3Q 2020 Investment Strategy Letter - SMA

REVIEW – THIRD QUARTER 2020

Benefitting from massive fiscal and monetary stimulus, global economies are showing signs of stabilization. Significant pandemic related challenges remain, however, especially for industries and sectors that rely on human interaction. Overall, risk assets were encouraged by this notable economic progress and stocks were duly rewarded. For the quarter, U.S. equities (Russell 3000) jumped 9.2%, while foreign stocks (MSCI ACWI-ex U.S.) climbed 6.3%; meanwhile, U.S. bonds (Barclays U.S. Aggregate) posted returns of 0.6%.

PERSPECTIVES

"I would rather have questions that can't be answered than answers that can't be questioned"

-Richard Feynman

Mankind can look especially "green" when too much of a good thing (stability) leads to complacency (reckless behavior), and ultimately ends in disarray (instability). Hyman Minsky understood this pattern all too well. Minsky (1919-96) was an economist and professor of economics at Washington University in St. Louis. The phrase "Minsky moment" refers to his well-known theory on economic cycles. We believe we are now approaching a Minsky moment.

The first ingredient for creating a Minsky moment is a long period of economic prosperity. Prior to the February, 2020 onset of Covid-19, the U.S. economy had enjoyed over ten years of essentially uninterrupted economic growth. This prosperity bred confidence which lead to an increased appetite for risk-taking and leverage. Mix in a little greed and complacency (easy button mentality) to the good times and eventually you have speculative and irresponsible lending with little or no safety net. When the music eventually stops, you end up with shaky lenders who have bestowed all types of borrowers with excessive debt to purchase assets at artificially puffed up prices. Ultimately, we land at the Minsky moment, where these inflated and unsustainable asset prices reverse course, and a new brood of now duly rational and responsible buyers emerge at much more reasonable prices.

It has been said that portfolio managers are "not paid to forecast, but to adapt." We generally agree. While we do naturally attempt to create and identify a wide spectrum of forecasts and risk factors (like potential Minsky moments), we recognize that our flexibility and timely adaptation to both economic and market realities are a critical aspect of our process and value add. Increasingly, so it seems, the proper question often provides more insight than most formulaic or textbook answers. This is a posture that we can and do readily embrace.

PORTFOLIO POSITIONING

These remain highly unusual times. Most of us can relate to the fact that there are currently many new unchartered tensions and juxtapositions that we now need to navigate. Not surprisingly, this holds true with portfolio allocations as well. To the point, reiterating from last quarter's letter – "Our portfolios are uniquely positioned for the brute reality that unattractive valuations and rising uncertainties are oddly coupled with the likelihood of massive and persistent fiscal and monetary stimulus." This is a remarkably true and challenging reality.

In our view, virtually all near-term economic growth is likely to be inorganically sourced from unprecedented and ongoing fiscal and monetary stimulus. Accordingly, we are seeking to identify ongoing opportunities in those sectors and industries which are aligning with incremental government spending initiatives. We will also continue to orient portfolios toward higher quality, less subordinated, securities in the capital structure. Overall, given the current realities of our unique economic (Covid-19 pandemic) and geopolitical (election related) uncertainties, our emphasis on risk management remains of paramount emphasis and importance.

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OUTLOOK

Attempting to finally normalize interest rates, the U.S. Federal Reserve (Fed) raised interest rates by 0.25% for eight consecutive quarters, beginning in early 2017. The final rate hike was implemented in December of 2018. These cumulative hikes brought the fed funds rate to 2.25-2.50%. This rather anemic rate level persisted for just seven months, until July of 2019, when the Fed, responding to emerging economic weakness, initiated the first of three consecutive 0.25% interest rate cuts in the summer and fall of 2019. We believe a review of recent Fed history is an important reminder for establishing a clearer perspective on the status of the non-distorted, pre-Covid-19, U.S. economy. The three consecutive 2019 rate cuts were telltale in that they took place in an otherwise benign/favorable economic backdrop. Said another way, this series of accommodative Fed cuts, starting from already historically low levels, while still in the latter stages of ongoing fiscal stimulus, were both highly unusual and a poignant signal of economic fragility at the time (in 2019). We ascribe this fragility to historically elevated and unhealthy levels of global debt. With or without Covid-19, economic risks were and are slowly rising.

In anticipation of the catastrophic economic fallout from the Coronavirus shutdowns this spring, Congress moved quickly by passing the CARES Act, a massive stimulus package which provided $2.2 trillion of economic relief. The impact was immense as personal income in the U.S. hit an all-time high, while the unemployment rate rose to levels not seen since the Great Depression. This combination of higher unemployment in tandem with rising income has no historical precedent. Without the vast stimulus, personal income would have experienced a devastating decline. It has been six months since Congress passed the CARES Act; the economic relief it provided has largely run its course, creating a prospective void as personal income is perched to fall as these benefits expire. With the fiscal gap looming ahead, politicians remain unable to compromise on much needed additional economic relief. While we believe there will eventually be another package, questions remain around its scope, size and timing. The longer the delay, the larger the economic impact, potentially dampening the still emerging recovery.

SUMMARY

We are confident our Multi-Asset managed portfolios remain well-positioned for a highly stressed global economy. We also understand and embrace our ongoing responsibility to insightfully differentiate between attractive and less attractive asset classes as we strive to deliver superior risk-adjusted returns. As we continue to work through these difficult times as a nation, we truly appreciate your confidence in partnering with us.

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