DANN ASSET ADVISORS, LLC

Second Quarter 2020 Update

July 13, 2020

2Q20 Highlights

- Monetary and fiscal stimulus spur hopes for quick economic recovery
- Stocks rebound 41% from March lows and at June 30 are down only 3.1% for the first half
- Market recovery masks sharp divergences in performance across sectors
- Consumers may turn more cautious if government support programs aren't extended
- Recent increase in Covid-19 infections in south and west adds uncertainty

The table below summarizes the performance of some key indices during the second quarter and year to date:

Market Performance		
Index	% Ch. 2Q20	% Ch. YTD
S&P 500	20.5	-3.1
MSCI All Country World ex US	16.1	-11.0
MSCI Dev. Markets (ex US)	15.6	-11.6
MSCI Emerging Markets	18.1	-9.8
US Aggregate Bond	2.9	6.1
Liquid High Yield	7.8	-5.2

Source: Morningstar, iShares

Equities. The market was unexpectedly strong in the second quarter, with the S&P 500 (index for large U.S. companies) returning 20.5% and registering its largest quarterly gain since the fourth quarter of 1998. According to a June 23 article in Barron's (quoting data from Bespoke Investment Group), the first and second quarters of 2020 represented the first time since 1932 that a decline of 20% in one quarter was followed by a 20%-plus gain in the next quarter. The speed and magnitude of the market's moves over the first half were confusing and even unsettling at times (we give our take on what's been happening later in the report).

Similar to the first quarter and really the past three years, large technology stocks again led the market. However, the quarter's gains extended beyond technology, with small company stocks as measured by the Russell 2000 index returning 25.4% and outperforming large company stocks for the first time in over two years. Value stocks, which have lagged growth stocks substantially in recent years, continued to underperform other than for a brief, three-week period beginning in mid-May. Value stocks tend to be more economically sensitive and began lagging again in mid-June as Covid-19 cases increased in the south and west, raising the possibility of more limitations on business activity. With seemingly slower economic recoveries than in the U.S., international markets in aggregate continued to trail the U.S.

Fixed income. Ten-year treasuries vacillated during the quarter but ended only modestly changed with rates declining from 0.70% on March 31 to 0.65% at quarter end. Two-year treasuries saw a relatively larger decline in yields, from 0.23% to 0.15%, as the market currently is taking seriously the Fed's commitment to keeping rates near 0% for the next two-plus years. More speculative fixed income, as shown by the iShares Liquid High Yield index, had a strong quarter. We believe this rebound was due to improved economic prospects and the Fed's first-ever commitment to

help support the high yield market by buying bonds and exchange traded funds.

Market sectors. The second quarter was a continuation of technology stocks leading the market, but complemented by strong performance from several sectors that had been among the worst performers during the first quarter. The rebound in many of the first quarter's laggards likely was due to optimism around the reopening of the economy and hopes for a fast recovery. Specifically, three sectors had gains of 30% or more in the quarter, with the consumer discretionary group up close to 40%. Amazon, which accounts for more than 20% of that sector, was up 42%; Tesla, a much smaller component but still in the top ten, rose over 150%; and several retail stocks also had strong quarters (from depressed March 31 levels).

The second and third best-performing groups in the quarter were energy (from ultra-depressed levels) and technology. The quarter's three worst sectors were utilities (up less than 3%), real estate investment trusts and consumer staples stocks (Procter & Gamble, Coca Cola, etc.) – each of these usually is considered among the more stable, less economically sensitive sectors. For the first half, technology (up almost 15%), consumer discretionary stocks and healthcare were the three best performers and the only sectors with positive returns. Energy, financials and industrial companies were the weakest, with energy still down 35%-plus year to date. The variance between the top and bottom sectors during the first half was one of the widest we've seen.

Portfolio Positioning

We made no significant changes in the fixed income portion of client portfolios during the quarter. For most clients, fixed income allocations remain 70% or more short duration (which we define as three years or less) and 90% or more investment grade. Our noninvestment grade allocation remains lower than usual as we'd sold a portion of more aggressive fixed income funds during the first quarter. While noninvestment grade fixed income has had a strong rebound from March lows, with all the uncertainty around the economy we believe it makes sense for now to continue focusing on less risky fixed income sectors.

On equities, for most clients we added only one new position during the quarter, a mid-cap growth fund. This fund was purchased for its emphasis on high-quality businesses with good long-term growth prospects. The fund replaced a small-mid cap, value-focused fund we'd sold during the first quarter. We view the switch as an upgrade in the quality, something we want in the current economic environment.

General Comments

From its high of 3386 on February 19, the S&P 500 fell 34% to its low on March 23 before rebounding 41% to close the quarter at 3100, only 8% below the all-time high reached in February. The combination of the magnitude and speed of these moves was highly unusual. But placed in the context of Covid-19 and unprecedented government-mandated shutdowns, the market's volatility makes some sense. Below, we outline our take on what's happened and where we are.

It's often said that markets hate uncertainty. Covid-19 and governments' response to shut down large portions of the economy created huge uncertainty, leading quickly to the conclusion that the economy and earnings would take a significant hit. All this contributed to the substantial and rapid market decline. Further, with many investors trying to sell at the same time, liquidity began disappearing and this exacerbated the declines.

As we've mentioned many times, markets usually are forward-looking, often anticipating what the economy and earnings will look like six to nine months later. Beginning the week of March 16, the Fed began taking action to address the then rapidly deteriorating economic and liquidity conditions, announcing numerous and sometimes unprecedented actions to support the markets and economy. It was roughly a week after the Fed's first actions that the stock market bottomed. Supplementing the Fed, congress and state governments also began providing substantial funds and other aid/stimulus to help consumers and businesses get through the worst of the government-mandated shutdowns.

In summary, a massive amount of monetary and fiscal stimulus was thrown at the markets and the economy. With the unemployment rate having hit 14.7% in April, these aggressive actions made sense and we don't doubt that the near-term economic outlook would be substantially worse had they not been implemented. However, in committing to do all it can to support the economy and maintain liquidity in markets, the Fed also has, in our opinion, given the impression that it will step in whenever markets are falling significantly. Otherwise known as the "Fed put", this perception that the Fed will be a safety net for stocks has added a speculative element to the market, making it expensive relative to where we believe the economy and earnings will be six to nine months from now.

Using recent estimates from Yardeni Research, consensus estimates for the S&P 500 are $125 and $163 for 2020 and 2021, respectively (compared with actual earnings of $163 in 2019). Taking the average of the two years implies that as of June 30 the S&P 500 was trading at an expensive 21.5x the next 12 month's earnings. We appreciate that low interest rates usually increase multiples and that projecting earnings in a Covid-19 environment is largely guesswork. Still, the only way we believe the market will move significantly higher over the near term is if Covid-19 is a nonevent for the economy going forward, potentially enabling all recent monetary and fiscal stimulus to lead to much stronger economic and earnings growth than anyone currently expects. Absent this potential positive outcome, we believe the market is fully valued at current levels.

It's also worth noting that former Vice President Biden currently is leading President Trump in many of the key states that went for Trump in 2016. While a Trump loss would be positive in many ways, if Biden were to win in November, it's likely that Democrats would attempt to raise taxes and increase business regulations, neither of which would be positive for the stock market. We're surprised that the market hasn't been focusing more on the election and view this as another nearer term risk.

A note on "the market". One question we've received from many clients since April is "How can the market be so strong with the economy so weak?" As discussed above, monetary and fiscal policies have had a huge influence on the market's rebound from the March lows. However, it's also important to remember that "the market" is an amalgamation of many individual stocks.

The S&P 500 index is the most widely used proxy for "the market" and consists of the stocks of the 500 largest publicly traded U.S. companies. In this context, largest refers to the stock market value of the companies rather than the size of the companies' revenues or earnings. The index is capitalization-weighted, meaning that stocks with larger market values have a greater impact on how the index moves. So to fully appreciate what's happening in the market, it's important to understand what's happening with the individual stocks, especially the largest ones.

At June 30, the five largest stocks in the S&P 500 were Microsoft, Apple, Amazon, Alphabet and Facebook. Together these five accounted for 21.6% of the index's value (compared with 16.8% at

December 31, 2019, according to iShares data), implying that in aggregate the performance of this group can have a material impact on the market. We note that each of the five has a commanding market share, leading technology and platforms, and services that in some cases are more in demand in an economy impacted by Covid-19. As a result, each of the stocks was up over the first half of the year, with the largest gain being Amazon's at nearly 50% and the smallest being Alphabet's at 6%. As puzzling as it may seem for the market to be down only 3% in the midst of a sudden and steep recession, the fact that these five stocks are up makes sense given their continued strong prospects.

An alternative way to look at the market is by measuring the S&P 500 on an equal weighted basis – meaning each of the 500 stocks has an equal impact on the performance of the index. Using this measure – which neutralizes the outsized impact of the large tech companies relative to other stocks – the index was down 10.8% over the first half of the year (based on the Invesco S&P 500 Equal Weight ETF). In our opinion, the equal weighted index gives a fuller picture of what happened to the average large-company stock over the first half of the year. Looked at in this context, it's clearer that the first half was a tough period for many stocks.

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