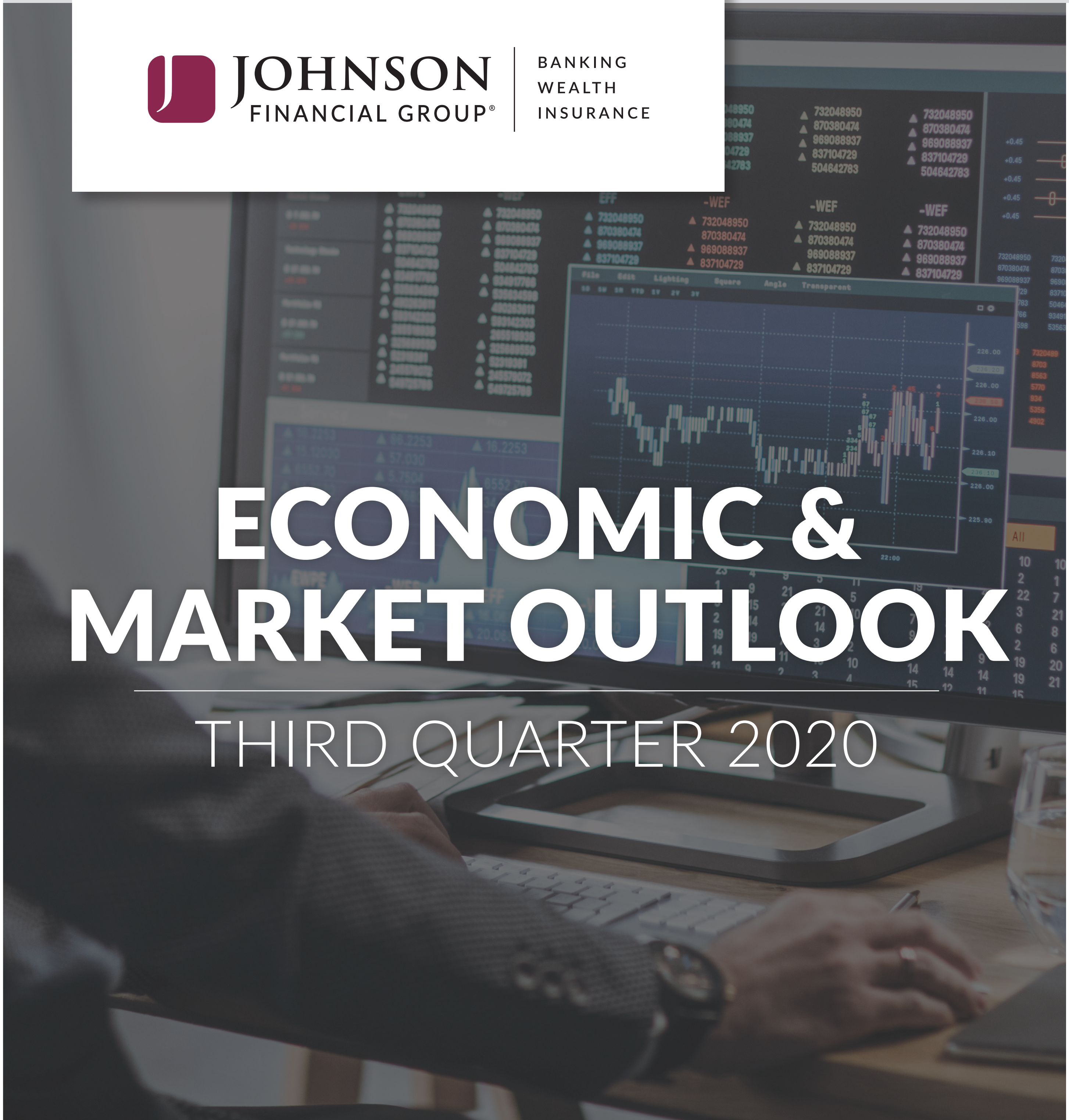

JOHNSON FINANCIAL GROUP®

BANKING
WEALTH
INSURANCE

ECONOMIC & MARKET OUTLOOK

THIRD QUARTER 2020

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EXECUTIVE SUMMARY

As we reflect on the first half of 2020, we are reminded of the fact that the economy and financial markets are not always in sync. While the rapid decline in asset prices during the first quarter was logical to reflect a lower profit outlook and heightened risks, the rebound during the second quarter seems out of step with the economic reality.

However, policymakers' efforts to bridge the gap in economic activity has reduced downside risk, which allows investors to look further into the future to identify the value of a business and the price of its stock and bonds. As a result, asset prices recorded significant gains during the second quarter as investors have been increasingly willing to look beyond the impact of the pandemic [Exhibit 1].

Still, the scale of markets' recovery gives us pause, and given the disconnect we have generally positioned portfolios in the following manner:

- Uncertainty over the pace of recovery and rich valuations lead us to underweight stocks. Investor complacency and a momentum-based market make stocks vulnerable to disappointment, in our opinion. While long-term returns for stocks are likely to outperform bonds, they are likely to be below average given high valuations. We recommend tilting portfolios toward the U.S. and quality, growth-oriented companies.
- For bonds, weak growth, low inflation and the central bank's commitment to low rates are positive in the near term. However, low interest rates mean low expected returns over the long run. We see investment grade corporate bonds and high yield bonds as more attractive than U.S. Treasury bonds in the current environment.
- Apart from traditional stock and bond allocations, some investors may benefit from weightings to alternative investments—particularly complementary strategies that offer returns with a low correlation to traditional assets. Alternative income investments, such as real estate and private debt, may be good substitutes for an equivalent risk level of stocks and bonds.

Economic Outlook

- Second quarter GDP is expected to post the largest decline ever as the economy plummeted during the self-prescribed recession. The number of unemployed persons skyrocketed with the unemployment rate quickly jumping to a record high of 14.7% in April, well above the 10% peak reached during the Global Financial Crisis.
- The economic plunge resulting from efforts to contain COVID-19 was met with an unprecedented policy response. The level of fiscal and monetary support provided by policymakers in the U.S. is estimated to total more than 44% of GDP, with additional measures being considered.
- The support packages appear to be delivering on what they were intended to do—bridging the gap in economic activity caused by the shutdowns and restoring confidence. While financial conditions have improved and economic "green shoots" are appearing, the trajectory of the recovery remains dependent in part on how the pandemic unfolds as businesses begin to reopen.

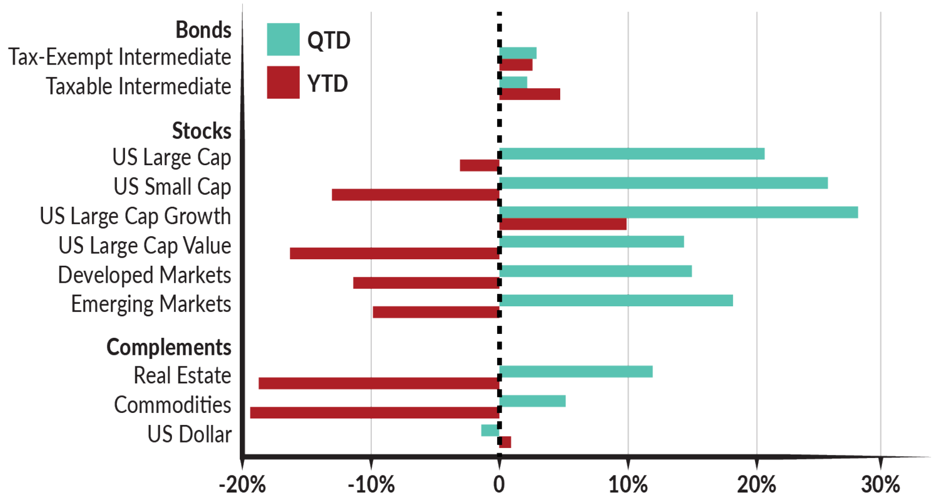
U.S. Equity Outlook

- Equities recorded their best quarter since 1998, with the S&P 500 Index gaining 20.5% during the period. The 44% gain from the bottom recouped about 75% of the decline that ended on March 23.

Exhibit 1

3-MONTHS & YEAR-TO-DATE PERFORMANCE

As of June 30, 2020



Index List: Tax-Exempt Intermediate: ICE BofAML 2-12 US Muni Index, Taxable Intermediate: BBgBarc US Ag Intermediate Index, U.S. Large Cap: S&P 500 Index, U.S. Small Cap: Russell 2000 Index, U.S. Large Cap Growth: Russell 1000 Growth Index, U.s. Large Cap Value: Russell 1000 Value Index, Developed Markets: MSCI EAFE Index, Emerging Markets: MSCI Emerging Markets Index, Real Estate: FTSE NAREIT All Equity REIT Index, Commodities: Bloomberg Commodity Index, U.S. Dollar: U.S. Dollar Index. Source: Morningstar Direct

- U.S. large-cap growth stocks led global markets higher. Investors have been attracted to their strong balance sheets and secular growth in a slow-growth, low-interest-rate environment. Other factors contributing to large-cap growth outperformance include price momentum and sheer size, given these companies are the largest weights in many indices.
- S&P 500 earnings are expected to decline 23% in 2020 followed by a 31% increase in 2021, which would return earnings to 2019 levels. The price-to-earnings (PE) ratio for the S&P 500 was 21.7x forward earnings as of June 30.

U.S. Fixed Income Outlook

- Taxable bonds posted strong 2.1% returns during the quarter and are now up 4.7% year to date. Investment grade and high yield bonds fared even better gaining 9% and 10% respectively as credit spreads narrowed back toward long-term averages.
- Tax-exempt bonds returned 2.9% during the quarter and are up 2.5% year to date as concerns over tax revenues begin to fade along with the reopening of the economy.
- Global central bankers have gone all out to support financial markets. The balance sheet of the Federal Reserve has increased from $4 trillion to $7 trillion this year, and the European Central Bank has entered into a 1.35 trillion euro bond-buying program.

ECONOMIC OUTLOOK

Possibly the Deepest & Shortest Recession on Record

As COVID-19 cases began to spread across the U.S., the self-prescribed shutdown of our economy triggered the sharpest drop in economic activity on record, plummeting the economy into a recession. U.S. second quarter economic activity, or GDP, likely contracted by a staggering -35% versus the prior quarter at a seasonally adjusted annual rate. As lockdowns are eased, growth in the third quarter is expected to show a sharp rebound, but then moderate after the strong initial bounce. This may be both the deepest and the shortest recession on record; however, we do not expect U.S. output to exceed its prior peak until early 2022.

The economic plunge resulting from efforts to contain the coronavirus was met with an unprecedented policy response. The Federal Reserve and federal government swiftly provided massive amounts of fiscal and monetary stimulus, totaling amounts meaningfully larger than during the 2008-2009 Global Financial Crisis.

Exhibit 2

GLOBAL MONETARY & FISCAL STIMULUS TO FIGHT COVID-19 IMPACT

February to June 2020 (CSM)

	Potential Central Bank Liquidity Injection		Potential Fiscal Stimulus		Both	
	$ Tln	% GDP	$ Tln	% GDP	$ Tln	% GDP
U.S.	$6.21	29.1%	$3.30	15.4%	**$9.51**	**44.4%**
Eurozone	$1.78	13.3%	$4.02	30.2%	**$5.80**	**43.6%**
Japan	$1.03	20.0%	$2.08	40.3%	**$3.11**	**60.3%**
U.K.	$0.37	13.6%	$0.23	8.3%	**$0.60**	**21.8%**
China	$1.33	9.3%	$1.22	8.4%	**$2.54**	**17.7%**
Others	$0.73	-	$2.67	-	**$3.40**	-
Global	**$11.44**	**13.2%**	**$13.52**	**15.6%**	**$24.96**	**28.8%**

Source: Cornerstone Macro 7.2.2020

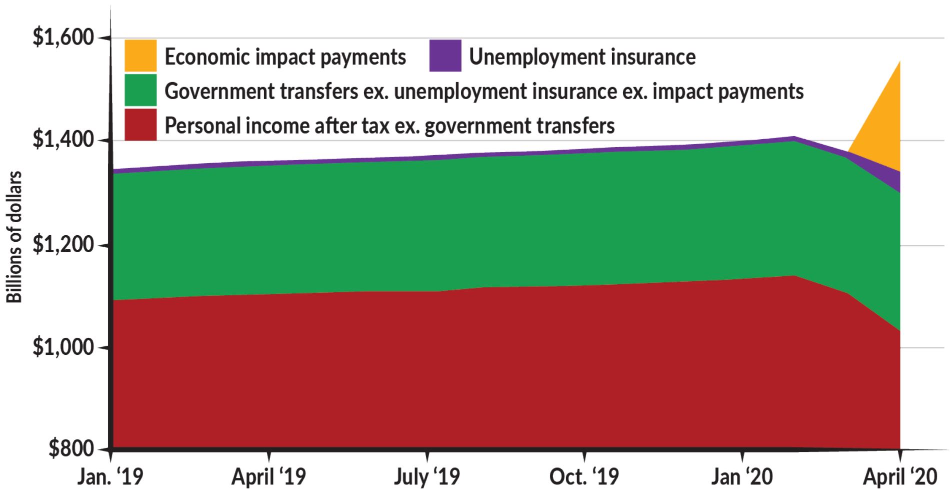
In our commentary at the start of the second quarter, we shared a table with the impact of the announced fiscal and monetary stimulus measures in the U.S. and in major economies abroad at that time. Exhibit 2 provides an updated table of that information. Over the past three months, the degree of policy response has increased significantly. In the U.S., support as percentage of GDP increased from 24.3% to 44.4%, and the total for all countries listed increased from 14.3% to 28.8%.

The U.S Federal Reserve cut short-term interest rates to zero, announced unlimited purchases of U.S. Treasury bonds and mortgage-backed-securities, and indicated a commitment to buy both investment grade and high yield corporate bonds. The fiscal response was provided primarily through the CARES (Coronavirus Aid, Relief, and Economic Security) Act, which provided direct payments to individuals and forgivable loans to businesses through the Paycheck Protection Program (PPP), provided certain conditions for maintaining payrolls are met. Forbearance programs, which allowed for the suspension of mortgage, rent, and student loan payments also provided temporary relief.

Exhibit 3

RECOVERY REBATES OVERCOMPENSATE LOSS OF INCOME

Billions of dollars

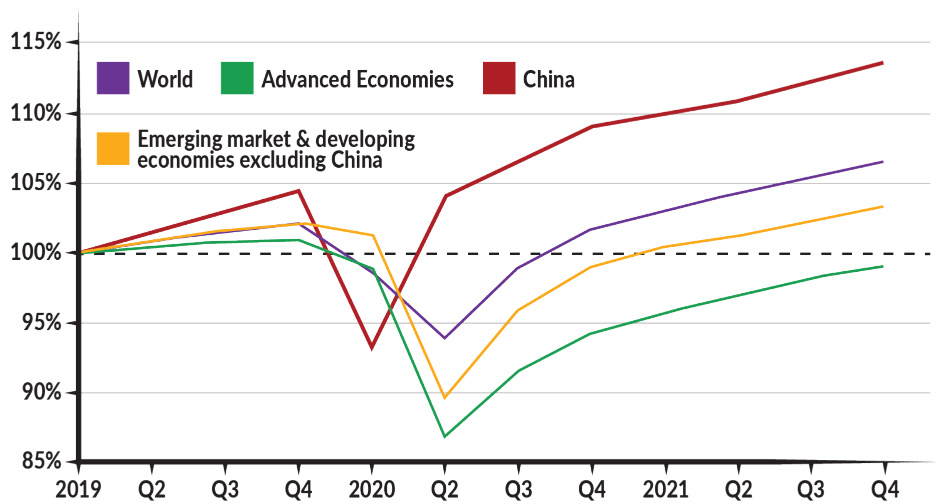


Source: U.S. Bureau of Economic Analysis and Haver Analytics as of 6.17.20

Exhibit 4

QUARTERLY WORLD GDP

2019:Q1 = 100



Source: IMF staff estimates

The support packages that have been provided thus far appear to be delivering on what they were intended to do—bridging the gap in economic activity caused by the shutdowns and restoring confidence. Government payments to U.S. households have more than filled the gap from the decline in U.S. wages. Exhibit 3 illustrates how the decline in personal income (i.e., wages and salaries—shown in red) have been more than offset by economic impact payments, which are the newly added category reflected in yellow.

While these support packages have stemmed what would have been a wave of bankruptcies and business failures, many of the programs are set to expire soon. With the economy remaining vulnerable, additional relief measures are being considered to prevent further damage to the economy. Congress is considering another rescue package that could potentially provide another direct payment to U.S. households, an extension of unemployment insurance benefits, and more support for state and local governments, among other things.

Potential Trajectories for Economic Recovery

Financial conditions have clearly improved and economic "green shoots" are appearing, but the economic recovery will in part be based on whether or not there is a reescalation of coronavirus cases as businesses begin to reopen. We are closely watching research efforts because development of more effective treatment options and/or vaccines would allow for a much clearer path to recovery.

Given the uncertain path to recovery and many unknowns, expectations for GDP vary widely. International financial institutions such as the International Monetary Fund (IMF), the World Bank, and the Organization for Economic Cooperation and Development (OECD), as well as the U.S. Federal Reserve, expect the U.S. economy to post a decline of -6% to -8% in calendar 2020, which would be twice as deep as the Global Financial Crisis and the worst since WWII. Exhibit 4 depicts the IMF's forecast for GDP for world economies, which generally reflects current consensus expectations for the path of the recovery, barring a second wave of infections.

As the graph depicts, economies are expected to have different recovery trajectories. China and other emerging economies are expected to rebound most quickly, with China potentially eclipsing pre-pandemic GDP levels by the end of this year. China was first to cycle through the coronavirus curve and was aggressive with the enactment and enforcement of shutdowns. Their measures were harsh by US standards, but effective. Developed economies are expected to have a slower pace of recovery. In the U.S., prior peak GDP levels may not be surpassed until early 2022 and expectations for Europe and other developed economies are similar. European economies are beginning to recover as their coronavirus curves flatten, but are more reliant on global trade, which has suffered during the pandemic.

The expectation for pockets of virus outbreaks have always been expected, but the current acceleration in cases in certain U.S. hotspots—especially in Arizona, California, Florida and Texas— are cause for concern. Other states also have increasing case trends, but not at the same alarming rate. We are starting to see some delays and even some ratcheting back of reopening activities.

In the hardest hit states, which are also among the country's most populous, we are seeing containment measures being re-imposed and have begun to see the resultant impact on mobility. Exhibit 5 shows Google mobility data, which tracks the movement of phone locations over time and is a good barometer of economic activity. While mobility has improved from April's lows, the purple line shows how states with an escalation in cases (Arizona, California, Florida, and Texas) are now seeing mobility flatten and turn lower. The rest of the U.S., shown in red, may be seeing a slight flattening in activity as well.

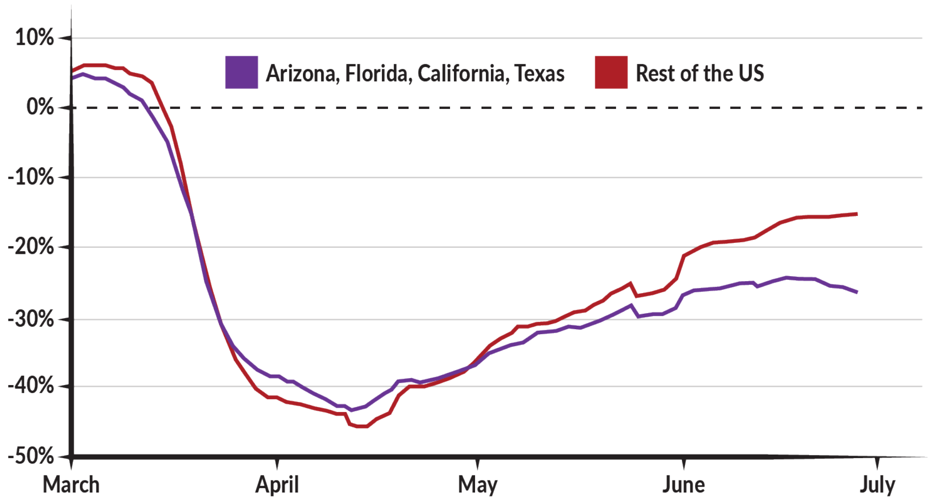
The more rapidly the economy reopens, the greater the risk that we experience a COVID-19 resurgence that may require re-implementation of containment measures on a rolling or regional basis which could slow the recovery. These risks have been highlighted in the U.S. Federal Reserve's minutes from its June meeting, which had a decidedly cautious tone.

> **"The Fed is warning that a second pandemic wave is reasonably likely and would increase the risk of another downturn."**

Exhibit 5

GOOGLE MOBILITY DATA FOR U.S. & SELECTED STATES

Activity as percent of pre-virus level



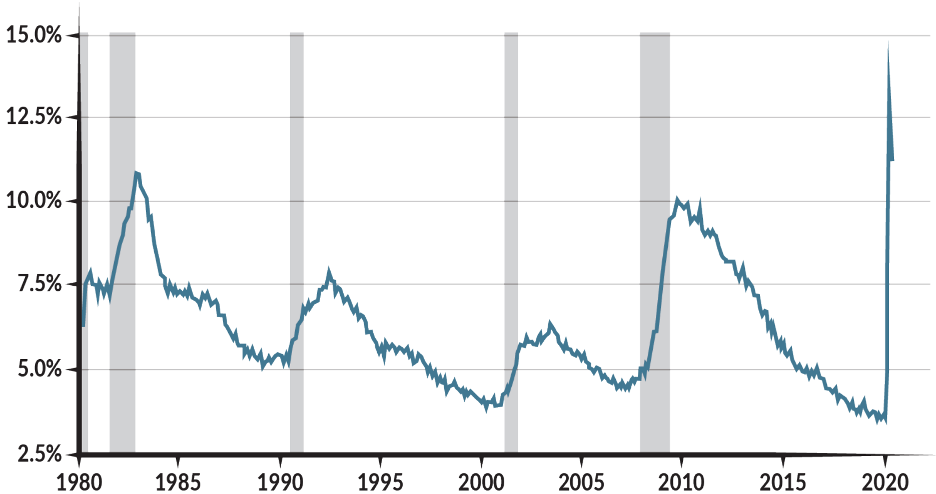
Source: Capital Economics

On a positive note, the minutes acknowledge that the economy may have bottomed in April. However, the release also repeatedly references "uncertainty" and "risk" and indicates that a number of Fed participants perceive "a substantial likelihood of additional waves of outbreaks," which could lead to further "disruptions and possibly a protracted period of reduced economic activity." The minutes noted that the effects of the pandemic were "extremely elevated" and that their more pessimistic projection was "no less plausible than the baseline forecast." Basically, the Fed is warning that a second pandemic wave is reasonably likely and would increase the risk of another downturn.

The economic recovery could take a number of trajectories, and one of the key areas we will be monitoring to gauge progress is employment. The unemployment rate spiked to 14.7% in April, well above the 10% level reached during the Global Financial Crisis as illustrated in Exhibit 6. It has since declined and was reported at an 11.1% rate in June.

Exhibit 6

UNEMPLOYMENT RATE

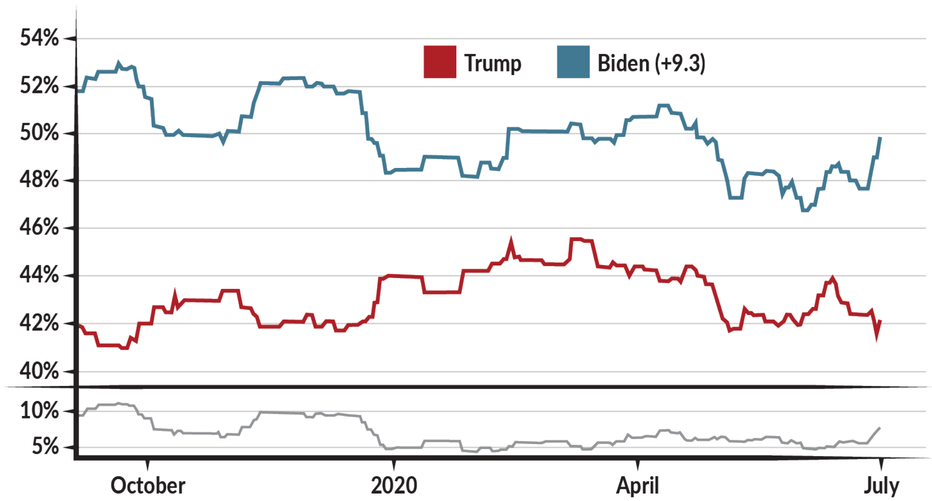


Source: FRED & St. Louis Federal Reserve

Exhibit 7

GENERAL ELECTION

Trump vs. Biden



Source: Real Clear Politics as of 7.2.20

An initial rapid improvement in employment was expected as economies reopened. The easy gains in bringing down the unemployment rate have come as businesses reopen and begin to call back furloughed employees. Much of the improvement has been in the hospitality sector as restaurants reopen, but to the extent reopening plans are halted or reversed, this may prove to be short lived.

It will be the last several percentage points in the unemployment rate that will be more stubborn and challenging to bring down. This view is consistent with the forecast presented by the U.S. Federal Reserve in its recently updated Summary of Economic Projections. According to the median forecast made in June of Federal Reserve Board members and Federal Reserve bank presidents, the unemployment rate forecast for the end of 2020 is 9.3%, well above the pre-pandemic low of 3.5%. We expect the unemployment rate to remain near double-digit levels as we enter 2021.

Other Key Factors

While COVID-19 has dominated the news cycle over the past few months, there are other potentially market-moving factors worth watching, notably the upcoming November elections. The RealClearPolitics general election poll average, shown in Exhibit 7, puts former Vice President Joe Biden ahead of President Trump by more than nine percentage points as of July 2. As we all know, a lot can change between now and November, and even polling data closer to the election do not always reflect the ultimate outcome.

The election outcome and legislative priorities of those whom we elect will affect markets and fiscal policy. A Biden presidency would likely mean higher corporate and capital gains tax rates. Even if Democrats win a majority in the Senate, they will almost certainly fall short of a filibuster-proof supermajority, making it harder to enact significant tax reform. Nonetheless, a reversal of the 2018 corporate tax cuts would reduce earnings and thereby result in more elevated valuation levels. This bears watching but positioning for a particular election outcome at this point is premature.

Longer-term positioning will also be impacted by the legacy of the pandemic, which will have ramifications for the economy and markets. Government debt levels have increased meaningfully to fund the much needed rescue packages and will need to be paid down. How that happens will be material to future growth and positioning.

We may also see higher savings rates as consumers shore up their personal balance sheets, which will impact discretionary purchases. We also expect a continued stalling of globalization as developed market economies move some production back onshore, where they are closer to end-markets rather than lower labor cost markets.

The pace of the economic (and financial market) rebound over the past couple of months has exceeded our expectations. Financial asset prices seem to be pricing in an expectation for a faster recovery than we foresee. Though we believe there has been somewhat of a disconnect between asset prices and economic activity over the near term, we remain optimistic for both over the long term.

EQUITY MARKETS

Stocks Defy Skeptics to Post Best Quarterly Return Since 1998

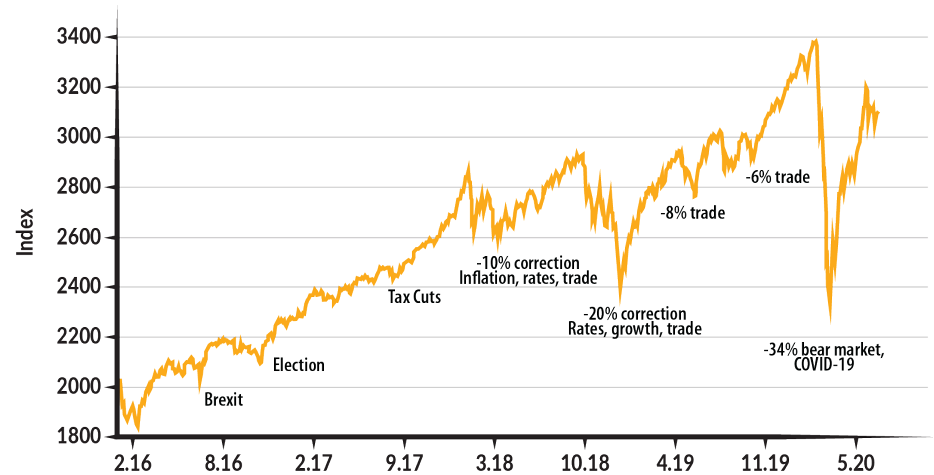
> **"Though we believe there has been somewhat of a disconnect between asset prices and economic activity over the near term, we remain optimistic for both over the long term."**

Even if the economic rebound doesn't turn out to be V-shaped, the rebound in equities certainly looks the part [Exhibit 8]. The 44% gain in the S&P 500 from the market bottom on March 23 recouped about 75% of the pandemic-triggered selloff. Federal Reserve action to shore up the bond market was the initial catalyst to stem the selling. Government stimulus to bridge consumer and business incomes, the reopening of the economy and COVID-19 treatment hopes served as additional catalysts to keep stocks moving higher during the quarter.

Exhibit 8

S&P 500 INDEX

December 31, 2015 to June 30, 2020



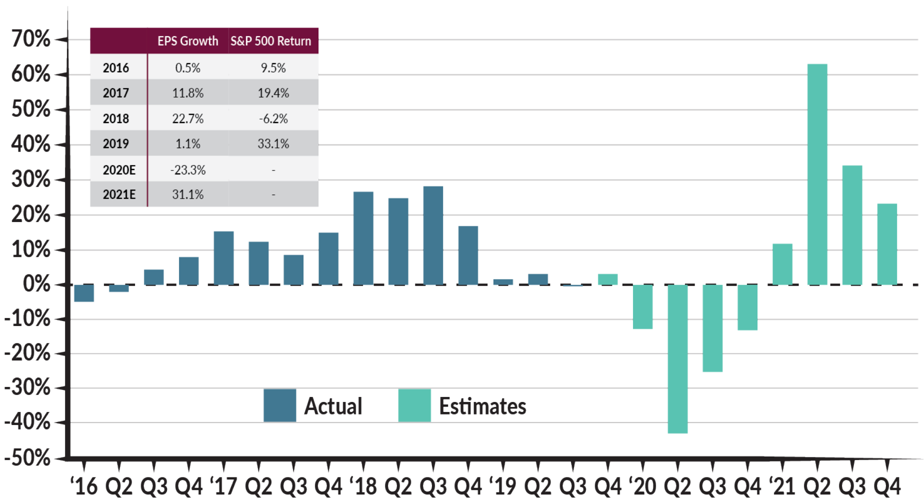
Source: Thomson ONE

Global equity markets gained 14-28% during the quarter, with the S&P 500 Index's 20.5% quarterly return ranking as the best since 1998, as noted in Exhibit 1. Although the S&P 500 is down just 3% year-to-date, most markets remain more than 10% lower than where they started the year and align somewhat better with the shock experienced by the economy.

Stocks in the Technology and Healthcare sectors were the top performers given strong balance sheets and lower exposure to the economic shutdown. Laggards included stocks in the Energy, Financial and Industrial sectors, which have greater exposure to the shutdown and low interest rates. The S&P 500, and U.S. stocks in general, outperformed global markets primarily due to greater exposure to the top performing sectors, especially the five largest stocks that now comprise 23% of the S&P 500 Index (Apple, Microsoft, Amazon, Alphabet (aka Google) and Facebook).

Exhibit 9

S&P 500 INDEX OPERATING EARNINGS GROWTH

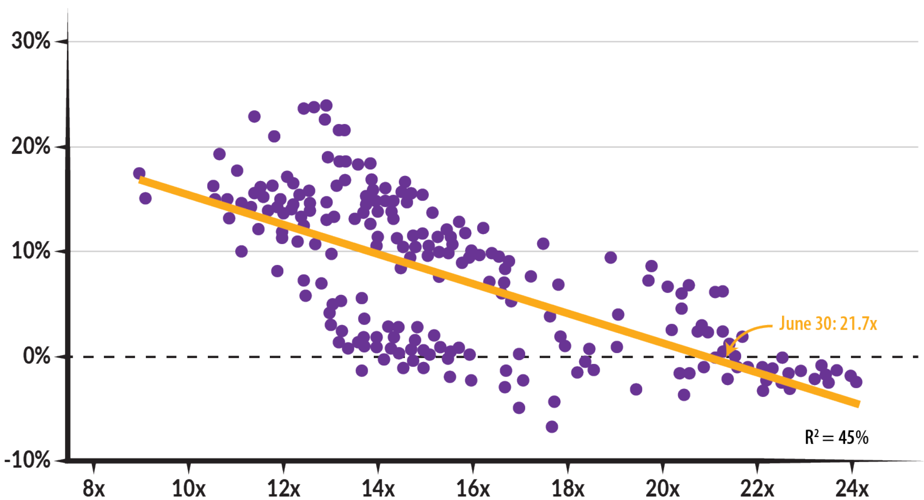


Source: Refinitiv as of 6.18.20

Exhibit 10

FORWARD P/E & SUBSEQUENT 5-YEAR ANNUALIZED RETURNS

S&P 500 total return index



Note: R2 represents the percent of total variation in total returns that can be explained by forward P/E ratios
Source: FactSet, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management as of 6.30.20

Earnings Expectations Anticipate Recovery By End of 2021

As we look forward, we believe that equities are increasingly pricing in an environment in which the economy and profits recover to pre-pandemic levels by the end of 2021. Exhibit 9 illustrates the quarterly profit growth forecasts for 2020 and 2021. Profits for 2020 are expected to decline 23% followed by an increase of 31% in 2021 and would return S&P 500 earnings back to 2019 levels.

For perspective, investors were anticipating that 2020 earnings would increase 9% to start the year. Stock prices tend to lead the economy and profits by 6-12 months; therefore, we will be monitoring company earnings and forward guidance to gauge the strength of the recovery.

Valuations Temper Long-Term Expectations

The S&P 500 is valued at 21.7x forward 12-month expected earnings. This price to earnings (PE) ratio is above its 25-year average of 16.4x. While investor sentiment tends to drive stock prices in the short-term, valuation levels have historically provided direction for long-term expected returns.

Exhibit 10 plots the forward PE ratio for the S&P 500 with subsequent five-year returns. The current PE ratio implies that returns are likely to be below average over the next five years. For perspective, 10 years ago the S&P 500 Index traded at about 11x forward earnings and proceeded to increase at a 14% average annual rate for the 10 years ending June 30, 2020. Today's 21.7x PE ratio, in contrast, suggests that investors should expect returns of low- to mid-single digits over the next 5-10 years.

While above-average valuations moderate our long-term return expectation, there are reasons that the PE ratio should be above average. The first is that the equity market has larger exposure to less-cyclical sectors than it has historically. Non-cyclical sectors (Technology, Health Care, Consumer Staples, Communication Services and Utilities) make up 64% of the S&P 500 today, compared to a range of 45-55% from 1995-2018. Historically, investors have been willing to pay a premium for a less-cyclical stream of earnings. An example is beverage giant Pepsico, with a PE ratio of 25x, compared to a cyclical business such as financial services behemoth JP Morgan, with a PE ratio of 15x.

Another important driver of equity valuations is the level of interest rates and inflation. Exhibit 11 segments the PE ratio for different inflation regimes. The PE ratio for the market has tended to be above average when inflation is low and stable in the 1-3% range. The reasoning is that when interest rates and inflation are low, companies are better able to absorb cost increases and expand profit margins. Also, when interest rates are low, a stock's total return from price appreciation and dividends is increasingly attractive compared to bonds. As of June 30, the dividend yield on the S&P 500 is 1.80% compared to the 0.66% yield on the U.S. 10 Year Treasury bond.

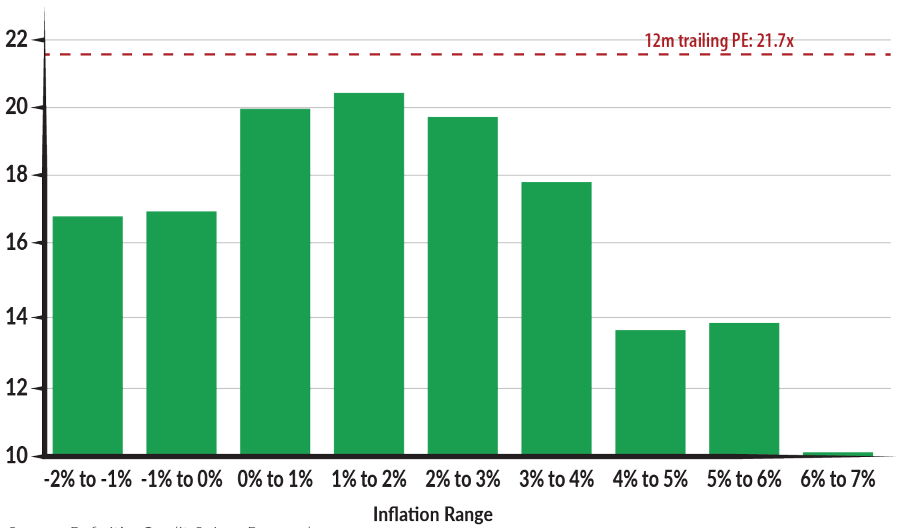
Equity Outlook

Predicting short-term equity returns is a challenge in normal times and is even more difficult in the middle of a pandemic. That said, a consolidation of the V-shaped gains is most likely with a high level of volatility.

Exhibit 11

U.S. AVERAGE TRAILING P/E

1972 to present



Source: Refinitiv, Credit Suisse Research

Keys to the outlook are virus and reopening trends, with investor sentiment as the wild card. Understandably, investor sentiment was extremely cautious on March 23. While not euphoric, investor sentiment can now be characterized as optimistic, leaving less room for disappointment.

Our outlook for a sharp initial rebound in the economy followed by an uneven recovery leads us to moderate our portfolio risk through an underweight to stocks in favor of investment grade and high yield bonds. Within equities we favor the U.S. over international markets given the less-cyclical sector composition. For similar reasons, we favor growth over value and large cap over small cap. We remain diversified, however, as it is important to maintain exposure to stocks that will benefit if the economy reopens more quickly than we expect.

While the virus remains the predominant risk to equity prices, U.S. election uncertainty, the U.S.-China trade war and weaker than expected corporate earnings top our list of additional concerns.

FIXED INCOME MARKETS

The Closer

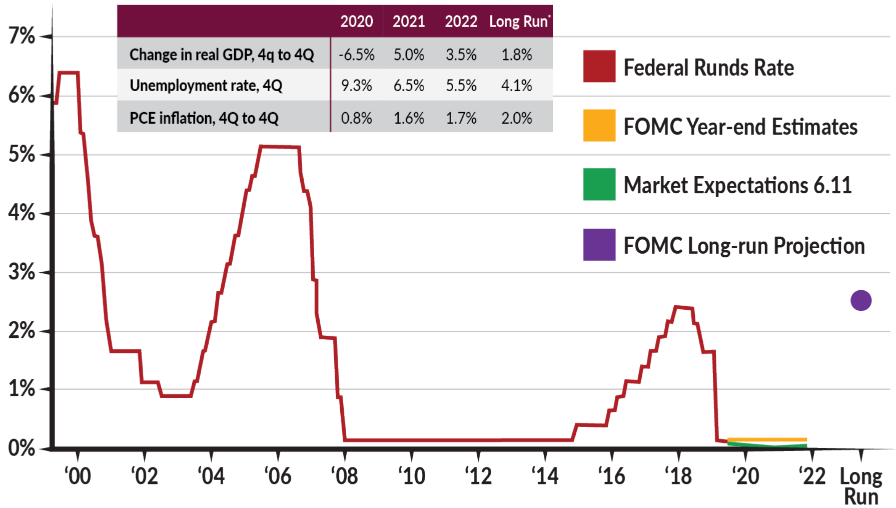
In mid-March of this year, newly minted European Central Bank President Christine Lagarde made the first major error of her tenure. With COVID-19 ravaging Italy and putting upward pressure on Italian bond yields, Lagarde proclaimed that the central bank was "not here to close spreads" between the borrowing costs of EU member states such as Germany and Italy. The statement rattled markets, and she was forced to walk it back, making clear that the ECB stood ready to provide the support necessary for Europe to weather the economic effects of the pandemic. That support has now taken shape in its 1.35 trillion euro bond-buying program.

Lagarde's gaffe was not one of actions but of words, and it demonstrates the importance and efficacy of Fed Chairman Jay Powell's jawboning campaign and commitment to forward guidance. In a rare television interview on March 26, Powell went on NBC's "Today" show and reassured the public in clear terms of the Fed's willingness and capability to use every tool at its disposal to support the economy. "When it comes to this lending we're not going to run out of ammunition. That doesn't happen," said Powell of the Fed's emergency lending to businesses battered by the pandemic.

Exhibit 12

FEDERAL FUNDS RATE EXPECTATIONS

FOMC & market expectations for the federal funds rate



Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management | As of 6.30.20

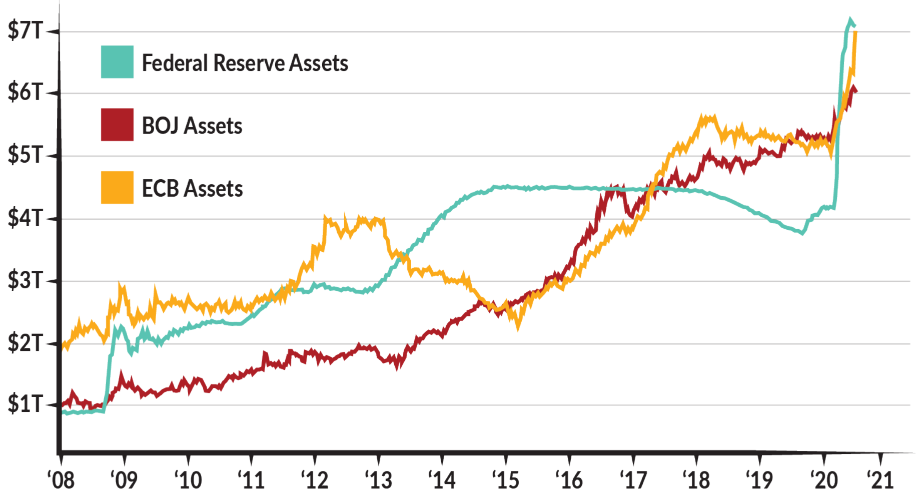
Following the Fed's June 10 meeting, in which 15 of 17 policymakers signaled that short-term interest rates would remain close to zero through 2022 [Exhibit 12], Powell again left no doubt. "We're not thinking about raising rates. We're not even thinking about thinking about raising rates," he said.

Questions about the limits of Fed power have been set aside for now as Powell has erased all doubt of the committee's resolve and markets feel the blunt force of its intervention. The Fed's balance sheet has increased from $4 trillion at the start of the year to over $7 trillion as the Fed continues its extremely accommodative bond buying program. Since resuming large scale asset purchases in March, the Fed has purchased $1.7 trillion of Treasuries, nearly $800 billion of Agency Pass-throughs, over $9 billion of Agency Commercial Mortgage Backed Securities and almost $9 billion of Credit ETFs and individual corporate bonds [Exhibit 13].

The disconnect in the market between narrow corporate yield spreads and weak fundamentals due to COVID-19 is a sign of just how successful the Fed has been. Unlike Lagarde, Powell has left no doubt about his intention to provide bridge financing to corporations by closing the spreads between the weakest and strongest credits and thereby lowering corporate borrowing costs for all but the most profligate borrowers. If the Fed's actions are successful, the current disconnect will resolve itself not with wider spreads but with improved fundamentals as the economy reopens and corporate earnings recover.

Exhibit 13

AGGRESSIVE CENTRAL BANK BOND BUYING



Source: Bloomberg Finance L.P. | As of 6.30.20

> **"The disconnect in the market between narrow corporate yield spreads and weak fundamentals due to COVID-19 is a sign of just how successful the Fed has been."**

Credit Makes a Comeback

In recent weeks, the last of the Fed's nine special lending facilities to support credit markets have come online. The mere announcement of support on March 23 buoyed markets even before implementation. While some of these facilities are similar to those used during the 2007-2009 financial crisis, the Fed has acted much more quickly this time and has expanded its toolkit to include purchases of corporate bonds.

In mid-May, the Fed began buying exchange traded funds (ETFs) composed of both investment-grade (IG) and high yield (HY) corporates and has also made its first foray into buying bonds outright, as disclosed on June 28. The central bank has accumulated $8.7 billion in corporate debt through June 24, including bonds of the largest American companies such as Apple, Verizon, and AT&T. While the Fed has authority to purchase $250 billion of previously issued bonds and up to $500 billion in newly issued bonds, markets have reacted so favorably that many question whether further direct intervention is necessary. Powell's response has been unwavering. "We feel that we need to follow through and do what we said we're going to do," he told Congress in June.

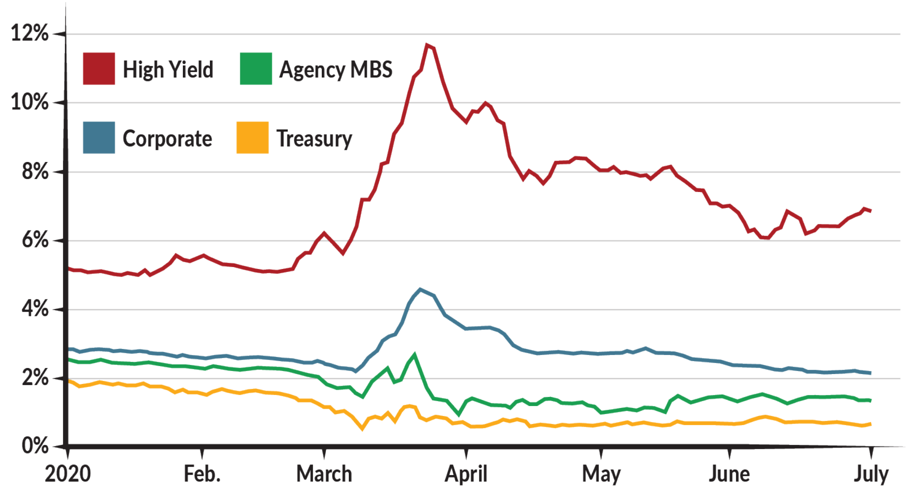
The result of these unprecedented policy moves has been a V-shaped rebound in corporate bond prices. On March 31, investors demanded 2.7 percentage points more yield to own IG corporate bonds than the safety of U.S. Treasuries, and 8.8 percentage points more yield to own HY. At the end of June, those yield spreads had declined to 1.5 and 6.3 percentage points, respectively [Exhibit 14]. With Treasury yields largely unchanged during the quarter, these narrower yield spreads resulted in total returns of nearly 9% for IG corporates and over 10% for HY. The Bloomberg Barclays Intermediate Aggregate Index, composed of both government bonds and investment grade corporates, rose 2.1% in the second quarter and is up 4.7% through June 30.

While our 2020 forecast of a slow and steady "coupon-cutting" year in the bond market was upset by the pandemic, our refusal to chase yield earlier in the year allowed us the flexibility to add to corporate bonds as value emerged and others were forced to sell to raise cash.

We decreased our government bond holdings as much of the Treasury curve approached all-time low yields and added to corporate bonds when their higher yields offered attractive risk-adjusted returns.

Exhibit 14

BOND YIELDS DECLINED FOLLOWING FED SUPPORT



Source: Bloomberg Finance L.P. | As of 6.30.20

In what may seem counterintuitive, our focus on risk management was a key driver in our decision to add to HY corporates. When yields spiked, they began to offer an attractive margin of safety to compensate investors for the possibility of default, or principal loss. Since bondholders are senior to stockholders in bankruptcy, opportunistic investors have the potential to reap equity-like returns from high yield bonds with less risk than stocks.

Similarly, in our separately managed bond accounts, we took advantage of wider spreads and an upward sloping yield curve to extend the maturities of our corporate bond holdings. By purchasing some bonds beyond the five-year maturity targeted by Fed purchases, we were able to avoid the most expensive part of the market and increase income for client accounts.

The Magic of Munis

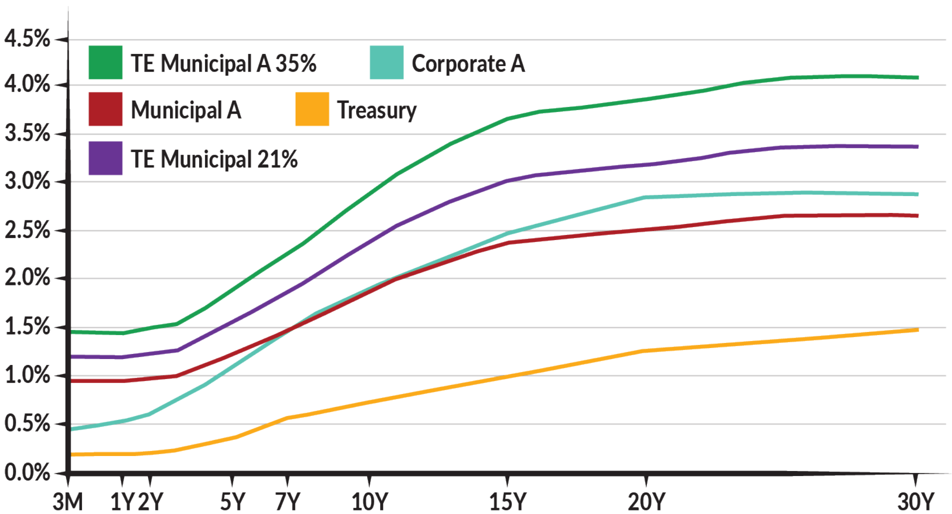
For professional investors, one of the beauties of the municipal bond market is its inefficiency. Dislocations between fundamentals and prices tend to occur with more frequency in the regional, fragmented muni market than the much larger and more crowded corporate bond market. This often creates an opportunity for active investors, and we believe the current consternation over municipal credit quality amid the pandemic is another such opportunity.

Tax-exempt municipal bond yields are attractive relative to both Treasuries and comparably rated corporate bonds [Exhibit 15]. Throughout most of 2019, only investors in the highest tax brackets benefited from municipal tax-free income. Today, a much broader set of investors can take advantage higher tax-adjusted yields.

While it's true that municipal revenues are vulnerable until the economy recovers, it is important for investors to note that overall municipal credit quality is high and

Exhibit 15

MUNICIPAL YIELDS ATTRACTIVE VS. ALTERNATIVES



Source: Bloomberg Finance L.P. | As of 6.30.20

> **"Throughout most of 2019, only investors in the highest tax brackets benefitted from municipal tax-free income."**

an unprecedented level of stimulus—including direct Federal Reserve lending to municipalities—is designed to ensure smooth market functioning and, most importantly, issuers' access to credit.

For municipalities that do run into trouble, the Fed has provided a backstop in the form of the $500 billion Municipal Liquidity Facility (MLF). The MLF was established to purchase notes maturing in three or fewer years directly from qualifying municipalities. There are 380 potential borrowers, but the intent is for the MLF to be the buyer of last resort. In many cases, issuers will be able to issue bonds at lower rates than the MLF is willing to pay.

The state of Illinois was the first issuer to access the MLF, selling $1.2 billion one-year notes at a rate of 3.82%. New York's Metropolitan Transportation Authority, the largest U.S. mass-transit system, has also qualified to access the MLF. This facility is not intended to be a long-term solution to problems such as too much debt or pension underfunding. But the Fed has made it clear that the current financial issues in the U.S. should not be made worse by allowing municipalities to run out of money before the pandemic is resolved.

In our separately managed accounts, we are avoiding bonds that are most affected by the economic slowdown, such as municipalities and projects that derive a large portion of their revenue from travel, public gatherings and senior living, while favoring general obligation bonds from communities and schools with healthy credit profiles and essential service revenue bonds.

The Inflation Monster

In school, we are taught that inflation means "too much money chasing too few goods." With the Fed printing money at an unprecedented pace and federal debt soaring as a percentage of GDP [Exhibit 16], many investors are asking if rampant inflation can be far off. Our view is that while government stimulus is certainly (and intentionally) affecting financial assets in the short term, broad-based inflation is unlikely due to the deflationary pressures of the pandemic, including declining GDP and high unemployment.

The stimulus measures we have seen are intended to provide a temporary patch to lost wages and income, not to spur growth above potential. Longer-term, the U.S. economy continues to face secular headwinds including an aging population and technological innovation that has restrained labor costs. It will likely take several quarters with core inflation above 2% for the Fed to begin to fear the so-called inflation monster.

Second Half Outlook

The second quarter of 2020 provided both stock and bond investors welcome respite from the tumult of March, and bond investors should take comfort that the safer portion of their portfolios once again helped cushion the blow from equity market volatility.

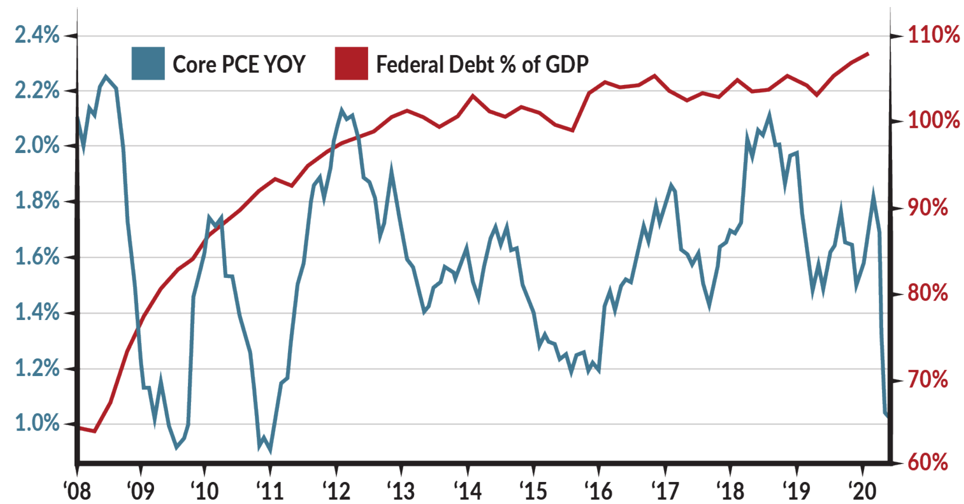
We would be remiss, however, not to recognize that we have had a year's worth of fixed-income returns in six months, and that yields are at or near all-time lows for Treasuries and high-quality corporate bonds. Without much room for yields to decline without turning negative, second-half returns for broad-based indices are unlikely to match the first half.

When thinking about positioning accounts, we always start with our clients' objectives. These can vary from seeking short-term alternatives to cash, to maximizing after-tax income, to maximizing total return as part of a balanced portfolio of stocks and bonds. Each goal is different and bond investors may need to think outside the box to solve for different mandates.

Investors with a short time horizon face perhaps the toughest task as short-term rates are near zero and will likely stay there until at least 2022. For a combination of limited risk and above-cash returns, we favor using Ultrashort bond funds with flexible mandates. These funds may invest in Treasuries, agencies, commercial paper, mortgages, corporate bonds, and asset-backed securities, and generally have an average maturity of under one year.

Exhibit 16

BELOW TARGET INFLATION DESPITE RISING DEBT



Source: Bloomberg Finance L.P. | As of 6.30.20

As we noted above, for investors in taxable accounts who also have a longer-term investment horizon, we like the relative value offered by tax-exempt municipal bonds. As economies open, we expect pressures on local government finances to ease and result in increased demand. If higher taxes are on the horizon, either due to depleted Treasury coffers or the winds of political change, munis' tax exemption is likely to grow ever more valuable.

For total return investors who have a longer investment horizon and moderate risk tolerance, we continue to like corporate bonds, including both investment grade and high yield. There is less compensation for corporate credit risk today than there was in March and April, but yields spreads are still at or above their longer-term averages. With the Federal Reserve's unprecedented efforts to help companies bridge the gap to a post-COVID recovery, we think corporate bond prices could continue to rise as yields grind lower.

For all accounts, we are closely monitoring interest rate risk. While it is likely that short rates will remain lower for longer, massive Treasury issuance to fund stimulus could put upward pressure on longer-term yields.

Most importantly, we will remain opportunistic and flexible with a focus on the best risk-adjusted returns for our clients.

CONCLUSION

A quarter ago, we wrote that we would know much more in the coming weeks—particularly about the unemployment picture and the impact of the CARES Act on individuals, families and businesses as stimulus aid started to flow. As that data came in, much of it was encouraging. Even the unemployment rate, after spiking to 14.7% in April, started improving sooner than many feared. Remember, just three months ago, many observers were envisioning unemployment could hit a Great Depression level of 20%.

It is possible, of course, that a devastating "second wave" of COVID-19 could force a reversal of reopenings and outstrip what fiscal and monetary policy can do to support the economy. But as investors, we seek to be aware of potential worst-case scenarios but not be overwhelmed by them. Risk and uncertainty are ever-present in the investing process. And at this moment in time, we believe the likelihood of a catastrophic economic collapse is even less likely than it was three months ago.

That said, our level of caution is greater than what we see reflected by the striking recovery in stock prices during the second quarter. As we wrote at the top of this outlook, there are times when the economy and financial markets are not in sync. We will continue to monitor economic and market conditions and adjust portfolio allocations accordingly—whether in adjusting risk exposures or seeking to take advantage of relative-value opportunities created by shifting investor sentiments.

As we adjust, we will continue applying the same disciplined mindset we do in any market environment. We thank you for the opportunity to do so in support of your financial goals.