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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

In our last newsletter, we described the expected impact on the economy of the COVID-19 coronavirus. **Three months ago the virus was just emerging in the developed world, and we anticipated the policies to contain the virus would produce an event-driven recession; event-driven because businesses were ordered closed, unlike the more familiar financial recessions.** As the economy begins to reopen, and virus cases begin to increase, we thought it would be worthwhile to review our thoughts with you. Our forecast of a U-shaped economic recovery, preceded by a V-shaped stock market, is still our primary forecast.

Source: FactSet

We will devote this newsletter to review the economic experience of the past quarter and how these events are likely to shape economic recovery into the future.

During the quarter, the economy showed a great deal of resilience. The major driver of better-than-anticipated economic performance must be attributed to the vast monetary stimulus provided by the Federal Reserve Bank and waves of record fiscal stimulus provided by Congress. As a consequence, retail sales increased 17.7% in May, evidence that consumer spending is recovering far quicker than most had expected. This also implies a smaller decline in consumption in the second quarter than we had expected. **We now suspect second quarter GDP contracted at a 30% annualized pace rather than the 40% we estimated three months ago.** While the services sector is rebounding quicker, the manufacturing sector has been slower to recover, reflecting the later reopening date of many factories. Auto plants, for example, were closed for April and most of May. After reopening in June, manufacturing output has accelerated significantly.

Similarly, external trade indicators confirmed both exports and imports plunged; heavily impacted by a shutdown of North American vehicle plants, which represented 25% of the decline. **While much of the weakness in goods imports are expected to reverse soon, travel services, air traffic, and U.S. service exports could take much longer to fully recover.**

While the 2.5mm rebound in payroll employment was a pleasant surprise in May, it still left the level of employment 20mm below the pre-pandemic peak. Even then, the initial surge in unemployment was probably understated by excluding the large number of workers who are classified as temporarily laid off rather than unemployed. It is also important to note that unemployment has had a greater impact on low wage earners, contributing to the rise in social unrest.

Headline CPI inflation fell close to zero in May, but should stabilize with higher gasoline prices and a rise in food prices. Core CPI declined further in May to a nine year low, probably less a reflection of deflationary collapse than sharp declines in travel sensitive categories. **Indeed, it seems more likely that inflation is poised to rebound from current levels.**

As we turn to the future, we expect a second wave of the pandemic in the fall and winter months. We think that the medical infrastructure is better prepared and the economy will not be closed during the next wave. **A second surge, or any sharp increase in virus cases for that matter, may moderate the pace at which containment measures can be dismantled, thus slowing the rate of economic recovery.**

We expect future economic growth to be bifurcated. Although analysts expect S&P 500 earnings, in 2021, to be close to where they were last year, this is mainly due to the profit outlook in the technology and health care sectors, the two largest sectors by market capitalization. Outside these two sectors, S&P earnings are expected to be down 8.6% from 2019 levels, or 11.2% in real terms. Earnings from cyclically sensitive industrials are expected to fall by 16% in the 2019-2021 period and earnings in the energy sector are expected to decline 65%! **This supports our continued view of an extended U-shaped economic recovery, and our higher sector allocations to health care and technology.**

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The stock market has rebounded more rapidly than one might expect from such anemic growth expectations. In large measure this is because the fair value of the stock market does not solely depend on earnings growth. It also depends on the discount rate used to calculate the present value of expected future earnings. **With the Fed once again managing the price of financial assets, the combination of lower interest rates, combined with the positive impact fiscal easing will have on earnings growth, leads us to a positive outlook for higher stock prices.**

The point of the stimulus was not to raise output, or to increase jobs; it was to keep households and businesses solvent during the shutdown. In April the U.S. savings rate shot up to 33%, mirrored by an increase in bank deposits which are now flowing into the stock market. Cash held in money market funds and savings deposits is still 10% higher, as a share of market capitalization, than at the start of the year. **This suggests that the monetary fuel to push stock prices higher has not been fully spent.**

There is an eminent risk of a “fiscal cliff,” where the Paycheck Protection Program will run out of funds, the $600/week in jobless benefits will end, and the average unemployment payments will fall by 60%, all in the coming weeks. Along with direct payments to households, these measures amount to about 5.5% of GDP. The good news is that in an election year politicians of both parties want to avoid this disaster. **Longer term, while it is too early to forecast the outcome of the November elections, a sweep by Democrats could result in a rollback of the corporate tax rate, resulting in a one-time reduction of earnings of as much as 12%.** Presumably, this would be partially offset by increased spending.

In the year ahead, we expect cyclical sectors to outperform defensive stocks. Value stocks should outperform growth, for a while, as margin expansion occurs from these companies’ renewed ability to raise the prices of their products. The pandemic could lead to additional changes not yet fully discounted by the market. Examples might include increased demand for cars due to decreased use of public transportation, accelerated reshoring of manufacturing, increased demand for suburban housing, and technology to facilitate remote working efficiencies.

Indeed, we expect significant societal and structural changes in a post COVID-19 world. Three out of five U.S. workers, who have been working from home, prefer to continue working remotely as much as possible. But, the shift in remote work has highlighted inequalities in the workforce. Jobs which can be done remotely tend to be higher paying, and those which require a physical presence tend to be lower paying, lower education jobs. Education technology could also get a boost from schools needing to teach remotely. The value of connectivity has increased and telecom network infrastructure has enabled the rollout of eHealth and Big Data & Monitoring. The rapid shift to work from home has been a catalyst for the development of software focused on productivity and collaboration. Business travel is likely to decline, adversely impacting the airline and hospitality industry. As corporations rethink office space, there is likely to be a debate over the role of cities and real estate.

Fixed Income

One of the key consequences of the unprecedented monetary and fiscal policy response to the COVID-19 coronavirus is a sharp rise in government debt. As huge costs from containing the virus mount, governments around the world have significantly raised debt levels to support their economies during the pandemic. It is unclear how far debt will grow, but if we experience a second wave of the virus, debt is likely to increase even more. That said, sustaining households and businesses through the pandemic is a valid reason for governments to borrow.

Combined fiscal and monetary policy in the U.S. has surpassed the stimulus measures that were extended in 2008-09. The Fed’s programs, deployed since mid-March, have increased its balance sheet by $2.9 trillion and may result in an expansion to $11 trillion by year-end. The fiscal response passed thus far in Congress has added $3 trillion to the deficit. Consequently, U.S. Government debt as a share of GDP is set to rise significantly. The future impact from this virus-related rise in debt has many investors questioning how the U.S. will manage what seems to be an indefinite upward trajectory of debt. First, the consensus view is that the cost of servicing debt will be sustainable as long as interest rates are lower than nominal GDP growth—debt will rise at a slower rate than GDP and, over time, the debt-to-GDP ratio will shrink. Given the ultra-low interest rates of the debt that has been issued, this suggests the U.S. government will be able to service its debt at locked-in low rates and the pandemic-related rise in government debt need not be a problem for the U.S. **Through the combined effects of economic growth, low interest rates, and the passage of time, it may be enough to reduce the debt burden gradually.**

What about the risk of rising rates? **There is still uncertainty over how quickly economic activity will recover from the pandemic, but it’s clear that we are set for an unprecedented period of near-zero interest rates.** “We’re not even thinking about raising rates,” Fed Chair Powell said in his press conference following the Federal Open Market Committee’s June meeting. The longer term outlook for rising rates is likely to mean additional policies to keep market interest rates artificially lower. The Fed may adopt some form of yield curve control policy in the future to prevent an unwanted rise in longer term rates.

Inflation risk has increased if the government chooses to “inflate away” the debt. Through higher inflation, a spike in price levels would, in theory, increase nominal GDP and therefore lower the debt-to-GDP ratio; a higher level of inflation would erode the real value of debt. **Although it is feasible that policymakers may want higher inflation to help bring the government debt burden under control, the risks outweigh the benefits.** The risk of targeting a higher inflation level is that inflation could rise much further than intended, resulting in an adverse effect on real GDP growth. Higher levels of inflation would also make it more expensive for the government to finance the deficit given that its borrowing costs would increase. The potential for a permanent rise in the money supply, and therefore structurally higher future inflation, is an additional risk from the unprecedented monetary policy stimulus. However, after an increase to $7 trillion assets on the Fed’s balance sheet, the pace of Treasury purchases has slowed dramatically and the funding from the new lending facilities has yet to be fully utilized. **As a**

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result, the Fed's balance sheet began to contract towards the end of the quarter; now, a slower expansion than initially thought is expected.

During the subsequent years of the last financial recession, it was widely believed that there was some threshold of debt, that once breached, would trigger a rise in interest rates that would slow economic growth. **But this recent experience has shown that the impact of a sharp rise in debt was not as direct as once thought; both interest rates and inflation levels have remained low.** The pandemic-related rise in government debt has not increased without risks; at this time, these risks seem to be largely contained. **The combination of economic growth, low interest rates, and the passage of time should be enough to reduce debt burdens gradually.**

International Market

In our last newsletter we stated, "event-driven slowing of economic activity usually results in a much shorter time period for economies to regain traction," and further cautioned "for investors who feel the urge to sell and exit the equity market, we recommend putting the current economic environment into perspective before making that irrational decision." The resilience of the global markets since that time has validated this point. **From the market low reached in March, both developed (MSCI EAFE Index) and emerging markets (MSCI Emerging Markets Index) returns have surged significantly.**

Despite the recovery achieved in China, as the first major economy to ease lockdown restrictions, expectations for the second quarter world Gross Domestic Product (GDP) remain dismal. Thankfully, high frequency indicators—such as driver route requests, visits to workplaces and recreational establishments, and electricity consumption—in addition to traditional indicators, such as the Global Composite Purchasing Managers' Index (PMI), all point to a recovery in activity that started in May. **Although activity remains far below pre-virus levels, and a slow recovery is expected, the equity markets' positive movement signals that investors believe the world economy may have passed the worst point—with the downturn in economic activity reaching the bottom—and a recovery is underway in most economies.**

While we have no immediate concern about global equities continuing to advance in the long run, we do proceed with the caution that the market may not be "out of the woods" yet. There is still a high likelihood for volatility to remain elevated in the near term. COVID-19 continues to spread across the world and concerns remain heightened for a looming wave of the pandemic to potentially cause a second downturn. Further, the resurgence of headline risk on the trade tensions between the U.S. and China, particularly as the election nears, will likely continue to spook the market at times.

Based on the recent developments in economies that have re-opened, we believe a second wave of the pandemic is most likely inevitable. Be that as it may, it is encouraging to see that despite the daily resurgence of new COVID-19 cases, the daily change in COVID-19 cause of death has stayed rather constant. It is an indication that as we learn more about this new virus, we are better prepared to deal with it and possibly treat it. **This confirms our belief that the medical infrastructure will be better prepared in the event of a second wave, and even though a second wave would slow the economy, it would not torpedo it.** In this event, another round of massive lockdowns causing a sharp decline in output across the world is not anticipated.

With the election just around the corner, we expect political rhetoric on China to increase and intensify. As U.S. public sentiment toward China has reached historic lows amid the coronavirus outbreak and trade tensions, increasingly negative views have climbed among both political parties. The passage of the Holding Foreign Companies Accountable Act, with unanimous consent by the Senate, serves as a prime example. You may be unfamiliar with the bill's official name as both politicians and the media purposely called it the "delisting of China Stocks bill." Headline reports stating the importance of the bill's passage to protect U.S. investors are in reality only political propaganda. For those who understand how American Depositary Receipts (ADRs) are currently regulated, they would recognize the disinformation and see the bill as nothing more than political rhetoric.

Through the passage of the bill, the notion that Chinese ADRs are currently not subject to reporting requirements is not only deceiving, but inaccurate. As stated in the Investor Bulletin on ADRs published by the Office of Investor Education and Advocacy of the U.S. Securities and Exchange Commission (SEC), "an ADR may not be established unless the non-U.S. company is either subject to the reporting requirement under the Securities Exchange Act of 1934 or is exempt under the Act… the non-U.S. company is required to register and file annual reports on Form 20-F with the SEC." Furthermore, in response to U.S. complaints that the Public Company Accounting Oversight Board is unable to inspect financial paperwork (audit working papers) in China, Yi Huiman, chairman of the China Securities Regulatory Commission, reaffirmed that China has never barred the provision of documents to foreign regulators. Chinese law only mandates that such information should be exchanged confidentially through regulators to ensure the safeguarding of sensitive information.

With the current legislature in place, the SEC already has the authority to delist both domestic and foreign companies for the omission of required filings. Therefore, the new bill, even if it passes the House and is signed into law by the President, brings no meaningful change. **From the start, both political parties intended for the bill to serve no other purpose than a political statement.** If the bill was intended to change the current legislation, the normal policy procedure would have been followed, sending the bill to committee, to allow the financial industry to comment. It would not have been sent directly to the Senate floor for passage.

Headline risks will continue to bring short-term market volatility, however we believe the long-term attraction of international equity remains intact. However, with a high likelihood of temporary market dislocation, we would once again advise our readers to exercise caution when contemplating portfolio changes during stock market selloffs, regardless of how tempting it may be. If you are invested in companies with sustainable competitive advantages—and these companies continue to maintain balance sheet strength in a crisis—prioritizing the long-term investment outlook, over a reaction to sell, will benefit your portfolio in the long run.