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Market Commentary

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Major Developments

In China, Japan and Europe, recovery from the pandemic progresses, while India continues to struggle to contain the epidemic. In the United States the epidemic is resurgent and there is no national plan to bring it under control.

The apparent strategy appears to be a bet on the quick arrival of an effective vaccine. However, if any plans for a mass vaccination program have been made they have not yet been shared with the public. In our June edition we noted that the government was placing a dangerous bet on the future course of the epidemic. At this point it is clear that, that bet has been lost. Recklessly, the government is doubling down on a losing bet. It has sought to coerce schools to reopen for the fall term. The apparent goals are to provide relief to working parents and to create the semblance of normality. It seems likely that if schools reopen at this juncture, then some children will get sick, a percentage of those may die and more will spread infection to their parents. The whole affair seems likely to be swept up in the cacophony of partisan politics. We are skeptical that a policy of reopening can survive pictures of dead kids and devastated parents appearing on the evening news. According to a recent New York Times poll, 61% of parents already feel this is a bad policy. To our mind, sounder policy would be to focus on improving distance learning rather than pushing a contentious and perhaps unsustainable policy.

In the United States, a consensus in favor of mask wearing is gradually forming. In Congress both Senate Majority Leader Mitch McConnell and House Speaker Nancy Pelosi are strong advocates of mask wearing. President Trump is now lending unenthusiastic support to this policy. Many states, tribes and local governments have mandated mask wearing. However, these policies meet civil liberties challenges in some quarters and a few individuals have even reacted violently against business employees seeking to uphold mask policies. In Georgia, the governor has taken action to strike down local ordinances requiring mask wearing despite the high rate of infection in the state. The courts have not yet addressed mask mandates specifically, but they are likely to uphold them given long standing health measures imposing dress codes; for instance, in restaurants customers are generally required to wear shoes and kitchen staff are required to wear hair nets. In a handful of religious liberty cases the Supreme Court has indicated that it will not favor civil liberty challenges to health regulations which are rational and proportionate. Much of America's existing quarantine legislation dates to the terrible epidemics of cholera, typhoid, tuberculosis, polio and dysentery which raged episodically up to the widespread use of vaccines and antibiotics after World War II and accompanying improvements in urban water supply and sanitation. Thus from a legal perspective, current health measures are sanctioned by long established precedent.

For several months now the polls have steadily indicated that President Trump will likely lose his reelection bid in three months time. On the other hand the President has been a vigorous supporter of vaccine development and it is possible that good news in this effort will arrive in the nick of time for him to turn the election from a referendum on his personal performance back to the ideological battle which is relatively more favorable to him. A seriously inept performance by his challenger former Vice President Biden in the presidential debates could also throw President Trump a potential lifeline. These are both contingencies, however, and investors should regard the advantage as currently lying with the challenger. With the real possibility that the President will be indicted by State and/or Federal authorities should he leave office in January, we can expect him to contest the election with more than usual vigor and for news commentary to continue on high boil.

The Democrats have been putting out a series of platform documents. These are mostly inline with the policy expectations we articulated in our June commentary. One item, however, bears special note. It is proposed that capital gains of persons with more than one million in income should be taxed as ordinary income, i. e. at a 40% rate rather than at the preferential rate of 20%. The platform document does not go into such details as whether personal residences would be excluded or whether some form of income averaging would apply to separate once in a lifetime windfalls from habitual events. Given the importance of New York and California to the party and the high price of real estate in those states's cities, we think the Democrats would likely shelter a retiree's sale of a highly appreciated family home from such a tax. However gains on financial and business investments are unlikely to enjoy such a shelter. If enacted, such a tax hike would probably pass into law in mid 2021 with an effective date of January 1, 2021. However, it is theoretically possible that it would be enacted in January with the date of the election as its effective date. Investors who already have a transaction resulting in significant gain in contemplation may wish to accelerate their timetable such that the transaction closes prior to the election or at least by year end.

Along with high incomes, inheritances are another favorite target of the Democrats' tax policy. Investors with potential exposure should monitor the evolving situation. Another possible change the Democrats will push is raising the ceiling on the payroll tax, possibly even removing the ceiling entirely, and extending the payroll tax to all types of income and not just earned income. Such changes could raise the maximum Federal income tax rate as high as 55%. As previously noted, however, reviving the economy will be a more immediate goal than addressing long term fiscal balance and we expect any tax changes to reflect the moderate end of Democratic policy making.

To enact major tax changes the Democrats will need to capture control of the Senate as well as win the Presidency. However, polling currently suggest that such an outcome is possible.

Internationally the United States seems unlikely to take strong stands until after the national election has clarified the political landscape. While United States leadership remains quiescent, the United States's traditional allies and India are quietly hardening their stance against China and US naval forces remain deployed to the Western Pacific.

Growth of fundamental knowledge about COVID-19 continues slowly. Much is still not well understood. Infection rates in Indochina and especially in Thailand are surprisingly low. It is possible that an older variant of the tuberculosis vaccine, still in use in some countries, may create resistance to covid-19. On the other hand, there are indications that any resistance created to the virus by actual infection may confer only temporary immunity. If this indeed proves to be the case for vaccine induced immunity, then a mass vaccination program would need to be rolled out in a short time window to halt the epidemic. Two vaccine candidates are currently in the final stage of testing and several other contenders shortly will begin final stage testing. First results could come as soon as two months after enrollment of test subjects completes. These initiatives appear on track to deliver at least partially effective vaccines at some scale in the fourth quarter. One may hope so; the United States is currently on track to experience 10 million cases and more than 300,000 fatalities by year end according to the latest projections from the Institute of Health Metrics and Evaluation at the University of Washington. This team has previously been noted as a modeling group with relatively more optimistic forecasts than its peers

Public demonstrations in favor of social justice are tapering off in most jurisdictions. Presumably this is a consequence of both the mounting risk of infection and the increasing focus on more traditional forms of electoral politics. It is too soon to evaluate what the lasting consequences of this upheaval will be. Certainly awareness of social justice issues has been increased and broad willingness to engage with social justice concerns has been exhibited. But we are cautious in evaluating the depth of commitment to this area of the political agenda. Virtue signaling and symbolic gestures are inexpensive steps to take. Making real progress on addressing the complex interlinked problems of poverty and racial disadvantage will require substantial well designed public programs applied for multiple election cycles. Until substantive discussion of such programs is underway it is difficult to gauge the true public commitment to this area of concern. The terms currently being thrown about of "defunding the police" and "reparations for slavery" seem more electioneering slogans than ideas which could survive serious policy scrutiny.

The path back to economic normalcy now appears to be an extended one. For some it may come too slowly, and we expect an increasing wave of bankruptcy filings and small business closures in the coming quarter. Areas of acute stress are restaurants, hotels, airlines, personal services, retail, mall and office building operators and energy. Specific banks will prove to be particularly exposed and may suffer substantial earning hits. By contrast, technology, cloud services, online retail, and package delivery have all benefited from the pandemic. Overall, the pandemic appears to be accelerating the economy away from the traditional economy of brick and mortar to the distributed economy of the technology enabled future.

Market Review

July continued the streak of positive performance, a continuing surprise to many though broadly consistent with a bottoming US economy. US employers added 1.8 million jobs over the month, bringing the unemployment rate down to 10.2% (relative to a prior 11.1% and an expected 10.6%).

Market Index	July 2020	Jan-Jul 2020
S&P 500	5.6%	2.4%
Russell 2000	2.8%	-6.4%
MSCI EAFE	2.3%	-9.3%
MSCI Emerging Markets	9.0%	-1.5%
Bloomberg Barclays US Government	1.1%	10.0%
Bloomberg Barclays US Aggregate	1.5%	7.7%
Bloomberg Barclays US High Yield	4.7%	-0.3%
Bloomberg Commodity	5.7%	-14.8%

Market volatility further subsided, from 30 to 24, its lowest level since late February. And with continued Fed support pushing yields down to 0.55% (for the 10 year US treasury note, its lowest ever) it's easy to see the continued relative appeal of equities.

Below these benign headlines, there is considerable market discontent. Old and new economy names have continued to diverge: the 5 largest US stocks (Microsoft, Apple, Google, Amazon and Facebook) have now added more (+$1.66 Tr) in market value this year than the next 495 have lost (-$1.6 Tr). Value investors looking for the "all but inevitable" turnaround have instead experienced further pain as retailers go bankrupt, airlines idle, and banks struggle with razor thin net interest margins. And in a nod to the risks of inflation and currency debasement, gold is now trading above $2000 per troy ounce, an all time record.

Outlook

With the US election looming, take care not to place large bets - intentional or otherwise - on binary outcomes. This applies to our prior discussions on which sectors could be favored under a Democratic administration, and what tax changes may come. Fortunately much seems assured regardless of who wins: continued stimulus, including likely fiscal in '21; continued economic renormalization, including eventually transport and hospitality sectors; and an ongoing recalibration of trade and geopolitical relations with China.

At current valuations, this market presents no obvious, no-brainer bargains. With macroeconomic news turning in a positive direction, and public health updates settling into a routine, superior investment opportunity is likeliest in relatively inaccessible niches: entrepreneurial businesses that capitalize upon the newly normalized modes of work, school, healthcare and socializing; distressed private debtors who lack access to government or bank facilities; owners of neglected or beaten down assets who successfully repurpose them. For the majority of investors however, what matters now is timeless: peace of mind in an uncertain time; confidence to re-engage during periods of market uncertainty, even if that means sitting longer on the sidelines or buying some insurance; and as always, the ability to focus on and achieve life defining goals.