June 2020

What a difference a few months make. This statement is just as relevant as it was three months ago when we opened our last newsletter with the exact same words. It's fair to say that 2020 continued to shock and awe pretty much everyone in the second quarter – COVID-19 has by all measures spread throughout the world and is here to stay; anti-racist protests took place in cities far and wide; the US economy officially entered a recession[1] (which is likely the case for the world as a whole); the presidential race came out of hibernation; and countries, states and cities emerged from self-imposed shutdowns. The shutdowns sent shockwaves of a magnitude never seen before throughout the global economy. Almost any datapoint you look up fell off the charts. All the while the US stock market had its best quarter since the late 1990s. Some form of a recovery has begun yet what shape it will take is still very much unknown.

Every recession has its unique traits and surely this one will be no different. We are witnessing a health crisis first and foremest. As a society, we are learning more and more about the virus each and every day. The speed of research has been astounding. We are seeing science work in realtime, which allows us to observe its human side and all the errors, trials, politics and recalibrations along the way. It is too soon to say we are out of the woods, either from a market perspective or an epidemialogical perspective, but this is certainly not the time to react. This is the time to stay calm and keep in mind a well thought out plan, which includes a diversified portfolio, can weather any storm. Such an approach provides you with exposure to many different asset classes, some of which perform well in times of market stress and others that are more volatile and as we've witnessed some can seemingly perform out of line with the broader economic environment, which we will touch on below.

Under the Microscope: When Stocks and the Economy Diverge[2]

Do you find it puzzling when a bleak economic report emerges from the press, only to be accompanied by a positive surge in the stock market? You're not alone. The last few months have produced many examples of a stark contrast between stock market performance and economic indicators. So why the apparent disconnect?

Markets are forward-looking, meaning current asset prices reflect market participants' aggregate expectations. Those expectations include whatever future economic developments are anticipated and their potential impact on cash flows, which are key to a stock's value. For example, if the market expects the economic environment to weaken company cash flows, stock markets may react well in advance of when we observe the impact on cash flows, as expectations are embedded in prices. And the eventual direction of the stock market will depend

[1] https://www.nber.org/cycles/recessions.html

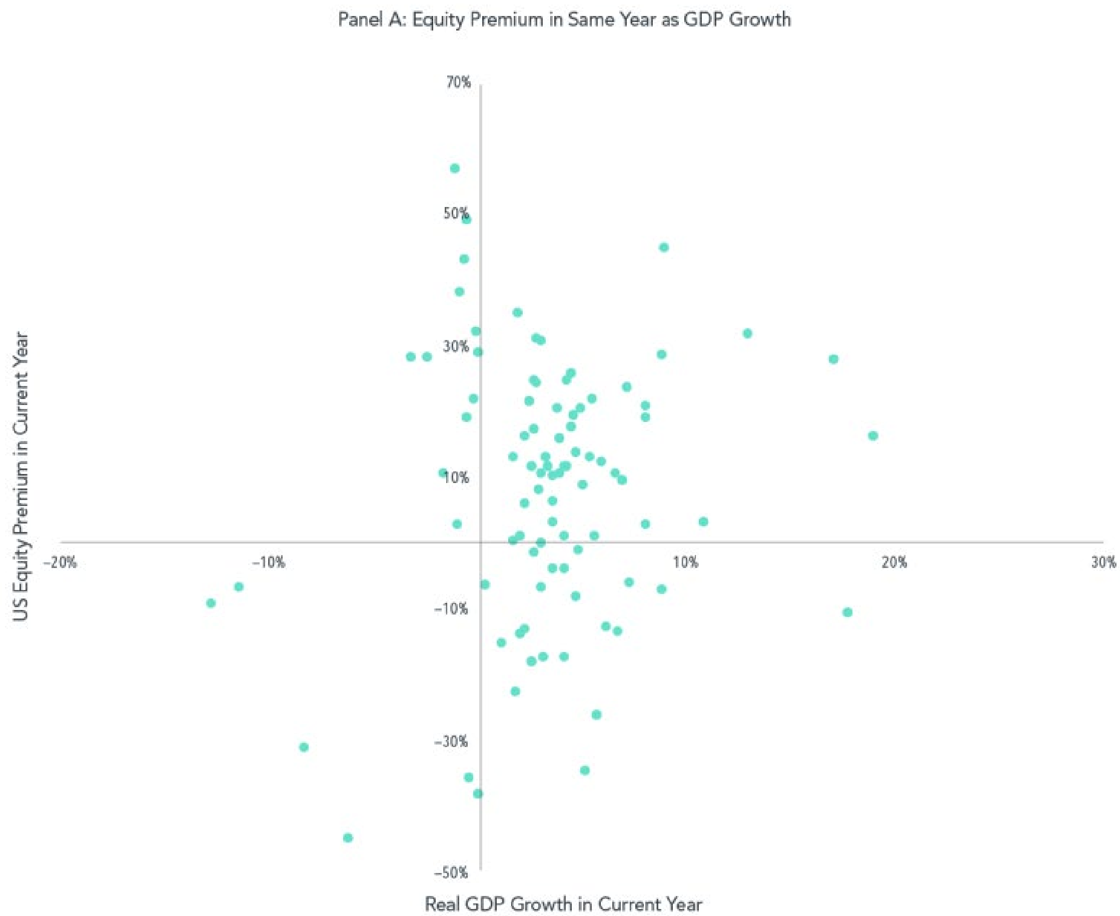
[2] Adapted from "Under the Microscope: When Stocks and the Economy Diverge" from Dimensional Fund Advisors LP.

on how the economic outcome compares to expectations. If things aren't as bad as expected, poor economic news can be greeted with a positive stock reaction.

LOOKING AHEAD

We can see this anticipatory nature of markets in action by looking at the relation between US gross domestic product (GDP) growth and equity premiums, or stock market returns in excess of one-month US Treasury bills. When annual US equity premiums are plotted against GDP growth for the same year (top panel of Exhibit 1), there is no discernable relation between the two. Changes in GDP have not been strongly related to simultaneous stock market returns.

Exhibit 1
Plot Development
US equity premium vs. GDP growth, 1930—2019



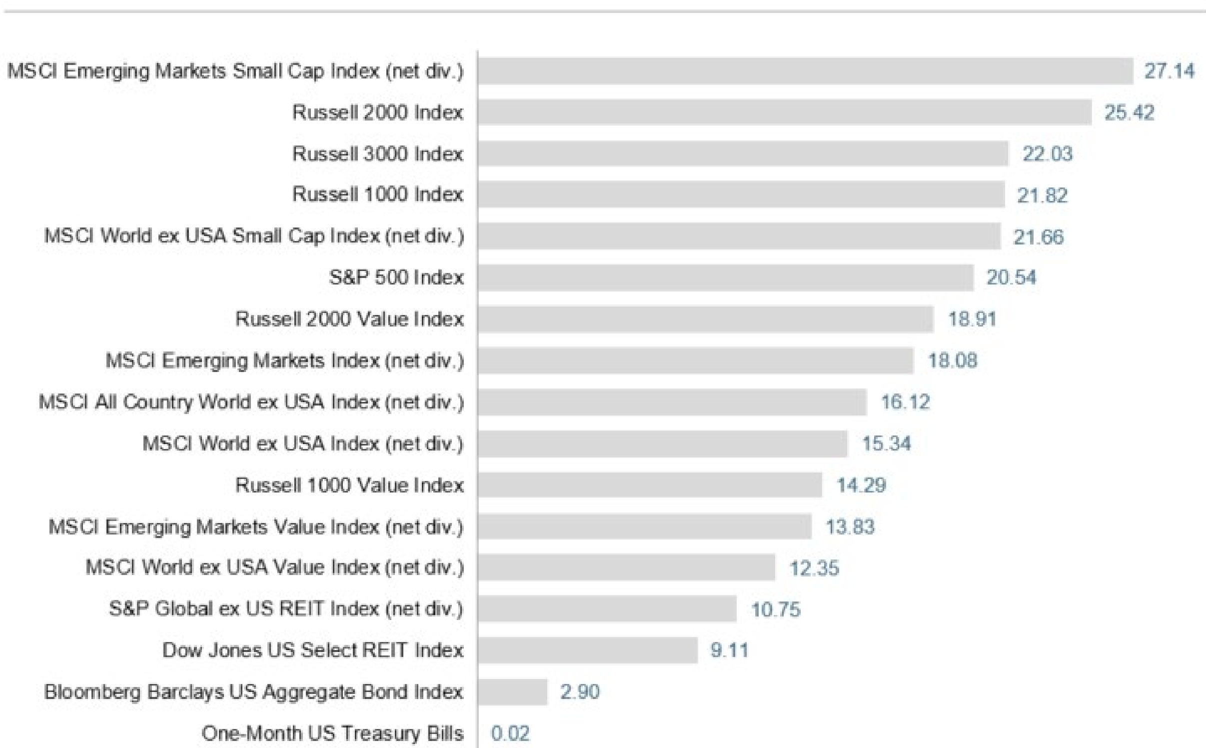
It's important to note that this result does not imply financial markets ignore macroeconomic data. After all, GDP encompasses several measures of the economy, not just corporate profits. However, while GDP may be an imprecise representation of the activities that ultimately drive stock prices, further analysis shows that is not the sole cause for the lack of relation between GDP growth and simultaneous equity premiums.

MARKETS AT WORK

Macroeconomic variables and investment decisions are like frozen turkeys and deep fryers—caution should be exercised when combining the two. The results presented here are consistent with markets aggregating and processing vast sets of macroeconomic indicators and expectations for those indicators.

Market Update – A Brief Around the World Tour of Markets

It has been the tail of two markets as we reach the midway point in the year. The first quarter was the worst such period for US stocks in over 10 years then the second quarter turned that on its head and saw the best quarter for US stocks in over 20 years. The gains in the second quarter were widespread across markets and asset classes with all but the stable, conservative bond market posting double-digit returns. The magnitude of equity returns left many scratching their heads as markets seemingly disconnected from the reality of the estimated economic damaged caused by the pandemic lockdowns. Safe havens assets like high quality bonds and gold also provided positive returns as the level of outright uncertainty remained elevated.



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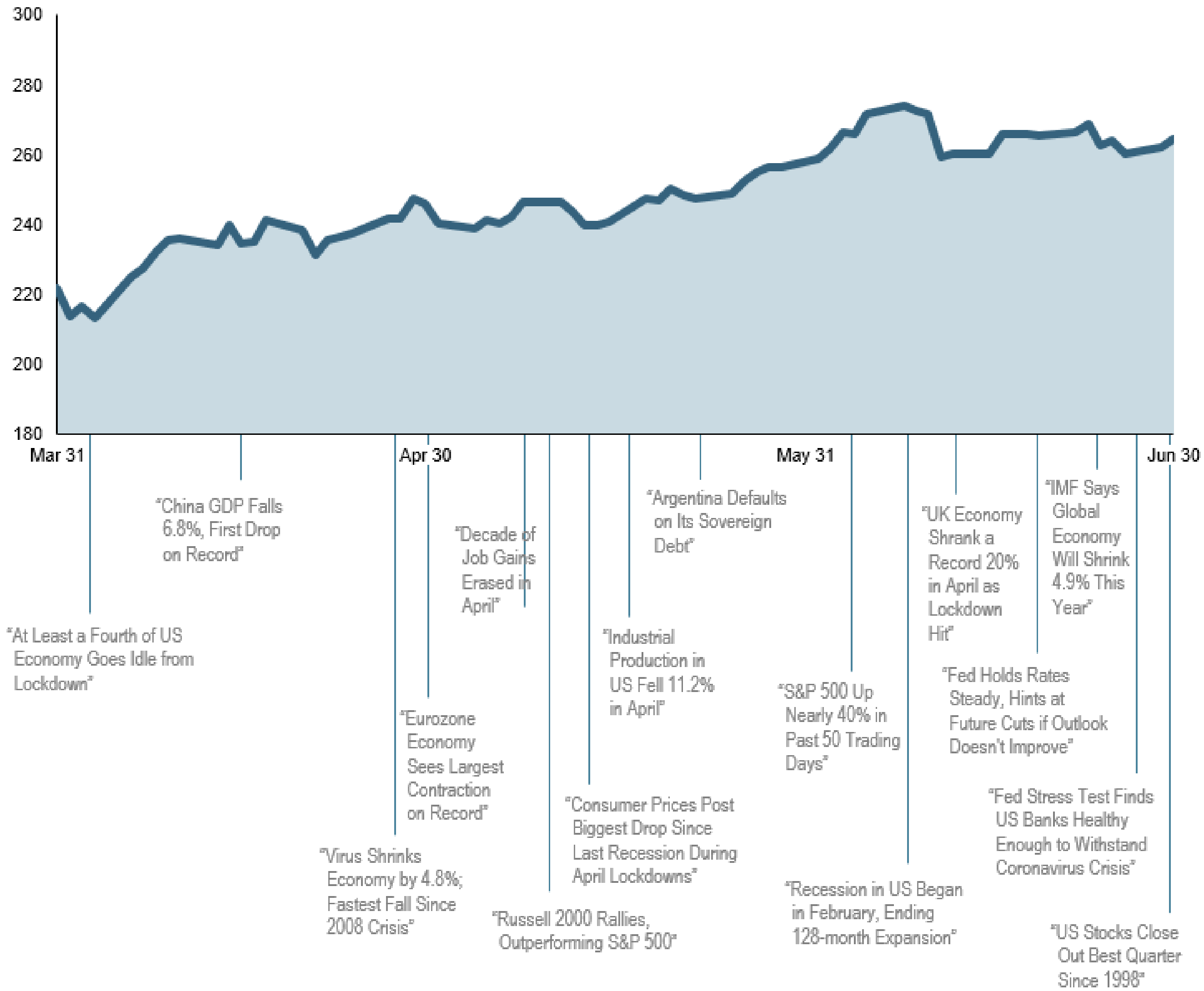
<u>On Stocks</u>

Growth stocks, and technology stocks specifically, continued their dominance in 2020. Growth is now ahead of Value by over 25%, the widest margin for a 6-month period since 1999. The NASDAQ returned to record highs and is back in positive territory for the year. Smaller companies outperformed large companies as investor's risk appetite increased, though larger companies were still ahead for the year-to-date period. International equities underperformed the US markets despite the apparent relative success against SarsCov2 (which is the virus that causes COVID-19). Emerging market small caps topped the equity market charts with a return just shy of 30%. Real estate, though near double digit returns, was in the back of the equity pack.

MSCI All Country World Index with selected headlines from Q2 2020

World Stock Market Performance



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index [net div.]. MSCI data © MSCI 2020, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

On Bonds

Bonds continued to provide security amongst the massive uncertainty that existed around the world. The broad based Barclays US Aggregate Bond Index returned 2.9% in Q2. Despite the uncertainty, the appetite for risk also increased in the bond market, with Corporate Bonds, High Yield and Leverage Loans seeing a strong bounce back. Interest rates remained relatively stable and at low levels thanks to actions taken by the US Federal Reserve (Fed). The Fed acted in unprecedented fashion to stabilize a wide range of fixed income markets. Their actions are credited with calming many nerves and contributing to the positive returns in both equity and fixed income markets.

Period Returns (%)

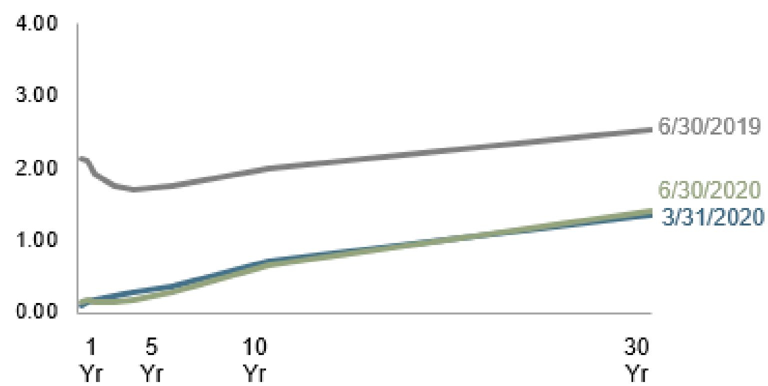
*Annualized

Asset Class	QTR	YTD	1 Year	3 Years*	5 Years*	10 Years*
Bloomberg Barclays US High Yield Corporate Bond Index	10.18	-3.80	0.03	3.33	4.79	6.68
Bloomberg Barclays US TIPS Index	4.24	6.01	8.28	5.05	3.75	3.52
Bloomberg Barclays US Aggregate Bond Index	2.90	6.14	8.74	5.32	4.30	3.82
Bloomberg Barclays Municipal Bond Index	2.72	2.08	4.45	4.22	3.93	4.22
FTSE World Government Bond Index 1-5 Years	1.41	2.11	2.27	1.86	1.68	0.62
FTSE World Government Bond Index 1-5 Years (hedged to USD	0.53	2.79	3.96	3.09	2.38	1.96
Bloomberg Barclays US Government Bond Index Long	0.28	20.97	25.14	11.96	9.21	7.71
ICE BofA US 3-Month Treasury Bill Index	0.02	0.60	1.63	1.77	1.19	0.64
ICE BofA 1-Year US Treasury Note Index	-0.03	1.69	2.86	2.25	1.54	0.95

On the Economy

After falling off the proverbial cliff, economic data did begin to show signs of recovery in the back half of the quarter, although the global economy remains mixed at best. Unemployment in the US is in the double digits but moving in the right direction and bankruptcies are climbing. Manufacturing and service PMI data have rebounded and the housing market has remained incredibly resilient while other measures of mobility and consumption remain depressed. As we turn the page on a new quarter, the focus will return to Washington as critical stimulus measures implemented early on in the economic shutdown are scheduled to cease at the end of July.

US Treasury Yield Curve (%)



Bond Yields across Issuers (%)