Private Ocean

JULY 2020

# Economic & Market Commentary

Prepared by the Private Ocean Investment Committee

# Executive Summary

- The novel Coronavirus (COVID-19) and associated "lock-down" wreaked havoc on the global economy, labor markets, and added extreme volatility to asset class returns during the first quarter of 2020. Starting from all-time highs in market indices, economic indicators, and employment, the crisis caused these recently positive trends to reverse, though they have started to recover in recent months.

- Large scale monetary and fiscal stimulus have been implemented in the form of lowered interest rates, increased purchasing from the Federal Reserve, and multiple rounds of stimulus, like the CARES Act, coming out of Congress, with more likely on the way. The fixed income markets have seen vast swaths of liquidity return as the Federal Reserve took unprecedented steps to purchase a multitude of assets including high yield corporate bond ETFs. Also, long duration treasuries have outperformed, due in part to the swift lowering of interest rates and the mad dash by investors seeking safe haven asset classes remain in negative territory year-to-date.

# Executive Summary (Cont'd)

- Following a market bottom on March 23rd, 2020, a strong rebound in domestic, international developed and emerging market stocks have offered solace to investors. This may appear as a “disconnect” between the underlying economy and the stock market; however, the market is forward looking, and processing the timing of when global economies will return to normal. This is certainly linked to improved treatments and the availability of a vaccine, with recent announcements creating some optimism.

- Private Ocean’s Investment Committee successfully made changes to the alternatives allocation in the first quarter that have outperformed the prior allocation.

- Many markets have recovered significantly, though most asset classes remain in negative territory year-to-date.

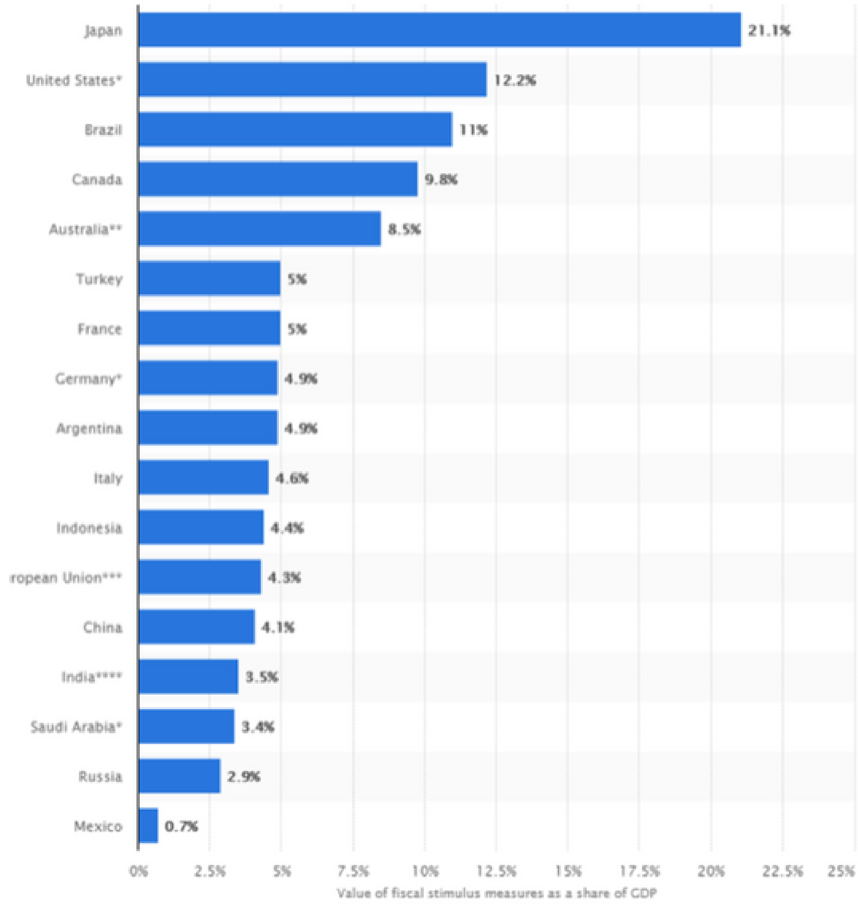
# Economic Environment

## *Major Themes*

The novel Coronavirus has caused unprecedented temporary damage to labor markets, global economies, and most asset classes in the first half of 2020. Between business closures, layoffs, and further stalling of reopening plans, it has left many investors uncertain and this has pushed volatility to levels not seen since the Global Financial Crisis. While there are certainly negatives to highlight, we believe it important to also highlight the large, swift, and synchronous recovery efforts and aid facilitated by world governments to help combat the issues stemming from the virus.

In the U.S., the Federal Reserve has taken unprecedented steps to improve liquidity in fixed income markets and act as the crucial lender of last resort. Congress too has stepped in to offer fiscal stimulus that has rivaled that of prior recessions, coming in at 12.2% of GDP, with more speculated to come in the latter half of the year. This has been the case the world over, as many countries have enacted massive fiscal stimulus, as shown in the following chart on Page 5:

**Value of COVID-19 fiscal stimulus packages in G20 countries as of June 2020, as a share of GDP(1)**



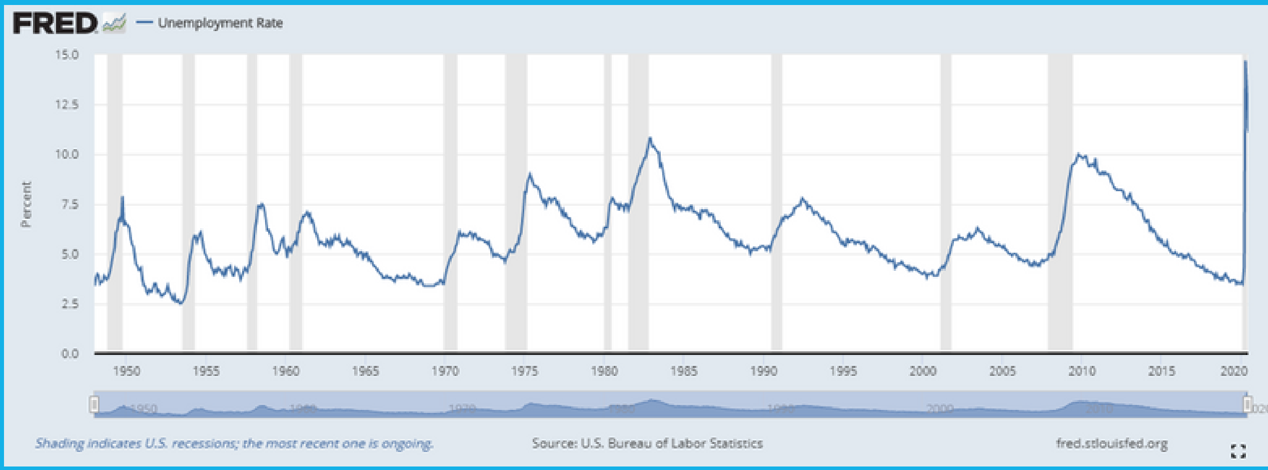

Equity markets, which have been pricing in new information in real time, have returned to heights seen before the Coronavirus Crash began in mid-February. Though they may seem disconnected from economic reality, it is important to note that equity markets are forward looking, which reveals that investors are optimistic about a recovery and a vaccine for the virus in the 12-18 month time frame. In more recent weeks, economic data has begun rolling in for the second quarter of 2020, which has offered some indication of where we stand and the direction we will head in the latter half of the year. To add to this, the 2020 Presidential Election is nearly upon us, which will likely cause a short-term increase in volatility due to the uncertainty surrounding it, specifically, future tax policy on corporations and individuals.

# COVID-19

Coronavirus has been able to infiltrate most of the world due to the tricky nature of the virus and how it spreads. The measures to effectively combat the disease (face masks, social distancing, business closures, etc.) have left unprepared nations and economies in dire straits as the world at large grapples with how to help businesses and individuals affected by both the virus and the protective measures themselves. As it stands, there are continued infections occurring predominantly in the United States and emerging market countries, such as Brazil and other Latin American countries. Other regions such as Europe and parts of Asia have effectively flattened the curve and kept it there due to adherence to safety protocols and widespread tracing as was exemplified by countries like South Korea and Japan.  There is uncertainty about the actual levels of infection because of different levels of testing protocols across the globe.

# Employment Market

Employment markets suffered their largest hit in recent history during the first quarter of 2020. This somewhat moderated as economies began to reopen in the second quarter, but the unemployment rate has remained elevated. As of June 30th, the unemployment rate was 11.1%, down from 14.7% in April.




Continued jobless claims also skyrocketed. With the supplemental unemployment benefits soon ending, there is some concern as to how to address the obvious income gap this will leave for many Americans. As indicated by Philadelphia Federal Reserve President Patrick Harker, it is likely that additional stimulus will be needed to make up for this "cliff effect" from unemployment running out.

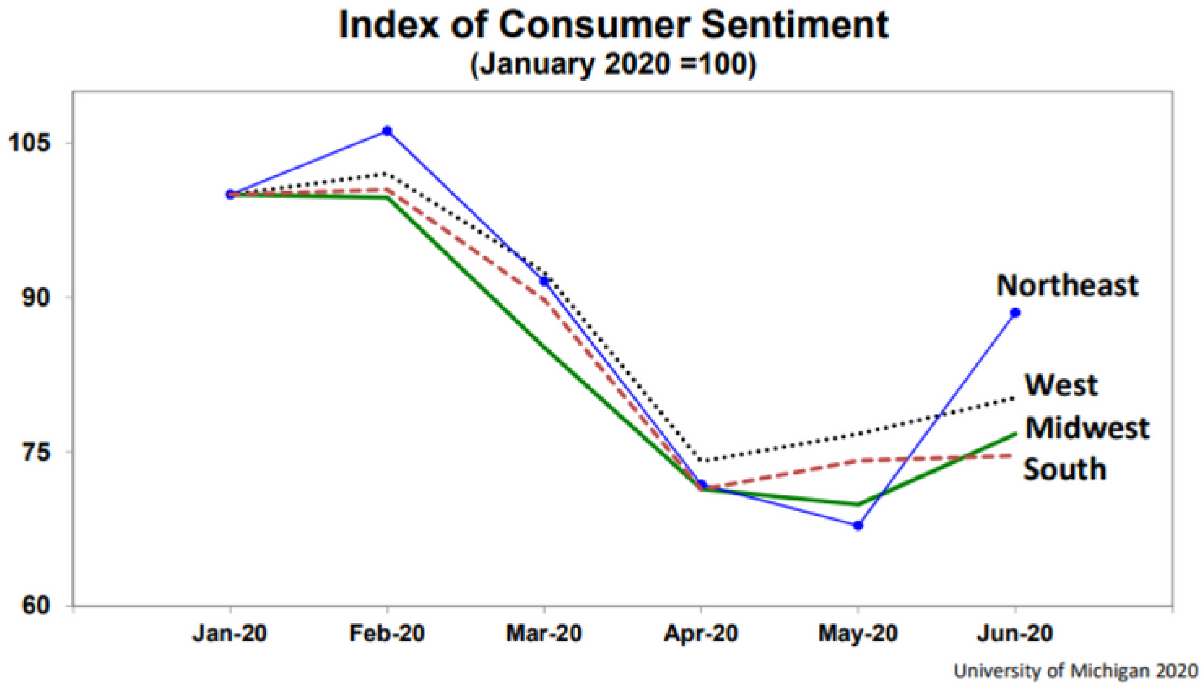
# *Inflation & Interest Rates*

There are two opposing forces that we currently see in the economy as it relates to inflation: on one hand you have higher saving rates by individuals in the form of savings accounts and money market funds (1), caused by large fiscal stimulus, dovish monetary policy and broad Federal Reserve purchasing via multiple credit facilities; on the other hand, individuals are buying less because they are forced to stay at home and there has been a severe hit to demand for things like oil, gas, airline tickets, dining out, hotels, among others. The latter force has largely outweighed the former, keeping inflation low. As the economy has begun to reopen, inflation - as measured by Core CPI - jumped 0.2% in June and is 1.2% year-over-year.

Interest rates have also been pushed to historic lows due in part to interest rate cuts by the Federal Reserve (and other central banks). They have also been impacted by recent mass sell offs of risky assets, with investors putting those dollars into safe haven assets, like Treasuries and gold. On March 16th, the Federal Reserve cut rates by 1% (after having already cut them 0.5% on March 3rd) to effectively move the Federal Fund's rate to a target of between 0-0.25%. The 10-year Treasury has also fallen to historic lows.

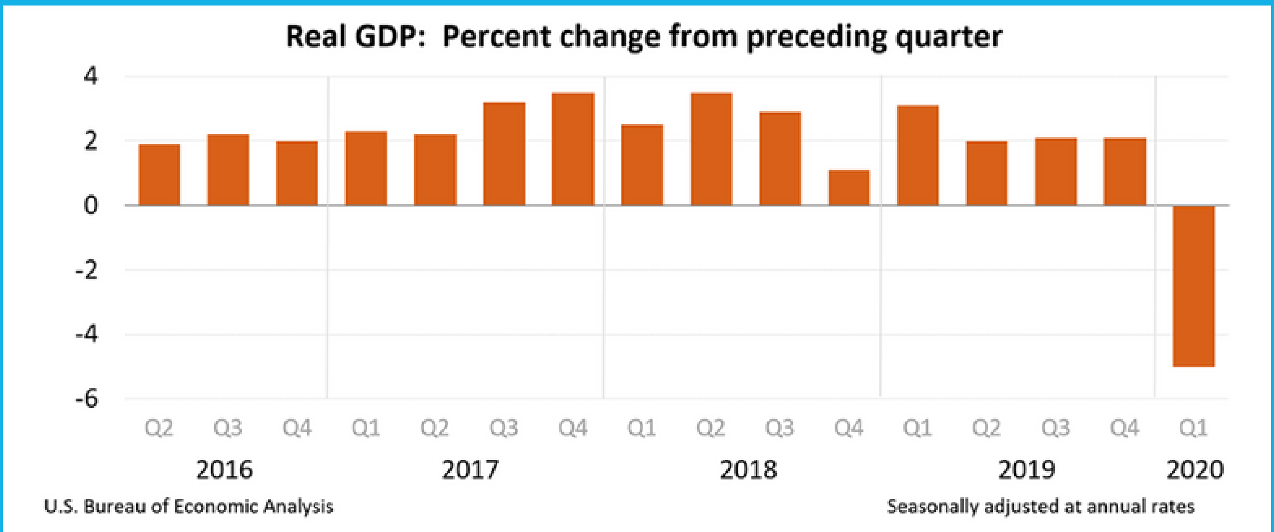

# Consumer Confidence

Consumer confidence has fluctuated wildly throughout the first half the year, as fear and uncertainty over COVID-19 and its impacts soared. The most well-known consumer sentiment survey is that of the University of Michigan. We saw it at relatively high levels to start the year, but as Coronavirus made its way across the country, it took a sharp downturn. More recently we have begun to see these figures rebound, though it is interesting to note that it differs by region. Much of these differences stem from the current state of the economy as well as new confirmed cases of Coronavirus in each of these areas.




# *Economic growth*

The future shape of the economic recovery (quick, slow, zig and zag) has been debated. Without settling this debate, what we do know is that the first half of 2020 GDP will be hard hit, as we began to see the effects of the Coronavirus towards the end of Q1 that continued through Q2. In the fourth quarter of 2019 GDP grew at a modest 2.1%. Then, in the first quarter of 2020, GDP sharply dropped to -5.0% as businesses and individuals were impacted by the virus and the measures put in place to slow its spread. As the GDP figures roll out for the second quarter, markets will likely be unphased as they have already anticipated these figures to be poor.




# Domestic Markets

Markets across the board suffered significant losses during the Coronavirus Crash, which started on February 19, 2020 and lasted until March 23rd, 2020. U.S. large cap stocks, as measured by the Russell 1000 Index, led the market and were down -2.8% during the first half of 2020. U.S. small cap, as measured by the Russell 2000 Index, on the other hand was hit particularly hard during the drawdown in February and March, leading to a return of approximately -13% for the first half. Interesting to note is the performance coming out of the downturn, however. Looking at figures from the bottom on March 23rd to the end of the quarter on June 30th, we see that small cap stocks outperformed, offering a 42.8% return, versus large cap stocks 36.9% return.

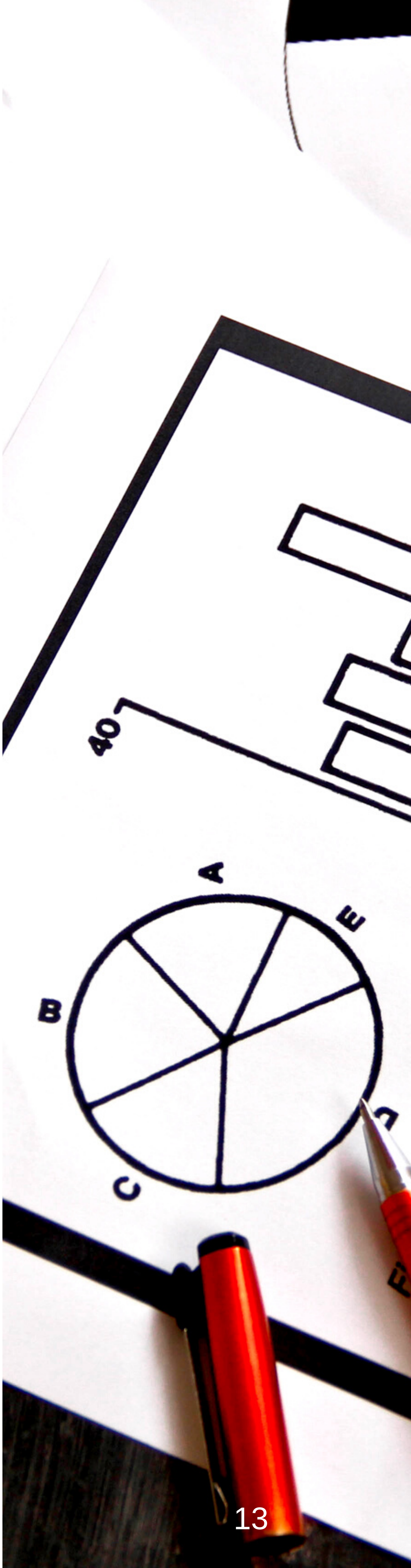
# Developed International Markets

Developed international markets also saw a strong recovery after the February and March drawdown, though for the first half of the year they did not fare as well as their domestic counterparts. International developed large cap stocks, as measured by the MSCI World Ex USA Index, suffered a -11.5% drop. International developed small cap stocks, as measured by the MSCI World Ex USA Small Cap Index, suffered slightly worse during the first half offering a -12.9% return. Further, coming out of the drawdown and through the end of the second quarter, international small cap stocks offered a sizeable 39.3% return versus 29.8% for large cap stocks.


# Emerging Markets

Emerging market stocks are typically hit the hardest during market drawdowns. Interestingly, emerging market stocks, as measured by the MSCI Emerging Market Index, outperformed international developed stocks, with a drawdown of -10.1% during the first half of the year. Their recovery from the drawdown was also notable as emerging market stocks offered a 25.8% return from their bottom on March 23rd through June 30th.

# *Fixed Income*




Fixed income markets fared well during the downturn, and this was in part due to [FD1] the vast stimulus and liquidity help coming from the Federal Reserve. The Fed made unprecedented moves to assist in fixed income markets, including opening credit facilities to assist with municipal bond market, treasury markets, and even corporate and high yield corporate bond markets. This significantly improved liquidity and trading conditions in these markets and helped facilitate a smoother ride amongst all of the volatility. For the first half of 2020, the overall U.S. bond market, as measured by the Bloomberg Barclays Aggregate Bond Index, offered a return of 6.3%. Municipal bonds also handled the drawdown well, especially after the Fed stepped in with assistive credit facilities. Municipal bonds, as measured by the Bloomberg Barclays Municipal Intermediate 5-10 Year Index, returned 2.3% for the first half. [FD1]Correlation is a RESULT that is seen, but not a CAUSE.

# High Yield

High yield bonds typically suffer from large sell offs in markets as investors move from riskier assets to safer assets, like long Treasury bonds. Regardless, the high yield market, both on the municipal side as well as the corporate side, ended only slightly down for the first half of 2020. High yield corporate bonds ended the first half down -3.8%, according to the Bloomberg Barclays Corporate High Yield Index. High yield municipal bonds offered a return of -2.6%, per the Bloomberg Barclays High Yield Muni Index.

# *Emerging Market Debt*

As previously noted, emerging markets are typically hit hardest during drawdowns, and this extends to their sovereign debt as well. That said, they were able to recovery initially large losses to end the first half of the year down only modestly at -1.8%, according to the Bloomberg Barclays Emerging Market Sovereign Bond Index.

# U.S. Tips

Treasury Inflation Protected Securities (TIPS) are a crucial part of the fixed income portfolio as they offer protection from unexpected inflation. The period we find ourselves in at current is anything but inflationary, as noted prior. However, they can also outperform in periods of low inflation due to their less risky nature, like treasury bonds themselves. For instance, TIPS returned 6% for the first half of 2020, as measured by the Bloomberg Barclays US Treasury TIPS Index.

# Real Estate

Real estate exposure in Private Ocean portfolios is accessed via publicly traded Real Estate Investment Trusts, or REITs. During these trying times, there have been several subsectors that have suffered from shelter in place orders and mandatory business closures. Unsurprisingly, hotels, resorts, malls and shopping centers, and healthcare REITs have suffered the lion's share of the losses both domestically and internationally. One area that has thrived during these times is found predominantly on the domestic side, where our fund managers at Dimensional Fund Advisors have been able to take advantage of investing in specialized REITs that focus on things like data centers and cell towers. This has led to sizable outperformance. Domestic REITs, as measured by the Dow Jones US Select REIT Index, were down -22% in the first half of 2020. International REITs fared worse, offering a -25.8% return, according to the Dow Jones Global Ex US Select REIT Index.

# Alternatives

During the first quarter Private Ocean's Investment Committee made great strides in improving the alternatives allocation across portfolios. In doing so, there has been significantly positive relative performance as compared to the prior funds that were in use. During March, Private Ocean's Investment Committee approved the use of the BlackRock Systematic Multistrategy Fund and the Vanguard Systematic Alternatives Fund. Since their implementation around mid-March, the BlackRock fund has offered a return of nearly 6%, and the Vanguard fund has offered a slightly negative return of -0.7%. These improvements to the portfolio continue to offer crucial diversification in times of large uncertainty in the market.

# Conclusion

During these trying times we are here as a resource and as your thought partner. Though it may seem like there is no end in sight, we do know that this too shall pass. As is evidenced by the current market run up, we continue to believe it is prudent to remain invested in the market as it is extremely difficult to know when and just how quickly markets will turn. Though there continue to be ongoing virus concerns, underlying economic issues, and volatility and uncertainty in the market, we still believe that over the long term the markets will offer positive returns and benefit investors. We encourage you to reach out to your advisor should you have any questions regarding your portfolios or financial plans.

## Footnotes

*1. Footnotes for Statista Graph*

*a. * Percentage calculated by Statista using values provided by the source.*

*b. ** Includes additional spending by state governments on fiscal stimulus measures, but does not include increased spending on the health system as a result of COVID-19.*

*c. *** Does not include second amendment to extend the scope of the State aid Temporary Framework adopted on May 8, 2020 as amounts not provided by the source.*

*d. **** Does not include additional spending on health infrastructure.*

*e. GDP data not provided by the source for South Africa, South Korea and the United Kingdom.*

*2. See the M2 money supply (https://fred.stlouisfed.org/series/M2) and current savings rate (https://fred.stlouisfed.org/series/PSAVERT*

## Sources

- *FRED St Louis Federal Reserve: https://fred.stlouisfed.org/series/UNRATE*
- *Bureau of Labor Statistics*
- *University of Michigan*
- *The Federal Reserve*
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- *Morningstar Direct*
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- *Organization for Economic Cooperation and Development*
- *JP Morgan's Guide to Markets: https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets*