Q2: A far different story than Q1. Significant uncertainty remains.

The markets recovered their February and March losses to a measurable degree in the second quarter. However, looking below the surface, the rebound was led by a handful of the largest technology stocks that were considered beneficiaries from changing consumer and business behavior patterns.

First, let's discuss why the market rallied and then explore Gries Financial Partners' current thoughts and future expectations around portfolio positioning.

Why the rally?

1. The Federal Reserve took action quickly and decisively with unprecedented monetary stimulus and a reduction of the federal funds rate which further lowered interest rates. Real rates of interest, taking into account inflation, are now below zero. This backdrop lends support to equities, as investors search for higher returns than fixed income can provide. In addition, the Federal Reserve announced many programs to assist public market trading and liquidity, such as buying parts of the corporate, high yield, and municipal bond markets.
2. Worst case virus fears did not transpire in terms of mortality and hospital utilization. Though the virus was and is devastating, the market was bracing for worse. As a result, many states and businesses started to reopen sooner than expected.
3. Progress on both vaccines and antiviral therapies. More than 100 vaccine candidates have been developed, with four or five promising enough for advanced trials. In addition, the medical establishment has improved treatment of patients who are ill with COVID-19, leading to what appears to be better outcomes and lower morbidity.
4. In consideration of the points above, the economic data has been better than expected. Jobless claims, housing data, car sales, and business spending have all been above tempered expectations.
5. The 500 stocks making up the S&P 500 Index are capitalization weighted (based on the size of a company's equity), meaning the big stocks that are doing well are driving the returns. This is masking most of the economic pain that has hit many sectors such as retail, travel and leisure, and parts of real estate. The equal weighted S&P 500 has had much less attractive returns and is a better reflection of reality. For example, year to date through June 30th, the equal weighted S&P 500 was -10.77% vs. the (cap weighted) S&P 500 -3.08%.

Reasons for caution as we enter the second half of the year

1. Valuation. The stock market on any measure other than equity risk premium (the excess return that investing in the stock market provides over a 'risk free' rate like a short-term treasury) is expensive. Relative to interest rates at close to zero, stocks are not overly expensive. However, relative to earnings they are expensive especially given the lack of visibility around future earnings over the coming quarters. The truth is no one truly knows how the virus will play out and when we will get back to normal (or some kind of "new normal"). Thus, price earnings multiples should be lower than normal due to excessive volatility and risk around the economy and the future recovery.
2. Distress already exists in many sectors such as travel, retail and entertainment. We are starting to see bankruptcy filings pick up, particularly in small businesses.
3. Municipal finances are dire. Many local governments are laying off employees due to lack of sales and tax receipts.
4. The pickup in recent coronavirus cases is extremely concerning and has caused rolling shutdowns in some very large states. If this case count continues, the recovery we all hope for will be in serious peril.

Clearly this environment is difficult to navigate. As you know from past letters and quarterly calls, we believe in diversified portfolios across asset classes and investments. We are very pleased with the global allocation funds we are using in client portfolios, as parts of Asia and Europe are starting to outperform. This is primarily due to better handling of the virus than in the U.S. as well as lower valuations.

In addition, we recently added investments with best-in-class active managers that replaced passive index exposure. We believe this is an environment where active equity and credit (fixed income) analysis is paramount. Going forward, we believe there will be significant divergences in market performance and high quality, carefully screened active management is critical. On the fixed income side, we continue to allocate to managers who have strong views on areas that are undervalued. One of these areas is non-agency mortgages (non-agency means not guaranteed by government agencies). This part of the housing market has been hit by liquidity, but underlying fundamentals are quite strong. With bond yields so low, we continue to source investments where the income component is high relative to the risk being taken. On the equities side, we are also utilizing hedged equity strategies, those active strategies that can mitigate risk while still generating attractive upside. One example of this is by, alongside a carefully constructed portfolio of stocks, employing a disciplined options strategy that reduces downside in a falling market.

As we move into the second half of the year, the one thing that seems certain is that volatility will remain high. The virus will dictate near-term sentiment and earnings expectations of many companies. In addition, with the Presidential election in November, we expect the market to be somewhat anxious about the uncertainty until the outcome is known. We feel this environment and backdrop demand a careful balance of risk and return and it is with this in mind that we consider current and future portfolio asset allocation for clients.

As always please call or email with any questions.

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