Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights

June 2020

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

There are perma-bulls. There are perma-bears. And then there's us.

A perma-bull is always bullish. A perma-bear is always bearish. The stock market goes up roughly 2/3rd of the time, so perma-bulls might seem better investors than perma-bears. However, perma-bulls lead with their chins when fundamentals deteriorate, and often suffer significant drawdowns from which it can take years to recover. Perma-bears trumpet their conservatism during bear markets, but then tend to miss subsequent bull markets.

RBA's strategy has always been to alter our positioning as fundamentals change. We are not wedded to any persistent market view, nor are we steadfast with respect to geography, style, size, sector, or factor. As we've said many times, our portfolios are like chameleons and their colors change as fundamentals change.

Market movements are typically based on "better" or "worse" conditions and rarely care about the absolute levels of profits or economic growth. Because fundamentals were deteriorating prior to COVID-19, our portfolios were defensively positioned going into 1Q20 and that caution served our investors well during the bear market. In April, we started increasing the cyclicality in our portfolios as data began to improve. Economic and financial conditions remain miserable in an absolute sense, but they are indeed getting better.

Recall that back in 1Q16 we shifted our portfolios from defensives to cyclicals in a single major change. Right now, however, the risk/returns seem more

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ill-defined than in 2016. There appears to be a tug-of-war right now between COVID-19 and government stimulus. US government stimulus has been record-breaking, but the US's COVID-19 response has been terrible relative to other developed nations' actions. Some investors discuss the possibility of a 2nd wave of the virus, but the reality is the 1st wave isn't even over.

We continue to prudently add cyclicality to our portfolios as fundamentals improve, but we believe a full-scale shift to cyclicals like in 1Q16's ignores the risks which the consensus has downplayed.

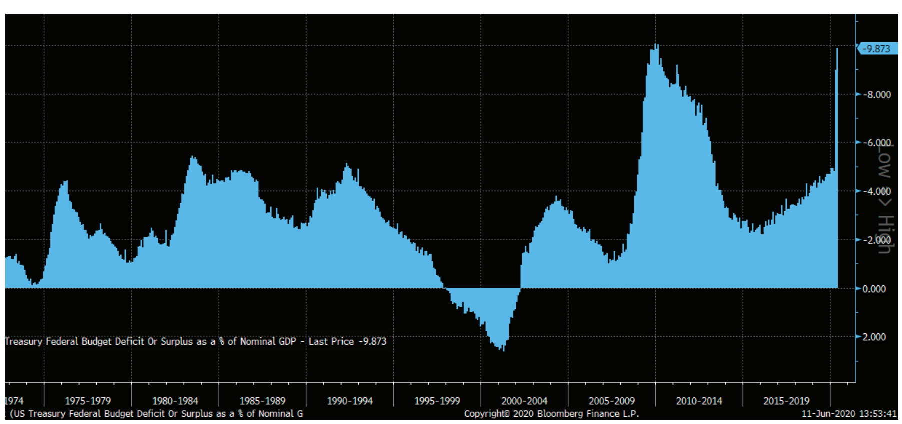
First in stimulus but...

We continue to manage our portfolios during this totally unprecedented period based on fundamentals, and not on market momentum or guessing. The US government has so far provided adequate cushioning of the economy, and economic data is starting to improve. As mentioned, this improvement argues for increasing cyclical exposure. However, the US response to COVID-19 has been woefully inadequate when compared to other major economies', and the risk of a reacceleration in cases is real. The risks argue portfolios should maintain some defensive exposure.

One cannot ignore the huge amount of short-term stimulus that's been injected into the US economy. Chart 1 shows the US federal deficit as a percent of GDP. In the last 50 years, the current budget deficit was surpassed only by the deficit associated with the Great Recession. Although the stimulus in this cycle is very short-term (i.e. the multiplier effects on the economy are short-lived versus those associated with infrastructure and other long-lived beneficial assets), it is clearly a massive attempt to provide a short-term cushion to the economic downturn.

CHART 1:

The US Treasury Federal Deficit or Surplus as a Percentage of Nominal GDP (Dec. 1968 - May 2020)



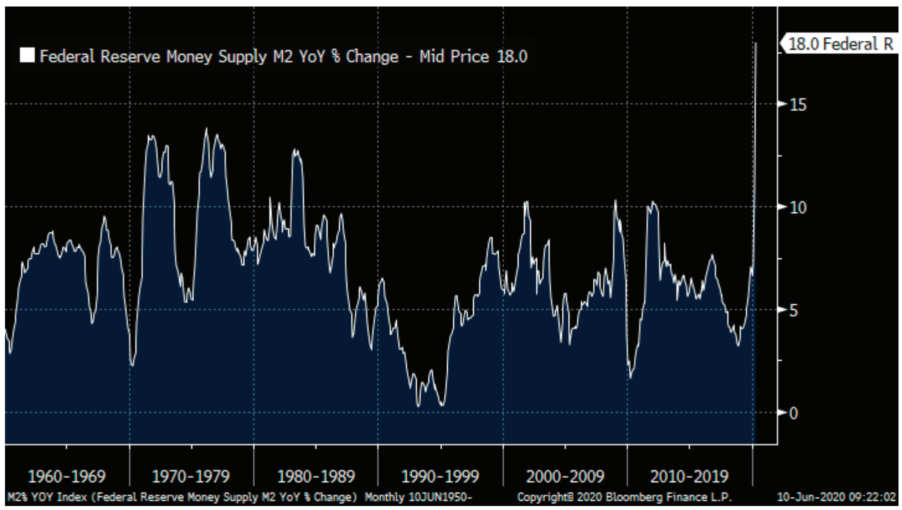
Source: Bloomberg Finance L.P.

 PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Bullish investors have similarly cited the size of the Fed's liquidity injection into the markets, but few understand the historical significance. Chart 2 shows the year-to-year growth in M2, which is currently the fastest in history. M2's 18% growth is nearly twice that seen during the Great Recession.

It is somewhat curious that observers who were so worried about inflation when the Fed aggressively tried to stem the Great Recession are now totally mum regarding inflation despite M2 growth being the fastest by far in modern US history.

CHART 2:
US Money Supply YoY Percent Change (Jan. 1960 - May 2020)

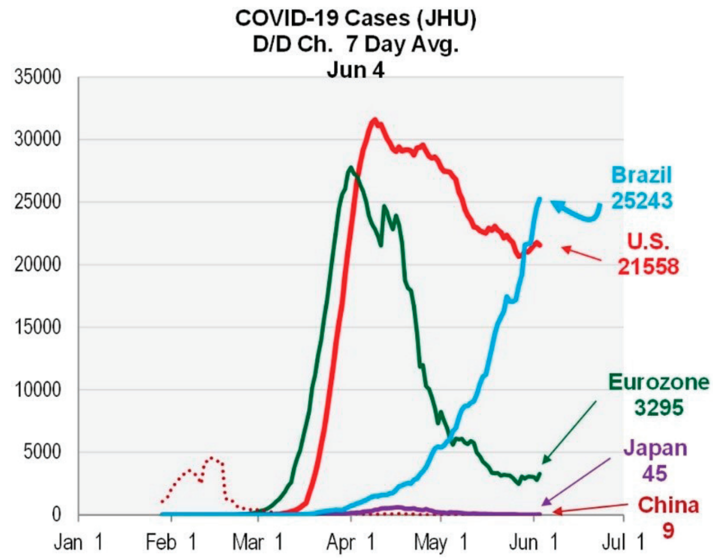


Source: Bloomberg Finance L.P.

...lagging in COVID-19

Cornerstone Macro, a leading independent economic research firm, succinctly described the dilemma investors currently face. The US has led the world in fiscal and monetary stimulus, but it has lagged the world in COVID-19 response. Only some emerging markets now have infection rate trends worse than the US's. The entire developed world has passed us in recovery trends. Chart 3 (Courtesy of Cornerstone Macro) shows the "curve" of COVID-19 cases in major economies. It is clear the US's response has been quite poor relative to other G-7 economies.

CHART 3:
COVID-19 in Major Economies



Source: Cornerstone Macro.

Many US investors apparently consider COVID-19 a thing of the past, and assume the economy will have a sure and swift recovery. However, the NYC Metro area has decidedly skewed overall US statistics. The initial surge in cases was largely centered in NYC Metro, and so is the recent decrease in cases. As of this writing, 21 states (up from 14 two weeks ago) have increasing COVID-19 cases. The path to COVID-19 recovery still appears more challenging than is generally thought. The risk of a negative surprise seems meaningful to us.

Adding cyclicality

As noted, we continue to prudently add cyclicality to our portfolios in accordance with fundamental improvement. In April, while maintaining overweighted positions we lowered our weights to Consumer Staples, Health Care, and Utilities in favor of a pan-sector quality tilt. We eliminated our position in REITs. We raised our Energy exposure from near-zero weight to a full equal-weight.

Because data has continued to improve, our latest changes include the following:

- Maintained, but further reduced overweights in Consumer Staples and Health Care. Reduced Utilities to equal-weight.
- China acted as a "safe haven" during the bear market (along with Switzerland). Because we are adding cyclicality, we lowered our weight in China and added

to more economically-sensitive non-US small caps.

- We had virtually no weight in Energy prior to our April additions. We further added to and are now overweight Energy. We have also added Transportation and Materials.
- Although we continue to believe that inflation is a greater risk than the consensus anticipates, we replaced TIPS with more economically-sensitive Corporate Bonds and Municipals. We also anticipate the changes to our equity positions will stand to benefit from higher inflation, reducing the need for TIPS in our portfolios.

Perma-bulls, perma-bears, and then there's us.

The extraordinary multi-black swan environment makes it difficult to be an ardent bull or ardent bear. Extreme positions seem based largely on guessing an outcome or market momentum rather than a thoughtful analysis of the fundamentals. **Fundamentals are improving from miserable levels and remain horribly depressed, but they are indeed improving. However, the reality of the US's inept response to COVID-19 should temper investors' enthusiasm at least to some degree.**

Our gradual rotation from defensive to cyclical considers the myriad of possible economic and financial outcomes without ignoring the extreme risks that are not dissipating. As has happened many times in the past, there are perma-bulls, perma-bears, and then there's us.

Don't miss out on future RBA Insights, subscribe today.

To learn more about RBA's disciplined approach to macro investing, please contact your local RBA representative.

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager focusing on long-only, global equity and asset allocation investment strategies. RBA runs ETF asset allocation SMA portfolios at leading wirehouses, independent broker/dealers, TAMPS and on select RIA platforms. Additionally, RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $9.4 billion collectively under management and advisement as of May 31st, 2020. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.