Market Strategy Portfolio

Turning a Corner

Second-Quarter 2020 Shareholder Letter

John Stoltzfus discusses the second-quarter market correction and subsequent rebound, key performance drivers for the Market Strategy Portfolio and the risks and opportunities for investors amid the Covid-19 outbreak as well as what to expect in the second half of 2020.

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After languishing for several months, the global economy is beginning to show signs of life. Prolonged shutdowns, shelter-in-place restrictions and social-distancing measures designed to slow the spread of Covid-19 pushed the economy into a recession.

But even with some states seeing a resurgence in cases and scaling back plans to reopen businesses, it's encouraging to see nascent growth in different facets of the economy. The resilience is due in part to the enormous fiscal and monetary policy stimulus from the Federal Reserve. Although some green shoots of growth are becoming evident in data from late May to much of June, the full impact of the economic shuttering of April and May is likely to be most acute in second-quarter earnings results.

As for inflation, prices remain subdued worldwide and deflationary pressures have brought inflation well below policy targets in many nations (including the United States,) partly reflecting unemployment rates, worker participation rates and counter-inflationary trends embedded in globalization and technology and the impact on consumer demand.

Liquidity Injection

In our view, the broad arsenal of monetary and fiscal policy tools could reflate the global economy as it addresses conditions created by Covid-19. Prices of most primary commodities—a driving force behind some emerging-market economies—have begun to recover from the lows caused by the pandemic and the U.S.-China trade war.

In addition, foreign currencies are likely to appreciate against the U.S. dollar when the "safe haven" flows that boosted the currency in 2019 and early 2020 recede and investors seek riskier assets and higher returns.

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Inside the Portfolio

In the Market Strategy Portfolio, all holdings contributed positively to second-quarter performance. U.S. stocks were the largest contributor. Mid-cap and small-cap stocks outperformed large-cap stocks and our market-cap agnostic approach proved beneficial. Sector performance was mixed, but consumer discretionary and an overweight to the Nasdaq 100 boosted performance within large-cap holdings. A recently initiated overweight to Russell 2000 Growth also proved beneficial.

Emerging markets also gained in the quarter, led by internet and e-commerce stocks, which jumped 48%. Within international developed markets, small caps outperformed their large-cap counterparts. With increasing currency volatility, we reduced exposure to the euro, swapping out of a position in the broad EAFE index with a currency-hedged EAFE ETF. The strategy maintains exposure to the euro through a new position in the EAFE Growth index, as well as a longstanding position in small-cap international equities. We also have exposure to global real estate and timber.

The MSP’s fixed-income sleeve gained more than 12% in the quarter, led by U.S. convertibles, as the equity-sensitive segment gained alongside the stock market. Senior loans gained nearly 10%, while municipal bonds gained roughly 3%. Real assets contributed to performance, led by global timber, materials and real estate. A new position in gold gained more than 2.5% in the quarter.

	2Q20	YTD 6/30	1 Year	3 Year	Annualized Since Inception*
Market Strategy Portfolio Gross	17.22%	-8.66%	-2.38%	2.81%	6.23%
Market Strategy Portfolio Net	16.88	-9.19	-3.54	1.59	5.04
MSCI ACWI	19.22	-6.25	2.11	6.14	9.06
Bloomberg Barclays U.S. Aggregate Bond Index	2.90	6.14	8.74	5.32	4.27

* Inception date: 10/1/2015

Looking Ahead

The Fed's policy stance continues to favor low interest rates and offers a potential pickup in job growth and fixed investment spending among businesses as well as moderate wage growth in some sectors. In our view, the Fed remains sensitive to both economic growth factors and vulnerabilities. We could see a third-quarter rebound if the virus shows signs of peaking while monetary policy, fiscal stimulus and financial aid support families and companies hit hardest by the shutdowns.

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When restrictions on business and social activity can be lifted with greater conviction, we expect attractive investment opportunities to surface. Some sectors that lend themselves to a stay-at-home economy—technology, consumer staples, health care and communications—have already benefited by providing essentials in the midst of the pandemic.

As more progress on containment is achieved, tech, consumer discretionary and industrials could drive robust recovery. Our contrarian pick, financials, should also benefit as economic risk ebbs and yield curves begin to steepen. In our view, diversification is essential. Know what you own, why you own it and have reasonable expectations as to how your portfolio will perform in different scenarios.

Disclosure

There can be no assurance that any investment strategy will be successful. The success of an investment program may be affected by general economic and market conditions, such as interest rates, availability of credit, inflation rates, economic uncertainty, changes in laws and national and international political circumstances. These factors may affect the level and volatility of securities prices and the liquidity of a portfolio's investments

The MSCI ACWI is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International (MSCI), and is comprised of stocks from both developed and emerging markets. The Bloomberg Barclays U.S. Aggregate Bond Index is a market-cap weighted index that measures the investment-grade, dollar-denominated, fixed-rate taxable bond market. Indices are unmanaged, hypothetical portfolios of securities that are often used as a benchmark in evaluating the relative performance of a particular investment. An index should only be compared with a mandate that has a similar investment objective. An index is not available for direct investment, and does not reflect any of the costs associated with buying and selling individual securities or management fees

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