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First Half Review and Investment Outlook

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To the astonishment of many, given the circumstances, the S&P 500 generated only a modest decline for the first half of 2020. The point-to-point return, however, does not reflect the volatility resulting from the global COVID-19 pandemic and the subsequent collapse in worldwide economic activity. Remarkably, very different sets of stock market returns were tidily separated into the two calendar quarters, with the 1st quarter being one of the worst on record (including a 30% drop in the S&P 500 in just over a month) and the 2nd one of the best (including the strongest 50-day rally in almost 100 years).

The table below provides total return figures for key asset classes for periods ending June 30th. U.S. stocks continued their outperformance versus foreign equities. However, bond returns were superior to both, as investors sought safe-haven assets. These returns occurred within an environment of abysmal near-term economic fundamentals, including unemployment at levels not seen since the eve of World War II and a collapse in economic activity whose speed and scope were, until this spring, unknown in modern times.

Major Asset Class Indices[1]	Total Return 1st Half 2020	Total Return Last 12 Months
S&P 500 (U.S. Large Cap Stocks)	-3.1%	+7.5%
MSCI EAFE (Foreign Developed Large Cap Stocks)	-11.3%	-5.1%
Bloomberg Aggregate Bond Index (U.S. Investment Grade Bonds)	+6.1%	+8.7%
US Short-Term Treasury Bills (Money Market Fund)	+0.3%	+1.2%

The longest bull market in U.S. history ended abruptly in the 1st quarter, driven by the unprecedented impact of the novel coronavirus. U.S. large cap stocks as measured by the S&P 500 declined 20% in the first quarter, with most of the drop occurring in the month of March, when stock declines were so sharp that on multiple occasions exchanges activated rarely-used circuit-breakers and trading was briefly halted. In this bear market traditional defensive sectors (e.g., consumer staples and health care) held up particularly well relative to the broader market. These sectors are well-represented in almost all portfolios managed at Rice, Heard & Bigelow and Minot DeBlois Advisors.

In the 2nd quarter, capital markets roared back, with U.S. stocks returning around 20%, their largest quarterly gain since the late 1990s. The almost complete recovery for the broad stock market was driven by massive global monetary and fiscal stimulus and led by large technology-related growth stocks. These were among the best performing stocks during the first six months of 2020, as many technological trends that had been underway accelerated; indeed, Microsoft CEO Satya Nadella described the pace of technological change as "two years' worth of digital transformation [being made] in two months." By some measures, the outperformance of technology stocks has reached levels last seen in the late 1990s and, given their size, leading technology stocks have done much to buoy the returns of indices based on market capitalization.

However, index performance can belie more disappointing returns by smaller stocks and by sectors and regions more impacted by the crisis. U.S. small cap, foreign developed, and emerging market stock indices all declined more than 10% during the first half of 2020. Even within the broad S&P 500, the median stock returned approximately -11%, which better represents the

[1] The S&P 500 Index is a broad measure of U.S. large capitalization stocks; the MSCI EAFE Index (Net) is a broad measure of mid-large capitalization stocks in developed international markets; the Bloomberg Barclays U.S. Aggregate Bond Index is a broad index of U.S. investment grade bonds; the 90-Day U.S. Treasury Bill represents short-term government money market funds. Returns are provided by sources deemed to be reliable but are subject to change or revision.

economic and financial harm caused by the pandemic. The sector divergence was also stark, as illustrated by technology's +15% return compared to financials -20%. We were pleased that stocks with characteristics that comport well with our investment philosophy held up relatively well as the market declined. These characteristics include strong balance sheets, good cash flow generation, highly regarded management teams and a clear path to achieving long-term growth.

We entered the most recent equity market downturn with our strategic stock weightings at their most conservative levels in more than a decade. Following the market's sharp downturn, in late March we incrementally raised our strategic stock allocation back toward a neutral weight for each investment objective.   While adding to stocks at such an unsettled time can be difficult, we continue to practice our strategy of disciplined periodic rebalancing among stocks, bonds and cash, which has historically provided better risk-adjusted returns by producing a smoother return pattern. During especially volatile periods, rebalancing can also lead to superior nominal returns.

Looking toward the remainder of 2020 and beyond, the most important developments we are monitoring are:

1. the progress of the disease itself and, as we write, the frightening resurgence of COVID-19 in many locations in the U.S. and overseas,
2. the attempts to produce a vaccine, effective treatment, or some combination thereof, that can be made widely available in record time, and
3. the efforts by fiscal and monetary authorities to support business and consumer incomes until conditions return to something approaching normal.

The first point above is obviously the most significant, and we sincerely hope that sensible actions by individuals and thoughtful government policies will reduce the record number of new cases recently seen in the U.S. With regard to a vaccine, most commentators believe that any prediction that a vaccine can be developed and distributed within 6 to 12 months is optimistic. In terms of governments' policy response, investors appear to have concluded that, in light of historically low interest rates and steps taken to date, government action will be sufficient to maintain a basic level of economic activity until sufficient medical advances are achieved. With national elections less than four months away, however, political risk is high in the United States.

While many economists have been surprised by the strength in retail sales and employment data, the International Monetary Fund recently lowered its annual global economic growth forecast for 2020 from -3% to almost -5%. Barring a sudden uptick in GDP growth, major central banks will keep interest rates low for some time to come. Low interest rates will, in turn, help support equity prices as future cash flows are discounted to a higher current value and investors hunt for yield. Despite the support from ultra-low interest rates, equity prices will likely continue to be volatile. The recent acceleration in COVID-19 infections, the advent of new protest movements, and the upcoming U.S. presidential election imply shifts – potentially dramatic ones – in investor sentiment over the coming months.

Given the resurgence of COVID-19, a relatively weak economic outlook and an anticipated fall in corporate profits, the bull case for domestic stocks rests almost completely on successful government actions, continued low interest rates, and (eventually) a vaccine. The market's rapid advance from its March lows while medical, economic, and political risks are rising, however, leaves little room for error. While we prefer stocks for the long term, with U.S. large cap stocks close to all-time highs, we are becoming increasingly more cautious about near-to-intermediate term stock market performance. We believe that economic fundamentals may disappoint and are positioning portfolios to better preserve capital should the market turn against us.

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