

Mid-Year Outlook 2020

In this issue of the Thinking Man, we address the investment outlook for the second semester of 2020. At the beginning of the year, when we published the outlook for the full year, we were cautiously optimistic. We believed that global economic growth would continue to improve, as the trade war seemed to be ending, corporate earnings were expected to increase by 10%, and both equities and fixed income investments were expected to have mid-single digit returns.

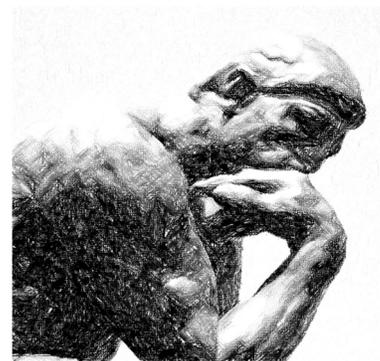
Even as we had anticipated some potential risks, we did not imagine that a black swan event in the form of a pandemic would completely change the investment landscape for the foreseeable future. Currently, the worst of the pandemic seems to be behind us. Global lockdowns are mostly over, and economies have started to recover. GDP data for the second quarter will likely mark the trough of the current economic recession at a historic 31% quarterly annualized contraction. That is, however, past data. More importantly, the economic expansion is expected to resume starting in the current (third) quarter, where a quarterly annualized GDP growth of 21% is expected followed by a further 8% improvement in the fourth quarter of 2020.

With this in mind, the following are our main expectations for the second semester of 2020.

- The economy is recovering faster than anticipated
- The economic recovery will likely lead to a cycle of upward revisions to earnings estimates, typically a market catalyst
- The potential for a coronavirus vaccine or treatment provides a light at the end of the tunnel for investors
- Monetary stimulus will continue to support the markets
- Increased volatility is here to stay and will be prevalent

At the end of the document, we present our updated tactical asset allocation, to serve as a roadmap for our clients' portfolios. However, clients should speak with their investment advisor regarding their customized portfolio, tailored to their financial preferences and needs.

The Thinking Man's Approach



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- We continue to be cautiously optimistic for the second semester, as we believe the market recovery is foreshadowing the economic and earnings recovery.
- However, the average investor remains extremely bearish despite the massive rally in the market since the trough at the end of March, which has led to historic levels of cash sitting in the sidelines.
- The second semester has many potential risks, including a second wave of Covid-19, geopolitical tensions and the U.S. presidential election, which could lead to some pullbacks in the market.
- We continue to believe that long-term investors should take advantage of the dips to continue adding to positions to their investment portfolios.
- At the end, the longest economic cycle was interrupted by the pandemic, but zero interest rate policy for the next couple of years, coupled with a fourth round of quantitative easing (QE) will probably lead to an unexpected melt up.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com



The economy recovery is faster than anticipated

As the first wave of the novel coronavirus was contained, especially in the northeastern parts of the U.S., states around the country were able to start lifting lockdown measures towards the end of April and beginning of May. Because of fiscal stimulus, specifically the Payroll Protection Program (PPP), many workers that had been initially furloughed were able to return to their jobs. Even as the unemployment rate remains at historical highs, the readings for May and June have completely surprised the market bringing down the unemployment rate from 14.7% to 11.1%.

We have argued several times before that the market was having an extraordinary V-shaped recovery, both because of the unrepresented size, scope and speed of fiscal and monetary stimulus, and because investors understood this was foreshadowing a V-shaped recovery for the economy and for an upward revision in future corporate earnings. In fact, apart from the jobs data, we have started to see green shoots around most of the recent economic data, from a recovery in PMI and other surveys, to a massive jump in retail sales as well as new home sales.¹

Nonetheless, some new hotspots of the coronavirus have been emerging recently around the U.S., specifically in California, Texas, Arizona and Florida. These new hotspots have caused the U.S. to reach new record highs of daily contagions, recently topping 50 thousand in a single day. The situation is particularly problematic in Arizona and Texas where ICU occupancy is rising rapidly. This has caused these states and others to pause the reopening efforts and even rollback some measures, such as the opening of indoor dining, bars and cinemas, which will probably limit the progress of economic recovery, but will definitely not stop the expansion. Typically, the development of a new vaccine usually will take years before approval. However, there are currently more than 130 efforts worldwide for the coronavirus vaccine, where governments and regulators are working around the clock 24/7, in an effort to ensure that a vaccine is developed sooner rather than later, which is providing further momentum to the market.

The positive news is that even as new daily cases have shot up, the fatality rate continues to trend down. Several factors can explain this apparent divergence. First of all, doctors are much more experienced now with dealing with the disease, and have a better understanding of the symptoms, and effective treatments, even as there is not a bulletproof cure for it. In addition, most of the new contagions have come from people in the age range of between 20 to 30 years old, who are less likely to die from the disease. Finally, deaths lag new contagions by around 3 weeks to a month, so we could eventually expect a reversal and spike in deaths during the middle of July.

Over the next several months, the market is going to revolve around economic data that will likely continue to improve despite the pauses in reopening in new hotspots, and the likely deterioration of the pandemic in the U.S. A recent statement by Dr. Anthony Fauci, director of the National Institute of Allergy and Infectious Diseases, acknowledged that if the trend were to continue, the U.S. could be seeing 100 thousand daily infections by the end of the summer. Hence, after the spectacular recovery of the second

¹ Green shoots is a term used colloquially to indicate signs of economic recovery during an economic downturn.



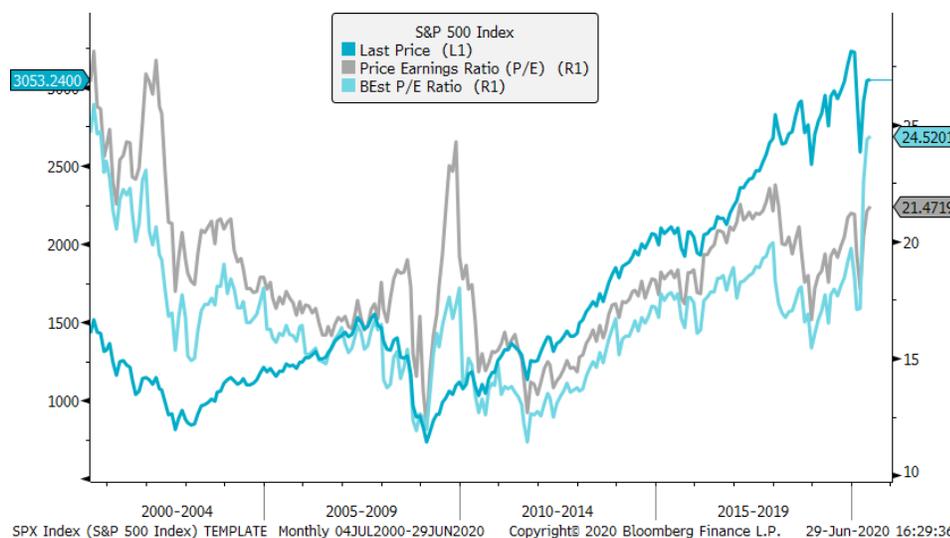
quarter, we can expect a range bound equity market, with a tug of war between positive economic news and negative news from increases in Covid-19 cases, new hotspots, and pauses in reopening measures.

Monetary stimulus will continue to support the markets

The Federal Reserve (Fed), in coordination with other central banks, has loosened monetary policy, by lowering rates to near zero, engaged in a fourth round of Quantitative Easing (QE), and used many of the “alphabet soup” facilities created during the Great Financial Crisis (GFC).² As mentioned previously, the unprecedented size, scope and speed of the monetary stimulus by the Fed has effectively prevented the sanitary crisis into transforming into a financial one. With its first announcements, the Fed restored the solvency in the credit markets, especially by taking the pressure away from potential fallen angels. Furthermore, the Fed remains committed in maintaining the order in financial markets.

More recently, the Fed announced that they would buy investment grade and high yield ETFs, only to announce a few weeks later that they would now start buying individual corporate bonds. The Fed’s Chairman, Jerome Powell, uses every opportunity he gets to admit that the economic forecast is highly uncertain because of the coronavirus, but that the Fed still has sufficient tools at their disposal to stimulate the economy, and as a result, protect the market from another meaningful correction. Investments analysts have named this phenomenon, where the Fed is putting a floor to the market by actively intervening when they sense a potential disruption as the “Fed Put”.

As long the “Fed Put” remains in place, any meaningful correction seems completely out of the picture. Any short term dip, caused by negative economic news such as the expected disastrous third quarter GDP, or by more negative news coming from increases in Covid-19 cases and potential rollbacks of reopening measures, should be used by investors to continue accumulating positions. As there are still massive amounts of cash waiting to be deployed while investors await more economic certainty, we believe that



long-term investors will likely be rewarded by buying the dips. Even as the market may seem expensive using valuation metrics such as price to earnings (P/E), the combination of near zero rates and “infinite” QE, could even provide for further rerating.

² Alphabet soup facilities refers to special lending facilities created during the GFC and have expanded the Fed’s balance sheet by over \$1 trillion in terms of total assets.



Nonetheless, as mentioned previously, the market and economic recovery could be leading to surprising revisions to earnings estimates towards the end of the year and beginning of next year, even as company guidance is currently practically nonexistent. In addition, as can be seen in the graph above, P/E multiples are not reliable predictors for stock returns in the long term.

Increased volatility is here to stay

Volatility has come significantly down since the highs of March. Measured by the VIX, volatility has come down from a high of 82 on March 16, to hovering between 25 and 40 during June. Despite the fourth round of QE and the “Fed Put” described above, we believe the VIX should remain elevated for the rest of the year, relative to the past decade, and should continue to move between 20 and 30.

First, as the coronavirus continues to expand at record rates, and new hotspots appear around the country, the economic recovery could be stalled, as states pause or rollback reopening plans. This would entail that the economic recovery does not have a V-shape, but rather a square root shape, where there is a quick recovery during the first months, but then plateaus. Currently there is a record amount of cash sitting in the sidelines ready to be deployed, when there is more economic certainty. If economic activity were to start disappointing again, then this cash would remain in the sidelines or even increase, which would lead the equity market to correction territory once again, and the Fed and Central Government would be forced to intervene through additional monetary and fiscal stimulus.

Second, there are several geopolitical issues waiting to be resolved. The probability of a cold war between the U.S. and China is increasing by the minute. President Trump seems to have a tough stance against China, but it appears to be common knowledge that he cannot risk another trade war that jeopardizes the economic recovery, completely burying his reelection chances. However, China seems to be aware of this and has been aggressively engaged in its expansionist agenda. It has recently stripped Hong Kong of many of its liberties, and if unopposed, which seems to be the case, the likely next target could be Taiwan. In addition, a trade war may be brewing between the U.S. and the European Union (E.U.) over a digital tax that the latter wants to implement. After abandoning plans for a new global digital tax framework for tech companies, the U.S. has warned the E.U. of retaliatory tariffs if they press ahead with their own measures. As tensions remain elevated both with China and with the E.U. volatility is likely to remain elevated.

Finally, volatility should start to rise in the months prior to the U.S. presidential election in November. At the beginning of the year, investors were discounting a sure Trump reelection. However, as a result of the mishandling of the pandemic compared to other developed nations, and the economic deterioration that came with it, the anticipated winner is now Joe Biden. Many things can happen between July and November, but as it stands, it is Biden's election to lose. What may be worrying, at least from an investment perspective, is that the chances of a Democratic sweep, where they also take back the Senate, have also been increasing. A democratic sweep would probably lead to greater regulation, price cutting for the pharmaceutical industry and a rollback of the tax cuts enacted by the Trump presidency among



other measures. Furthermore, both parties are in election mode, which could jeopardize an agreement on the extension of much needed fiscal stimulus for the continuation of the economic recovery.

New tactical asset allocation

For the second semester of 2020 we have updated our strategic tactical asset allocation as follows:

Asset Class/Type	BSP Moderate Neutral Strategic Allocation ¹		Outlook			Jul-20	
						BSP Moderate Tactical Allocation	
Cash	4.2%	--	-	Neutral	+	++	6%
Cash	4.2%						6%
Fixed Income	28.2%						29%
Fixed Income High Grade Developed (USD)	12.6%						15%
Fixed Income High Grade Developed (non USD)	2.4%						3%
Fixed Income High Grade Emerging (USD)	4.0%						4%
Fixed Income High Grade Emerging (non USD)	1.2%						1%
Fixed Income High Yield Developed	5.0%						5%
Fixed Income High Yield Emerging	3.0%						2%
Hybrids & Perpetuals	5.2%						6%
Hybrids & Perpetuals	5.2%						6%
Equities	33.0%						31%
US Equity	19.4%						20%
Europe Equity	5.8%						6%
Japan Equity	2.0%						2%
Pacific ex-Japan Equity	1.4%						1%
Emerging Markets Equity	4.4%						2%
Alternative Investments	23.6%						23%
Hedge Funds	2.4%						2%
Real Estate	7.2%						8%
Private Debt	7.0%						8%
Private Equity	7.0%						6%
Real Assets	5.8%						4%
Commodities and related securities	2.0%						1%
Gold and Gold Miners	2.4%						2%
Intangibles / Collectibles	1.4%						1%
Total	100.0%						100%

¹ Updated 07/20



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