BRIDGES | TRUST®

MARKET COMMENTARY

July 2, 2020

Dear Bridges Trust Client:

Below is our *Market Commentary* from Bridges Investment Management's Investment Committee as of July 2, 2020.

THE GREAT DISCONNECT

In our last *Market Commentary*, we remarked that the first quarter of 2020 was the worst for the Dow Jones Index in 124 years. Looking back on the second quarter, one is reminded of that old Nebraska saw, 'if you don't like the weather, just wait awhile. It'll change.' The S&P 500[1] rose 20% in the second quarter, marking its best quarter this century.

This has caused many to remark that the market's recovery seems oddly incongruous with an economy facing its sharpest contraction ever and a pandemic still very much in its first wave. While markets discount the future, and stocks and the real economy often diverge, prognosticators struggle to explain its strength. The Fed has provided the Mother of all stimulus, near infinite liquidity, and forward guidance on rates, which they're '*not even thinking about thinking about raising*'. The CARES Act[*] has provided $2 trillion in fiscal stimulus, equivalent to 9% of GDP. Some states have selectively reopened, allowing many economic indicators to go from dire to just plain awful.

But if the economy stabilizes at 90% of its run rate in January, that would still represent one of the worst recessions since the Great Depression, which may strike some as a peculiar backdrop for a bull market. Let's take a moment for a brief thought experiment. If stocks were somewhat appropriately priced in January, what are they now?

	JANUARY	JULY
S&P 500 [2]	3,215	3,100
2020 S&P Earnings (Estimate) [2]	$177	$125
2021 S&P Earnings (Estimate) [2]	$195	$162
Unemployment Rate [3]	3.6%	11.1%
2020 GDP Estimate [4]	2.2%	-5.9%
Fed Funds Rate [5]	1.75%	0.25%
Fed Balance Sheet [6]	$4.2 Trillion	$7 Trillion

Sources: [2]FactSet data and analytics. The S&P 500 Index opened at 3215.18 on 1/1/20 & closed at 3100.39 on 6/30/20. [3]Bureau of Labor Statistics. [4]Congressional Budget Office. [5]New York Federal Reserve. [6]Federal Reserve.
Past performance is no guarantee of future returns.

All of this to say that the Fed has done everything in its power and then some to shore up the economy. But just as borrowing today lowers consumption tomorrow, we suspect the Fed has driven up asset prices beyond what the current fundamentals would suggest. While bargains were plentiful in March, they've quickly gone into hiding.

While we don't doubt that this approach is likely to reduce permanent damage to the economy and delay corporate bankruptcies, it could also yield unintended consequences. Many are sounding the alarm about inflation but after 12 years of their yelling fire in a crowded theater, we suspect deflation is the bigger risk. Some point to zombie firms, those kept in business only by the existence of easy money, which robs the economy of the creative disruption necessary to stoke innovation. But then one looks at constituents of the Nasdaq and this worry quickly dissipates.

If you'll forgive a philosophical tangent, what strikes us as most odd is investors' diminished role in price discovery. The Fed has always controlled short term rates; now they want to control long term rates. By buying corporate bonds (including those recently downgraded to junk) they encourage lending to the less than credit worthy. By reducing the attractiveness of fixed income, they are incentivizing risk-taking in equities, which may lead to indiscriminate buying.

All of this is to say that the Fed's interventions have temporarily divorced prices from fundamentals and we are on guard for unintended consequences. The dollar's status as the world's reserve currency currently appears sacrosanct, but there are a few trillion more of them sloshing around than there was just a few months ago. Debt monetization has ramifications for stability as politicians may find it difficult to resist the temptation to create wealth from thin air. While income inequality is a necessary byproduct of capitalism, we suspect the Fed's actions may be exacerbating it.

As for the virus, we are not experts, but even the experts seem unable to agree. We suspect that hopes for a quick recovery or outright containment seem like longer than normal shots. Regarding a vaccine, the world is waiting on science to do its thing and that takes time, but we remain hopeful. In our experience, good things rarely come to those with a time horizon shorter than the market. While the news cycle provides a steady stream of reasons to panic and there are no guarantees of future performance, we look at the businesses we own and we're encouraged by their five to ten-year earnings outlook.

We suspect that economic activity bottomed in April, that investors will be willing to give companies a pass on second quarter earnings and that economic data may continue to improve. Much like the stock market, a sharp contraction followed by a sharpish recovery seems a likely path for the real economy. Some businesses will be extremely hard hit (travel, retail and energy come to mind) and may face permanent impairment. While others, like technology companies have actually benefited.

This is the path the economy is currently on. However, should COVID cases continue to accelerate, we may see more extreme quarantine measures which would likely alter the trajectory of the recovery. Whether people will comply with them is another question. The recovery may not be linear, comparisons may occasionally be negative month-over-month, but we suspect April was the nadir in economic activity.

Members of the Fed have hypothesized that a recovery could take until 2022, and while this may prove optimistic, it still seems favorable to a 10-year treasury at 0.62%. The opportunity costs of waiting simply aren't that high.

While this is scant reassurance, our investment team has over 100 years of combined experience navigating both bull and bear markets. Our philosophy of buying high quality businesses with strong balance sheets and long reinvestment runways still seems appropriate given the circumstances. We appreciate your confidence and trust in our firm, and as always, if you have any questions, please don't hesitate to reach out to your relationship manager.

Bridges Investment Management Investment Committee

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