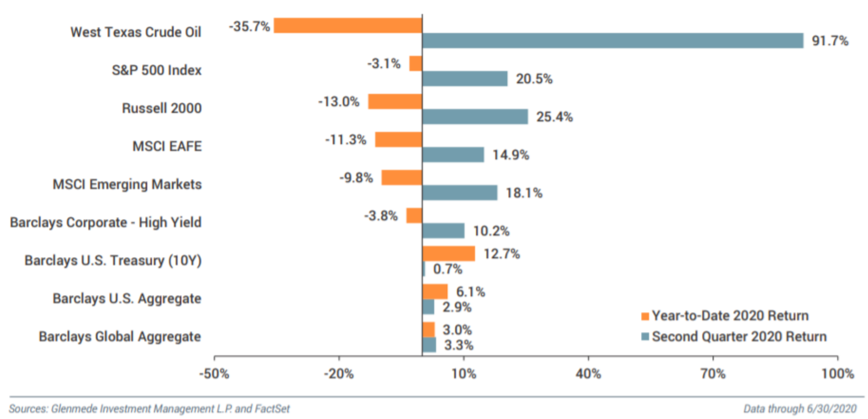
Redhawk Quarterly Commentary

June 30, 2020

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what's going on in the investment landscape and provide our perspective on a variety of topics. These aren't predictions and it represents our perspective on important market and economic information designed to help make decisions affecting your long-term financial strategy. Our goal is to help you understand what is going on in the markets so you can more clearly define investment goals, diagnose unintended risks, and utilize portfolios that can achieve a better financial outcome.

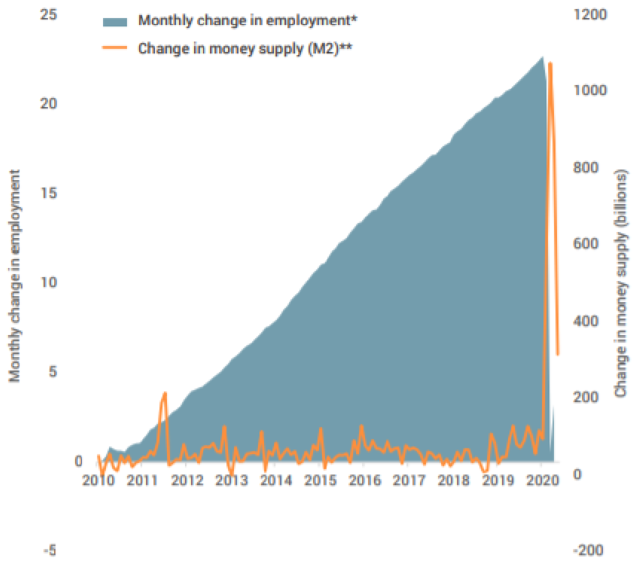
Market Commentary

The first half of 2020 was a story of two distinct markets. The first quarter saw the fastest peak to bear market in S&P 500 history, as volatility spiked to unprecedented levels and the coronavirus pandemic spread like wildfire. The second quarter, however, proved to be the best quarter in over twenty years. Aggressive stimulus, policy, vaccine and therapeutics optimism, and a faster-than-expected bottoming and rebound in some economic data contributed to the strong performance. For the second quarter, growth shares outpaced value by a wide margin, while technology, consumer discretionary, and energy performed best among sectors.



The S&P 500 index recovered from its bottom to within 5% of its February peak in only 53 trading days! The recovery drove the index to its highest-ever concentration as the top two stocks, Microsoft, and Apple, represented more than 12% of total market capitalization. In shutting down the U.S. economy, the pandemic produced another incredible result as West Texas Intermediate (WTI) crude oil futures traded at negative $40 a barrel in late April, before rebounding nearly 92% in the second quarter for its best performance since 1990 (see chart above).

10 years of job growth vanished in only two months — triggering massive Fed stimulus



*Cumulative non-farm payroll data, monthly, seasonally adjusted, 1/1/2010 through 6/30/2020.
**Change in M2 Money stock, monthly

Sources: Bureau of Labor Statistics, Federal Reserve Bank of St. Louis

Despite the strong stock market performance, the state of the economy remains mixed at best. Unemployment has been in the double digits, though declining, for three straight months, and the economy shed roughly 13 million jobs over the second quarter. Unemployment insurance claims have flattened out, but at a concerning level. Still, several data points indicate a more V-shaped recovery as the manufacturing and service Purchasing Managers Index (PMI) data have rebounded strongly and the housing market has remained resilient. All eyes remain on Washington, as an anticipated fifth coronavirus stimulus bill will be key to the continued recovery, particularly given the dire employment situation. After creating nearly 23 million jobs between 2010 and 2020, the U.S. economy lost 22 million jobs in March and April due to COVID-19-related shutdowns (see the chart to the left).

The Federal Reserve (the Fed) has continued to utilize their full range of tools to support the economy in this challenging time. Following their bold first quarter actions, the Fed has implemented and expanded several lending facilities aimed at both corporations and main street. Despite this support, the Fed has also continued to use its platform to support additional fiscal stimulus to help circumvent the longer-term effects of the pandemic lockdowns. The markets entered the new year with economic momentum fueled by global central bank rate cuts and an agreement on the first phase of the trade war with China. Global markets rallied until mid-January, at which point news of a virus outbreak in China emerged. Initially, the coronavirus was believed to be confined to China, and U.S. markets continued pushing forward as domestic economic data improved. Then it became clear the virus would not be confined, as infections rose in Italy, Iran, and South Korea. Today, there are infections globally, with the U.S. leading the world in confirmed cases.

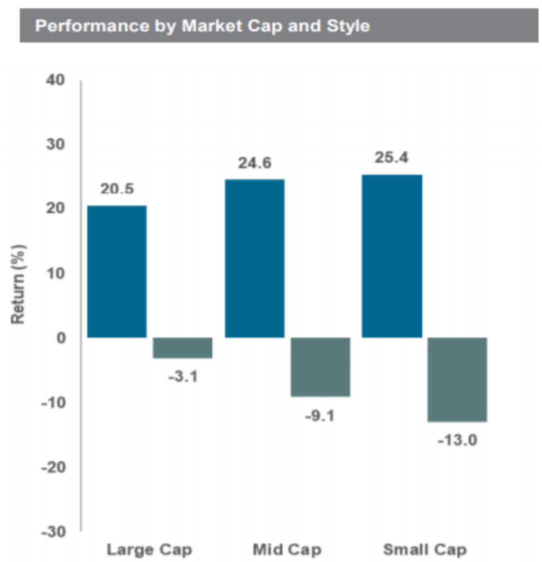
U.S. Market

Growth continued to trounce value this quarter with a 28% rebound for the Russell 3000 Growth and a 15% return for the Russell 3000 Value. On the year, large-cap growth is now ahead of large-cap value by over 26%, the widest margin for a 6-month period since 1999 (see the chart below).

Asset Class	Trailing Returns (%) Last Mo.	YTD	1-Year	3-Year	5-Year	10-Year	Annual Returns (%) 2019	2018	2017	Benchmark
U.S. Stocks										
Large Cap	2.0	(3.1)	7.5	10.7	10.7	14.0	31.5	(4.4)	21.8	*S&P 500*
Large Cap Value	(0.7)	(16.3)	(8.8)	1.8	4.6	10.4	26.5	(8.3)	13.7	*Russell 1000® Value*
Large Cap Grow th	4.4	9.8	23.3	19.0	15.9	17.2	36.4	(1.5)	30.2	*Russell 1000® Growth*
Mid Cap	1.8	(9.1)	(2.2)	5.8	6.8	12.3	30.5	(9.1)	18.5	*Russell Midcap®*
Small Cap	3.5	(13.0)	(6.6)	2.0	4.3	10.5	25.5	(11.0)	14.6	*Russell 2000®*

Source: Factset; Russell, MSCI, Bloomberg, Barclays, FTSE, and Dow Jones benchmarks. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

From a market cap standpoint, trends shifted in the second quarter. Investors had a renewed appetite for risk by favoring small-cap (+25.4%) over large-cap (+20.5%). YTD small-cap still trails large-cap by over 10%, as larger companies protected more on the downside in the first quarter (see the chart on the right).

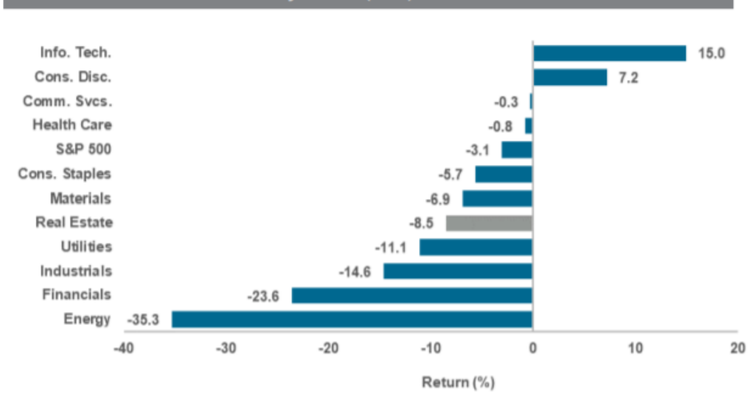


Source: Robert Baird

As depicted in the chart below, the best performing sectors during the quarter were consumer discretionary, information technology, and energy, which rallied over 30%. Defensive sectors, utilities (2.7%) and consumer staples (8.1%) lagged in the "risk-on" market. Information technology has been the leader for the year with a 15% return while energy (-35.3%) and financials (-23.6%) remain in negative territory.

S&P 500 Index: Performance by Sector (Latest Quarter)

S&P 500 Index: Performance by Sector (YTD)



S&P 500 Sector Statistics

	P/E Ratio (TTM)	P/E Ratio (NTM)	Dividend Yield (%)	EPS Growth (%)
S&P 500 Index	21.6	22.1	1.9	(8.3)
Communications Services	22.5	22.8	1.2	(0.1)
Consumer Discretionary	45.5	48.7	1.1	(10.5)
Consumer Staples	20.1	19.8	2.9	(3.6)
Energy	-	-	5.5	(74.8)
Financials	14.1	14.0	2.7	(11.4)
Health Care	17.0	16.7	1.8	14.7
Industrials	25.4	25.5	2.0	(14.5)
Info. Tech.	24.7	24.9	1.2	(1.1)
Materials	21.3	22.0	2.3	(33.4)
Real Estate	20.5	20.1	3.2	24.0
Utilities	18.8	17.6	3.4	6.3

Source: Factset. Performance greater than one year is annualized. Performance is represented by the benchmark listed in the "representative benchmark" column. See important disclosures and definitions included with this publication.

International Markets

International equities underperformed the U.S. Within international, emerging markets (+18%) outperformed developed international (+15%). The U.S. dollar weakened somewhat this quarter, which was a tailwind for foreign stocks. The best performers were Australia, South Africa, and Germany, which rallied more than 25% in the second quarter. Laggards included Hong Kong and the UK, which posted single digit returns during the quarter. China is one of the only countries with a positive YTD return of 3.5%. The Netherlands, Switzerland, and Taiwan are down less than 2% YTD. The two largest economies in Latin America, Brazil, and Mexico, have struggled this year, down 39% and 28% respectively. Both countries are facing surging levels of COVID-19 and are hurting from low commodity prices.

The country year-to-date returns are shown below.

Year-to-Date Performance

Source: Factset; Standards & Poor's (S&P 500); MSCI benchmarks (country returns). See important disclosures and definitions included with this publication.

Fixed Income Markets

The broad U.S. bond market, as measured by the Bloomberg Barclays Aggregate, delivered positive returns in the second quarter, increasing 2.9%. Risk sentiment experienced a nice bounce back as investors accepted COVID-19 and adjusted to the new reality. Economic data and virus-related news during the quarter were not as bad as initially forecasted, prompting a bid for risk assets and interest rate spread fixed income solutions. Policy remains accommodative, creating incentive for liquidity-driven increases across markets.

The second quarter saw rates stay relatively range bound, while credit spreads returned to normal as fundamental concerns were pushed aside and demand for yield took over. Sectors hit hardest in the first quarter experienced the biggest rebound in the second quarter, with high yield, leveraged loans, and investment grade credit leading, returning 9.7%, 9.6%, and 9.0% respectively. Investment grade spreads tightened despite the high degree of economic uncertainty and record corporate debt issuance of $1.6T YTD. Abroad, a not-so-dire growth outlook and a weaker U.S. dollar served as support for emerging markets debt, which saw a 10.0% increase in the second quarter. Laggards included U.S. Treasuries (0.5%) and mortgage backed securities (MBS) (0.7%). Because of their low yield profile, returns for these high-quality sectors are more driven by rates rather than income. The 10-yr Treasury ended the quarter at 0.67%.

Municipal bonds returned 2.7% for the quarter, lagging their taxable peers by 0.20%. With assistance from the Fed and policy invention, order was restored to the muni market during the second quarter. Sector differences continue to be heightened as COVID impacted areas such as transportation, education, healthcare, sales tax-backed, airports, and convention centers are still trading at wide levels vs. historical averages. Risk sentiment returned to the muni market during the quarter, leading to strong performance for high yield (4.6%) and taxable municipals (5.9%).

The chart below shows the returns for various fixed income instruments.

	Characteristics		Trailing Returns (%)						Annual Returns (%)			
Bond Types	**Yield (%)**	**Duration**	**Last Qtr**	**YTD**	**1-Year**	**3-Year**	**5-Year**	**10-Year**	**2019**	**2018**	**2017**	**Benchmark**
Broad Developed Markets												
U.S. Taxable Bonds	1.3	6.0	2.9	6.1	8.7	5.3	4.3	3.8	8.7	0.0	3.5	*BBgBarc US Aggregate Bond*
U.S. Municipal Bonds	1.5	5.4	2.7	2.1	4.4	4.2	3.9	4.2	7.5	1.3	5.4	*BBgBarc Municipal Bond*
Global Bonds	0.6	8.3	3.4	0.6	0.7	2.5	2.9	2.0	5.1	(2.1)	10.5	*BBgBarc Glbl Agg. Bond*
Broad Emerging Markets												
Emerging Market Bonds	4.7	6.5	10.0	(0.4)	3.0	4.2	5.2	6.0	13.1	(2.5)	8.2	*BBgBarc Emerging Markets*
Taxable Bond Categories												
Treasuries	0.5	7.2	0.5	8.7	10.4	5.6	4.1	3.4	6.9	0.9	2.3	*BBgBarc US Treasury*
Agencies	0.5	7.0	0.5	8.6	10.3	5.5	4.0	3.3	6.8	0.9	2.3	*BBgBarc US Government*
Mortgage-Backed	1.4	2.1	0.7	3.5	5.7	4.0	3.2	3.1	6.4	1.0	2.5	*BBgBarc US MBS*
Inv-Grade Corporate	2.2	8.5	9.0	5.0	9.5	6.3	5.8	5.5	14.5	(2.5)	6.4	*BBgBarc US Corporate IG*
High Yield Corporate	7.0	3.9	10.2	(3.8)	0.0	3.3	4.8	6.7	14.3	(2.1)	7.5	*BBgBarc US Corporate HY*
Municipal Bond Categories												
Insured	2.6	5.0	2.1	2.2	4.8	4.9	4.6	4.8	8.3	2.3	5.6	*S&P Municipal Bond Insured*
State GO	1.1	4.6	2.8	2.8	4.9	4.2	3.7	3.8	6.8	1.4	4.7	*BBgBarc Municipal State GO*
Local GO	1.3	5.6	2.9	3.1	5.8	4.7	4.2	4.3	7.9	1.2	5.9	*BBgBarc Municipal Local GO*
Revenue	1.7	5.8	2.7	1.7	4.2	4.3	4.1	4.5	7.9	1.2	6.0	*BBgBarc Municipal Revenue*
High Yield	4.9	9.5	4.6	(2.6)	1.0	5.3	5.8	6.1	10.7	4.8	9.7	*BBgBarc High Yield Muni*

Source: Factset; Barclays benchmarks. Individual security types are subsets of either the Barclays U.S. Aggregate or Municipal Bond benchmarks. Duration, measured in years, is a relative term that expresses the price sensitivity of an investment/benchmark to changes in interest rates. All else equal, the lower the duration, the less price sensitivity to interest rate changes. See important disclosures and definitions included with this publication.

Economic Outlook

The economic outlook has improved as fiscal and monetary stimulus announcements continue and economies start to re-open from lockdown. However, market sentiment and the support for oversold conditions is waning and markets are at greater risk of pulling back on negative news. Looking near-term, markets are vulnerable to negative news after a 40% rebound and with sentiment on the verge of triggering an overbought market.

The main risks come from a second wave of virus infections and the approaching U.S. federal elections in November. Some of the risks include:

- There is evidence of a meaningful second wave of virus infections following the easing of lockdowns across the globe. COVID-19 is highly contagious and has only been contained through the imposition of severe lockdowns. On the positive side, most countries are now better positioned to manage a second wave in terms of healthcare capacity and treatment. Also, the news on vaccine development is promising for availability late in the year or early in 2021.

- The U.S. elections are very close, and the country is mostly focused on combatting COVID-19 and protesting human rights. The elections will become a bigger focus for the markets if the Democrat nominee, Joe Biden, takes a decisive lead. Biden plans to partially reverse President Donald Trump's 2017 corporate tax cuts. This could deliver a hit to earnings per share in 2021. One of the key points to watch will be the election outcome of the Republican-led U.S. Senate. If there is Democrat control of the White House, Senate, and House of Representatives, a corporate tax hike is more likely and the likelihood of more corporate regulation.

- Another risk to the market is the re-escalation of the U.S. and China trade war. A recovery in the stock market and the economy provide President Trump with his best chance of re-election. This could go either way as Trump may not want to accelerate the trade hostilities if he expects to win, however, if he is in a losing position in the polls, he may conclude that nationalism and China-bashing increase his chance for victory.

So, what might all this mean?

The global economy has taken a huge hit from the pandemic and interest rates are zero or lower at all the major central banks. There is a lot of economic capacity which will keep inflation low for the next couple of years. This means central banks will keep rates low, which will keep bond yields low. Furthermore, after experiencing zero rates, central banks are likely to keep rates low once inflation rises. They will be reluctant to tighten too quickly.

Globalization will decrease as COVID-19 exposed supply chain dependencies and vulnerabilities. Some of this was happening before the pandemic with Brexit and the rise of the U.S. and China trade war. Global supply chains are being dismantled and the pandemic has created fears about food security and pressure for domestic production of medical supplies.

The lockdowns are leading to the largest rise in government debt levels since World War II and higher levels of government support for industries. Eventually, the political debate will turn to how to pay for the lockdown support measures and how to address the inequalities that have been worsened by the pandemic. Well-paid workers have been able to isolate at home while lower paid workers have been laid off or had to work in less-safe conditions.

Inflation should not be a problem for the next couple of years due to excess capacity caused by the recession. Longer-term, inflation could rise by more than expected as globalization was deflationary, and its reversal will be inflationary. It would be inflationary from higher input costs, higher labor costs, and rising tariffs and protectionism.

These trends should favor domestic stocks over those exposed to global revenues and supply chains. Mid- and small-cap stocks should do better than large-cap stocks, in a reversal of the trend of the last decade. Developed markets should benefit relative to emerging markets as there will be less technology transfer and less export-led growth. The unwinding of globalization is a headwind for emerging markets. Ongoing low interest rates favor higher yielding assets such as stocks, property, and infrastructure over government bonds and cash.

It is not enough to own a portfolio personalized for your situation, based on your comfort with risk and long-term financial goals. You must be patient and disciplined, too. With our risk management process, our investment committee is reviewing the market conditions and underlying investments on a weekly basis. Please contact your Redhawk advisor to learn more.

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