Large Cap Value Commentary

July 8th, 2020

The markets came roaring back in the 2nd quarter for three main reasons. The virus proved to be less deadly than some of the early March estimates, many activities are in fact returning to normal, and the speed and scale of the response by Congress and the Federal Reserve has been powerful. These have been challenging days for all of us, and the market's path has been tied to both the fear and hopes associated with it. We have heard neighbors and politicians talk about the value of a person's life as we feel our way between more activity and a stronger economy and more cases of the virus. The debate is challenging, divisive and each solution discussed is riddled with unintended risks and discomforts.

The Q2 rally came despite a lot of cautious headlines and list of questions, some of which we shared with you a few months ago, many of which still remain unanswered. The market optimist could argue that the wall of worry is clearly constructed and now we just need to climb it. Tensions with China have ramped back up, and the recent social issues and demonstrations are sure to make for a more contentious election season this fall.

The economic data of late tells a story of a "V-bottom" recovery, but the outlook is unclear and we see how several very different scenarios could play out. The May unemployment report is a great example of how unclear and unprecedented the situation is. In early June, it was reported that more than 2 million jobs were added in the US during the month of May. Not only was this an amazingly large number, but economists collectively expected more than 7 million jobs to be lost during the month. To put that into perspective, the economy has averaged a monthly gain of less than 200 thousand for the past 10 years.

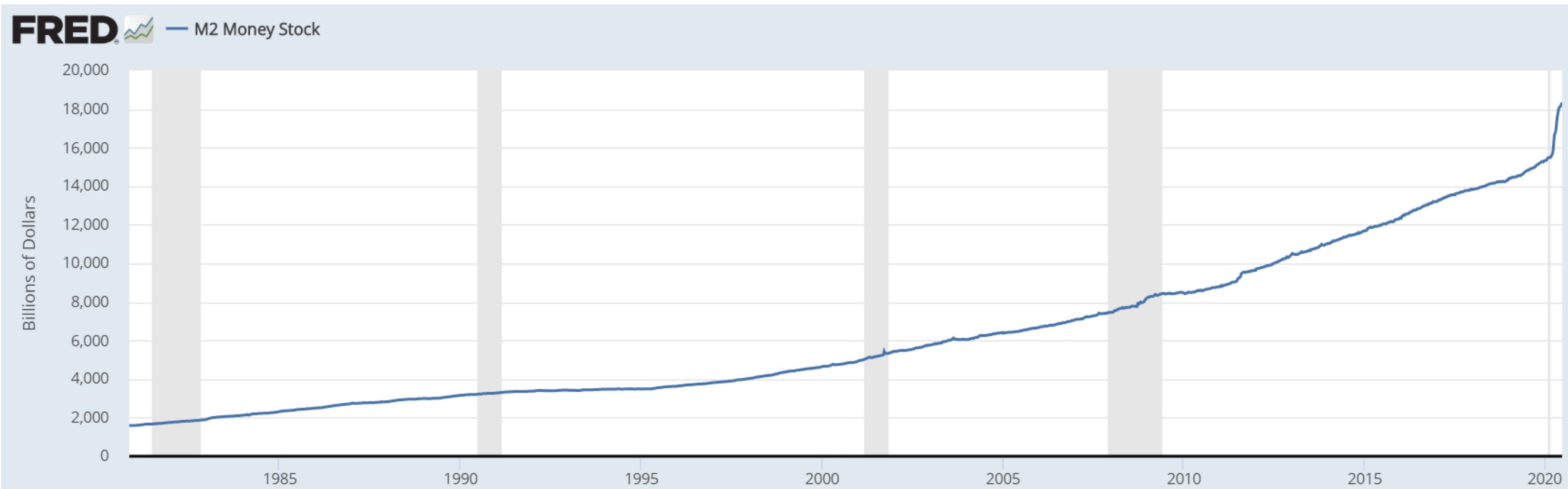
Finally, the efforts of Congress and the Fed deserve highlighting as well as praise from the market bulls. The actions of the Fed sound similar to the logic presented by many of our leaders who are trying to navigate this virus and have used the phrase, "out of an abundance of caution…" Actions taken by the Federal Reserve in the past few months dwarf anything that we have seen before. In fact, if you look at a chart of the supply of money in the US, you almost do not even notice the effect of monetary policy during the financial crisis 10 years ago. To be fair, it is not just the US that is pumping more support into the economy. The central banks of the U.S., China, the Eurozone, Japan, England, Switzerland, and Canada have injected $5.8 trillion in liquidity into their markets in the past four months according to Vincent Deluard at StoneX[1]. The Fed's balance sheet finished the quarter above $7 trillion. It could reach as much as $12 trillion and top 50% of gross domestic product by the end of the year, according to Bloomberg Economics[2]. The end result of the Fed's "no limit" policy[3] has been a spectacular rally in many markets as liquidity has returned and traders rush to buy ahead of the Fed.

Our portfolios performed well during the quarter. Sticking with our more pro-cyclical positioning helped as some of the panic selling reversed and the more defensive assets generally lagged in the quarter. We have been happy to see the rebound, but frankly we have not had much confidence behind many new ideas. The result was that we were a net seller during the quarter. We exited Charles River Laboratories (CRL), as its price and valuation metrics both rose to new highs. For others such as Goodyear Tire (GT) and Devon Energy (DVN), which we had added to the portfolios earlier in the year, we chose to take a loss after the market's bounce. For these two positions specifically, our confidence in the original thesis was broken, and we simply did not want that much cyclicality in the portfolio anymore. Despite the snap back in activity, we still have double digit unemployment, and the virus directly affects the consumer, which is the majority of our economy. While no two recessions are the same, the exceptionally high unemployment rate and the resilient measures of consumer confidence look inconsistent to us. We decided to sell the cosmetic retailer

Ulta Beauty (ULTA), partially due to concerns that the consumer would not quickly snap back to their normal spending habits, and operating in this environment will be more expensive.

Our strong performance in the quarter was helped by our overweight to the energy sector, which came charging back from nothing. I chose the word “nothing” because some oil contracts recently traded below zero given the extreme drop in demand. The refiner Marathon Petroleum (MPC) and producer Noble Energy (NBL), were up 58% and 48%, respectively in the quarter. The portfolios were also helped by Advanced Auto Parts (AAP), which will benefit from more travelers preferring the highway this summer. Our positon in the financier Royal Gold (RGLD) was also a top contributor, as their investments benefit from the higher price of gold which ended the quarter at $1,800.

As always, we are working hard for you to find good values in the market. We would be happy to schedule a meeting to discuss your individual portfolio, and we look forward to speaking with you soon.



Tyler Pullen, CFA

[1] Global Macro – June 2020 StoneX, Vincent Deluard

[2] Bloomberg, ‘Game-Changing’ Stimulus Is Starting to Lift Even the Worst-Hit Stocks By Vildana Hajric, April 28, 2020

[3] 60 Minutes correspondent Scott Pelley interviewed Federal Reserve Chairman Jerome Powell, May 13, 2020,

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