DM PORTFOLIO COMMENTARY
2nd Quarter 2020

I'm not young enough to know everything.
- Oscar Wilde

Human nature includes an outsized desire for certainty, even when our better judgment tells us that certainty is not available. This condition is revealed perhaps no more starkly than through our relationship with money and especially our interaction with equity markets. Though it's widely accepted that next year's stock prices are all but unknowable, a multi-billion dollar industry nonetheless thrives by providing confident predictions to impatient individuals hoping to crack the market timing code. Unfortunately, even the most disciplined investor can find it difficult to avert his or her eyes from the glare of these persuasively presented guesses and many a sound plan has been derailed by their allure.

If short term uncertainty is the hallmark of 'normal' markets, however, the COVID crisis has added an even thicker layer of complexity to the puzzle and significantly widened the range of possible economic and market outcomes. In fact, the current backdrop has sapped Wall Street's conviction so thoroughly that the dispersion between year-end targets for the S&P 500 is as high as it's ever been (incidentally, such indecisiveness is generally positive for future stock returns – equities tend to run into trouble when the 'experts' are in general agreement and tilting toward the same side of the capital allocation boat).

Four months after western markets first started to take note of the budding pandemic and its potential economic drag, several crucial questions remain:

Will a COVID-19 vaccine be discovered, or will we find ourselves stuck in a prolonged pattern of viral ping-pong between surge and remission?

Will the economic recovery follow the hoped-for V-shape, or will it resemble an L, a W, or some other letter or shape?

Will corporate earnings rebound to prior levels alongside recovering economic activity, or will they be permanently impaired in some way by the events of recent months?

Will companies hire back most of the employees that were laid off during the crisis, or will they use this as an opportunity to permanently downsize workforces?

Will inflation finally reawaken after decades in hibernation, or will we continue to enjoy the benefit of price stability and accompanying low interest rates?

Will the 'new' economy be increasingly run from home, or will workers eventually be drawn back to the amenities and interaction provided by the downtown office tower?

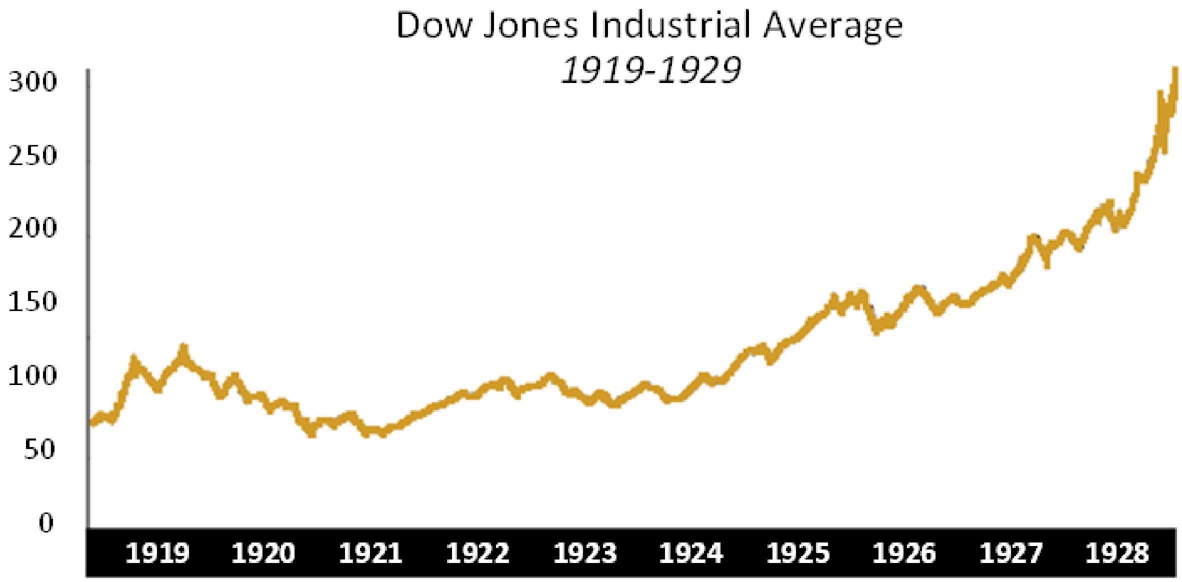
Our answer to each of these important queries is an emphatic "*yes!*"

Unfortunately, it's impossible to know how these or several other essential variables will evolve in the months to come, much less what their market impact will be. In fact, if the first half of 2020 has reminded us of anything, it's how tenuous the connection between economic and equity performance can be and how perilous it is to let media headlines guide investment policy. Initially, as investors grappled with the realization that the virus had reached our shores, the S&P absorbed this fear and careened downward in mid-March. Though stocks rebounded in the first quarter's final week, the US bellwether still shed 20% over the period to post its worst Q1 ever.

Good news remained scarce as the calendar flipped to April, with COVID-19 spreading beyond its original hotspots, mortality figures accumulating, and businesses struggling under the weight of plummeting sales and sticky fixed costs. Against this discouraging backdrop, however, the market staged a prodigious recovery during the quarter and gained a neatly symmetrical 20% to post its best Q2 since 1938 (unfortunately, however, a 20% loss followed by a 20% gain does not a breakeven result make and so the year-to-date return remained negative).

With an historic start to 2020 in the books, it's reasonable to ask why stocks aren't down by more when it's plain that health, economic, and even social troubles are far from being resolved. As you might infer from the words above and from the positions we've taken in past communications, we won't join the chorus of strategists and commentators providing definitive diagnoses as to how markets got to where they are or bold forecasts for where they're headed. All the same, there a few factors that are almost certainly contributing to the disarming buoyancy of equities within an unusually difficult economic setting:

- First, as we've mentioned previously, bureaucrats and elected officials acted with lightening speed and herculean force the moment the economy was thrown into dormancy. In helping to fill the income and spending chasms gouged by the shutdown, policymakers intentionally erred on the side of excess, letting loose significantly more capital than economic activity was likely to absorb. It is not unreasonable to assume that some of this liquidity found its way to stocks.
- Second, following the initial shock of COVID's appearance in the west, stocks have likely become more sensitive to *changes* in conditions rather than their absolute levels. What we mean by this is that the challenges faced by our economies, governments, and health systems are now well known by the market and its investing participants. Instead of focusing on this 'old news', share prices seem to be taking their cue from recent improvements in the employment picture, a bounce in manufacturing surveys, and a nascent consumer recovery to piece together what might be a path to recovery.
- Third, while share prices often gyrate wildly based on interim earnings, in reality stocks are most properly valued by discounting 10 or 15 years' worth of quarterly income. Setting aside the fact that no one could possibly know what any company's fortunes might look like that far in advance, including a few bad quarters in a long-term value assessment has less of an impact than one might expect. As well, the sharp drop in interest rates is likely as positive for the discounted cash flow calculation for stocks as the setback in income is negative.
- Finally, much has been made about the 'unprecedented' nature of the current situation and, based on the investing experience of everyone reading this letter, that is undeniably true. As we've all been recently reminded, however, the world was besieged by a similarly prolific and even more lethal virus at the end of the Great War. Though the Spanish Flu was a devastating disease that took a staggering number of lives, its passing also coincided with the beginning of the Roaring 20's and an extremely profitable period for stock investors. As the chart on the following page illustrates, the Dow rose roughly fourfold over the ensuing decade, despite economies having been ravaged by both a ruinous war and a deadly pandemic.



Source: *Global Financial Database*

In keeping with the instant gratification nature of contemporary society, it could be that the market is expecting the same result once COVID-19 has been tamped down or eradicated and is merely pulling this anticipated market trajectory forward by a year or two.

The past four months have impacted nearly every aspect of our daily lives and brought previously unfathomable health and financial hardship to many. Though it may be difficult to square the steep challenges faced by Main Street with the seemingly ebullient mood of the stock market, it's not uncommon for equities to look well past immediate difficulties in anticipation of better times ahead. To be sure, there remain significant hurdles, not the least of which is the recent surge in COVID cases across the American south. If this highly unusual period has reinforced anything about investing, however, it's that patience and diversification work. Those who stayed on-plan during the panic and carried a balanced portfolio allocation have seen their wealth only modestly affected by the generational events that were unexpectedly thrust upon us. Whatever the coming months might bring, we're confident that these time-tested principals will continue to hold.