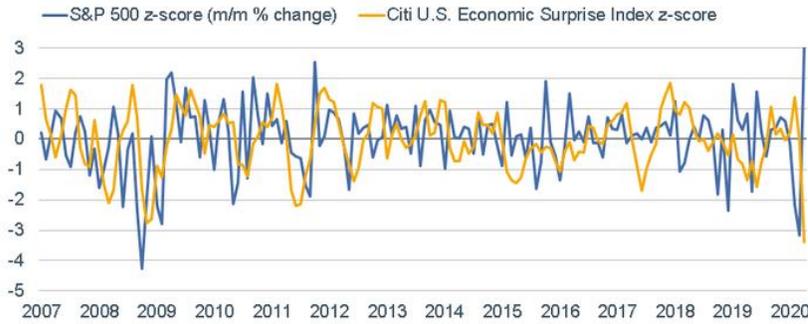




Whether it is Templeton’s perspective or that of Keynes that is most relevant today has, over the past two months, become much more than a purely academic debate, as there currently



exists a disconnect of arguably unprecedented scale between the historic collapse in the domestic economy and the record-setting rebound in the domestic equity markets.

All of a sudden, it has become all-important

whether it is truly “different this time”, in which case the explosive rally in the equity markets could ultimately be proven rational and justified, or if the market rebound is nothing more than a temporary reaction to the combination of technically oversold equity markets and the biggest surge of global monetary liquidity in history.

The above chart shows this divergence by comparing the “Z-scores” for the economy and the stock market. Z-scores measure the deviation between current readings and historical average



As you would logically assume, there is normally a fairly tight correlation between economic strength and market strength (the blue and orange lines). However, at present, both Z-scores are not only at extremes, but are at extremes in opposite directions, which has created a record divergence between the markets and the economy. This discrepancy was just reaffirmed in a recent report from Matt King, global head of credit strategy at Citigroup, which noted that “The gap between markets and economic data has never been larger”,

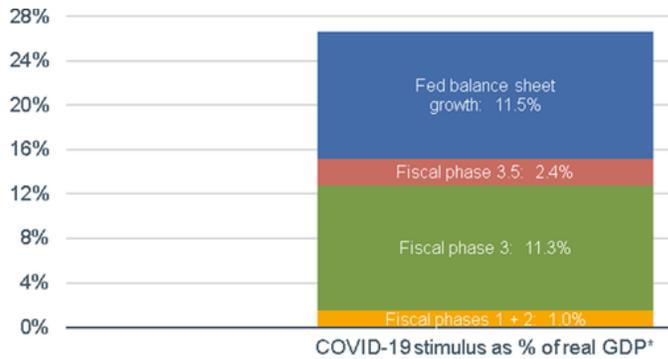


while economist David Rosenberg just compared the stock market rally in the face of an economic collapse to “someone wearing a red dress to a funeral”.

One of the measures that casts doubt on the sustainability of the current market rally in equities is the positioning of “Dumb Money”, which has historically done a very poor job of tactically adjusting equity market exposure versus “Smart Money”, which has historically done an efficient job of adjusting allocations. As you can see, the “Smart Money” turned bullish a little early and bought aggressively as soon as the Federal Reserve introduced its heroic monetary response, but has been selling over the past month. In contrast, the “Dumb Money” started buying equities much later, and has recently been accelerating their buying as the “Smart Money” has been selling. The blue chart shows how the market has historically performed after such divergences.

One of the measures that casts doubt on the

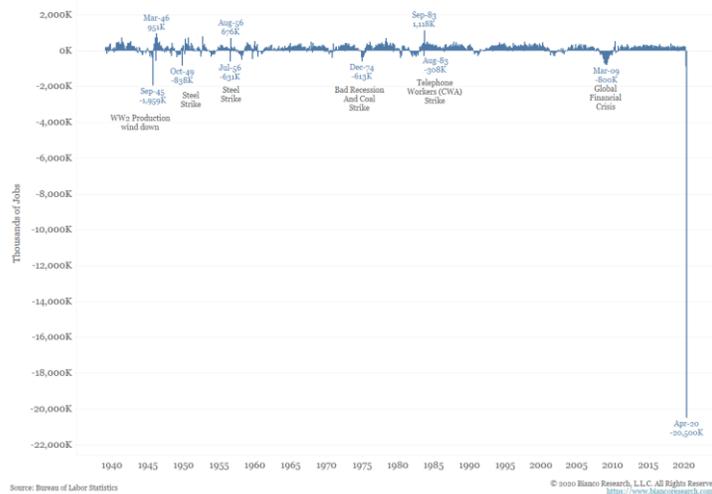
Ever since it first became evident that the Fed would do whatever is necessary (within their legal limitations) to re-liquify the financial system and support the capital markets, our perspective has been that of a nervous bull. On one hand, with an unlimited ability to create credit, the Federal Reserve (particularly when joined by the other major central banks) ultimately almost always gets the outcome that it wants. This time, massive monetary stimulus is being further supported by unprecedented levels of fiscal stimulus, such that they now combine to represent a whopping 26% of the size of the entire domestic economy (pre-pandemic). At present, the Fed's balance sheet alone is three times the size of the



Canadian economy, so it has significant power to stabilize and support the domestic economy, just as long as most of the economy restarts in time to keep the first quarter liquidity crisis from morphing into a solvency crisis.

On the other hand, in the past two months, the U.S. has gone from having the lowest unemployment rate in over 50 years to the highest unemployment rate in at least 80 years and, in doing so, has just wiped out the last eleven years worth of job gains. Further, Capital Economics estimates that, if the numbers were being calculated correctly, the actual unemployment rate would be closer to 20% than the 14.7% rate that the government is reporting. Moreover, 40% of workers earning less than \$40,000 per year have lost their jobs over the past two months. When you consider that 70% of the U.S. economy is directly attributable to consumer spending, it should be no surprise that the economy, as a whole, is suffering the worst contraction since the Great Depression.

Monthly Change in Total Payrolls



Of note, while the majority of those layoffs are intended to be only temporary, a just-released survey by the Society for Human Resource Management found that 52% of small businesses in the U.S. expect to close in the next six months, while the U.S. Chamber of Commerce just announced that 25% of small businesses have already closed and another 40% have enough working capital on hand to last another two weeks. Prior to the pandemic, small businesses accounted for the majority of U.S. jobs and more than 100% of job growth.

There are a multitude of factors that have kept many of the most experienced and respected market analysts rather skeptical of this “V-bottom” in the stock market, including the fact that, until just recently, the significant majority of gains were concentrated in the most heavily shorted stocks and the six or seven largest growth stocks that exert such a heavy influence on the popular, market-cap-weighted indexes.

Also concerning is the time-compressed nature of both the decline and the rebound. In fact, there were only twenty-three trading days between the S&P 500's record high and the recent bear market low, whereas the average bear market lasts for eleven months and the median average bear market lasts for seventeen months, with no previous bear market ever lasting less than three months.

#### How markets have rebounded through history

Cumulative returns from market bottoms for bear markets from 1870 onwards (%)



That said, it should be noted that there tends to be a sort of symmetry in regards to markets, where long, meandering bear markets tend to have long meandering recoveries, and short, sharp declines tend to be resolved via dramatic rebounds. This has represented the fastest dive to bear market lows and the

fastest recovery in history, so there is certainly symmetry, but that hardly seems adequate justification for a rally of this scope, in the face of such a dire economic reality.

Indeed, historically, bear markets that coincide with recessions average eleven months in duration and, according to research from Bank of America, the U.S. stock market has never reached its bottom in less than six months after falling more than 30% concurrent with a recession. Of course, the past is no guarantee of the future.

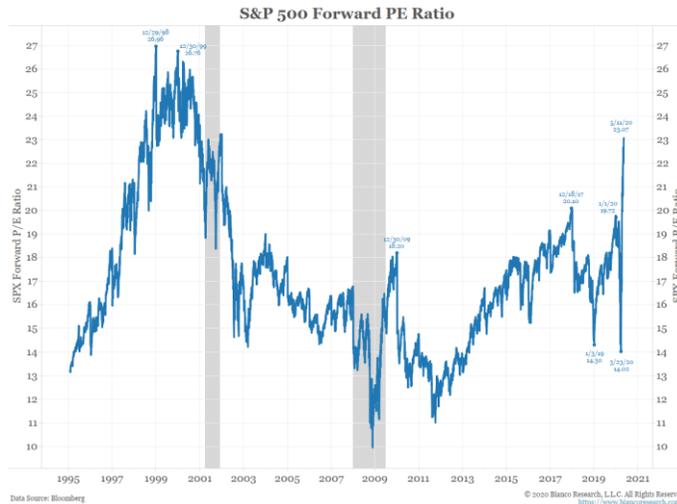
Another reason for skepticism is that the kind of outsized single-day gains that we have seen in the current rebound almost never occur in a bull market, and are instead much more prevalent during bear markets. As noted in last month's report, there have been only seven times over the past seventy years when the S&P 500 has gained as much as 7% in a day, and they have all occurred during periods of significant disruption. Three took place during the first quarter of this year, three occurred during the financial crisis, and one took place right after the 1987 crash.

Further, over the past two months, the Dow Industrial Average has closed up or down by at least 1% on 86% of all trading days, and the only precedents for this level of volatility are the Fall of 1931 and the Fall of 2008.



A look at equity market performance during the COVID-19 period is also instructive, with “going out” stocks (restaurants, movie theaters, etc.) still down by over 25%, economically-sensitive and transportation-related stocks still down by around 13% and “new reality/stay-at-home stocks” (Zoom, Netflix, Amazon, etc.) recently turning positive for the period.

We should also re-emphasize that V-shaped bottoms are rather rare throughout market history, as investors have traditionally wanted some evidence that a sustainable bottom is in place before making major new commitments to equities. As a result, between 70% and 80% (depending on the time periods measured) of significant market lows have included at least one retest of a significant prior low before sustaining a new bull market rally.

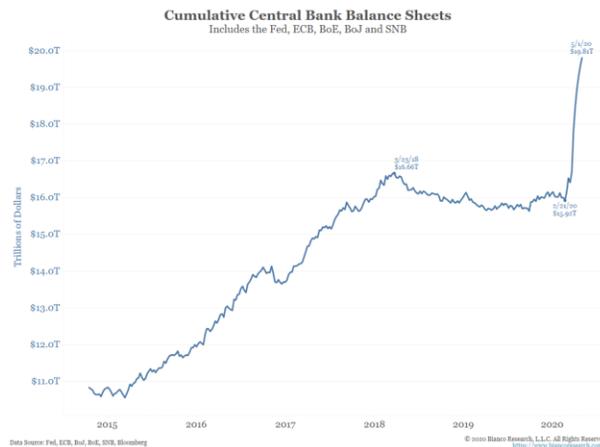


To top it all off, we are in a period with very little earnings visibility (40% of companies reporting Q1 earnings have cancelled forward-looking guidance), and what visibility does exist reflects a decline in corporate earnings that is far weaker than are equity prices, which has pushed equity valuations (relative to earnings) to levels not seen since the dotcom bubble of 1999. Further, these sky-high equity valuations are being awarded to stocks during the worst

global health crisis in 100 years and the weakest global economy in at least 80 years.

All of the above (and more) considered, the stock market has been behaving in a way that history strongly suggests that it should not, thus raising the questions of 1) is this time, in fact, different?, 2) if so, is that difference sustainable?, and 3) if the various lessons of history do still apply, what is allowing the market to rally so powerfully in the face of such a dramatic array of negatives?

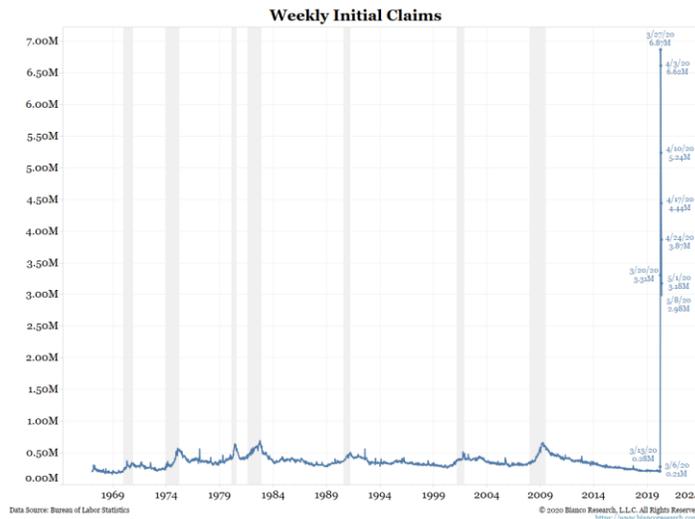
Despite these negative fundamentals, the market has not only been climbing higher, but climbing higher at a historic rate of ascent, and with most of the leadership concentrated in three groups: mega-cap growth stocks that are essentially acting almost as utilities in the current environment, healthcare companies involved in COVID-19-related research, and an array of speculative growth stocks, many of which are capitalizing on this “new normal” that we are all adjusting to. While it makes sense that these would be the leadership sectors, their leadership attributes alone are clearly insufficient to explain this rally in the broad indexes. So, what are the catalysts?



From our perspective, it starts with a belief in a “Fed Put”, which describes the broad perception, which has clearly been encouraged by the Fed, that the global central banks will do whatever is necessary to support both the global economy and the global financial markets for the duration of the COVID-19 pandemic. The Fed’s willingness to do even more was reaffirmed on May 13<sup>th</sup>, when Fed Chairman Powell stated, “While the economic response has been both timely and appropriately large, it may not be the final chapter, given that the path ahead is both highly uncertain and subject to significant downside risks.”

Indeed, at a press conference just last week, Fed Chairman Powell emphasized that the Fed is committed to employing its “full range of tools” to support the economy, and reminded the audience that “our credit policies are not subject to a specific dollar limit.”

It is our belief that, because of this open-ended and virtually unlimited commitment on the part of the Fed to do whatever is necessary (see last month’s report), instead of selling off on terrible economic news, equity investors are actually celebrating each and every dismal report (the worse, the better), as it virtually assures more and more fiscal and monetary stimulus, which tend to be even more bullish for equities than are economic growth and strong corporate profits.



For evidence, you need look no further than the stock market during the three quantitative easing programs necessitated by the global financial crisis, which produced one of the strongest equity bull markets in history during one of the weakest economic recoveries in history.

Similarly, if you want evidence that investors are celebrating the release of bad economic news,

you need look no further than the past seven weekly initial jobless claims reports, which represented the seven worst readings on initial jobless claims of all time. However, the Dow Jones Industrial Average rallied sharply after each of the six reports that came in even worse than expected, and by a combined 2,000 points. In other words, 80% of the stock market’s 25% rally since the end of March occurred on the announcements of the worst employment data in history, and two other significant rallies took place on the announcement of the worse-than-expected non-farm payroll and gross domestic product (GDP) data.

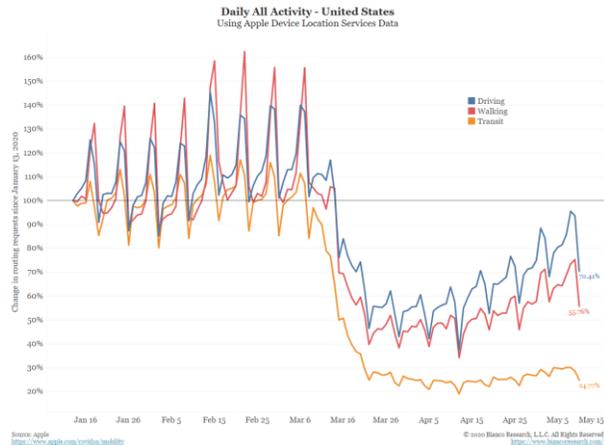
In contrast, when Federal Reserve Vice-Chairman Clarida stated last week that he thought that the economy would start to recover in the third quarter of this year, equities actually sold off on the news, because such a better-than-expected-prognosis could lessen the likelihood of additional stimulus.

Also adding to bullish sentiment has been a growing confidence that the global economy will benefit from a successful “re-opening”, and one that is happening earlier than many experts had expected. If true, that suggests that the economic damage will be less than expected and, in turn, that the massive fiscal and monetary stimulus programs may turn out to be outsized relative to what actually turns out to be the economic damage caused by the crisis.

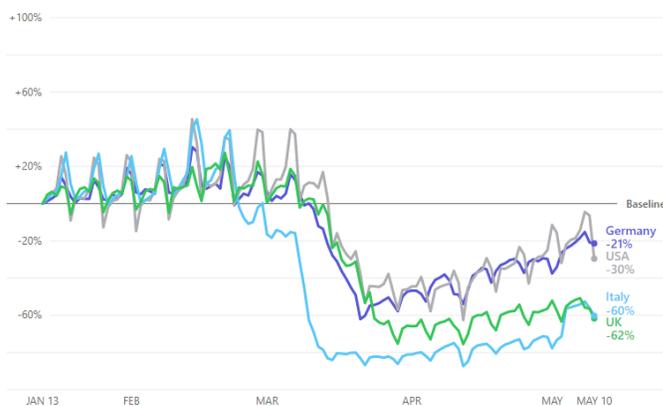
We believe that this expectation is likely to be at least partially correct, in that we do think that the global economy is going to reopen before many analysts had projected, and we actually don’t think that governments are likely to shut it down again. However, we do not hold this opinion because we expect for the reopening to avoid a new surge in COVID-19 cases. To the contrary, we are expecting a significant surge in new cases, which is what is already happening around the world in countries who reopened their economies ahead of the United States.

This risk was emphasized by Dr. Fauci on May 12<sup>th</sup>, when he warned that, if economic interests take precedence over public health concerns, “there is a real risk that you will trigger an outbreak that you may not be able to control [thus causing] some suffering and death that could be avoided [and which] could even set you back on the road to trying to get economic recovery.”

Instead, we think that the global economies are likely to stay open for the simple reason that, while it did serve to “flatten the curve” enough to keep the hospital system from being overwhelmed, “stay at home” policies have done very little to actually shrink the number of active coronavirus cases (or even to assure the health of those who stayed at home, as illustrated by the fact that 66% of new cases in New York City are patients who sheltered at home). It was a failed global policy designed to address a health crisis that instead caused an economic crisis.



However, the fact that we expect for most of the economy to stay open, does not mean that we expect a return to normalcy, at least until there is a viable and broadly utilized vaccine. Indeed, a look at the recent surveys from YouGov/CBS, Washington Post/University of Maryland, Gallup, Ipsos and The University of Michigan shows that they all have very similar findings. About 70% of consumers are taking a “wait-and-see” approach before resuming normal activities, over 60% are nervous about leaving their homes, almost 60% plan on staying on lockdown until the virus is “fully contained”, and 67% of Americans are “uncomfortable” going into stores. That hardly sounds like the launching pad for a “V-Shaped” economic recovery, nor reason to believe that the economic damage will be relatively smaller than the policy response from the government and Federal Reserve.

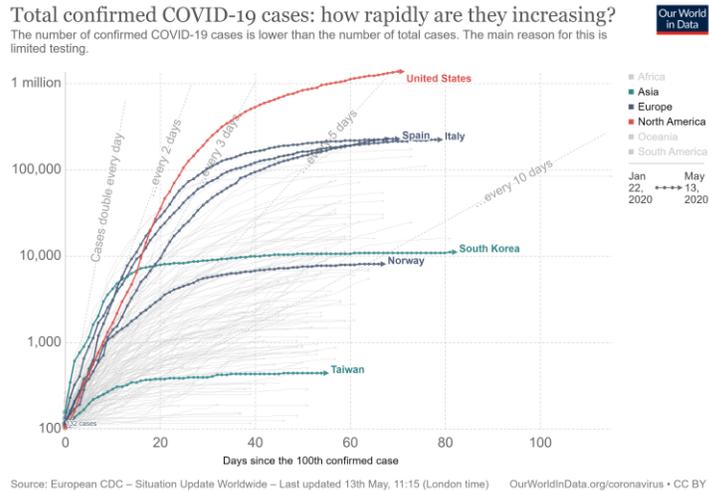


The data that we have seen thus far in the U.S. supports those expectations for a muted rebound, with cell phone data showing only modest increases in consumer mobility, whether it be by car, mass transportation or walking. Economy re-openings in Europe have been met with similarly modest levels of consumer enthusiasm.

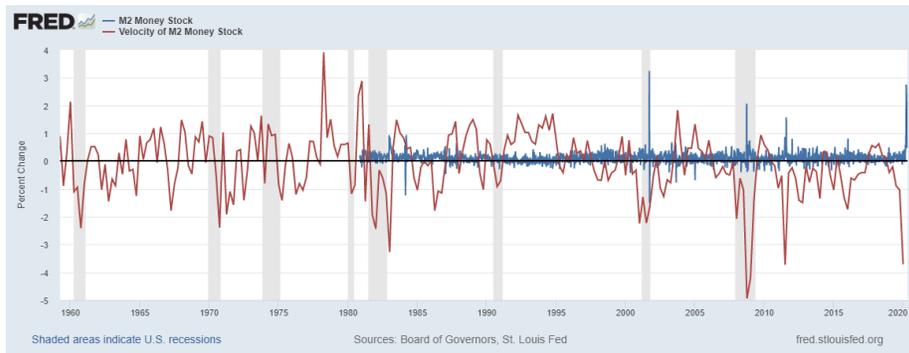
Ultimately, a return to some sort of normalcy depends on either a broadly available vaccine, or some sort of therapeutic that lessens the duration and effects of the virus, and this is one of the apparent reasons for the recent equity market rally that may make the most sense. We are not suggesting that the achievement of either of these goals will be easy, or that a vaccine is likely to be available any time soon. However, we believe that the rapid pace of the medical advances already being made are a testament to human innovation, with particular excitement being generated by messenger RNA and monoclonal antibody-related therapies.

While the individual odds of any given potential vaccine or therapeutic being “the” answer to this pandemic are not particularly good, the sheer number and variety of medical research projects underway gives us a degree of confidence that the world is likely to have a viable therapeutic within a year and a proven vaccine within two years. According to the World Health Organization, there are already 108 potential COVID-19 vaccines in development around the world, and the FDA reports that there are currently 72 therapeutic treatments in active trials and another 211 treatments in the planning stages.

Of course, producing enough of any treatment or preventative for America’s 330 million citizens (much less the 7.6 billion people across the globe) is another matter entirely.



In more normal times, any single macroeconomic factor discussed above would probably dominate every headline and discussion on both Wall Street and Main Street. However, when there seems to be a new crisis virtually every day, you eventually just become inured to your environment, and what would normally be considered mountains can somehow seem like mole hills. However, of all of these factors that have influenced the size, scope and composition of the stunning rebound in equities, the single most important one may also be



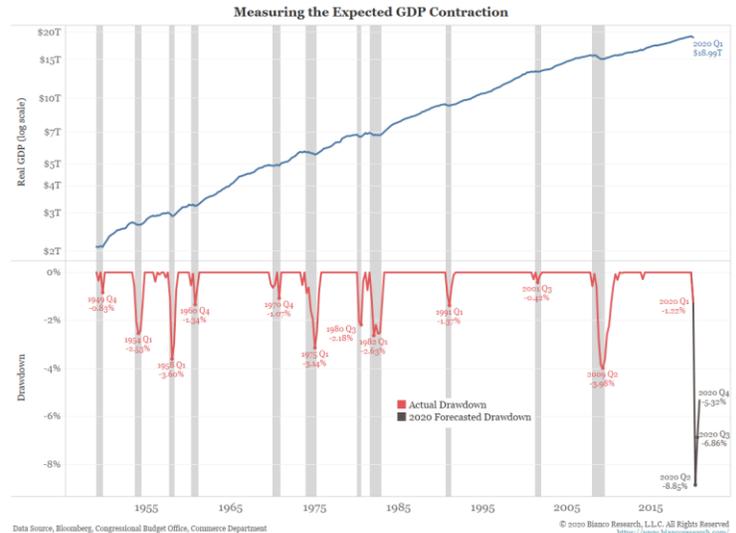
the most obvious, and even the most understandable, if you can just get past the economic jargon.

Economic liquidity is ultimately a function of two separate inputs. The first is the amount of money that is sloshing around in the economy. In this chart, money supply is shown in blue as a percentage change from a year previously. The second component is “velocity”, or how often each dollar in the economy changes hands. This is shown in red, also as a percentage change from a year ago.

What is immediately evident is that the Fed and Treasury Department are absolutely exploding the nominal amount of money sloshing around in the economy, but that it is not yet economically stimulative, as no one is spending it (i.e. the velocity is collapsing). This should start to change as the economy reopens. In the meantime, there is a dramatic excess of cash in the economy that is not being otherwise employed and, just as had been the case during the financial-crisis inspired quantitative easing programs (QE1, QE2 and QE3) the excess money needs to go somewhere, and it has been pouring into the stock market.

Theoretically, when the economy does eventually start returning to some sense of normalcy, there is a risk that this money will exit the equity markets, but if that were to happen, that would also suggest an improving economy and stronger and more predictable corporate earnings, which should help support stock prices despite the reallocation of capital.

It would be a significant understatement to say that we are expecting an unusually challenging investment environment, as the world is trying to recover from the almost untenable combination of a global pandemic and a global economic contraction that far exceeds anything seen since the worst of the Great Depression.



In our opinion, the world will be forever changed as a result of COVID-19, much as it was by the introduction of the internet, the invention of antibiotics, and the fall of the Berlin Wall.

Economist Joseph Schumpeter wrote about such periods of dramatic change causing “gales of creative destruction”, which can provide exciting

opportunities for investors who can effectively identify tomorrow’s winners today. By the same token, such periods of seminal change can also be a significant challenge for any investor who does not have the flexibility to adapt to this so-called “new-normal”.

It will similarly create both unprecedented risks and generational opportunities for companies because of not only how they adapt to, but even more importantly, how they capitalize on, this period of seminal change. Those companies that do it best could turn out to be the next generation of Googles and Amazons, and provide extraordinary returns to investors who can identify these emerging leaders. Similarly, there are companies, and even entire business models, that may not even survive the pandemic, which we believe should provide a compelling advantage for active portfolio management and securities selection over the passive strategies that have become so popular over the past ten to twenty years.

Indeed, we suspect that this may be doubly true since the S&P 500 Index, which is most commonly used as the preferred equity benchmark for passive investing, is capitalization-weighted, with the biggest five companies actually accounting for about 20% of the entire index. As such, it is, by design, weighted heavily towards the pre-pandemic leaders, some of which are unlikely to be post-pandemic leaders. In short, there is no doubt that at least some things are very different this time.

In conclusion, one might do well to remember the words of philosopher (and Presidential Medal of Freedom winner) Eric Hoffer, who noted that, “In a time of drastic change it is the learners who inherit the future. The learned usually find themselves beautifully equipped to live in a world that no longer exists.”

Be open minded, be nimble, and pay close attention to “the message of the markets”.

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