HIGHTOWER
RDM Financial Group

Market Update

July 9, 2020

Key Takeaways

- Its official, a recession started in March, 2020.
- However, recent data indicates a recovery is now underway.
- Fiscal stimulus and monetary support have initiated a pathway to recovery in the economy and financial markets.
- A rise in virus cases in some states could cause an interruption in the recovery process. To be determined.
- Importantly, earnings revisions have started to rebound.
- Overseas, economic growth appears to be on the mend.
- We remain overweight growth versus value, large cap versus small cap and the U.S. versus foreign markets.
- Concerns include U.S. - China relations, the upcoming election, rising debt levels, high unemployment and the return of COVID-19.
- The past several months have demonstrated how hard it is to try and successfully time the markets.

The first six months of the year have been a turbulent period for financial markets, the economy and investor portfolios. The spread of COVID-19 created a shock that had a large impact on the economy. The shutdown that occurred led to a slowdown in the economy and a recession that began at the end of February. Uncertainty about what might lie ahead also played a role and contributed to the volatility we experienced globally in financial markets earlier this year.

Importantly, as we start the second half of the year, we have already started to see signs that the economy, corporate profits along with consumer and business confidence have begun to rebound. This should hopefully set the stage for a more broad-based and long- term recovery over time. For the economy to fully open up and recover, a sustained rebound will likely depend on controlling the virus (through a combination of vaccines and therapeutics) during the second half of 2020 and beyond.

Looking back, this may well turn out to be the shortest recession on record. After a sharp downturn caused by the coronavirus, it looks like the economy likely bottomed this past Spring (probably in April or May). Congress, the Federal Reserve Bank and other global institutions provided trillions of dollars in crucial stimulus money to help bridge the gap between the precipitous downturn and initial evidence of a recovery which started this past Spring. It also provided meaningful liquidity to replace income lost from unemployment in a number of cases. We may very well see additional stimulus from Washington in the near future as unemployment benefits for many Americans are set to expire at the end of July. The markets have been supported and have rallied because of stimulus by the Federal Reserve resulting in low interests which will remain that way until we see lasting stability in the unemployment figures.

After having fallen 19.6% during the first quarter of the year, the S & P 500 bounced back and gained 20.5% during the second quarter. While the stock market has been led by a small group of large tech stocks in recent quarters, the advance last quarter was more broad based as the equal weighted S & P 500 (where each stocks gets one vote) rose 21.5%, the Russell 2000 Small Cap Index advanced 25.4% and the tech heavy Nasdaq Market jumped 30.9% last quarter (source FactSet). All 11 sectors of the market posted gains last quarter with the strongest returns coming from consumer discretionary, technology and energy stocks. Two cyclical areas of the market that we would like to perform better are the industrial and financial sectors. Similar to past quarters, growth outperformed value by a sizable 14% once again last quarter (Source: FactSet).

Looking at recent data, multiple economic reports including retail sales, housing data, consumer confidence, employment and manufacturing data signal that the U.S. economy has started to recover. GDP this past quarter will likely be the worst in decades, but growth is forecasted to bounce back in the current quarter. Overall U.S. GDP is currently forecast to decline 5.3% in 2020 before rebounding 4.5% in 2021 (source: FactSet). Growth is also showing signs of a rebound globally. These projections are all data dependent and will be carefully scrutinized in the coming quarters.

Looking ahead, we want to highlight a few of our observations. These include the unstable relationship between the U.S. and China, the uncertain outcome of the election in the Fall, rising debt levels and how long it may take to recover all of the jobs lost during the recent downturn. While it may be true that the markets have gotten somewhat ahead of themselves (which could lead to a period of choppiness or volatility ahead), one thing that the past few months have demonstrated is how hard it is to successfully time the markets. Markets tend to look ahead 6 to 12 months and have historically bottomed before the economy. The upcoming earnings quarterly season is likely to be very weak, but investors are already looking ahead at this point.

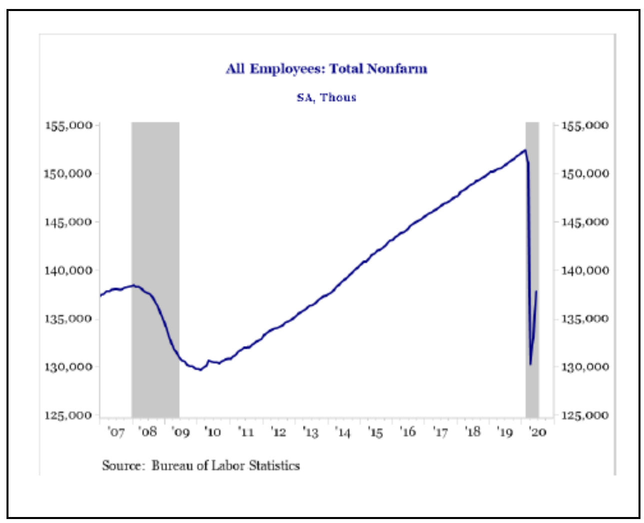
The U.S. Economy

Following the spread of COVID-19 earlier this year, the economy entered a recession at the end of February. Second quarter GDP and corporate profits (which have not been released yet) are likely to be the worst in many years if not decades. Importantly, we are now seeing multiple signs of recovery taking place. Over the past couple of months, retail sales data, housing activity, auto sales, manufacturing data and consumer and business confidence have all started to show signs of improvement.

Turning to employment, one encouraging sign is that following a surge in people filing for weekly unemployment benefits earlier this year, weekly jobless claims have now fallen for 14 consecutive weeks. However, this is offset somewhat by the fact that just under 19 million people are still receiving unemployment benefits and the rate of improvement in weekly claims has started to slow somewhat.

Last Friday, the monthly jobs report was released and overall provided further evidence that employment trends continue to improve. For example, last month 75% of all companies added to their payrolls, the economy added back another 4.8 million workers and the unemployment rate declined from 13.3% last month to 11.1% in June. The biggest increase in jobs last month came from leisure and hospitality (up 2.1 million), retail (up 740,000) and healthcare (up 356,000).

The chart below highlights the current level of employment and where it stands today compared with the trend over the past decade (source: Strategas Research).

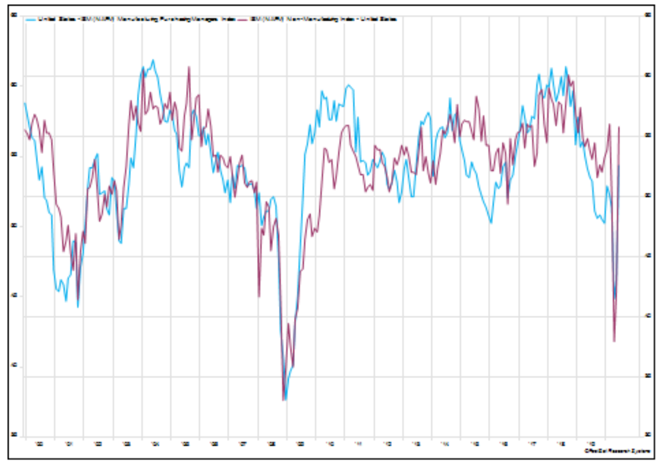


We are likely in the early stages of a recovery phase which in the past has been positive for risk assets both in the U.S. and in overseas. Currently, even with rising cases in a number of states, we are seeing fewer fatalities and hospitalization admissions. These are trends we will need to monitor in the months ahead.

The ISM manufacturing Index was also released earlier this month. The index is widely watched because it has been released for several decades and provides timely information on the state of the nation's manufacturing sector. After peaking earlier this year at a level of 50.9 in January, the manufacturing index fell to a low of 41.5 in April. While the overall index only weakened to a reading of 41.5, new orders and production (two of the most important components to track) both fell sharply to readings below 30. Following the decline to 41.5, the ISM Manufacturing Index staged an impressive rebound to 52.6 in May (source: FactSet). This is a positive sign showing a return to expansion. As a reminder, a reading above 50 indicates expansion while a reading below 50 indicates contraction. One last point is that while the ISM Manufacturing report indicates the direction of growth (which was clearly positive last month), it does not measure the level of growth (which may not have been quite as strong last month).

In addition to the ISM Manufacturing report, the June reading for the ISM non-manufacturing or services index was released on July 6th and posted a very big bounce to 57.1 from 45.4 (which was far ahead of the consensus forecast of 50.2 – source: FactSet). Like the ISM Manufacturing Index, this is a diffusion index. So, with a reading above 50, this indicates that a majority of businesses in the service sector are currently experiencing an increase in activity.

In the 20-year chart below, you can see the rebound in the manufacturing and services indices that have taken place over the past couple of months – source: FactSet).

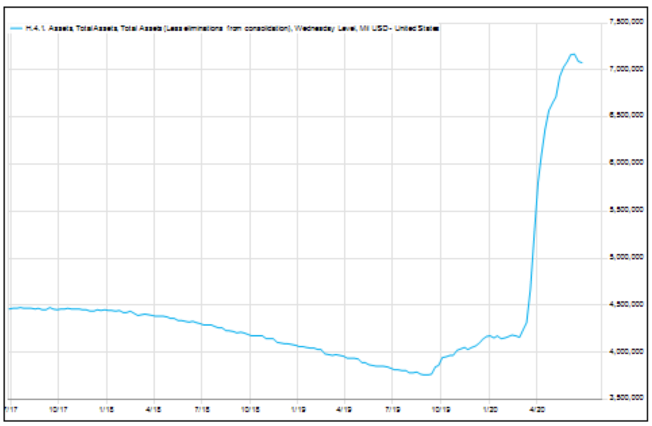


Lastly, we also monitoring a number of statistics to help gauge how the economy is doing in real time. A few examples include weekly mortgage applications, TSA air travelers data, the number of people dining out, passenger car traffic etc… Overall, the trend appears to be improving for most statistics. However, due to the recent increase in COVID-19 cases in some states, we would not be surprised if some of this data starts to temporarily weaken again.

Fed Policy

As a result of the recent economic downturn, the Federal Reserve Bank rolled out a number of important large-scale programs which provided liquidity for financial markets and helped set the stage for a rebound in the economy. In late March, the central bank also stated that they will do whatever it takes to help the economy. This was a bold statement by the central bank and one which got the market's attention.

In the chart below, you can see that as a result of massive asset purchases, the Federal Reserve Bank's balance sheet has increased significantly in size this year from about $4 trillion dollars to $7 trillion dollars (Source: FactSet). This represents a massive increase over a very short period of time.



The Fed has recently stated it plans to continue buying about $120 billion in securities per week. At some point, we expect this level of asset purchases to level off and slow down somewhat. However, it probably won't be until it's clear that the economy is on a sustained path towards recovery.

In addition, at its latest FOMC meeting, the central plan announced that it plans to keep short term rates near zero percent for an extended period of time in order to help support the economic recovery. Unfortunately, low rates act like a tax on savers (similar to the period coming out of the last recession in 2009), but that is the world we will likely be living in for some time to come.

Overseas

Around the world, central banks and governments have also provided large amounts of stimulus to help boost economic growth. With the number of COVID-19 cases slowing down and economies opening up for business, we have started to see signs of a rebound in economic growth across a number of countries overseas.

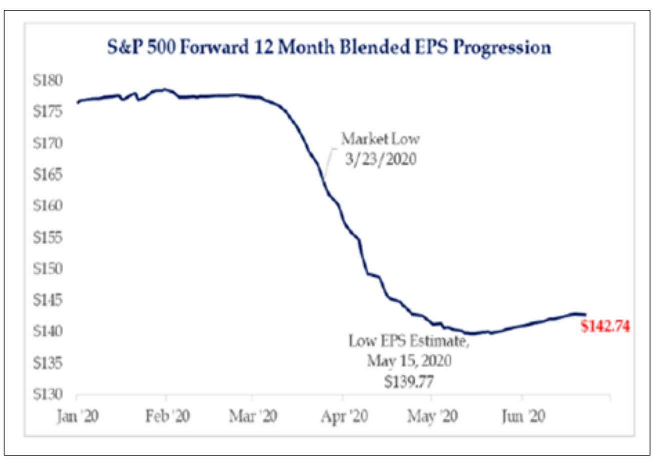
In China, the Caixin Services PMI Index rose to 58.4 in June which is markedly better than the consensus forecast of 53.2 and follows a reading of 55.0 the prior month. This month's reading marks the biggest expansion on the services side of the economy in China since April 2010. Manufacturing data in China has also improved but not as much as the services side of the economy. In Europe, the Eurozone Composite Index (which includes both manufacturing and services activity) rebounded for a second consecutive month to 48.5 in June versus a reading of 31.9 last month (source: FactSet). Economic data in Japan has so far lagged that of China and Europe but will hopefully start to improve before too long.

According to the most recent forecast from the IMF (June, 2020), global growth is projected to decline 4.9 percent in 2020, which is 1.9 percentage points below the IMF's April, 2020 forecast. As per the IMF, "The COVID-19 pandemic has had a more negative impact on activity in the first half of 2020 than anticipated, and the recovery is projected to be more gradual than previously forecast." Looking ahead, the IMF projects that global growth is forecast to rebound 5.4 percent next year.

Corporate Profits

Due to the sharp downturn in the economy earlier this year, corporate profits experienced a big hit. Now that the economy is starting to recover, so too are profits. In the chart below, you can see the direction of estimated profits for the S & P 500 over the next 12 months (source: Strategas Research).

The estimate for corporate profits over the next 12 months was around $174 per share in early 2020 but fell sharply to a low of $139.77 in mid-May. As you can observe in the chart below, the estimate for earnings per share over the next twelve months has stopped falling and has now started to rebound.



Overall, corporate profits are currently forecast to decline 21% for all of 2020 before increasing 28% in 2021 (source: FactSet). A lot can certainly change over the next several quarters. However, if recent signs of recovery continue, we believe this provide a positive tailwind for equity markets over the next few quarters.

Too Far Too Fast?

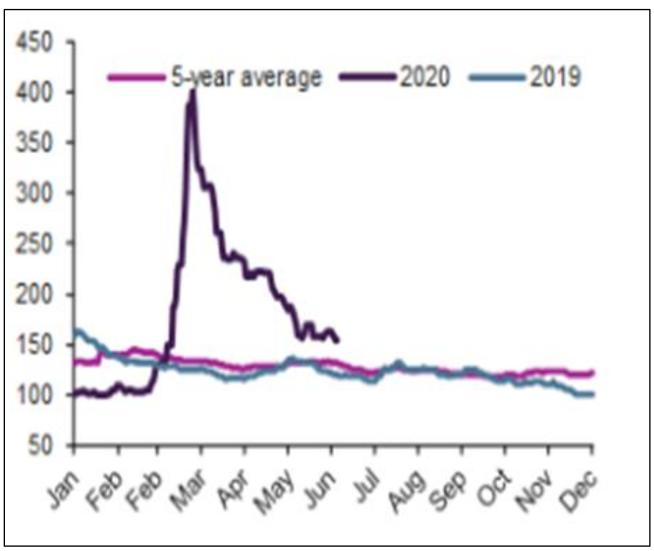
Some have questioned if the stock market has recovered too far too fast. The market seems to be pricing in a V shaped or rapid recovery. However, the economic recovery may actually be somewhat more elongated and experience a few bumps along the way. For example, the recent spike in new COVID-19 cases across a number of states has at least temporarily slowed the re-opening progress in various parts of the country.

In this cycle, everything seems much more compressed compared with prior economic and market cycles. For investors, an important point to share is that historically, equity markets have bottomed before the economy by an average of about four months. Not all sectors have participated in this rally and we expect to see rotations occur. With valuation levels at fair value vs interest rates, future market gains will likely be driven by further improvements in the economy and a rebound in corporate profits over the next 12-18 months. I would not be surprised to see a more range bound market over the next several months as investors digest recent gains. However, as the past several months have demonstrated, it is almost impossible to try and time the market successfully.

Fixed Income

At RDM Financial Group, many investors own corporate bonds as part of their investment portfolios. Historically, when equity markets have been volatile, corporate bonds have provided a certain level of stability (along with stable cash flow) to help offset some of the weakness in equities. This time around as the economy quickly fell into recession earlier this year, corporate bond spreads widened significantly.

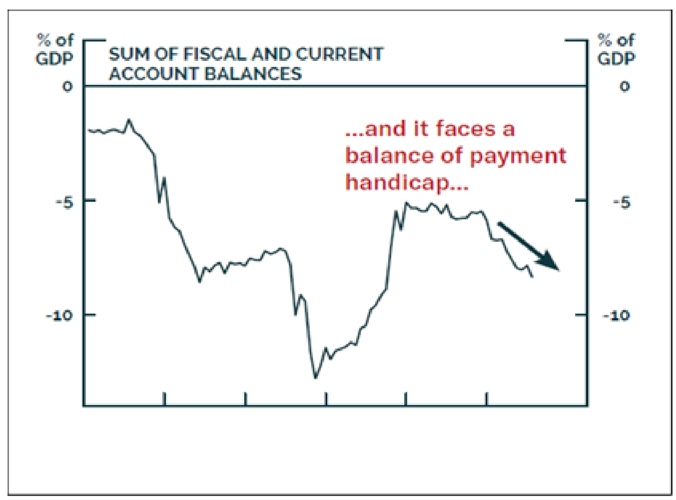
The chart below (source: CreditSights) highlights the spread between Investment Grade Corporate Bonds and U.S. Treasury Bond yields in 2020 (the dark blue line). What you can observe is that credit spreads rose significantly starting in February, 2020, before improving significantly once again over the past several weeks.



The sharp rise in corporate bond spreads earlier this year led to a decline in the price of many corporate bonds (since yields and prices move in opposite directions). Thanks to programs rolled out by the central bank and signs of improvement in the economy, bonds spreads have once again returned to more normal levels.

The Dollar

One piece of the puzzle that has always been challenging to forecast is the direction of the U.S. dollar. We generally try to avoid speculating on the direction of various macro-economic variables, but the stars seem to be lining up for a potential decline in the U.S. dollar ahead. For reference, interest rate differentials between the U.S. and overseas has been reduced, looking ahead it appears that the global economy (and not just the U.S.) is set to experience an economic rebound over the next several years and our trade and budget deficits as a percent of GDP are high and rising (see chart below – source: BCA Research).



If (and we realize this is a big question mark), the U.S. dollar does start to experience a sustained period of underperformance versus foreign currencies, this could have important implications for the relationship between U.S. and foreign stocks, the performance of various commodities and eventually, the rate of inflation.

Long-Term Trends – Where we Stand

Over the past several years our team has largely been overweight the U.S. versus foreign markets, overweight growth versus value (except in the RDM Income Model which has a different investment objective) and overweight large capitalization stocks versus small capitalization stocks. These allocation decisions have for the most part (except for a quarter or two from time to time) turned out to be astute decisions.

Equity markets tend to move in medium to long-term cycles and we are aware that trends can and do change over time. The assessment of valuations, secular trends, and a barbell approach in portfolios coupled with sector overweight and underweights are utilized in the construction of our models.

Market Technicals

As we have mentioned previously, a majority of what we focus on are business fundamentals which include things like GDP, manufacturing activity, employment, consumer and business confidence, monetary policy and corporate profits. However, we believe it is also helpful to keep an eye on market technicals as well.

Over the past couple of months during the current market rebound, we have witnessed several positive technical developments. Among them, 97% of all stocks in the S & P 500 recently moved above the 50 day moving average, a significant amount of stocks recently moved into overbought territory with a 14 day RSI index above 70 and over a recent 10 day period, the number of advancing versus declining stocks in the market registered a level of 2 to 1. In addition, on June 5th, 60% of the S & P 500 reached a new 3 month high (source: Strategas Research).

When we have seen these indicators occur in the past, they have tended to result in a short-term pullback or range bound market for a period of time. However, market returns over the following 6-12 months have historically tended to be quite positive. We do recognize that past market cycles did not have to deal with COVID-19.

The Human Impact

While acknowledging the terrible impact the virus has had on a global basis, we must also recognize the impact it has had on millions of American households. The widespread shutdown has been disruptive to families, health, businesses, and education but has also created new ways for people to interact and has started to produce changes in how society functions and lives on a daily basis. It will be interesting to see if we will still embrace some of these changes so many were forced to make because of the virus in the future. Many corporations have already stated that they are making adjustments to how their companies will operate in the future. We recognize the next phase will bring both risks and opportunities.

Summary

Following a very sharp (but short) economic contraction, it now looks like economic growth in the U.S. has started to improve once again. We can't try and forecast what things will look like over the next several weeks, but looking ahead over the next several quarters, we believe that we are likely to see further improvement in key variables such as GDP, employment, consumer and business confidence and importantly, corporate profits.

A combination of closing large parts of the economy, social distancing and working from home helped slow the spread of COVID-19 this past Spring. In order to help offset some of the impact from COVID-19 and the shutdown of the economy earlier this year, Congress and the Federal Reserve Bank provided several trillion dollars in financial support. The ability of the economy to make a full recovery will definitely take time but importantly, signs now point to the start of a rebound. When all is said and done, the most recent recession (which started at the end of February) may very well be the shortest on record.

While the economy has started to improve, we continue to have concerns and see a number of potential speed bumps ahead. Specifically, the relationship between the U.S. and China looks like it is on shaky ground, the timing of a vaccine or treatment to ultimately deal with COVID-19 remains uncertain, the election this Fall may bring uncertainty and we are unsure how long it will ultimately take to bring back a majority of the jobs lost earlier this year. In addition, our country's budget deficit continues to grow, although with low interest rates, this seems like a problem for down the road.

Market pullbacks, corrections and bear markets (which we just experienced) can lead to periods of heightened volatility and anxiety from time to time. Importantly, bull markets have historically lasted much longer than bear markets, and economic expansions (which we likely just started) have historically lasted longer than economic recessions. Having experienced and observed the above statement, it is important to understand your cash flow needs in order to successfully ride out the volatility.

In the most recent quarter, equity markets (based on the S & P 500) produced the 4th best return since 1950 (source: Raymond James). On a positive note, past history shows that strong quarters similar to the one we just had have been followed by another positive quarter. Of the top 10 quarterly returns since 1950, all were positive in the following quarter 100% of the time by an average gain of 9.09%. Furthermore, the following 12 months following a strong quarter have been positive 89% of the time by an average of 14.27%. We realize that every period is different and there are unique differences this time around.

Fiscal stimulus from Washington and liquidity programs from the Fed have combined to provide support for the economy and financial markets over the past several months. We hope that policy errors in the months ahead do not disrupt the emerging economic recovery that is currently underway. Especially at times like this, it is important to try and stay focused on the long-term and not just the next month or two. We understand that it is often hard to do this with the constant bombardment of news we get on a daily basis. We will continue to update you on our latest thinking in the days ahead as the economy and financial markets change.

We hope you and your families remain safe. As always, please do not hesitate to call us with any comments or questions you may have.

Respectfully,

Michael Sheldon CFA®, FRM®

Executive Director & CIO

RDM Financial Group

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HIGHTOWER
RDM Financial Group

10 Wright Street | Westport, CT 06880 | 203.255.0222

505 Fifth Avenue | 14th Floor | New York, NY 10017 | 212.682.2200

6501 Congress Ave| Suite 240 | Boca Raton, FL 33487 | 561.393.8500

www.rdmfinancialgroup.com