PARITAS
CAPITAL MANAGEMENT

SECOND QUARTER | 2020

INVESTMENT COMMENTARY

At a Glance

Global financial markets rebounded in the second quarter with the MSCI AC World Index returning 19.22% for the quarter while the Barclays US Aggregate Bond Index produced a return of 2.90% The Global Wealth Strategy portfolio participated in the markets move higher with a return of 6.09% for the second quarter which is the second-best quarter for the portfolio since its inception on July 1st, 2015.

Key Insights

Although equity markets were up during the second quarter, we believe they are far from being out of the woods. Our research shows that high risk market environments can occur during down and up periods.

Here are a few of the potential headwinds that could derail the economic recovery:

- It is unclear how many of the jobs created in May were the result of companies hiring back employees to spend the funds received from the Paycheck Protection Program (PPP). If business activity remains low after the PPP funds have been distributed to employees, companies may have to send some employees back to the unemployment line.
- The $600 in additional weekly unemployment benefits is set to expire on July 31st. If this benefit is not extended, it would have a major impact on the millions of people currently unemployed, putting some in the unenviable position of having to default on debt obligations like mortgages, credit cards and auto loans.
- The longer businesses are operating at reduced capacity the more strain is put on cash flows. Small to mid-sized companies are particularly vulnerable in these situations. This could lead to a spike in defaults in some segments of the corporate debt market.
- If there is a resurgence in COVID 19 cases and hospitalizations, states may roll back the reopening of their economies.

One of the advantages of our quantitative risk evaluation process is we eliminate the need to make subjective forecasts as to whether a risk will materialize or predict the assets that will be impacted. As a scenario unfolds, we calculate the risk of each asset in the portfolio and determine how its risk is changing relative to the other assets in the portfolio. This will indicate which assets are responding positively or negatively to the risk event and what changes are required to adapt the portfolio to the current risk environment.

For example, if business capacity continues to be restrained, some companies will be unable to pay employees after their PPP loans are depleted. Not only will this lead to higher unemployment, but without the additional unemployment benefit, many consumers will pull back spending which could cause the economic recovery to slow. If this were to happen, we would expect to see a spike in equity risk that would lead to an increase in the allocation to lower-risk assets like US treasuries to keep the risk in the portfolio balanced.

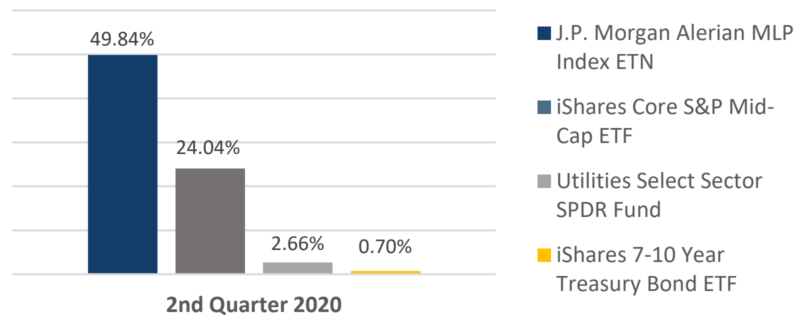
If on the other hand, there is positive news in the development of a COVID 19 vaccine or hospitalizations are at acceptable levels, we would expect our evaluation of global equity risk to significantly decline resulting in a meaningful allocation shift to growth assets from defensive assets.

We are mindful that the portfolio did not participate as much as we would have liked in the second quarter due to the overweight to US treasuries. Our evaluation of risk tells us there are multiple potential risk events present in the market that could potentially spark another major sell-off – even more severe than what we experienced in the first quarter when the S&P 500 Index was down as much as -33.79%. With a significant overweight to US treasuries, we believe the portfolio is prepared for such an event.

What Helped and What Hurt

The unprecedented amount economic stimulus and aggressive monetary policy helped all 12 segments in the portfolio finish the quarter in positive territory.

The improved outlook on oil demand triggered a major rally in MLPs with the J.P. Morgan Alerian MLP Index ETN returning 49.84% in the second quarter, making it the largest contributor to the portfolio's performance for the quarter.



The increase in unemployment benefits in the US is so substantial that many people found themselves getting paid more unemployed than when they were working. This put more dollars in the hands of many consumers and likely contributed to better than expected retail sales data during the quarter. This also may have been one of the catalysts that helped US equities contribute more to the portfolio's return than International equities during the quarter.

In the US, mid-sized companies performed well in the second quarter helped by a rise in investor confidence that the reopening of several state economies would improve business activity to relieve the strain on cash flows. The positive news helped the iShares Core S&P Mid-Cap ETF post a return of 24.04% for the quarter.

The biggest detractor from performance during the second quarter was the portfolio's overweight to US treasuries. As the first quarter ended, the risk in global equities reached extreme levels. As expected, to balance the risk in the portfolio required a significant overweight to US treasuries. In April, equities made a sharp reversal as if the pandemic and the ensuing financial impact were a thing of the past. We do not pretend to be economists, but with an unemployment rate of 11% along with a litany of businesses that will never recover, it is hard to believe the economy is in a better place now than before the pandemic. Markets can be irrational over the short-term, but reality usually prevails over the long-term.

Market Recap

During the second quarter global equity markets benefited from massive amounts of government stimulus and a flood of liquidity from central banks. Better than expected economic and employment data also played a role in the markets second quarter results. The April jobs report showed fewer job losses than forecasted and the jobs report for May showed a gain of 2.69 million new jobs vs a forecast of job losses (Factset). Some analysts cautioned that although the May job numbers were strong, the job market remains in a deep hole. On the economic front. retail sales surprised to the upside with a 16.80% month over month gain in May, however, some of the increase was likely from pent up demand from March and April (Factset).

The unexpected upbeat news resulted in gains across global equity markets. In the US, the S&P 500 Index ended the quarter up 20.54% while international markets lagged with the MSCI AC World ex-US Index returning 16.12% for the quarter.

The energy sector snapped back from a disastrous first quarter with the S&P 500 Energy sector gaining 30.51% during the second quarter, helped by extremely oversold conditions in the first quarter and an improving outlook on oil demand.

The move by the Fed to provide liquidity to credit markets calmed bond investor fears by avoiding a potential credit crisis. This was welcomed news to the credit markets with investment grade bonds bouncing back with gains that more than covered the -3.24% loss sustained in the first quarter. The iBoxx USD Liquid Investment Grade Index finished the second quarter up 9.67%.

We continue to focus on the long-term and given the level of market risk the portfolio maintains an overweight to US treasuries.

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