

July 31, 2020

BLUME CAPITAL MANAGEMENT
Third Quarter Newsletter

Surprisingly, given the ongoing global pandemic, stocks staged an impressive comeback in the second quarter. Following the worst three-month period for stocks since 1987, the S&P 500 gained 20.5% and almost erased year-to-date losses, a seemingly unimaginable result given the prevailing environment. However, the mega-cap, technology-heavy index masked larger declines for the majority of companies as the median S&P 500 stock remained more than 20% off its previous high.

Foreign stocks, as measured by the MSCI All-Country World Index Ex-U.S.¹, rebounded 17% in the quarter but trailed their U.S. counterparts given a smaller weighting to large technology companies. Emerging market equities returned 18%, while developed country stocks returned 15%.

In contrast, bond yields remained near the lows of the first quarter with the 10-year Treasury yield barely declining from .67% to .65%. The massive ongoing bond purchases made by the Federal Reserve to head off an economic collapse likely distorted true pricing trends and will keep rates low for the foreseeable future. Yields on corporate credit declined even further and the broader U.S. bond market returned 2.1% (bond prices move inversely to yields).

INDEX	Second Quarter <small>03/30/20 – 6/30/20</small>	Six Months YTD <small>12/31/19 – 6/30/20</small>	Twelve Months <small>6/30/19 – 6/30/20</small>
S&P 500 Total Return ¹	20.5%	-3.1%	7.5%
DJIA Total Return ¹	18.5%	-8.5%	-0.6%
MSCI All-Country World Index Ex-U.S. ¹	17.0%	-11.2%	-4.7%
Barclays Int Agg. Bond Index	2.1%	4.7%	6.6%

Market Perspective

The question we have repeatedly received from clients over the past several weeks is, “how can the market be performing so well and yet seemingly remain so disconnected from the real economy?” We, of course, don’t have definitive answers, but hopefully we can share some perspective to help explain why markets are behaving as they are.

First, it is important to remember that the stock market is always forward looking. It often generates the highest returns not when things are good (by then everyone already knows it), but when things are getting less bad. We are certainly digging out of a deep economic crater left in the wake of the Covid-19 shutdowns, but the global economy is healing. While unemployment is still disturbingly elevated, it is improving, and many economic indicators have rebounded sharply.

¹ Includes dividends in addition to index price appreciation.

Second, there is a very important linkage between interest rates and equity prices, and the Federal Reserve’s commitment to keep rates low until the economy fully recovers has a real and significant impact on stock prices. A little over a year ago with the S&P 500 trading not far from where it does today, the investing legend Warren Buffett said, “If you tell me that **3 percent long bonds (30 year Treasuries)** prevail over the next 30 years, then stocks are incredibly cheap. Interest rates govern everything.” To put that observation into perspective, note that the 30-year bond yield has now declined **from the 3% level Buffett referenced to 1.3%.**

Recall, a company’s next 12 month’s earnings typically account for a relatively small portion of its total value. If you believe we will eventually control the pandemic and are invested in durable companies with the financial strength to survive the downturn, then the stimulative actions by the Fed have largely offset the broader hit to equity values caused by the virus.

Lastly, it is important to be clear about the underpinnings of the stock market. As we write this note, the S&P 500 is within a few percentage points of its all-time high, but, as noted in the opening of this letter, that measure masks extreme divergences between different sectors and stocks within the index. As shown in the adjacent chart from Merrill Lynch, if the index was just based on the tech and healthcare sectors plus Amazon and Google, the index would already be up 23% year to date and over 4,000. However, all the remaining stocks would be down over 10%.

Tech/HC vs. Everything Else:

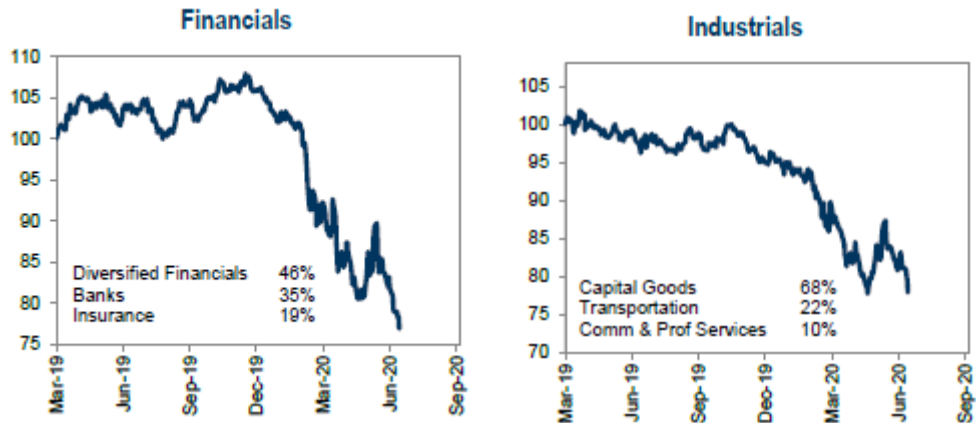


As the societal responses to Covid-19 have magnified and accelerated trends in place before the pandemic, many of the same leading stocks have become even bigger winners. Indeed, we are now witnessing the most top heavy and concentrated market in history with the top five S&P 500 companies (Apple, Amazon, Microsoft, Google/Alphabet, and Facebook) accounting for nearly one-quarter of the S&P 500.

Percentage of S&P 500 Accounted for by Top Five Companies

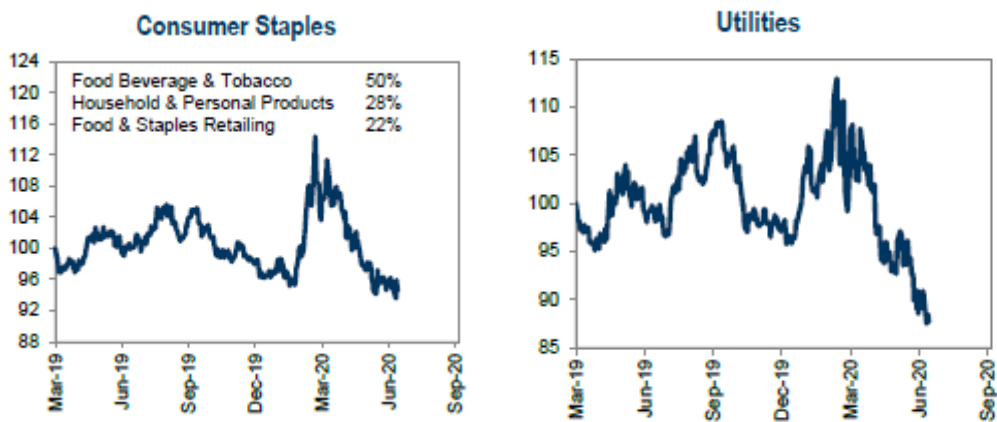


Meanwhile, many of the stocks at the epicenter of the pandemic (airlines, retail, restaurants) are still down more than 50%, and cyclical sectors remain significantly below the broader index. The charts below show the relative performance of the S&P 500 financial and industrial sectors, which have yet to recover.



Source: Goldman Sachs

Even the previously beloved “safety” stocks that investors fled to in the early weeks of the pandemic have significantly underperformed since March, as shown by the relative performance charts of the S&P 500 consumer staples and utilities sectors.



Source: Goldman Sachs

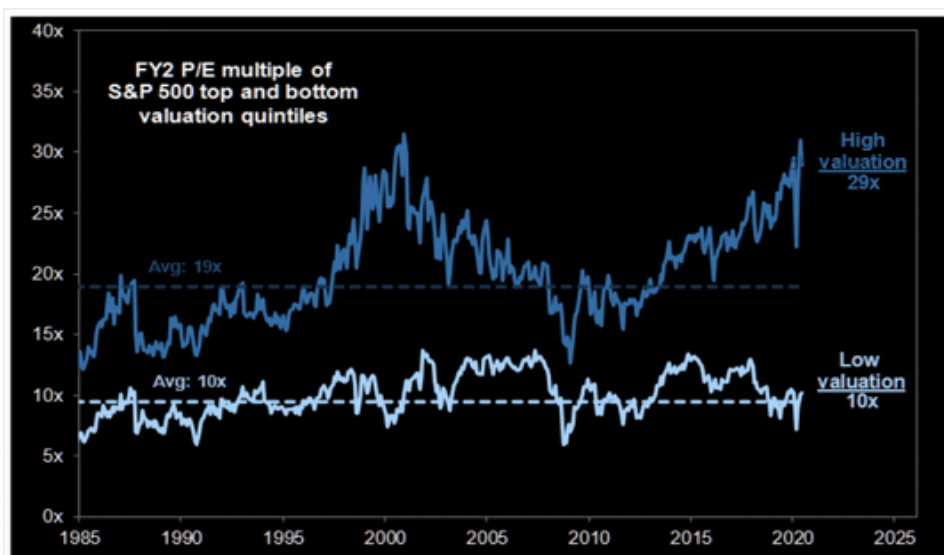
Clearly, the market’s leadership has increasingly narrowed to a handful of mega-cap tech stocks and perceived Covid-19 stay-at-home winners. The question is whether the scale of these divergences is justified and sustainable?

As we continually strategize about how to position client portfolios, we always start by benchmarking off of the safest assets in the world, a role traditionally occupied by U.S. Treasury bonds. However, if you define safety as maintaining the real value of your investments over the long term (i.e., able to purchase the same amount of goods in 2030 after accounting for price inflation) then Treasury bonds are no longer safe. It is now highly probable that the buyer of a 10-year Treasury note at a .6% yield today will have less purchasing power at the end of the 10-year holding period during which inflation is expected to run at least 1.5% annually (a return of only 0.6% minus a 1.5% loss to inflation would suggest a 0.9% loss in purchasing power per year).

On the other hand, consider mega-capitalization U.S. technology stocks, several of which we own. Many of these names are popular, widely owned, expensive, and offering lower prospective returns. However, these companies also have strong competitive positions, fortress balance sheets, growing end markets, revenue streams insulated from Covid-19, and massive cash flow generation. Investors are saying these companies are relative safe havens in today's world, offering stability and returns superior to bonds. We agree and continue to hold significant positions, although we are monitoring valuations and are alert to potential regulatory risk.

Lastly, investors are largely choosing to ignore more cyclical areas of the market even though many of these companies are well positioned to weather the pandemic and trade at exceedingly attractive valuations. In our last letter, we collectively referred to these as "Durable Cyclical." As shown in the chart below, the valuation difference between the most expensive and least expensive stocks is at the widest level in history, except perhaps for the 1999-2000 dotcom era. In our view, and with the assumption that we do eventually find a cure for the virus, the Durable Cyclical currently offer the most attractive risk-reward proposition in the market.

Price-Earnings Valuation of Most Expensive (dark blue) vs. Least Expensive (light blue) S&P 500 Stocks



Source: Wall Street Journal Daily Shot

Outlook

We would guess that many of our clients are spending a lot of time reading about the virus and vaccine trends. We, too, are constantly studying scientific data and developments that we never thought would be part of our investment process – regional case counts, hospitalization rates, death projection models, drug trials, mobility indexes, etc. It is unlikely that we can add any new insight on this topic. However, based on what we know today, we are relying on three primary judgments to guide our investment decisions:

- 1) We just endured the deepest recession since the 1930s, but it is over. Barring a substantially new and negative development with the virus (e.g., a mutation), the economy is recovering, even if it will likely be a long and bumpy ride.
- 2) Global policymakers are determined to head off the worst-case outcomes. They have provided massive stimulus that appears sufficient to bridge us to recovery and will provide more if needed.

3) Even if the timing is uncertain, science will eventually deliver a medical solution that allows the world to return to some semblance of normality.

Of course, all is not rosy in the world. With the direct hit to our service economy, millions of lower-skilled jobs have vanished overnight, and thousands of businesses have been ruined. Our premier U.S. cities may look very different in a couple years as retail, restaurants, hotels, and commercial office space all face secular headwinds, if not outright threats to their survival. It will likely take years to fully recover.

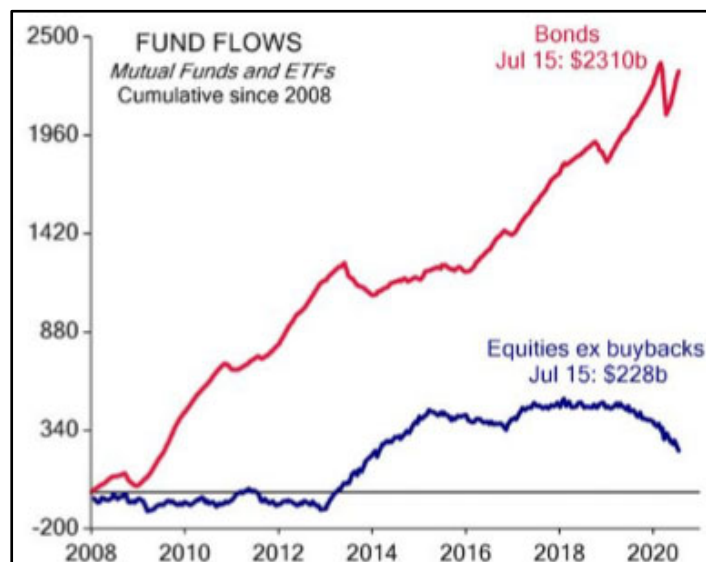
Furthermore, as is often said in the investment world – “there is no free lunch” - and there are likely to be long-term costs associated with the unprecedented, albeit necessary, actions taken by central banks and governments.

To reiterate, we are in a world where there is now virtually no opportunity to earn any “real” return (after inflation) in lower risk bond investments. Additionally, stimulative policies have boosted stock prices (and the economy by extension via the wealth effect), but in doing so have pushed valuations to expensive levels, effectively borrowing from the future and lowering prospective equity returns. Indeed, some momentum sectors and favorite cult stocks look to be in outright bubbles.

Finally, as we’ve highlighted on numerous occasions, the combination of massive government deficits and bond purchases by the Fed to effectively fund the government’s borrowing needs meaningfully increases the risk of currency debasement and inflation down the road. With Treasury yields nearing zero, we are likely approaching the limits of those policies, meaning the longer-term costs (higher inflation and/or a weaker currency) could materialize sooner than expected.

Interestingly, while we’ve seen a nascent move to protect against these risks (i.e., such as buying of gold and inflation protected bonds), most investors remain biased towards traditionally defensive areas. As shown in the chart below, money continues to flow into bonds and out of stocks, despite the risks to bonds outlined earlier in this note. If investors continue to follow this playbook, their portfolios will likely struggle, even if we see just a modest shift in the macro environment towards higher inflation.

Fund Flows into Bonds (red) and Stocks (blue): 2008 - Present



Source: Evercore ISI

Counterintuitively, in today's environment, we believe investors need be prepared to accept greater short-term volatility in order to construct safer, long-term portfolios. With a heavier weighting towards our Durable Cyclical theme and an allocation to precious metals and real assets, we believe client portfolios are well positioned to outperform when the world returns to "normal" while also protecting against the risk of higher inflation.

Closing Thoughts

We acknowledge that it is difficult to summon much optimism when we are enduring a global pandemic, watching a rapidly deteriorating relationship with China grow worse by the day, experiencing widespread social unrest, and anticipating a fractious political season. Indeed, we expect that investors will soon turn their attention towards the upcoming elections.

While it is still some time until November, the odds of a Democratic sweep appear increasingly likely. For investors, this outcome would likely bring some positives (infrastructure spending, reduced trade frictions) and negatives (higher taxes and regulation). On balance, we wouldn't expect the fundamental impact to be overly significant, but it could create near-term selling pressure, particularly if we see an increasing probability of higher capital gains rates. We'll share further thoughts on the election in our next letter.

We hope this note was helpful in providing some perspective on recent market developments. In spite of the many obstacles, in our view, your assets are well-positioned to navigate the potentially stormy days ahead.

The challenges of shelter-in-place notwithstanding, we hope you are enjoying as lovely a summer as possible. Stay safe and healthy.

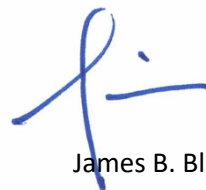
Sincerely,



Peter B. Reidenbach



Jeffrey V. St. Claire



James B. Blume

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