Market Perspective | 2Q 2020

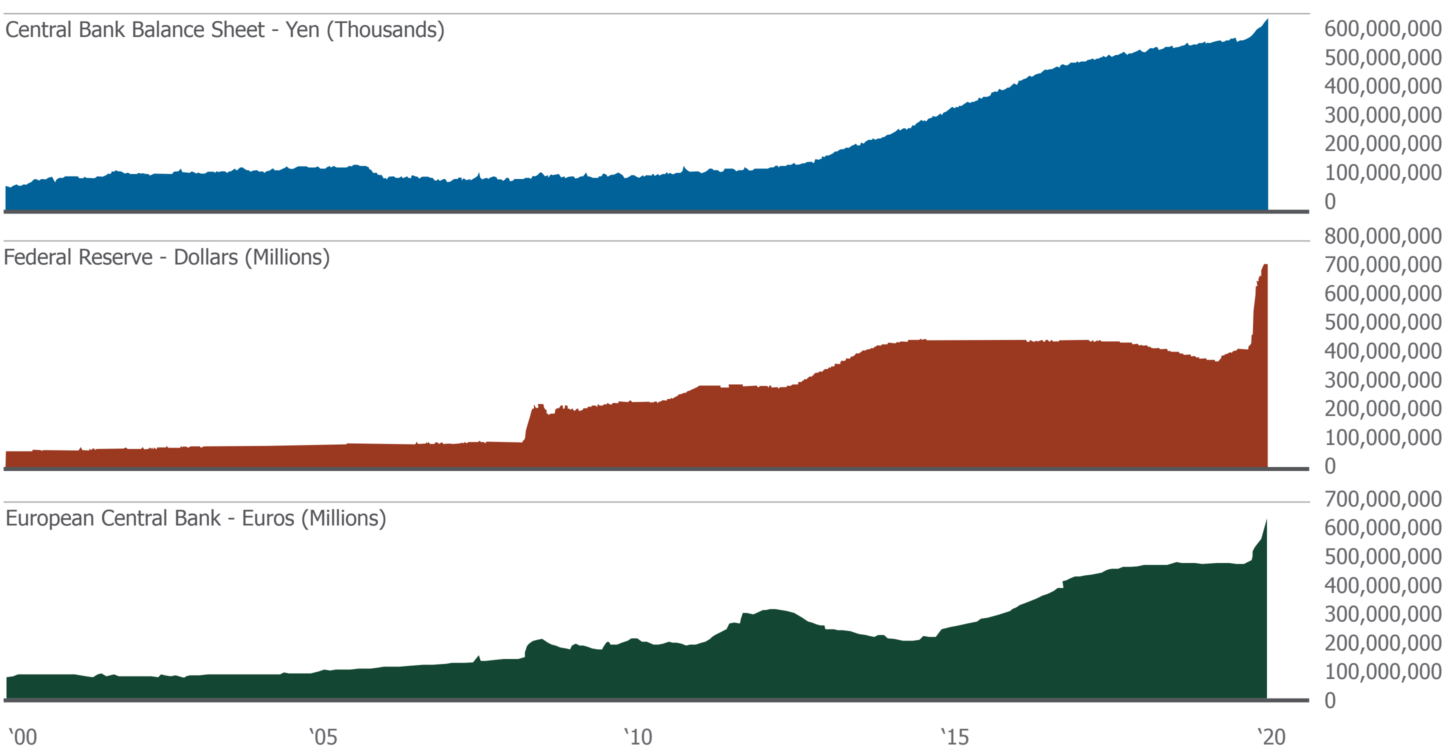
It's Daybreak, the Sails are Set, but the Seas Remain Turbulent

Cross currents! The financial markets have recovered during the second quarter of 2020, but it has been far from smooth sailing. We are faced with significant cross currents: race relations, health concerns, economic and financial uncertainty. We will be focusing on the economy and markets in this letter, but I encourage all to read the letter on CBIS' Reflections on Racial Discrimination by Jeffrey McCroy in response to the Black Lives Matter movement.

Last quarter we highlighted the significant amount of global monetary and fiscal stimulus worldwide. We expect the bar for additional fiscal stimulus to be quite low. We are seeing for the first time in quite awhile the coordination of both stimulative fiscal and monetary policies and the level of central bank support to bridge economies globally exceeding what was seen during the Global Financial Crisis. Chart 1 illustrates the burgeoning central bank balance sheets of Japan, the US, and EU.

CHART 1

Central Bank Balanced Sheet



Source: FactSet

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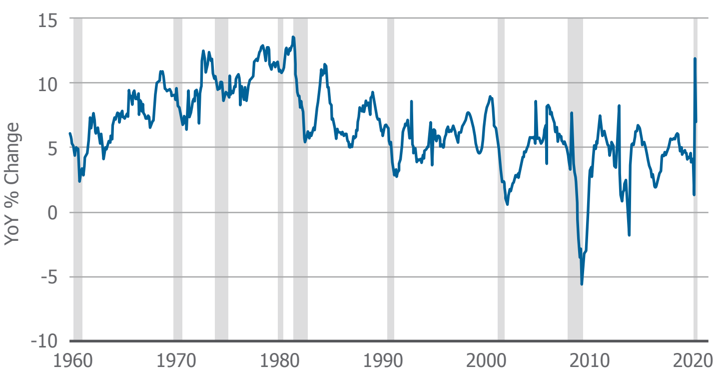
This stimulus, while necessary to counteract the economic slowdown due to the COVID-19 healthcare crisis, is generating a cross current we will have to navigate. Typically, we see personal income decline during economic downturns. We are experiencing the opposite in the United States. As can be seen in Chart 2, personal income has increased during this downturn largely driven by fiscal stimulus.

CHART 2
Personal Income



Source: FactSet **Shaded areas indicate:** U.S. recessions.

How much pent up demand will be unleashed as economies begin to open? Will that demand be tempered by an increase in the savings rate or reflect the depletion of pre-crisis savings for those who might not have qualified for fiscal stimulus? Central bank activity has also led to a significant increase in the money supply (See Chart 3 Below).

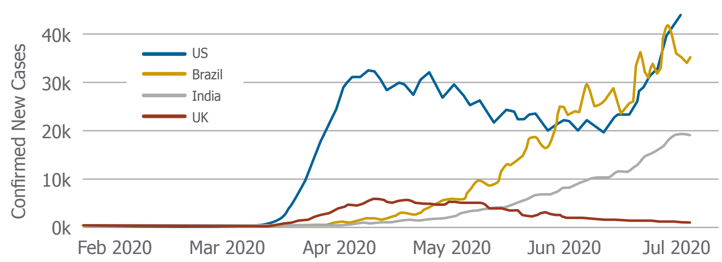
CHART 3
Central Bank Activity

Source: FactSet United

So far, this has not led to higher inflation due to the decline in money velocity during the economic shutdown. However, as economic activity resumes, will inflation be a cross current to navigate?

We must also recognize the cross currents of "re-opening" economies. The potential for normalized levels of growth and inflation will be difficult to realize while economies are operating below full capacity. Particularly in the US, we are witnessing meaningful increases in COVID-19 case counts in areas of accelerated openings, prompting the "re-closing" of certain establishments. The situation deserves close monitoring as it will impact the speed at which local, national, and global economies return to healthy levels of economic activity (See Chart 4 Below).

CHART 4
Daily Confirmed New Cases (5-day moving average)
Outbreak evolution for the current 10 most affected countires



Source: John Hopkins University, As of July 2, 2020.
Five-day moving average from most confirmed cases to least: US, Brazil, India, UK

Cross currents exist within the financial markets as well. For example, over the last 12 months the S&P 500 returned 7.51% on a market capitalization weighted basis, much higher than the -3.25% return using an equal weighted methodology. The more than 10% difference in return highlights how narrow the performance of the market has been and how size has dominated market returns. For context, the ten largest holdings make up nearly 30% of the market cap weighted S&P index. Additionally, the differential between the growth sector and value sector of the markets is noteworthy. The Russell 1000 Growth Index has a year-to-date performance of 9.81%, while the Russell 1000 Value Index has declined -16.26% for the same period. These dynamics are not US centric - this has been a global phenomenon.

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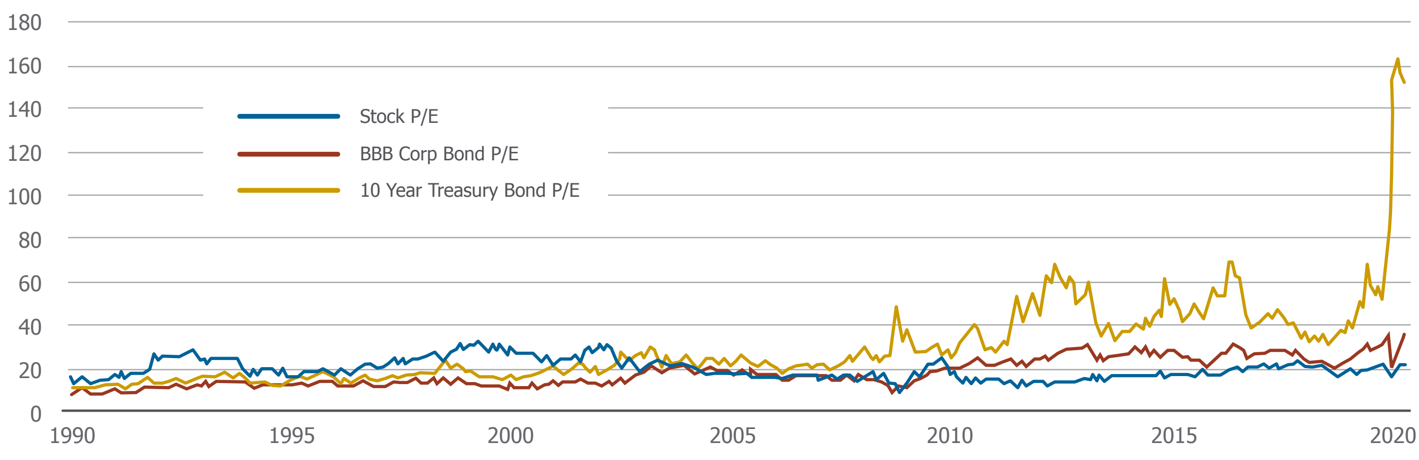
While the rebound in financial assets is encouraging, we must recognize the COVID-19 storm has not subsided. We are still feeling the economic repercussions of social distancing, reduced capacity constraints in numerous businesses and elevated levels of unemployment. As we look at the valuations of both fixed income and equity markets, we realize the traditional valuation metrics fall short at this time. This quarter, we've seen stocks and corporate bonds perform well in spite of the fact that visibility into future earnings is foggy at best. And although many of the equity indices returned close to 20% during the second quarter, based on current interest rate levels, it appears that, relative to fixed income, equities are undervalued (See Chart 5 Below).

Uncertainty is the operative word and where we go from here will depend upon the speed and health of an economic reopening, and more importantly, the timing of when government infused liquidity will move from financial assets into the real economy. In the meantime, we continue to cling to our philosophy of maintaining a well-diversified investment platform and a long-term view on the markets as we guide you through these choppy waters.

CHART 5

Stock and Bond PE



Source: FactSet

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