PENDLETON STREET
BUSINESS ADVISORS

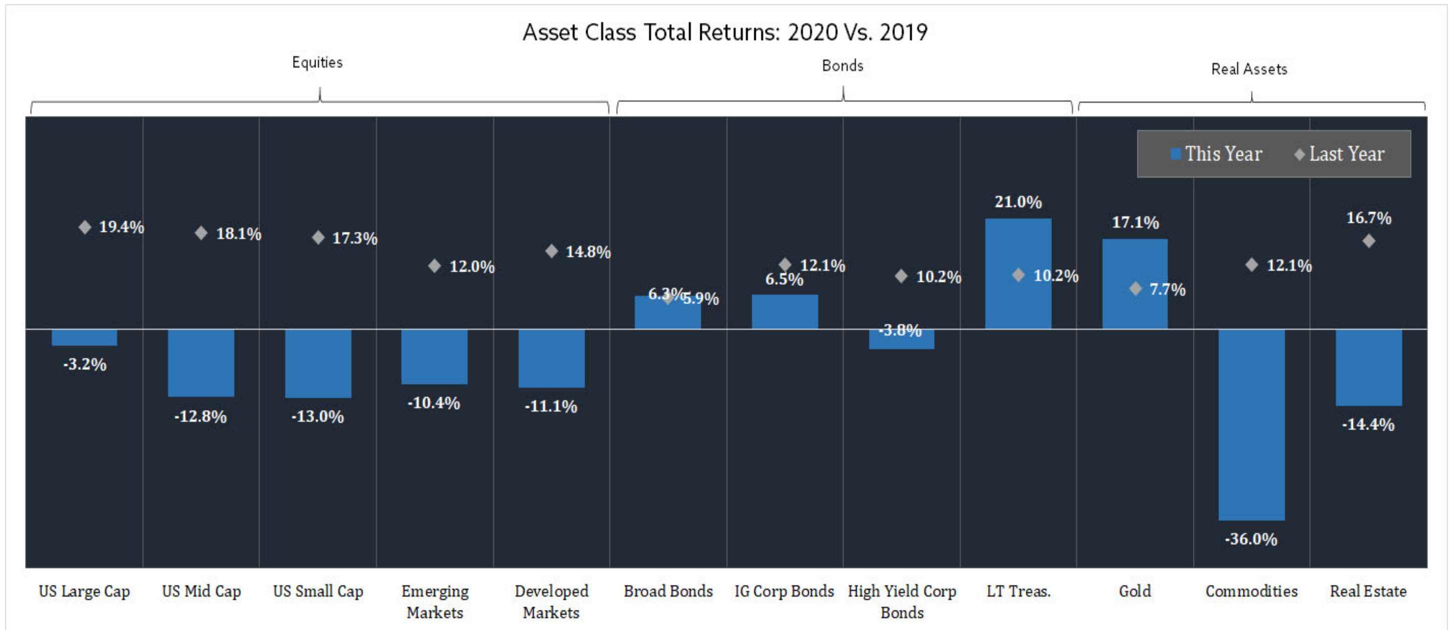
Pendleton Street Advisors
2nd Quarter 2020 Investment Commentary
July 17, 2020

Index Returns	2nd Quarter	Year to Date	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	20.5%	-3.1%	7.5%
MSCI All Country World Ex-USA Stock Index	16.1%	-11.0%	-4.8%
Barclays Capital US Aggregate Bond Index	2.9%	6.1%	8.7%
US Core Consumer Price Index - (Inflation)	-0.6%	0.0%	1.2%

**All figures as of 6/30/20 unless otherwise noted.*

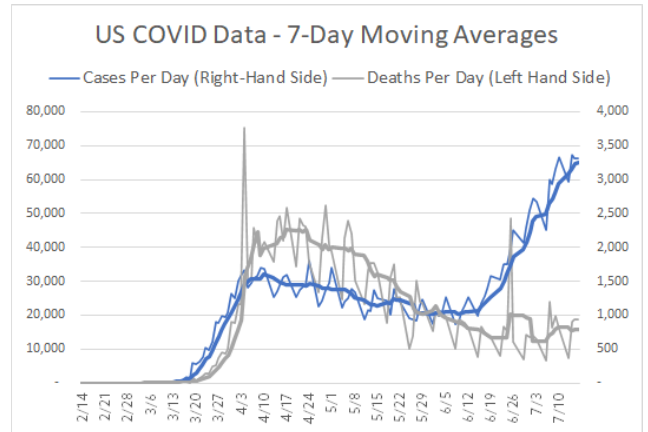
"If you can make it halfway and one more step, it's longer to go back, and shorter to finish. So, you just finish." – John Lakeman[1]

The end of the second quarter marks the mid-point of the year, and in many respects the above quote seems tailor made for 2020. The year for markets is another story, however, with fiscal and monetary stimulus as well as general optimism regarding an end to COVID-19's economic impact contributing to the continued recovery from lows reached in late March. We will spend time in this quarter's commentary discussing the current environment and looking ahead to what may be in store for the rest of the year. As the presidential election approaches in the US, and Coronavirus persists in making itself at home, we also discuss changes we recently implemented in client portfolios, and how we expect those changes and others made earlier this year to increase resiliency of portfolios.



[1] Fictional character from Amazon Studios' "Patriot."

Markets: As mentioned above, Coronavirus and its impact on companies and the economy as a whole continue to be front-of-mind for markets. Infections have increased since some states began relaxing social distancing in June, but the good news so far is that deaths and hospitalizations have not trended higher with active cases. It is possible that this is why even as the much-feared second wave of Coronavirus infections appears to be becoming a reality, the market recovery has persisted.



But the recovery is not spread evenly across categories, and it has not coincided with improvement in underlying economic indicators. For equities, the Nasdaq 100 Index - comprised primarily of technology and communication stocks - is up by close to 17% for the year, while small caps continue to be the hardest-hit, with the Russell 2000 down -13% year-to-date. We have noticed a wide disparity of returns within all three major asset classes, not just stocks (see accompanying chart).

Year-To-Date Best/Worst Returns by Asset Class

Equities		Bonds		Real Assets	
Nasdaq 100	Russell 2000	Long-Term Treasuries	High-Yield Bonds	Gold	Oil
16.9%	-13.0%	21.9%	-5.1%	17.1%	-34.5%

The wide differences between the winners and the losers within an asset class are clues about broader themes investors collectively favor as COVID-19 continues to impact the world. In short, **equity investors** have favored **large companies over small**, **virtual over physical** products and services, and **global sales footprints over domestic**. **Bond investors** have favored **long-term over short-term**, and **safety of capital over yield**. **Alternatives investors** have favored **stores of value over commodities** tied to economic productivity.

Year-To-Date Returns by Asset Class & Category (Q1, Q2, & Total)

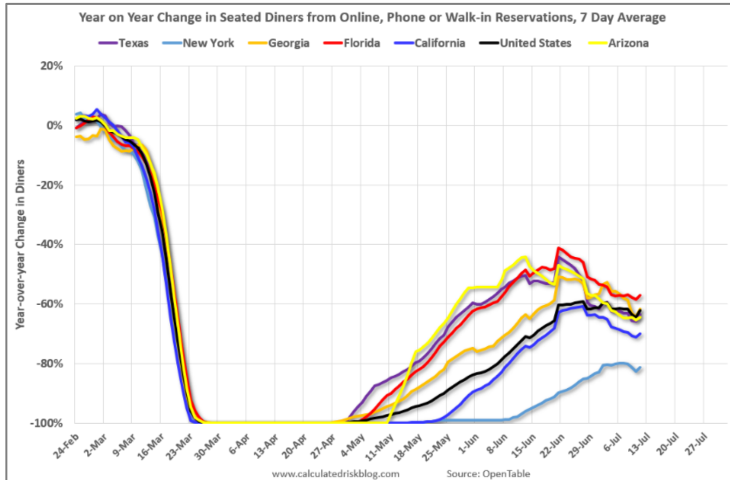
Equities

Category	1st Quarter	2nd Quarter	Year to Date
Nasdaq 100 (Technology)	-10.3%	30.3%	16.9%
S&P 500 US Large Cap Index	-19.6%	20.5%	-3.1%
Emerging Market Stocks	-23.9%	17.9%	-10.4%
Developed Market Stocks	-23.0%	15.5%	-11.1%
Russell 2000 Small Cap Index	-30.6%	25.5%	-12.9%

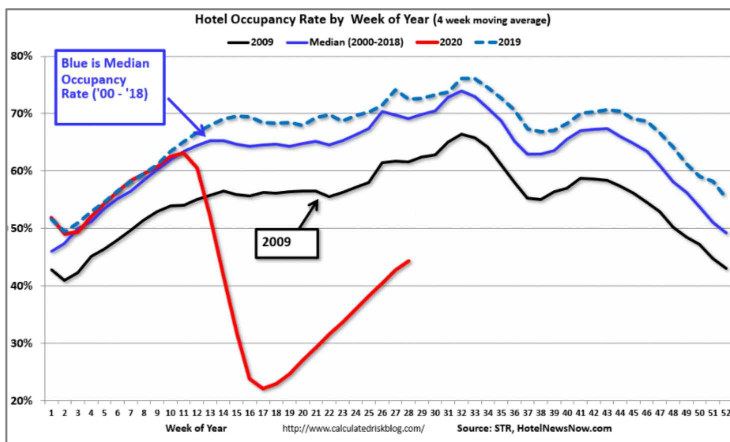
Bonds

Category	2nd Quarter	1st Quarter	Year to Date
Long-Term Treasury Bonds	-0.2%	22.1%	21.9%
Investment Grade Corporate Bonds	9.7%	-3.0%	6.4%
Broad Bond Index	3.1%	3.1%	6.3%
Municipal Bonds	3.8%	-0.8%	3.0%
High-Yield Corporate Bonds	7.3%	-11.6%	-5.1%

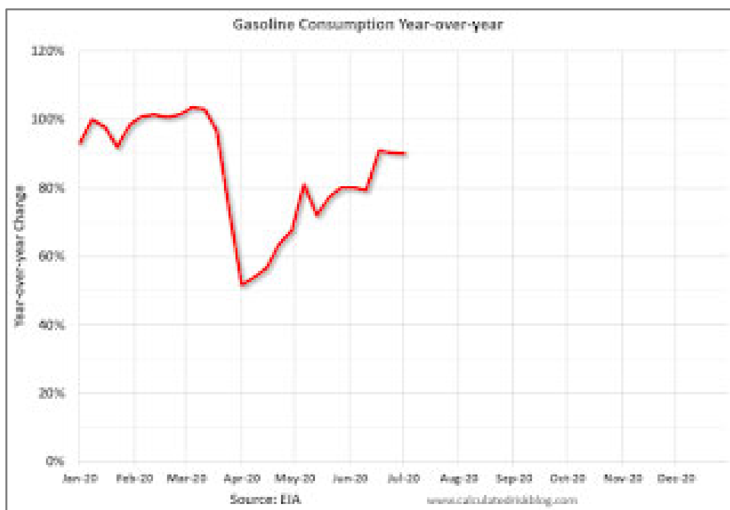
Restaurants



Hotels



Gas Consumption



Economy: That said, in aggregate markets are much closer to the highs they set in February than the lows set in March, which has a lot of people scratching their heads and asking: **How can markets do so well while the underlying economy is doing so poorly?** Before we can answer that, we have to also ask, **how bad is the economy doing right now**?

The economic indicators we track declined sharply beginning in the first quarter, and have mostly either continued deteriorating or improved sharply in late May and early June, only to level off or begin slowing down again:

-According to data from OpenTable, **weekly diner volume** at restaurants had been down as much as -99% vs last year in March and April, and is currently down close to -60% after having been down as little as -50% earlier in June. (*OpenTable*)

-**Hotel occupancy** vs last year has increased from as low as 20% earlier in the year, to now being around 45%. This compares to the historical median of over 70% for this time of year. (*HotelNewsNow*.com)

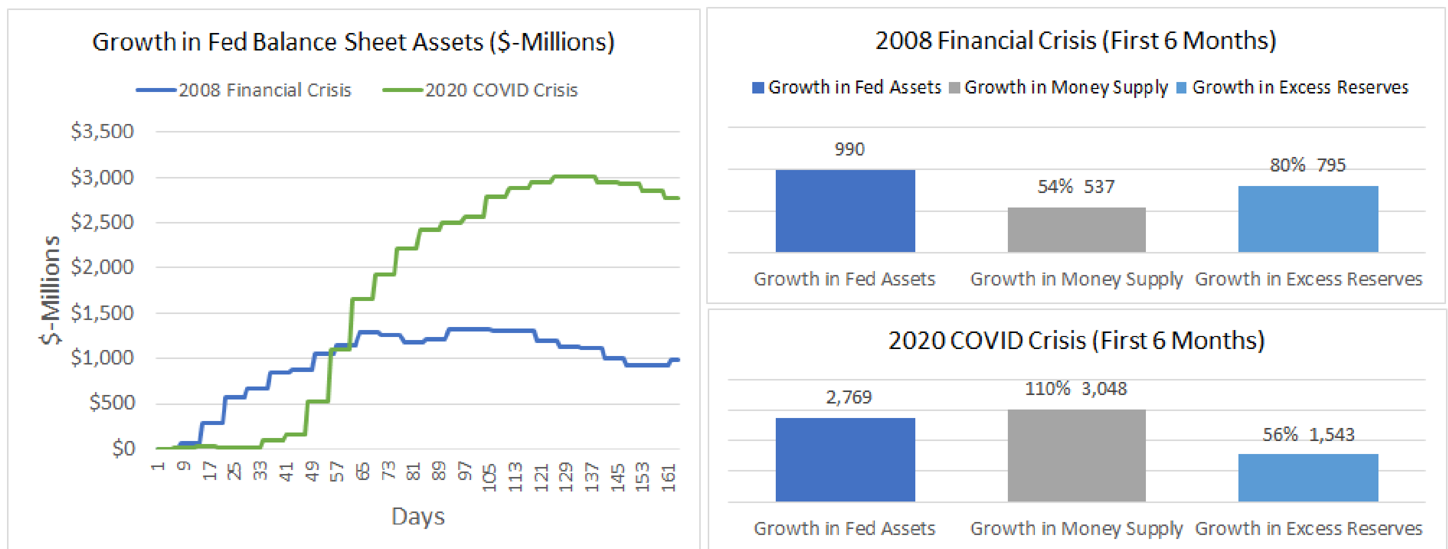
-**Gasoline consumption** is currently around 90% of last year's level, after having fallen to close to 50% earlier in the second quarter. (*EIA*)

More traditional measures of economic activity, such as Light Vehicle Sales, Unemployment, and Housing Starts are reported less often and with a bigger lag than the indicators highlighted above, but they too tell a similar story: **activity improved in May and June relative to March and April, but are still significantly below where they were at this point last year**.

One bright-spot is **Retail Sales, which increased around 5% year-over-year in May**. They were helped by a year-over-year increase in Disposable Personal Income of 8.3% in April, which is somewhat surprising given the employment situation… until you consider how much direct stimulus has gone to consumers **directly** in the form of the one-time stimulus payments and the enhanced federal unemployment benefits; and **indirectly** as small businesses have spent their Paycheck Protection Program loans on payroll.

The Fed: This unprecedented government spending via Coronavirus legislation has been funded by the Federal Reserve creating new money to: lend to the Treasury (which then distributed the funds to individuals and businesses via the IRS and the Small Business Administration); buy market securities such as mortgage backed securities and corporate bonds; and lend directly to companies through the Main Street Lending program.

The Fed's Balance Sheet has grown by $2.8 Trillion since January, 2020. For perspective, that is close to 90% of the $3.2 Trillion growth that occurred over the three rounds of quantitative easing that occurred between 2008 and 2013. **<u>The Fed has created almost as much money in the last SEVEN MONTHS as it did over the FIVE YEARS following the 2007-2008 Financial Crisis</u>**. One major difference between this round of spending and the spending coming out of the financial crisis is how much is ending up in the hands of businesses and consumers vs staying on bank balance sheets in the form of excess reserves.



The growth in the Fed's Assets plus the flow-through to individuals and businesses via increased currency and bank deposits begins to build a stronger case for inflation going forward than there was - in retrospect - in 2008. With potentially higher inflation looming, the challenge for investors is maintaining the purchasing power of their funds. Historically, the best way to meet that objective while minimizing risk was to buy bonds with a yield higher than the expected rate of inflation. Currently, and for most of the last 10 years, yields on US Treasury bonds have been below the rate of inflation. This is why so many investors – *including Pendleton Street* – have been increasing allocations to gold, which is seen as a store of value that is not linked to currencies like the US Dollar, Euro, and Yen.

The Election: The societal and economic impacts of Coronavirus will continue to play out, but we are also looking ahead to the presidential election in November as a major source of uncertainty for investors. With President Trump and Biden locked in as the only candidates with a chance, we have been evaluating how their interests and policy positions differ, with particular attention paid to the impact that a Biden White House could have on the business environment. As far as President Trump goes, we expect more of the same, but less inhibited. This will be his last term and we are not convinced he will be motivated to cooperate with his party to increase the chances of another successful run for Republicans in 2024 if it means compromising his agenda.

	Biden	Trump
Corporate taxes	**Raise corporate rate** to 28%; create minimum tax rate of 15% on book income	**Corp tax rate lowered** from 35% to 21%
Personal income taxes	Restore **top rate to 39.6%; raise capital gains tax** to ordinary rate for those earning >$1mn; **wealth tax** (details unspecified)	**Lowered federal rates** from 10% to 39.6% brackets to 10% to 37%
Trade	Enlist US allies to challenge China on trade; advocates enforcing existing trade laws while writing new rules that protect workers, the environment and labour standards.	**America First** policy involving withdrawal from TPP, renegotiation of NAFTA, trade/tech/investment war against China and early-stage trade war with EU
Healthcare	**Improve Affordable Care Act** (ObamaCare) by adding public insurance option; Medicare to **negotiate drug prices;** link domestic to **int'l prices**	**Failed attempt to repeal Obamacare** in 2017
Energy	**Ban new leases** for drilling offshore and on federal land; partially supports **Green New Deal** end fossil fuel subsidies; supports **carbon tax**; **end fossil fuel subsidies; 100% clean energy** by 2050	**Opened** more federal land to drilling **Reduced** Iran/Venezuela output through sanctions
Tech & Comms	Supports using **anti-trust legislation** to investigate anti-competitive practices	**No significant** sector-specific policies, though DoJ, FTC & FCC investigations ongoing
Finance	Support a **financial transactions tax**	**No signature legislation**, but more lenient interpretation of Dodd-Frank
Infrastructure	**$1.3trn** plan, including green proposals	**No signature legislation**
Immigration	End family separation; protect **DACA**; create a pathway to citizenship; give more resources to better leadership/training within ICE; don't decriminalize crossing the border	Border wall; record contraction in legal immigration through **visa limits**
Monetary policy	no public comments	Favors lower rates and **replacing Powell** Two open Board seats to fill
Other	**Raise minimum wage** to $15/hr	**Federal minimum wage unchanged** at $7.25/hr

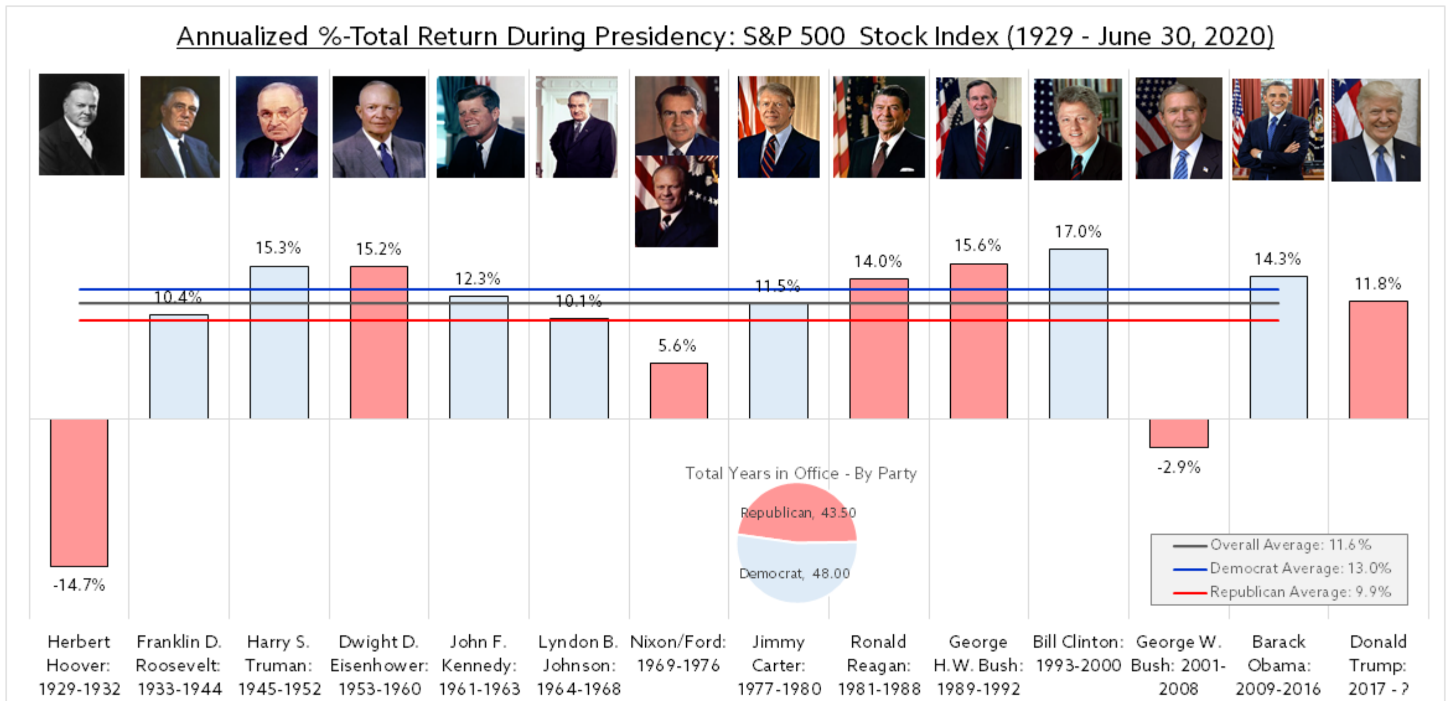
Source: J.P. Morgan, campaign websites and public statements

We see some of Biden's intentions as negative for the business environment (see accompanying table for an overview and comparison with Trump), but a Biden presidency could be less damaging than markets have so far implied, for a couple of reasons:

1) Biden's stated positions are - on the whole - more moderate than Obama's, and the economy and markets both grew considerably during Obama's presidency.
2) Markets thrive on predictability, and the most predictable thing about Washington is disagreement and gridlock. The Latin phrase *Ceteris Paribus,* loosely meaning "all other things held the same" is most-often used by economists but it works for investors, too. The less moving parts there are, the simpler it becomes to evaluate the impacts of the remaining moving parts and be confident in that assessment.

Given the second point, the most concerning outcome of the election from a market perspective would be if the Democratic party gains control of the Presidency, retains a majority in the House, and wins a majority in the Senate; which would make it much more likely that Biden could roll back many of the pro-business policies Trump has enacted over the last four years. That said, President Trump was unable to repeal Obama's Affordable Care Act even with Republican control of both the House and the Senate.

Regardless of who wins or gains a congressional majority, it is important to note that while politics are one important driver for markets, **market performance has been positive in all but 2 presidencies since 1929**. Both of the times returns were negative, Republicans were in office (see accompanying chart). We are not assuming causation, but instead pointing out that historically, factors outside of the control of any one-person (even the President of the United States) drive market performance.



We will continue diligently evaluating the political situation with emphasis on how it could impact portfolios in the long-term, but **we do expect the election to contribute to heightened volatility in the near term**. That uncertainty, along with the impacts of economic slow-down and uncertainty around continued fiscal and monetary intervention have already led us to make a few significant changes to portfolios in the last quarter.

- As prices declined in the first quarter, we initiated positions in the stocks of a few high-quality companies and market segments that had previously been too expensive based on our analysis.
- A lesson we have learned over this period is that we want to be able to move more quickly to implement changes to diversified portfolios once a decision has been made by our Investment Committee. To that end, we have been working to reduce the number of holdings in portfolios when it makes sense. For example, we reduced international stock holdings down from three holdings to one. The change does not reflect a strategic shift in our risk or return expectations for non-US equities. We reduced the number of holdings - *but not the underlying allocations to asset classes and market categories* - so that if our expectations do change we can quickly implement trades across portfolios to reflect those changes.
- We increased allocations to gold, by replacing holdings in Treasury Inflation Protected Securities (TIPS), because we expect gold to be a better hedge against inflation as interest rates remain low indefinitely.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We welcome hearing from you.

Contact: Matt A. Morley, CVA, CEPA
Chief Investment Officer
Pendleton Street Advisors
Website: www.pendletonstreetadvisors.com