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Rapid Changes

Lately, it seems that all of these are coming into play in rapid succession.

- COVID is sickening America, then it gets better, now it's getting worse again
- Some places re-open early, now they are facing closing again
- The economy collapsed, but some sectors are roaring back, other are not
- Some workers make more on unemployment and don't want to go back to work
- The country was together to fight COVID, but now is divided and there is social unrest

Amid all the bad economic news, the stock market stormed back close to its' all time high but over the last 2 weeks has had a decidedly more difficult time. Markets often move in extremes. How does this make sense?

We'd like to make some observations….

1) - In the long term the market is a weighing machine – it depends on fundamentals, like earnings and cash flow. In the short run it is a voting machine. Emotions rule over fundamentals.

There is little doubt that we have been on an emotional roller-coaster this year. The year begins with the economy as strong as it has been in a long time, unemployment was very low and the weighing machine was in action. Then the pandemic began to hit. Fear was spreading rapidly and being fueled by the media. Economies around the world shut down one by one, and we added economic fears to the mix, and markets plummeted with record speed.

Almost as quickly, markets recovered much of their losses.

- **We have learned more (but not enough) about COVID.**
- **It appears to be not quite as bad as first imagined**
- **Vaccines and treatments were deemed not too far off.**
- **Infection rates subsided**
- **Belief that the economy would recover took hold**

We now appear to be reversing ourselves again and markets began to sink late in the week.

- **Several Southern and Western states are at or close to the danger zone.**

- **Florida and Texas have begun to back track on their re-opening** schedule and closed down some businesses again
- **Where ICU units are already full, the next several weeks are bound to be full of bad and urgent news** (something we are unfortunately familiar with in the NY area).
- **The economic recovery in those areas is in jeopardy**

We read a short research note from Richard Bernstein Advisors that placed our thoughts into the most simple and effective words – **"The road to recovery starts with things getting less bad",** and the economic news has indeed been getting less bad. As shown in the Table below, of the ten leading economic indicators, nine were moving in a positive direction in May. We are not back to where we were, but directionally, we are moving in the right direction.

Conference Board Leading Economic Index Components	May-20	Apr-20	Mar-20
Average workweek, production workers, manufacturing (hours)	0.9	-2.8	-0.3
Avg Weekly Initial Jobless Claims (sign reversed)	1,892	-1,514	-2,453
Manufacturers' new orders, consumer goods and materials	793	-18,674	-6,753
ISM® New Orders Index	4.7	-15.1	-7.6
Manufacturers' new orders, nondefense capital goods excluding aircraft	1,194	-2,178	-596
Building permits	154	-290	-82
Average Consumer Expectations for Business Conditions (st. dev.)	0.23	-0.13	-1.64
Leading Credit Index	-0.39	-0.51	2.81
Interest Spread 10 year Treasury Less Fed Funds Rate	0.01	0.39	0.30
S&P 500® Index	158	110	-625
Conference Board Leading Economic Index	**2.7**	**-6.3**	**-8.4**
% Improving	90%	20%	20%

Source: Richard Bernstein Advisors LLC, Bloomberg, S&P, ISM, Conference Board

The Purchasing Managers Index (PMI) for June was released this week. The results in developed countries were all quite good in the sense that they indicated that the recovery is proceeding rapidly, although the US indexes lagged expectations. Here is a look at the data. (Note that an index value under 50 indicates a contraction and over 50 indicates an expansion.)

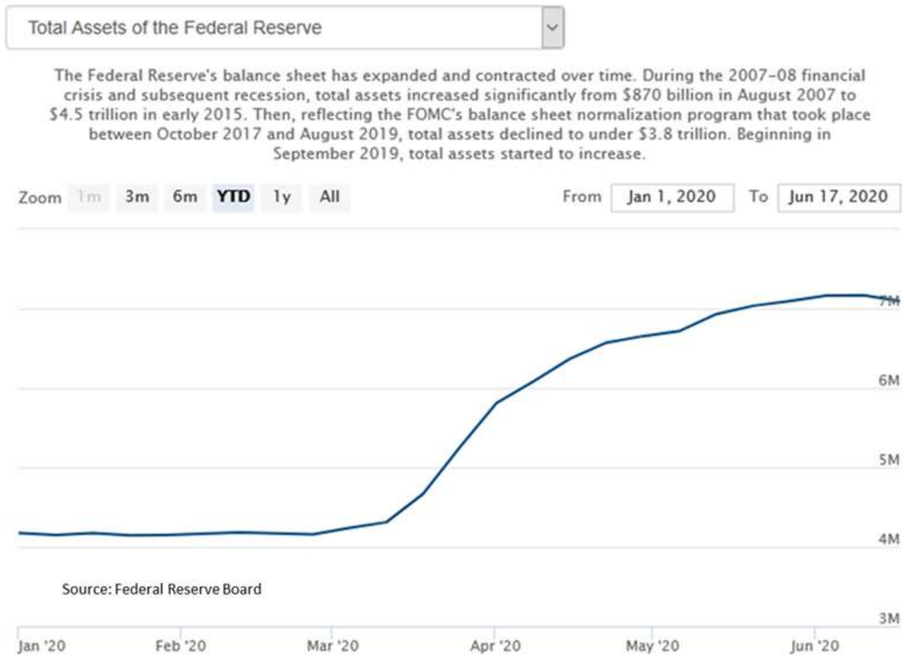
In the U.S., the manufacturing PMI reached 49.6 (blue line) and the service PMI reached 46.7. Both still contracting, but markedly better than April and May. Nonetheless, these results did not meet expectations, which were likely influenced by the massive run in the CITI Economic Surprise index over the last several weeks (red line).

2) COVID is not going away anytime soon – We need to find a way to coexist with the virus for the time being.

The new areas with COVID problems are not second waves, these are areas that generally escaped a first wave back in the Spring. With a large land mass and easy transportation from state to state, it is simply more difficult to contain a virus here. It appears that the lock-down and early re-opening was successfully in delaying the first wave, but not avoiding it. **The only question is whether these waves will be as scary and damaging as the early waves.** The Trump administration has said there will be no more lockdowns, at least on the Federal level. At the State level Texas and Florida began to back track on Friday. Others seem destined to follow.

The bottom line is that we need to learn to take care of ourselves. **The better we as a population react, the better the outcome, in terms of both health AND economics.** If you won't wear a mask for your personal safety, wear it for your financial safety. The economic impact has already been serious, but it can get worse if we allow it. If we take the attitude that wearing a mask is somehow infringing on my rights, it will be a much bumpier ride, not only for the economy but for our health care system.

3) The FED Put has also played a substantial role in the stock and other markets. As we have explained previously, when the Federal Reserve (FED) buys assets in the open market, it has to pay for those assets, which is a direct injection of money into the economy. That money has to go somewhere, and where it has gone is into other assets, thus supporting all financial markets and that support has not been trivial. **Since late March, the FED balance sheet (think of this as the measure of what they have purchased and therefore injected into the economy) has increased by roughly $3 trillion.**



The recent market stall may not just be a function of COVID. **It is interesting to note that the market rise has stalled just as the FED balance sheet has begun to roll over (see chart above).** We certainly do not expect the FED balance sheet to continue that recent downward trajectory, but we have switched from having a foot on the gas pedal to coasting down the highway. A new COVID outbreak could drive that higher again, but we need to always beware the day that the FED feels the need to hit the brakes.

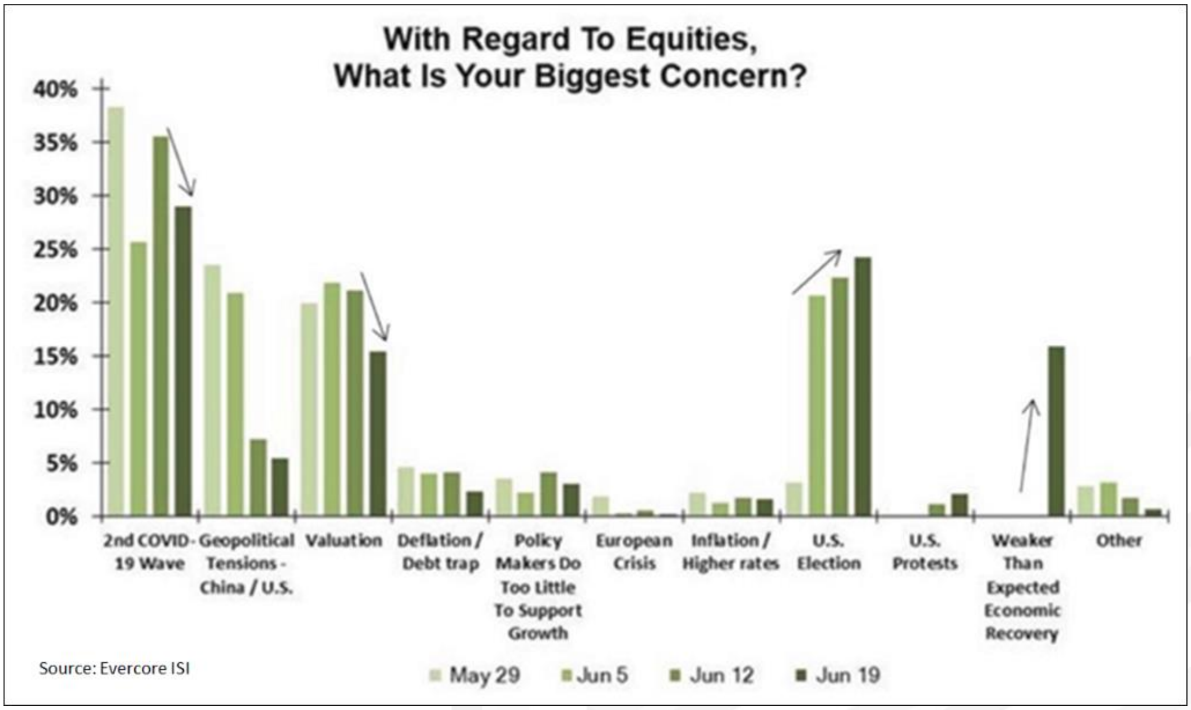
4) There are plenty of other things waiting in the wings that can disrupt the market – China relations and the election are high on that list. It is very difficult to envision how relations with China improve in the near term. **The President has made fundamentally altering the relationship with China a key to his administration. He is unlikely to back down before the election.** China, of course, is resisting that change and hoping that a Biden win can relieve that pressure. Between now and the election, so neither side has any motivation to appease the other. It's a stalemate at best until after the election. **The worst case is that an accident occurs as each side antagonizes the other, which could lead to a physical altercation of some sort.**

The election remains a wildcard. It will be here sooner than you think, but is still too far away to draw conclusions. **A Biden win, which is currently indicated in the polls, appears likely to result in higher corporate tax rates, which can be reasonably expected to have a negative impact on markets. A Trump victory will push the China de-coupling agenda forward, a process that will very**

difficult for both countries. In a Biden administration, relations would likely improve, but the old problems would remain. Pick your poison.

5) "Still a man hears what he wants to hear and disregards the rest" – Paul Simon

But it may be that all of the above really matters little. **When markets are rising, we tend to only see the positives, and when it turns, all those positives melt away very quickly. This has been a natural process in markets for generations. The one thing that has radically changed is the speed at which these changes occur.** That is partially a function of the wider and faster spread of news, but it is equally a function of the rise of the machines in the trading world. Computers change their minds in a nanosecond; we humans take a little longer. As a result, **cycles that traditionally took months or years, now take weeks, or even days, and that just makes markets that much more confounding.**



The road to recovery starts with things getting less bad, but that does not imply that the road is smooth. **Look for more strong sentiment swings as events unfold that take markets with it, and often at frightening speed. A steady hand on the wheel is required and that is what we aim to provide.**

Summarizing the Recovery

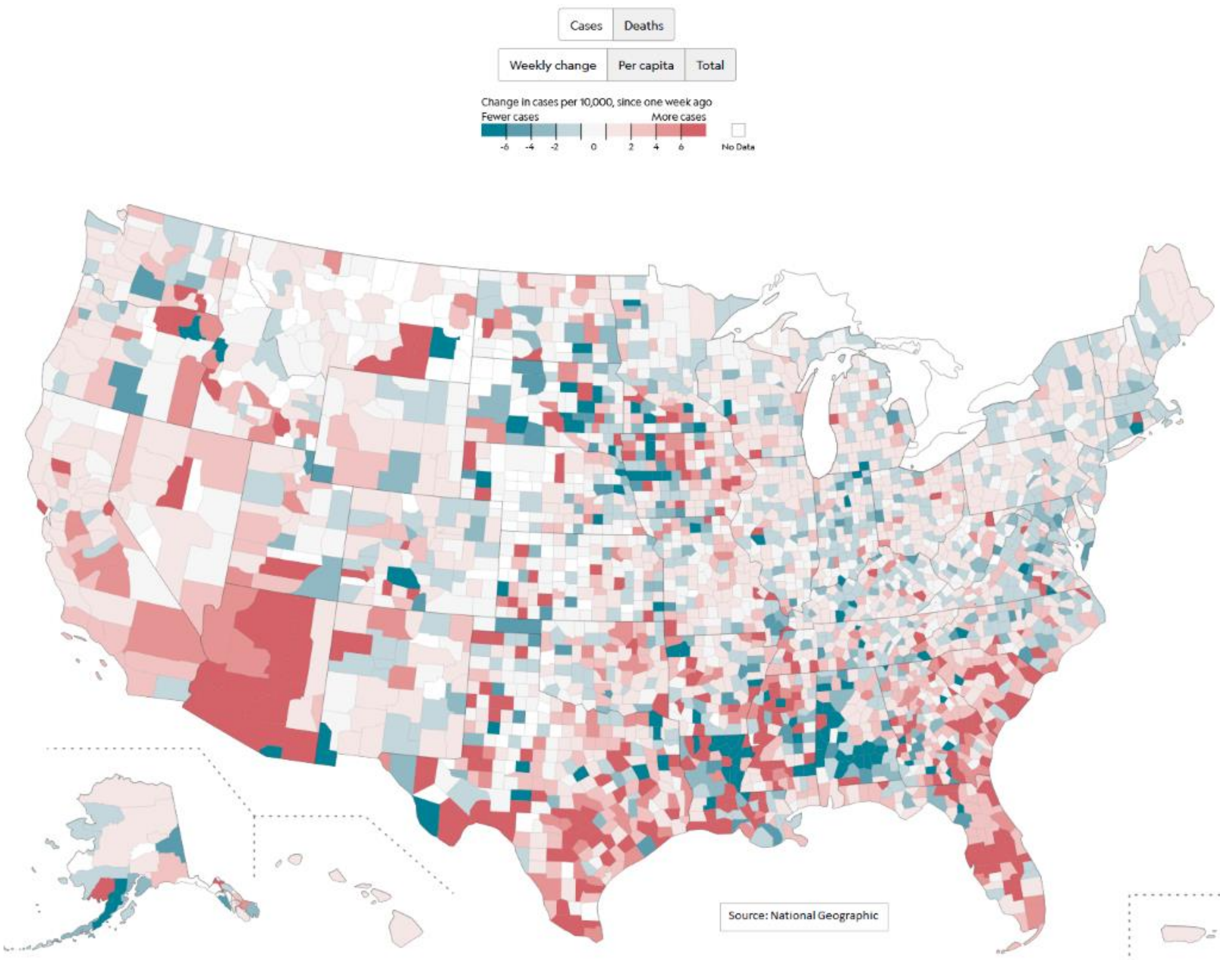
We believe there are three phases to this recovery.

Phase 1: A major leg-up in the stock market. We are passed this phase.

- **The S&P 500 increased 44.4% from the low March 23rd** . Pandemic response was positive and economic data improved. The news got less bad.

Phase 2: A second leg-up, or a leg-down, in the market. We are in this phase now

- Re-opening of the economy and either we successfully contain the virus or we don't. The Northeast is looking good, the South and parts of the West are not (See chart below). **S&P 500 is down 7.1% since the peak on June 8th.**



Phase 3: Begins when we the virus is contained in one way or another (vaccine, therapeutic or herd immunity)

- Markets will look past COVID and assess what economic damage is temporary and what may be permanent and assess a sustainable rate for economic growth after pent up demand is satisfied.

Conclusion:

In a complex world, we try to keep it simple. We believe these phases are a simple way to understand where we were and a framework to assess our progress. In our view, this is what you need to know and understand.

Finally, as always. PWM constructs portfolios that includes a diversity of the major asset classes that are not correlated to each other. While there is no guarantee, we expect this diversity will help us to protect our investor's capital on the downside as well as provide for us to participate on the upside as we progress through phases 2 and 3.