QUARTERLY INVESTMENT OUTLOOK

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Short-term investment prospects for risk assets have unexpectedly darkened because of the sharp and sudden reversal in health trends associated with the coronavirus epidemic. New cases and hospitalizations nationwide have spiked higher during the past three weeks, without warning, raising the risk of renewed shutdowns in certain regions. These health trends are disturbing and are a clear reminder that the direction of the COVID-19 pandemic is the 800-pound gorilla in the outlook for both economic growth and financial asset prices.

Summary and Major Conclusions:

- Financial markets rallied strongly in the second quarter, with common stocks outperforming bonds by a wide margin. Domestic stocks outperformed international stocks; growth stocks outperformed value stocks; and government bonds significantly lagged corporate bonds.

- World financial market returns during the second quarter were shaped by five powerful developments: Unprecedented monetary and fiscal policy stimulus; a steady downturn in new coronavirus cases, until quarter end; favorable news regarding a vaccine; expectations for restarting the economy; and much improved economic data in May and June.

- The financial market backdrop suddenly deteriorated in the middle of June, coincident with signs of a surge in coronavirus cases in a large number of southern and western states. *These disturbing health trends are a clear reminder that the direction of the COVID-19 pandemic is the 800-pound gorilla in the outlook for economic growth*.

- Short-term prospects for world financial markets have unexpectedly darkened because of an increased probability of renewed lockdowns, at least on a regional basis. The implications are that company earnings and common stocks could remain under persistent pressure in an environment of rising business closures and an increase in social distancing practices.

- In the worst case, a substantive and sustained decline in confirmed COVID-19 cases might not come about until there is an effective vaccine available for mass distribution or, at a minimum, one or more effective therapeutics.

- The investment implications are negative: The equity market could be entering a short-term consolidation phase, which could be evident in either a sideways pattern within a defined trading range, or possibly a market correction of 5% to 10%.

- A steep decline in stock prices is always possible but not probable, for several reasons. Spending has progressed well beyond its April lows monetary and fiscal policy will remain highly supportive.

- In addition, unusually high portfolio cash reserves should provide downside support. Finally, another nationwide lockdown of the economy as occurred in March and April appears highly unlikely.

- The implications are that equity investors should be patient and await a better entry point to augment stock positions. Until there is a long-term solution to the COVID-19 crisis, defensive assets are likely to continue to outperform risk assets.

- Looking beyond the daunting public health challenges in the short term, the outlook for common stock investing is favorable. While the *rate* of economic growth is highly uncertain, the *sustainability* of the business expansion cycle appears to be assured.

- Following a steep decline in the second quarter, company earnings should rebound in both Q3 and Q4, and full-year earnings in 2021 should easily exceed those of 2020. Profits should also increase in 2022, but precise estimates are not possible, at this time.

- The outlook for the fixed-income market is dismal over all future time horizons. At a current market yield to maturity of 0.65%, the ten-year US Treasury bond is massively overvalued and offers minimal return potential.

- Bond investors should be prepared for capital losses on fixed-income assets as interest rates drift higher in future months. Compared with a year-to-date gain of 8%, government bonds are almost certain to deliver negative returns in both 2021 and 2022.

- International stocks will begin to outperform the domestic equity market when there are clear signs of a strong acceleration in global economic growth and world trade. Whereas the US equity market is more domestically oriented, non-US stocks are heavily exposed to both exports and world trade.

- I continue to expect a shift in equity market leadership before the end of this year. A sustained shift in market leadership in favor of value stocks awaits concrete evidence of a healthy and sustained economic recovery, which should become a reality following a decisive public health solution.

FINANCIAL MARKET REVIEW

Following one of the worst quarters in decades, financial markets put together a monster rally in the second quarter, with common stocks outperforming bonds by a wide margin. Domestic stocks outperformed international stocks; growth stocks outperformed value stocks; and government bonds significantly lagged corporate bonds. The total return on domestic equities of 21.1% in Q2 was the strongest quarter since 1998 and slightly ahead of the 16.5% return on international stocks. The return on the investment-grade (aggregate) bond index was 3%. Growth stocks (+28%) trounced value stocks (+14.5%), while corporate bonds (+9%) bested government bonds (+0.5%) by a wide margin.

- **Technology Sector:** Information technology stocks were once again market leaders with a spectacular total return of 31%, ending the quarter at an all-time high. *A mere five mega-cap technology stocks comprise nearly 25% of the S&P 500 Index and nearly 50% of NASDAQ and were responsible for a staggering one-third of total index gains in the quarter*.

Specific Market Drivers: World financial market returns during the second quarter were shaped by three powerful developments:

1. **Government Policy:** The Federal Reserve and fiscal policymakers responded to the coronavirus crisis with unprecedented speed and force, providing trillions of dollars of stimulus for the economy and financial system. Government stimulus provided direct support to both stocks and bonds.

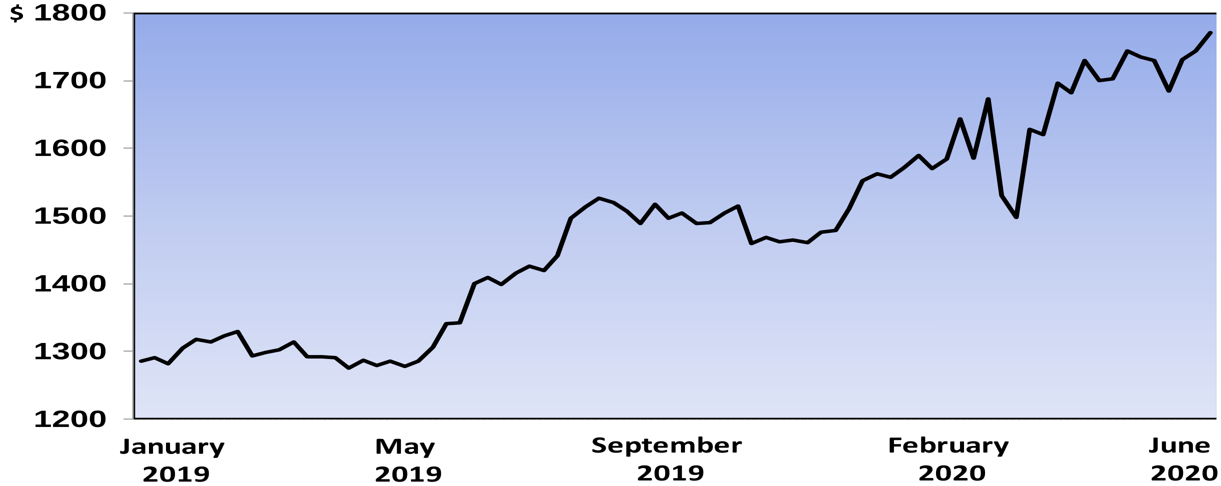
2. **Public Health:** Both hospitalizations and new cases of COVID-19 peaked in April and trended lower in May and early June, albeit at a very moderate pace when compared with Europe and Asia. News on the medical front was unexpectedly positive in the quarter, as the development of vaccines and therapeutics proceeded at an unprecedented pace. These favorable trends prompted a phased reopening of the economy on a state-by-state basis during May and June.

3. **Economic Data:** Following a disastrous April, the domestic economy exhibited consistent signs of improvement in May and June, providing encouraging evidence that the worst of the economic pain from the lockdown had passed.

Mid-June Reversal: As of June 8, the S&P 500 was actually up for this year. For the three months ending June 23, the total return on the S&P 500 was 42%, one of the largest three-month stock rallies in recent decades. Financial markets abruptly reversed course in the final two weeks of June in response to a sudden and unexpected surge in new infections and hospitalizations, concentrated in the south and west. Stock prices and government bond yields abruptly declined, with growth stocks massively outperforming value stocks.

- **Flight to Quality:** Uncertainty over the coronavirus pandemic triggered a stampede into all safe-haven assets — the 9% return on US Treasury securities in the first half of the year was the best six-month period in 25 years. The US dollar and the price of gold surged in response to the bad news on the public health front (see chart 1).

Chart 1: Gold Prices at an All-time High
US Dollar Price of Gold, Per Troy Ounce
Source: Bloomberg



FINANCIAL MARKET OUTLOOK

Short-term investment prospects for risk assets have darkened unexpectedly because of the sharp and sudden reversal in health trends associated with the coronavirus pandemic. Through the middle of June, financial markets were bolstered by the steady decline in infections that began in the middle of April. However, new cases and hospitalizations nationwide have spiked higher during the past three weeks, without warning, with some cities and states seemingly out of control.

- **Surge in Infections:** Nationwide data tell the story: From a daily peak of 36,000 in the middle of April, new COVID-19 cases fell to fewer than 20,000 per day in the middle of June. At the end of June, daily infections had surged to more than 52,000. Hospitalizations also rose sharply, although the fatality rate remained stable.

Complacent Behavior: The escalation of infections since mid-June has been concentrated in numerous states in the southern and western US, where reopenings were premature and poorly executed. Individuals have exhibited a shocking level of complacency — and in many instances contempt — toward hygiene safety.

- **Short-Term Caution:** *My short-term caution is derived from a rising probability of renewed social distancing mandates along with regional lockdowns*. Any measures to limit mobility and social interaction would undermine the smooth recovery in economic activity and company earnings anticipated by markets.

The 800-Pound Gorilla: The equity market could remain under pressure until current adverse public health trends are reversed, evident in a sustained decline in the numbers of new cases and hospitalizations. This could be accomplished by more aggressive social distancing practices, more widespread testing, contact tracing, and more disciplined use of masks. *These health trends are disturbing and are a clear reminder that the direction of the COVID-19 pandemic is the 800-pound gorilla in the outlook for both economic growth and financial markets*.

- **Lagging Economic Indicators:** White House officials continue to emphasize the strong economic data per se in May and June. However, any optimism based upon these historical data is misguided: In view of the sharp reversal in coronavirus infections, second quarter economic trends have become lagging indicators. As I have argued from the onset of the pandemic, ***trends pertaining to COVID-19 will be the primary determinant of the direction of the economy***.

Worst Case: In the worst case, a favorable resolution to the current public health crisis might not come about until there is an effective vaccine available for mass distribution. Under this more pessimistic scenario, the current spike in new cases will continue throughout the summer, with a second wave likely to emerge in the fall.

- **Consolidation Phase:** The implication is that the equity market may be in a prolonged consolidation phase, which would become evident in a sideways pattern for stock prices, or possibly an interim correction of 5% to 10%. Currently at 3000, the S&P 500 could fluctuate within a range of 2700 to 3200 over the next three or four months, with continued elevated day-to-day volatility.

Catalysts for Recovery: The all-clear sign for common stock investing will require one or more powerful catalysts:

1. A systematic and sustained downtrend in regional outbreaks in the south and west, achieved with the use of targeted interventions and/or partial shutdowns

2. Availability of a vaccine in mass quantities and/or an effective therapeutic that are approved for broad use

3. Greater conviction on the part of investors with respect to the future trend in company earnings in 2021

Chart 2: US Money Supply Expanding at a Record Pace
The M2 Money Supply, Annual % Growth
Source: Federal Reserve

Better Entry Point: The implications are that equity investors should be patient and await a better entry point to augment stock positions. Resumption of the cyclical bull market in common stocks is unlikely until there is a long-term solution to the COVID-19 crisis. In the interim, defensive assets are likely to continue to outperform risk assets, and growth stocks should continue to outperform value stocks.

Corporate Earnings: The level of uncertainty surrounding the short-term outlook for company earnings is unprecedented. Nearly 40% of the companies in the S&P 500 have suspended quarterly guidance for investors. The capacity of analysts to forecast company revenues, selling prices, and operating costs is extremely limited. As a broad generalization, *earnings should rebound in both Q3 and Q4, and full-year earnings in 2021 should easily exceed those of 2020*. *Profits should also increase in 2022*, but the growth rate is uncertain.

Long-Term Prospects: Looking beyond the daunting public health challenges in the short term, the outlook for common stock investing appears favorable. *While the **rate** of economic growth is highly uncertain, the **sustainability** of the business expansion cycle appears to be assured*. *A steadily expanding economy should be accompanied by a rising trend in company earnings and dividends*. The following factors support this favorable long-term outlook:

- The Federal Reserve has successfully restored the functioning of the financial system, assuring credit availability for businesses and households. The M2 money supply is currently expanding at the fastest pace on record, which is a precursor of faster consumer spending in the future (see chart 2).

Chart 3: Government Bond Yields Near All-Time Lows
Market Yield to Maturity, Ten-Year US Treasury Bond
Source: Federal Reserve

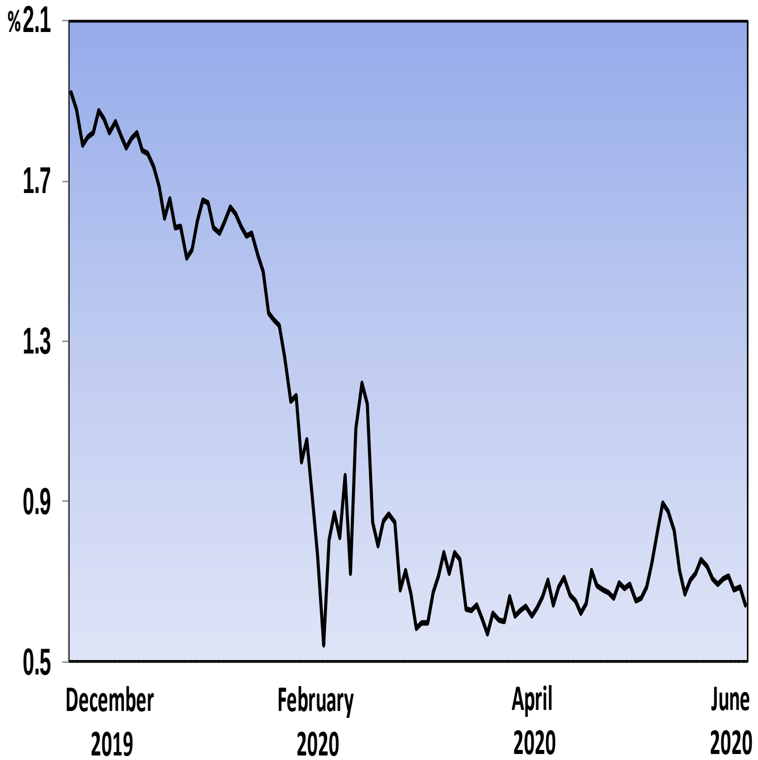


Chart 4: Resource Utilization at a Depressed Level
Capacity Utilization Rate, Manufacturing Sector
Source: Bloomberg

- Policymakers are determined to do whatever is necessary to support the recovery. I expect Congress to pass legislation providing more than $1 trillion in further unemployment benefits and individual income support.

- Bond yields are likely to remain near historic lows for an extended period (see chart 3).

- Market sentiment among institutional investors remains depressed, as cash reserves remain at multi-decade highs.

- Elevated unemployment and depressed capacity utilization in manufacturing imply many years of real growth before the economy is faced with bottlenecks (see chart 4).

- Inflationary pressures are likely to remain dormant over the medium term, with the consumer inflation rate remaining below 2% well into 2022 (see chart 5).

- US household finances are in good health, strongly suggesting that consumer spending will support GDP growth in 2021 and 2022, assuming a sustained recovery in employment (see chart 6).

Chart 5: Core Consumer Inflation in Decline
US Personal Consumption Deflator
Excluding Food and Energy
Annual % Change
Source: Bureau of Economic Analysis

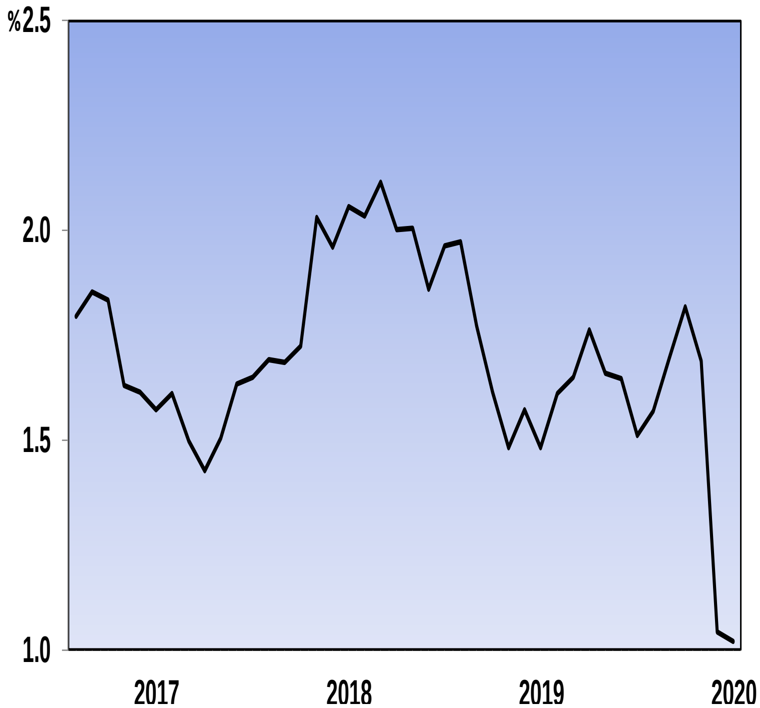


Chart 6: US Household Finances Are in Excellent Condition
Household Debt as a Percent of Household Income
Source: Federal Reserve

- Housing market fundamentals remain excellent, suggesting that residential construction will once again lead the economy out of recession (Chart 7).

- In the end, the health system will ultimately conquer COVID-19, implying that the virus will not constitute a permanently negative impediment to company earnings growth.

Although an accurate timing of the resumption of the equity bull market that began on March 23 is not possible, it seems reasonable to assume that equity market returns will reward buy-and-hold investors over a time horizon of one to two years.

Fixed Income: Conversely, the outlook for the fixed-income market is dismal over all future time horizons. At a current market yield of 0.65%, the ten-year US Treasury bond is massively overvalued and offers minimal return potential. Because the most likely path of interest rates over the next two years will be upward, investors should be prepared for capital losses on fixed-income assets. Corporate bonds are also overvalued. With a current market yield at an all-time low of 2.2%, high-grade corporate bonds are also unattractive and vulnerable to rising market interest rates (see chart 8).

Chart 7: Classic Signs of a Cyclical Rebound in Housing
Index of New Mortgage Applications for Purchase
Source: Mortgage Bankers Association

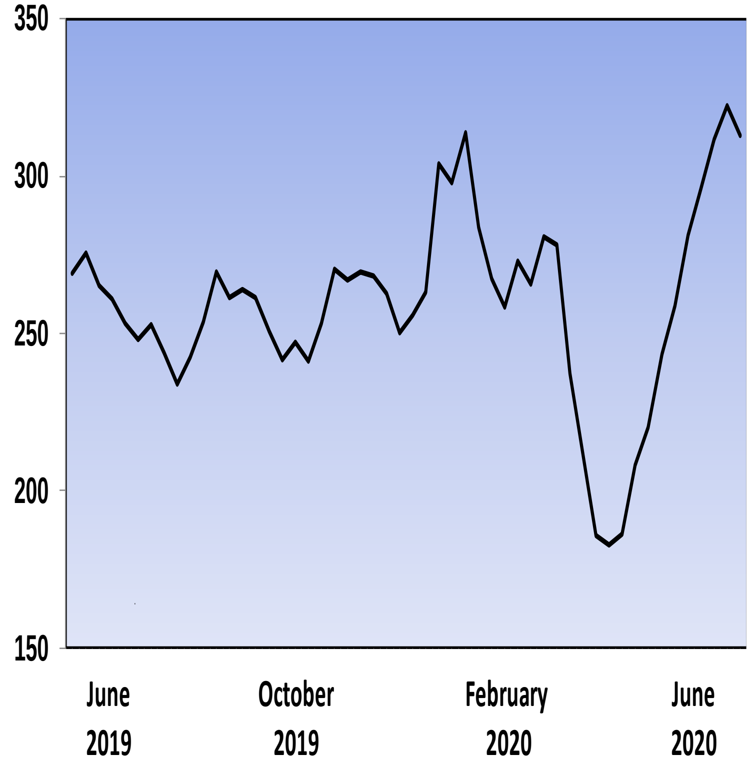
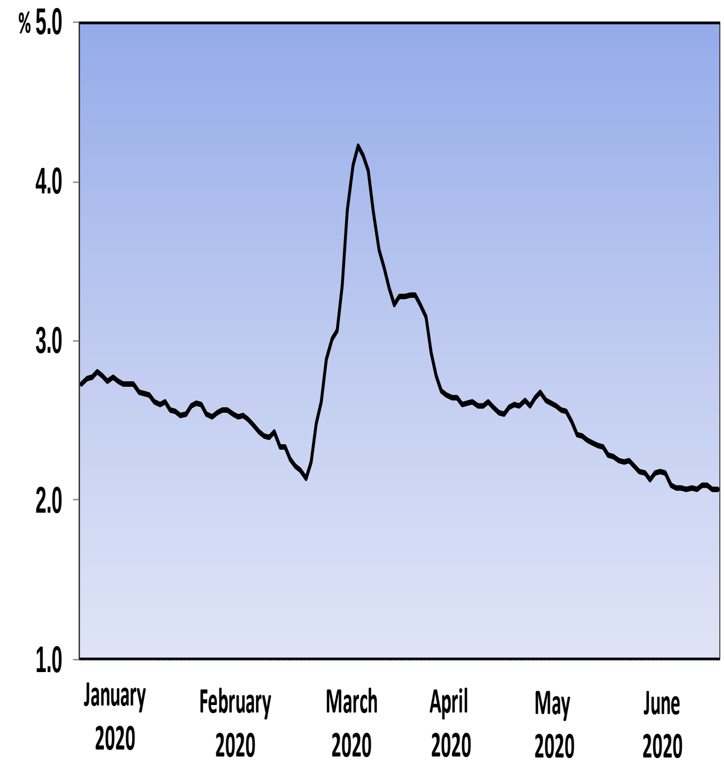


Chart 8: Market Yield on Corporate Bonds at an All-Time Low
Yield to Maturity, Investment-Grade Corporate Bonds
Source: Bloomberg Barclays Bond Index

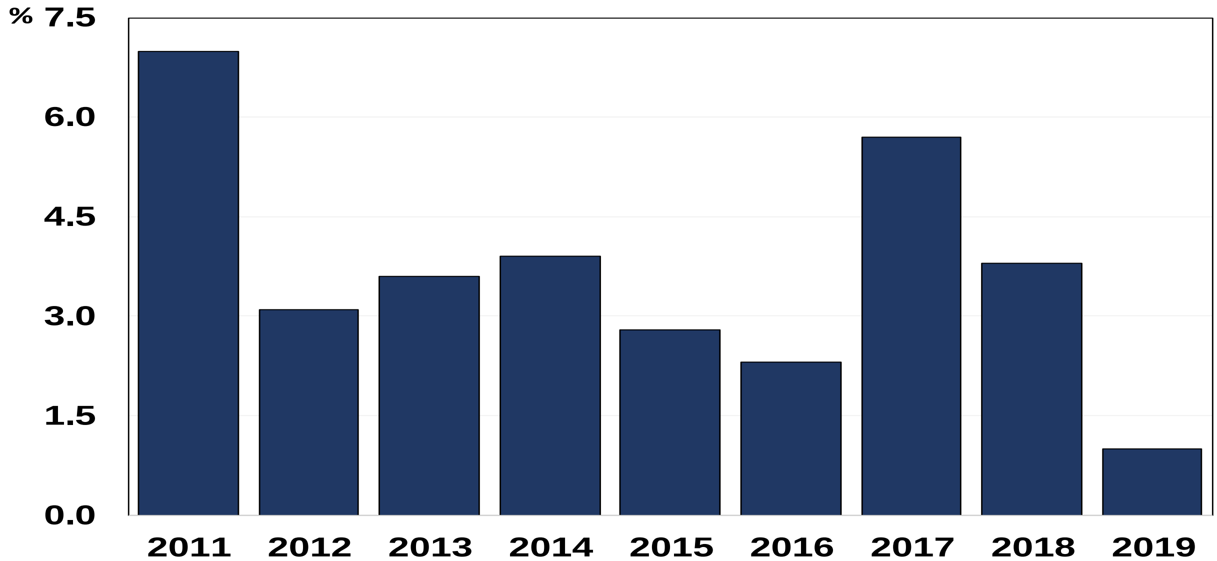


INTERNATIONAL EQUITY MARKETS

Non-US stocks have consistently lagged all major US benchmarks over the past decade with the exception of 2017, when international stock returns of 28% easily exceeded the 22% return for the S&P 500. What explains the outperformance of international stocks in 2017? There are several explanatory factors:

- World GDP expanded by 3.75%, its fastest growth rate since 2010, and well above the 2% growth in the US.
- Eurozone GDP growth of 2.5% in 2017 was the fastest in a decade and slightly faster than that of the US. China's GDP expanded by nearly 7%.
- Growth in world trade accelerated in 2017 to 5.75%, more than double the 2.25% growth in 2016 (see chart 9).
- The US dollar fell by a cumulative 15% in 2017, the biggest decline since 2003. A weak dollar is supportive of global liquidity and benefits non-US stocks relative to domestic stocks.

Chart 9: Growth in World Trade Accelerated in 2017
Volume of World Trade, Annual % Growth Rate
Source: International Monetary Fund



Main Catalyst: *International stocks will begin to outperform the domestic equity market when there are clear signs of a strong acceleration in global economic growth and world trade*. The US equity market is more domestically oriented, with the highest percentage weightings in growth stocks, most notably technology, consumer, and health care stocks.

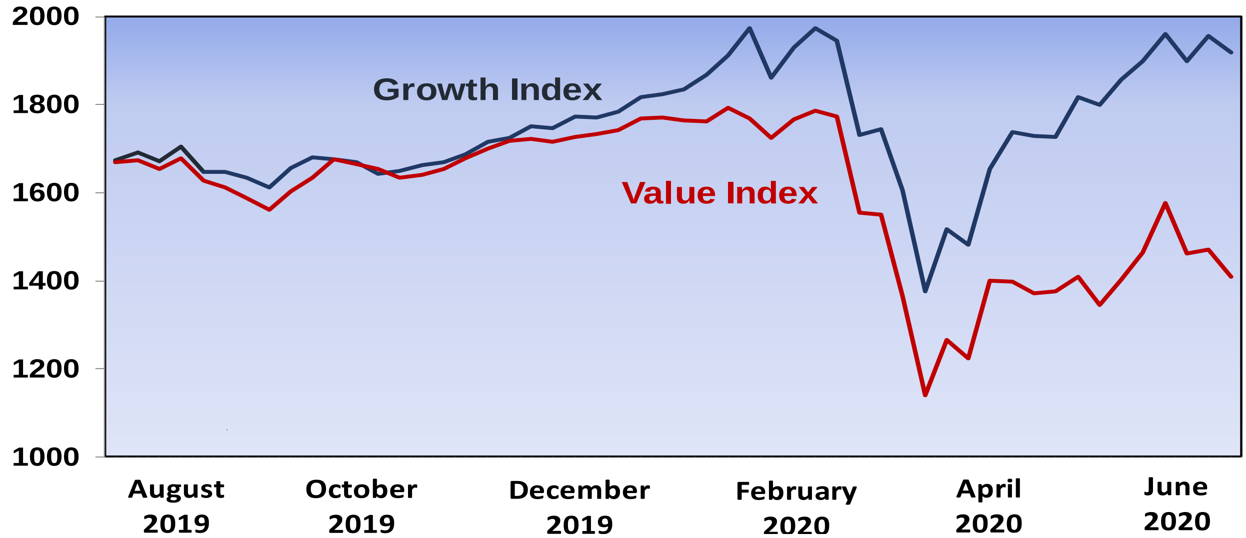
- **The World Economy:** Conversely, most non-US economies are export driven and more reliant on the world economy. Most non-US equity benchmarks have heavy weightings in shares of financial firms, economically sensitive businesses, and export-oriented companies. These stock groups should perform best in an environment of world economic recovery over the next several years.

Managing the Pandemic: Finally, policymakers in most European and Asian countries have managed the COVID-19 crisis far better than those in the US. Whereas new cases in the US ended June at record levels, new cases in both Germany and Japan have declined by 90% from their peak levels in early April.

GROWTH VERSUS VALUE STOCKS

Growth stocks have outperformed value stocks for more than a dozen years, the longest stretch of relative strength in equity market history. For the ten-year period ending June 30, the total return on the Russell Growth Index was **358%**, a compound annual return of 16.5%. By comparison, the Russell Value Index has returned only **160%**, a compound annual return of 10%.

Chart 10: US Growth Stocks Continue to Outperform Value Stocks
Russell 3000 Growth Index
Russell 3000 Value Index
Source: Russell Investment



- **Pandemic Favors Growth:** The relative performance of growth over value has accelerated since the COVID-19 pandemic. Whereas the growth index has generated a total return of nearly **+9%** for the first six months of this year, the total return on the value index is a **negative 17%**, an absolute differential of **26%** in only six months (Chart 10).

Catalyst for Reversal: While there are several economic developments that determine relative investment performance, the most important factor is the phase of the traditional business cycle. *With few exceptions, growth stocks have performed best during the late stages of an economic expansion, as investors prepare for the next recession*.

Value Stocks and Recessions: Conversely, *value stocks have performed best during the first several years of an economic expansion*. The rationale is straightforward: Because the expected duration of business expansions is between five and ten years, investors are not concerned about the next recession in the early years of recovery. Hence, *value stocks have consistently outperformed growth stocks in the immediate aftermath of recessions* — in the late 1970s, the early 1980s, the early 1990s, and the early 2000s. In fact, based upon historical precedent, a reversal in 2020 or 2021 seems inevitable.

Glimmer of Hope: I continue to expect a decisive shift in leadership before the end of this year. *A shift in market leadership appeared to be underway during the second half of May and first half of June, but fizzled as news of a resurgence in COVID-19 cases began to proliferate*. During this four-week period ending in the middle of June, the Russell Value Index appreciated by **21%**, well ahead of the **12%** return for the Russell Growth Index.

This period of value stock outperformance proved to be short-lived, aborted by widespread market fears of a renewed shutdown in the economy emanating from the surge in new infections nationwide. *An **uninterrupted** shift in market leadership for value stocks awaits concrete evidence of a sustained economic recovery, which in turn depends upon trends pertaining to coronavirus infections and news of medical breakthroughs*.

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Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid-cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: The S&P 500 or Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies.

S&P 500 Equal Weight Index (EWI) Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

Value Line Index is the equal-weight version of the widely-used S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.