Independence Asset Advisors

MarketMatter

INDEPENDENCE ASSET ADVISORS' QUARTERLY GLOBAL MARKET JOURNAL June 30, 2020

COVID-19

The virus affects different people in different ways, with a wide range of symptoms reported, from mild to severe. This particular strain of coronavirus is troublesome because symptoms may appear 2-14 days after a person is exposed, during which time the carrier may unknowingly transmit the virus to another person.

The fear of the unknown, the lack of a viable vaccine, the rapid pace of global confirmed cases, and the lethality of the virus have forced governments to impose business closures that are intended to limit close proximity interaction between individuals.

The shutdown of non-essential businesses around the world has undoubtedly slowed the spread of the virus in most countries, but have we done enough? Data from the World Health Organization suggests not, with 14.4+ million confirmed cases to date, and 600,000+ confirmed deaths.

The first round of business closures resulted in a global recession. A second round of closures is probable, and while markets have broadly recovered, the likelihood of a double dip recession is increasing.

In this issue...

Special Note

We hope all of the clients and friends of Independence Asset Advisors, along with their families and loved ones are staying safe and healthy during these unprecedented times.

-Scott, Katie, Rebecca and Tom

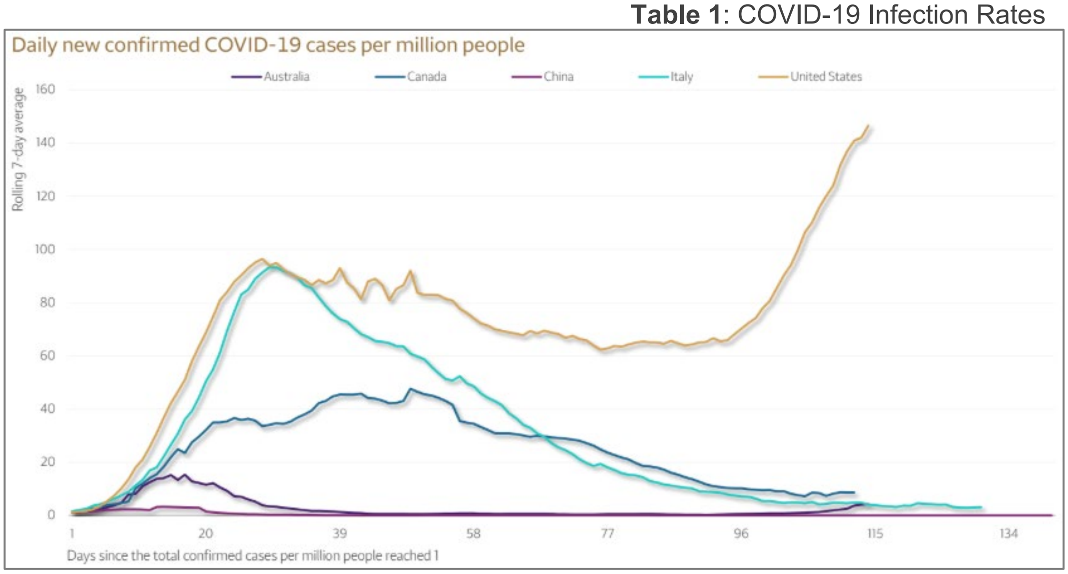
Market Overview & Key Themes

The second quarter was no less thrilling than the first quarter, although the results were far better. Global markets gained as massive monetary stimulus measures and fiscal support fueled higher stock and bond prices. In the U.S., the Fed's actions to slash interest rates and purchase corporate bonds and ETF's provided liquidity to the credit markets, but the balance sheet subsequently ballooned to approximately $7 trillion in a matter of months. In foreign markets, more aggressive quarantine and business closure measures halted economic growth, but positioned prudent countries for an accelerated pace of economic reopening.

In the face of sharp declines in global output, a massive fiscal response was necessary to support increased healthcare costs, replace lost household income, and prevent large-scale bankruptcies during the mandated closures. However, the policy response has also contributed to remarkably high global public debt levels, which are currently more than 100% of global GDP, marking the highest level in recorded history. This is a concern, especially as central banks posture to deliver a nearly unlimited amount of monetary support to minimize the depth and duration of the existing global economic recession. More support will undoubtedly be required, as every leading economic indicator has contracted (see Table 7), and new confirmed cases of coronavirus continue to pressure local governments to keep businesses closed and people isolated at home.

In Table 1, we show that a divergence has developed between the U.S. and other developed countries. Whereas others are showing a deceleration of new confirmed COVID-19 cases, the U.S. is reporting an acceleration. Note that while not shown, the data reflects an accelerated pace of new confirmed cases in most emerging markets countries.

Table 1: COVID-19 Infection Rates

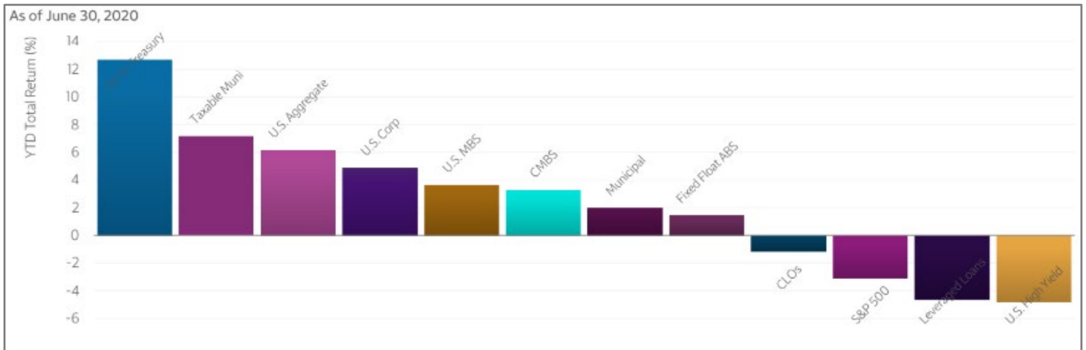


Sources: eVestment Analytics, Vanguard, Wells Fargo, BlackRock

Second Quarter Fixed Income Dashboard

Fixed income returns were universally positive during the second quarter, led by high yield bonds, bank loans and emerging markets debt. Investment grade bonds performed well also, with U.S. corporate bonds and municipals gaining 9.0% and 5.9%, respectively. As shown in Table 2, U.S. Treasuries have provided the strongest returns during the first half of the year, outperforming most equity market indexes, including the S&P 500 Index, which it beat by 15.8%. The offset is significantly lower yields.

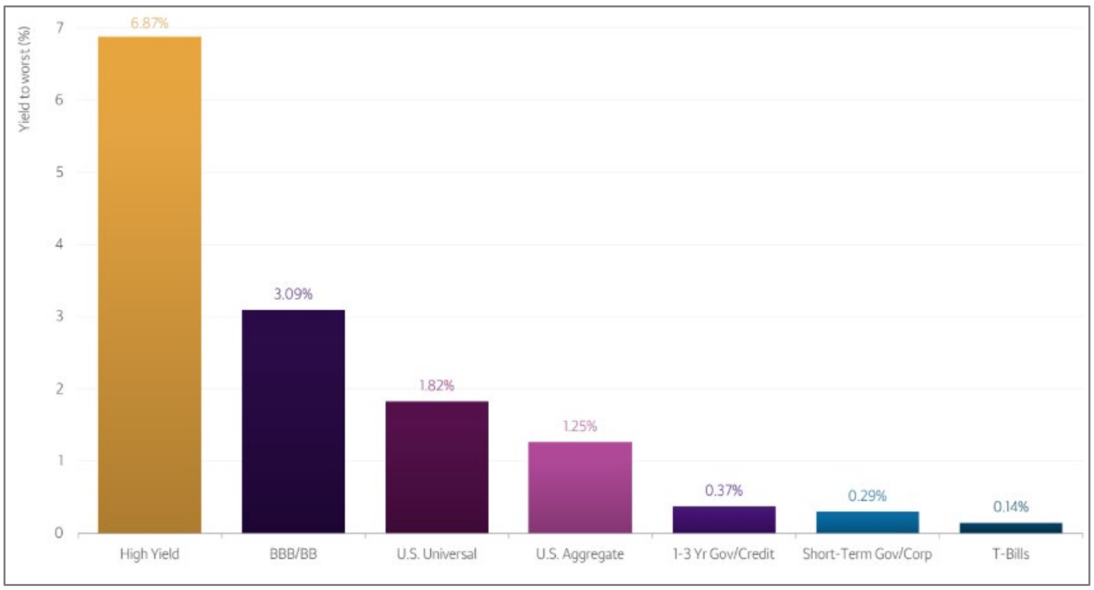
Table 2: Fixed Income Returns



Total Return (%)	10-Yr Treasury[3]	Taxable Municipal[3]	U.S. Aggregate[3]	U.S. Corp[3]	U.S. MBS[3]	CMBS[3]	Municipal[3]	Fixed Float ABS[3]	CLOs[3]	S&P 500	Leveraged Loans[3]	U.S. High Yield[3]
1 Month	-0.01	2.97	0.63	2.02	-0.12	1.89	0.97	1.33	0.94	1.99	1.14	0.97
3 Month	0.67	5.89	2.90	9.27	0.81	4.50	2.66	3.87	7.34	20.54	9.70	9.61
6 Month	12.69	7.14	6.14	4.84	3.62	3.26	1.97	1.41	-1.15	-3.09	-4.61	-4.78
YTD	12.69	7.14	6.14	4.84	3.62	3.26	1.97	1.41	-1.15	-3.09	-4.61	-4.78
1 Year	14.21	9.71	8.74	9.30	5.80	4.90	4.27	2.63	0.67	7.49	-1.99	-1.10
YTW	0.66%	2.40%	1.25%	2.22%	1.45%	2.25%	2.05%[2]	1.71%	3.21%	1.95%[1]	6.80%	6.85%

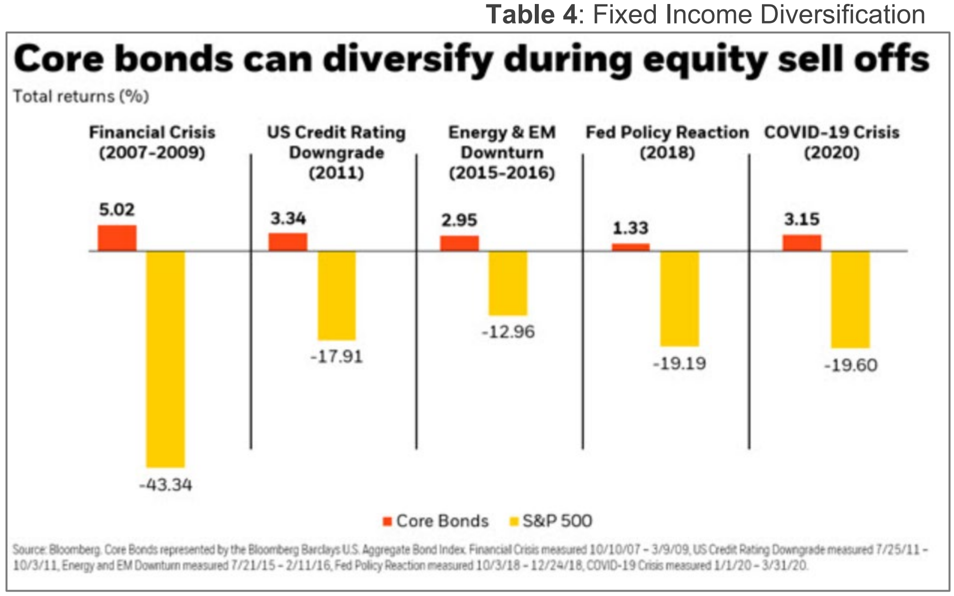
Yields generally compressed further during the second quarter as bond markets gained, although lower quality yields increased (see Table 3). Higher quality investment grade bonds have seen the greatest narrowing, with the 10-Yr U.S. Treasury ending June at 0.7%, down from 2.0% only twelve months ago. Investors seeking income and consistency of return from coupon payments are finding it necessary to move lower in credit quality (high yield bonds and bank loans), or farther out in maturity. In this case, we support upper tier high yield bonds and +BBB loans.

Table 3: Fixed Income Yields



The importance of equity diversification took center stage during the first quarter when the S&P 500 Index entered bear market territory. The blistering recovery during the second quarter then created a sense of urgency for bond owners who felt they were losing upside by remaining disciplined. If we have learned anything from the COVID-19 crisis, it is that not all market turmoil is caused by bubbles or fundamental issues. Corrections, bear markets, and a recession can happen without warning, and it is imperative to stay the course and not chase returns. Table 4 demonstrates how bonds have provided stability to portfolios during equity market down periods over the past decade.

Table 4: Fixed Income Diversification



Sources: eVestment Analytics, Wells Fargo, BlackRock

Second Quarter Equity Market Heatmap

Table 5: Equity Market Heat Map

QTD	Value	Blend	Growth
Large	14.3%	20.5%	27.8%
Mid	19.9%	24.6%	30.3%
Small	18.9%	25.4%	30.6%

YTD	Value	Blend	Growth
Large	-16.3%	-3.1%	9.8%
Mid	-18.1%	-9.1%	4.2%
Small	-23.5%	-13.0%	-3.1%

Current P/E vs. 20-year avg. P/E	Value	Blend	Growth
Large	18.1 / 13.6	21.7 / 15.4	29.8 / 18.8
Mid	19.8 / 14.2	23.9 / 16.1	39.2 / 20.4
Small	27.7 / 16.5	55.0 / 20.7	- / 30.1

Since market peak (October 2007)	Value	Blend	Growth
Large	77.2%	159.6%	269.6%
Mid	99.2%	141.4%	205.8%
Small	58.8%	103.6%	152.5%

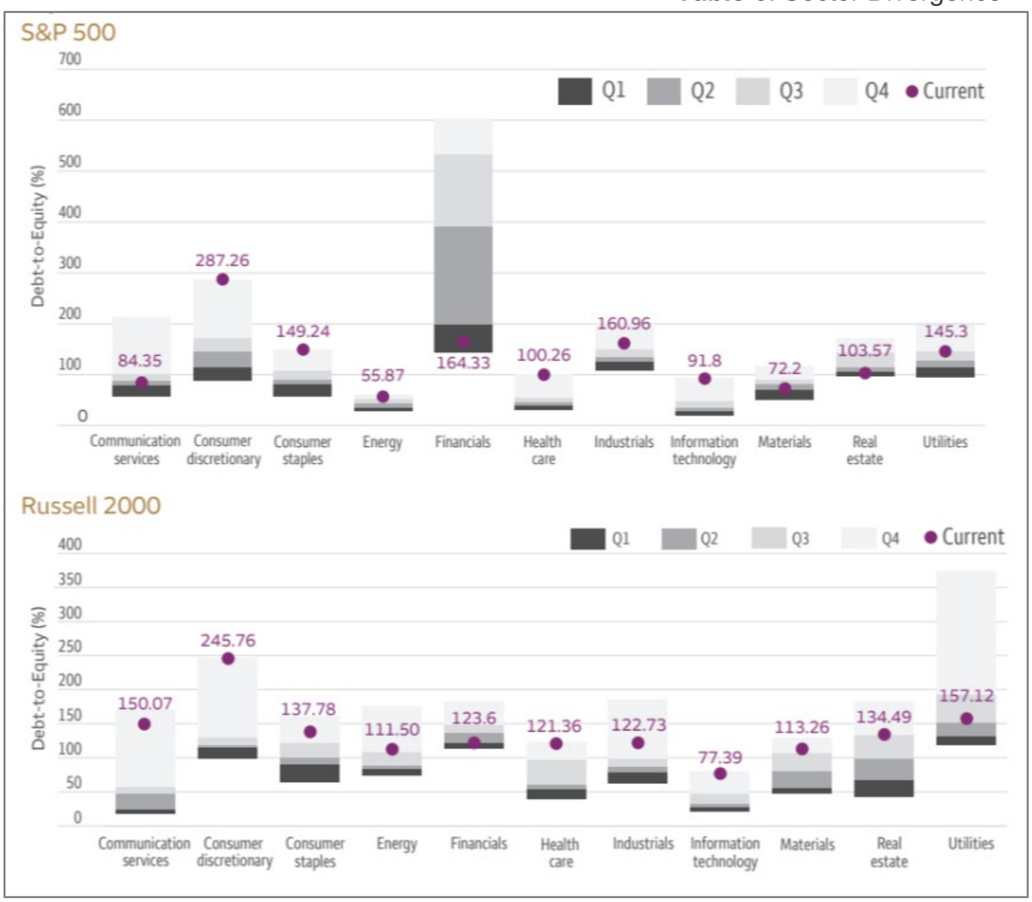
Since market low (March 2009)	Value	Blend	Growth
Large	341.9%	480.0%	653.8%
Mid	408.5%	482.5%	606.9%
Small	292.8%	391.0%	495.8%

Current P/E as % of 20-year avg. P/E	Value	Blend	Growth
Large	132.9%	140.9%	158.5%
Mid	139.3%	148.5%	192.2%
Small	168.1%	265.3%	-

Global equity markets exhibited a v-shaped recovery during the second quarter, with the MSCI All Country World Index gaining 19.2%. Excluding the U.S., global equities gained 16.1%, with international developed and emerging markets returning 14.9% and 18.1%, respectively, compared to the S&P 500 Index that gained 20.1%. Despite the rally, global equities remained negative for the first half, with the MSCI ACWI down 6.3%. Looking specifically at the U.S., the divergence between growth and value stocks continued to widen, with the former outperforming the latter by 26% (see Table 5).

The equity market recovery has been remarkable and surprising in that the COVID-19 concerns that triggered the 30% first quarter equity market sell-off have in no way abated. However, investor optimism that businesses would reopen sooner than expected, along with historically massive monetary support and fiscal measures, led to a faster and steeper economic recovery than what would otherwise be considered when measuring fundamentals. Despite the bear market, valuations did not meaningfully improve (meaning stock prices did not become less expensive), and have not improved following the second quarter rally. Therefore, we fully agree with Coho Partners' stance that "a more defensive posture is prudent until more evidence of sustainable earnings with commensurate dividend growth is seen".

Table 6: Sector Divergence



Again, focusing on U.S. equities, we can see that a disproportionate amount of the S&P 500 Index return has been recorded by the five largest market capitalization companies (see Quarterly Focus: MSCI All Country World Index on page 4). In fact, these five companies combined have provided 5.1% of the year-to-date return. If we consider this from another perspective, by removing these companies from the S&P 500 Index, the year-to-date return would be more than 8% negative.

Concerningly, we have not seen an improvement in equity fundamentals, specifically debt-to-equity. In Table 6, we can see that only the Financial sector has reported a material reduction of leverage since the financial crisis. Balance sheet health, and manageable leverage, is critical in the new COVID-19 environment.

Sources: JP Morgan, Eaton Vance Monthly Market Monitor, eVestment Analytics, Coho Partners

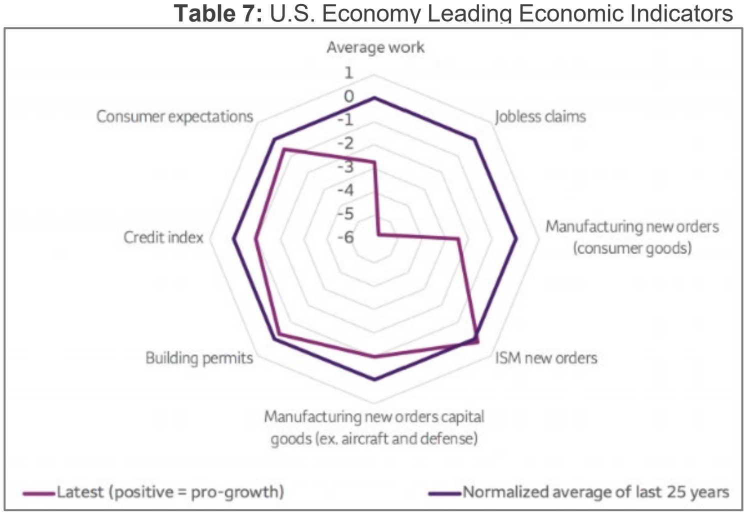
Global Market Outlook & Areas of Opportunity

Nothing about 2020 has been normal.

The global economy went into lockdown as the most debilitating medical crisis since the 1918 Spanish Flu shuttered nearly every non-essential business across the globe. The impact to global GDP has been severe, and yet equity markets have been able to recoup most of their first quarter bear market losses in an unprecedented v-shaped recovery founded on hardly more than optimism and the returns of a handful of highly weighted technology stocks. Bond owners, specifically those owning investment grade bonds, have been able to offset much of the equity market volatility through the first half of the year, but at the very important cost of massively lower yields.

The global market recovery has been more of a surprise than the sell-off, as nearly every component of The Conference Board Leading Economic Index has contracted versus its 25-year average (see Table 7). We expect to see some improvement to these important economic gauges during the second half, but our expectation is for a gradual recovery.

Table 7: U.S. Economy Leading Economic Indicators

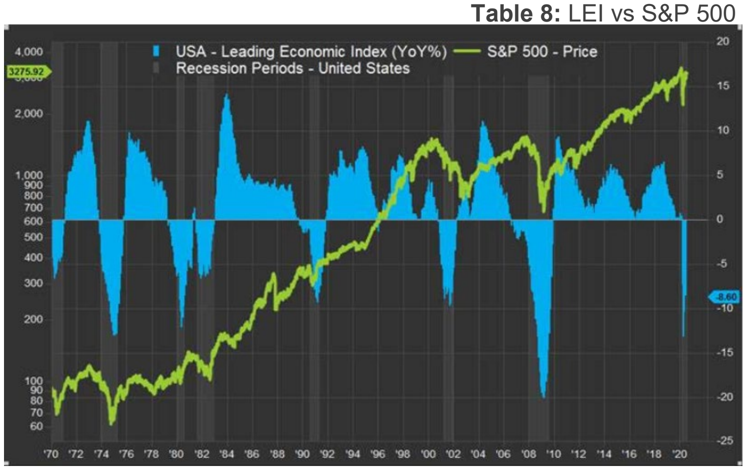


COVID-19 remains the single greatest potential variable and will almost exclusively dictate the pace of the economic recovery, or the length and depth of the current global recession. While we are optimistic that markets will be broadly positive in the second half, we do not anticipate a continuation of the blistering returns enjoyed during the second quarter. Unexpected bouts of market volatility are likely in the second half of the year, and we encourage investors to maintain their long-term allocations, and rebalance periodically.

Category	Outlook
U.S. Equities	Positive, but highly volatile; tech bubble developing; lower yields.
Foreign Equities	Positive, but highly volatile; less monetary support; lower COVID risk.
U.S. REITs	Neutral-to-negative; fragile market, particularly the corporate sector.
Energy Infrastructure	Neutral-to-negative; dependent on oil prices; some overleverage.
Investment Grade Bonds	Positive; low single-digit returns expected; yields to remain low.
High Yield Bonds	Positive; supported by +6% yields; susceptible to flights-to-quality.
Bank Loans	Neutral; supported by +5% yields; high demand for loans; defaults.
Emerging Markets Debt	Positive (hard currency; good valuations); (LCD; shifting; tactical call).

As a final thought, we wanted to share an overlay of the leading economic indicators (blue), the S&P 500 price (green) and recession (grey). Our base case view looks for global growth to bottom out, although we expect some lag in the U.S., followed by a gradual transition to a shallow recovery, and an intermediate-duration economic recession.

Table 8: LEI vs S&P 500



Quarterly Focus: MSCI All Country World Index

We often refer to this index as the benchmark for global equity market returns, but what makes this particular index the keystone for measuring all common equities across the globe? What countries are represented by the Index, and what capitalizations are covered?

Often referred to as the MSCI ACWI (acronym for Morgan Stanley Capital International), the Index reports the full opportunity set of large and mid-cap stocks across 23 developed and 26 emerging markets. Currently the Index covers more than 3,000 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. Float-adjusted capitalization (or free-float capitalization) is an important distinction compared to market capitalization, because it excludes locked-in shares, such as those held by company executives and governments. This methodology is considered a better way of calculating market capitalization because it only uses shares that are available for trading, thereby providing a more accurate reflection of true market movements without concentrations.

The Index covers a broad allocation of markets, including the Americas, Europe and the Middle East, the Pacific and Asia. Launched in 1990, the Index maintains a median market capitalization of $5 billion and an average of $16 billion. For reference, large-cap companies typically have market capitalizations of $10 billion or more, whereas mid-cap and small cap market capitalization are approximately $2 to $10 billion and $300 million to $2 billion, respectively.

As of June 30, 2020, the top 10 constituents of the MSCI ACWI represented 15% of the Index; however, Apple, Microsoft, Amazon, Facebook and Alphabet, represent a combined 12% of the Index. In total, the information technology sector represents 21% of the Index, while the United states comprises 58%. The next largest country representation is Japan, at only 7%.

Sources: Wells Fargo, MSCI