ENTASIS ASSET MANAGEMENT

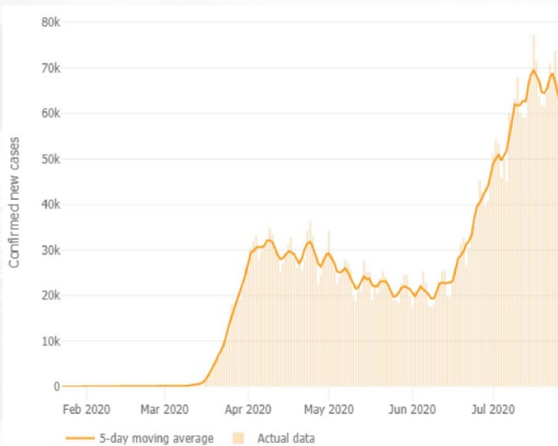
QUARTERLY NEWSLETTER

2Q2020

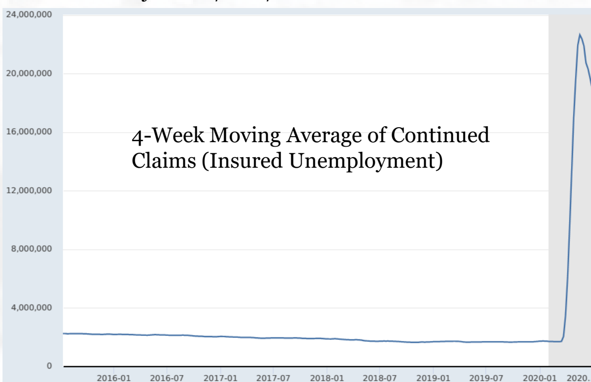
CEO Comments

This quarter as we were working through our comments a common refrain was that there was plenty to say but being concise was going to take time. As it turns out time did not provide much help.

In this type of environment, distractions are numerous as there is plenty of noise in the news. More time drafting this newsletter just meant more distractions. It did almost nothing to improve perspective. In a nutshell, the key variables we follow (economic growth, earnings and interest rates) continue to provide little insight. Economic growth and earnings are both anemic to highly negative and interest rates have remained extremely low. Last quarter we introduced two environment specific variables to potentially improve our understanding of the core variables we follow: the daily change (shown with moving average) in coronavirus cases as an indication of business health, and unemployment data (represented here by continuing claims), as an indication of consumer health. Both variables continue to paint a rather difficult picture for investing. See the charts below. And yet, second quarter market returns reflected optimism.



Source: Johns Hopkins Coronavirus Resource Center
Coronavirus.jhu.edu/data/new-cases



Source: U.S. Employment & Training Administration
fred.stlouisfed.org

Bob Batchelor, CFA
Chief Executive Officer

Summary

In this type of environment, distractions are numerous as there is plenty of noise in the news. More time drafting this newsletter just meant more distractions. It did almost nothing to improve perspective.

Last quarter we introduced two environment specific variables to potentially improve our understanding of the core variables we follow: new coronavirus cases and unemployment data. Both continue to paint a rather difficult picture for investing.

It has become clear that the very simple driver of market optimism has been liquidity driven by massive monetary and fiscal stimulus.

The impact on sentiment was staggering and it has opened some amazingly wide gaps among sub-asset classes.

We love return discrepancies because they are grounds for research. For those that know us well, we are not researching the areas that are trending hot. We are researching the downtrodden.

CEO Comments

With the data largely negative, why did optimism rule the day in the second quarter? By now it has become clear that the very simple driver of market optimism has been liquidity – driven by massive monetary and fiscal stimulus. C.J. and Mike will cover this in better detail, so I will not elaborate here, other than to say the impact on sentiment was staggering and it has opened some amazingly wide gaps among sub-asset classes.

For example, as of quarter-end, growth stocks (as measured by the Russell 1000® Growth Index) were up nearly +10% YTD. Value stocks (as measured by the Russell 1000® Value Index) were down over -16% YTD. That 26% gap is due to a sizable difference in the performance of technology stocks and energy / financials stocks. Another example is the difference in performance YTD of higher yielding areas of the bond market such as non-investment grade corporates (-5%) and local currency foreign bonds (-5%) versus the broad market (as measured by the Barclays Aggregate Bond Index), which is up over +6% YTD. There are numerous other examples, but those provide plenty context for my point.

We love return discrepancies because they are grounds for research. For those that know us well, we are not researching the areas that are trending hot. We are researching the downtrodden. It doesn't mean we will find anything attractive, but it drives our worklists, which are very full.

Like last quarter, C.J. and Mike will share thoughts on their areas of expertise and then we will bring it all together with some final thoughts. Each section has summaries if you would prefer the cliffs notes. Just click on the boxes below to get to each summary page.

Bob

Market Performance | Equity Portfolio Comments | Fixed Income Portfolio Comments

Final Thoughts

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 06/30/2020)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	7.51	10.73	10.73	13.99
Russell 1000 Index	Mid/Large Cap Stocks	7.48	10.64	10.47	13.97
Russell 1000 Growth Index	Growth Stocks	23.28	18.99	15.89	17.23
Russell 1000 Value Index	Value Stocks	-8.84	1.82	4.64	10.41
Russell 2000 Index	Small Cap Stocks	-6.63	2.01	4.29	10.50
MSCI EAFE Index	Non-U.S. Developed Market Stocks	-5.13	0.81	2.05	5.73
MSCI Emerging Markets Index	Emerging Markets Stocks	-3.39	1.90	2.86	3.27
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	-4.34	-0.17	2.50	6.05
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	2.50	3.75	5.51	6.68
Barclays Municipal Bond Index	U.S. Municipal Bonds	4.45	4.22	3.93	4.22
Barclays Aggregate Bond Index	U.S. Bonds	8.74	5.32	4.30	3.82
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	7.12	4.43	3.46	3.13
BofAML U.S. Treasury Master Index	Treasury Bonds	10.76	5.72	4.22	3.51
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	5.80	4.05	3.29	3.08
BofAML U.S. Corporate Master Index	Corporate Bonds	9.30	6.27	5.69	5.47
BofAML U.S. High Yield Master II Index	High Yield Bonds	-1.17	2.92	4.57	6.46
BofAML Convertible Bonds Index	Convertible Bonds	19.48	13.71	11.08	12.14
BofAML Euro Broad Market Index	European Bonds	0.35	2.40	2.93	3.02
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	1.08	3.20	3.34	2.49

Calendar Year % Returns (QTD, YTD as of 06/30/2020)

	QTD	YTD	2019	2018	2017	2016	2015
S&P 500 Index	20.54	-3.08	31.49	-4.38	21.83	11.96	1.38
Russell 1000 Index	21.82	-2.81	31.43	-4.78	21.69	12.05	0.92
Russell 1000 Growth Index	27.84	9.81	36.39	-1.51	30.21	7.08	5.67
Russell 1000 Value Index	14.29	-16.26	26.54	-8.27	13.66	17.34	-3.83
Russell 2000 Index	25.42	-12.98	25.52	-11.01	14.65	21.31	-4.41
MSCI EAFE Index	14.88	-11.34	22.01	-13.79	25.03	1.00	-0.81
MSCI Emerging Markets Index	18.08	-9.78	18.42	-14.57	37.28	11.19	-14.92
MSCI ACWI Ex USA Small Cap Index	22.83	-12.80	22.42	-18.20	31.65	3.91	2.60
BofAML Preferred Stock Fixed Rate Index	6.95	-2.49	17.71	-4.34	10.58	2.32	7.58
Barclays Municipal Bond Index	2.72	2.08	7.54	1.28	5.45	0.25	3.30
Barclays Aggregate Bond Index	2.90	6.14	8.72	0.01	3.54	2.65	0.55
Barclays Intermediate U.S. Gov/Credit Index	2.81	5.28	6.80	0.88	2.14	2.08	1.07
BofAML U.S. Treasury Master Index	0.20	9.02	6.99	0.80	2.43	1.14	0.83
BofAML U.S. Mortgage Backed Securities Index	0.81	3.62	6.51	1.00	2.45	1.67	1.46
BofAML U.S. Corporate Master Index	9.27	4.84	14.23	-2.25	6.48	5.96	-0.63
BofAML U.S. High Yield Master II Index	9.54	-4.84	14.41	-2.27	7.48	17.49	-4.61
BofAML Convertible Bonds Index	27.36	11.20	23.06	0.68	16.03	11.94	-1.15
BofAML Euro Broad Market Index	4.82	1.22	4.11	-4.39	14.61	0.37	-9.30
BofAML Local Debt Market Plus Index	9.37	-4.87	16.44	-4.90	14.71	6.53	-12.02

How should you use the information provided in the table?

- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Corporate Earnings and Market Valuations

The overall corporate earnings picture worsened during the second quarter as analysts continued to slash earnings estimates, revenue projections declined, and profit margins plummeted. In our first quarter newsletter, calendar year earnings estimates for the S&P 500® Index were roughly $143 and $174 for 2020 and 2021, respectively. As of July 17, calendar year earnings estimates for the S&P 500® Index declined to $127 and $163 for 2020 and 2021, respectively. Despite the sharp pullback in earnings estimates, stock prices continued to ramp sharply higher, which pushed valuations into historically expensive territory across a variety of valuation metrics. The forward PE (price-to-earnings) ratio chart below displays current market valuations compared to other periods of high PE ratios and market peaks.

The dramatic spike in forward PE ratios during the second quarter was historic on a number of levels, notably in its rapid expansion over a short timeframe and also when viewed relative to the previous peak in the late 1990's. Historical valuation comparisons like this generally draw the ire of unabashed stock market "bulls" whose arguments generally follow the line of thinking of "this time is different." In our opinion, these are four of the most dangerous words in investing. While some things will inevitably be different as you move forward in time, the negative underlying root causes of excessively expensive periods (behavioral characteristics of market participants such as excessive optimism, performance chasing, and herd mentality being three key causes) tend to be consistent across most timeframes. Said differently, the catalyst that causes valuations to adjust lower may be different (as well as the timeframe), but the

Charles (CJ) Batchelor, CFA
Chief Investment Officer – Equity

Summary

The dramatic spike in forward PE ratios during the second quarter was historic on a number of levels, notably in its rapid expansion over a short timeframe and when viewed relative to the previous peak in the late 1990's.

It is extremely important for investors to remember that a "great company" is not the same as a "great investment."

Just because something is expensive (or cheap) does not mean that it will not get more expensive (or cheaper).

PE ratios tend to have a rather weak correlation to future stock prices over the short-term, but become a much more constructive tool to project return environments over longer periods

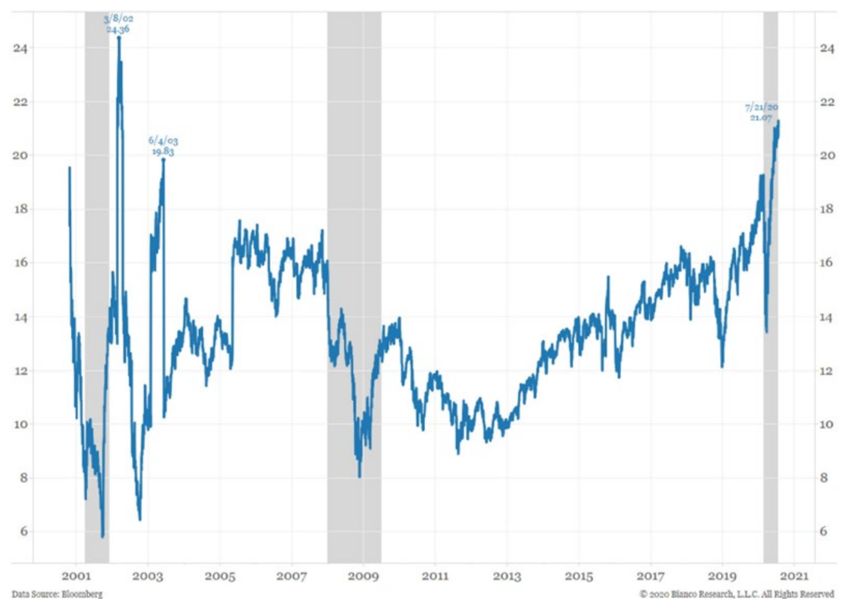
As we saw in February and March of this year, risk tends to happen slowly, and then all at once.

We have undertaken substantial research efforts to broaden our list of "on deck" investment managers that may be deployed if we arrive at a favorable intersection of value, opportunity and price.

result is the same, relatively weak long-term returns for late entrants into excessively expensive markets.

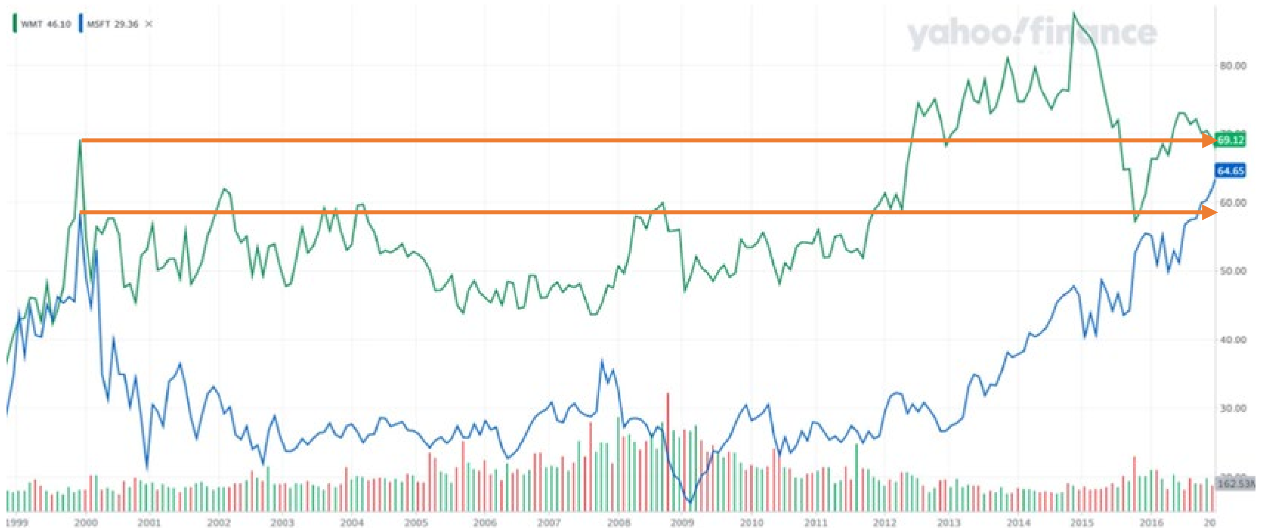
One of the more popular arguments to justify current valuations is that interest rates are substantially lower than they have been over the course of history, which in turn justify more lofty valuations for companies. It is indeed true that interest rates are much lower than they have been in the past. However, we would point out that countries such as Japan (a country that is both heavily indebted and has had low interest rates for a long time) do not have equity markets that trade at permanently higher valuations. In fact, the opposite is true. Of course, the U.S. is not Japan either, but this example shows that focusing on only one factor as a justification for high valuation multiples has flaws.

Another argument is that 2020 was an anomaly (was not a garden variety recession but caused by a once in a 100-year event) so basing valuations that include 2020 earnings estimates and other short-term earnings projections is a mistake. However, even when we look out well past 2020, market valuations continue to be stretched. The chart below is like the first forward PE ratio chart, except it utilizes 3-year forward earnings estimates in its calculation of a PE ratio.



So, even when factoring in earnings estimates that conceivably take into account improvements beyond the current COVID-19 induced earnings plummet from 2020, stocks remain historically expensive.

Yet another argument for justification of high stock prices in the absence of earnings growth is that the largest companies in the S&P 500® Index (technology and technology-related companies) that are driving equity market returns in aggregate are surviving and thriving in the current environment. And unlike other high valuation periods such as the late 1990's into 2000, these companies are making money and gaining market share. We are in complete agreement on this front as many of these companies are performing very well, especially given the current environment. However, it is extremely important for investors to remember that a "great company" is <u>not the same</u> as a "great investment." At some point, prices become detached from even the most optimistic growth outlook for companies. To illustrate our point, we have chosen two widely recognized companies that have grown their businesses substantially over the past 20+ years, Walmart (green line) and Microsoft (blue line) and plotted their stock prices going back to the late 1990's. See chart at the top of the next page.



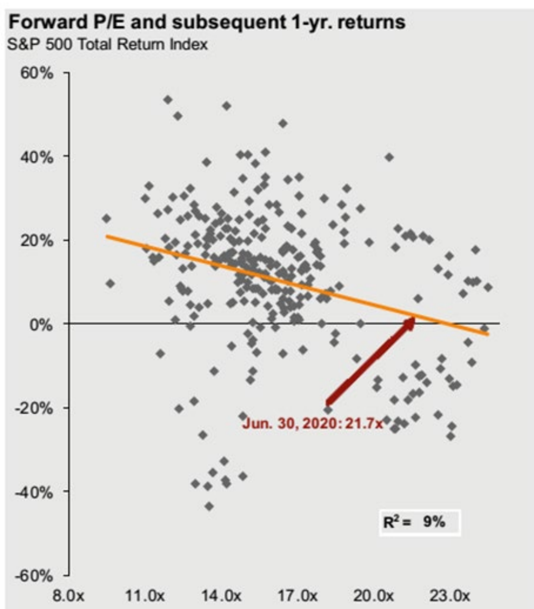
At their peak in the late 1990's, Microsoft's PE ratio was over 60x, while Walmart's PE ratio was approximately 40x. Both companies endured recessions and grew their businesses over time. However, if an investor purchased either company at, or near, their peak PE ratio, their returns would have been extremely poor for a long time. In both instances, it took 12+ years until the companies broached their previous peak share price (red lines). To reiterate, a great company does not mean it is a great investment. Price matters.

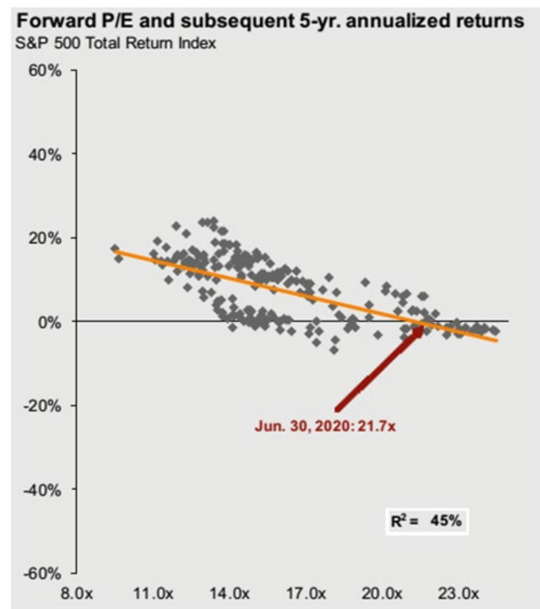
For skeptics that chide the usefulness of PE ratios, other valuation metrics paint a similar picture. One long-term valuation measure that we track (among many) is total market capitalization of the U.S. stock market relative to the gross domestic product (GDP) of the country. While this metric does not utilize corporate earnings, which could be adjusted through various accounting tricks at the company level, or incorporate overall share count, which can be modified to boost earnings per share estimates through buybacks, the result is the same. Historically high valuations.

The obvious question at this point is, "so, what does this mean for stock prices looking forward?" As we have communicated many times in our newsletters since the inception of our firm, over the short run, valuations have limited usefulness as a predictor of stock price movements. Just because something is expensive (or cheap) does not mean that it will not get more expensive (or cheaper). Stock prices do not decline simply because a PE ratio hits a given level, or another valuation metric crosses a certain threshold. There needs to be a catalyst. And in our opinion, there are many potential negative catalysts looking ahead, some of which include a resumption of economic damage as a result of COVID-19, disappointing earnings (not just this year but in upcoming years if the recovery is not as strong as predicted), a stall in the employment recovery and consumer

spending, a change to corporate tax policy, uncertainty at the overall size of fiscal and monetary stimulus, and geopolitical developments (further deterioration in the U.S. and China relationship). This certainly does not mean that there is not the potential for positive surprises, but when factoring in current prices, we do not see a favorable overall risk reward environment to become excessively optimistic either.

And while PE ratios tend to have a rather weak correlation to future stock prices over the short term (see the graph to the left below which examines beginning PE ratios relative to subsequent one-year stock market returns – note the dispersion of dots around the orange line), PE ratios become a much more constructive tool to project return environments over longer periods (see the graph to the right below which examines beginning PE ratio relative to subsequent five-year stock market returns – again, notice the dispersion of dots around the orange line).





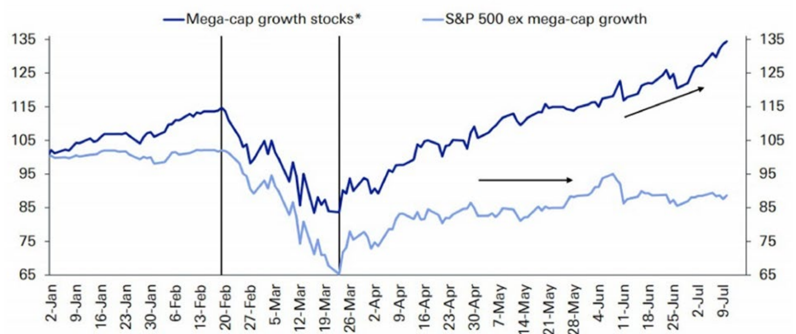
So, while we are not beholden to make large scale changes to portfolios simply because PE ratios are elevated, it is a key factor when determining longer-term broad asset allocation decisions.

In summary, we believe we can say with certainty that stocks (in aggregate) are overvalued across a variety of valuation metrics. In addition, we do not see a favorable environment for a sharp rebound in corporate earnings, especially in the face of a weak outlook for revenue growth and reduced corporate profit margins. In turn, we do not see valuation metrics improving because of a large increase in the denominator (earnings per share), but rather believe it is more likely that valuation metrics will contract due to a decline in the numerator (price). When this will happen is much more difficult to gauge, especially when things outside of corporate fundamentals (notably massive liquidity from the Fed, investor sentiment and behavioral biases) are currently the major drivers of market movements. However, we are confident that stock prices will eventually return to their long-term relationship of tracking the general path of corporate earnings and underlying business fundamentals. In the interim, we will continue to search for what we believe to be attractively priced investment opportunities that have the potential to generate relatively solid risk-adjusted long-term returns for clients.

Outlook

The S&P 500® Index shot higher in the second quarter to register its largest quarterly gain since 1998. However, the big story was not the overall return, but the wide variance in returns across sectors of the market and at the individual stock level. At the sector level, the consumer discretionary and technology sectors returned over +30%, while the utilities sector gained less than +3%. While significant, individual stock performance was even more striking. As can be seen in the chart below, the strong return for the overall S&P 500® Index was primarily driven by a handful of mega-cap growth stocks, while performance outside of these stocks was relatively meager (notably from the latter portion of April through the end of the quarter).

The impact of a relatively small group of individual stocks on the composition of the S&P 500® Index (both during the second quarter and in recent years) has been eye-opening. For instance, the S&P 500® Index is now the most concentrated it has been in over 50 years (the top five stocks account for roughly 25% of the S&P 500® Index compared to 12% in 2015) and the technology sector has become the largest percentage of the S&P 500® Index in history – surpassing its weight during the tech boom of the late 1990's into 2000. There are a number of contributing factors for the historically large moves among mega-cap growth stocks, which include massive fiscal and monetary stimulus (money needs to flow somewhere), low interest rates (no alternative to stocks), a surge in retail investors (day traders), increased popularity of market-cap weighted passive index products (such as broad-based equity market exchange-traded funds), "FOMO" (fear of missing out, which results in performance chasing with little consideration of price), and even more traditional fundamental reasons such as the overall resiliency of many of these companies' business models. Certainly, these factors (among others) have all played a part in the sharp ramp-up in these companies' stock prices and their relative size in the S&P 500® Index. What really caught our attention was the significant shift in the make-up of market participants and the overall trading volume from those individuals. The chart to the right shows the surge in interest for day trading, a hobby (or



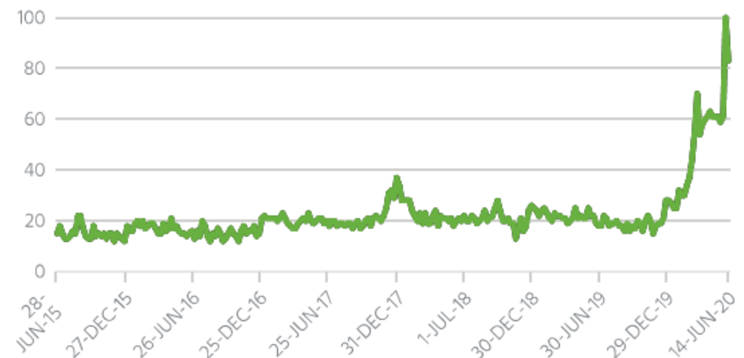


Chart courtesy of GQG Partners Second Quarter 2020

"profession" in some instances) that was popularized during the speculative tech boom. As a rule, a day trader could be classified as an investor that focuses on buying and selling stocks in a short timeframe (sometimes multiple times in the same day) in the hopes of making a quick return on investment.

Some may choose to dismiss these types of traders or other "retail" investors because their individual account balances may not be as large as other types of investors such as institutions or large pension plans. However, to completely disregard them would be a mistake, especially when viewing their impact on the market in aggregate. According to recent data from Bloomberg Intelligence analyst Larry Tabb, retail trading in 2020 accounts for approximately 18.5% of market volume in the U.S. (and up to 25% on the most active trading days), up from only 10% in 2010. This subset of investors has gotten quite large and can no longer be dismissed as a source of market volume and volatility.

What does this mean for other types of investors and the market as a whole? In our opinion, the increased interest in trading and investment among the retail segment of the market may very well help to push the market higher (both stock prices and valuation measures such as the price-to-earnings ratio) from current levels given their tendency to chase the best performing stocks (recency bias combined with "FOMO"). However, rising prices do not come without added risks because the further prices stray from underlying earnings and business fundamentals, the more difficult it becomes to sustain prices when cracks begin to form. As we saw in February and March of this year, risk tends to happen slowly, and then all at once.

Index concentration and large price moves in a small subset of stocks also raises other issues that investors should consider. At the top of this list is diversification, a concept that has become increasingly foreign to many investors. With the S&P 500® Index becoming significantly top heavy, this means many passive-based investors may no longer be as diversified as they think they are because future investment returns have become greatly tied to the fate of only a handful of companies. While this does not necessarily become an issue when market participants continue to plow money into the hottest stocks, it becomes a major issue when investors are no longer willing to pay a hefty premium for these stocks. As we discussed in the valuation section above, a good or even great company is not the same as a good stock or investment. Excellent companies such as Microsoft and Walmart proved to be horrible investments for individuals when purchased at historically high valuations at their price peak in the late 1990's into 2000. Our experience managing investments during other periods of high market valuations dictates that we to stick to our long-term investment process and the "foreign" concept of diversification at the present time. This means that the U.S. portion of portfolios continues to favor reasonably priced, high-quality (relatively low levels of debt in an increasingly indebted world) companies that have demonstrated a high degree of earnings consistency, attractive levels of long-term growth, a strong competitive position within their industry and that may also return value to shareholders in the form of dividends. The chart at the top of the next page helps to provide support for our current focus on "quality" companies given the underlying economic environment. The data compares the performance of the broad S&P 500® Index to the S&P 500 Quality Index during periods where GDP growth is above or below 2.5%.

Considering our view that broad economic growth will remain constrained over the short run (and conceivably well into the future), we believe these types of companies may be well-positioned to perform relatively well compared to companies with less healthy balance sheets.

We also favor large capitalization companies over small capitalization companies given the uncertain path of both economic growth and corporate earnings and remain neutral from a "style" perspective, with no meaningful tilt towards "value" or "growth" in portfolios on an aggregate basis. Among U.S. investments we have substantially grown our "on deck" list of investment managers across market capitalizations and styles through on-going research efforts at our firm. We have not yet made any large-scale changes to portfolios as we have instead favored patience in our pursuit for a more attractive entry point.

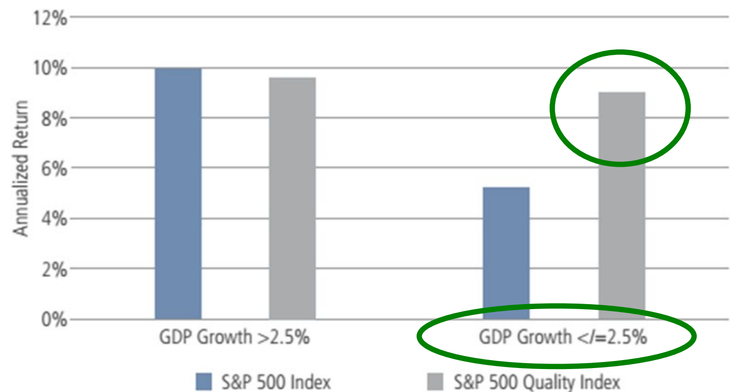


Chart courtesy of Neuberger Berman Investment Quarterly Summer 2020

Our intermediate-term outlook outside of the U.S. remains brighter, and therefore, we have undertaken a more aggressive approach through investment in small-/mid-cap developed foreign equity managers (which have the flexibility to invest meaningfully in emerging markets equities) and a dedicated emerging markets equity manager. The combination of U.S. dollar weakness, a resumption in growth potential, less fiscal burden and relatively attractive valuations reinforce our positive views on emerging markets equities. Regarding relative valuations, emerging markets valuations are less than 16X earnings while the U.S. is over 25X earnings.

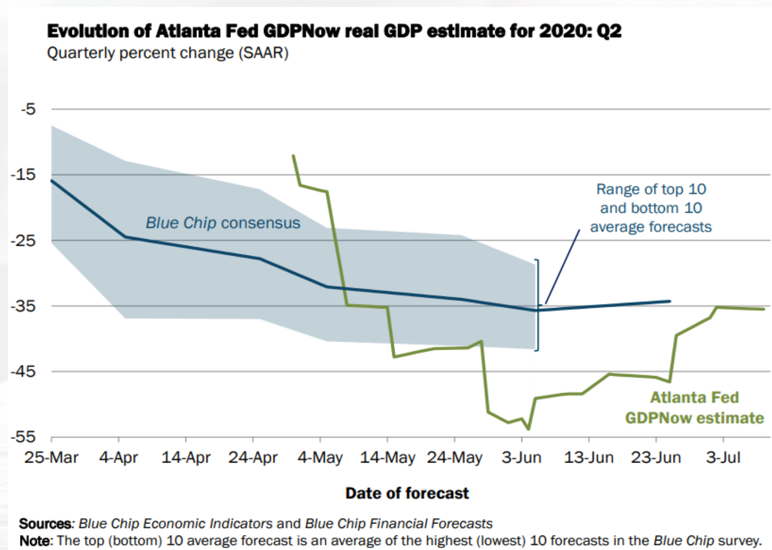
As shown earlier, forward P/E (price-to-earnings) ratios can be poor predictors of short-term results, but they tend to be more constructive over longer-term periods, especially when combined with the other attractive characteristics of emerging markets listed above. Like the domestic side of portfolios, we have undertaken substantial research efforts to broaden our "on deck" list of foreign investment managers that may be deployed if we arrive at a favorable intersection of value, opportunity and price.

In summary, we have a tepid outlook for U.S. equities largely due to our belief that corporations may not recover as quickly as currently expected and that uncertainty around the U.S. election season (notably the potential impact on tax policy), size and continuation of government stimulus, impact of COVID-19 on the economy and a bleak employment recovery may significantly add to market volatility in the coming months. These factors, along with weak corporate earnings expectations and by some measures, record high levels of valuations, combine to keep us relatively conservative in our U.S. equity positioning, instead favoring emerging markets equities and unique opportunities in underfollowed and underinvested areas such as foreign small- and mid-cap companies. Unlike an increasingly large contingent of investors, we are not willing to go "all in" on our reliance on the Fed to drive prices higher while completely disregarding underlying company fundamentals. In our opinion, to do so would not be anywhere in the same neighborhood as prudent for our clients and the long-term well-being of their portfolios. As one top Fed official recently stated, "we may be seeing significant pricing disconnects between the market and economic fundamentals, which could result in sudden and sharp repricing." As the mantra goes, "don't fight the Fed." On this quote, we could not agree more.

Fixed Income Portfolio Comments

Economic and Policy Review

In our opinion late cycle weakness in the U.S. economy was evident long before the virus-related shutdowns occurred in mid-March. In fact, slowing data can be traced all the way back to the third quarter of 2018. Nevertheless, the National Bureau of Economic Research determined that the current recession began in February of 2020, not in March, when shut-down activity began. While some data suggests a rebound is underway, analyst forecasts for Q2 economic growth range from -33% to -40%, which are numbers we never expected to see in our lifetimes.



Source: Federal Reserve Bank of Atlanta

It is likely the economic destruction the virus caused was exacerbated by softening prior to the collapse. At year-end 2019, corporate debt was at an all-time high (when measured against GDP), corporate profits were slowing, and funding stresses were apparent in the REPO markets. The Federal Reserve recognized these issues at prior meetings, which is likely why it mounted such an aggressive monetary response. The size and speed of the Fed's responses surpassed the expectations of most market participants. On top of cutting the policy rate to 0.00%, the Fed announced a new liquidity facility (known by a different acronym) on what seemed like a daily basis. See the summary chart at the top of the next page.

Each facility was targeted at a different area of the debt markets, which for all practical purposes, were frozen at the time. Although most U.S.-based debt markets received some level of support, the response was uneven across sectors. We believe the uneven response is the primary factor for the performance differential across sectors.

Mike Peters, CFA
Chief Investment Officer – Fixed Income

Summary

While some data suggests a rebound is underway, analyst forecasts for Q2 economic growth range from -33% to -40%, which are numbers we never expected to see in our lifetimes.

The size and speed of the Fed's responses surpassed the expectations of most market participants.

Although most U.S.-based debt markets received some level of support, the response was uneven across sectors.

Asset purchases and anticipated usage of the Fed's credit facilities are estimated to bring the Fed's balance up to $10.3 trillion by the end of 2021, over 13% of GDP.

We continue to shy away from below investment grade bonds. That segment is receiving less direct support from the Fed and is not priced appropriately based on expected defaults.

Fixed Income Portfolio Comments

Announcement Date	Operational Date or Proposed	Facility	Funded by CARES?	Acronym
March 17	April 14	Commercial Paper Funding Facility	No	CPFF
	March 20	Primary Dealer Credit Facility	No	PDCF
March 18	March 23	Money Market Mutual Fun Liquidity Facility	No	MMLF
March 23	June 29	Primary Market Corporate Credit Facility	$50 Billion	PMCCF
	May 12	Secondary Market Corporate Credit Facility	$25 Billion	SMCCF
	June 17	Term Asset-Backed Securities Loan Facility	$10 Billion	TALF
April 9	April 16	Paycheck Protection Program Liquidity Facility	No	PPPLF
	June 15	Main Street Lending Program	$75 Billion	
	May 26	Municipal Liquidity Facility	$35 Billion	

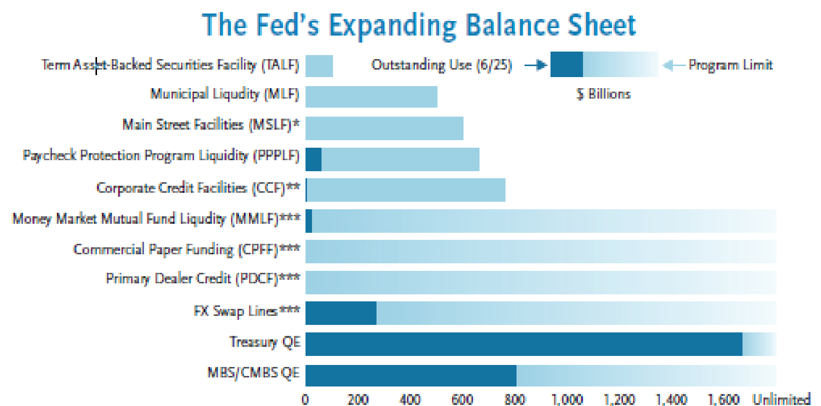
Source: Macro Strategy Partners

Areas like corporate debt, where fundamentals in aggregate were relatively weak (prior to the pandemic), received significantly more support than others, and have rallied more as a result. In addition to being able to lend directly to corporations, the Fed can purchase up to $800 billion in corporate bonds and ETF's (exchange-traded funds) on the secondary market via the Corporate Credit Facility (CCF). The direct involvement in the secondary market has done more to tighten spreads (resulting in better performance) than in areas like asset-backed securities. Asset-backed securities, whose fundamentals in aggregate were relatively strong (prior to the pandemic), received less support. Through the Term Asset-Backed Loan Facility (TALF) the Fed can facilitate up to $100 billion dollars of newly created loans but are not allowed to buy these types of securities on the secondary market. The lower level of support has led to a weaker rally in this area. In total, the combination of credit facilities took the Fed's balance sheet from $4.2 trillion at the end of February, to $7.2 trillion by June. The Fed's unprecedented efforts seemed to have worked because after a few weeks/months of intervention, debt markets thawed and started to function more normally.

Over the same period, the U.S. Government mounted a similar fiscal response to combat the crisis by passing several COVID-19 relief bills totaling approximately $3.0 trillion. Below is a summary of the accommodation to date.

- $8.3 billion Coronavirus Preparedness and Response Supplemental Appropriations Act
- $192 billion Families First Coronavirus Response Act
- $2.3 trillion (~11% of GDP) Coronavirus Aid, Relief and Economy Security Act ("CARES Act")
- $483 billion Paycheck Protection Program and Health Care Enhancement Act

In partnership with the U.S. government's fiscal response, the asset purchases and anticipated usage of the Fed's credit facilities are estimated to bring the Fed's balance sheet up to $10.3 trillion by the end of 2021, which is over 13% of GDP. For context, the same level of stimulus implemented since March took nearly three years to achieve after the 2008 financial crisis.

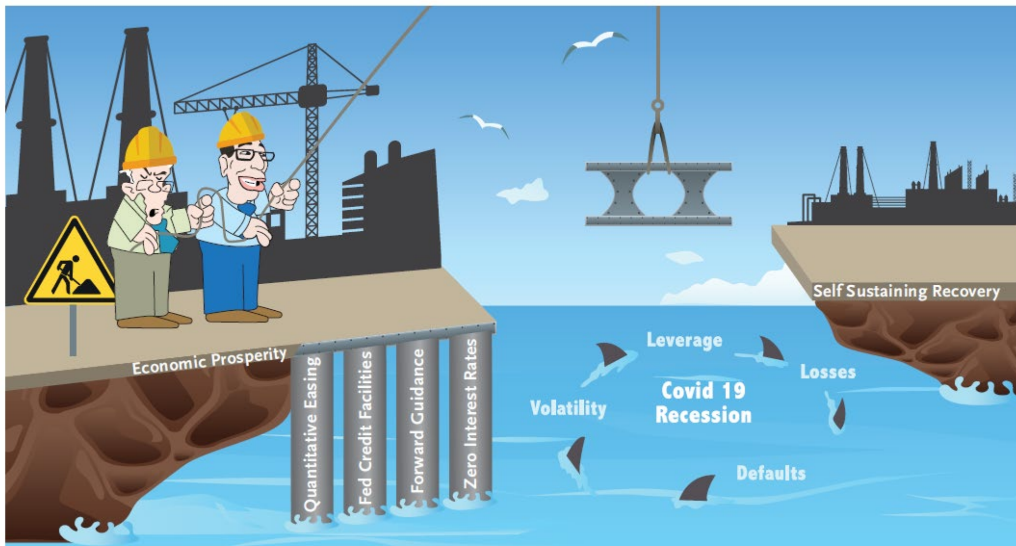


Source: TCW MetWest

Economic Outlook

Massive fiscal and monetary policy support has led to a significant recovery in risk assets and provided support for households and businesses. However, the question remains, “where will this policy bridge lead us?” Will we return to a pre-COVID-19 economy, or a more challenging environment, where unsustainable debt burdens lead to stagnating growth, defaults, and bankruptcies spread across several years?

2Q 2020: Bridge to Sustainable Recovery or Expensive Pier?



Source: TCW MetWest

At their June meeting, the Fed updated their economic projections for the first time since December and it did little to reaffirm the financial market’s view of a “V-shaped” recovery. The Fed expects GDP to decline by -6.5% and unemployment to only recover to 9.3% by the end of the year. These estimates seem to be in line with the central expectations of Wall Street economists. As a result, there is a tremendous disagreement between financial markets and the likely path of the economy.

To date, we have yet to get the virus under control nationwide, as the experience with the virus continues to vary notably across regions. During the second quarter, the Northeast was hammered while many southern and western states were relatively less affected. More recently, the tables have turned. States that largely missed the first wave like California, Texas, Florida and Arizona, are now seeing significant case counts, leading to the reclosing of areas in their local economies. In contrast, the Northeast is gradually opening from lockdowns and have yet to see a significant increase in cases. As a result, there remains substantial uncertainty over the economic outlook. Until a viable vaccine is rolled out to the populace or better treatments become available, it is likely to continue to be volatile as the virus and lockdowns ebb and flow. As this plays out, the financial stress caused by Covid-19 will likely continue. So far, despite signs of rising stress on corporate and public balance sheets, non-payments have been largely contained to certain adversely affected segments (Airlines, Hospitality, Retail and Energy). However, Fed support is primarily liquidity-based, meaning it gives issuers the ability to refinance their debts or take on more debt. It does not provide cash flow to those businesses to support the debt payments. As the economy stays weak, and cash flow remains scarce, it is likely

non-payments will spread beyond the most vulnerable sectors. According to surveys, most businesses continue to remain cautious about spending. This type of economic backdrop typically reduces borrowers' willingness and ability to meet their contractual obligations.

Unfortunately, some of this is already beginning to show up in data including a record-breaking pace for corporate bankruptcies, lengthening delays in commercial real estate payments and an increase in households falling behind on rents and credit card payments. The weakness has accelerated ratings downgrades and fallen angel activity (investment grade issuers downgraded to non-investment grade). The number of companies downgraded to high-yield was already rising prior to the virus-related slowdown and now accounts for over $162 billion this year. Another $300 billion of debt rated BBB- has a negative outlook, an increase of over 3.5x since January. Meanwhile, high-yield bond default rates have risen to 6.11%, with Fitch projecting a 12-month default rate of nearly 15% for 2020-2021.

Fixed Income Outlook

With Fed support, corporate bond markets rapidly recovered from the extreme shock in March – largely pricing in a "V-shaped" recovery. We believe this optimism is misplaced, particularly in below investment grade bonds. Increasing defaults and downgrades are evidence that the market has only just begun the process of deleveraging. The Fed has effectively addressed the liquidity issues that crushed the corporate markets in March, but it cannot fix underlying solvency problems, which are likely to get worse over the remainder of the year. Based on the Fed's support, we added some investment grade corporate bonds to client portfolios using two proven active investment managers. Picking winners and losers is particularly important in this type of market. We continue to shy away from below investment grade bonds. In our opinion, that segment is receiving less direct support from the Fed and is not priced appropriately based on expected defaults.

Fed support has also improved liquidity conditions in the securitized markets leading to a recovery of a large portion of the March spread widening (interest rates increasing relative to U.S. Treasuries). However, significant uncertainty remains regarding the longer-term economic and employment impacts and whether forbearances, deferrals and modifications will help avoid permanent losses to bondholders. There may be attractive opportunities down the road, but it is still too early to make those determinations. The managers we use in the space simply do not have enough data to accurately model expected cash flows given the lack of historical precedent. This is likely to improve every month as remittance reports come in. We continue to monitor the space.

The unprecedented monetary and fiscal policy responses to the economic shutdown produced a very strong rebound in municipal prices as well. As the second quarter progressed, fund flows across the industry turned positive and investor demand easily exceeded supply. However, a sharp decline in tax revenues due to stay-at-home restrictions continues to weigh on our outlook. The behavioral changes forced upon society by Covid-19 are unlikely to go away quickly. On the bright side, the Fed is unlikely to remove support from markets and the there is a high probability of additional fiscal stimulus from Congress. There is currently a bipartisan agreement for additional state and local government support, but no agreement on the details. Going forward, it is likely investment grade municipal rates will remain relatively low and range bound. However, there continues to be good pockets of value as tax-free yields are elevated relative to taxable Treasuries. Below investment grade spreads remain quite wide, suggesting that more spread tightening may occur as the economy improves, but prudent risk management is crucial as tax revenues have fallen sharply for many municipalities in this space.

Final Thoughts

During the second quarter, and up until the penning of this newsletter, risk-taking and liquidity were generally abundant, while prudence and cash flow were mostly scarce. Given that last Friday was opening day this year in baseball, we will use a baseball analogy to sum up our feelings on these points. In short, it feels like the Brewers just won a game due to an abundance of walks and errors. While we are thrilled with the win, we are leery about the team's ability to win this way consistently.

We feel the same about market returns. We were certainly pleased to see portfolio values increase in the second quarter. That is never a bad thing. We would just prefer more substance to give us confidence that it is repeatable. On the equity side of client portfolios, that means consistency in earnings and reasonable valuations. On the bond side of client portfolios, that means either lower levels of debt or ample cash flow to service the debt. And all of these things are influenced by business activity and sound management – not fiscal and monetary intervention.

We are not inclined to take further risk off the table. We feel that our general posture is defensive enough in client portfolios to retain capital relatively well should a rationalization pullback occur. We are also not inclined to add more risk to portfolios. The margin of safety available in the growthier areas of the equity market is very small, in our view, as are the highest yielding areas of the fixed income market. As a result, we have aligned with some of the most talented active investment managers we know in asset classes where we believe they can add value. In the short-term this means taking advantage of volatility and valuation discrepancies. Longer-term this means being patient.

Sentiment can change quickly, but business values and balance sheets don't change that significantly month-to-month. So we will wait. We will continue to measure. We will adjust when appropriate.

We hope you find a portion of this newsletter useful.

Thank you for taking the time to read it. If you have any feedback on the new format or anything else, it is always appreciated.

Bob

Our Team

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Bob J. Batchelor, CFA is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 20 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee.

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David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

IMPORTANT INFORMATION

Statements may be forward looking and are not intended as specific investment advice without further review of individual circumstances. Commentary, opinions, analysis, and recommendations may be subjective, do not guarantee future performance, and could change at any time without notice. Under no circumstances does the information contained within represent a recommendation to buy or sell any security. Charts and graphs provided are for illustrative purposes only.

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The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S.

The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries.

Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

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