**SCHNIEDERS**
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# Third Quarter 2020 Market Commentary

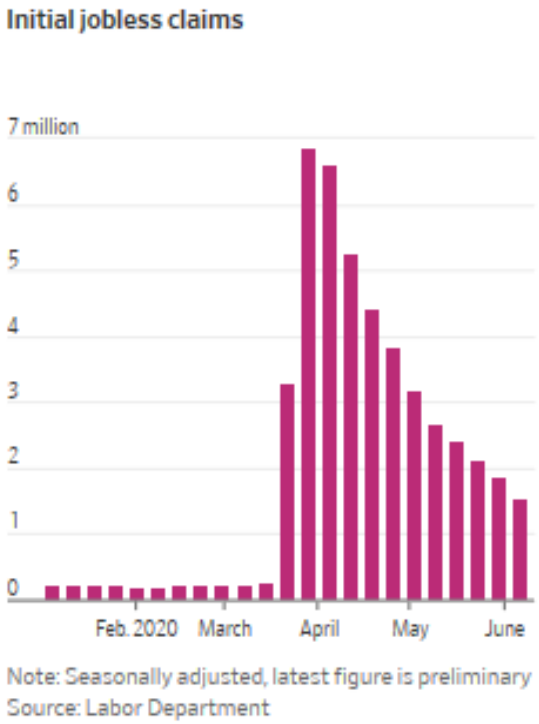
Despite a weakened economy due to COVID-19, double-digit unemployment rates, and many sectors of the economy still down double-digits on the year, the stock market did have a nice rebound off the lows in the second quarter. In this commentary, we will explain why the stock market rallied. In addition, we will lay out why we not only believe the economy is getting better, but also why we continue to believe the current economic recovery will be "U" shaped (slow recovery) rather than the much hoped for "V" shaped (quick recovery).

## Why the market rallied in the Second Quarter

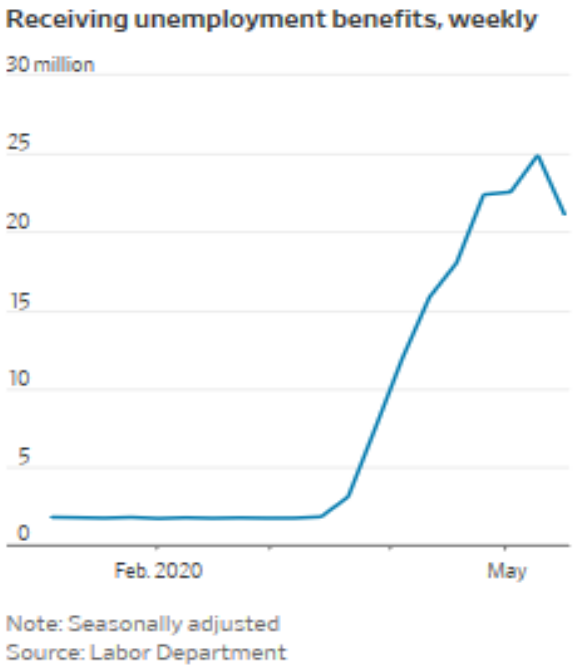
The market rallied in May on a surprisingly resilient jobs report. The unemployment rate is calculated monthly by the Department of Labor and looks at both job gains and losses, whereas the initial jobless claims are released weekly by the Department of Labor and look at just job losses. The initial jobless claim information is supposed to give insight into the state of the labor market. In the early weeks of the pandemic, 40 million initial jobless claims had been filed; the market was expecting to see a large spike in unemployment in May to the 20-25% unemployment range. However, when the unemployment report was released for May, the unemployment rate dropped to 13% from April's 14.4%. Actually, 2.5 million jobs were added during the month, and the number of people receiving continuing unemployment benefits dropped to a little over 20 million people. Partial economic reopening drew workers into the work force (this was much better than the 40 million people who had filed first time claims). The situation repeated in June with a surprisingly strong 4.8 million jobs being added and the unemployment rate dropping to 11.1% (still very high, but much better than feared). Since the start of COVID-19, new unemployment claims have totaled a staggering 45.7 million; which was

the leading reason for the market sell off. However, in the last three months, out of those 45.7 million people who lost jobs, almost 25 million of those people have already found new jobs, which is why we have had a strong partial recovery.

**First Time Unemployment Claims**

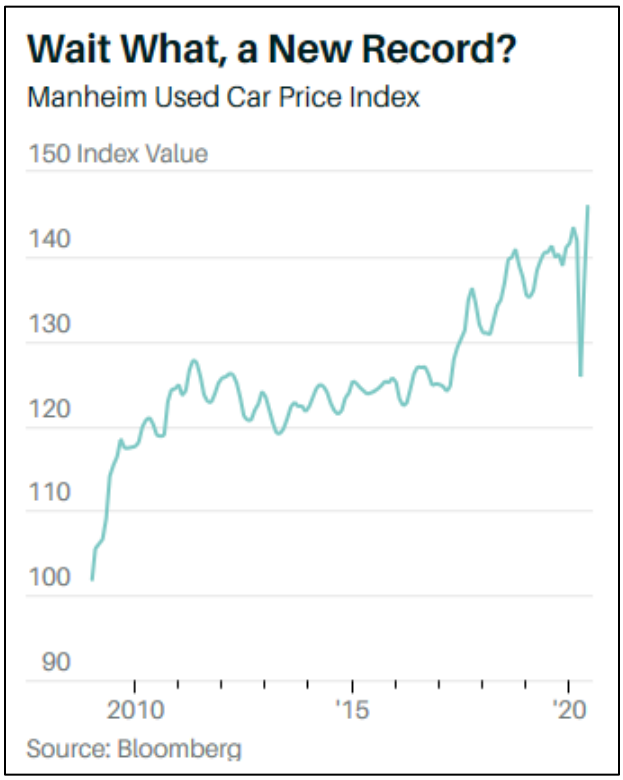


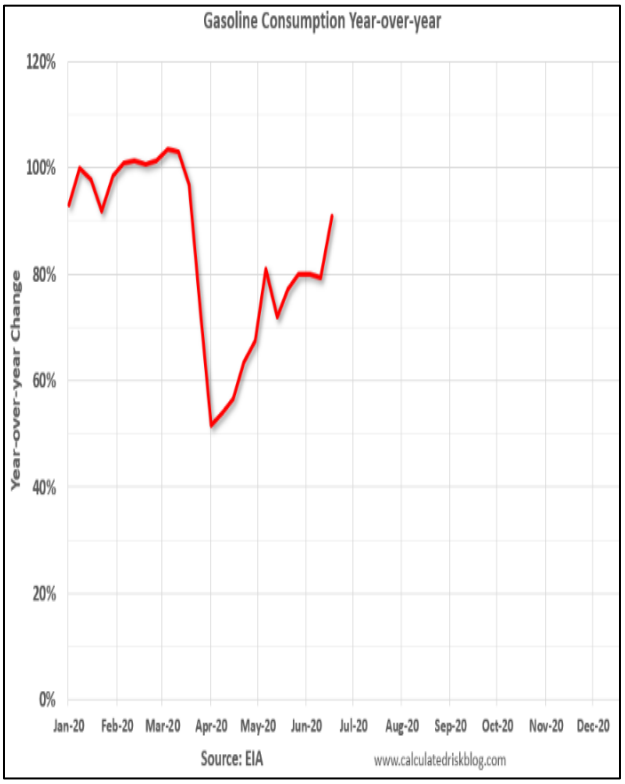

**Continuing Unemployment Claims**

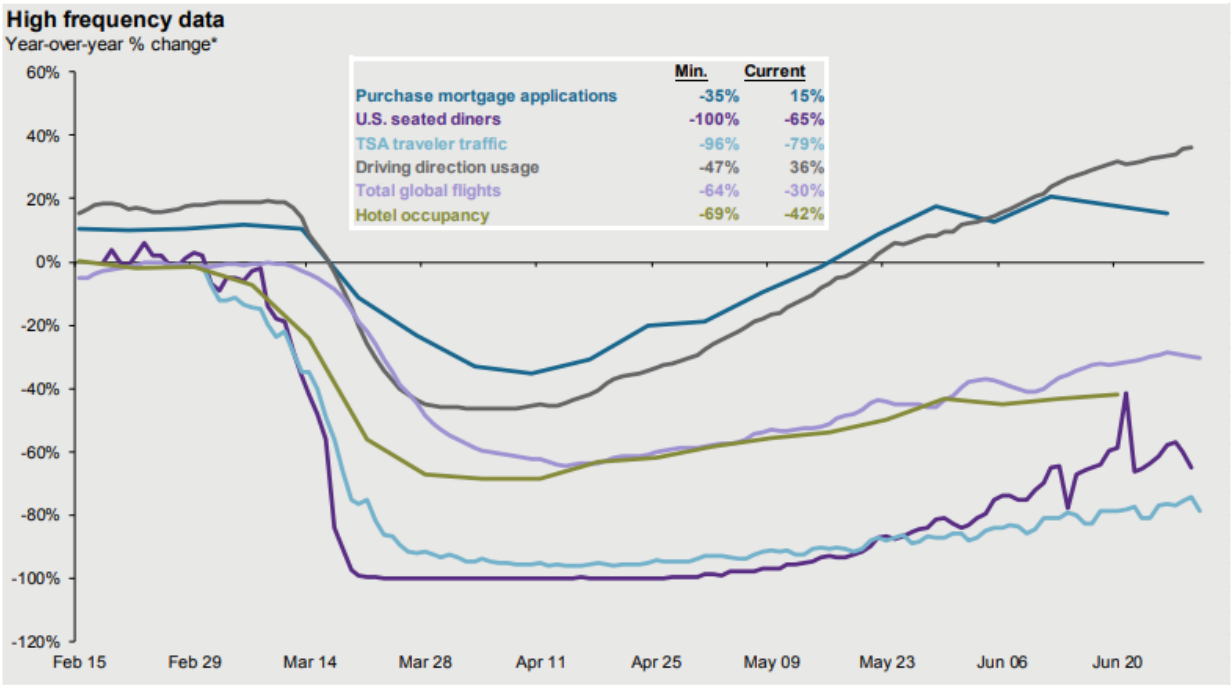



Other economic statistics also point to a recovery**.** Federal Reserve Bank of New York Governor, John Williams, stated in an interview on June 30th that the low point of economic activity is already behind us, but the pace of growth will be slowed, but not derailed, by recent COVID-19 outbreaks in several states. The data points seem to confirm this. Although the data is weak, recoveries are taking place across the economic spectrum and leading indicators like freight rates, purchase mortgage applications, and used car prices, are actually

hitting new highs, while some of the most affected areas from COVID-19, like travel, gasoline consumption, hotel occupancy, and air travel are improving off of their lows.



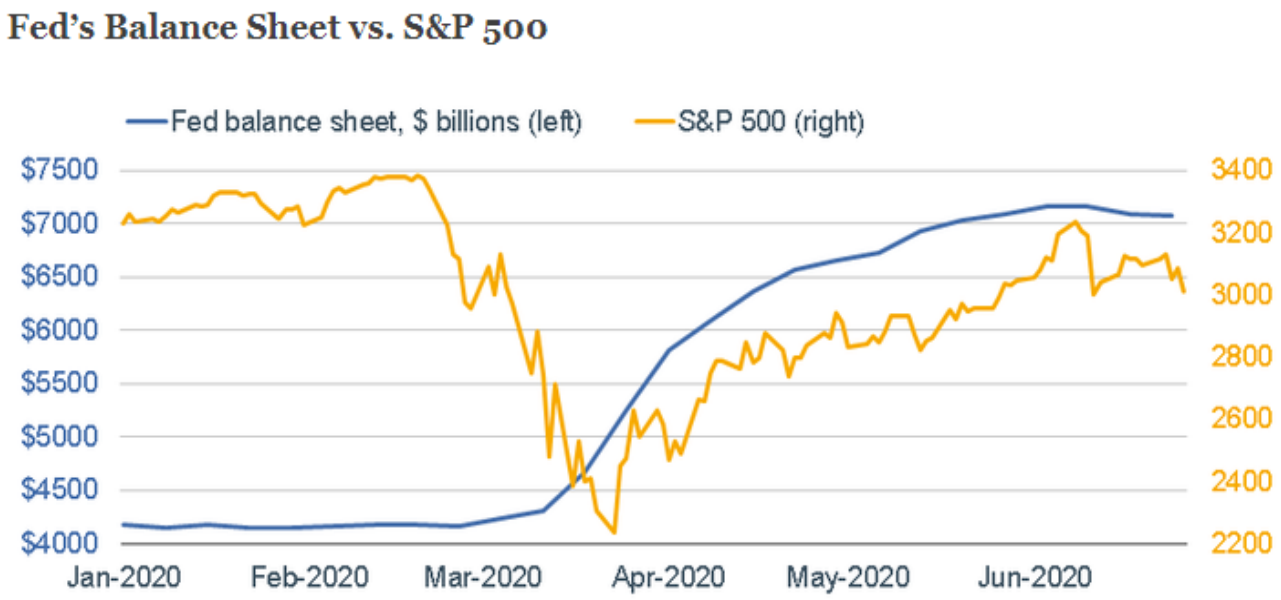

Source: Apple Inc., FlightRadar24, Mortgage Bankers Association (MBA), OpenTable, STR, Transportation Security Administration (TSA), J.P. Morgan Asset Management. *Driving directions and total global flights are 7-day moving averages and are compared to a pre-pandemic baseline. *Guide to the Markets – U.S.* Data are as of June 30, 2020.

In addition, a record $2 trillion of additional cash has been piled into the deposit accounts of U.S. banks since the Coronavirus pandemic first hit the country in January, according to data from FDIC (Federal Deposit Insurance Corporation). In the week ending June 10, deposits in U.S. banks totaled $15.47 trillion, that is nearly $2.2 trillion more than the $13.3 trillion that banks had in their deposit accounts at the end of February (FDIC data). Now that the Federal Reserve Bank has taken interest rates down to 0%, how long will that $2 trillion stay in banks before it moves back into higher earning investments like housing or the stock market? We suspect that as the economy improves, that money will move back into higher earning investments.

Perhaps the biggest reason for optimism that the market will recover from its losses this year is that the government is pulling out its playbook from the Financial Crisis of 2008-2010. It is now implementing the same programs that worked back then and also adding a few new ones as well. During the Financial Crisis it took the Federal Reserve two years to institute all of its recovery programs. The current Federal Reserve Chairman instituted these same programs in one month (March) during this pandemic. Combined with the new Payroll Protection Program and direct stimulus checks, these programs equate to more than 25% of the gross domestic product of the United States, according to the Congressional Budget Office.

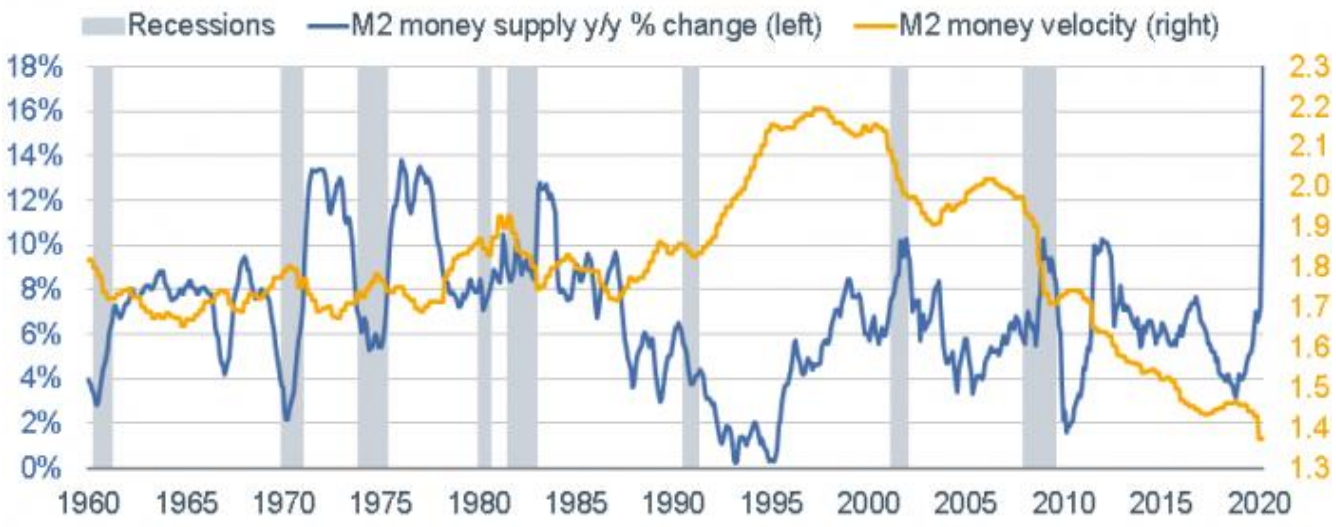
Indeed, as the Federal Reserve has expanded its balance sheet, the S&P 500 has rallied (see chart below); this is also what happened during the Financial Crisis. The way the Federal Reserve is expanding its balance sheet is by providing market makers cash to repurchase bonds on the open market. The market makers are then giving the Federal Reserve the bonds as repayment for the cash. This is helping provide liquidity and stability in the bond market in a time when a lot of people are selling to raise cash for COVID-19, and it is preventing panic

selling. As the bonds are repaid, the Federal Reserve is deleting the currency which should prevent inflation. In the meantime, investors are getting cash in a period of zero interest rates; increasingly, that money finds its way back into the equity market.




Source: Charles Schwab, Bloomberg, as of 6/26/2020.

Inflation from the money printing should also be subdued because economic activity is still far below normal, as measured by the velocity of money. (See chart below)



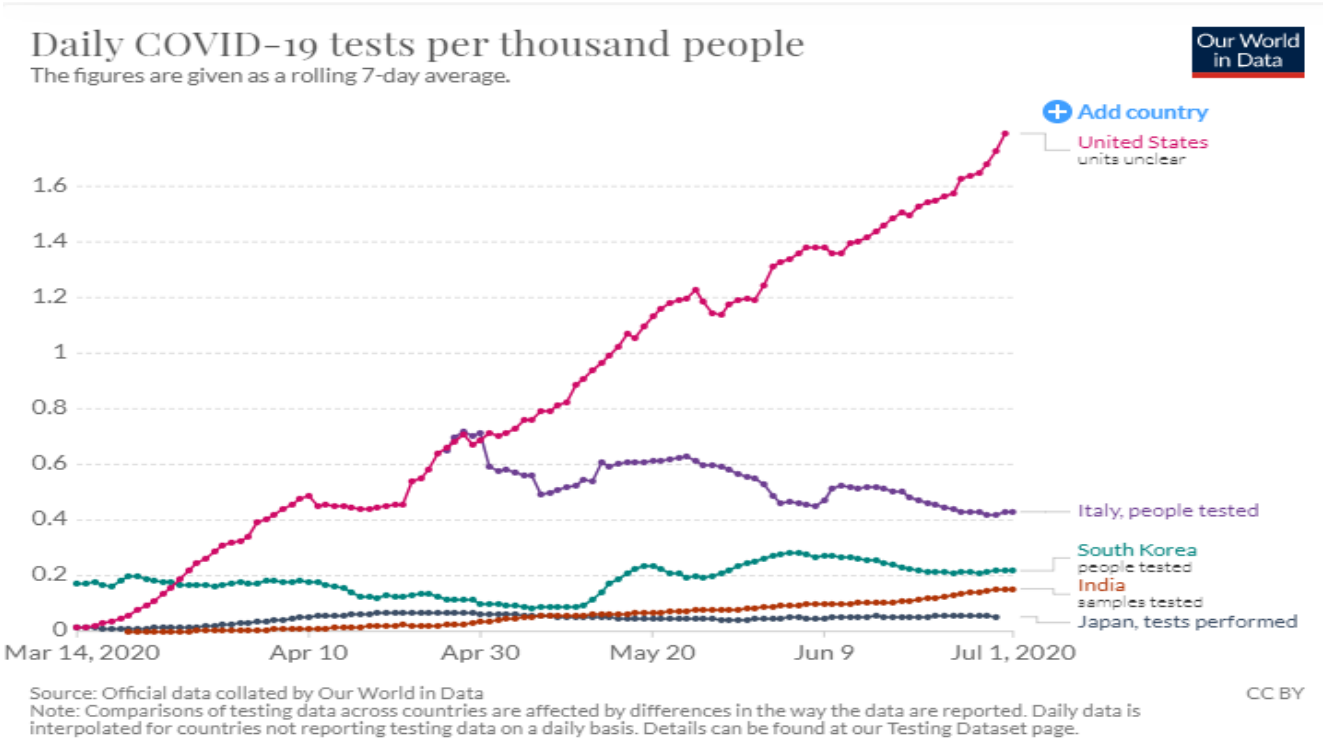

Source: Charles Schwab, Bloomberg, Federal Reserve Bank of St. Louis, as of 4/30/2020. **The velocity of money is the number of times one dollar is spent to buy goods and services per**

**unit of time. If the velocity is increasing, then more transactions are occurring between individuals in an economy.**

Since there is still so much spare capacity in the economy as measured by the unemployment rate, inflation should not pick up even though the Federal Reserve is printing money. Instead, asset prices like equities and real estate should rise (more dollars chasing few real assets). At least this is what happened last time during the Financial Crisis when the Federal Reserve used this program on a large scale**.**

## Treatment Options for COVID-19 Continue to Improve

The reason for the 44% overall market sell-off in March was due to the outbreak of COVID-19, and the market continues to watch and trade off of the daily COVID-19 infection, death, and hospitalization numbers. So, we would be remiss to not give an update on COVID-19. Fortunately, the treatment options and death rates for COVID-19 are improving, even though we have seen a spike in new cases. According to USA Today, since Memorial Day, the number of new cases has changed with over 55% of new cases occurring in people under age 45. Earlier in the pandemic, COVID-19 was predominately affecting people over age 50. The increase in younger people catching the disease is attributed to a lack of social distancing (especially at bars), not wearing a mask, and gathering in groups. The increase in confirmed infections is also due to the fact that the United States is now testing at a much higher rate than the rest of the world, so we are actually identifying more of those who have been infected.




Treatment options have come a long way in the last three months as well. In an interview with the New York Times on June 24th, Dr. Martin J. Landray, the United Kingdom's Dexamethasone study's senior author and a professor of medicine and epidemiology at Oxford University, said Dexamethasone was beneficial for those who had been sick for more than a week. Dexamethasone reduced deaths by one-third among patients on mechanical ventilators and by one-fifth among patients receiving supplemental oxygen by other means. The drug was tested in a clinical trial that included some 6,425 patients in Britain.

"It's almost like a disease with two phases," Dr. Landray said. "A first phase where the virus dominates, and the immunological phase, where the damage the immune system causes is dominant." "In the early phase of the illness, the immune system is your friend," Dr. Landray said. In this phase, the Gilead drug Remdesivir is helpful because it blocks the RNA of COVID-19 from being replicated; this in turn prevents the virus from multiplying. So, Remdesivir is

good if taken early and has shown to cut hospital stays by 30% (New England Journal of Medicine). If a patient continues to get sicker, the immune system goes into overdrive and begins to attack the body in a second stage; this is where the steroid Dexamethasone could be useful.

"In the first phase the immune system is fighting the virus, and dampening it is not a good idea." "In the later phase, the immune system is no longer your friend — it's responsible for the lungs failing, and dampening it down with steroids helps the situation and improves the chance of survival." In this phase, the steroid Dexamethasone is helpful by reducing inflammation according to Dr. Landray.

In other positive news on treatments for COVID-19, the University of Texas completed a small CDC (Center for Disease Control) Study of 25 patients that showed a 76% drop in the death rate from COVID-19 from the sickest patients. Pre-Peer reviewed medical journals, like MEDrxIV, are also showing 40-70% drops in the death rate using Blood Plasma Therapy. Hopefully, more peer reviewed and larger double-blind studies will be coming out shortly to confirm these numbers.

In an interview with Barron's financial magazine on June 20th, Geoffrey Porges, a doctor and biotech analyst at Investment Firm, SVB Leerink, suggested that the three leading COVID-19 treatments could be combined to lower the death rate by a larger percentage than just one treatment alone. According to Porges, "There is no reason to believe that a combination of Remdesivir and Dexamethasone and convalescent plasma might not give additive benefits such that you could be reducing the mortality by 60% or 70%, not 30% or 40%." If Porges is correct, the COVID-19 virus could become much less scary and deadly, and life may return to normal for many people more quickly.

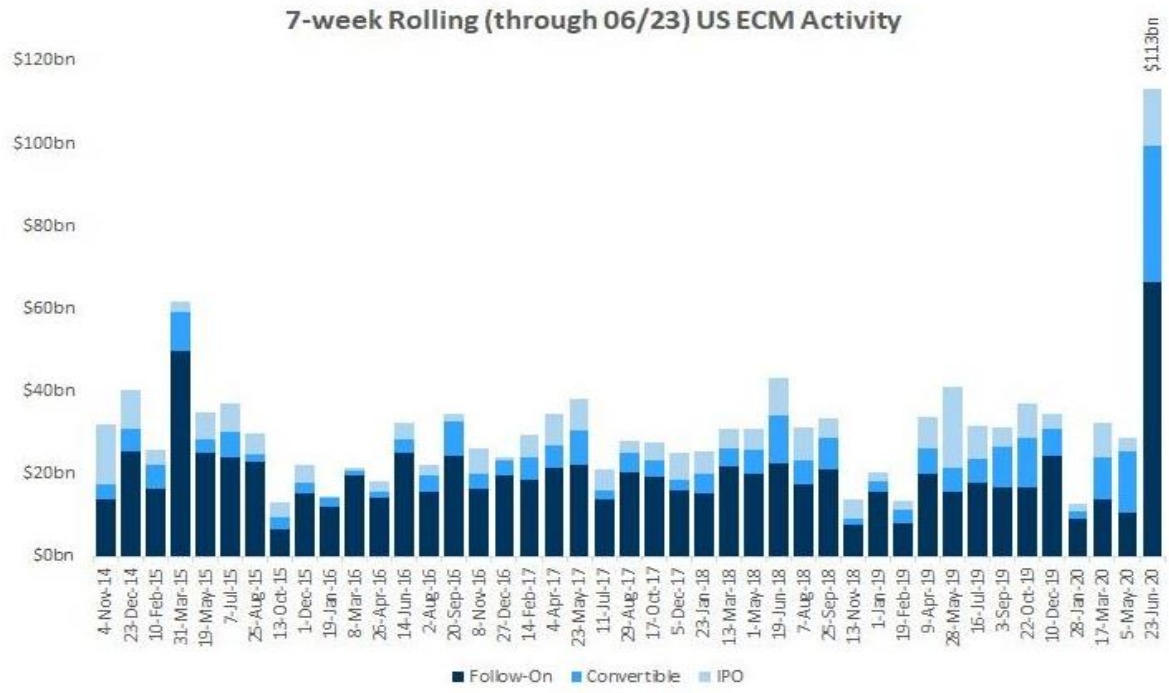
Indeed, the death rate of COVID-19 has been coming down in part because of these new treatments. The ultimate answer is still a vaccine, and Johnson & Johnson, Pfizer, Moderna and AstraZenca all have publicly stated that they think they will have a vaccine by the end of the year at best and the first half of 2021 at worst.

**Why we expect a "U" shaped (slow) rather than a "V" shape (quick) Recovery**

Despite all the stimulus, an improving economy, and better COVID-19 treatments, we still expect a full recovery will take longer, most likely well into 2021. The market initially rebounded after a stronger than expected jobs report. However, according to Barron's, the positive jobs report took place before the uptick in Coronavirus cases. Moreover, the total number of people claiming unemployment benefits still stands at over 20 million. This is nearly 15% higher than the "official" unemployment rate. According to government statistics, you have to be looking for work to be classified as unemployed, but not need to do so in order to claim benefits. Thus, the 11.1% unemployment figure is understating the true environment. Moreover, U.S. Bureau of Labor Statistics reports that nearly 10% of the U.S. workforce (16.78 million people) is employed in the hospitality industry (airlines, hotels, restaurants, etc.). This sector is having a hard time conducting business under the current conditions. We believe that until COVID-19 is under control, higher rates of underemployment in the hospitality sector will cause unemployment to remain at elevated levels.

Next, the United States, as well as the rest of the developed world had high debt loads going into this crisis. Debt loads across the world have gone up substantially to deal with the current crisis. At some point, this money will have to be paid back. That means higher taxes are likely and future taxes cuts are most likely off the table. Empirical evidence has shown that high debt loads slow economic growth, and our debt now stands at record levels.

In addition, Equity Capital Markets are at record issuance (see chart below). Over $100 billion of new capital has been raised by U.S. companies in June alone. This money will help the large companies get through the current crisis until the economy fully reopens and act as support for current economic activity. On a negative note, it will also hurt future returns, as ownership has been diluted. Over the past decade, companies have steadily repurchased shares which helped create higher earnings. With fewer shares outstanding, the same level of earnings causes the per share earnings to be higher. With COVID-19, the opposite is happening; companies are raising money which is giving them the capital they need to survive until after the pandemic is over. This is good and shows the capital markets are working. However, it will hurt future earnings per share, and future earnings growth as there are more owners in the companies, but the same level of earnings.



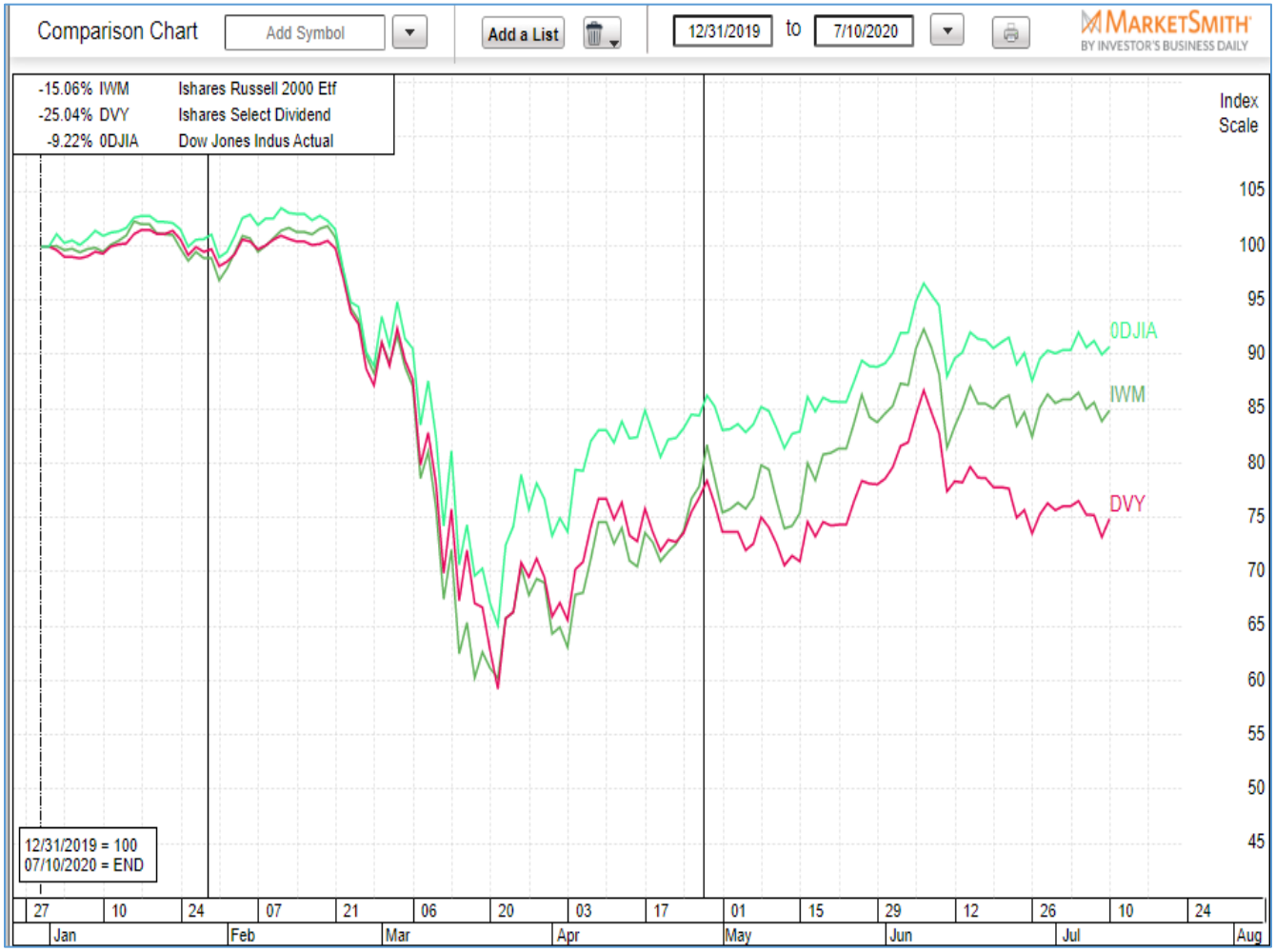

**Source: Goldman Sachs Research Division, Aditya Sharma, Dealogic. As of 6/24/20. Past performance is not indicative of future returns.**

Market concentration is another risk. Part of the reason for the market rally is that the total market capitalization of the U.S. market is now the most concentrated it has been in over 40

years. The top five largest companies in the USA (Microsoft, Amazon, Apple, Google and Facebook) now account for over 20% of the entire value of all publicly traded companies. These five companies have also directly benefited from COVID-19, as the world has moved at an accelerated pace to digitalization, online ordering, online communication, and remote working using the tools these companies supply. The market value of Microsoft and Amazon ($3.2 trillion), the two leading companies in web hosting for companies working remotely, is now worth much more than the entire economic output of England (England Gross Domestic Product 2.7 trillion).


These top five companies are having a strong year that mask the overall weakness of the rest of the market, which is generally doing poorly. According to William O'Neil + Co. (7-10-20, see chart below), the Russell 2000, which looks at the largest 2000 companies, is actually down over 15% this year, while the Dividend Index is down over 25%. The Dow Jones is down over 9%, while the top five tech companies are all up on the year. These five companies now

trade at heightened valuations, which will make it harder for them to continue to lead the market higher.




In conclusion, the market rallied in May and June due to tremendous amount of monetary and fiscal stimulus that has been released into the economy in response to COVID-19. Fortunately, the stimulus is working, and the economy is rebounding. The race for a COVID-19 treatment and vaccine is progressing. We also believe that with interest rates at zero percent, combined with record amounts of stimulus and cash currently held at banks, the market will continue to have support as it is one of the few places to actually earn a return on your money. However, we also forecast that longer-term growth rates will be subdued as the national debt builds and the Federal Reserve balance sheet has become bloated. Furthermore, the uptick in

employment took place before the recent spike in COVID-19 cases, so future months could show fewer gains. Moreover, American companies which had been buying back their own stocks (putting upward pressure on stock prices) have now raised over a $100 billion dollars of new equity to get them through the COVID-19 crisis. The new equity raised acts as the opposite of share buy backs, and while it gives companies needed cash now, it will dilute future returns. As a result, we do not believe that a full economic recovery will take place until a vaccine is discovered, and the threat of COVID-19 is behind us. Thus, we believe the current economic recovery will be "U" shaped (slow recovery) rather than "V" shaped (quick recovery).

We hope you have the best summer possible. We thank you for your continued support.

Sincerely,

James F. Schnieders, CFA
Principal

John C. Schnieders, CFA, CFP®
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William H. Schnieders, M.B.A
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