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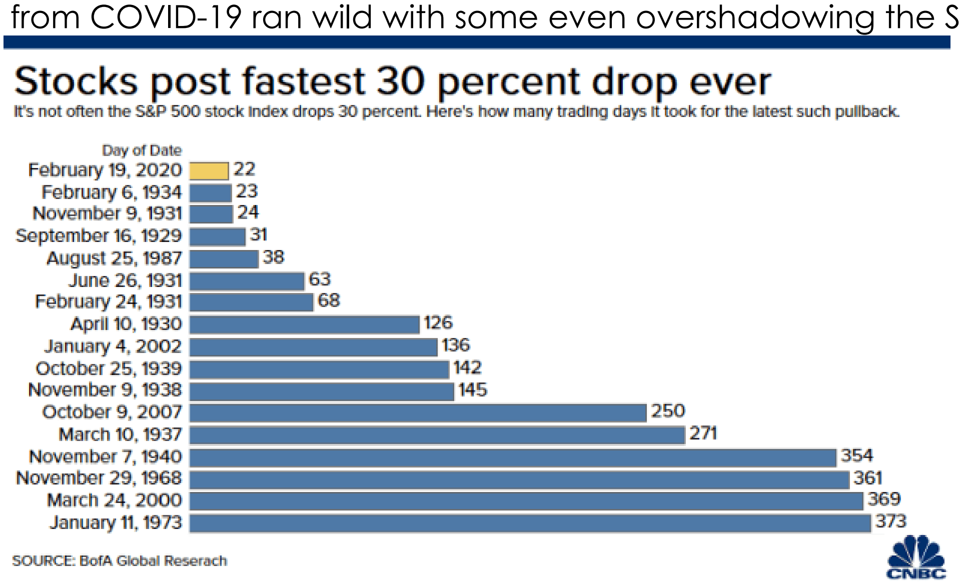
COVID CONUNDRUM

On February 15, 2005, the then Chairman of the Federal Reserve (FED), Alan Greenspan, was asked at a senate hearing as to why long-term rates were falling even as the FED was raising short term rates. He candidly said he could not explain and famously called it a "conundrum."

Financial markets' recent behavior has probably become a bigger *conundrum* for many investors. After all, how can an economy that contracted by 10% from 1Q20 to 2Q20 have stock market averages hitting at all-time highs? We believe the answer is straightforward but does require understanding the backdrop. Year 2020 began strongly for risk assets due to some very favorable prior year-end events ("CASH IS TRASH"). However, they suddenly ran into an unlikeliest of headwind - a global pandemic. What made COVID-19 different from other pandemics since the Spanish Flu of 1918 was the rapid pace of its spread and its asymptomatic nature of transmission. By mid-March, expectations of containing it had all but disappeared.

Epidemiologists were suddenly in vogue as participants began pricing in scenarios that were unimaginable just a month before. Estimates of human fatalities from COVID-19 ran wild with some even overshadowing the Spanish Flu's estimated 50 million. Panic gripped the markets and most risk assets sold off aggressively with U.S. stocks declining roughly 30% in just 22 days. As the chart on the left shows, it was the fastest 30% decline ever recorded.



All that made sense, though, given the real possibility of another great depression type environment. However, what unfolded was quite different. Actions from state and federal agencies managed to contain the fatalities to a much smaller number than initially feared. We want to mention here that our hearts go out every single person and family affected by this horrible disease and we are in no way minimizing the tragedy that millions of Americans are facing. We are simply trying to explain the market's thinking as we understand it.

On the economic side, the Federal government and the FED enacted new support programs that turned out to be timely and forceful. Despite the initial economic devastation which included more than 40 million lost jobs and thousands of business bankruptcies, these programs were crucial in saving the economy from a complete collapse. We have been very critical of the FED in the past for disregarding market expectations and acting in a highhanded manner. But the swiftness and the magnitude of their actions this time around was even better than what the market expected. Chairman Powell deserves praise for showing courage and acting strongly. The federal government also showed real bipartisanship spirit and deserves tremendous credit for acting decisively.

The result was $3 Trillion in fiscal stimulus and $4 Trillion in monetary stimulus – more than enough to give markets the much-needed confidence to look beyond near-term economic devastation and focus on the eventual recovery. The S&P 500 Index bottomed out on March 23, 2020 and rebounded so vigorously that many participants were again left totally bewildered – making it twice in just over two months! As the table below shows, that 50-day rally in stocks was

Largest 50-Day Gains Ever (Greater Than 20%)

This Was The Greatest 50-Day Rally Ever, Past Big Rallies Lead To Continued Strength

		S&P 500 Index Return			
Date	**50 Day % Change**	**1 Month**	**3 Month**	**6 Month**	**12 Month**
3/6/1975	26.9%	-4.0%	10.8%	3.0%	18.2%
10/22/1982	35.6%	-3.3%	3.6%	15.6%	20.3%
3/26/1991	20.8%	0.8%	-1.5%	3.0%	8.7%
6/24/1997	20.5%	4.9%	6.2%	6.4%	26.4%
12/18/1998	23.8%	4.0%	6.2%	12.4%	19.4%
5/19/2009	34.2%	1.1%	9.0%	22.2%	22.8%
9/16/2009	21.3%	2.6%	3.7%	9.1%	5.2%
6/3/2020	37.7%	?	?	?	?
	Average	0.9%	5.4%	10.2%	17.3%
	Median	1.1%	6.2%	9.1%	19.4%
	% Positive	71.4%	85.7%	100.0%	100.0%

Source: LPL Research, FactSet 06/03/2020 (1950 - Current)

All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future results.

The modern design of the S&P 500 Index was first launched in 1957. Performance before then incorporates the performance of its predecessor index, the S&P 90.

the fastest ever recorded. Interestingly, it also shows that the next 7 fastest rallies had ended with further gains after 6 and 12 months. If a vaccine is developed soon, the current rally may also go in that direction. More importantly, it may contain COVID and the associated *conundrum* for many investors.

Performance Review

OppoQuest Strategy	1H20 Strategy Returns (Gross)	Strategy Benchmark	1H20 Benchmark Returns	Outperformance / (Under-performance)
GROWTH	-7.61 %	S&P Target Risk Growth Index	-4.07%	(3.54%)
MODERATE	-12.60%	S&P Target Risk Moderate Index	0.03%	(12.63%)
CONSERVATIVE	-13.66%	S&P Target Risk Conservative Index	6.14%	(19.80%)

Before getting into the performance details of individual strategies, we want to quickly highlight the portfolio actions we took during this incredibly challenging time because we don't think the performance number for this half tell the full story. Let's start with the outlook from our last update where we mentioned that we would be selling into the market strength at the beginning of the year. Indeed, by late February, we had sold close to 15% of risk positions in all our strategies with the intent of continuing to sell more. But COVID's advent reversed the market's direction and by mid-March we had to assess whether the 25% fall in equities was attractive enough to start buying risk again.

One of our core principles is to never consider price of a security as a catalyst. In other words, buying any security *requires* a fundamental reason. Once a security is bought in a strategy, however, then any addition or subtraction may be tactical. So, as we assessed the situation in March, the first question we asked ourselves is: What will be needed for the overall economy be come back from the devastating impact that COVID was almost certainly going to inflict? And the answer to our minds was not that complicated – the FED and the Federal government will have to step in a very big way to support the economy.

As we thought hard about that answer, our minds kept going back to 2008 and the measures that both those entities took at the time to save the economy. That was just 12 years ago. Some of the current officials in these institutions were probably there in 2008 when decisions like TARP and forced surrender of Bear Sterns were taken. The more we thought the more convinced we became that they would have to step in again because not doing so would mean the total collapse of the U.S. economy. The final issue for us was to decide whether to wait for actual support measures to be announced and then add risk to our strategies or go ahead and start adding in small lots to spread the risk. Consistent with our approach of *incrementalism,* we chose the latter.

As indicated in our opening, the sell-off in stocks was fast and furious. Even our incremental approach ended up being less conservative than we expected and we were comfortably able to buy all positions that we had identified. The reallocation achieved was the most transformative we had implemented since inception. For example, in our GROWTH strategy, we added close to 20% in U.S. Equities while using all the 15% in cash and liquidating 5% of our Gold Miners position. Sector wise additions were in Technology (10%), Healthcare (7%) and Industrials (3%). Initial indications on performance of this repositioning have been very encouraging with 2Q20 return of close to 25% versus 12.5% for the benchmark. We expect to opportunistically continue such reallocations although the sectors beneficiaries will obviously depend on our outlook at that time.

Growth strategy

After an exceptionally strong 2019, OppoQuest's GROWTH strategy (GROW) underperformed its benchmark for the 1H20 by 3.54%. Technology and Healthcare contributed positively while Energy and Financials detracted. The top contributor was SPDR Biotech Fund XBI (+1.88%) which benefitted from positive developments in the COVID vaccine and therapeutics research. In fact, the announcements that leading vaccine development companies have made, drive us to expect a successful outcome by year end. More of that in the outlook section.

The biggest detraction to performance came from our position in European Financials thru EUFN (-2.01%). On March 27, 2020, the European Central Bank (ECB) directed the banks under its supervision to suspend dividends and stock buybacks through at least October 1, 2020. The goal was to shore up capital levels in case COVID related losses eroded normal capital buffers. While some form of restrain was justified, the actual announcement came as a big surprise to us. The FED in the U.S., in contrast, gave no such directive and encouraged banks to become more conservative through a broad set of measures. The result was that U.S. banks voluntarily suspended buybacks and increased provisions dramatically while increasing lending and maintaining dividend payouts. It was a balanced approach that the market could easily get behind. We found no such comfort with the ECB and even worse, their actions engendered fears that more restrictive measures could be in place after October 1. That was an unappealing risk for us to take and thus the position was eliminated in April.

Moderate Strategy

OppoQuest's Moderate strategy (MODR) lost substantial ground against its benchmark and underperformed by 12.63% for 1H20. Given this strategy's income consideration, Financials and Energy sectors are over weighted while Technology is under weighted compared to GROW. That positioning worked against MODR as Financials and Energy sectors lagged by a wide margin.

Adding to the underperformance was MODR's almost zero exposure to fixed income while the benchmark has roughly 30%. For reference, the Barclays Aggregate Index was +6.14% in 1H20 while S&P 500 was -3.08%.

Microsoft (MSFT) was the top contributor for this half (+1.63%) with the stock rising close to 30%. MSFT's highly defensible software business along with the continued growth witnessed by its Azure Cloud services is driving multiple expansion that we think will be sustained. Recall that MSFT position was initiated during the selloff in late 2018 and we added to it during March 2020 which helped the performance meaningfully. Another position that helped was AAPL which was a fresh addition to this strategy during March.

Wells Fargo (WFC) was the largest drag for this half as it declined by 52% for the half. In what turned out be the one of the worst performances by any of our holdings, WFC struggled with FED imposed asset cap of $1.9 Trillion and continued rise in expenses for litigation and employee retention. While we were expecting subdued topline growth due to the asset cap, the continued rise in expenses is hugely disappointing. Although the current performance of WFC is clearly frustrating and the temptation to exit the position is high, we think patience here will pay very high dividends. WFC trades at a steep discount (P/B = 0.6) vs peers (P/B > 1) and its Operating Ratio is in high 70% versus peers in the high 50%. This is an unfamiliar territory for WFC to be in given that it was for long the standard bearer of efficiency and profitability. So, the opportunity is certainly there and the new CEO, Charlie Scharf, who took over last fall (October 21, 2019) comes with a reputation of creating lean organizations (VISA, BNY). We believe he will begin turning things around soon. Indeed, a recent press report indicated that a massive reorganization is in the works.

Conservative Strategy

OppoQuest's CONSERVATIVE strategy (CNSR) had the worst performance numbers with an underperformance margin of slightly under 20% versus its benchmark. CNSR's benchmark has higher exposure to fixed income (40%) and lower exposure to risk assets. As a result, during risk aversion periods it tends to outperform significantly especially given our defensive positioning in the fixed income area. CNSR also has higher exposure to Financials and Energy which, as mentioned earlier, were meaningful laggards.

Technology Spiders ETF (XLK) was the top positive contributor (+2.30%) for this strategy as the fund rose by around 14% in the half. This ETF has significant exposure to AAPL and MSFT accounting for over 20% weight combined and so the strong performance is not surprising. We expect to monetize some of these gains and reduce risk as explained in the outlook section.

On the negative side, European Financials (EUFN) detracted (-3.84%) meaningfully. EUFN was a bigger weight in this strategy compared to the other two and therefore the impact was larger. This position has been eliminated and the rationale provided earlier holds true for this strategy as well.

Outlook

The biggest catalyst for financial markets over the next few months would be the reopening of economies worldwide. But many investors appear skeptical about the pace and timing of such outcomes. Underlying that skepticism is the uncertainly regarding the availability of a vaccine and the belief that even if a vaccine is available consumer habits may have permanently changed.

We are in the camp that believes a vaccine will be developed by the end of the year. With full acknowledgement that we are not medical professionals or have any inside information, our claim is based entirely on the public announcements made by the top five leading vaccine candidates namely AstraZeneca/Oxford, Pfizer/BioNtech, J&J, Moderna, and Novavax. All of them have published encouraging early clinical trials data with some of them even commencing phase III trials. This is public information and each investor has to decide how much trust and faith to put in it…just like the trust and faith needed in late March to expect the FED's intervention and government's actions.

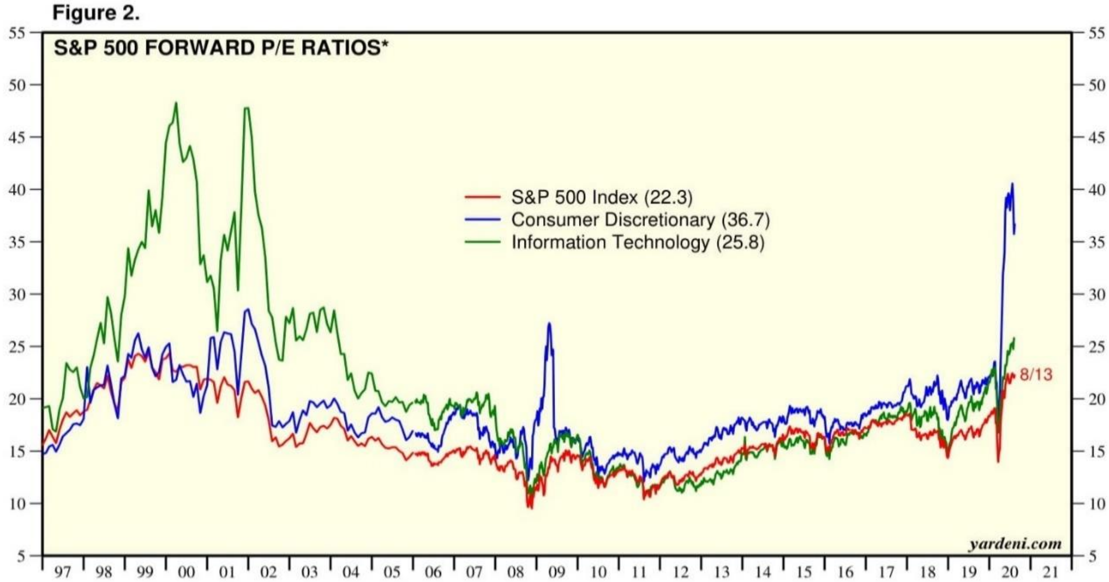
Another factor influencing our expectations is the extraordinary support given by the Biomedical Advanced Research and Development Authority (BARDA) in the U.S. to many of these vaccine candidates. Specifically, BARDA has funded "at risk" manufacturing of these yet-to-be approved vaccine candidates and committed billions of dollars. We believe that level of commitment would not have been made if the candidates under consideration did not show promising potential. Yes, we believe a successful vaccine development is not too far but also acknowledge that the timing is uncertain.

As for the other concern of consumer behavior being permanently altered, we don't think the change will be that dramatic. On the contrary, we think there is so much pent up demand for activities like live sports, vacations, and entertainment that cyclicals areas like airlines and hospitality are likely to come back strongly. We are already seeing some of that in higher air-travel traffic, higher energy consumption, and increased restaurant reservations.

We are, however, getting cautious of certain areas of the equity market given the sharp post-COVID rally that has taken most equity indices to almost their pre-pandemic highs. Ironically, we think the Technology sector, in particular, is vulnerable in the short/medium term given the front end loaded gains it received from the changed consumer behavior due to COVID.

We realize that this might come across as a counter intuitive argument, but our view is informed by the consistency of the pattern across many 2Q20 earnings calls of tech companies where we heard COVID benefits being strongly emphasized. Further enforcing our view is the expanding multiples of the tech sector as seen from the chart below from Yardeni and Associates. The forward multiple

Figure 2.



* Price divided by 12-month forward consensus expected operating earnings per share.
Source: I/B/E/S data by Refinitiv.

now sits close to 26 while it was around 15 in December 2018 and March 2020. Noticeably, the Consumer Discretionary multiple at around 37 is higher but that is due to the collapse in estimates for a large swath of companies in the hospitality, leisure, and entertainment industries.

So, our tactical approach over the next few months is to continue monetizing the gains we had made in the Technology sector and increase our exposure to cyclical areas like transportation and consumer discretionary. We already have specific names identified and will be executing these trades opportunistically. We do want to mention here that despite our near-term caution on Technology sector and the tactical trimming, we remain staunch believers in the secular growth of Technology related industries. That said, we also want to remind readers that we are even stronger believers of taking advantage of opportunities in the marketplace and making the best decisions for our investors.

For OPPOQUEST
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