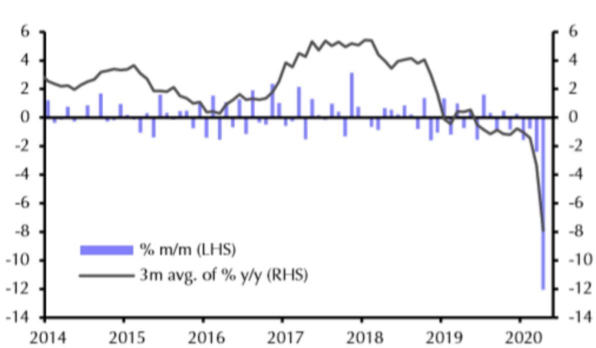
A GRAND PERIOD OF REFLECTION

QUARTERLY COMMENTARY – 2Q 2020

The system is being pushed to new extremes. In addition to the economic and health crises, the country is facing increasing political and social polarization. The cumulative events of 2020 has placed an enormous amount of strain on our democracy, and at times, our experiences today seem to resemble the many challenges we faced as a nation during the 1960s counterculture era. Media narratives from both the left and right produce sensationalized coverage on every story. Socially, we are re-testing the moral fabric of the country, and bringing to light the good, the bad and the ugly. Discrimination, biases, and decision making in various social and judicial constructs are being re-examined, as they should be, to create a more just environment for all. Economically, we have never seen such crushing blows to our workforce, and economy in nearly a century. The incoming data has truly been breathtaking. The whole system is being re-examined by governments, corporations, and consumers. Every major corporate management team around the globe is re-evaluating office capacity and utilization. Workers are re-thinking their proximity to their office sites in anticipation of more flexible work mandates rolled out by their management teams, which in turn can alter property values in dense city centers. Property owners are probably thinking about how to re-purpose existing properties that remain vacant in their current state. Pockets of glut across our supply chains, corporate structures, consumption patterns and preferences are all in for a big change. A vaccine may very well appear sometime next year, but it is hard to imagine a world where we go back to pre-COVID behaviors. Let's see how markets interpreted all of this action in the second quarter.

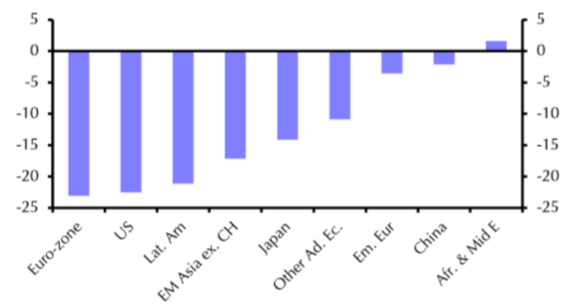
<u>Economic Update and Outlook:</u>

Chart 1: CPB World Trade Volumes



With another quarter now behind us, we finally have some bottom-up data points to draw on to help guide us through this recovery. And while there is a lot of news to digest here, we believe that with thoughtful selection, there are some very compelling opportunities that we can take advantage of. In short, the first half of 2020 further exhausted traditional asset classes (stocks and bonds) in terms of their return potential. Stocks became more expensive in a deteriorating economic backdrop, and bond yields more or less, hover closer to zero band than ever before. Uncertainty was and will remain in the picture for a long time to come. Stock market volatility as measured by the VIX Index remained elevated, closing the quarter at 30.23.

Chart 2: CPB World Export Volumes Country breakdown (% m/m)



As expected, the economic numbers were unprecedented. The April trade data showed the sharpest ever recorded monthly contraction, confirming the heavy blow the coronavirus lockdown had on global commerce. A closer look at this trade volume data shows that the Euro-zone and the US were hardest hit, where exports had fallen by over 20% month over month. Other regions appeared to hold up slightly better, namely emerging economies in aggregate than in advanced economies, where Latin American countries and Asian countries outside China experienced very sharp falls.

As for the labor markets, the early weeks of the COVID-19 shutdown resulted in 20.1mn people filing for unemployment claims, representing about 12.2% of the US labor force. During the quarter, unemployment spiked from a low of 4.4% in March to 14.7% in April (FRED St. Louis Fed data). The May print highlighted some improvement, closing the month at 13.3%. June surprises followed, with an additional 4.8mn jobs and brought the rate down to 11.1%. The question that should be asked is "just how permanent are these recovered jobs?". Any elevated unemployment rate will weigh on confidence and income growth, which in turn, handicaps a rapid rebound in external demand.

A historical look at unemployment recovery timelines paint a harsh reality, and make it clear that this recovery will be a grind (Exhibit 3, Franklin Templeton and US Labor Department):

- The 1990 recession saw a rise in the unemployment rate from 5.2% to 6.8%. It took 65 months to return to 5.2%.

- The 2001 recession saw a rise in the unemployment rate rise from 4.2% to 5.9%, which 14 months never to regain its pre-recession level.

- During the GFC, it took 23 months for the unemployment rate to rise from 4.7% to 10%. It would be another 85 months until we reached 4.7% again.

Exhibit 3: Historical Unemployment Rates:

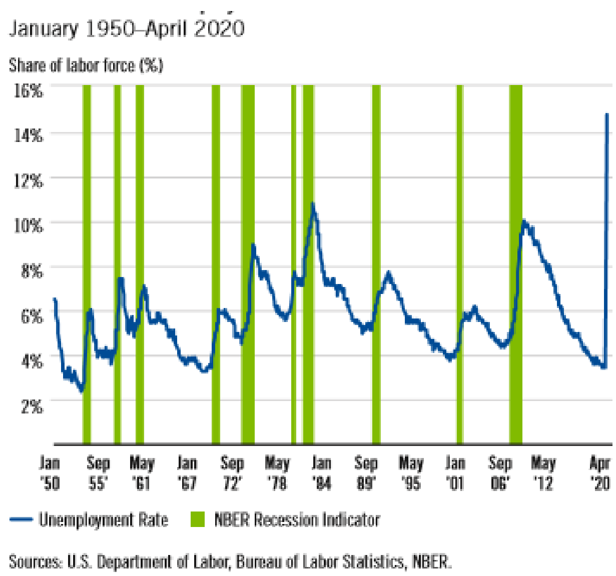
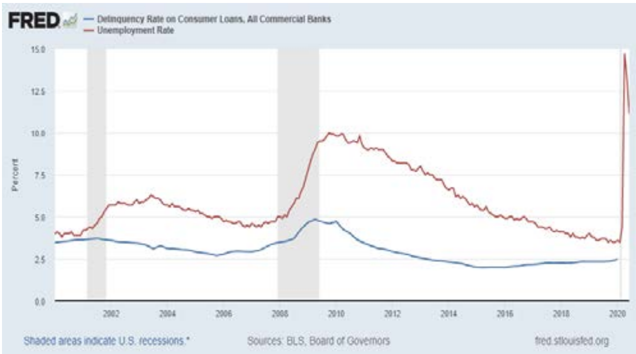
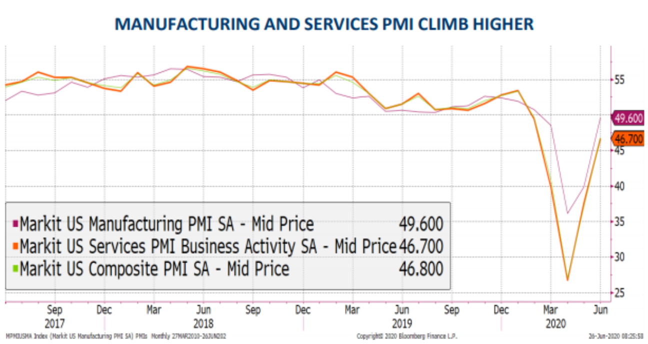


Exhibit 4: Chart of Unemployment Rate and Delinquency Rate on Consumer Loans as of May 2020:



With all of that said, it is worth highlighting some of the economic bright spots that emerged during the quarter. The June manufacturing and services PMI measures (the Purchasing Managers Index is a measure of the prevailing direction of economic trends in manufacturing. The PMI based on a monthly survey of supply chain managers across 19 industries, covering both upstream and downstream activity) rose strongly in June as the economy continued its re-opening. The manufacturing index's strong rise to 49.6 was a good sign, along with the strong composite print of 46.8 , see Exhibit 4.(any print above the 50 level is considered a period of expansion). Considering the depths of the reading back in April, the speedy snapback was a very positive sign. In addition, delinquency data for non-mortgage receivables (credit cards, auto loans) came in much better than expected. Now some of this is certainly attributable to the swift fiscal stimulus checks that were issued to consumers. We will continue to monitor these areas to understand the ongoing health of the consumer and the ability for demand to pick backup from here. Exhibit 4 charts both the unemployment rate and the delinquency rate, which illustrates the high correlation historically observed by these two data points. If households and businesses are willing to spend, production should eventually rise to meet demand, providing a boost to exports into the second half of 2020. Unfortunately, the bigger question is whether demand will hold up in the face of the resurgence in infections. Several states are now slowing or temporarily pausing their reopening plans. FL and TX, where positive test rates are rising, have re-closed partially open bars. Restaurant bookings fell sharply in affected metro areas according to several real time data sources. After the sharp recovery data seen in April and May, June data already reflects a slowdown in the recovery pace. This weakness is not a surprise given that daily U.S. coronavirus infections rose by 60% during the month, with epidemics quickly rising in three large states (TX, FL, and AZ). With that said state officials are keeping an open mind as long as hospital capacities are not constrained- new rounds of broad non-essential business closures are not in the plans as of now.

Exhibit 4: Manufacturing and Services PMI Indices:

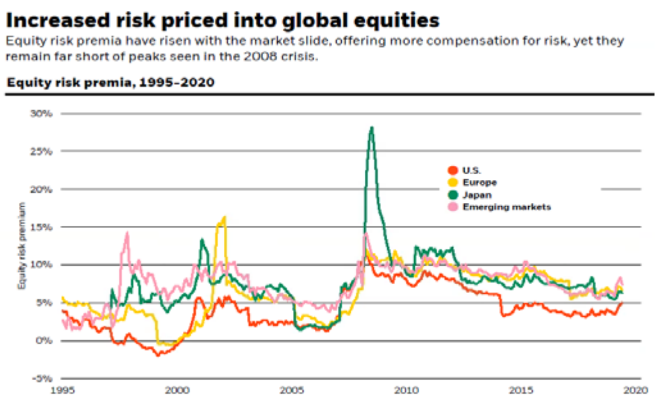


Data Source: Bloomberg

If new infections were not enough, the recovery is up for another test when fiscal stimulus concludes at the end of July. According to Carlyle Group, stimulus checks and "bonus" unemployment insurance combined to account for 15% of household income in Q2-2020, leading to a 7% increase in households' checking account balances despite a -8.5% decline in wages and salaries. An extension is likely, and necessary given the weak employment data. Four months of assistance to households and small businesses already consumed 12% of GDP, which is about twice as much fiscal stimulus as in other advanced economies on average (Source: Carlyle Group). The good news is that the Fed and federal government have voiced that additional assistance is being worked out. At this point, the worst is likely behind us, both in terms of economic output and market liquidity.

Equity Markets:

Exhibit 5: Rolling Chart of the Equity Risk Premium:



Equity markets have displayed an astonishing recovery since March. The S&P 500 Index experienced a near 34% correction at a record pace, only to be followed by a rapid recovery that saw the index rally from a March 23rd low of 2237.40 to 3100.29 by quarter end. This is a near 40% recovery!

Frankly, we are stunned by the staggering disconnect that is observed today between equity prices and their underlying business fundamentals. With that said, equity returns during this second quarter are a perfect illustration for why investors need to take a strategic allocation the asset class-timing is a difficult game. There are many ways to measure the perceived valuation of equities. A common valuation measure utilized by many large allocators is gauging where equity risk premium levels sit relative to history vs. the risk-free rate. The equity risk premium is understood as the additional return an investor should expect to earn by taking on the risks embedded in stocks relative to risk-free bonds (treasury bills). The move seen in equity risk premiums in Exhibit 5 reflects only a slight rise in attractiveness given the market drawdown in March. They are far short from the peaks seen in the other contractionary periods.

The following charts further highlight the puzzling dilemma we face:

The forward-looking price to earnings multiple (forward P/E ratio) confirms the stretched valuations of equities today. The only other period where stocks traded at a higher forward P/E ratio was back in 2000, when they traded nearly at 24X the 1 year forward earnings. At these current levels, history highlights that there is very little juice left in the squeeze. Subsequent 1 and 5 year returns from current valuation levels look dismal. Exhibit 7 below, shows that historically, investors earned a near zero return or a slightly negative return from this type of elevated multiple level. Equity markets have clearly priced a sharp recovery in economic output and consumer demand. To us at least, the pricing mechanism is "out of order", where the incoming economic data will likely need to surprise consistently to the

Exhibit 6: A historical chart of the S&P 500 Index (as of June 2020), and valuation characteristics prior to various market corrections:

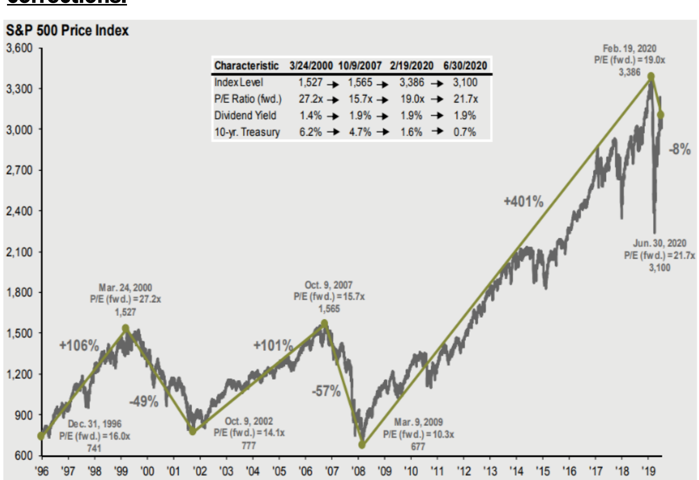
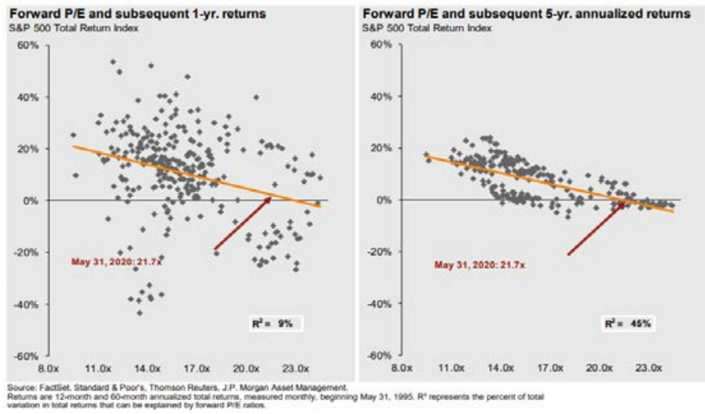


Exhibit 7: A historical plotting of forward P/E ratios and subsequent 1-year and, 5-year returns:

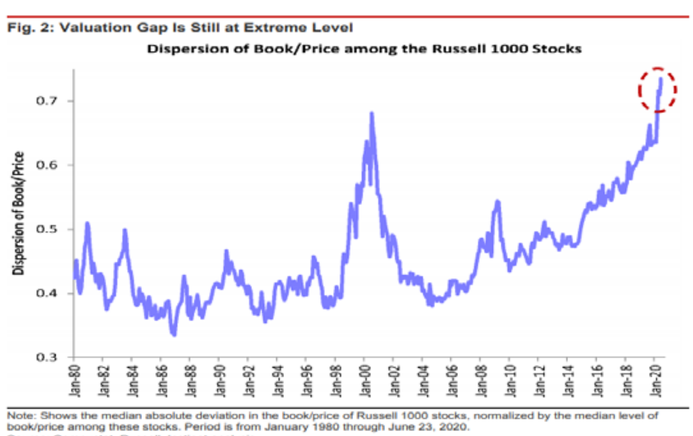


upside at this point to justify today's pricing per unit of earnings. It will likely be several years before we grow into a pre-COVID type earnings environment.

There's more to it than just the high valuations we are witnessing at the index level. By looking underneath the hood, you can get a glimpse of other extraordinary shifts. As highlighted in our previous commentaries, the nosebleed valuations seen across growth stocks today is unprecedented, having only worsened over the first half of 2020. Exhibit 8 shows this valuation gap as of June 23rd. The chart presents the dispersion in book/price ratios seen among Russell 1000 Index stocks. *It is the widest it has ever been in history!* It is worth highlighting that the growing valuation gap of the index is due to expensive stocks getting ever more expensive over the past decade, while cheap stocks remained relatively range bound until the recent COVID-19 crisis. This dynamic is shown using Exhibit 9 below.

Some final thoughts on our equity outlook. In addition to tough a earnings season ahead, equities face several other risks. A Biden victory, coupled with the Democrats winning control of the Senate, could present a backdrop where we see a meaningful increase in corporate taxes. If you recall, the last boost in corporate earnings was driven by Trump's fiscal stimulus (corporate tax cuts) back in 2018. I do not want to give the impression that such an outcome equates to a guaranteed tax hike because there are certainly other factors at play. If the Democrats do win a majority, they still do not represent a super-majority in the Senate, making it very difficult to pass major tax legislation. If corporate taxes were to be increased, it is believed that it would be part of a broader fiscal package that includes increases in government spending, and therefore mutes its negative impact on GDP. With that said, any hit to earnings growth from here is a negative risk for equity returns.

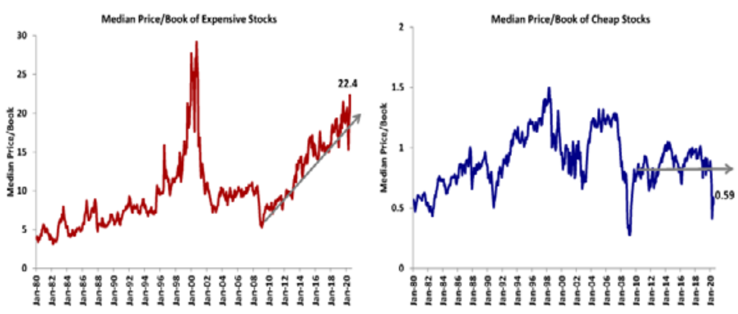
Exhibit 8: The Valuation Dispersion Observed in the Russell 1000 Index:



Secondly, international, and domestic geopolitical risk is a re-emerging theme that threatens mega cap, and tech firms. These firms have meaningful exposure to escalating China-US retaliatory trade restrictions, in addition to domestic political risk around social media boycotts that decrease their advertising revenues. Lastly, anti-trust/regulatory risk is always a looming factor as Biden's poll numbers improve dramatically.

Given their stretched valuations, various political risks, and the difficult earnings season ahead, we believe underweighting exposure to growth names at this time is the prudent allocation decision. Value and small cap stocks on the other hand have much more upside from here assuming there are positive coronavirus surprises. As some of the economic data above highlighted, we seem to be departing the trough of the downturn. If deaths remain relatively muted throughout this second wave of infections (many of the new infections are younger populations that have lower mortality rates), and/or we get a tapering off in infection rates, we believe value and small cap exposures are the winners in a risk-on rally from here.

<u>Exhibit 9 Median Price to Book Metrics on Stocks:</u>

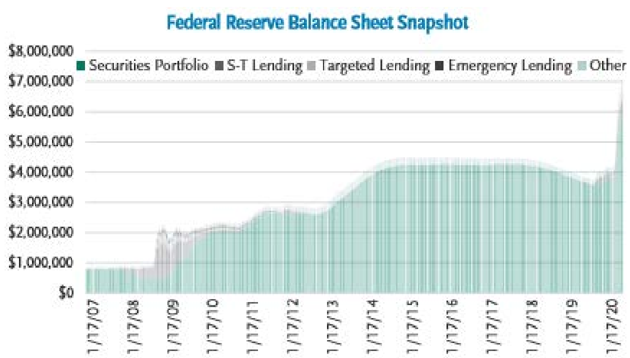


Note: Shows the median price/book multiples of the expensive decile of Russell 1000 stocks (excluding companies with negative book value). Period is January 1980 through June 23, 2020.
Source: Compustat, Russell, Instinet analysis

Note: Shows the median price/book multiples of the cheap decile of Russell 1000 stocks (excluding companies with negative book value). Period is January 1980 through June 23, 2020.
Source: Compustat, Russell, Instinet analysis

<u>Fixed Income and Credit:</u>

<u>Exhibit 10: A Look at the Federal Reserve Balance Sheet:</u>

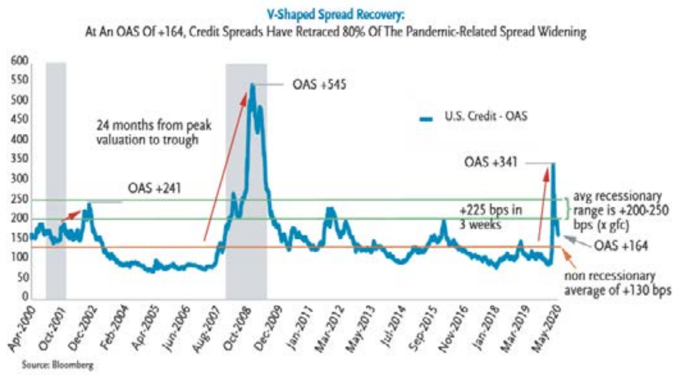


Source: Jeffries, Federal Reserve

Fixed income investing in the US has become an even more challenging endeavour given the low level of yields. This dynamic has long been a global phenomenon given central banks' appetites to borrow their way our out of every crisis. To date, roughly $11.8trn dollars of bonds globally trade at negative yields. Since March, bond yields across the US, UK, Germany and Japan markets have generally found some level of stability. The US 10-year Treasury yield ended the second quarter at roughly 65bps. The Fed remains heavily involved in facilitatiing the functioning of capital markets, maintaining their promise of low rates, and continued purchases of bonds. Its recent growth in Treasury and Mortgage Backed Securities bond buying has increased its balance sheet by $3trn dollars. Similar to past contractionary periods, credit extension and borrowing has been substituted for real savings/equity. The decoupling of assets prices from underlying data also took place in credit markets this period. Spreads retraced nearly 80% of the COVID related widening seen in March. The chart below helps illustrate this overshoot relative to historical averages.

After the Fed alleviated liquidity concerns, there were record inflows into credit markets from both domestic and overseas investors. Issuers met this demand by borrowing $262bn from IG bond investors in May, which was the second highest supply month on record. YTD supply stood at $1

Exhibit 11: A Look at Historical Corporate Credit Spread Levels:

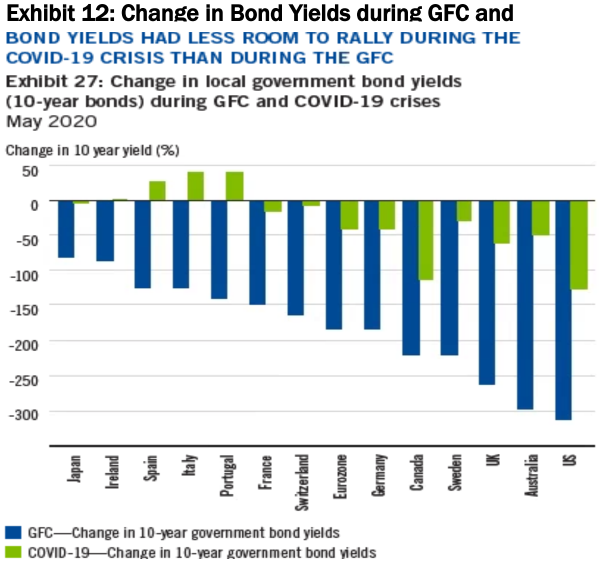


trillion in just five months! This is an increase of 95% vs. the same period last year. While it is great to see firms being able to tap into capital markets, the net increase in debt levels will have to be addressed at some point. The credit extension was obviously necessary to bridge the gap in output for both corporations and households. While there is no vaccine on the public health front, the economic medicine of the Fed is an even stronger dose of borrowing.

In summary, our fixed income and credit outlook is one of caution. A "normal" recession usually brings a decrease in leverage across the economy, where any issuance of government debt to provide fiscal stimulus is offset by declines seen in private sector debt. These typical downturns are characterized by tighter financial conditions and a rise in defaults that ultimately force households and non-financial businesses to de-lever their balance sheets. Contrast that with what we are witnessing today- while we see a containment of household debt levels, we are also seeing an unusual rise in non-financial business debt (which already stood at record levels prior to the pandemic). Fed purchase programs were effective in creating liquidity for credit markets, but it does not for solvency. By the end of Q1, corporate credit levels jumped to 342% of GDP from a level of 327% the previous quarter (Source: Capital Economics). It remains to be seen if this renewed round corporate borrowing was "precautionary" or if it is being used to fund operating losses. Total public sector debt increased to 23trn (106% of GDP). Perhaps the only silver ling here is that household balance sheets are in better shape today than they were coming out Great Financial Crisis.

We maintain our view that traditional bonds and credit have become less attractive, and re-emphasize our case for finding both duration and credit substitutes largely because of the following two concerns (read our last publication which provides an understanding of how we source and allocate to such alternative subtitutes here):

Exhibit 12: Change in Bond Yields during GFC and



- With rates having already traded below zero in some developing countries, and with the US now inching even closer to the zero bound, the upside return potential in bonds is likely to be muted. We continue to underweight duration-focused strategies as a result, which may not provide the same protection for investors as they did in past periods. This makes sense given the limited room for yields to move down from here. See Exhibit 12.

- Increasing fiscal deficits across the globe hurt the case for government bonds to serve as a stabilizer to portfolios in periods of volatility. Secondly, levels of corporate credit have increased meaningfully, while sectors outside of

COVID sensitive areas are nearly trading at their pre-COVID crisis tights in terms of spread levels.

Final Thoughts and Conclusion:

The point is that a heightened level of uncertainty has entered the picture and is here to stay. Central banks moved quickly to ease financial market stress by expanding purchases of assets ranging from sovereign bonds to non-investment-grade corporate debt, and as a result, investors seem confused about the differences between financial market liquidity and private sector insolvency risk. We think asset prices, in general, have yet to reflect this type of transition. One of the few positive developments of this period has been the considerable fall in carbon emissions following the lockdowns. During a four-week period beginning in February, China, the world's largest producer, saw a 25% reduction in emissions. In Europe, the daily carbon emissions fell by 58%. The virus's impact on markets reminds us that environmental and social issues are financial risks that are all interconnected and need to be taken into consideration. More importantly, the various crises we are dealing with now reveals the need to invest in flexible measures before the storm arrives. This grand period of self-reflection hopefully guides us towards a path of recovery that better prioritizes not just financial maximization, but an economic recovery that much more heavily considers a system of sustainability from an economic, social, and political perspective. How we get there remains to be seen, but we believe our philosophy of incorporating alternative assets and strategies in these very uncertain times is the best way to navigate our client portfolios. Thank you again for your trust and support.

Best,

Johann Lee, CFA

Director of Research

Appendix:

Barclays Capital US Aggregate Bond Index: The index consists of approximately 17,000 bonds. The index represents a wide range of securities, from investment grade and public to fixed income.

ICE BoAML HY Index: The index is a commonly used benchmark index for high-yield corporate bonds. It tracks the performance of US dollar denominated below investment grade rated corporate debt publically issued in the US domestic market.

Russell 3000 Index: The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the FTSE Russell that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities.

MSCI ACWI (All Country World) Index: The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI Index is comprised of stocks from both developed and emerging markets.

S&P 500 Index: S&P 500 index is a float-adjusted market-cap weighted index, largely reflecting the large-cap US equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

Purchasing Managers' Index (PMI): PMI Index is an indicator of economic health for manufacturing and service sectors. The purpose of the PMI is to provide information about current business conditions to company decision makers, analysts and purchasing managers.

ISM Manufacturing Index: The ISM Manufacturing Index is a widely-watched indicator of recent U.S. economic activity. The index is often referred to as the Purchasing Manager's Index (PMI).

CBOE Volatility Index (VIX Index): The VIX Index is a real-time market index used to measure the market's expectation of future volatility. Being a forward-looking index, it is constructed using the implied volatilities on S&P 500 index options (SPX) and represents the market's expectation of 30-day future volatility of the S&P 500 index which is considered the leading indicator of the broad U.S. stock market.

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