Q2 2020 Update

Dear Members of Flower City Capital,

We hope you all had a safe and healthy Fourth of July. Markets have largely returned to their pre-crisis levels. For many, that's all you need to know. The following is a brief summary of where we are and where we might be headed in the second half of a very eventful year.

Executive Summary

As always, we begin with an executive summary:

The Virus

- Global infections are rising and the number of cases in the US is accelerating, though fortunately death rates have slowed
- Further demand on healthcare capacity could trigger additional lockdowns, slowing the recovery

The Economy

- The economy is starting to turn back on after effectively grinding to a halt in March and April
- The speed of the recovery should begin to slow as people return to work, but some businesses will not re-open and it will take several years to recover lost jobs

The Market

- The S&P 500 and broader market have diverged from a still struggling economy with the best quarter since 1988, largely making up for the losses in Q1
- This can largely be attributed to fiscal and monetary stimulus flooding the system with cash
- Markets will remain volatile as businesses and individuals adapt

Our Portfolios

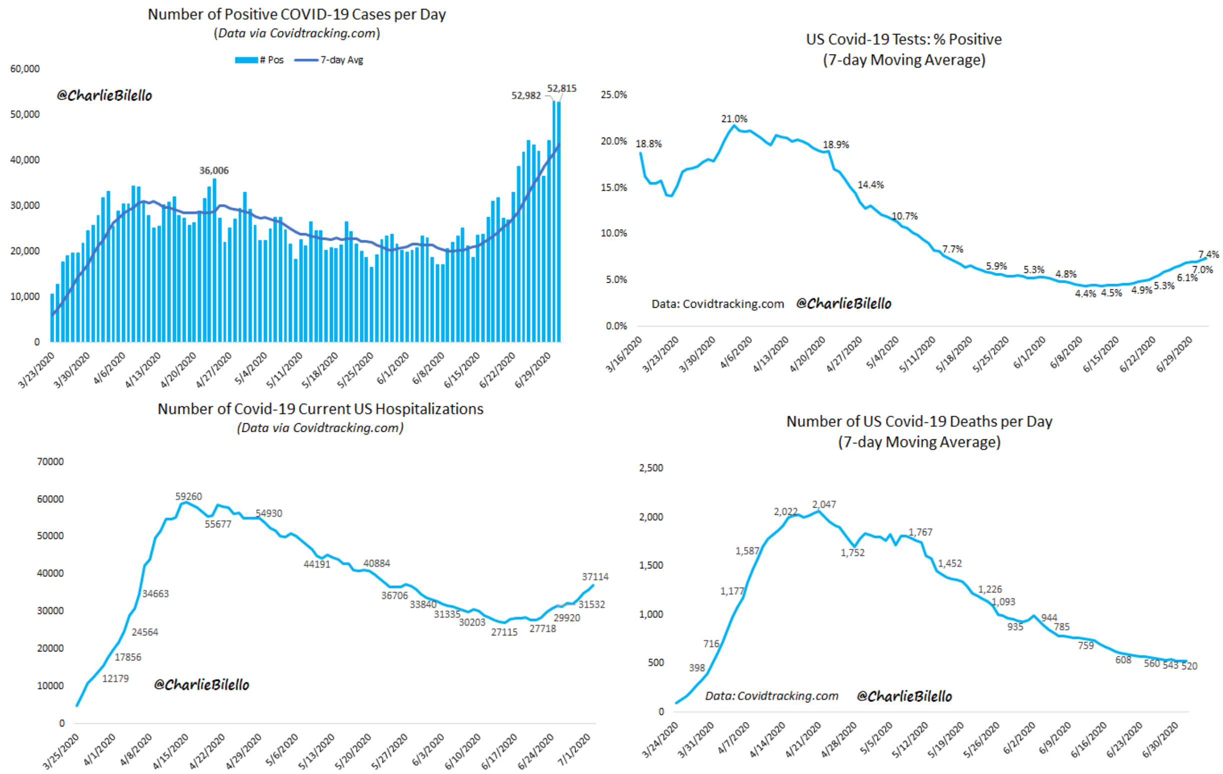
- We continue to like our neutral positioning as it provides optionality in different environments
- Please let us know if you would like a walkthrough of your portfolio, this most recently quarterly report or wish to discuss what happened and how we are positioning for the future

The Virus

As of July 6th, there were more than 11.5 million cased confirmed globally. Infection rates have increased in the US - the country with the most cases - as some states have reopened faster than others with different levels of precautions.

On the other hand, the medical community is getting better at treating the virus and cases are more likely to occur among younger, healthier populations. Unfortunately, fatalities do follow hospitalizations with a lag. The coming weeks will be telling as ICUs become increasingly strained. In addition to the human toll, this matters for the economy and markets as another round of shutdowns would hinder a recovery.

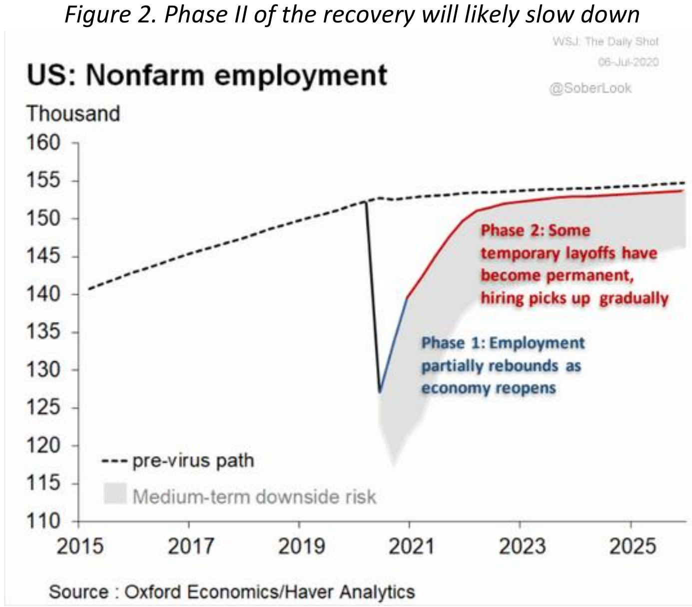
Figure 1. Cases and hospitalizations are rising while death rates are falling



The Economy

The economy is recovering quite rapidly. Though we could cite any number of charts to make this point, the labor market provides a useful illustration of what is expected to be a staged recovery. The initial snap back will likely level off a bit as some businesses shut down permanently.

Figure 2. Phase II of the recovery will likely slow down



We are not out of the woods. There may still be several episodes of fits and starts if the virus is not contained and lockdowns persist. With headline unemployment at 11% and many temporary stimulus measures set to expire, Washington is expected to be active in the coming months continuing to provide support.

The Market

The market has largely shrugged off the recent surge in virus cases. It chooses instead to focus on the nascent economic recovery stemming from unprecedented government support and monetary stimulus from central banks – not to mention improving sentiment.

In fact, after returning over 20% the S&P 500 hasn't performed better on a quarterly basis since 1988. Naturally, some industries are still down considerably due to the impact of the virus: restaurants, airlines, hotels, etc. It's easy (and dangerous) to forget the calamitous end to Q1 as a distant memory.

Figure 3. Most markets are up to slightly down on a last twelve month "LTM" basis.

	Total Return *(As of June 30, 2020)*			
	Q2 2020	YTD	LTM	Yield
Equities				
US Large Cap (S&P 500 Index)	26.1%	(3.1%)	6.7%	1.9%
US Mid Cap (Russell 2500 Index)	34.7%	(11.1%)	(5.1%)	1.7%
US Small Cap (Russell 2000 Index)	34.9%	(13.0%)	(6.8%)	1.5%
Intl. Developed USD (MSCI EAFE Index)	15.9%	(10.3%)	(4.8%)	3.2%
Emerging Markets USD (MSCI Emerging Markets Index)	19.4%	(5.4%)	0.9%	3.3%
Fixed Income				
US Bond (BBarclays US Aggregate Index)	2.8%	6.1%	8.9%	1.3%
International Bond USD (BBarclays Global Aggregate Index)	3.2%	3.0%	4.5%	1.0%
High Yield (BBarclays US High Yield Index)	11.4%	(3.8%)	(0.2%)	6.9%
Emerging Market Bond USD (BBarclays Emerging Markets Index)	10.6%	(0.4%)	2.7%	4.6%

Source: Factset

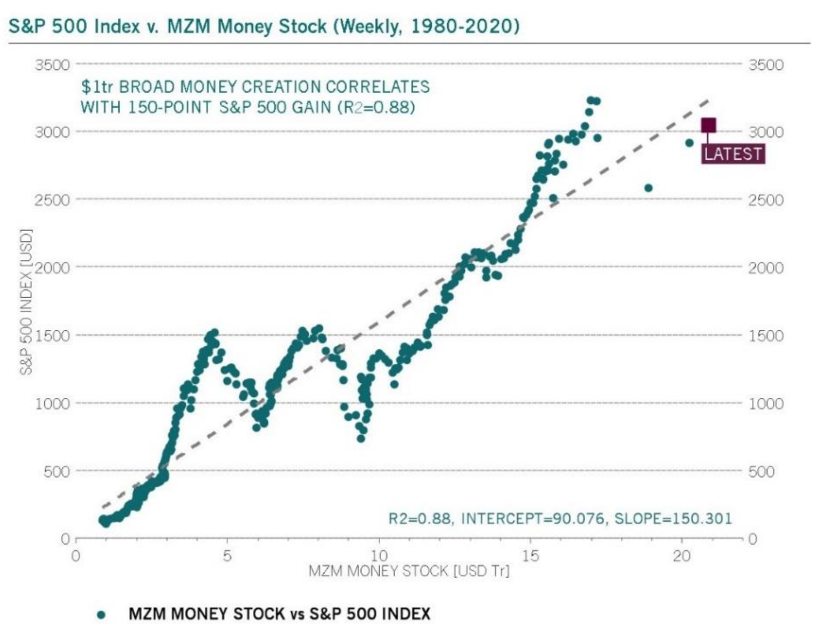
Figure 4. The rebound in Q2 largely made up for the downturn in Q1

Source: Cetera Investment Management, Morningstar, Standard & Poor's. Data as of 6/30/2020.

There have been reports of rampant speculation among those receiving stimulus checks, but there isn't much evidence of this overly impacting the market. The much bigger driver has undoubtedly been exceptionally accomodating central banks and governments around the world.

Thanks to lower interest rates and countless other stimulus programs, cash has flooded the system and found its way into the markets. Much of the recent market rally can be attributed to this massive liquidity boost despite a still suffering economy

Figure 5. An elevated money supply is strongly correlated with the S&P 500



Source: Refinitiv Datastream, Pictet Asset Management

We expect the market to remain volatile through the rest of the year as businesses and households adapt to an economy entirely different from only a few short months ago.

What the Bulls Are Saying

- Unprecedented support from governments and central banks is creating easy conditions for individuals and businesses
- US Households remain strong as the backbone of the economy, which should help drive consumption and limit defaults
- The global business cycle is already improving with manufacturing and production rebounding

What the Bears Are Saying

- The stock market is trading at historically high valuations already pricing in a rapid v-shaped recovery
- Political risks abound both at home and abroad (i.e. the US presidential election)
- Perhaps the biggest risk of all, a resurgence in the virus could spell the return to the economic and market lows of March/April

Our Portfolios

We continue to follow our long-term approach. Our portfolios benefited a great deal from rebalancing off of the market lows and continue to benefit from the higher yield of the risky bond positions purchased during the downturn. We are working to exit some of these positions in the near-term after performing very well in the market rally and add to positions where opportunities still exist.

We do not like the long-term setup of government bonds (0.6% starting yield with a high probability of losing money if interest rates rise from their record low levels). Therefore, we are happy to hold some of the risky bond positions over the long-term as they provide a higher yield and protection from a potential increase in interest rates down the road when the economy starts to improve.

Our safe bonds are up on the year and provide us plenty of “dry powder” to add to stocks on any major pullbacks. We continue to like our neutral positioning over the second half of the year as it provides optionality in different environments. Stated simply we’re ready to buy again on any big dips and we’re being patient as economy catches up to the rapid market advance of the last few months.

Please do not hesitate to contact us with any questions, investment or otherwise.

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