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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

The pace of the economic recovery slowed recently, but is still impressive given the surge in coronavirus cases over the summer and the recent expiration of enhanced unemployment benefits. Retail sales, mostly spending for goods, continue to trend higher, despite having already surpassed pre-pandemic levels. Industrial production, however, remains well below its pre-pandemic level and the unemployment rate is still elevated. **While the recovery could continue to decelerate into fall and winter, we expect continued economic expansion due to loose monetary policy and the possibility of another fiscal relief package.**

Recently, we were asked to address several concerns which may be of interest to our readers. So our newsletter, this quarter, will be structured based on these questions and our responses. **The first question asked us to describe the current and near future investment landscape.**

In the near to intermediate future, we continue to anticipate an uneven, or bifurcated, recovery where some industries continue to grow while others recover more slowly, or not at all. For an understanding of the seemingly elevated stock valuations, it is essential to appreciate the role played by extraordinarily low interest rates. Our view is for interest rates to remain at historically low levels for an extended period; a view which has been reinforced by recent Federal Reserve Bank policy statements. While many investors, due to fear of recession or misperception that the market may be overvalued, missed the rapid recovery and increase in stock prices, it is important to keep things in perspective. Financial theory has taught us that the price of a stock approximates the expected future stream of cash flow (e.g. earnings, dividends, etc.) generated by a company over time, discounted to a present value. The discount rate, which represents the time value of money in this calculation, can be extrapolated from expected inflation or the interest rate yield curve and represents the value of money at each period into the future. **With inflation and interest rates at historically low levels, and expected to remain low far into the future, and with earnings expected to recover from recessionary levels well into the future, it should come as no surprise that stock prices should be relatively high.** This is because the lower the discount rates, the more significant the contribution will be to present value of future cash flows. This simple formula also partially explains why technology stocks, as an example, whose valuations reflect the growth of cash flow into the more distant future, have displayed the greatest relative performance recently. We sometimes describe these companies as being of longer duration, because of the longer payback from cash flow. This is much like bond duration, which is the time weighted average of cash flows. By contrast, lower valuation, lower growth rate companies can be described as of shorter duration. **For now, and in the future, we expect longer duration companies to outperform.** When the coronavirus is finally under control and businesses return to normal, we suspect that shorter duration cyclical companies might have a period of outperformance. This will be a consequence of margin expansion and rapid earnings growth in the recovery phase of their profit cycle. With no real insight into when, or if, this will happen, we don't think sector rotation into short duration cyclicals makes much sense, even as a short term strategy.

Another question was asked about the potential for a major recession. We have been consistent in our belief that we are recovering from the forced recession in March, which was not a financial-, but an event-driven downturn. This recession did not occur because of a reversal of accumulated excess in the economy; instead it was the result of the mandated shutdown of profitable, and growing, companies and the economy in general. As we have said before, the vast amounts of liquidity created by Congress, the Executive Branch, and the Fed in the U.S., and by monetary authorities globally, was not provided to stimulate recovery from a financial recession; rather it was provided to insure final demand when the economy restarts. **With all this liquidity, and the economy beginning to reopen, we do not see any catalyst for a financial recession in the foreseeable future.**

An additional expressed concern was the potential inflationary impact of multiple trillion dollar deficits. We explained that it isn't deficits, per se, but the liquidity pumped into the financial system which creates the risk of inflation. We like to reference Milton Friedman, who pointed out that deficits have utility in their ability to constrain politicians, to slow or curtail spending. Friedman also provided the most quotable principle on inflation: **"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."** We thoroughly discussed the combined impact of fiscal and monetary policy in the context of inflation and output in our last newsletter. In essence, we pointed out, "…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." Our view was recently reinforced by Federal Reserve Chairman Powell's willingness to see inflation above the 2% target for an extended period in order to restore economic growth. **Although we do not regard it as inevitable, we do acknowledge some risk of inflation; but, at this time, even the risk of damaging inflation is beyond our immediately investable horizon.**

A final question asked what we will be doing differently to navigate these possibilities. To this, we responded that our asset allocation remains fully invested with a preference for stocks of longer duration. Recent shifts have seen a slightly lowered exposure to financials, consumer services, and health

(continued)
services; we are increasing or maintaining over-weighted exposures in electronic technology, technology services, and health technologies. Although we are cognizant of the potential volatility associated with overly dramatic election headlines, and hyper political posturing, our view is that the economy, and the stock market, will continue to climb higher as we adjust to the dislocations caused by the coronavirus.

Fixed Income

Throughout history, the Federal Reserve's monetary policy has evolved in order to respond to major challenges. In the 1980s, the challenge was to contain inflation by adopting a policy of raising interest rates. Since the 2009 financial crisis, the Fed has implemented a low interest rate policy, intending to stimulate economic growth with a 2% inflation target. Although this policy supported growth, it failed to sustain 2% inflation over the last decade. The Fed's most recent change in policy continues to support low interest rates, for at least the next couple of years, with the adoption of "a flexible form of average inflation targeting." Rather than simply trying to attain the target rate, the Fed will now "seek to achieve inflation that averages 2% over time." **This subtle shift indicates that the goal of monetary policy will now seek to sustain inflation above 2%, for an indefinite period of time, to offset the below target inflation levels of the past decade. Despite the Fed's shift on their target, the policy change does not imply an increased risk of rising inflation.**

The pandemic monetary policy response provided a massive liquidity injection into the economy. However, this stimulus is unlikely to generate higher levels of inflation in the immediate future. **While the sheer magnitude has the potential to pose a risk of inflation further out, such an outcome would be dependent on the continued evolution of Fed policy.** Consumer and business spending remains cautious and the effects from this lower demand are expected to keep inflation subdued for a while. Also, the uncertain economic outlook, until a vaccine is available and widely distributed, will encourage businesses and consumers to hold significantly higher cash balances. This helps to prevent monetary stimulus from pushing up inflation. Higher levels of unemployment, resulting in lower household income, will also limit demand which also limits the risk of inflation. **Lower levels of demand should therefore restrain a rise in prices despite the higher level of money supply.**

Despite the Fed's loose monetary policy over the past decade, inflation levels have remained consistently below their 2% target. Experience from the last financial crisis has shown that large levels of stimulus into the economy, combined with near-zero rates, did not result in an inflation spike. **Increasing inflation requires that money circulate through the economy; a structurally higher level of the money supply, alone, is not sufficient.** Although a permanent rise in the money supply has the potential to fuel higher future inflation in the long-term, we continue to believe that inflation is not an immediate concern. Besides, the Fed always has the tools necessary to lower inflation by reversing the rise in the money supply and raising interest rates. **Although the unprecedented levels of monetary support are a byproduct of this unusual time, the Fed's support will not cause runaway inflation any time soon.**

International Market

Despite the intense focus on a "second wave" of COVID-19, economic activity has continued to improve much more than anticipated as lockdowns have eased in most economies. The Organization for Economic Co-operation and Development (OECD) is now forecasting global GDP to contract only 4.5% this year, an improvement from the negative 6% projection made earlier in the year. This revision is driven by better than expected growth in the U.S., Euro Area, and most notably China.

While we expect the global economic recovery to continue, we currently believe the initial, rapid part of the rebound has passed. This is consistent with our previous newsletter commentary for expectations of "a U-shaped economic recovery, preceded by a V-shaped stock market rebound." **Although the road to economic recovery will continue to be bumpy at times, amid a second wave of new infections, the recent release of the Purchasing Managers' Index (PMI) continues to foreshadow an ongoing global economic expansion.**

Economic activity continues to improve in European markets. The region's recent business surveys such as the Composite Output PMI not only point to an expansion, but the readings from high-frequency indicators—such as traffic congestion and the use of public transportation across the region—**have returned to normal levels; traffic congestion is now at 94% of pre-COVID levels and the use of public transportation has attained 72% of normal.**

While in aggregate, global economic activity is rebounding, there are significant variances in how individual countries continue to recover. As noted earlier regarding our expectation for a bifurcated recovery among industries, we anticipate this will characterize countries and regions as well. Government stimulus support from monetary and fiscal policies and successful containment of the virus have allowed the economies of specific countries and regions to recover at a faster pace; perhaps the most notable example would be China.

China has been foremost among those countries to quickly recover, and we expect it to retain this lead. Early recovery in China has been fueled by a surge in government investment. The Chinese government's plan for borrowing signals that spending on infrastructure will remain high; however, it also introduces a concern that China may be reverting to its old playbook of relying on credit-fueled, investment led projects for its economic expansion. The risk would be a setback to the Chinese government's push to shift the economy to a domestically led, consumption driven market. While consumer spending has lagged early in the economic rebound, we believe household spending will begin to pick up, given the rapid recovery of the economy and the labor market. The recent increase in vehicle sales serves as a sign that both investment and consumption are contributing to the recovery.

Similar to when the term "trade war" first surfaced in early 2018 to cause investor panic, there is growing concern that increased tension between Washington and Beijing will derail the global economy. As we have noted numerous times in our previous newsletters, we continue to caution that although U.S.-China tensions introduce a psychological element to investor sentiment, when "materiality" is considered, the impact to the global economy is actually trivial. **The main concern surrounding the "trade war" was the potential disruption of the supply chain as a negative impact to the global economy. Our position has been, and continues to be, that a restructuring of the supply chain will occur if needed.** In fact, the pandemic has recently put the supply chain through a live stress test! When manufacturing lockdowns began in China, there were concerns that supply chain dependencies would amplify and extend the disruption around the world; in reality, supply chains have generally functioned well. **The early success of restructured supply chains validates our view that the global economy is not as dependent on manufacturing capacity from China as people believed it to be.**

The political relationship between the U.S. and China is likely to remain tense, regardless of which candidate wins the White House in November. **We continue to believe the potential impact to China's economy will be limited to the export sector, as exemplified by the "trade war" of the past few years.** The condition of other sectors, particularly those with a focus on domestic consumption, will continue to improve. China's growth is already higher than previous year levels, and with policy support set to remain strong, it is on course to return to its pre-COVID path by the end of the year; far earlier than estimates for other major economies. **Although growing tensions remain a concern, we continue to believe it is prudent to have exposure to the world's number two economy, not only given its faster growth, but also to maintain diversification in a global portfolio.**