JULY 16, 2020

How quickly the world seems to change. At least as defined by financial markets. A quick recap of the first six months of 2020: The S&P 500 reached an all-time high on February 19, then dropped 34% over the next 33 days before reversing course and climbing an astonishing 45% over the subsequent 77 days. Meanwhile, the yield on the 10-year U.S. Treasury Note fell from nearly 2% at year-end to 0.50% on March 9, more than doubled to 1.25% only nine days later, and then settled in at 0.65% at quarter-end. Happily, our client portfolios benefited from rebounding equity markets with solid double-digit gains in the second quarter. Yet, these gyrations add fuel to the fire of global anxiety created by Covid-19.

The biggest question on the minds of investors today is: Why have stock prices recovered virtually all of their losses while economic activity is sharply lower? Theories abound. Most start with an assessment of the bond market and confidence in the willingness and ability of the Federal Reserve (as well as other global central bankers) to maintain a sustained period of near-zero interest rates. Chairman Powell has assured the market that the Fed "will not run out of ammunition" and will continue supplying liquidity "for as long as it takes". Many share the view that ultra-low rates will continue to induce investors toward stocks and justify higher valuations. This phenomenon even has a catchy name: TINA – There Is No Alternative.

Some observers also point to the swelling ranks of amateur day traders and other signs of irrational exuberance. We acknowledge both, but hard numbers suggest that there must be something more at work.

We believe that the sheer speed of the market rebound suggests that investors are taking economic recovery for granted and drawing conclusions from studying previous recessions. Historically, recessions play the same role as natural forest fires, clearing out dead wood and allowing new growth to flourish. Excesses built up in an overheated economy are expunged; unstable competitors vanish through bankruptcy and surviving companies reduce costs. All of this leads to higher levels of profitability for surviving entities as the cycle improves.

To justify current valuations of many companies, we think investors must be counting on an increased level of profits in addition to a low interest rate, inflation free environment in a swiftly approaching post-pandemic world. While this might be correct, in our view there is little room for error. There are simply too many questions that are too difficult to answer. At this juncture, we prefer a healthy dose of skepticism to optimistic rationalization. We are a bit more Harry Truman ("show me") than Warren Harding ("return to normalcy").

To start, we do not believe this is a "normal" recession. The current duress is a global phenomenon caused by disease and wide-reaching government policy rather than the usual excesses of previous cycles. Forecasting is far more challenging. Predicting the course of the pandemic has strained even the "experts", and investors should not try to become overnight epidemiologists. There is a list of significant questions that do not yet have firm answers:

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- When will there be a widely available effective vaccine or treatment?
- With cases rising and policy responses varying from state to state, how will consumers react?
- How long will it take businesses to resume normal or close to normal activity?
- How many laid off or furloughed workers will be rehired?

If stocks were cheap, as they were very briefly in March, we might be more sanguine. Given elevated valuations and because the answers to these questions require significant guesswork, we continue to take a cautious approach to security selection and, where appropriate, asset allocation. We strongly believe that the right stocks will be attractive long-term investments. That said, we have slightly greater than average levels of cash in portfolios to both provide a cushion and to allow us to pick up bargains should opportunities present themselves.

Portfolio adjustments have been made to increase the overall quality of our equity holdings and to reduce exposure to companies that depend on robust economic growth. As we noted in our first quarter commentary, market turmoil allowed us to make new or add-on investments in very good companies at attractive valuations. We believe that all of our holdings continue to be in sound financial condition and well-positioned to survive even the most challenging environment. Needless to say, we are monitoring each very closely.

In cases where a fixed income allocation is appropriate, we are keeping a close eye on the Federal Reserve. The feverish pace at which it continues to operate is affecting all markets, and its actions will reshape the fixed income environment for the better half of the next decade. We are interpreting Fed policy and shifting portfolios accordingly. To date, the Fed has created an environment that is investor and company friendly. Liquidity is robust, and companies will likely be able to refinance their short-term liabilities at record low costs. While interest rates are anchored, it will be harder to invest proceeds in the longer term. Investors are probably better off preparing for a low interest rate environment now rather than waiting. We believe the proper way to do this is with individual bond ownership versus funds, slightly longer portfolio durations, and proper credit selection.

Likewise, while our equity portfolios enjoyed well-above historical average returns, our cautious approach did not quite keep pace with the extraordinary rebound in broad benchmarks. Given the unprecedented level of uncertainty, we feel that sticking to high quality assets is the most prudent way to steward our clients' capital. Now is the time to measure risk carefully and concentrate on investments that have the best chance of success, while enjoying better than average defensive characteristics. While we continue to be long-range optimists, you can count on us to closely monitor the current environment with safety foremost in mind.

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