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Investment Commentary

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We are in uncharted territory when it comes to the economy and financial markets. The daily barrage of information, too much information, is not helpful. So it is necessary to cut through the “noise” and make investment decisions in a highly uncertain environment.

Status of the Covid-19 Virus

The number of new Covid-19 cases has surged after a period of decline. The virus appears to be rapidly outpacing containment efforts. And at this juncture, there appears to be little desire to re-establish stay-at-home orders.

The virus will not be contained until there is a vaccine and it has been administered to the bulk of the population. Some reports indicate a vaccine could be available as soon as this fall. But the process of manufacturing the vaccine and administering it to the population will take several months.

It appears we will continue to be in an environment of wearing masks, social distancing, hand washing and avoiding large crowds for longer than we think.

The Economy

The economy is far from normal and will take a long time to absorb the millions of unemployed workers who will hold down consumer spending, threaten corporate profits and weigh on strained state and local budgets. The viral threat remains, casting a cloud over the economy and financial markets.

Some sectors of the economy have been devastated while others have only been moderately affected. Small, local businesses have been affected much more than large national and multinational companies. Many local businesses have permanently closed and some companies, including large ones, have declared bankruptcy. As the economic downturn continues there will be more closures and bankruptcies. Small businesses are expected to fail in mass.

The rate of unemployment is currently very high and could take 2 years or longer before we reach the level of employment prior to the economic downturn. More

economic stimulus is likely forthcoming but it remains to be seen how much it will impact the economy.

Inflation

In accordance with orthodox economic theory, lower interest rates and a high level of government spending create inflation in a good economy/full employment scenario. Over the past 12 years or so interest rates have been historically low and levels of government spending high. But inflation has been below 2.0% which is lower than the historical average of 3.0%.

The extraordinary levels of government spending this year have significantly increased the Federal debt. Debt at the current level is more associated with a slowing of economic growth as opposed to an increase in inflation (as in past years). It is difficult to see much of an increase in inflation over the next few years.

But it is important to keep an eye on inflation. It has a detrimental effect on financial assets, primarily bonds and other fixed income.

The Stock Market

There continues to be a disconnect between the economy and the stock market. After a sharp drop in February and March, the stock market bounced back quickly. The stock market is "violently flat" as volatility has returned. In spite of the fact the economy will take time before returning to normal, there are some reasons why the market rallied so strongly from the bottom reached in late March.

- The overall stock market is being "propped up" by a handful of stocks, mostly technology and social media, that are relatively unaffected by the current downturn in the economy.
- The stocks of companies severely impacted constitute a smaller part of the index.
- Other asset classes such as bonds and real estate are not providing much return in the current environment. Stocks (primarily large cap growth) are the only game in town.
- The Federal Government has provided an unprecedented amount of monetary and fiscal stimulus providing liquidity for the financial markets.
- Some of the hardest hit stocks have been bid up due to speculation. Day trading has become popular as people are staying home.

Value and small/mid-cap stocks continue to underperform large cap growth stocks. That will continue to be the case until economic growth resumes. The overall stock

market has been moving "sideways" in recent weeks but I do expect a move back down at some point. That will provide a buying opportunity in stocks, possibly large cap value stocks.

Many countries in Europe and particularly East Asia have been more successful than the U.S. in taming the virus and should consequently experience shallower recessions and quicker rebounds. This should boost profits relative to those in the U.S. and could also precipitate a dollar decline. International stocks could outperform domestic stocks but it remains to be seen if that will be in the near term or for a longer period.

The Bond Market

Interest rates are incredibly low and likely to stay low for the foreseeable future. The Federal Reserve has been buying bonds on the open market to maintain liquidity and hold down interest rates.

In this environment, a mixture of different sectors of the bond market is advisable. Lower rated high yield bonds and longer-term bonds should be avoided. And inflation protected bonds are not likely to provide much return.

Preferred stocks and even utility stocks will likely provide a higher yield than bonds going forward. However, it is best to wait for a pullback in the overall stock market before adding to those two sectors.

Alternative Assets

With an overvalued stock market and incredibly low interest rates, alternative assets are being discussed yet again. But they have performed poorly in the last few years as compared to both stocks and bonds. And the performance is inconsistent. They do not always respond to market conditions the way they intend to.

The Department of Labor has recently made a pronouncement that allows 401k plans to allow investments in private equity. Numerous research studies, white papers, consultant reports and other studies have emerged in recent years supporting the investment case for inclusion of private equity, direct real estate and other less liquid asset classes in target date and other multi-asset investment portfolios. While the underlying investment theory appears to be sound, holding illiquid assets in retirement accounts is not always practical. I believe this has more to do with Wall Street finding a new source of funds to invest in financial products where they can charge high fees.

Even Vanguard is getting into the private equity business. In February they launched a new private equity fund for institutional investors. It will eventually be offered to high net worth investors and then “retail” investors. It remains to be seen how this will work but I am skeptical it will be a good investment for retail investors.

Due to high fees, illiquidity, inconsistent performance and extreme volatility, I am not recommending private equity at this time.

Overall Perspective

We are in an uncertain environment with tremendously reduced economic activity and a wide range of potential outcomes. The only thing we can do is remain patient, stay safe and keep in mind it will come to an end at some point. The economy will eventually recover and things will get back to normal. Investment portfolios will recover over time but for now it is prudent to minimize risk.