INVESTMENT COMMENTARY
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Executive Summary

Financial markets have experienced extreme volatility so far this year. Government efforts to contain the spread of the coronavirus resulted in a sudden stop of global economic activity—one of the deepest and sharpest recessions in modern history—and a broad selloff across risk assets. Policymakers responded with extraordinary monetary and fiscal support measures that restored confidence. Uncertainty remains high, but our base case assumes a slow, uneven economic recovery that should underpin financial markets. After a strong rally from the March lows, however, US equity valuations may reflect an overly optimistic outlook while bond yields remain near record lows.

Against this backdrop, we expect volatility to remain high, as is somewhat typical of a presidential election year. We recommend a slight defensive tilt in portfolio strategy while maintaining a broad level of diversification across risk factors. Our tactical positioning themes include:

- Retain an elevated cash/short-term fixed income position as "dry powder" but continue to target an underweight position to core/investment grade bonds given record low yields.
- Target an underweight position in US equities while emphasizing large-cap, high-quality stocks and more reasonably priced international and emerging markets.
- Target a slight overweight position to certain flexible/alternative strategies that are potentially attractive for their diversifying returns, particularly given the valuations of traditional asset classes.

Asset Category Performance (As of July 31, 2020)	YTD 2020	Full Year 2019	Last 5 Years*	Last 10 Years*
Fixed Income				
Municipal Bonds (Barclays 1-10 Year Municipal)	+3.3%	+5.6%	+3.1%	+3.1%
Taxable Bonds (Barclays Intermediate US Gov/Credit)	+6.1%	+6.8%	+3.5%	+3.1%
Bank Loans (S&P/LSTA US Leveraged Loan)	-2.7%	+8.6%	+3.3%	+4.2%
High Yield Corporate Bonds (Barclays US High Yield)	+0.7%	+14.3%	+5.9%	+6.8%
Equities				
Global Stocks (MSCI All Country World)	-1.3%	+26.6%	+7.4%	+8.9%
US Large Cap Stocks (S&P 500)	+2.4%	+31.5%	+11.5%	+13.8%
US Small Cap Stocks (Russell 2000)	-10.6%	+25.5%	+5.1%	+10.1%
Non-US Developed Markets Stocks (MSCI EAFE)	-9.3%	+22.0%	+2.1%	+5.0%
Emerging Markets Stocks (MSCI Emerging Markets)	-1.7%	+18.4%	+6.2%	+3.3%
Real Assets				
Commodities (Bloomberg Commodity)	-14.8%	+7.7%	-4.5%	-5.9%
Energy MLPs (Alerian MLP)	-38.0%	+6.6%	-12.9%	-2.5%
Global REITs (MSCI ACWI REIT)	-10.0%	+27.1%	+5.5%	+8.9%
Flexible/Alternative Strategies				
Directional Hedge (HFRI FOF Strategic)	+0.6%	+10.5%	+2.1%	+3.2%
Less-Directional Hedge (HFRI FOF Conservative)	-0.4%	+6.3%	+1.7%	+2.7%

*Note: Data provided by Zephyr Associates. *Indicates annualized return. Past performance is not indicative of future results.*

Market Review

Financial markets have experienced an incredible amount of volatility thus far in 2020. The first half of the year was dominated by the rapid spread of COVID-19, which forced global economies to shut down and caused markets to plummet. Equities and other risk assets declined sharply while government bond yields collapsed, benefitting from "safe haven" demand. Almost all asset categories suffered amid an acute liquidity crunch in March. For example, after reaching an all-time high on February 19th, the S&P 500 Index (a benchmark proxy for US large cap stocks) plunged more than -30% in only 24 trading sessions—the fastest fall into a bear market in US history. Arguably, the dislocation in credit markets was more severe as spreads[1] widened in March in a matter of days to levels not seen since the 2008 Global Financial Crisis (GFC).

Governments and central banks around the world responded quickly to provide massive stimulus measures to support their economies and markets. For instance, the US Federal Reserve (Fed) made two emergency rate cuts in March and re-launched many of the same programs first developed during the GFC but at an unprecedented scale, perhaps five times larger than in 2008.[2] On the fiscal side, the Federal government had approved by May roughly $3 trillion of emergency funds seeking to bridge the income gaps to businesses and individuals caused by the coronavirus. Similar spending plans were announced outside of the US. European Union leaders took a big step toward deeper economic cooperation and agreed on an unprecedented stimulus package worth €750 billion, providing vital support to southern European economies hardest hit by the virus.[3]

These expansive measures restored market function and boosted investor optimism, fueling a strong market rally off the March lows. Indeed, the S&P 500 Index just experienced its best return *ever* over any 100-day period, gaining over +50% since March 23rd. But there is a major bifurcation beneath the surface as growth stocks have continued their decade-long run of outperformance relative to value stocks. The year-to-date return differential is almost +30% in favor of growth.[4] This short-term return discrepancy between the two segments is nearing levels last seen during the dot-com bubble of the late 1990s. Certainly, underlying sector performance explains a lot of the difference. For example, the S&P technology sector has gained +21% so far in 2020, while the energy and financial sectors have declined -39% and -21%, respectively.

In fixed income markets, the 10-year Treasury bond yield remains near a record low at 0.7%, held in check by an ongoing bid for safe haven assets, the Fed's quantitative easing program, and a global low-yield environment. Despite the rally across risky assets over the last several months, flows into bond funds totaled more than $200 billion in the second quarter[5]. At the same time, short-term interest rates are now zero or negative in most of the developed world. Accordingly, investment grade fixed income sectors have generated solid returns thus far in 2020—with longer-duration and higher-quality bonds posting the best year-to-date results.

As a final observation—the severe drawdown in equities followed by an extremely sharp rebound is another striking example of how difficult it is to time market inflection points. It illustrates just how easy it can be to get whipsawed and miss the market's best days if an investor attempts to "sit out" a bear market, waiting to get back in "when things clear up." In our view, this underscores the importance of relying on an appropriate asset allocation strategy for investment discipline while being prepared for a wide range of potential outcomes.

Macro Backdrop

The global economy experienced a sudden stop as many countries adopted stringent measures to slow the spread of the coronavirus. These actions led to a broad global recession that has been deeper and faster than any in recent history[6]—what the International Monetary Fund has described as the "Great Lockdown." For example, the US economy contracted in the second quarter at a record pace, as gross domestic product—the value of all goods and services produced across the economy—fell at an annualized rate of 32.9%, or a 9.5% drop compared to the prior quarter. This was the steepest decline in more than 70 years of record-keeping.[7]

Yet, it may be that the worst of COVID-19's shock to the economic system is behind us, with the US recession being one of the shortest in history. Overall activity remains below normal, but retail sales have bounced back to above year-ago levels, while survey-based measures of the health of both the manufacturing and services sectors[8] have rebounded back into expansion territory. So far, the trillions of dollars in aid extended by the Fed and Congress has held the economy together, providing much-needed income replacement and preventing a depressionary spiral from taking hold. But this support is assumed to be temporary. And despite recent progress, policymakers still face the lingering effects of high unemployment. Last week, continuing jobless claims—or the number of people receiving unemployment benefits for at least two straight weeks—declined to 14.8 million. Clearly, there is still a long way to go, as continuing claims a year ago were only 1.7 million.

As always, we seek to frame the macroeconomic backdrop by considering a range of potential outcomes. What's unique about the current environment is how dependent the outcomes are on the course of COVID-19. Significant uncertainty remains as to the progression of the virus, even as economies around the globe reopen and relax social distancing standards. The timing, availability and effectiveness of treatments and vaccines are also highly uncertain but crucial variables for the economic outlook. Ben Inker at GMO remarks:

> *Economic forecasting is a difficult proposition in the best of times. The fact that the economic outcomes from here significantly depend on the evolution of a pandemic caused by a virus that the world has a total of [eight] months of collective knowledge about makes the task close to impossible.*[9]

Acknowledging a high degree of uncertainty and wide range of plausible outcomes, our base case assumes a slow, uneven economic recovery and continued fiscal and monetary policy support. Also, ongoing social distancing measures will likely prevent many countries from returning to pre-crisis levels of aggregate economic activity for at least a couple of years. And risks to the outlook appear skewed to the downside. Yet, we continue to believe that the likelihood of a financial crisis is relatively low. Given the nature of the COVID-19 economic shock, the Fed doesn't face any "moral hazard" problems by intervening to shore up the stability of the financial system. In addition, banks are generally better capitalized and less leveraged than they were in 2008.[10]

In our view, the chief near-term risk is the potential for a widespread second wave of COVID-19 infections and hospitalizations that force another large-scale economic shutdown. This could lead to a double-dip recession and result in permanent business closures and job losses. Some states have already had to delay or reverse their reopening plans. As a result, some of the high-frequency indicators, such as credit card spending and airline passengers, suggest the economic recovery has started to stall.[11] This reinforces the need for additional fiscal stimulus—and highlights that the premature removal of government support as another key risk. A re-emergence of trade tensions between the US and China also poses a threat to the outlook. Relations between the two countries have deteriorated significantly in recent months into several disputes, including the origins of the pandemic, Hong Kong's independence, the South China Sea and other issues.[12]

The COVID-19 pandemic has accelerated certain pre-exiting trends, such as deglobalization and the digitization of commerce. But, in terms of other long-lasting effects, we worry about the potential for a persistent increase in risk aversion in the private sector—that businesses and households are simply more cautious. This would reinforce the "secular stagnation" thesis advanced by former US Treasury secretary Larry Summers. As he puts it, "just in case will replace just in time," with the private sector wanting to hold greater financial reserves in case of further shocks.[13] More precautionary saving by households and less investment by businesses would translate into even slower growth. Yet, Neil Shearing at Capital Economics takes a more sanguine view. He argues that, since the effect of weak demand is being mitigated by wide-scale fiscal support, so long as governments avoid policy missteps, some of the pessimism around the longer-term economic impacts of the virus may be overdone.[14]

Monetary Policy

After the Federal Open Market Committee (FOMC) meeting in June, Fed Chairman Jerome Powell made it very clear that the Fed intends to keep monetary policy extremely accommodative for the foreseeable future. Powell said, "We are strongly committed to use our tools to do whatever we can, and for as long as it takes, to provide some relief and stability, to ensure the recovery will be as strong as possible and to limit lasting damage to the economy…We are not thinking about raising rates. We are not even *thinking about* thinking about raising rates." To this end, most FOMC participants expect the federal funds policy rate to remain near-zero at least through the end of 2022. So, the Fed is leading the way for other global central banks to enact their own extremely loose monetary policies. According to Ned Davis Research, 97% of central banks are now in an easing cycle (cutting rates), and 87% of central banks have their current target interest rate a record low level. In addition, global central bank balance sheets, in aggregate, have increased to a record 38% of global GDP.

We've previously observed that, during the past decade, investor sentiment and the broader economy have been increasingly at the mercy of central banks. Low interest rates and accommodative policy became the norm as central bankers aimed to combat the deflationary pressures of the 2008 global recession. For example, the Fed kept its target funds rate at virtually zero for seven years following the GFC, only beginning to gradually raise the target in December 2015. This "policy normalization" campaign ended in 2019 with a peak fed funds rate of 2.5%, perhaps confirming the suspicion that the "neutral" rate of interest—the rate consistent with full employment and stable inflation—is now extremely low. Given the limited scope for conventional monetary policy easing, central bankers are likely to continue to err on the side of aggressive action to provide downside protection to the economy. In fact, the Fed has signaled it will effectively abandon its strategy of preemptively lifting interest rates to head off higher inflation—a practice it has followed for more than three decades.[15]

Market Outlook

As James Montier at GMO points out, investing is always about making decisions under a cloud of uncertainty. Investors today face an unusually wide range of potential outcomes as the near-term economic backdrop remains largely dependent on the course of the coronavirus. Thus, it is also the key variable for corporate earnings and financial markets. Policy actions, though, are also likely to have an increasingly large influence on asset returns. Recognizing these "known unknowns," our base case scenario of a slow, uneven economic recovery and continued low interest rates should allow corporate profits to recover. This backdrop, along with ongoing monetary and fiscal policy support, should underpin financial markets and prove favorable for risk assets like equities and credit. However, valuations are a bit stretched, while market volatility is likely to remain high.

Given the strong rally over the past few months, many risk asset valuation levels have rebounded to near historical averages but are most elevated in US large cap stocks. For example, the forward price/earnings (P/E) multiple for the S&P 500 is now roughly 22.3x compared to the 10-year average of about 15.3x.[16] Perhaps some valuation premium relative to history is appropriate given the low level of interest rates. PIMCO argues that equity valuations are "fair, after adjusting for easy financial conditions."[17] Indeed, for the foreseeable future, equities are unlikely to face the headwinds of central bank tightening. Yet, US corporate profit growth may be slower than currently anticipated. Consensus estimates are for S&P 500 earnings to return to pre-recession levels by the end of 2021—a much faster rate of recovery than the typical three years.[18]

History tells us that recessions often lead to changes in market leadership—and we may be on the cusp of such a change. Leadership by geography (US versus non-US) and style (growth versus value) tends to reverse at the start of a new cycle. The economic and market backdrop over the past 12 years has clearly favored US stocks and growth. But P/E ratios for international developed and emerging markets remain lower than those for the US. Low valuations reflect investors' pessimistic outlook for these regions, which creates the potential for a positive surprise. In addition, a recovery in global economic growth should give a boost to value stocks and sectors, such as industrials, financials and energy. In fact, it could mark the inflection point ending the extraordinary dominance of growth stocks over value.

After spiking in March to levels last seen during the GFC, volatility remains elevated. The CBOE Volatility Index (VIX), often referred to as a "fear gauge," currently stands at 23 (versus the ten-year average of 17). It's a bit unusual for the VIX to stay above 20 for an extended amount of time beyond periods of instability or disruption. However, there's no shortage of risks that could cause swings in market sentiment, such as the potential for multiple waves of COVID-19, a further deterioration in US-China relations, and increasing social and political unrest. Financial markets tend to experience volatility ahead of US presidential elections—and volatility is highest when the incumbent party loses. Seemingly, investors' biggest fear about a Biden win is a Democratic sweep that leads to higher taxes. The Biden campaign has been gradually releasing its economic platform and has proposed raising the corporate tax rate from 21% to 28%. Ned Davis Research estimates this would reduce S&P 500 earnings by about -12%.[19]

Tactical Asset Allocation Views & Portfolio Positioning Themes

Within the context of a sound, long-term asset allocation framework, we believe that an active, flexible approach can enhance returns by shifting capital to attractive risk/reward opportunities. Portfolio activity so far this year has been higher than normal as we sought to take advantage of market volatility. But our positioning themes have remained fairly consistent. And given the level of uncertainty, proper diversification may be as important as ever. Portfolios should be structured to participate if an optimistic V-shaped recovery is realized while remaining resilient if the recovery is slow and environment remains turbulent.[20] From a tactical perspective, we continue to recommend a slight defensive tilt with an emphasis on opportunities we believe offer more attractive risk-adjusted return potential—specifically non-US stocks, selective high yield credit and certain diversifying alternative strategies.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash & Short-Term Bonds				✓	
Fixed Income					
Investment Grade Municipal Bonds		✓			
Investment Grade Taxable Bonds		✓			
High Yield Credit				✓	
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks		✓			
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities			✓		
Public Real Estate	✓				
Flexible/Alternative Strategies					
Directional Hedge			✓		
Less Directional Hedge				✓	

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investing horizon.

Based on our assessment of the fundamental backdrop, asset class valuations and risks, our current portfolio positioning themes include the following:

- **Maintain a broad level of diversification across a range of risk factors while targeting a slight defensive tilt.** Given the level of economic uncertainty and wide range of potential outcomes, we recommend maintaining an elevated cash position (and/or short-term fixed income) as "dry powder" to potentially take advantage of significant volatility.

- **Continue to target an underweight position to core/investment grade fixed income.** High quality bonds play an important role in portfolio strategy, providing a source of stability, liquidity and diversification of equity market risk. However, the predictable income component of these "protective assets" has further diminished given the move lower in yields.

- **Recent weakness created an attractive opportunity to initiate an allocation to below-investment grade corporate credit.** In March, high yield bond spreads widened to levels last seen during the 2008 global financial crisis. With the Fed's support, credit markets have since recovered, but spreads remain somewhat elevated. In our view, high yield credit still offers attractive return potential relative to US stocks, while the asset class benefits from a higher position in the capital structure in the event of another economic downturn. Yet, we recommend a selective approach to the space, aiming to utilize skilled managers to minimize default risk.

- **Target an underweight position in US equities while emphasizing large-cap, high-quality stocks.** Low interest rates and ongoing policy accommodation should continue to provide support to US equites. And when compared to the ultra-low yields on investment grade bonds, US stocks appear *relatively* undervalued. Still, from an absolute perspective—comparing the current market price to the expected stream of profits and dividends—we think valuations are stretched and perhaps reflect an overly optimistic outlook. Therefore, we recommend an underweight position. We also continue to prefer a tilt towards higher quality companies (those with strong balance sheets, stable earnings and high margins) that typically exhibit more resilience in challenging economic environments.

- **Stay fully invested in more reasonably priced international developed and emerging markets stocks.** In our view, foreign stock market valuations are attractive on an absolute basis and relative to the US. This is particularly true for emerging markets where the cyclically adjusted P/E ratio—an absolute valuation metric—for the MSCI Emerging Markets Index currently resides near its lowest level in 35 years of history. We also believe that the headwind of a strong US dollar over the past several years could reverse itself, given extremely accommodative US monetary policy and the large and expanding federal budget and current account deficits.

- **Target a slight overweight position to diversifying alternative strategies.** We continue to believe that certain types of hedge fund strategies are valuable for their diversifying active returns (and lower correlations to traditional asset classes). In our view, the investment case is particularly compelling given the extremely low yields across most fixed income sectors, while taking into consideration the less-liquid nature of some diversifying alternative strategies.

- **Where appropriate, continue to develop private equity and private real estate investment programs.** Because of the associated illiquidity and inherent inefficiencies, private assets typically compensate investors with a premium return. In the current environment, we recommend maintaining the planned pace of commitments as new capital deployed during periods of economic disruption often generate significant upside. We continue to suggest a selective approach that emphasizes lower middle market private equity and niche/opportunistic real estate. Yet, private markets generally take longer than public markets to show signs of stress, and attractive opportunities could present themselves across other sectors, such as private lending.

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[1] *Based on the Bank of America US High Yield Index Option-Adjusted Spread.*
[2] *Corbin Capital Partners, "2020 Mid-Year Investor Letter."*
[3] *Viktoria Dendrinou, Nikos Chrysoloras, and Morten Buttler, Bloomberg, "EU Clinches Massive Stimulus Deal to Bind Continent Together," July 21, 2020.*
[4] *Based on a comparison of the MSCI All Country World Growth and Value Indexes as of July 31, 2020.*
[5] *Morningstar, "U.S. Mutual Fund and ETF Fund Flows for June 2020," July 17, 2020.*
[6] *Franklin Templeton, "Midyear Outlook: Risk, Recovery and New Market Realities," July 10, 2020.*
[7] *Harriet Torry, The Wall Street Journal, "U.S. Economy Contracted at Record Rate Last Quarter; Jobless Claims Rise to 1.43 Million," July 30, 2020.*
[8] *Based on the Institute of Supply Management (ISM) Manufacturing and Non-Manufacturing Purchasing Manager Indexes as of July 2020.*
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[10] *Preston Caldwell and Eric Compton, CFA, Morningstar, "It's Not the 2008 Global Recession All Over Again," August 20, 2020*
[11] *Katia Dmitrieva and Maeve Sheehy, Bloomberg, "US Economic Hole Remains Deep Despite Jobless Claims Milestone," August 13, 2020.*
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[13] *Gavyn Davies, Financial Times, "The Effects of Covid-19 Could Deepen Secular Stagnation," May 31, 2020.*
[14] *Neil Shearing, Capital Economics, "Why History May Not Repeat in Covid's Aftermath," August 10, 2020.*
[15] *Nick Timiraos, The Wall Street Journal, "Fed Weighs Abandoning Pre-Emptive Rate Moves to Curb Inflation," August 2, 2020.*
[16] *John Butters, FactSet, "FactSet Earnings Insight," August 7, 2020.*
[17] *Erin Browne and Geraldine Sundstrom, PIMCO, "July 2020 Asset Allocation Outlook."*
[18] *Fidelity Asset Allocation Research Team, "Fed Stimulus, Reopening Hopes Spur Rebound," July 16, 2020.*
[19] *Ned Davis Research, "2020 Election Handbook: A Unique Election Cycle with Some Unexpected Parallels," July 14, 2020.*
[20] *Erin Browne and Geraldine Sundstrom, PIMCO, "July 2020 Asset Allocation Outlook."*