2020 Second Quarter Review and Outlook

The COVID-19 pandemic has delivered a historic shock from which the global economy continues to reel. Financial markets, however, currently reflect a high degree of optimism about the future. An unprecedented fiscal and monetary intervention by the Federal government has allowed investors to look past the economic turmoil to the prospect of an eventual recovery. After falling as much as 30-40% in March, global stocks rebounded dramatically to end the first half of the year down a modest -6%. The S&P 500 Index was impacted even less, at -3.1%. With interest rates pushed sharply downward, investment grade bonds rallied and the Bloomberg Barclays US Aggregate Bond Index finished the period up +6.1%.

Are Markets Irrational?

At first glance, it might appear that the flood of cash injected into the financial system by central banks and stimulus checks has magically lifted all boats. Some observers question the apparent decoupling between financial markets and the real economy, pointing to the uncertain trajectory of the pandemic and the precariousness of the fledgling recovery. The reality is more complex.

First, there has been much greater dispersion in market returns than is evident in the headlines. The S&P 500 Index has been dominated by Amazon and the tech sector, which together represent almost one-third of the index's total value. The outperformance of these giant growth stocks has obscured steep declines in economically sensitive sectors like Energy (-35%) and Financials (-24%). Meanwhile, smaller companies lost -13%, and many service sector businesses affected by social distancing fell even more. There have been similarly wide differences in returns among bond sectors, with high yield bonds trailing the broad index by almost 10% this year. Rather than a rising tide raising all boats, we see markets in transition, with both growing opportunities and daunting challenges.

Many people are now concerned that markets have swung from excessive pessimism to undue optimism. But this is a unique crisis, and normal business cycle dynamics don't necessarily apply. As we muddle through the pandemic, with trillions of dollars in government stimulus helping support us along the way, we will have to be patient and accept that heightened market volatility could last well into 2021.

Looking Forward

Despite an economic contraction that has proved the sharpest since 1946, we are hopeful that policy measures will be sufficient to prevent the permanent loss of jobs and productive capacity. It seems likely that by this time next year, we will be looking towards a brighter future, though the recovery will no doubt be uneven until a vaccine is in wide distribution. There are risks to this scenario, including that the recovery could be slower than markets indicate, or that effective vaccines could take longer than expected to bring to market. In this environment, we feel that a well-balanced, widely-diversified portfolio, with a slightly more cautious tilt than usual, is the best way forward. It may be helpful to recall that in the devastating Spanish Flu pandemic of 1918-1919, markets initially fell 20%, but recovered in short order.

Countries that provide financial support for households and businesses, as well as comprehensive health care programs, will emerge faster and stronger. Industries that can function while social distancing is practiced will prosper. The pandemic is also likely to accelerate certain trends (e.g. online retailing and remote work) while exacerbating others (global poverty and social unrest). In response, government policies related to public welfare, taxation, and spending, are likely to change. Over time, this could fundamentally alter the investment landscape.

Our advice to "stay the course" through the upheavals of the past months has largely paid off. Tax-loss harvesting, portfolio rebalancing, and a few opportunistic moves to take advantage of extreme market movements have kept us busy. In recent weeks, with many financial markets almost back to previous highs, we have moved to make portfolios a little more defensive, shifting 10% of core equity allocations into mutual funds that hedge their downside risk.

We have continued working remotely for the most part and we are still holding client meetings by phone or videoconference. One or two of us are now in the office most days but we are making every effort to ensure that our staff and our clients are not exposed to unnecessary risks.

Please let us know if you have any questions or would like to set up a meeting with us.

We wish you and your loved ones a beautiful summer and thank you as always for your trust.

David

Harlan

Doug