MARKETS IN FOCUS

SECOND QUARTER 2020 JULY 16, 2020

GEMMER ASSET MANAGEMENT LLC | LOCAL PARTNER GLOBAL INVESTING

Market Benchmarks

Market Indices	2ND QTR	YTD	3-Yr An
S&P 500 Index	+20.3%	-3.2%	+10.6%
Russell 2000	+25.5%	-13.0%	+2.0%
Global Equities	+19.7%	-6.8%	+5.9%
Int'l Index (EAFE)	+15.5%	-11.1%	+0.6%
Emerging Mkts	+17.9%	-10.4%	+1.2%

Other Indicators	6/30/20	3/31/20	12/31/19
Fed Funds Rate	0%-0.25%	0%-0.25%	1.5%-1.75%
2-Year Treasury	0.15%	0.24%	1.57%
10-Year Treasury	0.66%	0.66%	1.92%
S&P 500 P/E Ratio*	21.7	15.4	18.2
Crude Oil	$39.42	$20.07	$61.16
Core Inflation	1.0%	1.8%	1.6%

**Forward 12-month operating earnings per S&P*

Quarter-In-Review – Of all the quarterly letters we've written throughout the years, the last two have proved to be among the more challenging. Entire books will probably be written about 2020 and those authors will have the added benefit of hindsight. But today how do you capture the events of the last few months, offer thoughts about an exceptionally uncertain future, and keep it all within four pages?

Well, let's start with a quick recap of the quarter. It was a rewarding one for stocks with the S&P 500 gaining +20.3%, the largest quarterly gain since the fourth quarter of 1998. For the Dow (+18.3%) it was the best quarter since 1987. The rally was broad based with global equities advancing +19.7%, small-cap stocks +25.5%, and emerging equities +17.9%. It is worth noting that value lagged growth again, with traditional value sectors such as financials and REITs trailing the broad market.

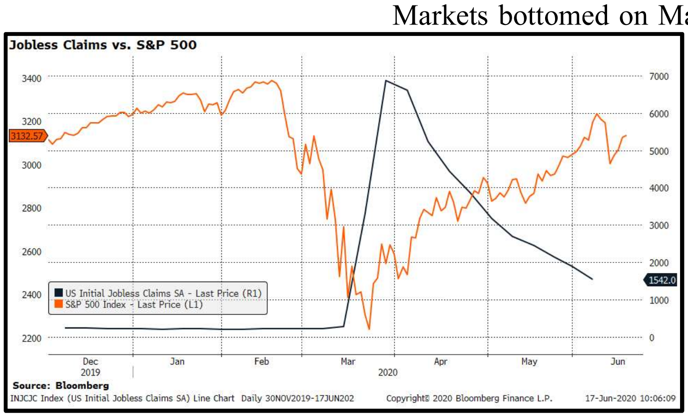
There were also solid gains to be had in the fixed income space. Government bonds, for once, were unexciting as yields remained relatively stable during the quarter. But other sectors of the bond market did well. Investment grade corporate bonds advanced +9.7% while high-yield was up +7.4%. As we will touch on later, the Federal Reserve played a huge role here as they moved to buy up corporate bonds during the quarter.

Despite the gains in the second quarter, most asset classes remain in the red for the year. However, given what has transpired the last few months, the losses are relatively muted. And, if anything, this disconnect between the markets and the daily news is disquieting for many investors. How can the markets rally in the face of all the bad news? Surely the markets are acting irrationally. While on some level we are sympathetic to this view, we think there is more to the story, as we try to address below.

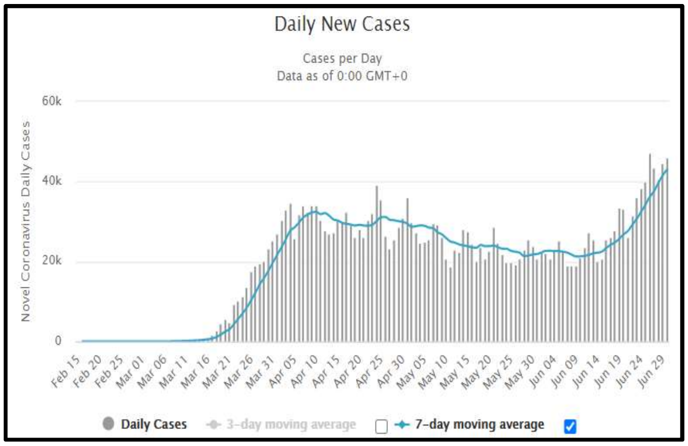
From an Economic Sudden Stop to a Partial Thaw – It seems like forever ago, but in February the global economy hit a brick wall. First China closed down, then Europe, and then large parts of the U.S. Soaring COVID infection rates led to shelter-in-place restrictions in many regions and economic activity fell off a cliff. We won't belabor how bad the data has been, but a few statistics jump out:

- GDP growth in the U.S. fell -5% at an annualized rate in the first quarter. The second quarter is expected to be down roughly -35%.
- Global growth is now expected to be negative in 2020 – the first such contraction since the 1930s.
- In a single week in March, 6.87 million people filed for initial unemployment claims in the U.S.
- On April 14th, 2019 2.2 million people passed through a TSA checkpoint. On the same day this year the number was only 87,534 (-96%).

However, beginning in late February in China and early April in parts of Europe, case numbers started to dwindle and the clouds started to part. Even in the U.S. the most heavily hit areas such as New York and New Jersey saw significant improvements in caseloads, ICU use, mortality rates, etc. And as the markets almost always do, they started to look through the bad data towards a rebound. Markets bottomed on March 23rd and rallied throughout the second quarter. While many pundits called the rally irrational, as you can see from the chart to the left, the move in the markets coincided with the peak in weekly unemployment claims. The situation was similar in 2009 when the markets started to price in a recovery in March of that year even though the



employment situation didn't stabilize until October. But herein lies the disconnect that has many scratching their heads. The market has put in a 'V' shaped bottom and appears to be discounting a complete return to normal in 2021. After all, most equity indexes are only off modestly for the year. However, no one foresees a strong economic recovery. There are real questions in the U.S. about whether we are going to have to suffer through another round of lockdowns. Case growth nationwide is picking up again (see chart above), and some states such as Texas and Arizona are rolling back their reopening plans.



<u>The Drivers Behind the Rebound</u> - So why have the markets rebounded in the second quarter? What are they seeing that has them so excited? We would argue that there are two critical drivers:

- Massive fiscal stimulus is allowing consumers and businesses to 'weather the storm.'
- Central banks' easy monetary policies that are flooding the system with liquidity.

<u>Fiscal Policy as Disaster Relief</u> – It's hard to put in context just how massive the fiscal response to the COVID crisis has been. As you can see below, so far in the U.S., Congress has spent roughly 18% of GDP in response to the pandemic. This is not really stimulus, but disaster relief aimed at tiding people and businesses over until the economy starts to recover. By now we are all familiar with the checks that went out to families, extended unemployment benefits, loans to small businesses, etc. But it is hard to overstate just how large the impact has been. The chart at the top of the next page shows total labor compensation including unemployment benefits. As you can see, during the financial crisis labor compensation went negative and stayed there for two years – something we hadn't seen in the post-war period. However, during the current recession we've only seen two months of contraction before growth resumed. And this is with large parts of the economy still shut down!!

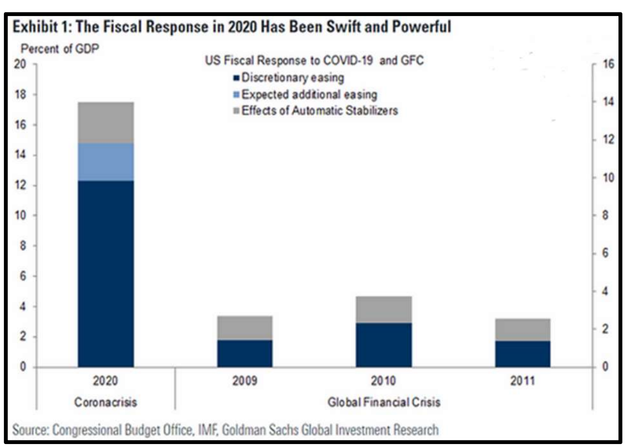


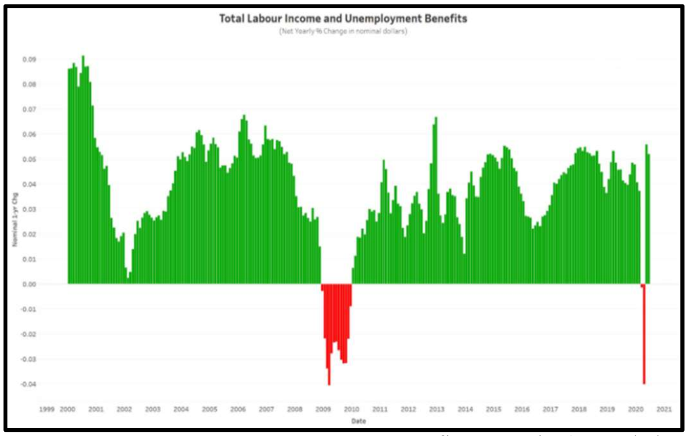
Exhibit 1: The Fiscal Response in 2020 Has Been Swift and Powerful

Source: Congressional Budget Office, IMF, Goldman Sachs Global Investment Research

But a risk going forward is that policy makers swing towards austerity similar to what they did in the post-2009 period. For example, the expanded unemployment benefits will end July 31st. For many, this may be the difference between paying the rent/mortgage and default. Congress is currently debating another fiscal package, but nothing is firm yet. There is talk about another round of direct payments plus extending the unemployment benefits, possibly at a lower level. Also, on the table is money to help states and local governments deal with the hole that has been blown in their budgets. There is no question that the economy needs more help. If Congress allows the economy to hit the 'fiscal cliff' at the end of July then the repercussions would be significant and the markets would react violently. Thus, we think we see another plan of between $1.5tn to $2tn. But until the ink is dry the risk remains.

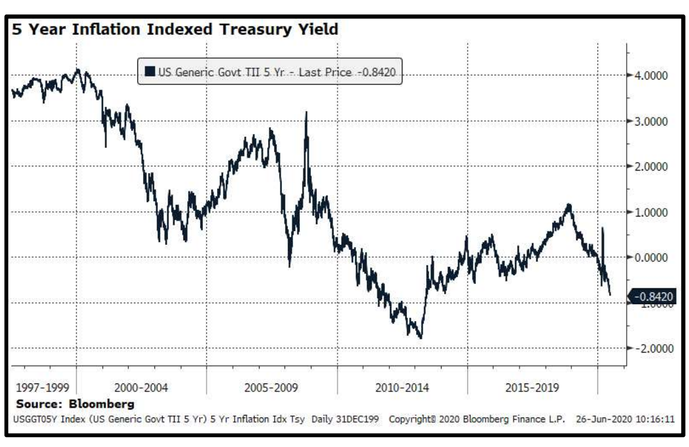
<u>The Fed and Negative Real Yields</u> – The other major player in the stimulus game is the Fed and other global central banks. As we noted last quarter, the Fed pulled out what we thought were all of the stops in the first quarter when they cut interest rates to essentially 0%, unleashed unlimited quantitative easing, and set up a number of liquidity facilities to support municipalities and corporations. However, we underestimated their determination. During the second quarter they started to buy corporate bonds directly and communicated that they planned to keep the current policies in place until at least 2022. More surprisingly still, Fed Chairman Powell said the Fed would not respond to possible bubble conditions in the capital markets. He stressed that the Fed was solely focused on getting the economy moving and reducing the unemployment rate. Finally, there is more and more talk about the Fed engaging in something called 'yield curve control.' This is where the Fed would aim to keep rates at or below a certain level at a particular point on the yield curve. For example, the Bank of Japan has been aiming to keep their 10-year yield at or below 0% for a few years now. Recently the Australian central bank committed to keep yields on 3-year bonds below 0.25%. The Fed did something similar during WWII when they targeted both short-term Treasury rates and long-term bond yields to help control funding costs for the war.

What all this means is that the Fed has driven bond yields after adjusting for inflation (real yields) deeply negative. As you can see from the chart at the bottom of the next page, the yield on the 5-year bond after inflation now stands at -0.84%, the lowest level since 2013, and far below where real yields got to during the financial crisis. In a sense getting paid to borrow is hugely reflationary – both for the economy and financial assets.



<u>What About Debt and Inflation</u>? – The questions that we all have about the fiscal and monetary response to this crisis concerns 1) how much debt is too much, and 2) when will inflation return? There are no easy answers here and there is certainly no consensus among experts.

By way of background, what makes it possible for the government to run such large deficits and for the Fed to push policy to such extremes is the fact that inflation remains on the back foot at the moment. As you can see from the chart at the top of the next page, the latest report showed year-over-year core inflation falling to +1.0% while annual headline inflation plummeted to just +0.55%. Over the short-term it is hard to make the case that inflation is headed higher in any material way. With unemployment over 11% and consumers struggling to just pay rent or the mortgage, there clearly won't be any demand driven inflation anytime soon. And if anything, this is providing ammunition to a branch of economists who are advocating for Modern Monetary Theory (MMT). In essence, MMT argues that government deficits don't matter for countries that print their own currency, and the only constraint on the size of the national deficit is inflation. They highlight Japan with debt-to-GDP at over 200% and stable prices and argue that other developed economies should follow the example and actively spend. This theory is clearly controversial, both inside and outside the economics profession, but we suspect we are going to explore how far we can push the envelope in both the U.S. and Europe. One of the most amazing political transformations in recent history (and there have been many) has been the disappearance of the fiscal conservative on either side of the isle. There is simply little coherent resistance to more public largess, and this will probably continue regardless of who wins in November.



This could very well set the stage for an inflation problem over the intermediate-term (say the next three-to-five years), especially if globalization starts to reverse. One of the consequences of the COVID shock and the recent trade disputes is the desire to move some manufacturing capabilities back to the U.S., essentially reversing the globalization trends of the last forty years. This will almost certainly increase production costs. After all, that's why so much manufacturing moved overseas in the first place. How much of the increased costs will be absorbed by corporate America (bad for profit margins) and how much will be passed on to consumers (bad for inflation) is an open question. It's worth noting that the consequences of onshoring wouldn't be all negative – it would mean more blue-collar jobs in the U.S., clearly a good thing in many ways. We don't think this is an issue for this month or this year, but if you look longer-term, we seem to be setting the stage for higher average inflation rates for the first time in decades. But for the time being disinflation and deflation will be the underlying themes for the markets.

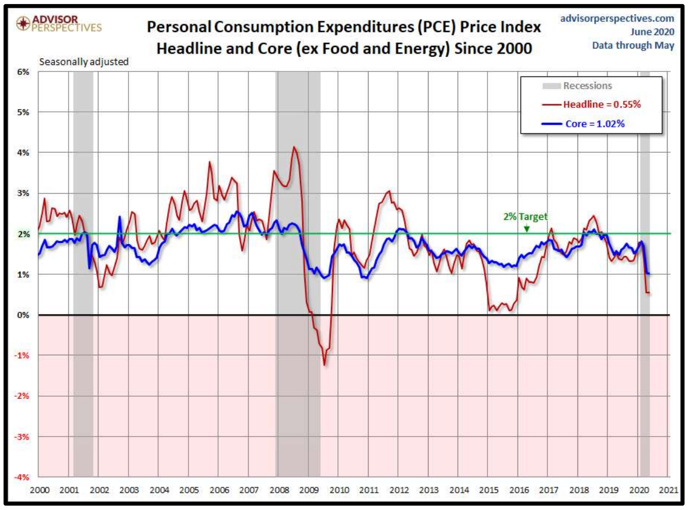
<u>The Path Forward</u> – Last quarter we laid out two of the most likely scenarios we saw for the global economy over the coming months and quarters. To quickly recap:

<u>The U-Shape Recovery</u> – This is the more optimistic of the two. In essence, falling infection rates around the world allows the global economy to slowly reopen and for economic activity to restart. Under this scenario the global economy will transition from intense near-term pain during the virus-suppression phase to gradual healing over the next six-to-twelve months. However, even under this optimistic scenario, the restrictions on economic activity will likely be lifted only gradually and at different speeds for different sectors and regions, thus the rebound will be muted. It will take us many years to get back to pre-COVID trend growth and the opportunity cost will be huge. A recent estimate from the International Monetary Fund pegs the cumulative output lost from the COVID shock at over $9tn globally. This means fewer workers employed, more bankruptcies, increased foreclosures, etc., with a lot of the pain being felt at the lower end of the socio-economic ladder.

<u>The W Scenario</u> – The other, less optimistic, scenario is an initial recovery interrupted by a relapse as countries shut down once again due to rising infection rates. Another deep downturn would be possible if case growth resumes exponential expansion and no vaccine is found by early

2021. This scenario would imply a wave of corporate bankruptcies in the third or fourth quarter and would be decidedly bearish for the stock market.

We'd be the first to admit we have no great insight into the path of infection rates. Even the experts disagree, sometimes vehemently!! But our investment committee leans towards the 'U' scenario because we don't think there is broad public support for 'one size fits all' shelter-in-place requirements. We suspect regional outbreaks will be dealt with at the local level.



What Does it Mean for the Markets? – We'd be the first to admit that the markets have moved quickly to price in the 'U' scenario over the last couple months. As such, the markets remain susceptible to a setback/correction if the news takes a turn for the worse in the weeks to come. Rising infection rates, consumers hunkering down and not spending, renewed trade spats, or a whole host of things could fall into the unwelcome news category. At a minimum we should prepare for periods of angst, volatility, and unnerving daily market moves in the third and fourth quarters as we wait for either a vaccine or effective policies to 'flatten the curve.'

Another issue to grapple with is the fact that corporate earnings will be slow to rebound. While estimates for this year and next are down a lot, there is more room to fall, especially if a possible Democratic sweep in November increases the odds of a corporate tax hike. However, we shouldn't lose sight of the countervailing positives. It is quite possible the global recession ended in June and that we've seen the worst of the job losses. Fiscal policy is providing a massive safety net, and for all the talk about rolling back benefits, it's unlikely we see dramatic changes. Finally, monetary policy is hugely stimulative and rates are deeply negative when adjusted for inflation. And low rates play just as an important role in valuing equities as earnings. An analysis from Bank Credit Analyst estimates that the fair value for the market might actually be higher post-COVID simply because the discount rate used to value the future stream of earnings has fallen so dramatically. We wouldn't call ourselves bullish or bearish for the third quarter. We suspect we see some large swings and Mr. Market will try to shake investors out of their long-term allocations at some point. However, with rates as low as they are today, we think stocks will beat bonds over a 12-to-18 month horizon.

Looking Ahead – One thing that history seems to teach us is that generals always prepare to fight the last war. For example, at the start of WWI the Austro-Hungarian army initially went to battle on horseback carrying sabers. The same theory works for the markets. How many times did we read about the risks in real estate or the banking system for ten the years after the financial crisis? But the COVID crisis was unlike anything we'd seen in living memory. We didn't know the biology of the virus, how infectious and deadly it was likely to be, and how governments would react both in terms of restrictions and policy support. Not since 1918 had we seen such a pandemic. But today (to steal from Donald Rumsfeld) COVID has become a known known. We are slowly getting a handle on what works and what doesn't work in addressing the problem (although the process is admittedly ugly), and the markets are able to price in a future path with some certainty. We may not like the path, but from a market perspective, a level of confidence in what the path holds can be more important than the path itself. Certainly, if the authorities are forced to shut-down the global economy again then we could see a repeat of February and March, but we suspect our collective reaction to more COVID hotspots will be different. As we mentioned earlier, we think we will see more regional and nuanced restrictions as policy makers try hard to balance safety with the need to keep the economy moving forward.

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