

BCA Q2 2020 Investment Outlook and Review

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Summary Outlook

- The rapid decline in Q1 set records for speed, yet Q2 brought an equally rapid rebound. This “worst quarter, best quarter” dynamic has thrown investors for a loop, but makes sense in the context of a severe, but ultimately transitory setback accompanied by a liquidity crisis. The virus will continue to dominate the narrative, thus progress on reducing infections or at least treating COVID-19 is a requisite for recovery.
- Second wave fears are now hitting the markets. Despite likely volatility, our advice remains to take a balanced diversified investment approach. Like the first wave, the outbreak will likely be brought under control through a combination of increased voluntary social distancing and renewed closure of crowded indoor space. Lockdowns will not be as severe as before. The U.S. could end up with herd immunity as the default strategy, but probably not before a vaccine is ready.
- Government policy will remain an important factor in financial markets’ confidence. We see both parties as highly incentivized to get another round of stimulus passed in the coming weeks.
- The first half has brought significant volatility to the fixed income market, as well. Because high quality bonds remain an important source of protection during selloffs, they are important for portfolio stability. Yet the Fed is again punishing savers, and yield is harder than ever to come by. High interest rate sensitivity is a future risk if the Fed is (finally) successful in triggering higher inflation, possibly magnified by the huge increase in government debt.

Second Quarter Performance

Following the painful pandemic crash in the first quarter, stocks reversed sharply in the second quarter. The S&P 500 Index soared 20.5% to recover almost all of 2020’s losses and represented the best quarter since Q4 1998. Halfway through the year, we have already witnessed a sudden crash followed immediately by a rapid recovery, bewildering many investors. A severe liquidity crunch vastly worsened the pandemic crisis, which government policy action almost as quickly alleviated.

Total Index Return	Q2 2020	Year to Date
S&P 500	20.5%	-3.1%
Russell 1000 Growth	27.8%	9.8%
Russell 1000 Value	14.3%	-16.3%
Russell Small Cap	25.4%	-13.0%
MSCI EAFE (International)	12.8%	-11.1%
MSCI Emerging Markets	16.8%	-9.7%
US Aggregate Bond	2.9%	6.1%
High Yield Bonds	10.2%	-3.8%

Source: Factset Research. Total returns priced in USD.

Looking at equity market returns, some notable trends were consistent both on the way up and down. Stocks with higher anticipated growth continue to dominate returns, leaving more cyclical value stocks far behind. Despite previous years’ outperformance, the first half of 2020

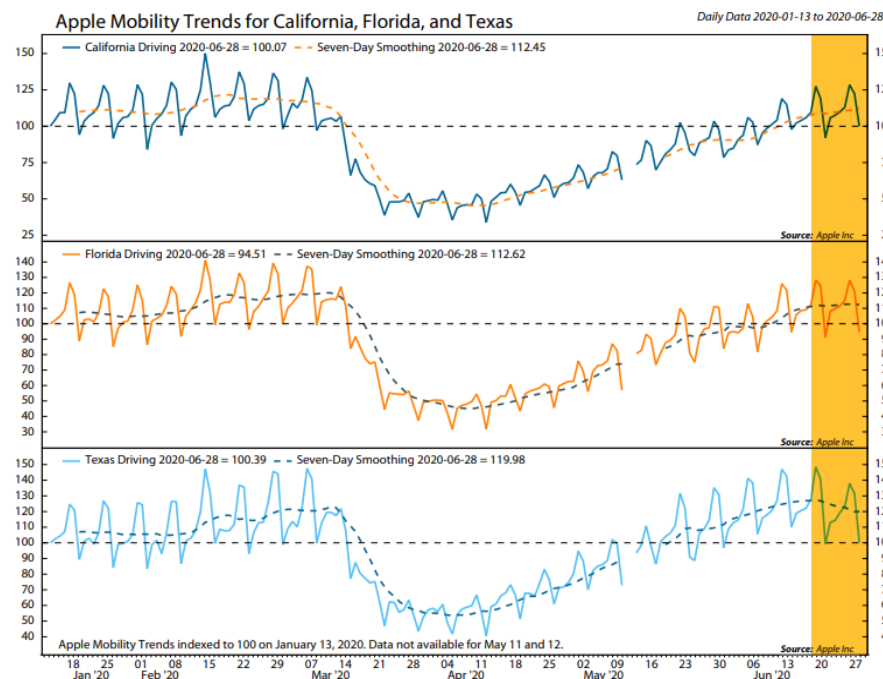
has seen the best start ever for growth stocks versus value. U.S. stocks continued to significantly outperform foreign shares, as well. In a reversal, small caps outpaced large caps during the quarter, but are still lagging badly for the year. Overall, it remains a narrow market dominated by mega cap growth stocks.

While equities raced back, the bond market also performed well as the Barclays U.S. Bond Aggregate rose 2.9%. Higher credit risk bonds and loans rebounded sharply: the worst categories in the first quarter proved the best in the second. Despite this resumed risk appetite, Treasury bonds are the best performing major asset class by far in 2020. Thus, the market is experiencing both an extraordinary flight to safety that has not reversed and a powerful large cap stock rally simultaneously.

Commodities also rebounded this quarter, with gold especially enjoying steady gains. Gold has attracted investors due to its reputation as an alternative store of value and as the opportunity cost of holding is lower due to minimal bond yields.

2H 2020: Reopening or Retrenchment?

Reopening versus retrenchment is the dominant dynamic in the market today. Risk assets have performed strongly when confidence in reopening is rising, there is news of medical progress and consumer spending shows signs of recovery. Government support was critical in encouraging unemployed and frightened consumers to spend, and more is likely to be needed as reopening is stalling. Initially, the market enjoyed a rapid recovery. During part of May, even cyclical stocks began to outperform and talk about long term inflation increased. By contrast, July brought rising COVID cases that have crushed these hopes, stalling the market. One of the best real time indicators is the Apple device mobility data shown below, which shows the stalled reopening trend in states where the virus is resurgent.



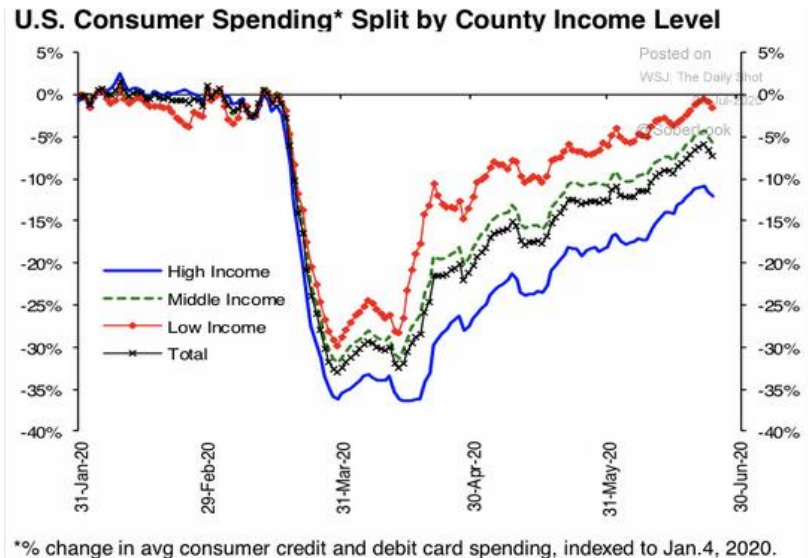
Despite this negative news, the market's near-term direction is uncertain and potentially volatile. While cases are exploding, much of them are in younger cohorts with better outcomes. It remains to be seen how much deaths will rise in response. Luckily, treatment options have improved as doctors have learned more about the virus. Hospitals have more protective equipment and ventilators than before, but still not enough if we face a huge wave. Governments around

the world are pouring resources into vaccine development, which has resulted in some tentatively hopeful candidates.

Our collective reaction to more cases also remains to be seen. Even in “Blue” states appetite for a lockdown as severe as March - April seems unlikely, as California’s approach so far indicates. All this suggests that a second wave will weigh on global growth over the coming months but is unlikely to result in a replay of the huge economic dislocations experienced in March.

Consumption spending dominates the U.S. economy, so consumer confidence and ability spend remain critical factors. As seen in the credit card usage chart below, after initially crashing, consumer spending quickly resumed but now is stalling out. Lower income groups, in particular, spend stimulus checks quickly, which puts money right back into the economy. Another round of support to these consumers will help ameliorate both the humanitarian and economic dislocations from the crisis.

While the economic data confirms that the worst of the global recession is likely behind us, it is increasingly clear the recovery will absolutely not be a “V.” Both parties are still highly incentivized to open the government money spigots, and so at least another \$1 trillion of stimulus is likely to come together in July.



Source: Deutsche Bank

Unlearning the lessons of the 1970s: Fed Unlikely to Tighten

The Fed’s role as “the lender of last resort,” has never been more important. Critics might argue the Fed is becoming a lender of first resort, unable to stand by during a market crash. The Fed argues it is following its mandate to prevent excess unemployment. Regardless of the motivation, monetary policy has never been more important. Hand in hand with the government’s fiscal transfers to consumers and businesses is the crisis-fighting role the Federal Reserve has undertaken.

In the 1970s and 80s, the Fed learned to be preemptive to combat inflation, as monetary policy operates with a lag. Yet despite an eleven-year expansion starting in 2009, CPI inflation failed to breach even 2%. In other words, the penalty for huge government borrowing and numerous rounds of quantitative easing was nonexistent to policymakers. After Coronavirus, long term inflation expectations are extremely low. That means the

central bank will very likely wait for inflation to move notably above 2% before tightening policy. Looking at the past four Chiefs – Greenspan, Bernanke, Yellen and now Powell – the Fed clearly does not see fighting asset bubbles as its job.

Despite (or perhaps because of) unprecedented monetary action, and unlike Europe and Japan, the interest rates in the U.S. remain in positive territory. While the yield curve remains flat overall, the curve has steepened during the recent recovery. This is good news for banks as they would be under even worse pressure if the curve was flatter. Recall that banks typically pay short but receive long when it comes to interest rates.

U.S. Government Yield Curve: 10 Year - 2 Year Treasury Bonds



International Markets: More Fiscal Stimulus Ahead

Like the U.S., overseas economies are also pushing hard to keep their economies from faltering even further. With even lower borrowing costs than the U.S., other G-7 countries are also spending. The developed nations as a group averaged an enormous 11.7% of GDP in fiscal stimulus, compared to 4% of GDP in 2008-10. China is also loosening credit standards, and the Chinese budget deficit is on track to hit the highest level on record.

Economies in Asian emerging markets may also be helped by a behavioral factor. Most people in east Asia are used to wearing masks and their compliance is much higher than in the U.S., one reason why the region has suffered relatively fewer cases. Greater compliance and contact tracing efforts in Western Europe, Australia, and New Zealand should also help their economies recover more quickly, a trend we are watching for investment implications.

U.S. Politics and the Markets

2020 is a Presidential election year in the United States. Rocked by the dislocated economy and the public's antipathy to his handling of the Coronavirus, at present Donald Trump's campaign is faltering. Increasingly investors are asking what would happen in a Biden-led, Democratic "clean sweep." Regardless of the victor, the impact on the market isn't clear. While corporate tax rates would likely rise somewhat under Democrats, a Biden administration may raise less than expected, focusing instead closing loopholes in the tax



code. And even if corporate tax rates do rise, spending would likely rise even more, resulting in a net increase in fiscal stimulus. Trade tension with China might also ease, reducing that source of market pressure.

Conclusions

In the second half of 2020, investors will continue to live in interesting times. Due to the upcoming election and the seriousness of the health crisis, emotions may run very high and markets will swing. Investors are best suited to acknowledge the difficulty of seeing the near-term impact of the pandemic and the authorities' response. The trends that do seem clear are higher volatility, a growth-dominated market, and the difficulty of finding reliable yields. Berman Capital continues to turn over rocks in search of attractive investment opportunities with reasonable risk.

Thank you for your support and interest. Please reach out to your Wealth Advisor with any questions or comments. We wish you and your families a safe and pleasant second half of the year.

Berman Capital Advisors

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