Economic Update

A Review of Second Quarter 2020

Markets rallied during the second quarter, as unprecedented governmental monetary and fiscal stimulus has more than offset an otherwise brutal global economy. However, even with a full quarter of COVID-19 at our backs, the path forward is still unclear. While a few states seem to have put the worst behind them, the number of new cases in many locations is just now ramping up for the first time. For example, as of this writing, hospitals in Los Angeles are currently airlifting patients to San Francisco, as city health officials expect to run out of available hospital beds within the month.

Just as there were many different approaches to the shutdown, there now appears to be just as many different approaches to a potential reopening. However, in some respects, it doesn't matter whether individual states are open or not. A recent study by economists at the University of Chicago, "Fear, Lockdown, and Diversion", compared high frequency social mobility data in various states and found that only 7% of the difference could be explained by the mandated shutdown policies of one state versus another. The rest of the difference is due to consumer preference. In other words, most people would be avoiding restaurants and theaters even if they were fully open. That is unlikely to change until the majority of people believe that the virus is actually under control.

U.S. Economy

While there has been much diversity of opinion with regard to the best approach to dealing with the virus, there is an equal diversity of opinions about the long-term economic impact that it will cause. We are just coming off of an economic expansion that had lasted over a decade. While our underlying economic foundation from that long expansion remains in place, the fits and starts of reopening could cause longer-term damage. The recent political and domestic unrest also contributes to this uncertainty, making any sort of quick recovery even more difficult.

On a positive note, total nonfarm payroll employment rose by 4.8 million in June and the unemployment rate also declined from 13.3% to 11.1% during the month. Leisure and hospitality industries were the sectors that showed the biggest gains. This represents a promising resumption of economic activity, or at least it did before coronavirus cases began to escalate once again. Additional job gains seem unlikely during July given the recent surge.

GDP fell by 5% annualized during the first quarter of 2020. At the end of July, the U.S. Bureau of Economic Analysis will almost certainly be reporting a much larger decline of roughly -20% to -40% for the second quarter. It is important to note that these are *annualized* figures. On an absolute basis, the actual GDP drop during the quarter will only be roughly one-fourth of that amount.

Altogether, JP Morgan is estimating that we will experience an absolute GDP decline of 12.8% total from the high point to the low point of the current recession. While not as horrifying as the headlines noted above, it still represents an extremely large number. For comparison, the total U.S. GDP decline during the 2007-2009 Financial Crisis was less than one-third of that amount, or 4.0%.

To date, the U.S. government has spent approximately $2.5 trillion, or 11.8% of annual GDP, on economic relief related to the virus. Relief has taken the form of rebate checks, boosts in unemployment benefits, small business grants, direct aid to state and local governments and health-related spending. On top of that, we also saw an additional $2 trillion liquidity injection from the Fed. Additional aid is likely on its way through Congress as well.

While this government debt likely has long-term implications for our economy, that seems to be a secondary concern at this point. Inflation expectations are still low, as are interest rates. Home sales are surprisingly brisk despite the pandemic, as mortgage rates fell to an all-time record low during the week ending July 2. 30-year fixed rates averaged 3.07% during the week.

International Economy

In Europe, employment numbers have remained high as compared to the U.S. The unemployment rate was only 7.4% in the Eurozone during May. Of course, this is because most Eurozone governments have implemented employment protection programs that subsidize employers for keeping employees on the payroll despite businesses being closed. These programs are estimated to be helping 45 million workers combined in Germany, France, the U.K., Italy and Spain. That represents approximately one-third of their total labor force, so clearly unemployment would be significantly higher without this governmental support.

Unfortunately, many jobs probably won't be coming back. A recent analyst report by Allianz suggests that nine million of those 45 million jobs will be permanently lost due to a decrease in the size of industries such as restaurants, hotels, airlines and retail stores.

The IMF continues to reduce estimates for global GDP growth. The June update to the World Economic Outlook now calls for a 4.9% total GDP decline in 2020, which is nearly 2% lower than their estimates from one month prior. Of course, they are the first to admit that there is a "higher-than-usual degree of uncertainty around this forecast." It all depends on progress towards virus containment and/or an eventual vaccine.

Markets

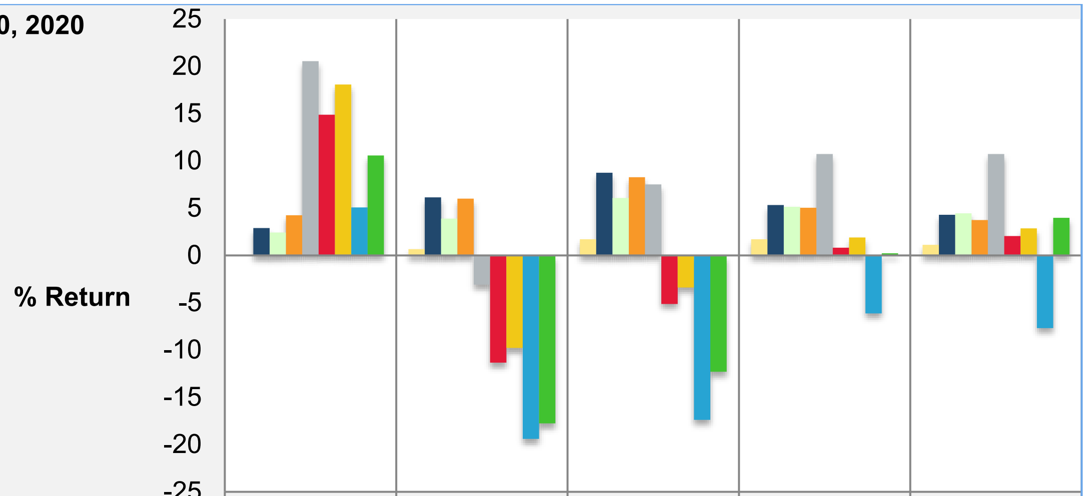
This year has seen extreme differences in performance between the various market sectors. Large companies have fared much better than small ones during the pandemic. Growth has also trounced value as technology companies have been the relative big winners so far this year. This is consistent with 2020 corporate earnings projections. Earnings for S&P 500 Technology, Consumer Staples and Healthcare companies are expected to remain fairly comparable to 2019, whereas companies in the Energy sector are projected to operate at a collective loss for the year.

For the market overall, U.S. large-cap equities, as represented by the S&P 500 Index, gained 20.54% for the quarter. They are now down just 3.08% year-to-date. For comparison, developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter up 14.88% and are now down 11.34% for the year thus far.

Emerging markets performed slightly better than international overall. The MSCI Emerging Markets Index finished the quarter with gains of 18.08%, and are now down 9.79% year-to-date. Alternatives such as commodities and real estate have not done well so far this year. The Dow Jones UBS Commodity Index is now down 19.4% year-to-date while the Wilshire REIT Index is down 17.77% during the same period.

Bond indexes have had a very good year so far due to declining interest rates. The Barclays U.S. Aggregate Bond Index gained 2.90% for the quarter and is now up 6.14% for the year overall. The Barclays U.S. Inflation-Linked Bond gained 4.24% for the quarter and is now up 6.01% for the year overall. The Barclays Global Aggregate Bond Index has gained 2.42% and 3.90% respectively over the two periods.

Through June 30, 2020



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.02	0.66	1.70	1.71	1.12
Barclays US Agg Bond Index	2.90	6.14	8.74	5.32	4.30
Barclays Global Agg Bond Index	2.42	3.90	6.07	5.14	4.44
Barclays US Infl Linked Bond Index	4.24	6.01	8.28	5.05	3.75
S&P 500 Index	20.54	-3.08	7.51	10.73	10.73
MSCI EAFE Index	14.88	-11.34	-5.13	0.81	2.05
MSCI Emerging Markets Index	18.08	-9.78	-3.39	1.90	2.86
DJ UBS Commodity Index	5.08	-19.40	-17.38	-6.14	-7.69
Wilshire REIT Index	10.56	-17.77	-12.30	0.23	3.98

Outlook

Optimistic talk concerning a vaccine has been rampant, as drug development is undoubtedly proceeding at speeds never seen before. While we can certainly be hopeful, it is unrealistic to expect large scale quantities of any vaccine to be available for at least nine months. Unfortunately, absent a known medical approach to safeguarding the most vulnerable members of our population, it is now apparent that our economy will likely continue to remain stagnant for the remainder of 2020 and at least part of 2021.

Near-term market direction is impossible to predict without some unique insight regarding virus containment and the likelihood of significant additional government relief. A diversified portfolio containing a reasonable amount of equity exposure is always recommended for an investor with a long enough time horizon. However, this does not seem like a good time to be taking outsized risk.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.