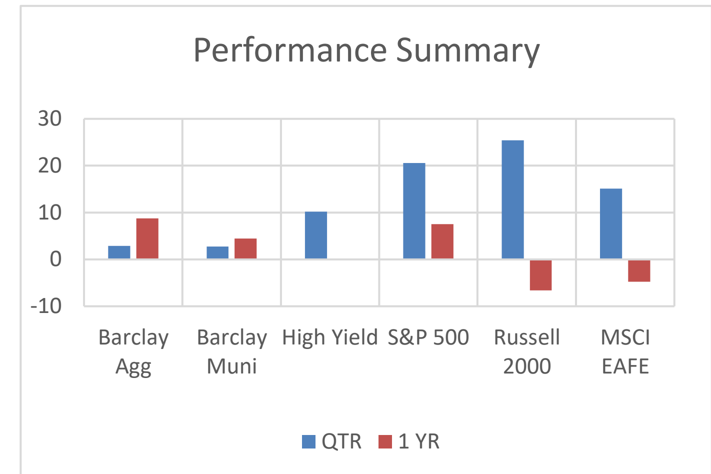
Year to date the stock market has been a tale of two quarters. After plunging 19.6% for its worst Q1 on record, the S&P 500 index soared 20.5% in Q2--the best quarter since Q4 1998. Investors' risk appetite surged in the second quarter in response to aggressive central bank actions to backstop both the U.S. and global economies. However, by quarter's end, some of that optimism waned as COVID-19 cases surged anew in the U.S.



For the quarter, stocks outperformed bonds by the widest margin since Q2 2009. Small-cap stocks rebounded and outperformed large stocks, finishing the quarter with a 25.4% gain. Growth stocks continued to outpace value, up 27.8% vs. 14.3%. Foreign stocks recovered, with developed market stocks up 15.1% and emerging market stocks up 18.2%. In June and early in July emerging market stocks have been the best performing stock category.

After a flight to safety in the first quarter, investors turned to riskier bonds in the second quarter. Core bonds were up 2.9%, while high-yield and emerging market bonds were both up over 10%. Overall, interest rates remain historically low and the yield curve was little changed from March to the end of June, having steepened dramatically in the first quarter.

The global economic recovery appears to have begun, making this likely the deepest yet shortest recession in post-war history. The case for a sharp recovery has been strengthened by recent economic data surprises. In the U.S., improving labor data, expanding manufacturing, and rebounding consumer activity have supported expectations for a potential acceleration from the Q2 trough. The primary risk to an economic recovery remains virus-related, followed closely by a resurfacing of global tensions with China. Upcoming elections may also be a source of increased volatility, as well as ongoing Brexit negotiations.

More Debt, More Liquidity, More Asset Reflation:

The Global Markets Strategy team at JPMorgan recently published a research paper on the impact higher levels of debt is having on liquidity and asset prices. Here is a summary of their findings. Similar to the 2008 financial crisis, the COVID crisis is causing a significant increase in the amount of total debt in the financial system. It is estimated that $16 trillion of debt will be added in 2020, bringing the total debt in the world (private and government) to a new record high of $200 trillion. **This will raise the total debt to GDP ratio for the world by close to 35%, from 243% at the end of 2019 to 278% by the end of this year, see chart.** A staggeringly high number and a far bigger increase than the 20% increase seen during the 2008 financial crisis.

Figure 1: Global debt levels vs. global bond yields

Source: BIS and J.P. Morgan calculations

The huge increase in debt has three main implications. First, the private sector is likely to save more, as we've seen after previous crisis. A persistently higher savings rate would keep economic growth and inflation low, and make it even more difficult for debt levels to decline vs. incomes in the future. **Second,** very accommodative central bank policy and low interest rates are likely to continue for a very long time in order to make it possible to sustain these much higher debt levels. The **third** implication is more liquidity in the financial system. More debt and more central bank stimulus in the form of quantitative easing, both imply more liquidity (extra money supply and cash) which may result in more asset reflation. **The bottom line is higher debt combined with easy monetary policy are helping to pump up the prices of both stocks and bonds.** No

one knows how long this cycle will last or the ultimate capacity for debt around the world. However, we do know that higher interest rates and/or inflation would likely bring an end to this debt cycle.

Election Implications:

With U.S. elections only a few months' away investors are busy projecting outcomes and implications. One scenario of growing interest is the potential for a Democratic sweep, setting the stage for a shift in the legislative agenda. **The current prediction markets imply the probabilities of a Democrat in control of the White House at 62%, the Senate at 61% and the House of Representatives at 85% (as of 7/7/20).** The consensus view of investors is a sweep by the Democrats would be a negative for stocks. The reality is more nuanced and may actually be neutral to a slight positive for markets. We'll have to see how much of Vice President Biden's campaign agenda is implemented if he is elected and what the make-up of his cabinet will look like. **History suggests that challengers to an incumbent typically campaign at an extreme only to converge to the center post-election.** It's also important to remember that his policy priorities were established in healthy economy prior to COVID-19 and are likely to change if the economy weakens. Here's a quick recap of Biden's major policies and whether they will have a positive or negative impact on markets: **1. increase corporate tax rates from 21% to 28%-** this would be a drag on earnings and likely reduce capital spending and corporate buybacks, a negative for stocks; **2. Increase the Federal minimum wage**- should increase aggregate demand with limited impact on margins, overall neutral for stocks but with significant winners and losers. **3. Softening on tariffs**- trade relations with China would likely improve and would be a net positive to global trade and the markets. **4. Higher infrastructure spending-** a net positive for earnings and the markets. **Overall, we think a potential Democrat sweep in November would be relatively neutral for the broad markets, however there are likely to be significant winners and losers**. **Industries that will likely benefit are**: Green technologies; healthcare; infrastructure; low labor intensity and high margin (i.e. tech); and U.S. China tariff de-escalation. **Industries that may underperform are:** defense contractors; private prisons; gun manufacturers; high labor intensity (i.e. retail, grocery etc.) and energy.

Closing Thoughts:

The extraordinary events of the past few months serve as a reminder of the benefits of diversification as well as the importance of paying attention to valuations and maintaining a long-term perspective in your investment strategy. Given the heightened uncertainty and volatility in the current environment, relying on timeless investment principles is more important than ever. One of my favorite (and smartest) investment strategists**, Howard Marks, recently described the three stages of a bull market in a recent commentary as follows**: **the first stage**, when only a few unusually perceptive people believe improvement is possible; **the second stage**, when most investors realize that improvement is actually taking place; and **the third stage**, when everyone concludes everything will get better forever. In hind-sight the first stage began in mid-March and culminated on March 23. At that time, very few people were thinking about economic improvement or stock market gains. We then passed briefly through stage two and straight to stage three. We think this accurately describes market activity over the past few months.

Looking forward, we think investors have factored in a lot of optimism for the economy and markets based on the Fed's injection of liquidity and the Treasury's stimulus payments creating a bridge to a fundamental recovery. **No one knows for sure how events will play out over the next year, which is a key reason we base much of our investment decisions on valuations and not forecasts.** As you read through our asset class commentary on the next page, keep in mind, our recommendations are driven by current valuations and long-term expected returns. Which are much easier to evaluate than short-term economic forecasts, profit recoveries, virus trends, etc. Please let us know if you have any questions or would like to discuss.

Asset Class		* ↔ Neutral weight ↓ Underweight ↑ Overweight
Equities	***View****	***Comments***
U.S. Large Cap	↓	The recent rally has brought valuations up to a historically high level. Given the uncertainty around the economy, earnings and increased volatility we are recommending an underweight to US stocks. We have a preference for high quality companies that are growing dividends and earnings.
U.S. Small/Mid Cap	↓	We are underweight small/mid-cap stocks for the same reasons mentioned above, with some additional concerns about high debt levels and less resilient business models.
International Developed	↔	Valuations are attractive for the long-term. We like dividend paying stocks but would focus on the highest quality balance sheets with consistent earnings power and relatively low payout ratios.
Emerging Markets	↔	Valuations are very attractive for the long-term. However, emerging markets tend to be high beta and are always susceptible to further selloffs in bear markets and volatile times. Wait till this crisis settles down and then upgrade to an overweight.

Fixed Income		
Investment Grade	↓	With the 10- year treasury yield near 0.65% we are under-weight core bonds. We recommend keeping some exposure for disciplined risk management and diversification purposes.
High-Yield Bonds	↔	We went overweight high-yield in late March, but have since reduced our rating to neutral as yields spreads have narrowed the past couple of months. As long as the economy is improving and rates are low, HY will perform well but it is no longer a cheap asset class.
Municipal Bonds	↔	We are neutral to positive on municipal bonds relative to Treasury bonds and they remain attractive for high tax-bracket investors.
TIPS	↔	Inflation break-evens are low and TIPs are a hedge for higher inflation. We are comfortable holding a position in tax-deferred accounts as a long-term hedge against inflation, and would favor them over traditional treasury bonds.
Floating-Rate Loans	↔	Similar to HY bonds we were overweight FRLs in late March, but have reduced our rating back to neutral as valuations have risen. We have some concern that rates aren't likely to increase any time soon, limiting the appeal of the floating rate feature.
Emerging Markets	↔	This asset class can experience big performance swings and direct exposure may only be appropriate for higher risk tolerant investors. We get some exposure thru our core bond managers and don't anticipate buying any direct positions.

Alternatives		
Absolute-Return/Alternatives	↑	We like this asset class and have raised our rating back to overweight given the strong rally in stocks and bonds. We like alternative funds as a way to hedge volatility and improve the risk vs reward in portfolios.
REITs	↓	REITs have rallied since the March lows and we are underweight in portfolios. We think many REITs may be structurally impaired in the future as a result of shifts in work habits and technology growth during the virus.
Commodities/Gold	↑	We view commodities as an effective way for long-term investors to diversify their portfolios and hedge against higher inflation. Commodities have been in a long-term bear market and when this cycle bottoms, we see significant upside. Gold has performed well as a hedge and small positions are reasonable in portfolios, we have also added positions in Silver.

U.S. Stocks
Market Performance, Second Quarter 2020

Index	Q2 2020	1 YR
S&P 500	20.54%	7.51%
Russell 1000	21.82%	7.48%
Russell 1000 Value	14.29%	(8.84%)
Russell 1000 Growth	27.84%	23.28%
Russell Midcap	24.61%	(2.24%)
Russell 2000	25.42%	(6.63%)

Source: Morningstar

- Global stocks rallied dramatically in the second quarter, led by US growth and tech stocks.
- Growth stocks continued their dominance over value and outperformed by a wide margin in the quarter and YTD. The relative performance of value stocks improved the past couple of months, but will need the economy to continue improving for that to continue.
- We continue to favor high quality dividend paying stocks that can grow both earnings and dividends. In this low interest rate environment they will continue to be attractive.

International Stocks
Market Performance, Second Quarter 2020

Index	Q2 2020	1 YR
MSCI EAFE	15.08%	(4.73%)
MCSI EME	18.18%	(3.05%)
MSCI BRIC	16.99%	0.02%

Source: Morningstar

- Foreign developed markets have bounced nicely in the second quarter and continue to look attractively valued compared to US stocks.
- Twin deficits in the US are ballooning, and when this crisis ends we expect the US $ will trade lower. If the Dollar does sell-off we think it will be a catalyst for better foreign stock performance. Emerging markets, particularly value stocks, may offer the best absolute return potential over the next 5 years.

Fixed Income

Market Performance, Second Quarter 2020

Index	Q2 2020	1 YR
Vanguard Total Bond Index	2.95%	8.85%
Barclays Muni Bond	2.72%	4.45%
Barclays US Corp High-Yield	10.18%	0.03%
JPM GBI- EM Global Diversified	9.82%	(2.82%)
iShares TIPS Bond	4.32%	8.32%
BofA Merrill Lynch 3 month Treasury Note	0.31%	1.89%

Source: Morningstar

- Core bonds were positive for the quarter, up 3.0%. With interest rates at current levels we would be underweight core bonds.
- High-yield bonds have rallied sharply and we are neutral. In more aggressive accounts we think they have the potential to outperform as long as we avoid an economic downturn.

Alternative Assets

Market Performance, Second Quarter 2020

Strategies	Q2 2020	1 YR
PIMCO All Asset All Authority	13.13%	(7.19%)
AQR Diversified Arbitrage	9.91%	5.42%
JPMorgan Hedged Equity	9.06%	9.30%
Vanguard REIT	13.44%	(6.98%)
BNY Mellon Global Real Return	8.57%	1.12%

Source: Morningstar

- Most alternative performed well in the quarter and significantly outperformed bonds. We continue to like select managers, gold and silver as diversifiers and hedges against further market volatility.
- We like alternative assets as a strategic way to reduce risk and increase absolute returns in portfolios. We plan to maintain a position in alternative assets unless we see a significant pullback in traditional assets. We expect alternatives to significantly outperform bonds over the full market cycle.

Appendix:

Benchmark Definitions

U.S. Equity		Description
S&P 500	Index	The index includes 500 leading US companies and captures approximately 80% coverage of available market capitalization.
Russell 1000	Index	The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe and includes approximately 1000 of the largest securities. The Russell 1000 represents approximately 92% of the U.S. market.
Russell 1000 Value	Index	The Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values.
Russell 1000 Growth	Index	The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.
Russell Midcap	Index	The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.
Russell 2000	Index	The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.
International Equity		**Description**
MSCI EAFE	Index	The EAFE (Europe, Australasia, Far East) index consists of 21 developed market country indexes, excluding the US & Canada. It is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets.
MCSI EME	Index	The index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets and includes 23 emerging market countries in the index.
MSCI BRIC	Index	The index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the following four emerging market country indexes: Brazil, Russia, India and China.

Fixed Income		Description
Vanguard Total Bond Index	Index Fund	This index measures a wide spectrum of public, investment-grade, taxable, fixed income securities in the United States—including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.
Barclays Aggregate Bond	Index	The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-through bonds), ABS, and CMBS sectors.
Barclays Muni Bond	Index	The U.S. Municipal Indices cover the USD-denominated long term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.
Barclays US Corp High-Yield	Index	The index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market and excludes Emerging Markets debt.
JPM GBI- EM Global Divers	Index	The index tracks returns for actively traded external debt instruments in emerging markets. Included in the index are US-dollar denominated Brady bonds, Eurobonds, and traded loans issued by sovereign entities.
iShares TIPS Bond	ETF	The iShares TIPS Bond ETF seeks to track the investment results of an index composed of inflation-protected U.S. Treasury bonds.
BofA Merrill Lynch 3 month Treasury Note	Index	The 3-month US Treasury Note Index is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue.
Alternative Assets		**Description**
PIMCO All Asset All Authority	Mutual Fund	The investment seeks maximum real return, consistent with preservation of real capital and prudent investment management. The primary benchmark for the fund is the S&P 500, with a secondary objective of Consumer Price Index +650 basis points.
AQR Diversified Arbitrage	Mutual Fund	The investment seeks long-term absolute (positive) returns. It invests in a diversified portfolio of instruments, including equities, convertible securities, debt securities, loans, warrants, options, other types of derivative instruments.
JPMorgan Hedged Equity	Mutual Fund	The investment seeks to capture the majority of the returns associated with equity market investments, while exposing investors to less risk than other equity investments. The fund invests in a broadly diversified portfolio of common stocks, while also selling index call options and purchasing index put options.

Alternative Assets		Description
Vanguard REIT	ETF	The investment seeks to provide a high level of income and moderate long-term capital appreciation by tracking the performance of a benchmark index that measures the performance of publicly traded equity REITs.
BNY Mellon Global Real Return	Mutual Fund	The fund allocates its investments among global equities, bonds and cash, and, generally to a lesser extent, other asset classes, including real estate, commodities, currencies and alternative or non-traditional asset classes and strategies, primarily those accessed through derivative instruments.