HIRTLE CALLAGHAN & CO

Chief Investment Officers

INVESTMENT PERSPECTIVE 3Q 2020

RIDING ON THE "V" TRAIN – DO WE KNOW WHERE IT'S HEADING?

"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people."

- Andrew Mellon

History remembers men as often for what they do not do as for what they do. Such is our debt of gratitude to Andrew Mellon for our current good fortune. Mellon served as Secretary of the Treasury from 1921 to 1932 under three successive administrations. He became immensely influential as a voice for fiscal rectitude. His laissez-faire advice to President Hoover at the onset of the Great Depression stemmed from a deeply-rooted Scots-Irish sense of personal accountability. It was also deeply unpopular. The public reviled him to such an extent that he narrowly avoided impeachment. Generations of economists would lay at least some blame for the depth of the Depression for his opposition to opening up the taps of fiscal spending. The playbook of crisis response policy is now directly opposite Mellon's views.

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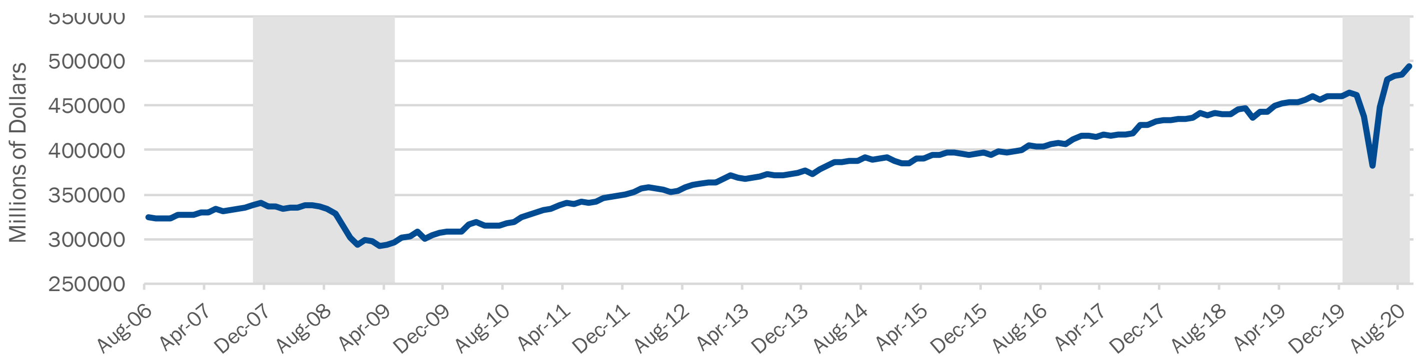
(Continued)

Back in the mists of time - this past April - the parlor game of economists was predicting the shape of the recovery. Popular choices ranged from V to W to Nike Swoosh to square root. Clearly stock market investors bet on a V-shaped rebound. And that seems pretty close to the reality so far. From the sudden stop of complete lockdown, the world economy has staged a miraculous recovery. The U.S. has recovered one half of the 22 million lost jobs. U.S. retail sales (chart below) have exceeded the prior trend. Estimates for U.S. third quarter GDP are tracking at +35% quarter-over-quarter (seasonally adjusted annual rate) vs. -31% in the second quarter. That certainly resembles a 'V'. China has performed even better. Its output in the third quarter grew 4.9% over the prior year - almost back to prior trend.

Advance Retail Sales (Excluding Food Services) Monthly, Seasonally Adjusted



Source: St Louis Federal Reserve, Census Bureau. As of September 30, 2020.

Of course, the W and √ are still plausible. The virus seems to be staging a resurgence – somewhat ominously in colder places like Europe and the upper midwest in the U.S. Many small businesses are teetering. Any enterprise that relies on proximity - hospitality, travel and real estate - are still challenged by a secular shift in preferences. But new fiscal stimulus and continued monetary accommodation are almost assured. On balance, the optimists have the upper hand.

One of our astute clients (aren't they all?) recently posed the tongue-in-cheek question "Where is the money coming from?" Of course, the government's largesse is coming from us. Or at least from our future selves and generations of unborn American taxpayers. (Let us a say a small prayer for a strong birth rate.) When the economy has ample spare capacity and minimal inflation and a negative real cost of capital, the obvious choice is to spend it now to keep resources engaged. It may be the right policy for today, but let's not fool ourselves. The opportunity cost of $4-6 trillion in incremental deficit spending by the U.S. must be borne by some reduced future spending.

Let us spare a thought for at least a part of Secretary Mellon's argument. Our current policy of liquefying as opposed to liquidating will have other costs. At least part will be the moral hazard that we are encouraging. Those egregious change fees and baggage charges you paid U.S. airlines the last 10 years apparently did not go into a rainy-day reserve fund. The airlines instead levered and repurchased stock (that was the basis for their incentive plans). I am picking on airlines but their situation is broadly emblematic of U.S. corporations. I imagine that rather than let the 'enterprising people' pick up from the 'less competent,' we will keep a raft of zombies afloat. Bagehot once wrote that the one way to ensure that no responsible bank was ever formed again was to bail out an insolvent one.

The silver lining of the virus is a potential productivity gain. By necessity we have learned to operate an economy remotely. Hours of business travel, commuting and waiting in medical offices have been spared. And billions of new capital are being directed at businesses that enable the virtualization of all activities. The creative destruction of the in-person and the capital intensive by the instantaneous and capital-light is accelerating. The great dichotomy in the stock market between information technology and everything else is a real time score card of that process.

Our investment discipline attempts to balance the costs and benefits from the current environment. We have to understand how much has been priced into current securities valuations - both the positive and negative implications. We are slightly cautious on global equities. Within the overall neutral weight to stocks, we are however overweight the U.S. given its greater weight to productivity-enhancing beneficiaries and underweight Europe and Japan. We are underweight fixed income duration and long exposure to inflation with a view that more stimulus will be forthcoming. Markets now seem finely balanced. Stocks are expensive, but the direction of least resistance seems to be recovery. We will continue to watch both market pricing as well as indicators from the real economy very closely.

—T. Brad Conger, CFA
Deputy Chief Investment Officer