COLORADO FINANCIAL MANAGEMENT®

Economic & Market Review

Written by Brad Bickham, CFA, CFP®
Partner & Chief Investment Officer

July 2020

SUMMARY:

- Inflation – less than 2%.
- The Fed – will keep rates near zero through 2021.
- Earnings – no real data until later this year.
- Valuations – OK relative to low interest rates, but limited upside potential. Risk, if there are negative surprises.
- Politics – Noise is getting ready to ramp up. Expect surprises.
- The dollar – weakness lasts two months, favors international investments.
- Oil – stabilized at $40.
- Sentiment – Middle ground.

As Of 6/30/20	YTD	Last 12 Months	Last 5 Years	Last 10 Years
60/40 Balanced World Index	-1.8%	4.2%	5.4%	7.3%
World Equity Index (ACWI)	-6.2%	1.2%	6.1%	9.1%
U.S. Large Cap Equities (S&P 500)	-3.1%	7.5%	10.7%	14.0%
U.S. Small Cap Equities (Russell 2000)	-13.0%	-6.6%	4.3%	10.5%
Foreign Equities (ACWI-ex U.S.)	-11.0%	-4.8%	2.3%	5.0%
U.S. Bonds	6.1%	8.7%	4.3%	3.8%
Global Bond Index	3.0%	4.2%	3.6%	2.8%
HFRI Fund of Funds Composite	-1.8%	0.3%	1.6%	2.8%
U.S. T-Bills (proxy for cash returns)	0.5%	1.5%	1.1%	0.6%

Dear Clients and Friends,

It has been quite a roller coaster this year. Despite the Coronavirus, an economic recession, 15% unemployment, and stock market volatility, the return on a balanced portfolio is down less than 2%. There are some additional pieces of information in the table above I would like to point out.

Long-term returns for a balanced portfolio have averaged 5% to 7%. We often get asked what to expect, and 5% has been a reliable conservative number when you include down market years. 7% to 8% can be expected when you stretch out the period longer. We use 5% for financial planning purposes.

US Large Caps are dominating the financial markets… especially large cap technology companies. We'll address this later in this letter.

Returns on cash and equivalents have been anemic for a decade. This is unlikely to change anytime soon.

Returns on bonds have been much higher than normal, and are destined to be lower going forward.

Hedge funds (HFRI Fund) as an asset class have been discredited over the last decade.

As usual, let's run through our investment pillars to better understand where we are and where we are likely to go: i) the economy; ii) inflation & interest rates; iii) earnings & valuation; and iv) sentiment & politics.

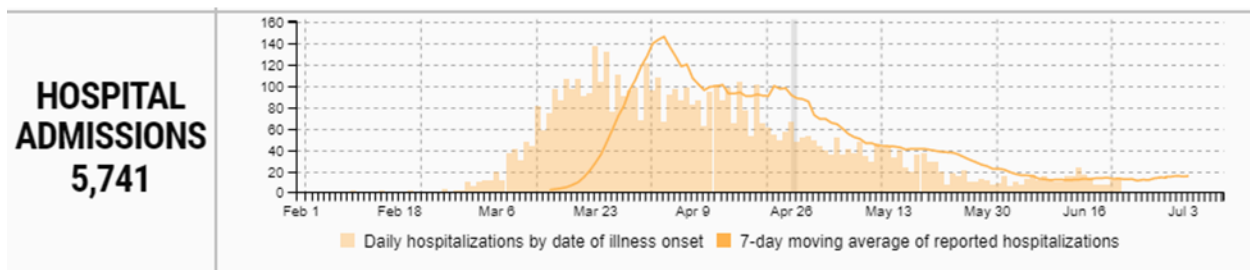
To understand where the economy is and where it is going, we have to first examine Covid-19 and its progress for the weeks ending:

	Worldwide		United States		
	# of Cases	# of Deaths	# of Cases	# of Deaths	# of Tests
4/10	1.6 M	97 k	466 k	17 k	
4/17	2.2 M	147 k	662 k	29 k	3.4 M
4/24	2.7 M	192 k	869 k	50 k	4.6 M
5/1	3.3 M	234 k	1.1 M	63 k	6.2 M
5/15	4.4 M	304 k	1.4 M	86 k	10.3 M
5/29	5.9 M	364 k	1.7 M	100 k	15.1 M
6/12	7.6 M	422 k	2.0 M	114 k	21.9 M
7/8	11.9M	545 k	3.0 M	132 k	36.9 M

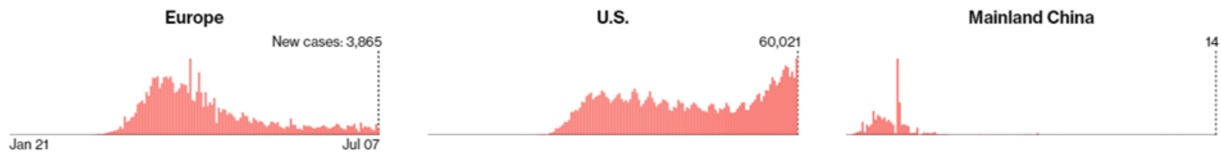
By now you have heard about the surge in cases in the sunbelt. Here are a few headlines pulled from the newspapers:

- US hits 3 million infected
- President Trump disagrees with CDC on guidelines for reopening schools
- Director of Harvard Global Health Institute said that reopening schools in heavily infected states would backfire
- Harvard University and MIT sued the federal government over its policy regarding international students
- States failed to anticipate that reopening would lead to a surge of infections
- European Union bans travelers from the United States
- Months into the pandemic, many US cities still lack testing capacity
- Over the first five days of July, the US reported its three largest daily case totals
- Brooks Brothers files for bankruptcy
- United Airlines warns it may cut workforce in half

The good news (if you can call it that) is that the surge in new cases is over-represented by younger people who have a much lower percentage of significant problems. Nonetheless, the increase in cases is resulting in increased hospitalizations. In Colorado, on July 5th there were 171 patients hospitalized with confirmed coronavirus, up 30% from a week earlier. I believe this is the statistical trend most meaningful, and the trend in Colorado still looks ok.



One of our basic assumptions regarding the effect the virus would have on the economy was that our government actions would help control the epidemic. That is clearly not true. By having no federal policies, states have been left to their own devices and many are not up to the task. We stopped international travel, but we did nothing to stop the virus from spreading from state to state. Confidence in the WHO, the CDC, and even Dr. Fauci has been undermined to the point where they are being ignored. The performance of the US has been an embarrassment.

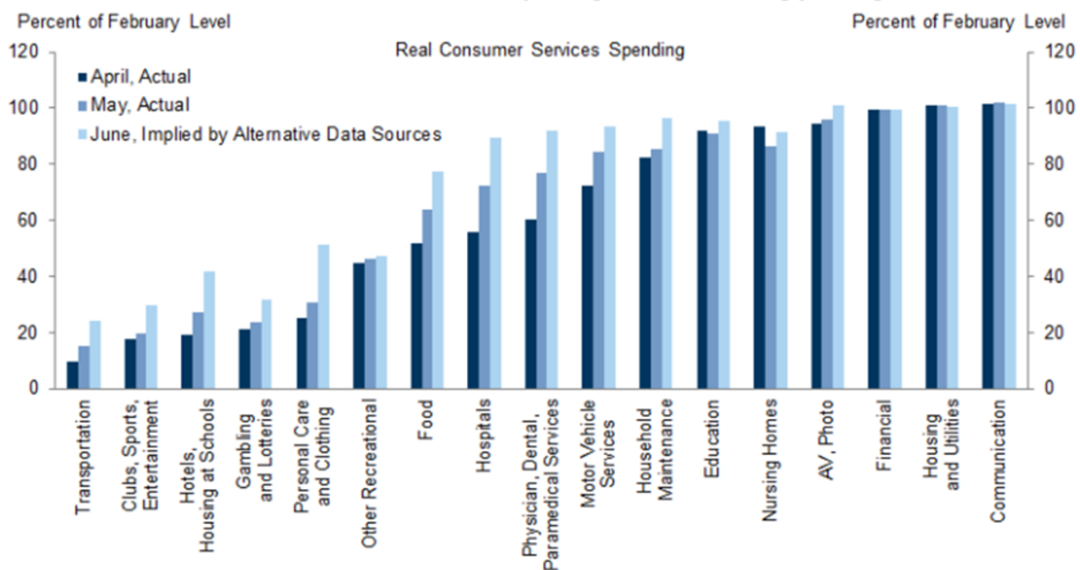


Our assumptions about the recovery of the economy need to be adjusted downwards. The strength of the economy is inextricably linked to the virus for obvious reasons.

Here are a few examples about reopening:

- Retailers are more cautious on reopening. Macy's noted that sales recovery has stalled at -35% vs. prior year.
- United Airlines backtracked on flight additions expected in August due to declining demand.
- Construction equipment operating rates were down only 1% in June from last year's levels.
- Farm equipment capacity utilization has improved. Dealer inventories of used tractors were down 15% year over year in June.
- Restaurant activity has picked up from the lows, but it is inconsistent across geographies.

Overall, analysts expect US GDP to fall 4% to 5% in 2020, and then to grow 5% to 6% in 2021. Unemployment, which peaked at about 15% should fall to 9%-10% by the end of this year and continue to fall in 2021.



Economic growth always rebounds after a recession due to pent up demand.

The most common question we get from clients is how can the stock market be doing so well when the economy is still doing so poorly. If our assumptions about the economy have deteriorated, should our expectations for the market do the same? Maybe not. We have written about this before, but will try and expound on it more. We offer 7 reasons for the strength of the stock market, and while it may pause, it probably won't decline significantly.

1. The makeup of the US stock market is different than the broader economy. The US economy is dominated by thousands of small businesses. The stock market is dominated by a few industries and companies. At least 50% of the stock market are technology related companies, which are being affected little by the crisis. An additional 25% of the market companies are in healthcare and consumer staples. In aggregate, those sectors are also affected little.
2. Furthermore, 20% of the US market is now concentrated in 5 companies: Apple, Amazon, Facebook, Alphabet/Google, and Microsoft.

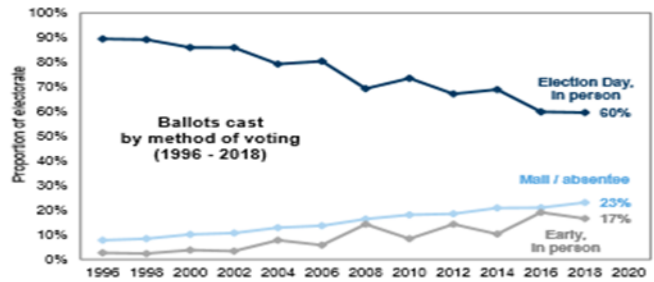
	EPS Growth '19-'21
S&P 500	3%
S&P 500 Consumer Discretionary	-6%
S&P 500 Consumer Staples	5%
S&P 500 Energy	-57%
S&P 500 Financials	-27%
S&P 500 Health Care	39%
S&P 500 Industrials	-10%
S&P 500 Information Technology	27%
S&P 500 Materials	13%
S&P 500 Communication Services	13%
S&P 500 Utilities	9%
S&P 500 Real Estate (proforma pre-9/19/'	-29%

3. The stock market is a discounting mechanism that looks into the future. The volatility is created because the future is uncertain and our view about it changes, but when valuing a company (the market is a collection of companies) we are thinking about years in the future – not the next six months. Here is a closer look at how the discounting math works:
    a. Zach Cole, one of our Portfolio Managers, performed an analysis of a generic company that loses all earnings for 2020 and then in 2021 recovers its 2019 level. The company is expected to grow at 5% per year for 10 years, and the discount rate is 10%. The value of the company would fall by 9%.
    b. However, if the discount rate used to value that company fell by 1% (which it has this year because interest rates have fallen), then the value increases by 8% even with no earnings in the current year.
4. TINA (There Is No Alternative). With interest rates at zero, there are few attractive investment alternatives.
5. FOMO (Fear Of Missing Out). Many investors have missed this rally, both professionals and individuals. Professionals have career pressure to get back in. Individuals are just greedy.
6. MOMO (Momentum). Many investors follow a momentum strategy. Whether it is based on stock trends or earnings momentum it favors large cap growth, and more and more investors add to these stocks. These investors are not valuation sensitive.
7. Indexing. A great deal of money is invested through index funds. The largest of these are cap weighted – meaning more money goes to the largest holdings such as Apple and Amazon. As people plow more and more money into these index funds, a disproportionate amount goes into the largest companies. Again, there is no valuation mechanism.

The discount rate mentioned in point #3 is why we include inflation and interest rates in our investment pillars. Historically, changes in interest rates have had a big impact on the direction of the stock market, and have an obvious and direct impact on the return from bonds. Over the last 12 months, the yield on 10 year US Treasury bonds has fallen from 2% to 0.69%. That is a 67% change. As shown earlier, the result has been an almost 9% return on US bonds. As we approach 0% yields, it gets mathematically impossible to achieve the same kind of returns unless the US goes into negative yield territory. Federal Reserve officials have made it abundantly clear they do not want that to happen, and so far the Fed has been one of the few areas of the government that has been both useful and trustworthy. And, there really isn't much risk of inflation rising any time soon. There is too much slack in the economy, both labor and goods, for inflation to get started. So, for the foreseeable future, expect rates to stay pretty close to where they are now: 0% for cash and money markets, 0.5% to 1% for longer term US Treasury bonds, a little more for corporates and municipal bonds.

The biggest source of volatility for investments the remainder of 2020 is likely to be the election, but it could be for a different reason than most people expect. It is difficult to write or talk about politics without offending half the audience, but my effort is to describe how I think investors will react. Here are a few facts and conventional wisdom according to Wall Street and political analysts we follow:

- Prediction markets currently suggest a Democratic sweep. The current probabilities are 62% for the White House, 61% for the Senate, and 85% for the House. These can change rapidly. In February they were 43%, 30% and 61% respectively.
- The Options market suggests there will be no known winner on Election Day. Implied volatility around November 3rd is extremely high. The trend toward early voting and voting by mail was already under way before the coronavirus, and will be even greater this year because of it. In 1996, 90% of voting was in person. In 2016 it was only 60%.
- We know already there are likely to be challenges to the vote counts. It may even wind up in the Supreme Court again.
- Tax policy has the potential to be the most substantive consequence to equity investors. Under President Trump, corporate taxes were lowered. If that tax cut is repealed, some analysts estimate that S&P 500 earnings for 2021 could fall from $170 to $150. Of course, in addition to taxes, corporate earnings will also be sensitive to regulations, trade policy, government spending, and other policies. Recent reports indicate Biden will not rush any tax changes due to the weak economy, but the perception will be there that a Biden Presidency will lower earnings in the near term.
- There is also the potential for higher capital gains tax rates, and other taxes on wealthy individuals. The historical record on past changes is not conclusive. What can be expected is probably a short term decline in equity prices as well as underperformance of high momentum winners as investors attempt to lock in gains before tax rate increases.



Source: Voting and Registration Supplement of Current Population Survey, MIT Election Data and Science Lab, Goldman Sachs Global Investment Research

Aside from politics, which we believe is a lot less important to the market than generally perceived, our biggest concern for the market is the concentration of performance from a few companies. As shown in this chart, 5 companies now make up 20% of the market – higher than during the dot com bubble. We do not believe there is the same kind of valuation problem as then, but it can't continue.

Source: FactSet, Goldman Sachs Global Investment Research

Company	Current Price
Apple	376
Amazon	3,047
Facebook	244
Google	1,504
Microsoft	212

We don't know how this will be resolved. The most likely and optimal conclusion is for the rest of the market to outperform and take up a bigger share. As the economy improves, cyclical companies such as banks should do better. We will be monitoring this situation closely as these stocks are widely included in many ETFs and Mutual Funds, and in many of our stock portfolios.

Finally, a couple of company matters that we would like to share with you. The recent tragedies in Minnesota and Atlanta and subsequent protests across the country are reminders that our society still has a long way to go in terms of ensuring equal and fair treatment for all. Like most, we are troubled by recent events and wish to affirm our dedication to equal opportunity and respect for everyone.

CFM is working to set the right foundation for the workplace. All of us have signed a company policy affirming our commitment to treat our fellow employees in the workplace and the people with whom we do business with respect. In the belief that striving to do a better job understanding and respecting one another creates an opportunity for CFM to be a better company, we have committed to diversity and inclusiveness training for all employees and owners.

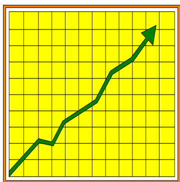
CFM has formed an Employee Resource Group (ERG) which is responsible for sourcing education for our staff and for providing a forum in which our staff can share ideas and recommendations to help build on our diversity and offer a safe and comfortable professional environment for all. Quarterly meetings of this group will be led by a combination of employees and Partners of the company. All employees will be welcomed at meetings held by this group.

Like many others, our company gives back to the community, both through volunteering and by making contributions to local not-for-profit organizations. When considering these gifts CFM will emphasize support for non-profits that support and encourage diversity, inclusion, and equal opportunities within Colorado.

We are grateful for the opportunity to live and work in a wonderful place, and that our company has been fortunate to attract talented and dedicated staff and wonderful clients. We will strive to sharpen our focus on respecting and capitalizing on our differences, and contribute to the welfare and success of our company and community.

And last, but not least… We are happy and sad to report that Bill Walker is retiring. Bill has been working with us for 15 years. Bill was the second member of our 'Senior' team, joining a few years after Denis Nock. Bill had a distinguished career in banking in Boulder going back to the First National Bank days and continuing with them as they became Bank One and then JP Morgan. His second career with us allowed him to stay engaged, and for us to enjoy his incredible intelligence, experience, and good nature. I don't remember Bill ever having a bad day. Like the other previous members of the Senior team: Dick Stebbins and Gary Powell, Bill will continue to participate in our Equities Committee that meets every Tuesday when he can. We are going to miss him but are happy for him to have more time to read his never ending list of books, and enjoy his kids and grandkids.

Happy returns,



Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

And Your Entire Colorado Financial Mgmt. Team

Index Definitions & Disclosures:

Standard and Poor's Index

- **S&P 500:** The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index:** The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
- **MSCI All Country World Index Ex US:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- **Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).
- **Barclays Capital 1-3 Month U.S. Treasury Bill Index:** The Barclays Capital 1-3 Month US Treasury Bill Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and nonconvertible.

Other Indices

- **HFRI Fund of Funds Composite Index:** This index is a composite made up of multiple hedge funds via funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio.
- **Russell 2000® Index:** The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set

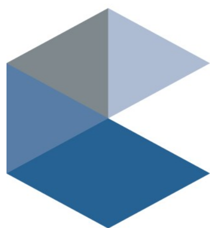
Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

References to specific investments should not be construed as a recommendation by Colorado Financial Management to buy or sell securities.

Past performance is not an indication of future results, and as is the case with all investment advisors that concentrate on equity investments, future performance may result in a loss. Portfolio holdings and weightings are subject to change at any time due to ongoing portfolio management. Portfolio returns given are after trading costs but not after fees. Returns do not reflect the holding of cash in the account, if any. This report is for informational purposes only.

Colorado Financial Management, LLC (CFM) succeeds registration as Sargent Bickham Lagudis, LLC. Sargent Bickham Lagudis, LLC (SBL) succeeds registration as Sargent and Company. SBL's registration was effective March 8, 1999. Sargent & Company's registration was effective in 1988. Sargent Bickham Lagudis merged with Colorado Financial Management effective January 1st, 2016. For the year 2016 and after, the composite performance will include both firm's households for each asset class. For returns before 2016, only returns from legacy Sargent Bickham Lagudis will be included in the composite.



COLORADO
FINANCIAL
MANAGEMENT®

303-443-2433 www.colofinancial.com

Boulder
4840 Pearl East Circle, Suite 300E
Boulder, CO 80301

Denver
3033 E First Ave, Suite 408
Denver, CO 80206

Loveland
4848 Thompson Pkwy, Suite 320
Johnstown, CO 80534