Quarterly Investor Letter— Second Quarter 2020

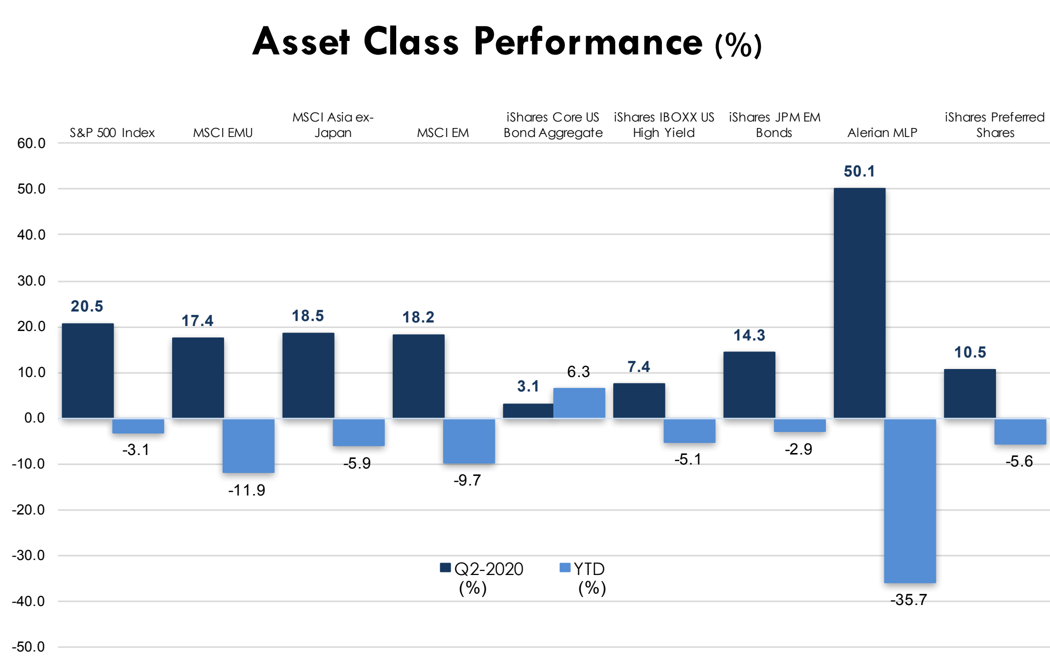
August 7, 2020

1.0 Q2 Market Recap

On January 30, 2020, the World Health Organization (WHO) declared Covid-19 a global pandemic. US investors were somehow slow to notice the potential ramifications of the virus. The S&P500 Index kept on climbing until February 19, when the panic started. Between February 19 and March 23, the US stock market sold off nearly -34%. This was the fastest drop of such magnitude ever recorded. It occurred in only 33 days. Unaccustomed to such sharp and quick moves, investors fled most investments and sought refuge in US Treasury bonds.

The unprecedented steps taken by the US Federal Reserve and US Congress in mid-March helped stabilize the markets. As the lockdown restrictions started being lifted and the chatter about vaccines and treatments began, investors flocked back into the market. Between March 23 and June 30, the S&P500 index rebounded more than +38%.

Chart 1 – Q2 2020 Asset Class Performance. Negative For the Year, Except For US Treasuries.



Source: Bloomberg Professional Services

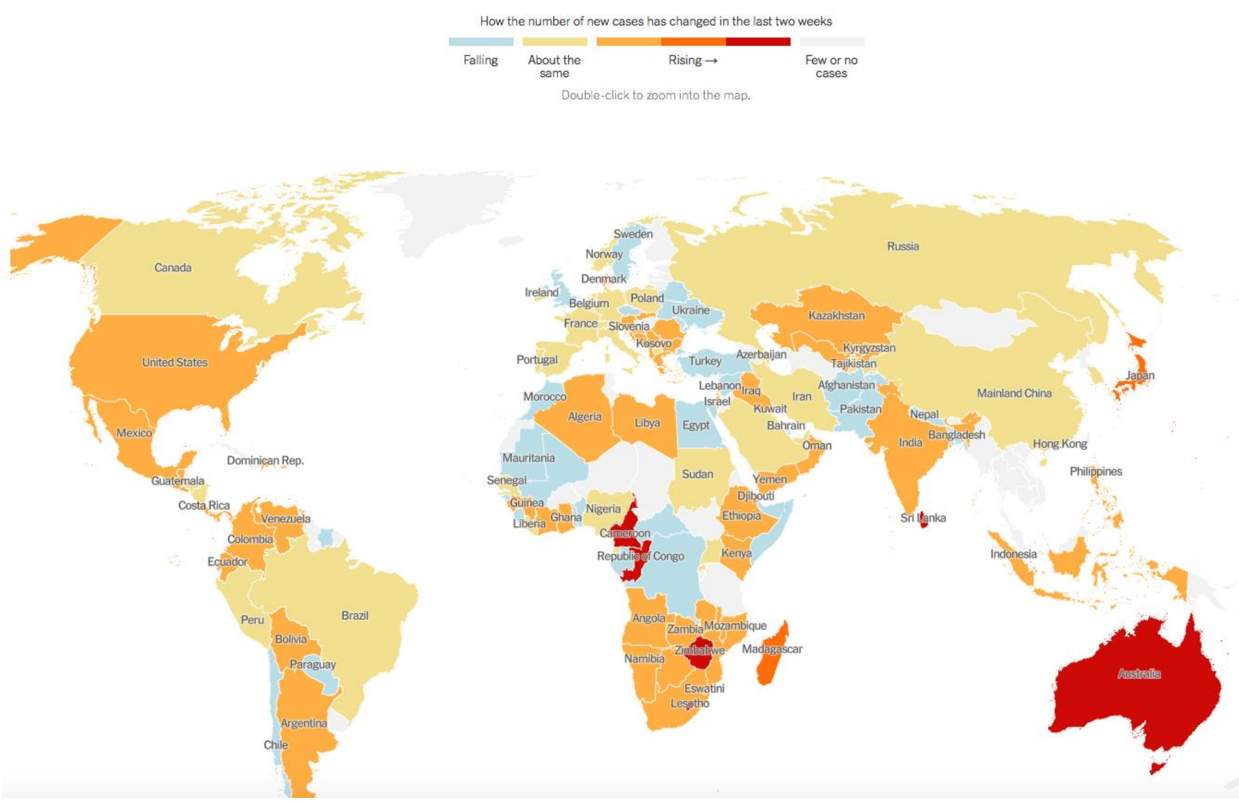
The rally was, however, not broad- based. The main beneficiaries were mega-cap technology companies, perceived to be immune from the economic fallout of the virus. Despite regaining some ground in the quarter, most investment categories remain deeply in the red for the year, including US value stocks, small caps, international stocks, high yield bonds, preferred shares, real estate, and commodities.

2.0 Coronavirus Status

The pandemic and consequent lockdowns have caused an unprecedented global economic contraction, the size of which we have not seen in decades. In order to understand any path to potential economic recovery, one must first look at the root cause of the crisis. As of July, the contagion does not show any signs of abating. It is growing in the US, Latin America, Africa and Asia. The virus is also staging a strong comeback in countries that were originally very successful at containing it (Israel, Australia).

Despite the bad news, the mortality rate of the virus seems to be falling. This is due partly to more testing availability and partly to improved medical treatments. Hospitals have developed better triage protocols for Covid vs. non-Covid cases. Patients with respiratory symptoms are turned on their bellies. Antivirals, steroids and antibody medications are used effectively.

Chart 2 – Covid-19 World Cases



Source: New York Times (July 13, 2020)

About 180 different vaccines are being developed and emergency fast track approval procedures have been instituted by health authorities. The most advanced and promising vaccine is the one being developed by Oxford University jointly with AstraZeneca, PLC. The first important clinical results are expected at the end of August. The head of the US CDC, Dr. Anthony Fauci, expects a safe and effective vaccine by January 2021.

In order for the coronavirus to disappear or to be downgraded to an "endemic," we will need:

1) the population to reach "herd immunity" (= enough people caught the virus and developed immunity), and/or
2) enough people not to be susceptible to catching the virus (= they have been vaccinated).

Even when a vaccine is found, it will not be readily available for everyone and many people may be reluctant to get vaccinated. Therefore, it seems likely that it will take a good while before this battle is won completely. <u>It appears that the medical treatments being developed carry more promise than a quick vaccine.</u>

Under the assumption that the health crisis will take time to be gradually solved, how is the economy going to recover from the abyss it fell into in the first part of 2020?

There are already many signs that a bottom for this recession, which officially began in February 2020, was touched in Q2. Numerous indicators point to improvement both in the US and abroad. The more relevant question for investors is: what type of economic recovery are we likely to experience? Will it be a "V", "W" or "U" shaped economic recovery? Expect the markets to follow the shape of the recovery.

3.0 The ~~ABCs~~ UVWs of Recession Shapes

Economists make extensive use of the alphabet in formulating predictions about the recession that began in February 2020 and the recovery that will follow it. The varieties of downturns observed historically go by the following letters:

V

A V-shaped recession consists of a short but sharp downturn, followed by a swift recovery. The powerful Q2 2020 in equities suggested that the market was anticipating this economic pattern. Surveys of investors, however, have consistently shown a minority of investors in the V-shaped camp. In late May fivethirtyeight.com reported that economists saw only an 11% probability that U.S. Gross Domestic Product would reach its previous (Q4 2019) peak as early as H1 2020.

U

In a U-shaped recession, the decline continues for several quarters and the economic growth resumes only gradually. This is a likely scenario for the present cycle. Some of the initial attempts to reopen the economy have been walked back as they were followed by a new rise in COVID-19 cases. Early indicators such as credit card data implied that after rebounding strongly in June, retail sales were faltering in July.

W

A W-shaped recession, in which a second major downswing precedes the definitive recovery, cannot be ruled out. The possibility was raised in mid-July by sources such as Federal Reserve governor Lael Brainard and IHS Markit. This scenario could result from prolonged constraint of economic activity by the COVID-19 pandemic.

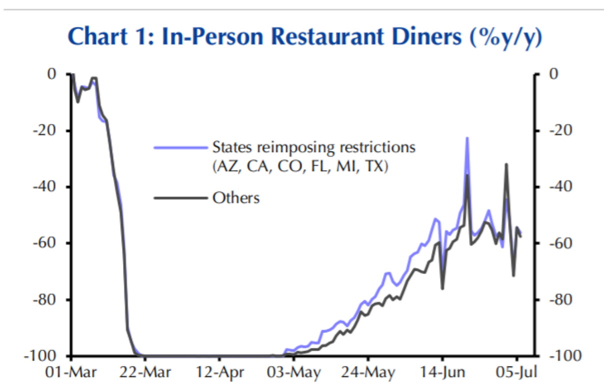
L

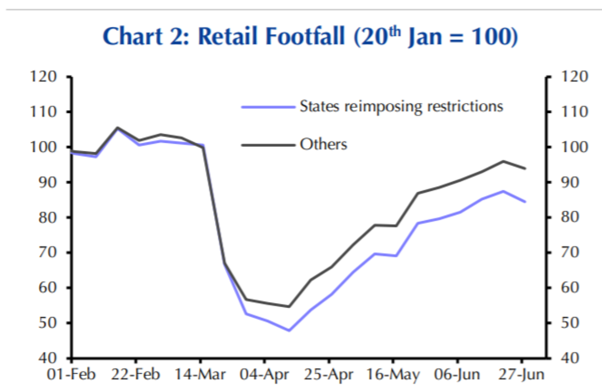
The most pessimistic of the four patterns discussed here is the L shape, in which the economy enters a severe recession and growth fails to resume for many years. The Great Depression of the 1930s falls into this category. Highly expansionary monetary and fiscal policies on a global basis all but exclude the possibility of such a dire outcome in the present cycle.

The current economic landscape abounds with uncertainty. Unemployment remains very high. The June Jobs report, released in early July, was a positive surprise for the markets. It showed an unexpected and remarkable drop in unemployment to 11.1%!

The latest data, however, is as of mid-June, prior to the current coronavirus spike. At that time, re-openings were not being halted or pared down, much less reversed. The market, which is forward-looking, seems to be pricing in a pretty rapid economic recovery. The number of viral cases and rates of positivity in testing are increasing, however, which skews risks to the downside.

Chart 3 and 4 – In-Person Diners and Retail Footfall stalling from mid-June onwards



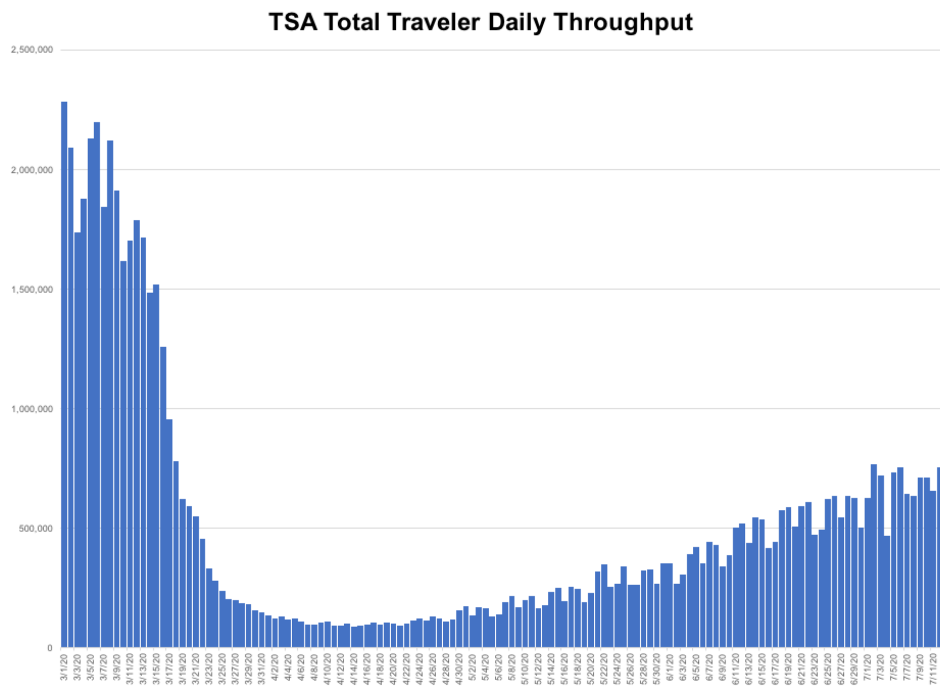


Source: OpenTable, Ninth Decimal, New York Times, Axios

Since the official economic statistics are released weeks or months after their reference period, it may be useful to use some of the so called "real-time" or "high-frequency" data to learn more about the behavior of individuals. These data rely on different technologies (mobile phone location systems, credit card transactions, online purchases) to represent real-time aggregate data. For instance, traveler mobility (measured by TSA screenings), retail foot traffic, and diners at restaurants (opentable.com bookings) suggest that the recovery has been stalling since mid-June.

Coincidentally, mid-June was around the time when Covid-19 cases began flaring up again in the US.

Chart 5 – TSA check-ins at 30% of pre-Covid levels during summer travel season



Source: TSA daily screenings

Whether another lockdown occurs or not, the economic recovery hinges primarily on the behavior of the consumer. As commonly noted, consumers account for two-thirds of the US economy. The focus will be on how safe consumers feel and their propensity to wade back into retail purchases that require traveling, thereby contributing to the economy. If people are scared and uncomfortable, the recovery may take longer than the strong rebound currently priced in by the markets. Households' savings rates have soared and credit institutions lending standards have tightened. Most of the stimulus received by low-income families has already been depleted. As the spread of the virus continues, there is a growing risk that many jobs and businesses that were temporarily put in limbo may never come back.

For now, the disposable income of the US family has been maintained by government support. Should this change, the economy may suffer very severe setbacks. The bull case in this debate is that the consumer has become fatigued from staying locked down and pent-up demand will drive economic growth.

On balance, we remain optimistic about the long-term prospects for the US economy, once the pandemic is gone. The housing sector is holding up well and is being supported by ultra-low interest rates. Energy costs are low. The combined monetary and fiscal stimuli are unprecedented (nearly 25% of GDP). Given the likely path of the contagion, however, we believe a "W" or "U" shaped economic rebound is more likely than a "V" one.

4.0 2020 Equity Mid-Year Outlook

Equity markets have been rallying since they hit their lows on March 23, 2020. The abrupt decline and the swift rebound have been unprecedented. Although the current markets may seem disconnected from economic reality, one must keep in mind that stocks are always looking forward, well past the present conditions.

Several reasons can be cited for the magnitude and speed of this market's rally. Undoubtedly, the Federal Reserve's intervention has been key for the swiftness of the rally:

- ***The Federal Reserve's massive and swift liquidity intervention.*** The Fed's balance sheet has ballooned to over $6 trillion with the aim of aiding businesses and households.

- ***The unlimited bond buying of the Fed via Quantitative Easing*** has pushed down rates and the Federal Open Market Committee (FOMC) has unequivocally indicated that it will keep rates at 0% for the next 2-3 years.

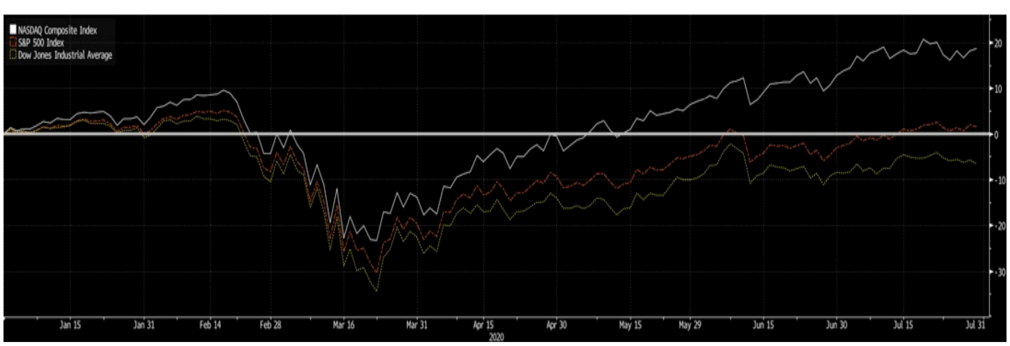
- ***In addition, a subsequent stimulus package*** focusing potentially on households and businesses with the value of $1-$1.5 trillion is being discussed and may be implemented by August.

- ***The Fed's bond buying and the subsequent splurge in liquidity*** hasn't directly ended up in equity markets but has restored confidence and has brought on the "There is No Alternative" (TINA) phenomenon for equities, given the paltry yields available globally.

- ***The "Fear of Missing Out" (FOMO) effect*** has been an additional catalyst for the markets, driven by retail exuberance.

As previously mentioned, the equity rally has not lifted all boats. A historically wide gap exists between the three US benchmark indices (Dow Jones Industrial Average, S&P 500 and Nasdaq Composite) in terms of current year-to-date performance.

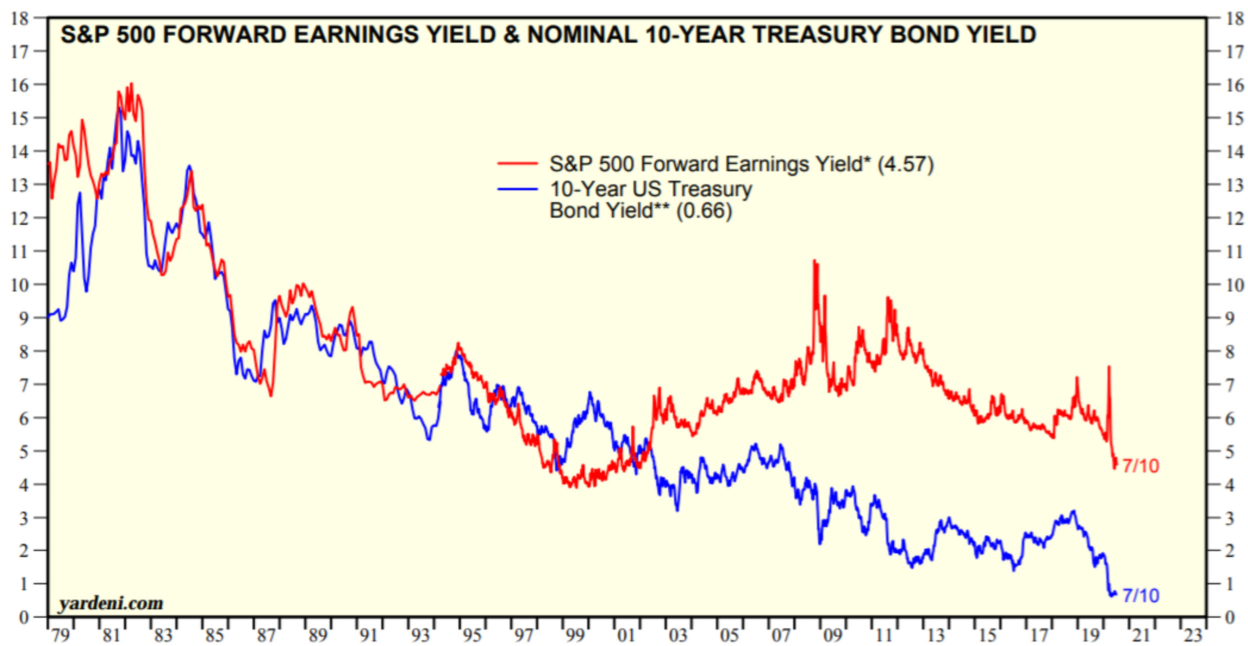
Chart 6 – 2020 Historical Outperformance of Nasdaq Composite Index compared to Dow Jones Industrial Average and S&P500 Indices



Source: Bloomberg Professional Services

The extent to which rallies have been fueled by a few large companies (indicating weak market breadth) is evident when we compare the performance of an equally weighted version of the S&P 500 with the standard market-capitalization-weighted version. Year-to-date the market- cap-weighted version is ahead of the equally weighted index by 7.5%. This data point makes one truly appreciate the disparity between mega-cap technology companies and the rest of the market. The technology sector has been both resilient and dominant in terms of performance, while also catching a tailwind from the pandemic.

Chart 7 – S&P500 Index Trading at High Multiples but Less so if Compared to Treasury Bond Yields



Source: Yardeni.com

COVID-19 has actually given many technology and healthcare companies a boost due to changed consumer behaviors juicing the demand for their products. In this day and age, these companies have essentially become utility-like and have taken on defensive characteristics.

As long as the "homebody economy" continues, we can expect the momentum to persist for stocks of companies in e-commerce, digital content, telemedicine, home improvement, pet care, digital payments, outdoor recreational activities, gaming and e-sports, auto parts and healthcare. Investing in high-quality companies with sustainable competitive advantages and earnings that are expected to compound at double-digit rates remains the cornerstone of our investment approach.

Looking at the second half of 2020, we are about to enter a period that has historically coincided with seasonal market weakness. There is a general election in November (more in the next section). The political climate is highly polarized and it is aggravated by civil unrest. During this time, <u>we expect market volatility to pick up and to offer entry points for motivated, long-term investors</u>.

Considering that:

a) most institutional liquidations already occurred in February and March,
b) large cash balances from institutional and retail investors are sitting on the sidelines
c) and that the level of pessimism (the VIX index is still elevated, "safe haven" assets like gold and US Treasuries are flying high) is already running high,

We think that any significant market drop will be curbed by investors buying the dips.

5.0 Elections and Financial Markets

You owe it to yourself, your family, and your country to exercise your precious right to vote. There are many reasons why it matters who occupies the White House and who represents you in Congress. The expected performance of your investment portfolio is not one of them.

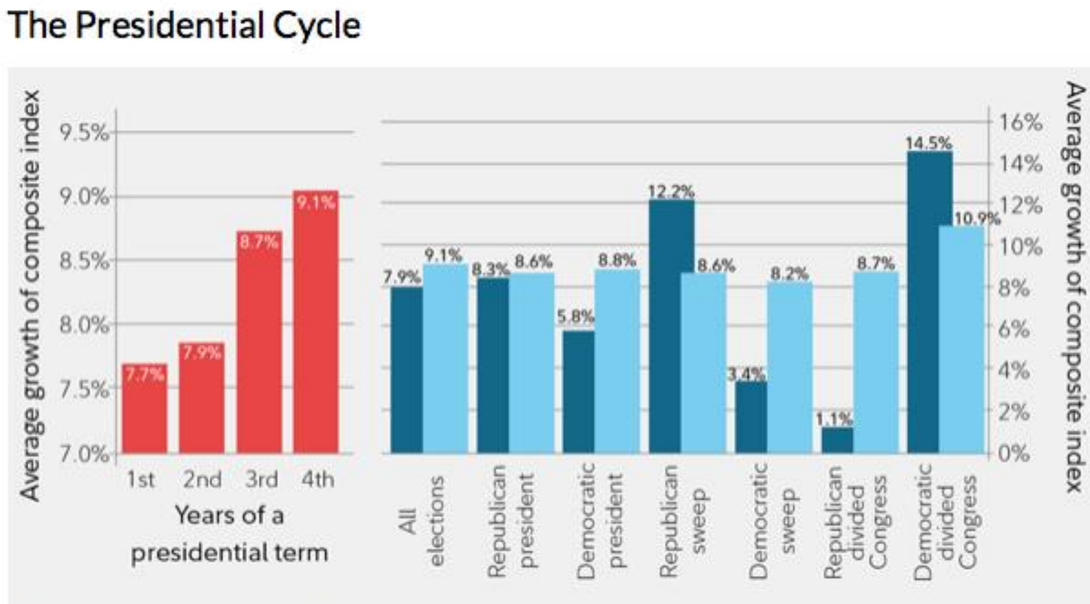
Numerous studies have been conducted on the relationship between U.S. election outcomes and stock market returns. They approach the question from a variety of angles. The researchers are united, however, in one finding: You should not base your investment strategy on which candidate you expect to triumph in November.

The most noteworthy finding from studying the history of markets is that stocks tend to perform better under split governments. Jurrien Timmer of Fidelity's Global Asset Allocation Division found that in the first two years following the election, stock values grew by +8.3% per annum when a Republican won versus +5.8% when a Democrat prevailed. Over the full four-year terms, however, the GOP edge disappeared, with the Republicans scoring +8.6% per annum versus a negligibly different +8.8% for Democrats. [1]

When the party that won the presidency failed to obtain a majority in either the House or Senate or both, Democrats fared better than Republicans for the first two post-election years, +14.5% per annum versus +1.1%. Once again, the partisan edge sharply diminished over the full four years; the annualized returns were +10.9% for Democrats versus +8.7% for Republicans. Even that difference should be taken with a grain of salt, as Turrien cautioned that the sample sizes were small for some of his cuts on the data.

[1] https://www.fidelity.com/learning-center/trading-investing/markets-sectors/stock-returns-and-elections

Chart 8 – Historical Stock Market Performance After Elections



Right chart shows annualized forward returns based on various election outcomes, measured from the close of the October preceding the election to two and four years later. Two years later shown as dark blue. Four years later shown as light blue. Monthly data since 1789 (mix of S&P 500, Dow Jones Industrial Average, & Cowles Commission). Source: FMRCo.

Source: Fidelity Investments

Further evidence that the president's party affiliation matters little to investment performance is found in Martin Fridson's 1998 book, *It Was a Very Good Year*. The author studied the stock market's 10 biggest one-year gains of the twentieth century. Republicans presided over a bare majority of those largest advances. What the narrow six-to-four split really tells us, though, is that the party that controlled the White House had no bearing on the Very Good Years. Fridson found that the usual ingredients for one-year total returns of 35% or more were (a) depressed prices at the start of the year and (b) easing of monetary conditions during the year.

The historical evidence does not uphold the idea that electing one presidential nominee rather than the other will guarantee higher investment returns over the next four years. Financial market performance is far too complex to come down to that single factor.

6.0 Conclusions

The US stock markets staged an unexpected and remarkable comeback from the depressed levels of March 23, 2020. The market's unpredictable behavior in 2020 is living proof that investors need to stay invested according to their long-term investment plans. In the face of an unprecedented health and economic crisis, those investors who stayed calm and kept their long-term plans intact were rewarded better than those who panicked and sold.

Table 1 – Portfolio Positioning going into 2nd Half of 2020

Asset Class	Positioning	Notes
Cash & Equivalents	**=**	"Cash is king", but negative real rates will prove to be a drag.
IG Bonds	**=**	Dislocations in the **municipal bond** space may provide opportunities. **TIPS > nominal US Treasuries**
HY Bonds	**=/-**	Fairly valued only taking into account Fed's actions. Expect defaults to climb.
Preferred Shares	**+**	Focus on **high grade preferred of quality issuers**.
US Equities	**=**	High P/Es but low interest rates. Liquidation phase likely over and technicals supportive. **High Quality/Growth > Value**
International Equities	**-**	Lower valuations than US point to long-term outperformance, but weak recoveries may be drag. **US > Int'l.**
REITs	**+**	Attractive valuations and focus on specialty REITs.
Gold	**+**	**Positive trend and supported by negative real rates.** May not provide enough of a hedge for stocks.

Source: Livian & Co. and Lehmann Livian Fridson Advisors

The current global recession has been caused by a health crisis (an external shock to the economy). For the economy to recover we will need to get past the health crisis and its ramification on the behaviors of individuals.

Much of the data at hand shows visible signs of improvement in the economy, but also a consumer that is still very hesitant and reliant on government subsidies. We will closely monitor the data and reassess as needed. We believe there are still several economic headwinds that may taper the strength of the rebound.

As we enter a period that has historically coincided with increased volatility, especially during an election year, we stay alert and look for new investment opportunities. Please find in the table above a summary of our portfolio positioning.

As usual, please do not hesitate to contact us for any clarifications or questions.

Stay safe and healthy.

Sincerely,

Michael Livian, CFA
Martin Fridson, CFA
Sagar Shah, CFA