FINANCIAL MARKETS COMMENTARY

2ND QUARTER, 2020

TELEMUS®

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SECOND QUARTER HIGHLIGHTS

- The quarter began on a low note as several economic indictors experienced some of the worst readings in history. As social distancing restrictions appeared to have contained the spread of the virus and economies gradually began to reopen, there was a sharp rebound in economic activity with record readings to the positive.
- Swift actions around fiscal and monetary policy have helped to ease the impact of demand destruction stemming from the COVIC-19 pandemic along with stabilizing markets. Thus far, these efforts have helped to mask the economic strain, although some of the stimulus measures are set to expire in the third quarter.
- Equity markets experienced their best quarter since 1998, rebounding with growth stocks leading the way. In fact the last two quarters mark two of the best five quarters for growth stock performance dating back to 1979.
- Bond markets rallied on the back of lower yields in riskier sectors such as corporate bonds and mortgage backed securities. Interest rates on Treasury bonds were range bound for most of the quarter with tighter yield spreads being the dominant contributor to returns.
- Commodity markets were volatile, but generally finished the quarter at higher price levels. Oil stood out after having achieved its first ever negative price, before rebounding and finishing the quarter up by nearly 100%.

ECONOMY

"YOU CAN'T PREDICT, YOU CAN PREPARE"

—Howard Marks, co-Chairman of Oaktree Capital

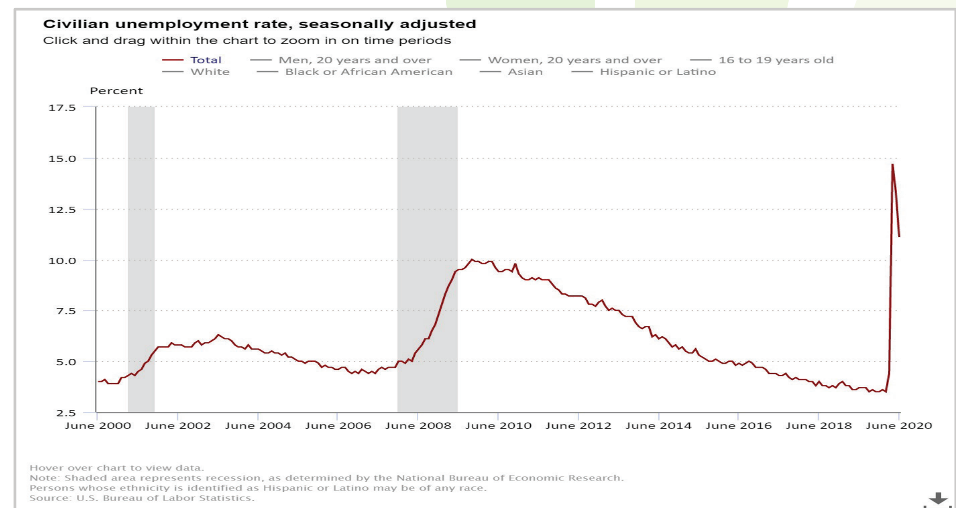
The second quarter witnessed the most extreme change in economic indicators on record; both to the downside and to the up. The nature of the COVID-19 pandemic, and associated efforts to restrict activity in order to contain the virus, drove this outcome.

MACRO CONDITIONS

Early in the quarter, unemployment claims accelerated at a rapid pace, ultimately peaking with the unemployment rate reaching 14.7%. Employment data has been particularly challenging to capture given the nature of recent government policies. The federal government's Payroll Protection Program (PPP), which provides forgivable loans to business if they maintain payroll levels, led many businesses to hire back employees that had been previously laid off. Moreover, an additional $600 a week unemployment benefit resulted in some unemployed workers temporarily choosing not to look for work, and hence they don't qualify for inclusion in some of the unemployment figures. As the U.S. economy exited the second quarter, the unemployment rate had dropped to 11%, although weekly unemployment claims remain well north of 1 million, versus pre-crisis levels that averaged around 200,000.

The federal government's swift actions to provide fiscal support through the CARES act has proved to be a positive in bolstering conditions for consumers. After falling considerably in April, retail sales rebounded sharply, up 17.7% in May. Consumers that have been financially impacted by the pandemic have experienced some support through the combination of higher unemployment insurance benefits and economic stimulus checks that were distributed during the quarter. In fact, according to a University of Chicago working paper, they calculate that 68% of unemployed workers have been making more on unemployment than when they worked. In addition, the reduced number of businesses open to serve consumers also helped to drive higher savings rates. In total, the personal savings rate in April was 32%, the highest on record. As the quarter progressed, consumers began to spend more and save less, but at least for now consumer balance sheets as a whole are in good shape.

U.S. UNEMPLOYMENT RATE



ECONOMY

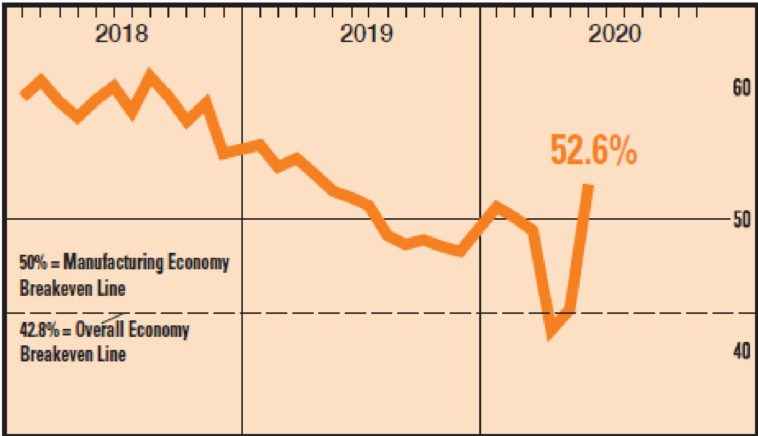
As we look ahead, consumer spending will face challenges as the $600 added unemployment benefit is set to expire in late July, the average number of hours worked remains low, and with some early PPP loans beginning to reach the point where they are forgivable, employers may choose to take action to adjust the size of their workforce.

Early on in the quarter, industrial activity declined to levels the U.S. hasn't experienced since the Great Financial Crisis (GFC). The ISM Manufacturing index, fell to a reading of 41.5, down from 50.9 earlier in the year. Levels below 50 indicate that activity is contracting. Industrial activity rebounded toward the end of the quarter to finish at an expansionary reading of 52.6. This was a remarkable bounce back and growth in new orders is an indication that the current level of industrial activity may have some legs to it. What stands out to us about the drop and corresponding rise in industrial activity is that the U.S. has faired much better than other parts of the world. Activity levels in Europe had fallen more, and earlier in the year China's industrial activity reading fell as low as 35.

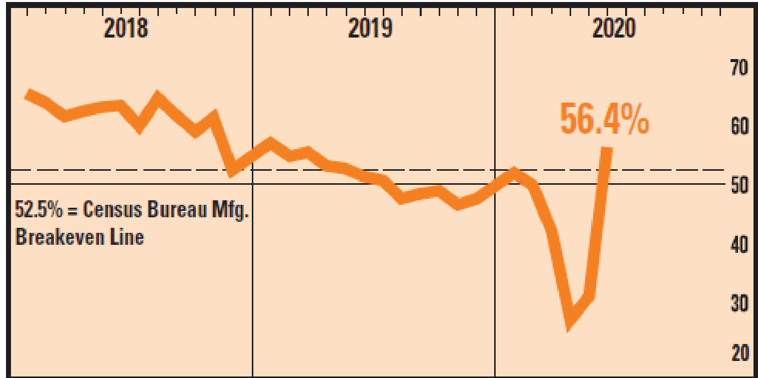
INTEREST RATES AND MONETARY POLICY

The Federal Reserve was quite active during the month of March, both in putting policies into place and in cutting interest rates. The second quarter was more about implementing its various policies and programs.

ISM PURCHASING MANAGERS INDEX



ISM NEW ORDERS INDEX



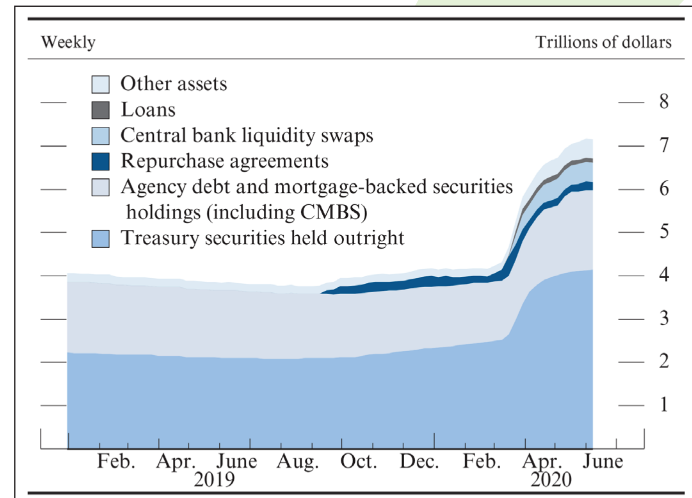
Source: Institute of Supply Management, ISM Report on Business, June 2020

ECONOMY

The Fed's largest monetary stimulus program is quantitative easing or QE. Since March, the Fed's balance sheet has grown from just under $4 Trillion to over $7 Trillion, nearly doubling. The size and pace of this increase was much greater than we or most market participants expected. The Fed initially started its latest round of QE as a means of stabilizing the bond market through the purchase of Treasuries and mortgaged backed securities. In early April, the Fed was buying roughly $400 billion worth of bonds a week. That number tapered down toward a weekly run rate that averaged $50 billion in June. The Fed's significant involvement in buying Treasuries has helped to keep interest rates low and in a tight trading range, despite a record amount of Treasury bonds being issued by the Treasury in order to support the fiscal deficit.

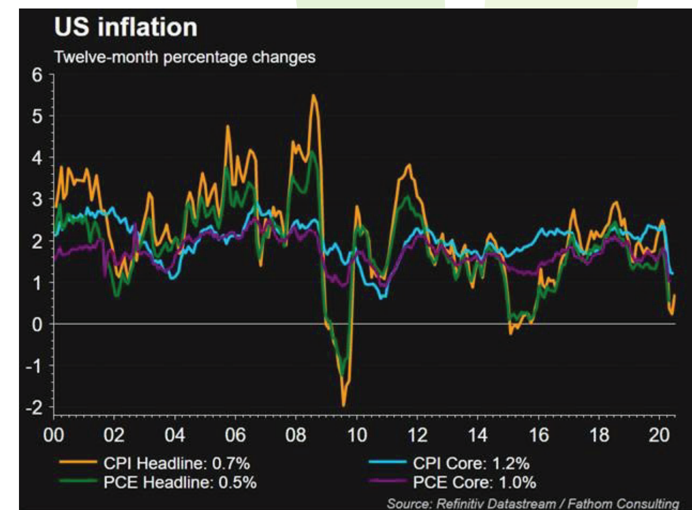
As the quarter progressed, commentary and testimony from Chairman Powell made it clear that the Fed's monetary stimulus efforts had evolved from supporting the functioning of markets toward ensuring there was sufficient liquidity to support the economy during this challenging time. As inflation rates (as measured by the Core Consumer Price Index) dropped to 1.2%, from 2.4% early in the year, the Fed appears to have cover under its dual mandate (high employment and moderate inflation) to stimulate the economy in order to help the labor market.

FEDERAL RESERVE'S BALANCE SHEET



Source: Federal Reserve, Monetary Policy Report, June 12, 2020

INFLATION



Source: Refinitiv

ECONOMY

PERSPECTIVE

The challenge in assessing recent economic data is that it has occurred over such a brief period and is highly influenced by an unprecedented level of stimulus. Moreover, as we exited the quarter, the number of cases was on the rise in the U.S. with select actions being taken to reverse prior restrictions. The fact that infections remain elevated just as some fiscal stimulus measures begin to roll off, it seems highly probable that the recovery will not be V-shaped but more like a U, W or even a Nike swoosh symbol.

As we look to the next quarter, it would seem likely that the federal government authorizes some level of additional stimulus. However, while the $3 billion CARES bill was swiftly passed through the House and Senate, there may be less bi-partisan support for further large scale packages. To the extent there is, it's less certain whether markets will support further deficit spending without driving interest rates higher.

While the second quarter had its low points, it finished on a positive note. However, the economy is not out of the woods yet. We don't believe the economic pain will be brief, like a Band-Aid being ripped off, rather one should brace for a more gradual recovery with some level of pain along the way.

EQUITIES

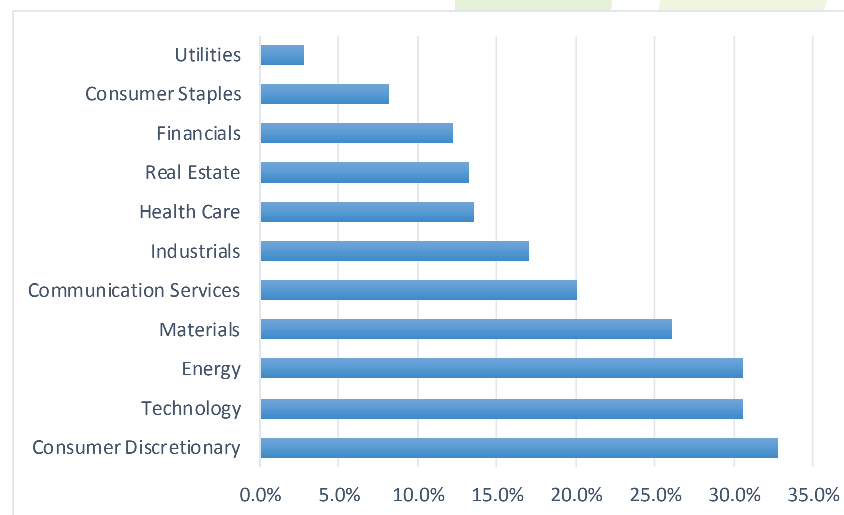
The stock market rebounded at a pace and magnitude few expected, with the S&P 500 Index generating its best quarterly return since 1998. A combination of Fed stimulus driving some investors toward risk assets, a flattening of the COVID curve and a gradual reopening of the economy drove positive sentiment. Having gained 20.5% in the second quarter, the S&P 500 is down a mere -3.1% for the year.

	Q2 2020	Year-to-Date
S&P 500	20.5%	-3.1%
NASDAQ	30.6%	12.1%
Dow Jones Industrial Avg.	18.5%	-8.4%
Russell 2000	25.4%	-13.0%
MSCI EAFE	14.9%	-11.3%
MSCI Emerging Markets	18.1%	-9.8%

Riskier sub-classes of the equity market had robust rallies as small caps outperformed large within the U.S. In international markets, emerging market stocks outperformed developed. Less volatile stocks lagged the broader rally. From a sector standpoint, as the more stable utilities and consumer staples sectors were the laggards on the quarter. Alternatively, consumer discretionary, technology and energy sectors generated the strongest returns.

While the strong rebound in the market has been well received by investors, its important to recognize the rally has been quite narrow in growth stocks, and in particular larger capitalization growth companies, notably technology related. This was most evident with the tech heavy NASDAQ composite returning over 10 percentage points more than the S&P 500. If we look at growth stock performance from the lens of the Russell style indices, the Russell 1000 Growth gained 27.8% while its Russell 1000 Value cohort was up 14.3%. The 13.5 percentage point differential is an extreme outcome for a quarterly period. In fact, in each of the past two quarters, the magnitude with which growth stocks have outpaced value ranks in the top five periods dating back to 1979, the origin of the Russell style index data.

S&P 500 2ND QUARTER SECTOR RETURNS



EQUITIES

With the benefit of hindsight, the rally in growth stocks is understandable given the changes in behavior as a result of the COVID-19 pandemic. Technology stocks have benefited from greater demand for productivity solutions and infrastructure spending. Health Care stocks, which are also a larger component of the growth index, have also benefitted from increased health related spending, particularly in drug development and diagnostics.

While fundamentals for many growth stocks appear to be improving, valuations are near the high end of historical levels. While we acknowledge the attraction of businesses such as Amazon, Microsoft, Zoom, among others, to us the long-term revenue and earnings growth trajectories seem to be well reflected in the prices of many of these stocks. As such, the risk/reward does not appear to be as favorable.

Alternatively, value stocks, which are more concentrated in financial, energy and industrial stocks, trade at attractive valuations relative to historical levels. These stocks, however, are facing more challenging fundamentals. Its understandable why investors are less excited about purchasing energy stocks when oil prices are depressed or banks when loan losses are on the rise. Long-term, the valuations of these assets appear attractive, although we acknowledge its unlikely that market participants will get excited about these in the short-term. We do remind investors that coming out of the tech bubble, it was value stocks that outperformed over a multi-year period.

TOP GROWTH QUARTERS (SINCE 1979)

	Russell 1000 Growth	Russell 1000 Value	Difference
12/31/1999	25.14	5.43	19.72
6/30/2020	27.84	14.29	13.55
3/31/2009	(4.13)	(16.77)	12.64
3/31/2020	(14.10)	(26.73)	12.63
12/31/1998	26.74	16.61	10.13

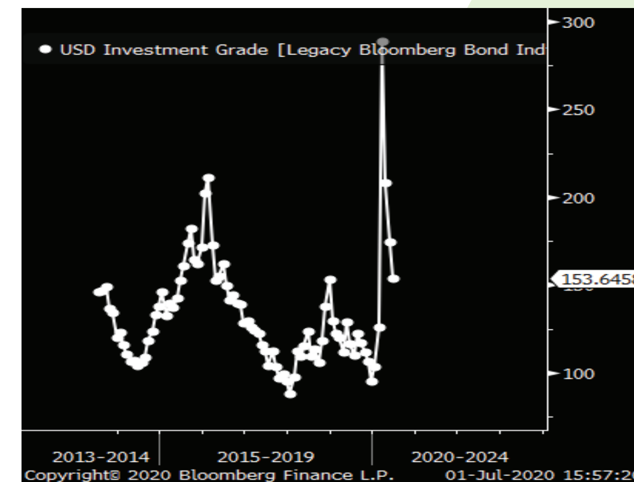
FIXED INCOME

After an eventful first quarter, conditions in the bond market calmed in the second. Interest rates were remarkably stable as Treasuries traded in a tight trading range. The June FOMC announcement, which included participant forecasts, suggested the Fed Funds rate would remain in the 0-1/4% range through 2022. This expectation provided an anchor to short-term Treasury yields, which remain below 0.25% for maturities 3-years and shorter. Market consensus is that yields are likely to remain stable for an extended period, which should result in interest rates having a limited impact on bond prices over the near-term. Over time we would expect the magnitude of deficit spending and likelihood of rising inflation expectations to lead to higher longer-term rates and a steeper yield curve.

Credit markets experienced a remarkable improvement in comparison to first quarter levels. Unprecedented support from the Federal Reserve led to greater risk appetites as investors concluded the Fed would do what was needed support the bond market. Credit spreads, which quantify the difference in yield between corporate bonds and comparable Treasuries, were notably lower. In particular, investment grade bond spreads retraced roughly 70% of the yield increase that occurred during the first quarter. High yield bonds also experienced sizable improvement in spreads, although they did not experience the degree of retracement that investment grade bonds did. The charts depict the swift retracement in spreads among both investment grade and high yield bonds.

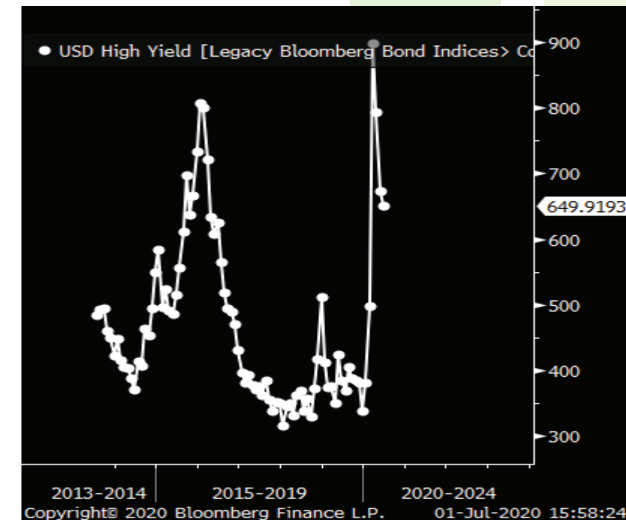
For the quarter, fixed income returns were positive with the Bloomberg Barclays U.S. Aggregate Index appreciating +2.90%. Interest rates had little impact on results, as tighter spreads contributed to a majority of the returns.

US INVESTMENT GRADE BOND SPREADS



Source: Bloomberg

US HIGH YIELD BOND SPREADS



Source: Bloomberg

FIXED INCOME

The programs the Federal Reserve has put in place to support corporate bond markets, in addition to mortgage and asset backed securities, proved highly successful in improving the functioning of markets from their stressed levels in March and April. The Federal Reserve remains active in adding fixed income securities to its balance sheet through a number of programs.

After initially making sizable purchases of mortgage backed securities in March and early April, most of the Fed's more recent Quantitative Easing activity has been in Treasury bonds. For the first time ever, the Fed has begun to purchase corporate bond ETFs and individual corporate bonds, although the size of these purchases has been modest in comparison to its Treasury bond purchases. Another Fed backed program, the Term Asset Backed Securities Lending Facility (TALF), was launched during the quarter to support bonds composed of car loans, credit card receivables, and other main street assets. Spreads on these bonds have come in considerably to a point where demand for TALF has not been as high as expected. In our view, the Fed's efforts to establish programs and reinforce the notion that they are ready and able to support markets if they become stressed, has been enough to support investors' risk appetite.

The level of retracement in spreads has been surprising and may not accurately reflect current business conditions for all issuers. As such, we believe security selection is of particular importance in this environment as well as a bias toward conservatism.

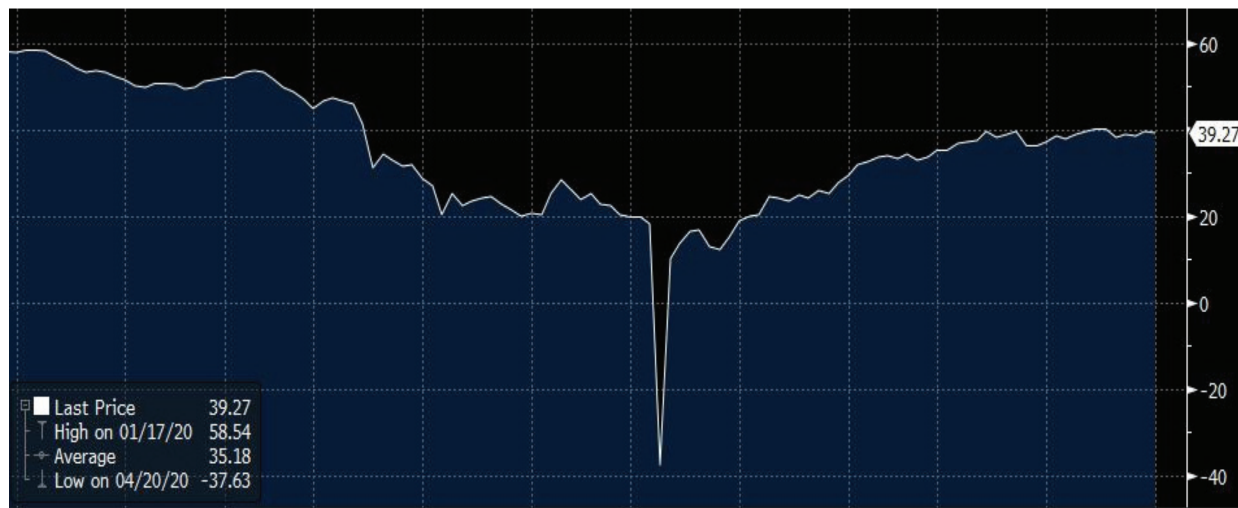
Similar to taxable bonds, municipal bonds had a positive quarter, with the Bloomberg Barclays Municipal Bond Index rising +2.72%. The Fed's actions to establish facilities capable of purchasing short dated municipal bonds and directly lend to municipalities led investors back into the asset class, leading to a notable reduction in yields. While rates on municipal bonds are lower than where they began the quarter, they continue to trade at yields north of 100% of Treasury bonds, making them modestly attractive relative to taxable bonds.

COMMODITIES

OIL

Oil had a quarter like no other. After falling in March in response to supply increases out of Saudi Arabia, prices continued to decline into April as demand for gasoline dropped precipitously across the globe. Oil prices, which are based off the active futures contract, went negative closing at a price of -$37.63 a barrel on April 20th, as investors and speculators tried to sell the active contract and purchase the next month's contract. Given the glut of oil supply sitting in Cushing, Oklahoma and a lack of storage capacity, few investors were able to take other side of contracts from investors that were forced to sell. This pushed prices negative, a notion many investors weren't sure was even possible. After the futures contract flipped to the next month's (June) contract, prices began to stabilize. Throughout the rest of the quarter, oil prices continued to climb higher, delivering incredible gains for those that bought near the bottom.

WEST TEXAS CRUDE OIL PRICE (YEAR-TO-DATE AS OF JUNE 30, 2020)



Source: Bloomberg

COMMODITIES

GOLD

After falling with risk assets in March, gold prices rebounded ending the quarter 12.9% higher. Gold is often viewed as a safe haven asset. Investors looking for diversification reallocated to it during the course of the quarter. Fears around long-term inflation as well as views that some major currencies, such as the dollar, may fall as a result of record deficit spending led to increased demand, and hence higher prices, for gold.

Source: Refinitiv

CURRENCY

The U.S. dollar was range bound for much of the quarter before falling during June. All told, the dollar depreciated by -1.7% in the second quarter. Year-to-date the dollar has appreciated by 1.0%.

U.S. DOLLAR INDEX (YTD)

Source: Refinitiv

LOOKING AHEAD

The fiscal and monetary stimulus measures taken early on in the pandemic, while not perfect, have provided significant support to the economy and have helped to temporarily ease the sudden and severe demand shock.

As we look ahead, stimulus measures will run out and its unlikely that the economic output will have rebounded to the point where it offsets the scale of government stimulus. The federal government could choose to extend some or all of the previous programs, which will help to smooth the near-term recovery, however, it will make the long-term recovery steeper and more challenging. While deficit spending associated with stimulus measures has thus far gone off without a hitch (i.e., interest rates and inflation have not gone up), the unprecedented nature of these efforts makes one question at what point will there be an economic impact. Moreover, the debt burden of these programs will have to be addressed down the road, likely through higher taxes given the sheer magnitude of deficit spending. Higher taxes will have an impact on profitability of companies, the spending power of consumers and could ultimately put downward pressure on equity markets.

For investors, the sizable gains generated in the second quarter have been a positive respite after the challenges of the first quarter. Long-term investors must be cognizant that risks remain and that government and market responses may have changed long-term return expectations.

As the quote from the beginning of this commentary indicates, we can't predict but we can prepare for the environment ahead and have been taking steps to account for how our long-term expectations have been evolving. First, while economic conditions are improving, there is an abnormally wide range of potential outcomes and portfolios should incorporate a level of downside protection in the event that an adverse scenario plays out. Second, its increasingly important to have assets that are truly diversifying within portfolios. Lastly, there are likely to be businesses that are clear winners and losers coming out of the pandemic; we believe security selection will be of greater importance, and hence investing with active investment strategies is prudent at this stage of the market cycle.

We recognize that during these periods of uncertainty it is only natural to have questions and concerns. Our quest at Telemus is to enrich the lives of our members, and this is of increased importance during times like the present. We aim to keep you informed with a variety of updated information available at www.telemus.com. In addition, feel free to reach out to your Advisor at any time. For those of you who are not our clients feel free to contact us as well.

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