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Two Steps Forward, One Step Back...

Scott Loyek, CFA®, *Managing Director, Portfolio Manager*

I want to begin this update by pointing out a bit of good news; WE ARE MORE THAN HALFWAY THROUGH 2020! Even in periods of chaos, time passes and progress is made. Granted it may be hard to see that progress in the daily 24-hour news cycle.

In watching the response to the Coronavirus, I am reminded of taking my children to the beach for the first times. First, we would quarantine them in a tent or pool far away from the surf. Gradually we opened the beach to them, just a little, letting them run on the sand and play in tide pools and maybe even the surf. Next comes the time to check out the waves. This slow feeling out process had a two steps forward, one step back feel to it, but eventually you make it all the way; then a crab bites your foot. The point of this somewhat silly story is that we are undergoing a similar physical and psychological challenge today as we try to search for some semblance of normalcy.

Play Ball!

My love of baseball coincides perfectly with this industry's penchant for measuring financial events in innings. Unfortunately, this year the baseball season is starting about three and a half months late and will include less than half the regular number of games. This might be an apt description of the economy as well.

It may bring a certain level of dismay to you when I suggest that we are probably in the very early innings of this game - a game that was delayed by rain for the better part of 3 months. The period of the economic shutdown was much like the first half of the baseball season, it was just lost. Only as we begin to venture out and re-open will we get a sense of just how much damage has been done. To borrow a phrase from a friend of mine, *"It is hard to be worse than the worst ever."* This was said in the context of a likely improvement in economic data we expect to see as the effects of the government mandated lockdown fades.

Unemployment Claims as a Percentage of U.S. Population

Year	Description	Peak (MM)*	% of Population
1975	Stagflation	2.24	1.0%
1980	Fed Tightening (Volcker)	2.52	1.1%
1982	Double Dip	2.70	1.2%
1991	Desert Storm	2.01	0.8%
2001	Dot.com	1.96	0.7%
2009	GFC	2.64	0.9%
2020	Great Lockdown	23.16	7.1%

** Worst 4-week sum*

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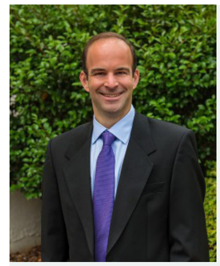
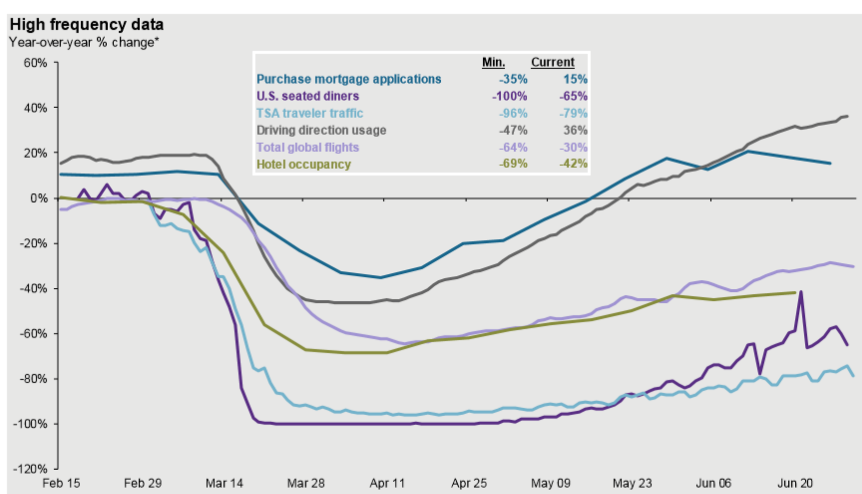
Several economically important states are still in the early stages of their re-opening. For me the question is not the direction of economic activity, as it will certainly improve, but the magnitude of the recovery. I would argue that we are able to see economic recovery in the range of 60-80% of pre-Covid levels this year, but there is a lot of difference between 60% and 80% when you are talking about a 22 trillion dollar economy. I think the appropriate way to think of re-opening is not as some orderly planned out process to return the economy to normal. Rather I view it as a gradual testing process with the goal of reaching the point of maximum economic activity possible with an "acceptable level of health risk." In this context, I think it is fair to say "re-open" is proceeding as a reasonable person would expect it to. We have gotten a lot right and are adjusting as we learn from our mistakes and focus on those areas where there is the best return for our efforts.



Scott consults with TSWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TSWM in 2006.



Source: Apple Inc., FlightRadar24, Mortgage Bankers Association (MBA), OpenTable, STR, Transportation Security Administration (TSA), J.P. Morgan Asset Management. *Driving directions and total global flights are 7-day moving averages and are compared to a pre-pandemic baseline. *Guide to the Markets – U.S.* Data are as of June 30, 2020.

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On the positive front, we understand both the way the virus spreads and how to treat those who are infected better than we did 3 months ago. Obviously, there is still a long way to go, but the progress made has been undeniable. As this information works its way through the media and various levels of government, we expect clear and consistent recommendations to emerge. The optimism from medical experts around a vaccine in record time is encouraging. Particularly since it is the vaccine or treatment front that brings us to the point where we can start discussing economic activity returning to 100% or more of pre-Covid levels.

Driving Blind?

As investors, we are driving in the dark with no headlights right now because we have no ability to project the short-term prospects for the economy. The ranges of projections are very large and provide little usable insight. In this environment we have chosen to move slowly and try and stay safe. We are confident that the sun will come out eventually, and we want to make sure we don't have an accident before it happens.

To that end, clients might have seen a higher than normal level of activity in their accounts over the last few months. Rest assured this activity was not driven by panic but opportunity. First, many of our clients with taxable accounts were able to harvest significant tax losses to offset future gains by swapping one investment for a similar one amid market turmoil. Most of our clients took advantage of the panic in the markets during March and April as part of normal portfolio rebalancing and were able to add money from cash or bonds to equities at very attractive prices. I am often teased in the office because of the level of excitement I feel when there is true panic in the market. There definitely was a period in this correction where I was amazed at the prices at which we were able to make a number of good investments.

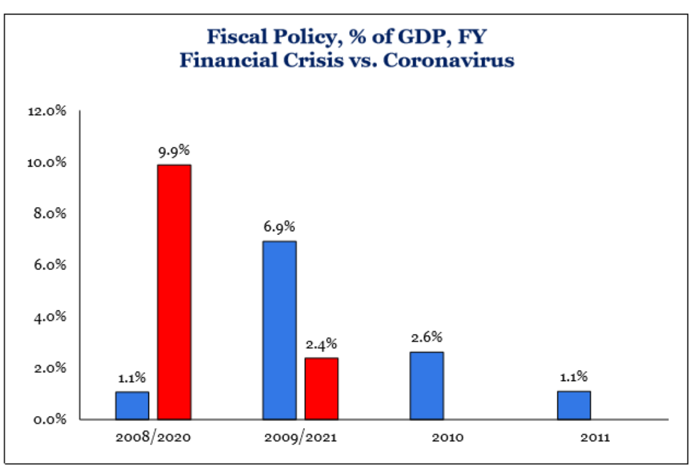
We are focused on a few key milestones that will inform our expectations. First on this list is identifying where the equilibrium level of economic activity is during the re-opening process. Stated differently, how close to normal activity can we get before we are able to contain or cure the virus? Will schools open in the fall? Are we able to move past phase 2? How many businesses will re-open? These are all key considerations that will determine how much damage has been done.

The second thing we are focused on is the point at which we achieve containment or are able to cure or vaccinate against the virus. This will likely be the emotional highpoint for the general public. From an economic perspective, this is the point where we go from trying to contain the damage to moving forward again and where we will have a true understanding of the strength of the economy. It is also the point at which we would expect to be able to access the likely path to recovery.

This will also presumably be the point at which we have some feel for what will drive growth and serve as the catalyst to motivate business and private investment. There are many potential growth engines out there, infrastructure improvements; 5G Internet build out, and other technology based innovations just to name a few that could potentially spark the next leg of economic growth. This type of focused investment would likely be the final ingredient for getting back to a truly normal level for the economy.

You Don't Want to Miss the Victory Party!

We don't know when or exactly how the recovery will begin but we would not want to miss it when it comes. The reason for this is the historic amount of both monetary and fiscal stimulus being injected into the economy. It seems a bit repetitive to be talking about how accommodative the Federal Reserve has been, as friendly monetary policy has largely characterized the last decade. Though it is hard to believe we find the Fed more dovish than ever injecting unprecedented stimulus into the economy.



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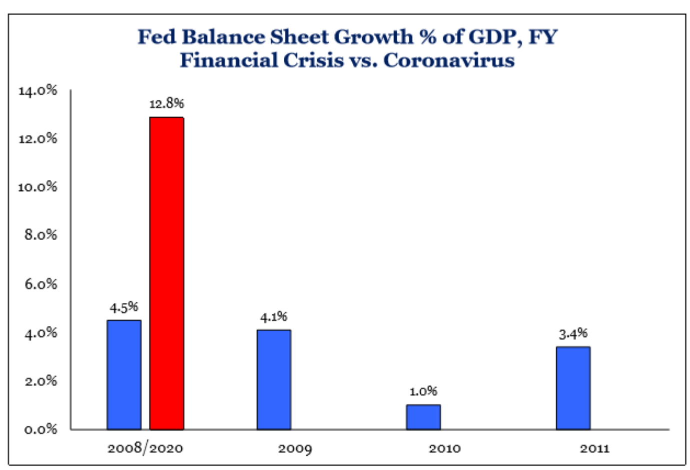

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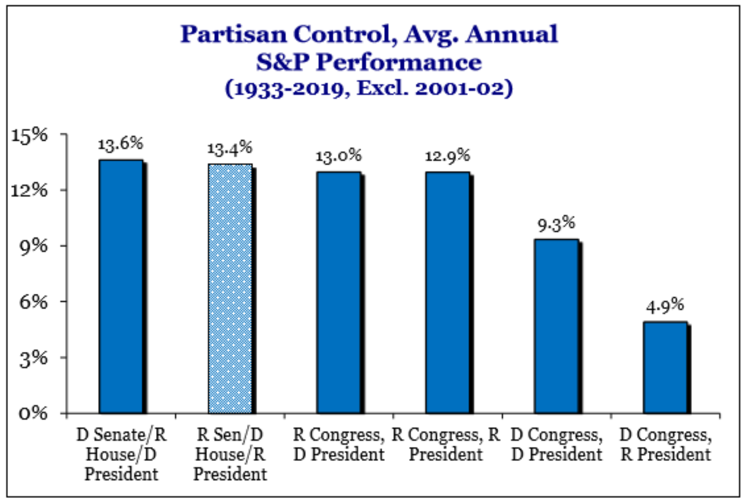
The unusual thing, at least for the recent past, is that these Fed actions are being complemented by fiscal policy. Dating back to the Great Financial Crisis we have not really had a sustained period of monetary and fiscal policy coordination and we have never seen fiscal policy of this size. We have significantly more fiscal stimulus today than we saw following the Great Financial Crisis and, at least so far, none of the regulatory policies that partially offset the benefits of those programs. Similarly, the current stimulus package is larger than the tax cuts of the last few years and has not been accompanied by rising interest rates or trade disruptions.

Coordinated monetary and fiscal policy has historically been a powerful force and one we would not want to bet against. There certainly will be some challenges caused by lingering effects of the shutdown and societal shifts but, at least for the intermediate term, we think there is a potential for these negatives to be overwhelmed by this wave of stimulus. If we can avoid policy errors in the near term we feel that the prospects for recovery are quite good.

It Matters Less Than You Think.

It is an election year, so we have to acknowledge the fact that at least for the short-term some market uncertainty caused by the political headlines is to be expected. As this chart highlights, there is little value in trying to make investment decisions based on politics. For example, who would have expected oil companies to flourish under Obama's regulatory policies and struggle under Trump's. My point here is simply that there is a lot more than politics that impact the economy and it is very hard to predict who the ultimate beneficiaries of policy might be. Regardless, the media and markets will undoubtedly bring up some consistent themes; my hope is to be objective and offend no one or at least offend everyone equally as I briefly discuss them.



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I do think the markets are at least mildly concerned about the potential for a Democratic sweep. This scenario would likely result in a higher risk of an economic policy error in the early stages of a recovery. The rise of the Progressive wing of the Democratic Party does concern investors for a variety of reasons. Higher taxes are in all probablility unavoidable over time, but the pace and structure of those reforms can have vastly different impacts. The worry is this sweep scenario has some risk of resulting in large ideologically driven changes, versus a more gradual balanced approach.

Conversely, the market is relatively indifferent to the outcome of the presidential election should the Republican Party maintain control of the Senate. Interestingly, a Biden win combined with a Republican majority is often suggested as the most bullish scenario for the stock market, as it removes the likelihood of major tax increases and reduces the risk of further trade conflicts. Similarly, a Trump re-election likely brings with it meaningful individual level tax reforms similar to the corporate reforms we saw in his first term.

The election tends to impact the markets around the party conventions, and historically we have seen that the incumbent's odds of re-election are correlated with the stock market performance during this period. An increase in the market is often indicative of re-election while a decline is predictive of change. It is far too early to have any real expectations of how the election will play out. How the recovery evolves will have a significant impact on what ultimately are the key issues in the election.

What's Next?

We are likely past two significant negative events. First, there is consensus that the stock market bottom was reached in late March. The panic and illiquidity we felt in the markets during that time is unlikely to return given the measures the Federal Reserve has put in place. Second, the economic bottom in all probability has also been reached as we are unlikely to shut down the entire economy again and we have seen some recovery in most major economic statistics.

Without question we are in a period of transition. The recovery in the stock market has far outpaced that of the economy. However, even within the stock market the recovery has not been evenly distributed across the economic sectors. Similarly, the damage to the economy has not been evenly distributed. Earnings for the market are expected to fall considerably in the short term and we are guessing at best when we attempt to predict them.

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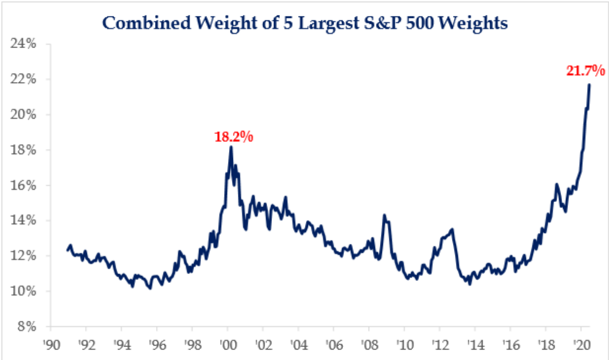
The re-opening process is key because it will determine the intermediate level of economic activity and the level of permanent economic damage that might be done. The concern I have is that many of those areas that may be most impacted are areas that do have considerable financial leverage or relatively high fixed costs. Commercial real estate, retail and hospitality are significant parts of the economy and are hurting badly. Conversely, other segments of the economy are thriving and even benefiting from the current environment. The important issue is that we keep the financial problems to those struggling businesses on the income statement and off the balance sheet. To the degree that we are successful on this front, then these businesses will be able to survive and participate in the economic recovery which would result in a shorter and shallower recession. I am encouraged that much of the fiscal stimulus thus far appears to be focused on this front. There is reason to hope the long-term economic damage will be far less than the short-term economic disruption.

From an investment strategy standpoint, in periods of uncertainty we focus on the same things we always do but only a little more so. We have made some subtle adjustments to portfolios to lessen the impact of potential rises in interest rates. Similarly, we have been more comfortable letting cash levels creep up with the market in anticipation of some attractive entry points ahead.

Lastly, we are mindful of the changing environment we are in and particularly the fact that a few very large companies comprise a substantial percentage of the market indexes. We continue to work to strike a balance between risk and return and not chance those areas where there is little margin of safety. Understanding what we own and having a focus on reasonable valuations is likely to be increasingly important as we navigate a stock market that currently awards Tesla a higher valuation than Honda, GMC, Volkswagen and Ford combined.



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As always we welcome your questions and comments. All of us at Triangle Securities Wealth Management wish you a safe and happy summer.