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SECOND QUARTER COMMENTARY
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We hope you and your loved ones are healthy as COVID-19 continues its march across the south and west of the United States. Our office is open, though most of our team is working from home. For many investors, there has not yet been a serious economic reckoning of the damage caused by the pandemic, despite the suffering of millions of jobs lost. Unprecedented fiscal and monetary stimulus have forestalled the worst outcomes and powered the recovery of risk assets.

All major equity indices rose significantly in the second quarter, and some segments of the market seem to be looking through the pandemic. The S&P 500 returned 20.6%, its best quarter since 1998, following the 19.6% decline in the first quarter. It is down 3% for the year, showing that down 20% and then back up 20% does not equal a 0% return. The NASDAQ, which embodies the resilience of growth and technology throughout the pandemic, was up 31% in the quarter and is up 12.7% for the year. Growth continues to outperform value across all market caps, and the disparity between the two has reached historic proportions. Large Cap Growth was up 9.8% in the first half of 2020, while Large Cap Value was down 16.3%. A similar (though not as extreme) gap persists between Large and Small Cap returns, with the S&P 500 down only 3% for the year, while the Small Cap Russell 2000 was down 13%. Small Cap Value was down 23.5%, trailing Large Cap Growth by 33.3%, the largest gap since the dot com bubble. International stocks lagged most US indices for the quarter and year-to-date. Long short hedge funds have bounced back though results vary widely, while most credit-oriented funds have not yet fully recovered.

Government bond yields were relatively unchanged in the quarter, while corporate bonds rallied with equity markets. Continued Federal Reserve intervention in almost all bond markets kept credit markets orderly. The following are Treasury yields for various maturities:

MATURITY*	12/31/19	3/31/20	6/30/20
3 Month	1.55%	0.10%	0.16%
2 Year	1.57%	0.20%	0.15%
10 Year	1.92%	0.68%	0.65%
30 Year	2.39%	1.32%	1.41%

*Source: Factset

The Treasury yields above, much like the lagging returns of value and small cap stocks, signal deep economic damage from COVID-19. Unemployment claims moved from 50 year lows to post WWII highs in two months, with the unemployment rate currently hovering at 11%. Consumption collapsed in April, highlighted by the lowest monthly auto sales since at least 1975. Not surprisingly, manufacturing indices are at deep recessionary levels, though the latest readings show a bounce in activity.

Equity and credit markets climbed steadily since the March 23rd bottom. After the stomach-churning volatility in the first quarter, when the Dow Jones Industrial Average had twelve +/- 1000 point days in March alone, the second quarter only had two such days. The economy was flooded with money from both the Federal Reserve and various legislative stimulus packages. To wit, the Federal Reserve expanded its balance sheet by $3.25 trillion (+84%), including the purchase of over $2 trillion in US Treasuries. The CARES Act pumped another $2 trillion into the economy through direct payments to many workers, an additional $600 per week in enhanced unemployment benefits, and hundreds of billions to encourage small and large businesses to keep employees on their payrolls. All this income, plus depressed spending, led to April having the highest savings rate ever recorded, and appears to have ended the shortest yet sharpest recession in US history. Retail sales were up 17% in May, easily the largest jump on record, but are still down 6% from May 2019. Employment rebounded in May, which shocked most economists, and continued to improve in June as some workers were rehired. The US seems to be on a similar recovery trajectory as China, which troughed two months earlier and has not relapsed. Whether the escalating tensions between mainland China and Hong Kong have global economic repercussions remains to be seen.

US politics are also particularly contentious, which is not unusual in an election year, but even wearing a mask has become politicized. COVID-19 has already claimed more than 130,000 American lives. Hundreds of thousands of small businesses, perhaps millions, have closed. The medical problem does not yet have a medical solution, though the staggering amount of intellectual and financial resources attacking the virus offers hope there will be some mitigation in the relatively near future. While there is no vaccine, there are over 170 in various stages of development, and positive progress reports have buoyed the markets. The medical community is having more success treating symptoms. After falling for over a month, COVID cases have risen sharply in areas of the country which had heretofore been relatively unscathed, though thankfully the death rate has not gone up. Will these flare-ups be stamped out, or the start of a second wave? As states halt or reverse reopening, will the recovery slow or reverse?

Uncertainty like this often leads to high volatility and excellent investment opportunities, but that may not be the case today. The Federal Reserve has guaranteed low returns for low risk assets (high quality bonds). This has pushed investors seeking even modest returns into riskier assets (equities). Money has flowed to the areas which have done best, widening the gap between winners and losers.

While stocks offer the promise of higher returns, some caution may be warranted. The S&P 500 valuation metric "price to expected earnings over the next twelve months," or "PE," is now at levels not seen since October 2000. Over the following ten years (11/1/2000-10/31/2010), the S&P 500 generated a negative return. During that period the Russell 1000 Growth Index had also been flying high, returning 71% the previous two years (11/1/98-10/31/00), only to return -22% over the next ten years.

There were areas of the market set to outperform in 2000. Over that same ten-year period (11/1/2000-10/31/2010), the Russell Mid Cap Value index was up 116%, having returned a mere 9% the prior two years. By way of reference, as of 6/30/2020, the Russell 1000 Growth returned 92% since 1/1/17, while the Russell Mid Cap Value returned a paltry 3.5%.

This presents difficult choices for investors. Investing in what is popular is easier than investing in what is out of favor. The areas of the market which have done the best are the most expensive, yet human nature draws investors to them like moths to a flame. The unloved parts of the market, such as "value" and small cap stocks, may more clearly reflect today's economic reality, and therefore may be valued more sensibly, but it is not easy buying and owning what is out of favor.

Diversification and patience are as important now as ever. The Portfolio Strategy Group firmly believes diversification serves our clients well over the long term, and we have the data to prove it. It can be frustrating when one sector outperforms so dramatically, but consistently timing the change is impossible. If history serves as a guide, when the reversal in leadership eventually occurs, it will be swift. Large Cap Growth last outperformed Small Cap Value by 33% over six months in 1998/1999, yet Small Cap Value outperformed Large Cap Growth by more than 41% in the second half of 2000. Our clients' total portfolio will not earn as much as the best performing sector. Instead, we aim to build investment plans consistent with each client's long-term goals and financial and emotional risk tolerance, which gets tested in times like these. Understanding the tradeoffs between the returns low risk assets offer and risk taken to achieve return goals is critical to maintaining proper asset allocation.