INVESTMENT INSIGHTS

Market Outlook

July 2020

Navigating the Certainty of Uncertainty

Market/Economic Update

The first half of the year has been quite a rollercoaster ride for investors with the initial shock of the coronavirus sending markets into a freefall to end the first quarter and then the quick rebound that saw much of the ground regained since that time. Volatile markets have become the new normal as investors attempt to gauge the impact of both the medical data and historic monetary stimulus on markets as policymakers have sought to build a bridge to recovery. The disconnect between a rising stock market and an economy with its highest unemployment rate in decades has created confusion for many investors as we have seen diverging views presented by many of Wall Street's leading strategists. This highlights the fact that markets often do what's least expected and explains why market timing strategies are such a source of frustration for long term investors. The market has been a paradox indeed with the S&P 500 off a modest -3.09% during the first half while the equal weighted S&P 500 suffered a more severe decline of -10.80% telling us that the average stock is not faring near as well as the major indices which are size weighted and dominated by large cap technology companies. The performance differential across sectors was the largest in recent memory with tech rising a robust +14.90% for the first half while financials dropped -23.66% and the industrial sector fell -14.61%.

> Volatility has become the new normal as investors are conflicted between high unemployment and record stimulus.

> Large disparities in performance across sectors with technology a clear leader.

These large disparities suggest that the economy as a whole is not nearly as healthy as the S&P 500 would lead us to believe. This is particularly true in an environment where new cases of Covid-19 are rising quickly. The economic uncertainty highlights the need to take a thematic approach to building portfolios as there will be winners and losers resulting from Covid as many trends that were already present have accelerated. The transition to remote communications for work and school is at the forefront and explains in large part why the tech sector has continued to thrive. In contrast, the markets for commercial real estate and energy should continue to see some headwinds as there is less demand for office space and energy consumption. Interest rates could remain at low levels for longer than many expect as the lack of business investment continues to keep inflation at bay. This is an ongoing theme that helps to explain the performance of industrial and resource based markets across the global economy. It also foreshadows some risks going forward for banks as the margin environment is challenging at a time when credit quality has become uncertain.

> The Main Street economy is not as healthy as the stock market would indicate.

> Low interest rates reflect the lack of business investment.

The Fed has recognized these risks and provided an unprecedented level of support to get us through this period. Investors have returned to risky assets as a result, but questions remain with regard to the sustainability of the advance for the long term. Among the unknowns is the impact that the rapid increase in the money supply and national debt will have on growth once the crisis has passed. Our competitive advantage in technology puts the U.S. in a strong position, but investors will need to take a diversified approach to manage risks in an environment that may continue to be uncertain for some time to come.

> The U.S. is well positioned but the environment may be uncertain for some time.

— Charlie Mathews, CFA

Bank of New Hampshire
WEALTH MANAGEMENT

Equity Markets

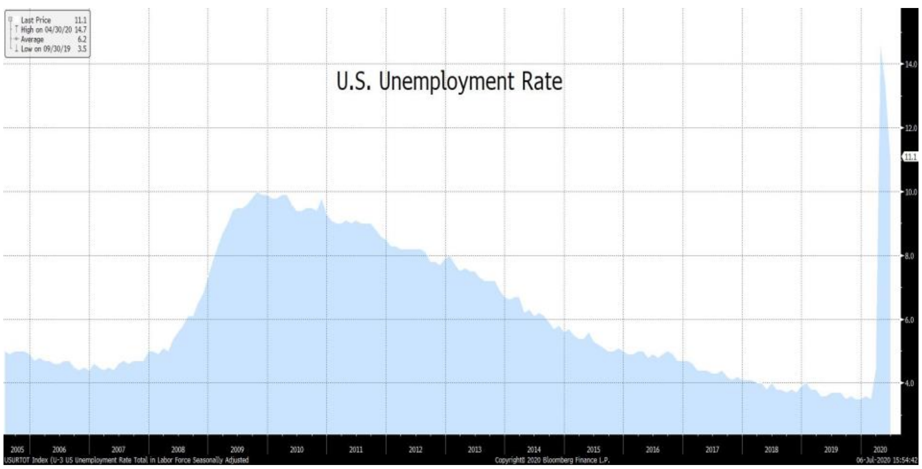
It has been said that the more things change, the more they remain the same. This has certainly been the case for the stock market in recent months as large cap U.S. growth stocks lead by the technology sector have dominated the landscape. As the impact of the coronavirus ravaged other sectors, tech has been one of few beneficiaries in a market that has been at times unforgiving. A look at the numbers shows the large cap S&P 500 off -3.09% for the first half in spite of a second quarter surge that showed a gain of +20.54%. This was in stark contrast to small caps that saw the Russell 2000 fall -12.99% through June 30th and the MSCI EAFE Index of international stocks give back -11.03% during this time. The key factor in each instance has been the weighting of technology stocks in the various indices. The five largest tech companies (Apple, Microsoft, Google, Amazon and Facebook) represent more than 20% of the market cap in the S&P 500 at a time when they have been among the best performers.

Stocks rebounded solidly during the second quarter.

Technology exposure made a big difference.

The impact of Fed policy intervention played a big part in the rebound, but it also helped that our worst fears were not realized as business reopenings occurred at a faster pace than expected helping the job numbers to come in ahead of estimates as the quarter went along. While the unemployment rate rose faster than at any time since the 1930s Great Depression, stocks actually rebounded because the news was not as bad as the market had expected. Short covering also played a role in adding some fuel to the fire as positions had been overwhelmingly bearish to start the quarter and the rally forced many investors to buy back stock at a furious pace.

Our worst fears were not realized so stocks rallied.



Source: Bloomberg, LP

The level of unemployment will continue to be an issue.

The second quarter rally leaves us breathing a sigh of relief while recognizing that July earnings reports will show us the full impact of business shutdowns on corporate profits for the first time. It is possible that the recent surge in Covid cases will slow the pace of reopenings in the coming months making it difficult for the market to rally above its pre-Covid highs. With that said, investors will continue to seek out companies whose earnings streams are insulated from the impact of Covid since there are few compelling investment alternatives in other asset classes given that interest rates are approaching zero. Stock selection will continue to be critical to success until we see signs that the virus is under control or a vaccine is developed as there is likely to be considerable return dispersion among industry groups. Sector performance trends favoring tech, communications and biotech firms should continue to persist while risks will continue to be present in consumer cyclicals, banking and older economy industrial companies.

It will be difficult to trade at pre-Covid levels.

Stock selection will be more and more important in an uncertain environment.

— Robert Magan, CFA

Credit Markets - "The Good, the Bad and the Ugly "

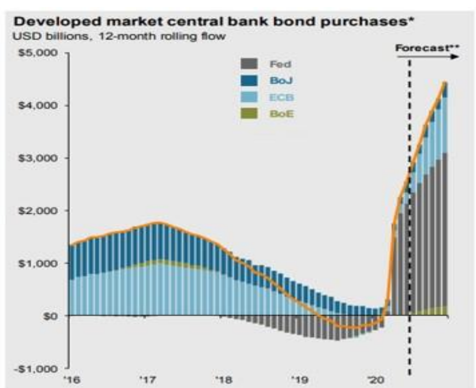
This was my favorite of the 1960's spaghetti western series, *Dollars Trilogy*. While filming, director Sergio Leone established a rule that the characters' ability to see would be limited by the sides of the frame: what the camera cannot see, the characters also cannot see. This added an element of uncertainty to the scenes forcing the actors to view the world through a different lens. Covid-19 has had a similar effect on credit market investors who have had to step back from the lens for a wider scope of peripheral vision and thinking, forcing us to make uncommon connections and to look for answers beyond the confines of historical experience. What values and habits were being driven to change? How will commerce, economies, and life-styles be altered? What are the longer term effects of unprecedented massive amounts of government stimulus? Is medical data now driving our actions and becoming more relevant than economic data in this transformed landscape?

> Covid-19 has forced us to look at the markets in different ways.

The film's title, *The Good, the Bad and the Ugly,* also describes what has transpired in the bond market this year. The first quarter was *the Bad* as it ended with a collapse of every sector other than US Treasury securities. From highly-rated corporates to the junkiest of high-yield bonds, to tax exempt municipals, no one wanted to take on risk of any sort. Since then, credit markets have mostly stabilized and returns are actually *Good* once again. Investment Grade debt jumped to a +5.3% total return in April from -7.47% in March. High-yield jumped from a -11.8% total return in March to +3.8% in April. The lower-quality and longer-dated securities of both investment grade and high yield have outperformed those of higher quality with shorter maturities as markets continued to stabilize through the quarter. The key to the second quarter turnaround has been the role that global central banks have played by purchasing securities in the open market and providing unprecedented liquidity to ensure that capital continues to be available.

> Markets stabilized during the second quarter

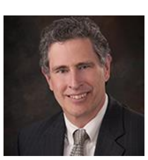
> Central banks played a key role through market intervention.



Despite the Fed's aggressive action, many companies are expecting a decline in earnings and cash flow this year which has caused them to tap the new issue markets at an unprecedented rate. This increase in leverage in an uncertain environment leaves us concerned about credit fundamentals heading into the second half of the year as Covid-19 has restrained retail sales, energy demand, and manufacturing investment. Rising leverage and uncertain demand has turned our focus to higher quality bonds in industries where there is more earnings visibility at the moment like technology, health care and consumer staples. This is also true for municipal bonds as cities and towns rely on taxes, and with the pandemic, revenue uncertainty has increased appreciably. With this in mind, our analysis needs to look at demographics and the stability of the revenue source as the economic impact of Covid could be longer lasting than we might expect. It is an environment where safety will be more important than yield at least for the time being until there is a path to vaccine or treatment that will return us to a more normal environment. — Dona Murray

> Lower rates and capital needs have driven issuance at an unprecedented rate.

> Credit fundamentals are a concern moving forward.



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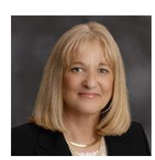

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