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MARKET REVIEW

June 2020

Theory of Relativity 2.0

“Genius is doing the average thing when everyone else is losing their minds.”

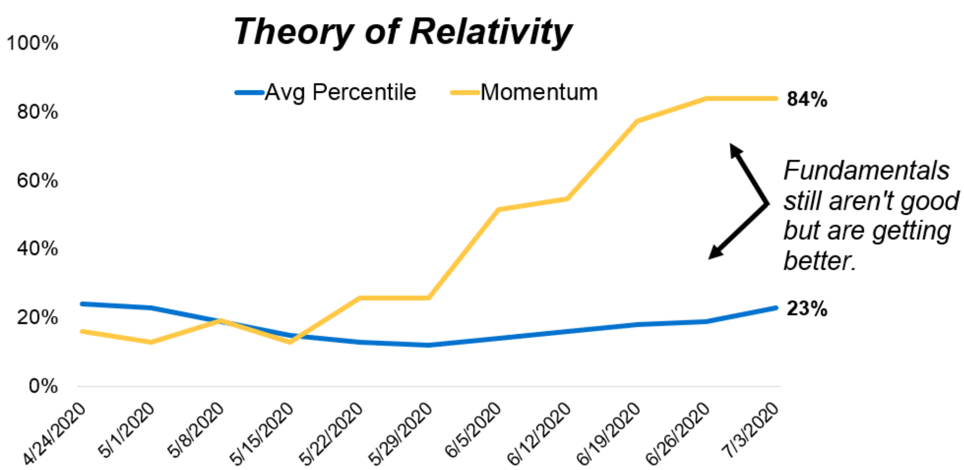
– Napoleon Bonaparte 1769-1821

Albert Einstein’s *Theory of General Relativity* related to the notion that gravity causes a warp in the space-time continuum. We’re not sure exactly what that means but the *Theory of Relativity* could be applied to the investment backdrop in a simpler kind of way.

One of the fundamental maxims of investing is that markets don’t care about the absolutes of “good or bad” but rather the relatives of “better or worse”. This has been framed by many of the most successful investors of our lifetimes. One might even call it the *Theory of Relativity 2.0.*

One way to express this is in the chart below which tracks over 30 fundamental data points and relates them to two measures. The average percentile is where a metric scores on a range of 0 to 100 relative to its history. A low percentile score would indicate a below average reading and vice versa. The momentum score is the percentage of data sets that are showing improvement over the prior month. In this way, one can capture both the absolute (percentile) and relative (momentum) perspectives. Clearly, the fundamentals are not good – scoring in their 23rd percentile, on average, relative to history. However, progress is being made as over 80% of the fundamental metrics are now showing improvement over their prior month’s reading. ***The bottom line is that the fundamentals aren’t good but are getting better.***

The tricky part is that the improvement was bound to happen given how awful the fundamentals got. Most measures were quite literally “off the charts” relative to anything we’ve seen in history. The most difficult question to answer now is ***“can this momentum be sustained?”*** Clearly, there’s room for continued improvement but this also comes in the face of another ramp up in the number of daily US COVID cases – which have now eclipsed the prior peak back in March/April. The US now looks like an outlier. The virus hasn’t gone away and science continues to work to catch up. What is one to do?



FFWM Research. Percentages are based on a number of Fundamental indicators tracked. Percentiles are shown relative to history and are an average across all metrics in the Fundamental category. Momentum is defined as the percentage of metrics that are showing improvement over the prior month.

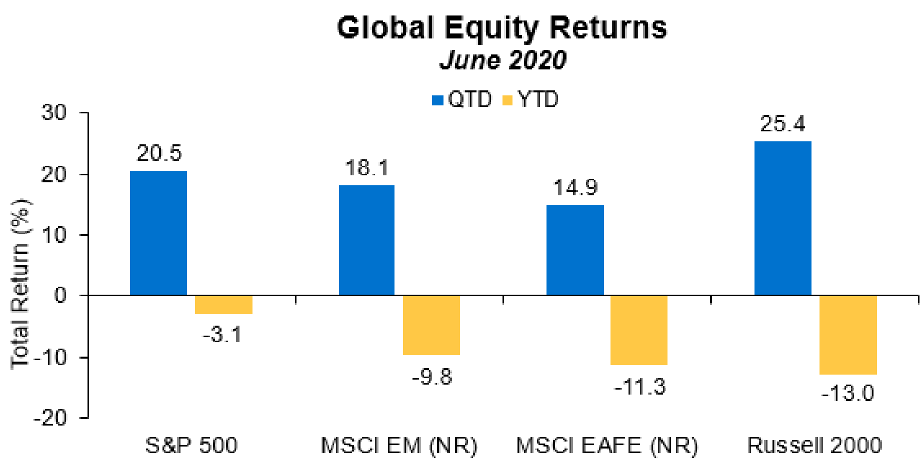
We take inspiration from Napoleon’s quote above. In an unprecedented environment with such a wide range of outcomes one doesn’t need to be a hero nor does one need to panic. Investor sentiment can be volatile and we expect the market will be choppy driven by the likelihood of dramatic headlines. ***Stay diversified and stick to a disciplined, objective approach backed up by a solid long-term plan to ensure you stay on target. Let everyone else lose their minds.***

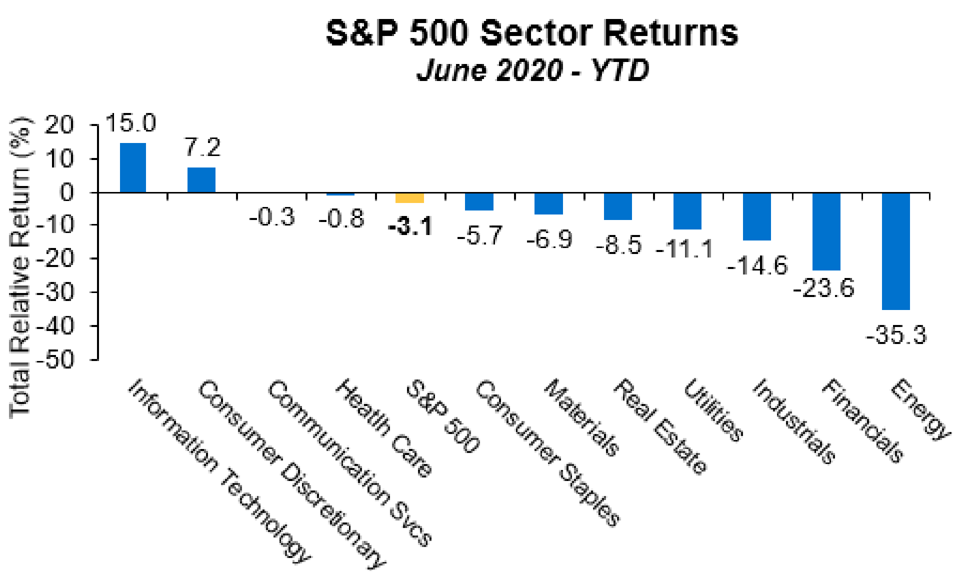
We’ll continue to trust the process – being clinical in our macro assessment complemented by our disciplined, security selection framework both of which are grounded within a planning construct.

Market volatility has been a key characteristic of 2020. This year's second quarter was the best 3-month performance for the S&P 500 since 4Q98 following its worst quarter (1Q20) experienced since 4Q08. As a result, market trends shifted from "risk off" to "risk on" with the latter continuing throughout June.

Stocks

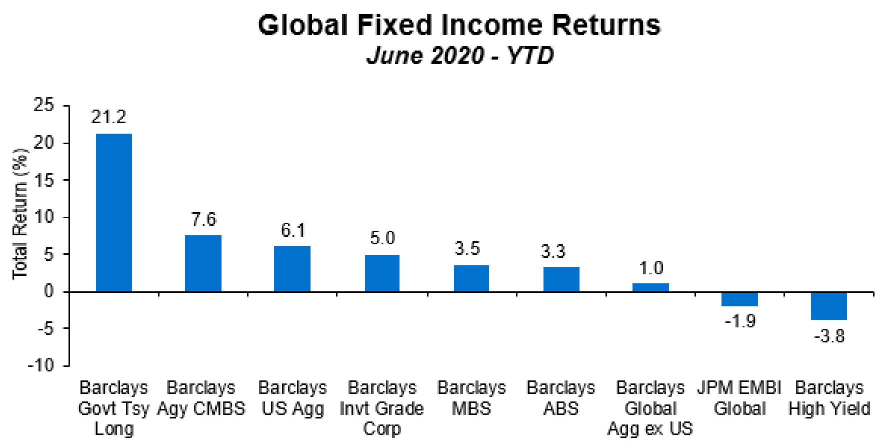
The stock market selloff and recovery is especially apparent when looking at the dichotomy between the year-to-date and quarter-to-date returns. Year to date stock returns remain depressed but have improved due to the strong recovery in the second quarter. US markets outperformed international markets with US small caps (Russell 2000) leading the way after being hit the hardest. Policy response likely attributed to US outperformance though concern is brewing given the inability to mitigate the COVID case spread. The re-ramping of daily case increases has clearly turned the US into an outlier. By S&P 500 sector, two areas moved into positive return territory for the year though all eleven posted positive returns in the second quarter. Due to business models benefiting from the lockdown, Tech and Discretionary have acted much more defensively than historically has been the case. These areas also tend to be dominated by mega cap companies like Apple, Microsoft and Amazon. Some of the most beaten up areas like Energy and Materials outperformed in the quarter as well though they still have some work to do to reach positive return territory for the year. Other cyclical value areas like Financials and Industrials lagged more noticeably as did the more traditionally defensive areas like Utilities, Staples and Real Estate.





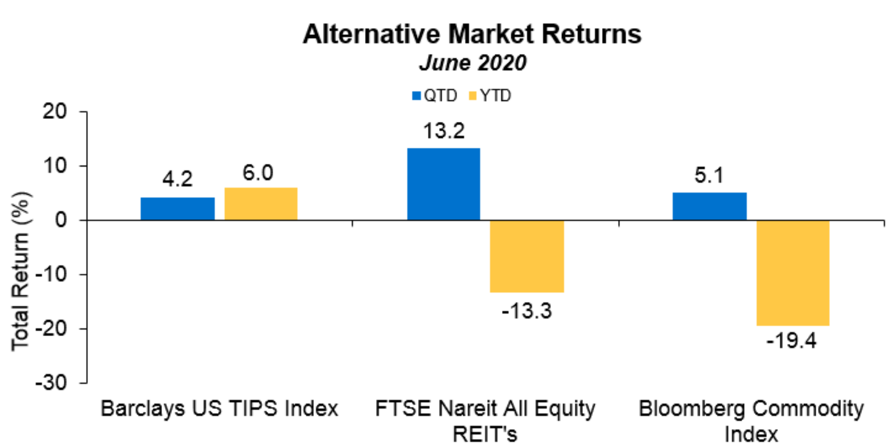
Bonds

Interest rates fell dramatically in the first quarter and stabilized (albeit at exceptionally low levels) in the second quarter. Long duration Treasuries (Govt Tsy Long) were the major outlier to the upside year-to-date given the flight to safety trade in 1Q. Conversely, corporate credit and international fixed income sold off in the first quarter but saw a nice recovery in the second quarter. These more cyclical areas were helped by the Fed's policy response in stabilizing capital markets as well as the more recent improvement seen in the fundamentals. As such, credit spreads narrowed benefiting corporate credit (Invt Grade Corp, High Yield) and EM Debt (JPM EMBI Global). The dollar weakened in the second quarter which also led to outperformance in international fixed income (Global Agg ex US). Most sectors of the bond market are now in positive return territory for the year with High Yield and EM Debt – two of the most cyclical areas – closing the gap.



Alternatives

The dichotomy of quarter to date and year to date returns is also very evident within Alternatives. Publicly traded real estate (REIT's) recovered in the second quarter though returns lagged those in the stock market as concerns over commercial real estate demand have increased given the potential durability of the "work from home" trend. Commodity returns recovered but were also held back due to the prior collapse in Energy prices and continued pressure in Ag prices. Encouragingly, all areas in the commodity index posted positive returns in June led by strength in the more economically sensitive Industrial Metals area. Finally, Treasury Inflation Protected Securities (TIPS) failed to keep pace with nominal Treasuries for the year but outperformed in the second quarter given a recovery in inflation expectations.



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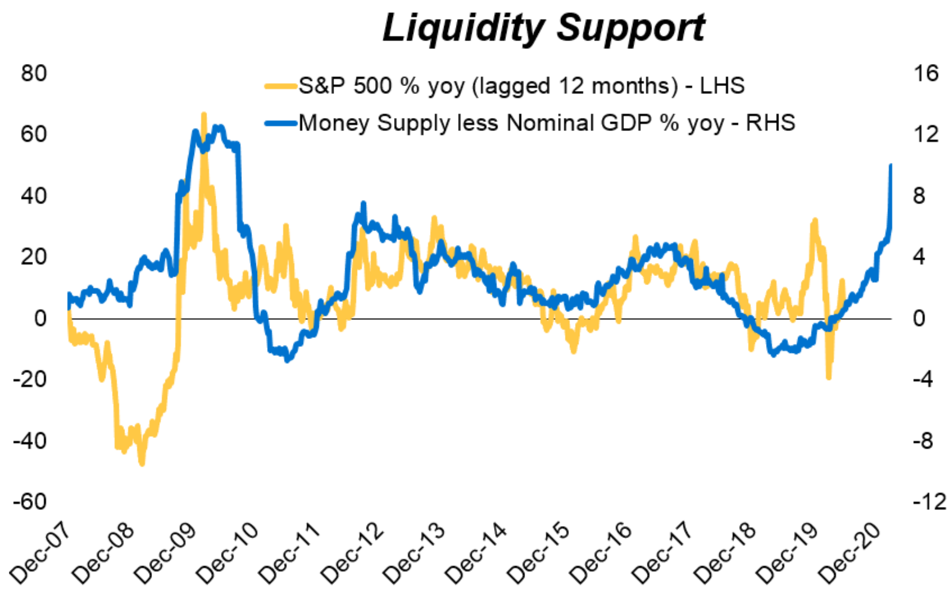
Market Outlook

To be clear we've had our fair share of concerns about the market's move off the bottom. Much of the initial move we attributed to an upturn in sentiment anticipating an eventual fundamental improvement – which at the time was worsening. As mentioned earlier, the fundamentals still aren't good but are now getting better. That's a more comfortable backdrop and yet so much still remains up in the air.

Given how awful the backdrop got, the fundamentals were bound to get better. We're in that period now but is the improvement durable? In May and June, the labor market recovered about one third of the 22 million total job losses suffered in March and April. Continued improvement here will be key to the recovery effort. An individual's main driver of consumption power is predicated on being employed with a sustainable income.

And the virus still lingers. In fact, the daily increase in COVID cases have well surpassed the prior peak back in March/April. This doesn't appear to be a second wave per se but rather a rolling wave that is sweeping across the country hitting hardest the areas that were less impacted earlier on. Of course this comes at a time of economic reopening and national protests which makes things even more complex. Vaccine development continues and some effective treatments have been encouraging but science still has some catch up yet to do.



Source: Factset

Despite the many concerns one of the more bullish arguments is tied to the liquidity backdrop. As bad as this crisis is, it's been met with a "bazooka-like" policy response. One liquidity measure is called the money supply or M2. This is defined as the total value of money available in an economy and typically includes direct forms like cash and checking account balances as well as what are viewed as "near cash" instruments like savings account balances and money market funds. More money in the system means more money can be spent. The Fed can influence the money supply indirectly by raising and lowering short term interest rates but also directly (and atypically) by expanding the size of its balance sheet.

As can be seen in the chart above, the change in the money supply relative to the change in nominal GDP has a loose correlation with the change in the S&P 500. This relationship suggests that the money supply has a lagged effect on the equity market by about a year – partly because it takes time for the change in M2 to have an effect on the fundamentals. Today, growth in the money supply is about double the pace of the fastest periods we've seen in history going back to the 1960's. Of course, that's needed given that the decline in nominal GDP is also expected to be the worst we've seen as well. ***The bottom line is that the increase in this measure would suggest that there's an inordinate amount of liquidity underpinning equity markets in the intermediate term.***

Of course this doesn't come without a potential longer term cost. Rising deficits and more market control in the hands of regulators may have longer term consequences such as ***(1) debt burdened growth (2) higher inflation and/or (3) excessive risk taking.*** These are three long-term implications that we're noting as potential consequences of the response. In the near term, policy is meant to act as a shock absorber and it certainly has had that affect on the markets.

Our outlook and tactical positioning haven't changed all that much from last month when ***we downshifted risk a bit as risk assets have continued to perform well.*** We modestly trimmed our equity exposure (still OW) and initiated a position in High Yield bonds (still UW) while also adding to our more defensive Diversified Alternative managers. This month we took profits by trimming some expensive growth stocks and added exposure to the cheaper, cyclical value area within our individual stock portfolio.

As we mentioned in our previous writing, we still don't think it's time to be uber bearish or uber bullish. In an unprecedented backdrop there are still many scenarios that could play out. On the one hand – if a "V" shaped recovery comes to fruition and normality returns quickly with the advent of a vaccine, then the the optimistic sentiment readings will prove out correct in anticipating the improvement we're starting to see in the fundamentals. If, on the other hand, the recovery effort is more drawn out, the illness is more resilient and/or political risks ramp up, one could argue the opposite. ***In short, now is a time when diversification becomes a critical factor and our portfolios have many underlying hedges throughout.***

Barbell Posture

Bullish	Bearish
OW Emerging Market Equities	OW US Large Cap Equities
OW Cyclical Value Sectors	OW Defensive Sectors
Small Cap Value Tilt	UW Small Caps
OW Credit	UW High Yield

Source: FFWM Research

Within equities, we remain slightly OW both US Large Caps (defensive) and Emerging Markets (cyclical). We also have OW's to some defensive sectors balanced against OW's to some cyclial value areas. While we're UW Small Caps, we have a value orientation which tends to be more cyclical.

Within fixed income, we remain UW the most cyclical parts of the bond market but our US Core managers are OW investment grade credit and UW (defensive) treasuries. We also continue to carry a shorter duration bias (less interest rate sensitivity).

Within alternatives, we <u>are</u> more defensively postured with a continued UW to REIT's and are using our Diversified Alternative managers as a hedge against market volatility.

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