July 9, 2020

To Our Clients and Friends:

We are pleased to bring you our report for the second quarter of 2020.

The first half of 2020 will be remembered as one of the most challenging and difficult times in our history. Many factors were at play, and in great succession. A global pandemic with half a million deaths worldwide; a social distancing-caused recession; sudden, precipitous drops in employment; massive and unprecedented monetary (Federal Reserve) and fiscal (government) stimulus measures; scarcity of medical equipment; political tensions; and nationwide protests triggered by the killing of George Floyd. The entire country was affected, and individual states faced additional challenges during shutdowns. All these combined to create a set of challenges of a magnitude and breadth that no one has ever faced before.

Despite all this, the equity markets not only made it through one of their roughest quarters in history, they did it in a big way. The S&P 500 Index was up more than 20%[1] for the quarter, its biggest gain (on a percentage basis) in more than 20 years[2]. That left the Index still in negative territory (down -3.08%) for the year, but, at 3,100 (as of June 30), it is still a vast improvement (over 25%) from the 2,477 low it reached on March 18. We think a more relevant statistic is the fact that, year-over-year (July 1, 2019 – June 30, 2020) the S&P 500 Index is up 7.5%. The Bloomberg Barclays U.S. Aggregate Bond Index returning 1% more than the S&P 500 Index over that 12-month period, something that is unusual, is a great example of the benefits of having a diversified portfolio.

Despite the relief that many are now feeling, the markets will have a lot to wrestle with over the coming months.

Economics. As most of us are aware, the economy is in a deep recession[3]. What no one knows for sure is the speed and shape of the recovery. Much of this is going to depend on when widespread distribution of an effective vaccine will be available because, while some industries (for example, manufacturing,[4] automotive[5] and home sales[6]) are doing well in a social distancing environment, there is a large swath

[1] Non-US stocks continued to lag their U.S. counterparts, with the MCSI World ex USA (including dividends) up 15.55% for the quarter but still down -11.20% for the year. The Bloomberg Barclays U.S. Aggregate Bond Index gained 2.9% for the quarter and is up 6.14% for the year. Notably, and to a large part reflecting the technological advances in working remotely, the Nasdaq Composite, which is heavily weighted toward big tech stocks, was up 31% for the quarter and is up 12% for the year.

[2] In fact, this was the largest quarterly percentage gain since the last three months of 1998. Source: *Wall Street Journal* July 1, 2020.

[3] JP Morgan estimates there has been a roughly 12.8% decline in real GDP from the end of February through June 30.

[4] The ISM Manufacturing Survey, New Orders Index, leapt from 27.1 and 31.8 in April and May, respectively, to 56.2 in June, which was the best reading so far in 2020. Source: Goldman Sachs Asset Management.

[5] Light vehicle sales went from an annualized rate of 8.7 million in April to 13 million in May. Source: Investment Strategy Group.

[6] The Pending Home Sales Index rose from 69 in April to 99.6 in May. Id.

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of the economy (including travel[7], sporting events[8] and sit-down restaurants[9]) that cannot realistically re-open at profitable levels before this happens. Additional fiscal and monetary stimulus packages are all but certain over the next few weeks and months[10]. However, prolonged fiscal stimulus measures are likely to leave the economy with a very high debt to GDP ratio over the next couple of years. Should we see a sharp rise in inflation, which has not been a factor for years, in the wake of an accelerating economy, higher interest rates and/or taxes could potentially pose economic challenges.[11]

Employment. The slump in the economy was reflected in the April jobs report, which vaulted unemployment to an 80-year high of 14.7%. The June jobs report that was released on July 2 was extremely strong[12]. 4.8 million net new jobs were created, far above the median consensus of 3.1 million and almost twice the 2.5 million that were created in May[13]. As good as the report was, however, employment levels remain far below what they were in February, and the 7 million jobs that were created in May and June still represent only a third of what would be needed to get back to pre-March levels[14]. Uncertainty ranging from the near-term effects of increasing COVID-19 cases on retail traffic and travel levels to longer-term considerations of to what extent "right-sizing" of businesses in a COVID-19 world is going to result in "permanent" reductions in employment are both going to make the employment picture going forward cloudier than the economy would prefer to see[15].

Earnings. The economic recession is sure to be reflected in second quarter corporate earnings, which are expected to be dismal[16]. Additionally, the unwillingness of many companies to release earnings guidance[17] due to their uncertainty is making it that much more difficult to get a picture of what lies ahead and estimate stock valuations. Despite this, the market, so far anyway, seems to be looking past Q2 earnings and is focused on what it sees as a gradually improving earnings landscape.

Elections. We are hearing increasing debate about how the presidential and Congressional (primarily the U.S. Senate) elections might impact the market. The markets, a forward looking mechanism as we said, seem, correctly or incorrectly, to either be predicting a Trump win or downplaying a Biden win[18]. This may be because history has shown that it doesn't matter

[7] Commercial air travel has only recovered to about a quarter of the level observed last year. Source: TSAcheckpoint; Goldman Sachs Asset Management.

[8] According to a May 21 ESPN report, the sudden disappearance of sports in the U.S. will erase at least $12 billion in revenue and hundreds of thousands of jobs. Worldwide, the sports industry could lose as much as $61.6 billion in missed revenues by the end of 2020. Source: Two Circles.

[9] Seated diners remain 70% below the same period last year; unfortunately, however, latest observations show a reversal of the improving trend. Source: Open Table; Goldman Sachs Asset Management.

[10] Goldman Sachs expects that Congress will enact another $1.5 trillion (which is 7% of GDP) by August, and that the Fed will continue its asset purchases as long as needed. Source: GSAM Conference Call, July 7, 2020.

[11] The outcome of the November presidential and Congressional elections could have a significant bearing on the magnitude of this risk.

[12] Strong is an understatement: It was the highest figure since the government started keeping records in 1939.

[13] Source: Mohamed A. El-Erian in Bloomberg *Opinion*, July 5, 2020.

[14] Id.

[15] For what it's worth, Goldman Sachs projects unemployment to be at approximately 9% by year end and drop relatively linearly to 5.5 at the end of 2023.

[16] The estimated earnings decline for Q2 2020 is expected to be 45.3%. If this is in fact the actual decline, it would be the largest year-over-year decline since Q4 2008. Source: FactSet

[17] Only 48 of the S&P 500 companies issued earnings guidance for Q2 2020, well below the 5-year average for a quarter (107). More than 180 companies in the S&P 500 have withdrawn their forecasts for 2020. Source: FactSet.

[18] Regarding the latter possibility, the Nasdaq is up 9%, and the benchmark S&P 500 has risen 4% since June 1, during which time betting odds have moved from a 2-point spread in favor of Trump to a 20-point spread for Biden. Source: RealClearPolitics database

much what political party is in the White House[19]. Similarly, there has been talk that the combination of a Biden win, the Democrats keeping control of the House and gaining control of the Senate is going to be bad for stocks[20]. This too has proven to be somewhat of an urban legend[21]. Obviously, anything can happen. We will know soon enough[22].

Many people are asking the question "If the economy is so bad, why is the stock market doing so well?" This is a fair question, especially with the discussions above. There are many reasons, but they all revolve around the fact that markets and the economy, while of course related, are two very different things. One reason is the massive federal stimulus has tended to lessen the impact of the weak economy by artificially propping it up, despite, as we said above, there being a price to be paid for this sometime down the road. Another is that markets are forward looking, which means they often do not react significantly to bad economic news since that is in the past. Markets price in probable future scenarios, whereas economic data is backward looking. This is a bit counter-intuitive we'll admit but is important to keep in mind in times like these.

If one needs a catalyst for self-assessment, particularly one's sensitivity to and ability to tolerate breathtaking market swings, they need look no further than Q2 2020. Things we preach about regularly are far more difficult to experience than they are to read about in our missives when times are good and markets seem to go nowhere but up. But sometimes an actual punch to the gut is what human nature requires us to experience in order to learn the lessons and see how well we really know ourselves, our emotions and levels of self-discipline. Those who had (and stuck to) a well-designed financial and investment plan have done well under the circumstances and should be poised to handle the future as well. Those who did not have (or found they could not stick to) a good plan likely fared far worse and likely will not be able to handle very well what is practically certain to be some short-term rockiness ahead. Our advice: Focus on the things you can control, such as having a plan that is designed with your needs in mind to harness market returns as well as keep you from overreacting to short-term market volatility to the point of abandoning it.

[19] In fact, going back to 1900, the DJIA has performed slightly better with a Democratic president (an average of ~9% annually) than with a Republican president (~6%). Normal variations in market returns dwarf this difference.

[20] Biden's (pre-COVID anyway) tax plan includes, among other things, a repeal of President Trump's individual income tax cuts for incomes over $400K, taxing capital gains for taxpayers with over $1 million in income as ordinary income, subjecting earnings over $400K to the Social Security payroll tax and limiting itemized deductions for those in the 28% bracket and above. It would also increase the top corporate rate to 28% and impose a 15% minimum tax on companies' book income. Source: GSAM Conference Call, July 7, 2020.

[21] According to research by InvesTech, average returns are the highest when one party controls them all, and slightly lower when one owns the White House but another controls both the House and the Senate.

[22] Interestingly (and with no significant precedential value), data going back to 1928 shows that the incumbent party has won 87% of the time if the S&P 500 Index is positive over the three months that precede the election and lost it when it is negative. Source: *Wall Street Journal* July 1, 2020.

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