Introduction

The global economic contraction triggered by the COVID-19 virus has occurred at a greater speed, scale, and breadth than any other recession since World War II. In the 1970s, we had the recession driven by supply-driven oil-price shocks caused by production cuts. In the early 2000s, we had monetary tightening in response to inflation, and in the late 2000s, we had an unwinding of large-scale financial imbalances.

The current economic crisis has been a deliberate policy-induced cessation of economic activity to suppress the spread of the COVID-19 virus starting in mid-March. The result has been a dramatic and rapid demand, supply, and financial market shock occurring simultaneously, interacting with and magnifying each other. In the U.S., GDP declined by 4.8% in the first quarter of 2020. As the virus spread globally, the suppression shocks hit both the supply and demand side across a large range of industries, including recreation, travel, tourism, and large portions of retail. Where during previous economic downturns manufacturing activities faced larger swings, this downturn has had a disproportional impact on services. Social distancing measures have halted a large portion of economic activity that requires person-to-person contact.

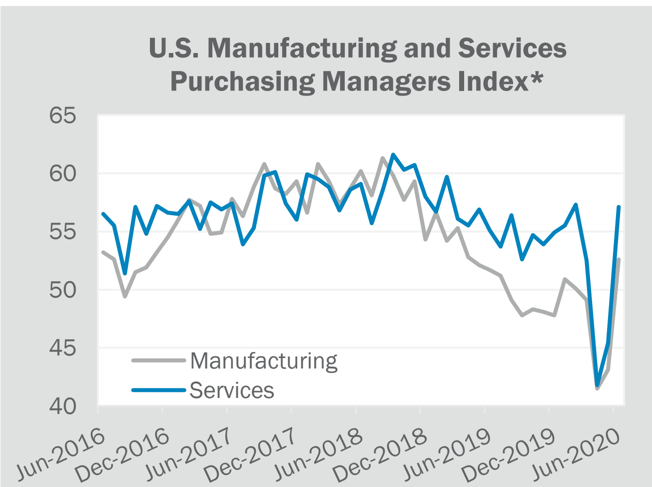

*Figure 1. Source: Institute of Supply Management. *A reading below 50 indicates contraction, while a reading above 50 indicates expansion.*

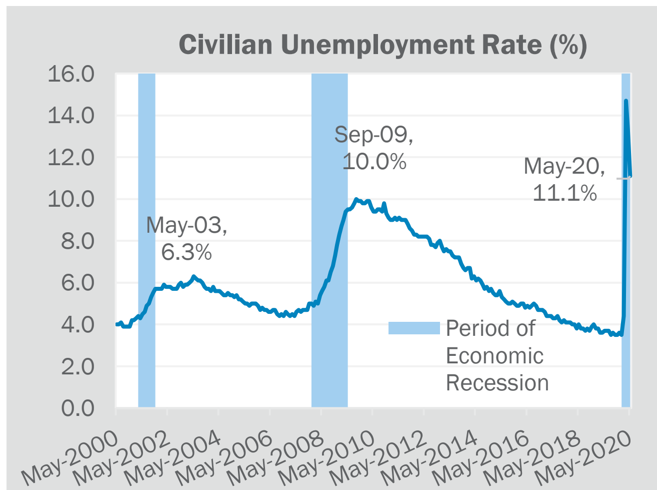

Figure 2. Source: Bureau of Labor Statistics

Swift and large-scale stimulus packages by central governments worldwide have helped provide temporary economic relief to individuals and businesses that have faced large income and revenue declines. New initiatives towards partial openings of businesses have also made an impact on bringing down unemployment from their recent peaks. The June Institute of Supply Management's (ISM) numbers for Manufacturing and Services indexes show a rebound back to levels over 50. However, if spikes in the number of COVID cases require suppression measures to continue, the lost spending and income in those sectors most affected will mount up to large demand shock for other sectors of the economy as the circular flow of income around the economy is impaired.

Further, while economic activity has stalled tremendously, financial obligations such as interest payments and mortgages, continue at their normal pace. Over short periods, these mismatches cause liquidity issues, but over longer periods, this can become a solvency problem, forcing otherwise viable businesses, contracts, and other economic matches into default.

The incidences of pandemic induced economic slowdowns in Asian regions over the last two decades generally showed steep declines followed by strong subsequent rebounds. This global pandemic may follow a similar path, particularly as we did not have any major imbalances that drove the downturn. However, the depth of the downturn and its global scale leaves a lot of uncertainty regarding the possible path to recovery. What will be the impact on government balance sheets, the path for growth, the path for interest rates, and inflation?

The rebound in the price of risk assets, across equities, commodities, and credit during the second quarter, would imply a possible V-shaped economic recovery, but we have also experienced a marked increase in market volatility, reflecting a lack of certainty regarding the recovery.

Equities

After a dramatic decline in equity markets over less than two weeks in the latter half of March, most equity markets staged a strong bounce back during the second quarter. Despite estimates of more than 40% decline in year-over-year corporate earnings for the second quarter, broad equity indexes had their best quarterly performance in over two decades.

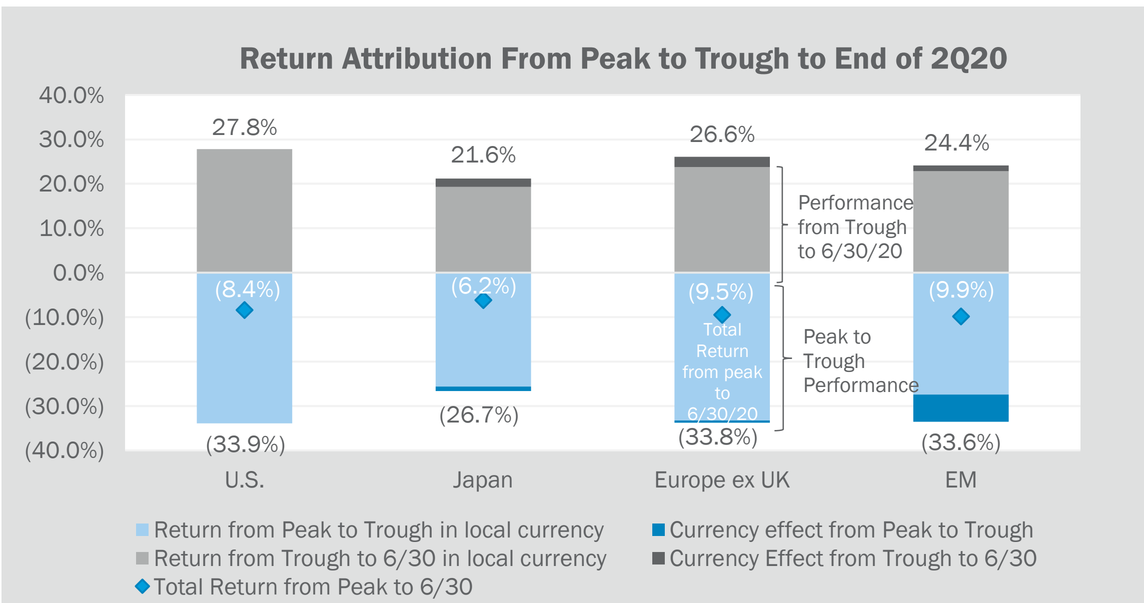

Figure 3. Sources: Standard & Poor's, MSCI

The R3000 Index was up 22% for the second quarter, while the MSCI ACWI ex U.S. and Emerging Market indices were up 16.1% and 18.1% respectively. The currency effect was negative during the downturn but was a positive effect when markets rebounded as the U.S. Dollar weakened relative to most currencies during the second quarter. Net of the large market swings over the four months, major country and regional indices were down less than 10% from their peak levels in the early part of the first quarter. Perhaps, equity markets are looking past the earning declines in 2020 and are looking ahead to recovering growth rates in 2021 and 2022. Another driver may be the lack of other attractive options. With most sovereign bonds yield curves having fallen to levels of near-zero rates, we feel that for investors with long investment horizons, equities provide a more attractive valuation. The S&P 500 Index has over 2% in dividends compared to the 10-year U.S. Treasury that is yielding under 0.7%. Over the near term, however, we may continue to experience single-day swings of several percentage points on news related to macroeconomic, political, or healthcare matters. Algorithmic trading and the activity of Quant traders have exacerbated this volatility, but that may be here to stay.

Between December 2019 and June 2020, the estimates for 2020 earnings for the S&P 500 has gone from a positive 10% growth to a 22% decline. The drop has been much more acute in sectors directly affected by the cutback in travel and consumer services. Energy companies have had to face losses in gross margins given the additional cost incurred to store their growing inventory. Sectors that have benefited from the quarantine conditions, such as Technology, have also seen the most improvement in performance.

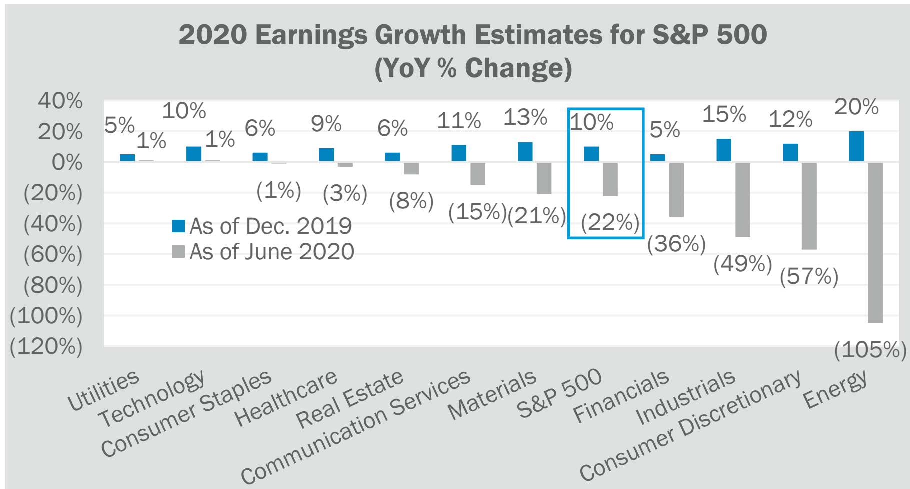

Figure 4. Sources: Standard & Poor's, Factset, JP Morgan

The performance disparity is most evident in the performance of the various style benchmarks. In the U.S., the Russell 2000 Value Index is down 23.5% for the first six months, lagging the Russell 1000 Growth Index by over 3300 basis points. The same style differential is evident in non-U.S. equities as well. Over the near term, growth sectors such as Technology may seem to have brighter prospects, but the higher risk premium demanded by investors to hold the value names may also push up expected returns for those companies in the upcoming quarters.

1H 2020 Performance of Russell U.S. Indexes

	Value	Blend	Growth
Large	(16.3%)	(3.1%)	9.8%
Mid	(18.1%)	(9.1%)	4.2%
Small	(23.5%)	(13.0%)	(3.1%)

Figure 5. Source: Russell Investment Group

Fixed Income

The U.S. 10-year Treasury bond rates went from 2.0% to 0.6% at the end of March and remained close to that level over the second quarter. Core fixed income bond yields all declined in line with Treasuries. The Barclays U.S. Aggregate generates a yield of 1.25% at the end of June, which is less than the historic yield of a low duration bond strategy.

Corporate bond spreads continued to come in during the quarter as the Federal Reserve began making open market purchases of investment-grade bonds and high yield and higher spreads drew in investor capital. By the end of June, investment-grade spreads narrowed to around 200 bps over Treasuries and high yield spreads reduced to around 600 bps above Treasuries with comparable maturities.

Companies in Retail, Travel, and Energy offer more attractive yields on their bonds, but these come with a higher risk of default, as these industries continue to come under pressure. Leveraged loan and high yield

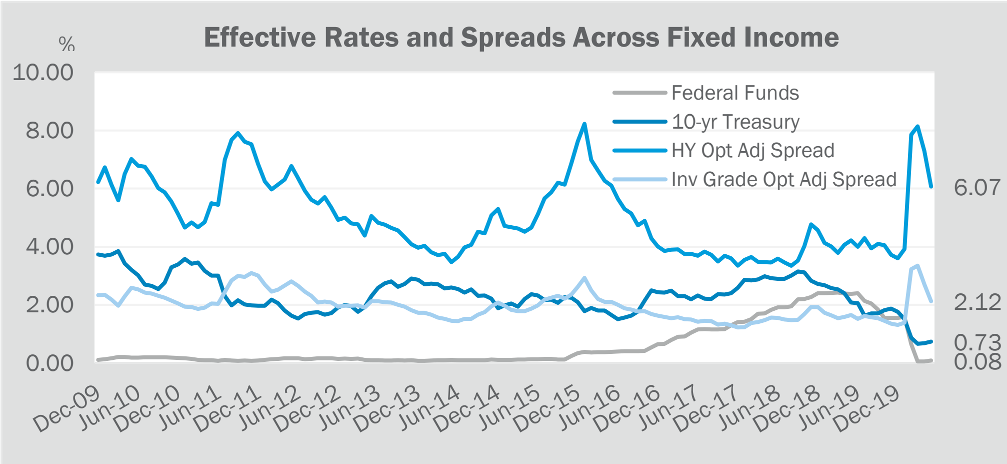

Figure 6. Source: U.S. Department of Treasury, Federal Reserve Bank of St. Louis

bond default rates have steadily risen over the course of this year, with several household names such as Hertz, Nieman Marcus, J Crew, and JC Penny defaulting on their debt.

We find that it has become increasingly difficult to find value in fixed income. Credit risk has gone up as the current recession puts pressure on businesses. At the same time, low rates and longer duration create a higher level of interest rate risk with intermediate core fixed income. Emerging Market bonds offer better yields, but they have a low correlation to U.S. core bonds and have higher volatility.

	6/30 Yield	YTD Return	Duration	Correlation to 10-year
U.S. Aggregate	1.3%	6.1%	6.0 yrs	0.88
Global ex U.S. Aggregate	0.8%	1.0%	8.1 yrs	0.24
U.S. High Yield	6.9%	9.4%	5.3 yrs	(0.25)
European HY	5.6%	(5.8%)	6.3 yrs	(0.28)
EM Debt ($)	5.5%	(2.8%)	7.3 yrs	0.09
EM Debt (Local Currency)	4.5%	(6.9%)	5.4 yrs	(0.04)
EM Corporate	4.7%	(0.2%)	5.7 yrs	(0.04)

Figure 7. Source: Barclays Capital

We had kept the duration of the fixed income segment lower than that of the Aggregate Index as a way to reduce the interest rate risk in the portfolio. We have been hurt by the shorter duration as rates have gone down further over this period. We do not expect much in terms of expected return from the core fixed income segment, but it remains valuable as an anchor during risk-off periods in the equity markets.

Liquid Alternatives

Hedge funds and liquid alternative mutual funds benefited from the bounce back of equity and credit markets in the second quarter. For the year-to-date period, funds that followed a growth style or had larger exposure to the U.S. fared better. For long-biased managers, having a value bent, either in having allocations to emerging markets or value equities, did not hold up as well as U.S. equities and large growth equities.

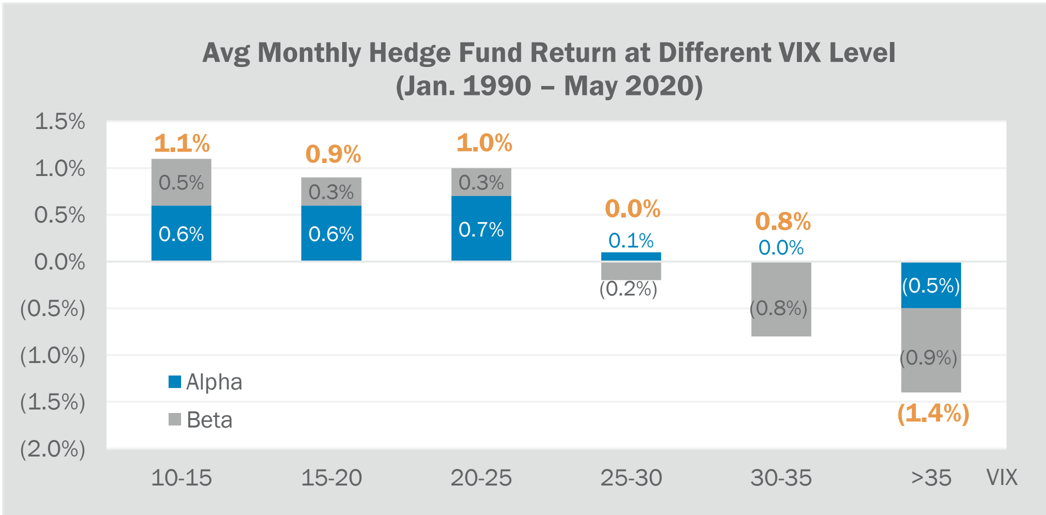

Figure 8. Sources: HFRI, JP Morgan

We categorize hedge funds within the capital preservation bucket, as they do exhibit lower volatility than long-only equities. However, we have seen over their historic performance pattern that hedge funds do not hold up well during periods of sharp market declines within a short period. The average monthly return is negative during periods of high volatility, the type that we saw in March and April. We have been particularly vigilant with credit-oriented managers holding CLO tranches or bonds of companies that have become stressed or face the possibility of credit downgrades.

Real Assets

The global recession that set in over a span of a few weeks made a strong impact on commodity prices across both hard and soft commodities. Oil prices fell to a low of under $20 to end the second quarter at just under $40.

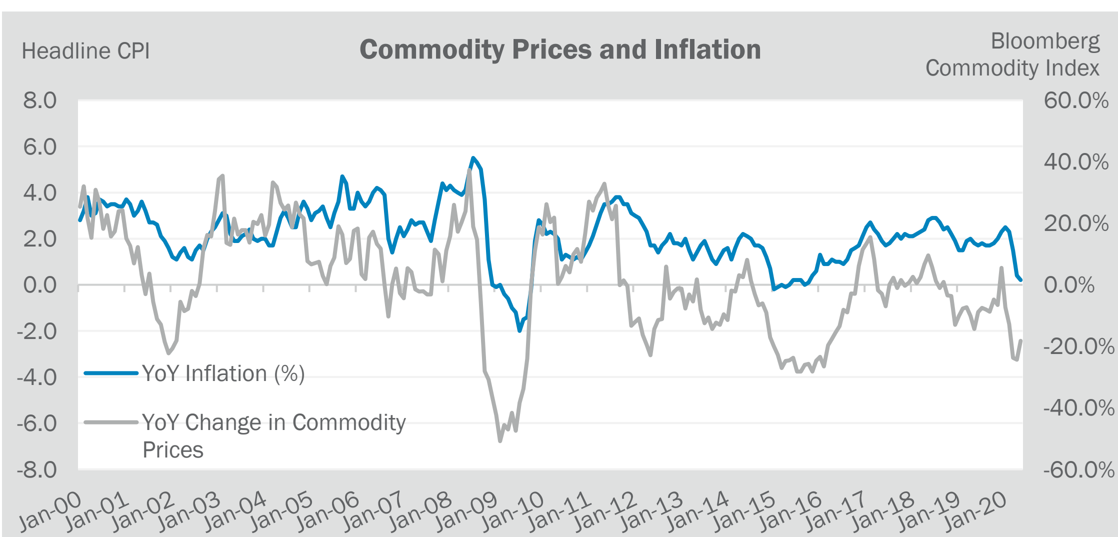

Figure 9. Sources: Bloomberg Index, Bureau of Labor Statistics

The real asset investment remains a small position in the portfolio at 5%. The multi-strategy includes hard and soft commodities as well as infrastructure equities, REITs, MLPs as well as floating rate bonds. The supply-demand imbalance will resolve itself as the COVID-19 related suppressions get lifted over time. Most commodity prices are hovering at values that are close to two standard deviations from their mean and should recover as demand picks up. We also see this segment as a hedge against potentially higher inflation that may be triggered by a large amount of Treasury issuance, the federal deficit balance, and the very low-interest rate that may ultimately push the value of the U.S. Dollar lower.

Private Equity

Fundraising activity and private equity exits slowed down considerably as a result of the pandemic-related shutdowns. Data through the first quarter of 2020 show a steady pace of activity in the earlier part of the quarter, but with market volatility and the uncertainties related to the duration of the slowdown, managers are being more cautious.

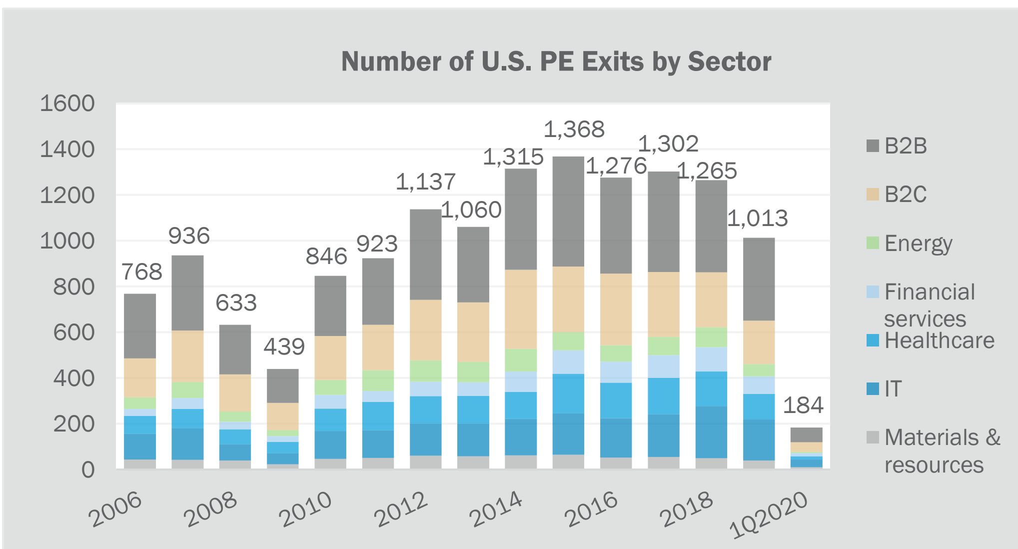

Figure 10. Source: PitchBook

Given the rapid rebound of public markets, there may not be an immediate impact on the valuations at which deals are done. The rise in default rates among smaller companies, particularly in certain sectors that have been directly affected by the pandemic have created opportunities in distressed investing. Many sectors such as Retail, Energy, and even areas of Healthcare were already being disrupted by new technologies and distribution services. The current recession and COVID-19 related pressures have hastened the restructuring of companies and sectors.

We have continued to commit selectively to private equity managers that we feel have the capability to decipher quality companies and add value through operational improvements rather than financial engineering. We are also maintaining an ongoing dialog with managers active in the secondary market in private equity should there be opportunities in that area with distressed holders of private equity that are forced to sell their positions.

Overall Remarks

While financial markets have recouped a good portion of the losses from the decline in March, we feel that there remain fundamental risks given the uncertainties around the opening up of economies and the subsequent recoveries. While there were no major imbalances that would need to be unwound, a prolonged process of partial openings or a reversion to more quarantine conditions could further hurt business margins. We remain fully invested but have maintained ample liquidity, should it be necessary to make it available to our clients, or to take advantage of opportunities that the markets may present.

We value your trust in us and remain in your service.

Sincerely,

Poorvi R. Parekh, CFA

Director of Outsourced Investments

Ms. Parekh is a member of the Board of Directors, a shareholder of Canterbury, and directs the Canterbury Outsourced CIO platform, which caters to institutions and private clients seeking to outsource the day-to-day management of their portfolios. In this role, Ms. Parekh is the chair of the Canterbury Outsourced CIO Committee and a member of each of the firm's five Manager Research Committees. Joining Canterbury in 1996 as the manager of analytics, she directed the firm's account analysts and client services group, securing many of the asset allocation modeling and research software tools we use today. In 2001, she became the director of manager research — responsible for oversight of all manager, fund, and product research; maintenance of Canterbury's proprietary research database; and chairing the Investment Manager Research Committee. Ms. Parekh graduated from the University of Hong Kong with a Bachelor of Arts in economics and completed her Master of Business Administration at Shenandoah University.

About Canterbury

Canterbury Consulting is an independent investment advisory firm based in Newport Beach, CA, overseeing $24.0 billion in assets as of December 31, 2019. Canterbury provides consulting services to tax-exempt organizations — including community foundations, educational endowments, religious organizations, arts and cultural foundations, health care organizations as well as individuals and family offices. Founded in 1988, the firm designs and manages custom investment programs aligned with each client's specific goals. Canterbury acts as the investment office for its diverse clientele and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury strives to deliver performance and service that exceeds client needs and expectations. Learn more about Canterbury Consulting at www.canterburyconsulting.com.