ALETHEIA PRIVATE CLIENT GROUP
of Oppenheimer & Co. Inc.

What's Next?

Quarterly Commentary | Q2-2020

In brief...

- The market reaction to the novel coronavirus (COVID-19)
- Where does central bank intervention lead us
- Where to overweight – innovation
- Things that keep us up at night
- A Return to Normal….hinges on the timing of an effective and scalable vaccine?

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Coronavirus

The novel coronavirus (COVID-19) has had an overwhelming impact on all of our lives and the U.S. economy. To recap the past several months hardly seems necessary; yet, we are still tasked with providing thoughtful perspectives on the investment landscape and guidance for long-term investment decisions. So let's start with the following summary of S&P 500 Total Returns:

Off all-time highs:
As of March 23, (33.8%)
As of June 12th, (5.1%)

To get back to all-time highs:
From March 23, needed to rise +51%
From June 12th, needs to rise +6%

5-Year Annual Return:
March 23rd, +3.3%
June 12th, +11.1%

10-Year Annual Return:
March 23rd, +9.0%
June 12th, +13.9%

We challenge anyone to take the obviously tumultuous return data shown on the left and craft a sound explanation for it based purely on verifiable economic data; concrete projections for global revenues, earnings and growth rates; and applying historically accurate valuation methods. We know full well the challenge is rhetorical, but we might have at least given it a shot until the last month or so, when a speculative frenzy in bankrupt companies like Hertz and others presented some seriously unhealthy behavior.

A quote from writer Alex Danco may summarize it best: I believed that there were two types of bubbles. The first is one where *"everyone thinks the future will be the same,"* and the second is, *"everyone thinks the future will be different."* However, the recent Hertz mania has made it clear that a third type of bubble exists: *"Everyone thinks the future doesn't matter."*

Of course, we don't bother with predictions of bubbles and the Hertz silliness will be short-lived, but it's an uncomfortable reminder that in the short term, we should not kid ourselves that market behavior, even when it involves multi-trillions of dollars, is completely rational. More so than usual the word disconnect best describes the relationship between the economy and the stock market currently.

We believe the rally in stocks does not reflect the pain in the economy. The "recovery" illustrated by the S&P 500 Index warrants a closer look:

- Approximately 21% of the total market cap of the S&P 500 Index is dominated by five stocks (Microsoft, Apple Inc., Amazon, Facebook and Alphabet / Google), equal to the market cap of the bottom 350 stocks.
- Nearly 100% of profits for the last decade have been from earnings of technology-related companies.
- The performance differential between the top three and bottom three industries reached approximately 30 percentage points in March, the highest level since 2009, and perhaps evidence of pricing in all the good news.

Central Bank Intervention

To be certain, the true long-term economic impact of Covid-19 remains unforecastable, and the addition of trillions of dollars to the U.S. debt does not guarantee a robust recovery. Further complicating things are the unorthodox actions of the Federal Reserve—guaranteeing low rates for years to come and extended QE programs may just be the start. Never mind the uncertainty of deflation/inflation, the strength of the U.S. Dollar and how the Federal Reserve eventually unwinds ~$7 trillion of assets.

As a point of reference, the size of the U.S. Federal Reserve's assets was less than $1 trillion as of early 2008 (it took the entire history of the U.S. to reach that level!), and ballooned to ~$4.5 trillion by mid-2014 coming out of the Great Financial Crisis. The Federal Reserve did little to reduce its assets after 2009, and then in an effort to support the U.S. economy during COVID-19, added over $3 trillion of additional assets, to bring the total assets outstanding to over $7 trillion. Many think this still will not be enough, and while most can't articulate whether Quantitative Easing even benefits the real economy, they are comforted by Powell's bold statements about the Fed's abilities. Although the Federal Reserve's balance sheet is theoretically 'unlimited,' one must remain curious about how they might unwind such large positions, particularly given effectively zero unwinding over the 10+ year recovery from the last major recession. Speaking of which, volumes have already been written about Central Bank actions during and since the 2008 Global Financial Crisis ("GFC1"). Surely the current "GFC2" (mandated shutdown of the global economy) will produce an order of magnitude more analysis. So, our takeaway concerning the Fed is the following:

- GFC1 created an unprecedented crisis, with an unprecedented response, leading to financial system fragility never experienced in our history
- We never fully escaped it and then came Covid-19 and GFC2
- Without even touching the many non-health related challenges facing our country today, the system remains fragile, US equity performance notwithstanding

The above commentary does seem a bit 'grim.' So, is there anything across our investment outlook that excites us? Absolutely, and we prioritize our efforts to get exposure to it.

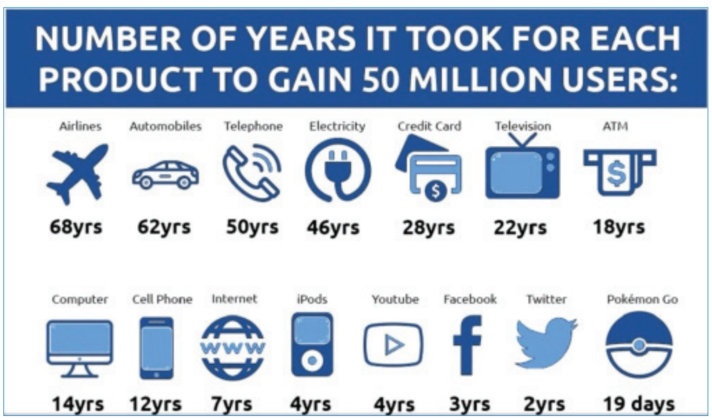
Investing in Innovation

> *"We always overestimate the change that will occur in the next two years, and we underestimate the change that will occur in the next ten years"*
>
> *–Bill Gates*

There will always be a dynamic component to the investment landscape. However, we're more convinced than ever that true, groundbreaking innovation lies ahead and it will drive the most attractive future returns.

In fact, when it comes to investing today, we are more bullish than ever in these specific underlying trends. The trick will be how to capture appreciation while appropriately managing risk. With markets at record high valuations, and a newly minted generation of technology millionaires and billionaires, we are constantly reminded that, "what got us here, won't get us there." The foundational advances of recent decades (internet, mobile, software as a service, semiconductors, cloud) have simply lead us to a point of transformational innovation platforms (e.g., AI, DNA Sequencing, Robotics, Renewables and Energy Storage, Electric Vehicles) which will profoundly change our lives.

In just one example, Artificial Intelligence ("AI"), spending is projected to grow at 28% annually, approaching $100 billion by 2023 (Alkeon Capital, April 2020).



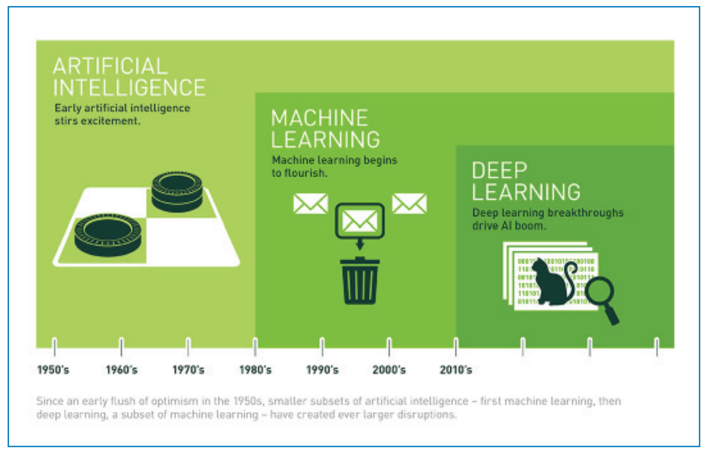
Source: Morgan Stanley

One of our favorite managers defines this deeply transformative wave of innovation as the "Fourth Industrial Revolution." In other words:

> *"…a beautiful fusion of technologies that is blurring the lines between the physical, digital and the biological….a technological revolution that will fundamentally alter the way we live, work and relate to one another"*
>
> – Klaus Schwab, Founder and Executive Chairman, World Economic Forum, 2016

All of this was happening before Covid-19, and now the crisis has further accelerated a change in consumer and business behavior. The change is not only sustainable but likely to fundamentally change human to business interaction in a secular manner. A number of converging trends will digitally transform business collaboration, learning and training as well as the entire sales cycle. In addition, the global supply chain and the concept of reliability and redundancy take on new meaning. These issues are not limited to the tech sector and investment implications will be dramatic.

Now is not the time to own lots of low growth, highly-levered companies with potentially broken business models.   Rather, innovative companies with resilient capital structures, low fixed costs and durable pricing power will benefit from the long-term thematic opportunities that will thrive in the post-crisis world.



Source: nvidia

Final Thoughts

Our goal is to be concise in our communications. We have an extensive list of topics/questions that deserve full examination, so we're devoting the final section of our Q2 note to setting the table for future discussions on a few topics we view as interesting and potentially critically important to good decision making in years ahead. We'll expand just a little on the first topic—inflation vs. deflation—because it's getting so much attention in the financial press today. In general, our challenge is to ask valuable questions, whether the answers can be determined by us or not.

Deflation vs. Inflation? Is record setting levels of debt combined with the Federal Reserve's unprecedented, earth shattering monetary stimulus the ultimate showdown between deflation and inflation? The Fed has made it clear they will do anything possible to promote inflation, even if they've been unsuccessful at it for the last decade (jawboning the markets notwithstanding). The real problem is that inflation is not the opposite of deflation, meaning it's not a battle between the two concepts. The battle is deflation/inflation against monetary instability, and both are signs of a fragile and vulnerable system. Between the forest fires of GFC1 and GFC2, we've had an endless series of small brush fires around the globe, and the one place where it wasn't obvious is the returns of the S&P 500

How was the market able to recover almost to pre-COVID-19 levels so quickly? The impact of COVID-19 will surely be meaningful. The enormous stimulus will surely help, but how can the projected growth of earnings immediately be the same coming out of a global pandemic?

Low interest rates and the dominance of index investing define the current investment era. Where do we go from here?

Expectation for future returns (capital market assumptions) across asset classes and how to apply them

Will the '60 / 40 portfolio' deliver attractive, absolute returns? We have discussed with clients in recent years that low rates alone will challenge the viability of the traditional 60/40 portfolio

Current equity valuations—History proves that the starting point, or what you pay, matters

Will social unrest impact demand or drive significant change to fiscal policies? ...wealth concentration and income inequality are a key theme. Globally, many segments of the population are discontent, and the gap between winners and losers across the income spectrum has led to declining trust in governments. Further, technology has enabled movements and individuals to better coordinate

Cash in money-market funds reported to be $4.6 trillion. This is the highest sum on record going back to 1992. It also leaves out other cash-like assets like bank deposits and short-term commercial paper. Is this really 'dry-powder' and will it support further upside in the markets? Some observers laugh at the dry-powder argument since every investor that sells cash to buy stock, just puts that cash into someone else's hands.

Ultimately, non-financial variables such as the availability of rapid testing, widely available vaccines and a potential treatment/cure for COVID-19 will govern how fast economic activity can rebound.

We wish you and your families continued health.

Please call us with any questions or thoughts. We love hearing from you.

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The Standard & Poor's (S&P) 500 Index is an unmanaged index that tracks the performance of 500 widely held large-capitalization U.S. stocks.