Second Quarter 2020 – Investment Commentary

WEST SHORE BANK

Early in the second quarter Covid-19 fears were rampant as positive test cases and fatalities were on the rise, most states were implementing shelter in place mandates, and the U.S. economy came to a screeching halt. In May, the first readings on the damage done to the economy were released and as expected it was ugly. Record monthly declines were set for labor and retail metrics. Also in May, Covid-19 protection measures began to slowly loosen to the dismay or delight of many. As the quarter closed, the economy was on the mend as record monthly gains were posted for labor and retail metrics. The severe recession looks to be short-lived but the question for the remainder of the year is to what degree virus case levels will continue to increase, whether a second wave will occur in the fall, and how these events may prolong the recovery.

Based on the stellar performance of stock markets this past quarter, the U.S. economy is in the beginning of a strong V-shaped recovery. Stock markets posted their best quarterly performance in decades retracing a large portion of the losses experienced in the first quarter. Despite the strong quarterly performance, most indices are still in negative territory for the year except for the technology heavy NASDAQ index which recently posted a new all-time high.

Table 1 – Stock Index Total Returns – as of June 30, 2020

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	6.07	30.95	12.67	26.94	19.14	16.36	18.25
S&P 500	1.99	20.54	-3.08	7.51	10.73	10.73	13.99
Dow Jones Industrial	1.82	18.51	-8.43	-0.54	9.08	10.62	12.99
MSCI Emerging	7.35	18.08	-9.78	-3.39	1.90	2.86	3.27
MSCI Developed	3.40	14.88	-11.34	-5.13	0.81	2.05	5.73
S&P 400	1.26	24.07	-12.78	-6.70	2.39	5.22	11.34
Russell 2000	3.53	25.42	-12.98	-6.63	2.01	4.29	10.50

The fuel driving stock markets sharply higher were the Federal Reserve, Congress passing the CARES Act, and exuberant optimism surrounding states reopening their economies.

The aggressive actions the Federal Reserve took to stabilize credit markets worked as credit risk premiums have declined significantly, bond new issuance has climbed steadily, and treasury yields remain near historic lows. But these actions call into question the stock and bond markets increasingly utter dependence on the Federal Reserve. Is it the Federal Reserve's job to come to the rescue and bail out essentially all levels of credit and liquidity risk via special purpose vehicles each time there is market and economic turmoil? It is increasingly becoming the norm and greatly discounts the notion of risk and reward. Failure is an essential part of the capital market system. It is called "risk and reward" for a reason.

The recent steps taken by Federal Reserve has ballooned their balance sheet to over $7 trillion. This rise poses a long-term structural risk for the Fed and capital markets. How is the Fed going to unwind their balance sheet without again disrupting credit markets? Look what happened most recently when they tried to gradually unwind their balance sheet. Overnight repo market operations were greatly disrupted and the level of available bank reserves became constrained. This was when the Fed's balance sheet was at $4 trillion. This past quarter, the old adage of "don't fight the Fed" again held true. At some point going forward, it will be the Fed fighting itself handcuffed by being the unending savior and protector of credit and liquidity risk and stock markets as well. A few years from now, when the handcuffs are to be loosened, the capital markets will be shouting keep them on!!

Another major development this past quarter and likely for the remainder of this year was volatility. Stock market volatility as measured by the VIX Index reached an all-time high last March. As this quarter unfolded, market volatility gradually trended lower but settled in a range much higher than its historical average. This above average level of volatility indicates stock markets are still unconvinced as to the pace and depth of the economic recovery. Moreover, between now and the November presidential election, social unrest, and all methods of political rhetoric (lucky us!) will be on the rise adding to volatility and uncertainty.

Another indicator that questions the validity of the stock markets V-shaped recovery premise are treasury yields. Bond markets had solid total returns last quarter but it was not because of a drop in interest rates, it was due to taxable and tax-exempt credit spreads compressing as tight financial conditions loosened due to steps taken by the Federal Reserve to support credit market liquidity.

Table 2 – Fixed Income Index Total Returns – as of June 30, 2020

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Barclays Aggregate	0.63	2.90	6.14	8.74	5.32	4.30	3.82
Barclays Inter Gov't/Credit	0.62	2.81	5.28	7.12	4.43	3.46	3.13
Barclays Municipal	0.82	2.72	2.08	4.45	4.22	3.93	4.22
Barclays High Yield	0.98	10.18	-3.80	0.03	3.33	4.79	6.68

If the economy is going to be rebounding so quickly and strongly, why haven't longer-term bond yields risen? Treasury yields barely budged across the yield curve last quarter which indicates bond market participants are not convinced the economic and corporate earnings rebound will be as robust as the stock market expects. We concur with the bond market and believe current stock market valuations are not befitting.

Clouding the economic outlook is the vast level of disruption caused by Covid-19. The shutdowns impacted the collection of economic survey data and has most certainly hampered the degree of reliability of some economic reports. This in turn has led to gigantic estimate misses by economists and analysts, and an overall lack of clear visibility on what is actually going on with the economy. Take the labor market for example. April, May, and June estimates missed the mark by astonishing gaps leading many pundits to question the veracity of the reports. While monthly job growth came in at records levels in May and June, weekly initial jobless claims remain stubbornly high, and the number of people on unemployment insurance rose by 916,000 last week to a whopping 31.4 million. So you can see why there is confusion on discerning the level of labor market strength. Labor market clarity is vitally important because employment in large part drives consumer spending and confidence.

The recent rise in the number of positive Covid-19 cases has led many states to pause or reverse reopening phases and this has raised concerns the economic recovery could stumble and be prolonged. As the U.S. economy begins its ascent out of this record recession, the path forward is going to be uneven and the pace of recovery is likely to encounter fits and starts until a vaccine is found. Markets could move higher from here and even reach new highs, but these stretched valuations are not sustainable and are inconsistent with underlying fundamental trends. Given the level of uncertainty surrounding this current economic and political environment, we expect volatility to remain above average and err on the side of cautious optimism. Our tactical strategy employs a prudent modest underweight to stocks and overweight to bonds and cash.

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Sources: FactSet, U.S. Department of Labor, Federal Reserve