to see the S&P 500 up +20% in the March to June period, the- 19.6% decline to start the year was the worst Q1 in the entire history of the index. Many investors (ourselves included) had hoped that the virus containment in the US would be sufficient at this point, unfortunately, the opposite has proved to be true. We share the long-term concerns articulated by Mohamed El-Erian, Chief Economic Advisor at Allianz who recently wrote for Bloomberg "The expectation was that the onset of the third quarter would mark the close of a highly damaging and uncertain second quarter for the U.S. economy and, importantly, herald a sharp and durable reversal. Instead, with health concerns forcing a growing number of states to either stop or reverse their re-openings, and with some businesses and households withdrawing from active economic re-engagements, a cloud is now forming over the third quarter, threatening the depth and breadth of the economic recovery". We would agree and suggest that capital preservation via high quality cash-flow entities is where we prefer to spend our risk budget in the current unsettled environment.

As we look forward, feedback from clients and others we speak with suggests that a more frequent, less in depth analysis, would be valuable. To that end, the blog portion of our website will be enhanced and updated shortly allowing us to share our thoughts on an on-going basis. We will keep you informed regarding the blog re-launch on our website later this month and look forward to hearing your feedback.

	Quarter to Date June 30	***Year to Date***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	**20.54**	**-3.08**
Russell 2000 Index	**25.42**	**-12.98**
MSCI EAFE Index	**14.88**	**-11.34**
MSCI Emerging Markets Index	**18.08**	**-9.78**
Fixed Income		
Barclay's U.S. Aggregate Bond Index	**2.90**	**6.14**
Barclay's U.S. Aggregate Credit Index	**11.08**	**5.92**
Barclay's U.S. Aggregate Corporate High Yield Index	**10.18**	**-3.80**
Barclay's Municipal Bond Index	2.72	2.08
Macro Measures		
Gold	**12.77**	**18.21**
Crude Oil	91.75	-35.69
CBOE Volatility Index	-43.16	120.83
USD Dollar Index	-1.68	1.04

Current Theme – Risk Assets Continue to Appreciate Despite a Very Poor Macro Environment that Shows Few Signs of Improvement.

Various State Re-Openings Have Gone Poorly Highlighting the Fact That Pushing Beyond Common Sense Measures Will Extend the Hardship

Without question, the fact that US equity markets have recouped a large portion of their Q1 losses is a positive development. As fundamental investors, we share the general consensus view of awe when considering these moves. They are simply not justified. However, Goldman Sachs recently confirmed our view that there are five drivers of the rally: 1) Fed liquidity, 2) Fiscal Stimulus, 3) Virus outlook stabilizing, 4) Narrow major leadership, and 5) Optimism about an economic re-start in 2021 and beyond. We will explore these ideas in more detail, but for now, we would suggest that a trading range between 2725 and 3000 is likely for the S&P 500 over the coming summer months.

S&P Has Retraced 2/3 of Losses; Remains -10% Off High

Source: Refinitiv

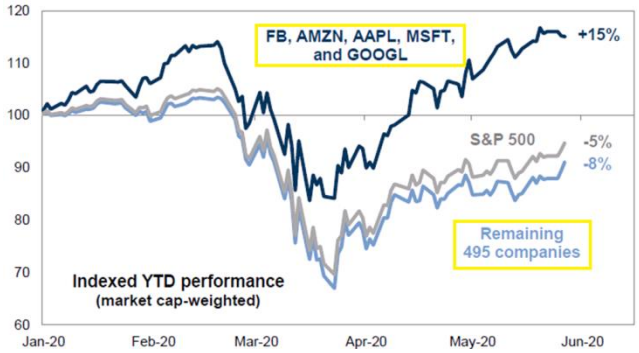
At a very base level, it is easy to explain the rally in one word - Technology – literally every other sector has lagged.

Clear Differentiation – Tech +12%, Rest of Market Down

Source: Koyfin

As the previous chart highlights, the Technology sector is up roughly 12% year to date while every other segment is down, with notably sharp declines in the cyclically oriented sectors with Energy (-36%), Financials (-25%) and Industrials (-16%).

Just 5 S&P Stocks Leading – Other 495 -8% as a Group



Source: Goldman Sachs Global Investment Research

In fact, as the chart above illustrates, one didn't even need to commit to the technology sector to outperform – just 5 big tech stocks have pulled the market higher on their own. AAPL, AMZN, FB, GOOGL and MSFT are up roughly +15% year to date as a group.

Median S&P 500 Stock is Down -11% - Large Dominating

S&P 500 Median Results Through July 3, 2020

Company Size	Market Cap	P/E	P/S	P/FCF	P/B	YTD Returns
Top 10	$848.5 billion	31.4	6.3	33.2	6.3	9.6%
Top 50	$198.7 billion	28.7	4.6	23.3	5.5	2.4%
51-100	$77.6 billion	26.0	3.8	25.0	5.3	-5.7%
101-150	$49.5 billion	22.9	3.9	23.6	4.1	-1.9%
151-200	$30.5 billion	26.4	3.0	23.5	4.1	-6.7%
201-250	$24.6 billion	24.4	2.6	20.0	3.2	-9.3%
251-300	$20.2 billion	23.2	2.6	21.8	3.3	-5.5%
301-350	$14.9 billion	23.9	2.8	22.8	2.5	-8.5%
351-400	$11.8 billion	22.1	1.8	18.4	3.0	-17.6%
401-450	$8.9 billion	13.3	1.4	12.8	1.9	-22.6%
451-505	$5.1 billion	13.9	0.8	10.0	1.2	-38.5%
S&P 500	$21.8 billion	22.8	2.4	20.4	3.0	-11.0%

Source: A Wealth of Common Sense; Y Charts

Refining this trend even further, Ben Carlson published the above on his blog, "A Wealth of Common Sense", on July 4th. The table demonstrates that the largest market capitalized and most expensive names have delivered the best year to date returns, while the smallest market capitalized and cheapest names have fared very poorly. Taken together, as of July 3rd, the median year to date return for S&P 500 stocks has been -11%. This tells us that the market leadership during the rally off the bottom has been very narrow. While it is not illogical for the market to reward large cash-flow generative businesses that will thrive both

during and after the COVID environment, (we heavily favor these companies well), it clearly exemplifies a market of "haves" and "have-nots" as opposed to healthy broad market strength.

To a large extent, it's somewhat futile to fight the relentless tide of asset flows into these market leadership names, but if one chose to analyze the broader market based on actual fundamentals, the results would not be encouraging.

2020 Earnings Per Share Among Worst Decline on Record

Source: Earnings Scout

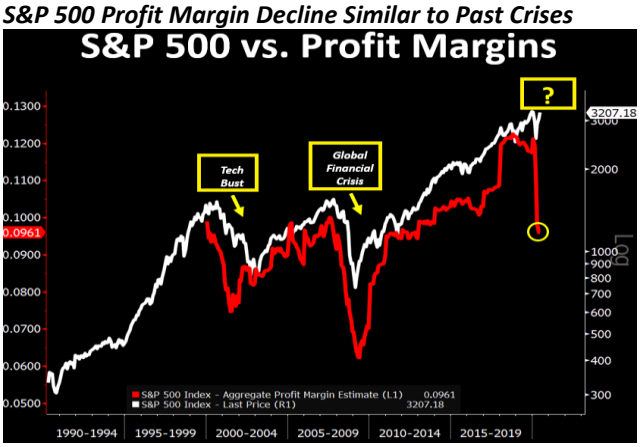
As the chart above illustrates, 2020 earnings for S&P 500 companies are set to absolutely collapse, punctuated by a -44% year over year decline in Q2 (additionally, Q2 GDP is estimated to contract by over -35%). These are historically bad results, however, it could be argued that this is "priced-into" the market with investors already looking ahead to 2021. We will not contest that point, but even if true, investor sentiment suggests that these deeply depressed earnings are still expensive. According to the most recent BoA Merrill Lynch Global Fund Managers Survey, 78% of respondents say the market is overvalued, the highest reading on record.

"Overvalued" View Even Higher Than Tech Bubble

Source: BoA Merrill Lynch Investment Research; The Market Ear

If market participants do indeed view current earnings as expensive but are simply looking forward to 2021, then one must assume that the future environment will be better. However, the damage being done to the economy right now is severe. Looking at profit margins which have historically led equity prices, the outlook is not good as can be seen in the chart below.

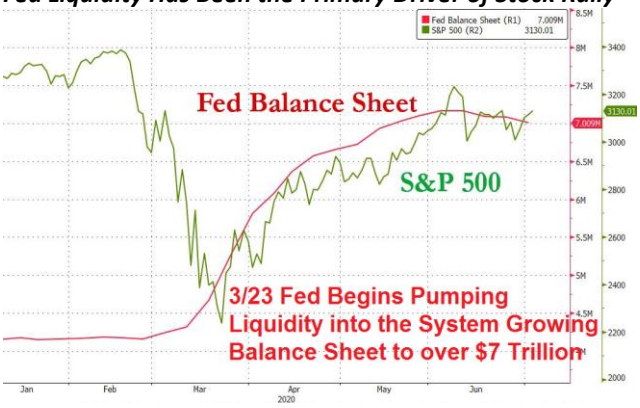
S&P 500 Profit Margin Decline Similar to Past Crises



Source: Bloomberg; Crescat Capital LLC

Clearly, the good news has been that the monetary response from the Federal Reserve over the past few months has been extraordinary.

Fed Liquidity Has Been the Primary Driver of Stock Rally

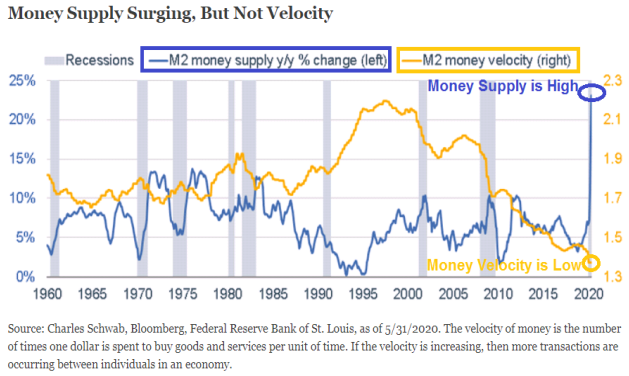


Source: Bloomberg; Zero Hedge

As shown above, the Federal Reserve's initiation of liquidity injections beginning on March 23rd, has unequivocally been the main impetus behind the move higher for stock prices. This is a bit of a double edged sword however. While certainly productive from the standpoint of trying to "keep the gears" of the economy running, it is undeniably an artificial factor impacting the market. And it is temporary. Of note above, as the amount of stimulus has leveled off, so has the price action of the S&P 500.

What's more, this money is not truly flowing through the economy as intended. As highlighted below, while the supply of money has been the largest on record, it is not being put to work – essentially it is stuck sitting in financial institutions which is clearly not productive.

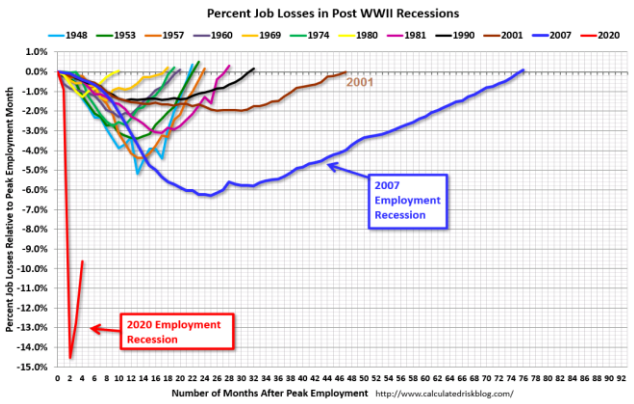
Money Supply High, But Not Moving Through Economy



Source: Charles Schwab, Bloomberg, Federal Reserve

Unfortunately, despite the rise in equity prices, a recovery in the economy is desperately needed to truly assist most Americans. As of July 2nd, according to the Department of Labor, over 31 million Americans are collecting unemployment insurance. That is almost 20% of the roughly 164 million people in the US labor pool. As the chart below illustrates, COVID has inflicted an astounding amount of pain on the labor market much more quickly than any previous recession. There is a lot to be said about whether these job losses are temporary or permanent, (3 million are estimated to be permanent at this point) however, if the past is any guide, it will take a minimum of 24 months to regain the lost jobs and perhaps much longer (5-6 years) as experienced during the 2001 and 2007 recoveries.

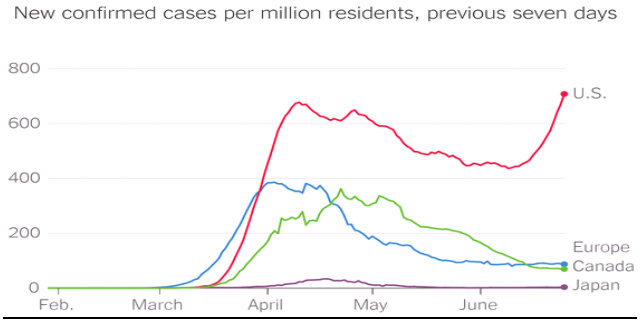
Jobs Recovery has Taken 24+ Months in Past Recessions



Source: Calculated Risk

It's important to discuss why the scenario in the United States is particularly challenged. While charts regarding COVID data literally change from day to day, the one below conveys the simple message that contrary to other parts of the world, the US has seen a sharp increase in infections, reversing the progress made since late April.

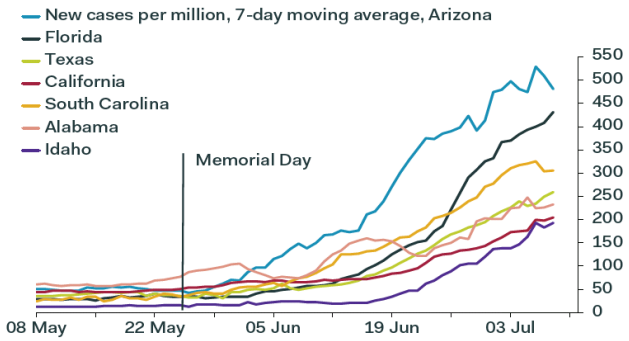
US Cases Per Million Rising While Other Areas Improve



Source: The New York times

In hindsight, we now have clear evidence that the re-opening process since Memorial Day in many states located in the South and West has not been well managed. It appears that unlike in the Northeast, where high infection and death rates instilled a sense of caution among residents, other states essentially "threw the gates wide open", resulting in skyrocketing COVID cases as seen in the chart below.

States in The South and West Have Re-Opened Poorly

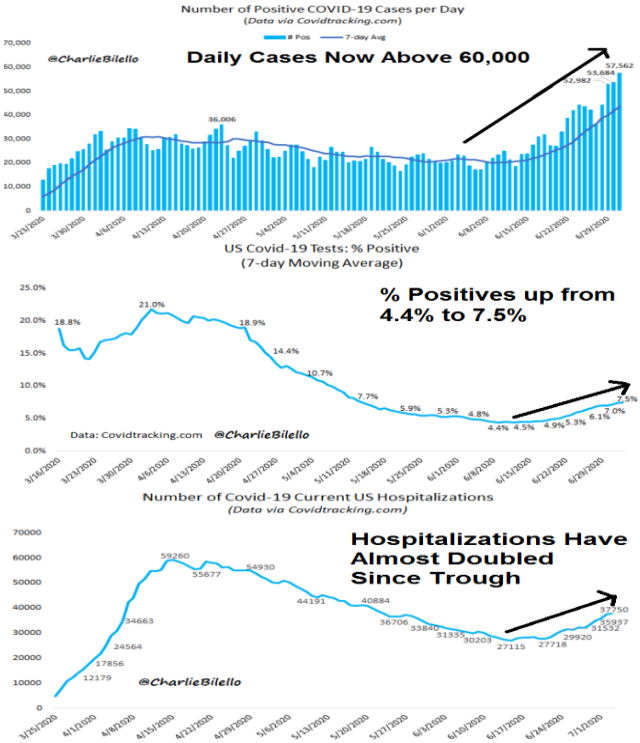


Source: Pantheon MacroEconomics

This is problematic not only from the shear tragedy of roughly 800 Americans dying form the virus every single day, but also because it severely hampers the effort to return the economy back to something approaching normal. Unfortunately, we are now seeing regressive declines in real-time recovery data like restaurant reservations, public transportation, air travel and small business hiring.

Sadly, the trends continue to deteriorate. Consider the "report card" of new positive cases, 7 day average positivity rate and current COVID hospitalizations.

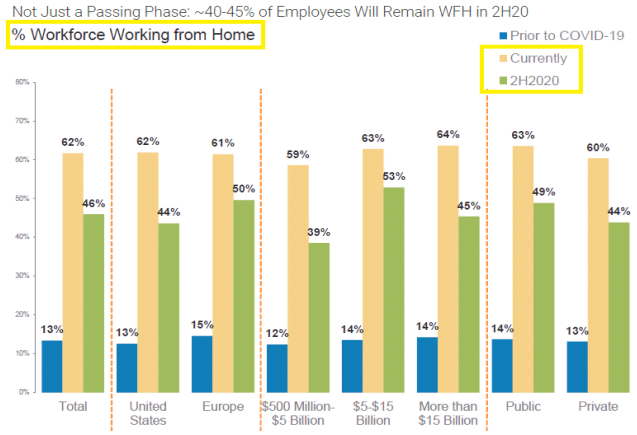
COVID Trends in US Continue to Grow Worse



Source: Charlie Bilello; CovidTracking.com

At this point, the US, which represents about 4 percent of the global population, now accounts for roughly 25% of both global cases and deaths (133,291 in the US as of July 9TH). The repercussions of the unsuccessful attempts to curb the spread of the virus are meaningful. Consider for example, that the current "hot-spot" states of California, Florida, Texas alone account for 29% of US GDP. Extended economic slowdowns in these areas will obviously have an impact more broadly across the economy. We also see evidence that the new trends in the pattern of the workforce may be longer lasting than anticipated. As the previous chart from Morgan Stanley highlights, over 60% of their surveyed companies' workers are working from home and close to 50% intend to continue doing so for the remainder of 2020.

Work From Home % Remains Above 50% Across All Areas



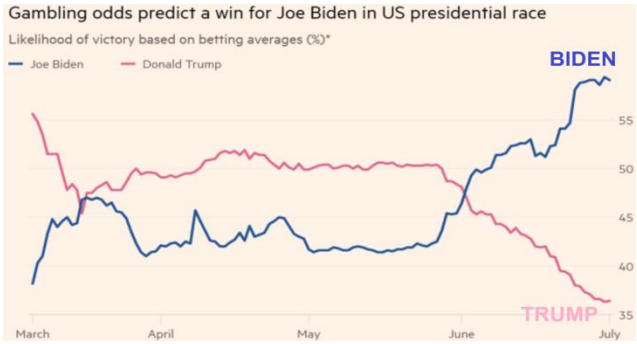
Source: AlphaWise; Morgan Stanley CFO, COO Survey

This dramatically changes the outlook for commercial real estate, restaurants and retail stores focused around high density work environments. As we mentioned earlier, over 30 million Americans are utilizing unemployment insurance at the moment and we continue to see high-profile bankruptcies across industries such as Hertz, Brooks Brothers and Chesapeake Energy. Just this week, United Airlines announced that they plan to furlough over 36,000 employees.

More concerning, according to a survey of over 7,300 small businesses conducted by Alignable Pulse in mid-June, 43% of small businesses who took Paycheck Protection Program (PPP) loans anticipate running out of cash when the program expires at the end of July. More alarming, 69% of respondents who did not take PPP government assistance said they would be out of funds by the end of the month.

Clearly, changes are needed in the response mechanisms in place to address both the spread of COVID and the negative economic consequences we are all experiencing as a result. This is not lost on market participants. Perhaps the most concrete of this is the dramatic shift in Presidential election odds since the "re-opening" after Memorial Day.

Presidential Election Odds Have Mirrored COVID Trends



Source: The Financial Times; Real Clear Politics

Going Forward

As of June 30th, things are not nearly as good as had been hoped. As we have discussed, the virus infection rate, hospitalizations, and case positivity rates are all increasing and hitting new all time highs. Based on historic behavioral patterns, one would think that the path forward would be a sideways move throughout the summer months, establishing the foundation for a more sustainable move higher in the fall and early 2021.

If we were in a typical economic slowdown, the general playbook for an asset manager would be fairly obvious. However, as we have highlighted, this cycle has been dominated by a select few large cap technology companies. Fortunately, we have held the bulk of those leadership names within our top 10 position ownership even after taking profits in many of these names after their strong 2019 gains.

While we are still ardent believers in long-term investment commitments and broad diversification to achieve superior risk adjusted returns over time, we were active sellers of overbought names in the second quarter of 2020. Conversely, we were buyers of names which we view as trading at discounts to their long-term value, namely in the financial, industrial and energy sectors.

While we had been taking profits since the start of this year in names that delivered outsized returns in 2019 during late February, we reached our policy maximum limits in cash exposure across our portfolios. As stated, we never wish to put our clients in a position where missing a few strong up days will hinder their long term results. Keeping our clients within their investment policy parameters has demonstrated its value this year in particular.

Unsurprisingly, with market sentiment vacillating wildly during the past six months, investor behavior with regard to sectors has fortunately been altered in a very predictable manner. Outside of large capitalized technology and communication names, the market has been aggressively tilted toward defensive sectors, (Utilities, Consumer Staples, Health Care, etc.). If investors held a true belief that a strong economic recovery was taking hold, they would be buying the pro-cyclical sectors like Financials, Industrials and Energy. These sectors have clearly been the laggards thus far in 2020 and present opportunity in our view.

This behavior does not suggest that a meaningful recovery is likely near-term. That being said, we are strong believers in purchasing strong cash-flows at discounted prices and think there will be significant opportunities to purchase high quality companies in the technology, financial, consumer and industrial sectors that have been sold down more than merited in our view. This also holds true for small and mid-cap stocks which have fared worse than their large-cap counterparts during the 2020 sell-off.

Equity markets outside of the US have generally declined in line with, and in some cases, worse than US markets. While we continue to believe that compelling opportunities exist within non-US exposure, we would not be adding to our allocations until we get more clarity on the impact of the virus on economies abroad.

As a testament to diversification, our fixed income exposure has provided both positive returns and volatility reduction this year. We continue to place our emphasis on less interest rate sensitive options available with shorter duration exposures and unconstrained strategies as a focus. We also favor municipal bonds and short-term corporate bonds based on the belief that the opportunity in these segments provides a better relative value. A notable change this year however, is that many areas of the fixed income space have been irrationally driven up by a “flight to quality” trade mentality. This has resulted in a poor risk/reward scenario for the near-term. That being said, long-term bonds as expressed via the 10-Year Treasury, have been remarkably strong and we continue to hold our exposure in that segment given the very opaque environment going forward.

Our measured allocation to gold has continued to serve us well as a non-correlated asset during times of market stress. We continue to believe that this exposure will add value in the coming months.

Thank you for taking the time to read our thoughts and opinions on the markets this month and we look forward to speaking with you soon.