2020 MID YEAR **INVESTMENT REVIEW**

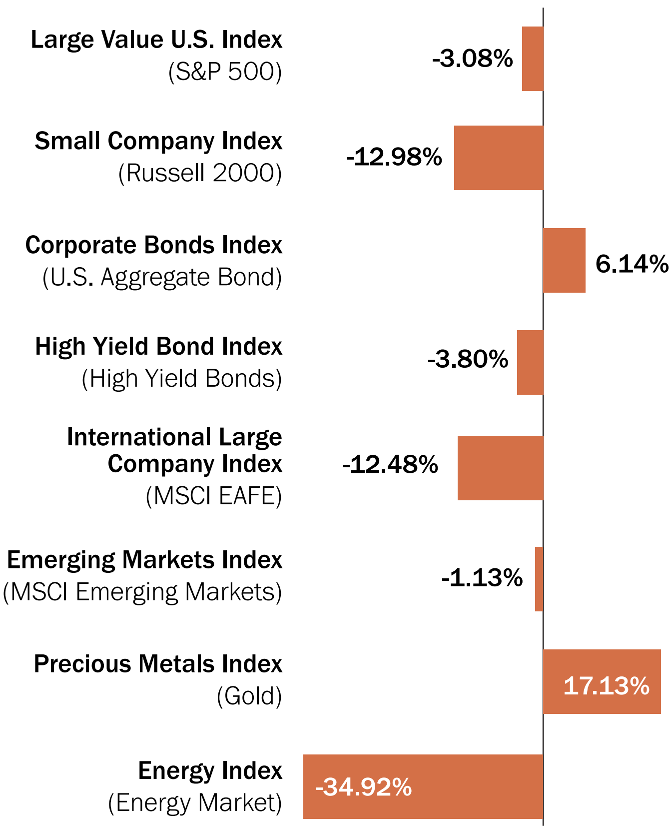
Market Overview

Equity markets suffered steep declines across the globe during the initial outbreak of COVID-19.[1] Since then, stocks have rebounded sharply from their lows, with the S&P 500 nearly back to break-even for the year.[2] Global central banks provided much of the help in quelling volatility and boosting prices by pumping liquidity into the system via stimulus programs and bond purchases in both high yield and investment grade markets.[3]

A CHALLENGING FIRST HALF FOR MOST ASSET CLASSES

On the fixed income side, rates remain near historical lows[4] as evidenced by the 10-year Treasury yield plunging from 1.88% at the beginning of the year to 0.66% on June 30.[5] In response, duration-based investments, such as the U.S. Aggregate Bond Index, performed well over this period (see Figure 1).

FIGURE 1. YEAR-TO-DATE TOTAL RETURNS BY INDEX (1/1/2020 – 6/30/2020)



Source: Morningstar, data as of 6/30/2020.

Energy markets have struggled thus far in 2020. Forward-looking demand weakened ostensibly as people cut back on travel due to federal and state restrictions as well as personal health concerns.[6] Inversely, gold delivered strong gains as investors apparently sought real assets that could protect against inflation, given all of the central bank liquidity being injected into our economy.[7]

Navigating Through the Fog With a Broken Compass

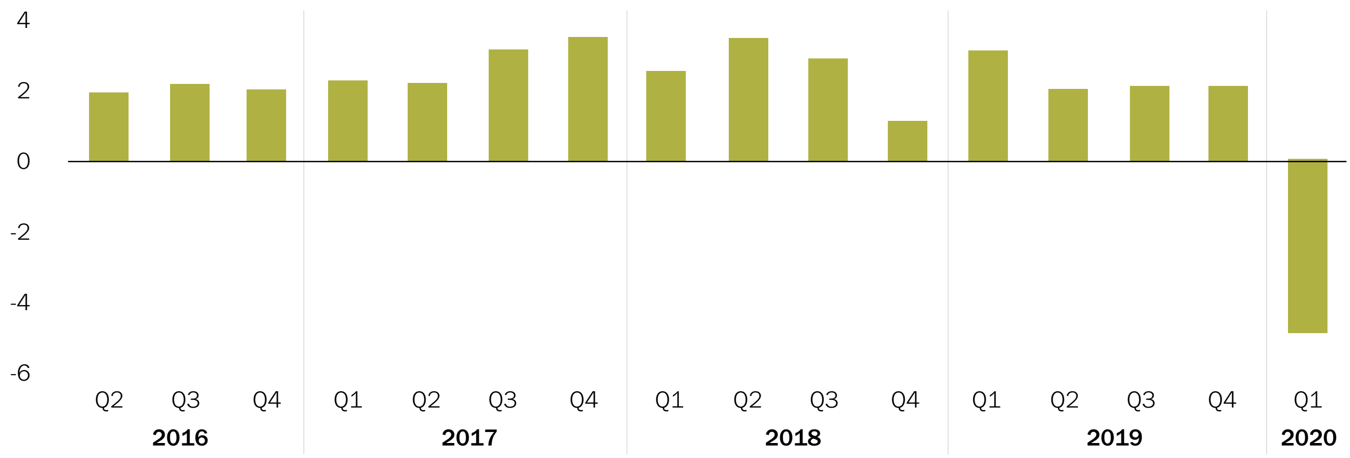
The economy is now grappling with the effects of the global pandemic. According to the National Bureau of Economic Research, real gross domestic product (GDP) increased 2.1% in the fourth quarter of 2019 and peaked in February 2020.[8] GDP decreased at an annual rate of 5% in the first quarter of 2020 as "stay-at-home" orders led to drastic changes in consumer demand and spending, business operations, and schooling (see Figure 2). GDP continued to fall in the second quarter as the unemployment rate went from 4.4% in March, to 14.7% in April, to 13.3% in May, to 11.1% in June.[9]

ECONOMIC GROWTH DERAILED BY COVID-19 RESPONSES

According to Woody Brock of Strategic Economic Decisions: For decades, consumer spending (the bulk of GDP) has remained remarkably stable, mirroring stable employment in the service sector representing 86% of all incomes. But in

1 https://www.reuters.com/article/us-global-markets/stocks-fall-close-out-biggest-quarterly-drop-since-2008-idUSKBN21I02G
2 https://www.bloomberg.com/markets/stocks
3 https://www.reuters.com/article/us-usa-fed-repo/fed-provides-massive-liquidity-injection-to-calm-markets-amid-signs-of-stress-idUSKBN20Z31H; https://www.cnbc.com/2020/06/29/the-fed-is-buying-some-of-the-biggest-companies-bonds-raising-questions-over-why.html
4 https://www.cnbc.com/2020/03/09/10-year-treasury-yield-plunges.html
5 https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/TextView.aspx?data=yieldYear&year=2020
6 https://oilprice.com/Energy/Crude-Oil/The-Oil-Gas-Sector-Could-Already-Be-In-Terminal-Decline.html
7 https://www.marketwatch.com/story/gold-prices-extend-climb-above-9-year-high-as-traders-see-few-limits-to-central-bank-stimulus-2020-07-08
8 https://www.bea.gov/news/2020/gross-domestic-product-1st-quarter-2020-third-estimate-corporate-profits-1st-quarter-2020
9 https://www.bls.gov/news.release/pdf/empsit.pdf

FIGURE 2. REAL GDP: PERCENT CHANGE FROM PRECEDING QUARTER



Source: U.S. Bureau of Economic Analysis. Seasonally adjusted at annual rates.

the current environment, it was the implosion of the service sector that caused the first recession in history to be generated by a collapse in consumer spending.

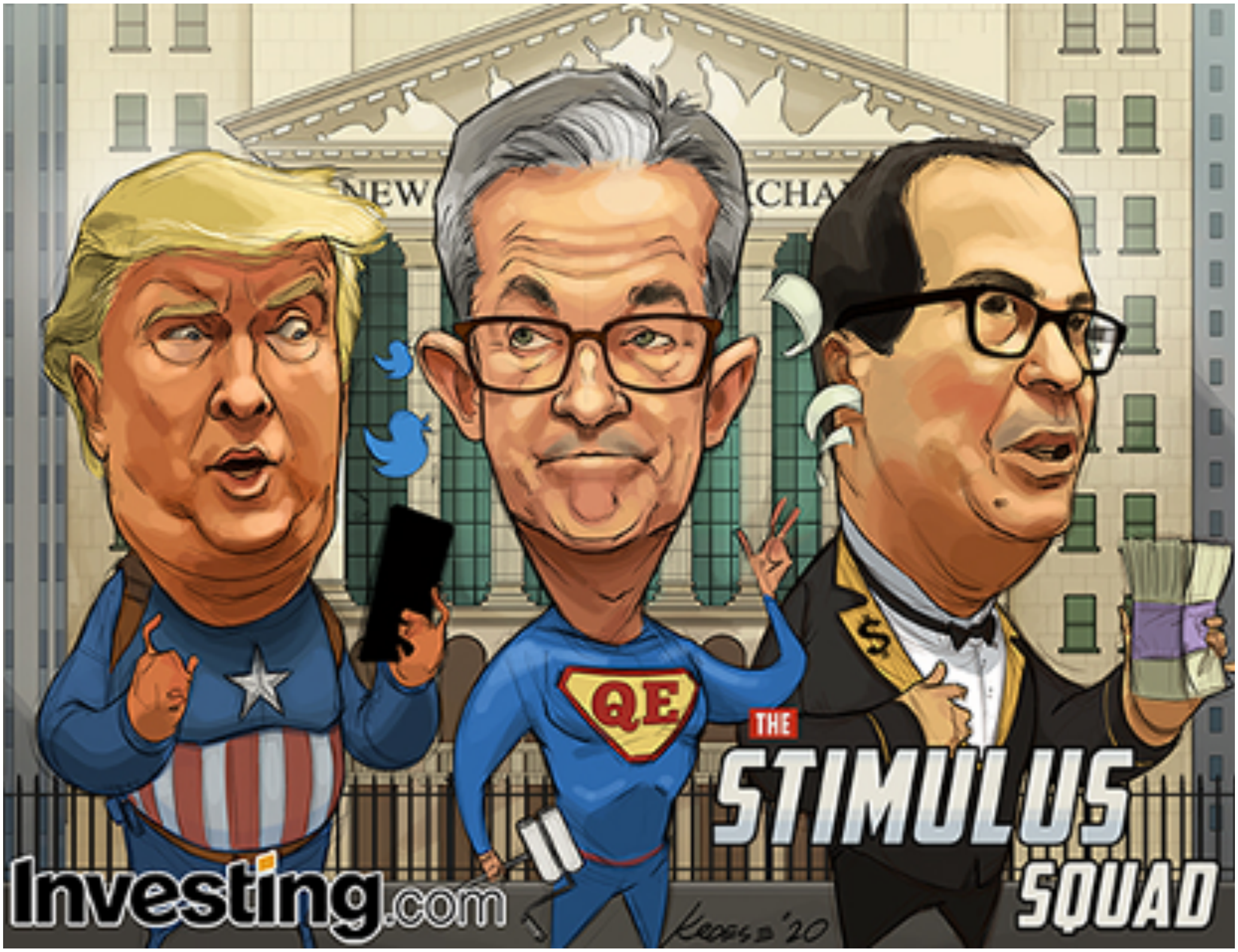
This collapse on the demand side of the equation prompted a monetary and fiscal stimulus response much larger in scale and scope than the one following the Global Financial Crisis of 2008-2009.[10] We believe what makes today's situation so unique is that it is a policy-induced recession created by suppression of economic activity to mitigate the spread of COVID-19. In addition, the global supply chain was disrupted across operations in ways that are difficult to model and assess.

We feel the resulting combination of an unprecedented policy-induced recession and large monetary and fiscal response cast a thick fog over the economic landscape, making it extremely difficult to navigate investment markets. While fiscal and monetary stimulus act to temporarily support the economy and investment assets, the full extent of COVID-19 and its long-term implications remain unknown. More is being learned every day about the health consequences, but we still don't know the effects on consumers, workforce behavior, or supply chains. This makes it difficult to anticipate how the service sector will respond to evolving consumer spending habits.

Without understanding how the service sector will recover, it is challenging for the supply side to know what to deliver. For example, supply/demand for commercial office space is difficult to predict, in part, because we don't know how many people will continue to work from home. How will social distancing affect how much office space is needed? In turn, how does this affect office space pricing and construction, which could also impact building materials and jobs, office furniture companies, lending institutions, and other related industries?

Questions like these only increase uncertainties about the economy's future direction, even as we learn more about COVID-19. The Federal Reserve is providing liquidity to the system, but how far can they go if insolvency issues arise? How much and how long can fiscal relief continue to support unemployed workers and small business owners? What are

10 https://www.mckinsey.com/featured-insights/coronavirus-leading-through-the-crisis/charting-the-path-to-the-next-normal/total-stimulus-for-the-covid-19-crisis-already-triple-that-for-the-entire-2008-09-recession



the long-term effects of an expanding Fed balance sheet and growing fiscal debt? Although the economic downturn didn't start as a financial/banking crisis, there is growing concern it may become one due to the repercussions of COVID-19. As of this writing, the number of confirmed cases continues to rise, while Congress is drafting another stimulus package.[11]

SFG's Response

Because COVID-19 will likely reshape the economy, we continue to monitor its direct impact on monetary and fiscal policy, consumer behavior (demand), and businesses (supply). As the virus dissipates and signs of the next economic expansion begin to emerge, we believe the technology sector will lead the way, much as it has done throughout the pandemic. Accordingly, we believe this

[11] https://www.forbes.com/sites/zackfriedman/2020/07/15/second-stimulus-checks-unemployment/#1b1efe56ce90

decade will see tremendous technological development and disruption. “According to [Joseph] Schumpeter, the ‘gale of creative destruction’ describes the ‘process of industrial mutation that continuously revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one.’[12] We hope the “financialization” of the economy doesn’t slow down this process.

When we review our clients’ portfolios, there is only one question we now apply to all investments: risk versus return. In other words, is the projected return clients receive on today’s value worth the risk or the price they are willing to pay? As we navigate a foggy economy in which so many variables can change at any time, we assess each investment using scenario analysis to evaluate whether we believe clients are being rewarded for risks taken. As we like to say, while the debt music continues to play globally, we want to make sure we have a chair when it stops. Right now, the music is getting louder and we’re not hearing clear notes.

[12] https://en.wikipedia.org/wiki/Creative_destruction#:~:text=According%20to%20Schumpeter%2C%20the%20%22gale,incessantly%20creating%20a%20new%20one%22