2nd Quarter 2020 Investment Letter by Erik Ridgley, CFA July 2, 2020

We want to wish all our clients and friends a safe Summer, plus provide a review of the markets in the 2nd Quarter and our thoughts about the second half of 2020. We continue to patiently invest for the long-term per each client's custom investment policy statement. During this downturn we implemented our normal portfolio management processes, which included portfolio rebalancing into equities at lower prices and further improving after-tax returns with tax-loss harvesting. Tax tip: Don't take your 2020 IRA RMD.

Asset Class Benchmark Index Returns – 2nd Quarter 2020 (2Q20) and Year-to-Date (YTD)

2Q20: +19.22%	YTD: -6.25%	Global Equities: MSCI All Country World Index (ACWI)
2Q20: +2.72%	YTD: +2.08%	Municipal Bonds: Bloomberg Barclays Muni Bond Index
2Q20: +10.97%	YTD: -2.09%	50/50 Blend Portfolio: 50% ACWI / 50% Muni Bond
2Q20: +20.54%	YTD: -3.08%	U.S. Large Cap Equities: S&P 500 Index
2Q20: +25.42%	YTD: -12.98%	U.S. Small Cap Equities: Russell 2000 Index
2Q20: +14.88%	YTD: -11.34%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
2Q20: +18.08%	YTD: -9.78%	Emerging Markets Equities: MSCI Emerging Markets Index
2Q20: +11.71%	YTD: -18.34%	Real Estate: S&P U.S. REIT Index
2Q20: +10.18%	YTD: -3.80%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
2Q20: +2.90%	YTD: +6.14%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)

Long-Term Investing

Bear markets can be emotionally jarring, even though we all know they are both inevitable and temporary. When a market bounces off the bottom, it often rallies higher and faster than it should. The initial phase of a new bull market is typically met with widespread disbelief. People naturally suffer cognitive dissonance whilst reconciling rising stock market prices with the collateral damage of recessions. Eventually, those who regret having sold will begin to believe the data indicating economic recovery, but markets will have already priced it into equities. Long-term investing is a good defense against these traps.

As Warren Buffett says, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, in order to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets. As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized planning and disciplined implementation.

"It's Different This Time" Are the Four Most Dangerous Words in Investing

Although this pandemic induced recession feels unprecedented, the dynamics we are seeing in financial markets have many important parallels to those of prior recessions. Normally, US business cycles die from our central bank raising the Fed funds target rate too high for too long, to cool off an overheating economy, but coronavirus was an exception to this rule. The Fed response to this recession has been to roll out the same liquidity programs used by the Fed in 2008-2009, and this time the response was much bigger and faster. Central banks in Europe, Japan, and elsewhere reacted similarly.

Former Fed Chairman Ben Bernanke successfully overcame severe disinflationary forces unleashed during the Great Financial Crisis of 2008 with inflationary monetary policies such as extraordinary asset purchase programs (APP) and aggressive quantitative easing (QE). In a panel discussion on January 4, 2019, former Fed Chair Janet Yellen said the Fed would use APP and QE again during the next recession, after lowering the Fed funds target rate to zero (but not negative). She was correct.

Mario Draghi, former President of the European Central Bank (ECB), will be best remembered for his promise that the ECB would do "whatever it takes to preserve the Euro" in a speech on July 26, 2012 during the depths of the European sovereign debt crisis. Fed Chair Jerome Powell said as much on March 26, 2020, promising on national TV that "we will not run out of ammunition." He is to be believed.

Don't Fight the Fed

The combined amount of announced fiscal stimulus, APP, and QE adds up to 46% of U.S. GDP, which is astonishing, and significantly exceeds the projected damage to the U.S. economy from the coronavirus. Monetary policies and fiscal stimulus implemented by credible governments with the power to print money can significantly change price levels across global markets (whether Adam Smith likes it or not). This lesson has been re-learned by investors over and over since the creation of the Federal Reserve Bank.

Based upon ample empirical evidence that the central banks in Japan, Europe and U.S. have been unable to raise inflation up to their preferred targets, the Fed has become more concerned with fighting deflation than inflation. Simply put, the Fed knows how to defeat inflation, but they don't know how to defeat deflation, and so now deflation is the more dangerous foe. Inflation has remained below the Fed's target of +2.0% for many years, and the Fed has indicated it is willing to allow inflation to rise above its target level "for a sustained period" before feeling compelled to react with additional rate hikes. As Fed Chair Powell recently said, "We're not even *thinking about* thinking about raising interest rates." (Not a typo.)

It's Never Just One Thing Because of the Feedback Loops

Stock markets are forward looking and capable of lightning fast reactions. Vast pools of capital and massive access to information are in the hands of profit seeking investors with fundamentally different valuation methodologies, investment time horizons, and risk appetites. There are feedback loops, side effects, reaction functions, and then more feedback loops. These forces collide with each other endlessly to clear the market and render the process of price discovery. Price discovery does not create value, nor does it measure value, rather it indicates where equilibrium temporarily exists between buyers and sellers.

Value creation occurs inside of businesses. Entrepreneurs and managers have significant control over the outcomes of their ventures, and our capitalist system allows long-term investors to participate in the economics of this value creation. It is measured by income statements, balance sheets, and statements of cash flows. Businesses worthy of investing in must be able to operate in recessions without running out of cash. Similarly, asset allocations based on well-designed investment policy statements should enable investors to get through bear markets without selling equities. This is common sense risk management.

Review of Markets in 2nd Quarter: The Fed Went All-In, and Markets Reacted Accordingly

The S&P 500 index of stocks rallied 20.54%, including dividends, from 2,585 to 3,100. 10-year Treasury yields went sideways from 0.70% to 0.66%. West Texas Intermediate (WTI) crude oil prices per barrel careened wildly from $29 to $40, with the front month contract closing below zero on April 20th. The US dollar currency index weakened a bit from 99.05 to 97.39. U.S. unemployment rates peaked at record high levels (high teens percent) in May, then turned around and partially recovered to low teens levels. EPS growth in both 3Q19 and 4Q19 was negative, so even prior to coronavirus we were in an EPS recession (albeit a mild one) for the first time since the second half of 2015.

The world's economies plummeted in the 2nd Quarter due to coronavirus, government-imposed shutdowns, and involuntary mass quarantines. The U.S. economy (real GDP) declined -39% sequentially (Q/Q) in the second quarter of 2020 according to the Atlanta Fed's "GDP Now" forecast, although this eye-catching number probably overstates the decline. Unemployment rates spiked around the world from record low levels (e.g. 4% in Germany before coronavirus), with the most severe damage wrought upon global service sectors, which now dwarf the more cyclical global manufacturing sectors (which were already contracting in 2019). Capital markets are finally imposing financial discipline on profligate U.S. shale oil drillers, which is forcing rig counts and production levels to fall.

Outlook for Markets in the Second Half of 2020: Data Indicate Economic Recovery is Underway

Real-time daily feeds on credit card transactions and other "alternative data" sources indicate with a high degree of certainty that the US economy bottomed in mid-April, and labor market reports indicate the US unemployment rate peaked in May. Economists are forecasting a sharp recovery with sequential (Q/Q) U.S. real GDP growth of +16%, +12%, and +7% for 3Q20, 4Q20, and 1Q21, respectively.

S&P 500 operating earnings per share (EPS) growth forecasts started falling March 11th, were marked down aggressively for the next two months, and then rose slightly from mid-May through June. Year-over-year consensus forecasts are -15.0% for 1Q20, -43.4% for 2Q20, -25.2% for 3Q20, -13.4% for 4Q20, & -22.9% for FY2020, which then flip to double digit yr/yr EPS growth beginning in 1Q21, and +29.5% for FY2021, per I/B/E/S data by Refinitiv. If analysts' consensus estimates are correct, then 2021 EPS would be equal to 2019 EPS. The stock market narrative is that 2nd Quarter 2020 will be the low point for EPS, in large part because governments and central banks will continue to aggressively support economies and capital markets with fiscal stimulus, APP, and QE. Guidance pronouncements from managements of companies that are reporting 2nd Quarter earnings throughout July might be less meaningful than usual, because of the uncertainty surrounding the coronavirus.

S&P 500 revenues per share are forecasted to fall -5.3% in 2020, and then grow +8.6% in 2021, and net profit margins are projected to decline from 11.5% in 2019 to 9.4% in 2020, then recover to 11.2% in 2021, per I/B/E/S data by Refinitiv.

Price/earnings (P/E) multiples are 19.4, 15.1, and 12.3 for U.S., foreign developed, and emerging markets, respectively, where E is EPS on next year earnings (2021 EPS), per Bloomberg consensus. The long-term average for U.S. P/E multiples is 15 ½. Thus, equity valuations are 25% above average, although most researchers would say that the lower interest rates we have today (and those forecasted for the future) should allow for higher P/E multiples, all else being equal. The counter argument to this would be that lower U.S. Treasury bond yields are signaling lower future GDP growth, which should dampen future EPS growth.

The yield curve is currently pricing in the Fed funds target rate to remain at 0% to 0.25% for at least two years, and 10-year Treasury yields of 0.8% at year-end 2020 (per Bloomberg FWCM). More importantly, the yield curve is priced for 10-year Treasury yields to remain below 2% for at least 15 years. The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind.

The yield curve has steepened significantly, with 10-year Treasury yields higher than 2-year Treasury yields by 58 basis points (bps), which is a leading indicator of economic growth.

High yield bond spreads (over Treasuries) peaked at 1100 bps (or 11%) and have settled back down to 575 bps, indicating credit markets are concerned, but on the mend.

The highly respected UCLA Anderson Economic Forecast is predicting that U.S. real GDP "will decline by 8.6% in 2020 and then increase by 5.3% and 4.9% in 2021 and 2022, respectively." They are forecasting year-end unemployment rates of 10%, 8%, and 6% for 2020, 2021, and 2022, respectively. Wall Street's full year consensus forecast for 2020 U.S. real GDP is -5%. Europe's economy is forecasted to decline -5.5% in 2020 (per ECB), well below its trend rate of 1% growth, and Japan's economy is forecasted to decline -5.5% (per UOB), well below its trend rate of 0.5% growth.

Consistent & Predictable Processes: Portfolio Rebalancing, Tax Loss Harvesting, and Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements (IPS). Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g. >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good judgment, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because they can be used to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or even avoidance of realization of capital gains through judicious planning and portfolio management. Unrealized capital gains can be permanently eliminated over time with proper trust & estate planning via step ups in cost basis when wealth transfers from one generation to the next. Tax tip: Don't take your 2020 IRA required minimum distribution (RMD), it was waived.

Conclusion

We hope everyone stayed away from the coronavirus during the second quarter of this year, and we wish all of you a healthy and safe Summer. Please let us know if you have any questions. Thanks!

Best Regards, Erik

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