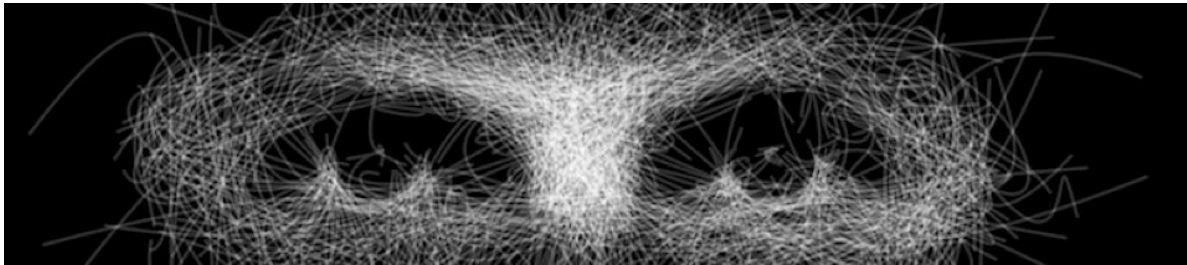


INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

SECOND QUARTER 2020: EYES WIDE SHUT

Blinding ignorance does mislead us. O! Wretched mortals, open your eyes!
- Leonardo da Vinci



A severe recession. Massive unemployment. A global pandemic infecting 13 million people. Populist uprisings in search of social justice. Trade disputes growing. Geopolitical tensions on the rise.

Companies abandon earnings guidance. Traders speculate in bankrupt companies. Oil producers commence a price war.

Not, seemingly, the ideal set-up for a major market rally. Especially one following immediately on the heels of a rapid, deep market plunge. Indeed, market participants had to shut their eyes to multiple concerns, to avert their eyes from a plethora of challenges threatening domestic and international political and economic stability.

But, since truth is indeed stranger than fiction, that's exactly what they did, choosing a vision of hope over a vision of despair. In this *Investment Outlook*, we'll ponder not just the economic environment and market environment, but also whether investors' eyes are failing them—whether they are not seeing as they ought to see, or not seeing what they ought to see.

That said, it must be acknowledged that whatever the explanation, market returns for the second quarter were nothing short of eye-popping. Investors may feel they have double vision (technically, diplopia, a condition where a single object is seen in duplicate) as they feast their eyes on double digit returns.

Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	20.5%	-3.1%
US Small Cap Stocks	Russell 2000	25.4%	-13.0%
International Developed Markets Stocks	MSCI EAFE	14.9%	-11.3%
Emerging Markets Stocks	MSCI EM	18.1%	-9.8%
Real Estate Securities	MSCI US Real Estate	11.7%	-18.5%
Commodities	Bloomberg Commodity Futures	5.0%	-20.0%
Bonds	Bloomberg Barclays US Aggregate	2.9%	6.1%
Cash	FTSE 3-month US T-Bill	0.1%	0.5%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

All equity classes produced very solid returns. Even beleaguered commodities generated a positive return, as did bonds.

These strong results, however, were insufficient to unwind the sharp losses from the first quarter. Year-to-date returns follow a familiar pattern from recent years: US stocks out-performed international stocks, large cap stocks out-performed small cap stocks, growth stocks out-performed value stocks. Those trends, so far, remain intact.

THE COVID ECONOMY: DOWN IN THE DEPTHS OR ON THE MEND?

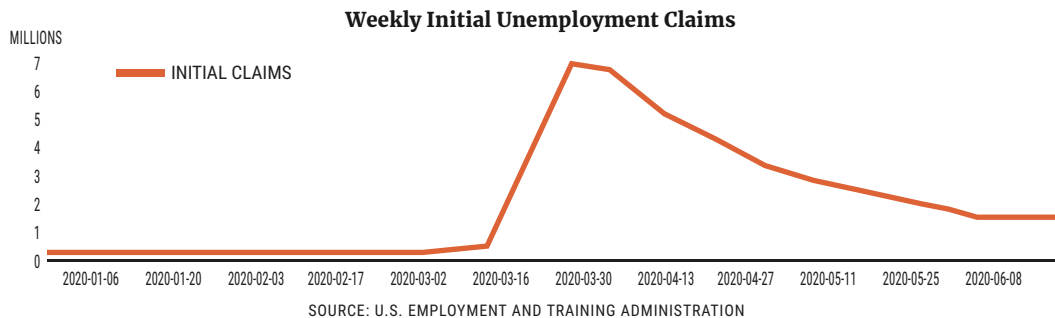
*It was the best of times, it was the worst of times, it was the age of wisdom,
it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity,
it was the season of Light, it was the season of Darkness, it was the spring of hope,
it was the winter of despair, we had everything before us, we had nothing before us,
we were all going direct to heaven, we were all going direct the other way...*
- Charles Dickens

Discussions about the state of the US economy read a lot like the famous introductory paragraph in Charles Dickens' *A Tale of Two Cities*, wherein "the noisiest authorities insisted on its being received, for good or for evil, in the superlative degree of comparison only." We are not big fans of hyperbole, nor of cognitive dissonance in which two directly contrasting perspectives demand a seemingly impossible reconciliation.

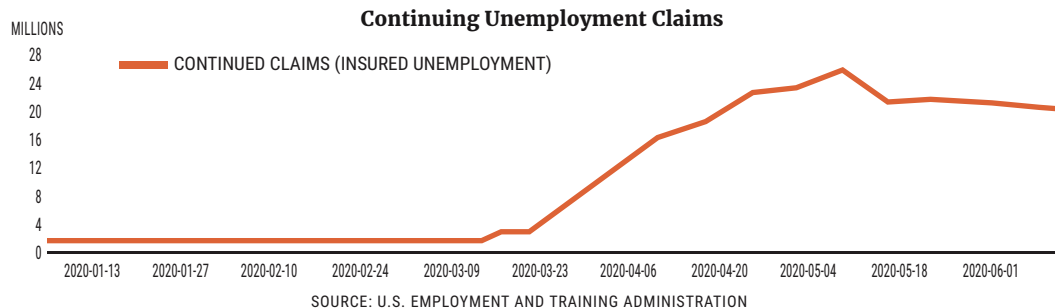
But economies are complex systems, and economics is not so much a hard science as an interpretative art, and interpretations may vary. In this very indeterminate moment, it seems to come down to this. Do we look at the absolute level of economic data—how many unemployed? How much unutilized capacity? How much has service sector activity collapsed? Or do we look at change in levels—fewer unemployed, less unutilized capacity, rising service sector activity? In other words, is it the level, or is it the direction, that matters in the interpretation of economic data?

Take labor market data, for example.

As the graphic below shows, new weekly unemployment claims were consistently running at a rate of barely 200,000. Then the pandemic hit, lockdowns were imposed, and in one particularly miserable and memorable week almost 7 million new applications were filed for unemployment benefits. The good news? New weekly claims have fallen dramatically, to a level of about 1.3 million. The bad news? That's still 1.3 million new people losing jobs in just one week.



It's the same with continuing claims—people who previously filed for unemployment and continue to collect benefits because they haven't been hired back or found a new job. In the recovery following the global financial crisis, continuing claims had been running at a level of about 1.6 million. Bam. The pandemic strikes, and continuing claims explode upward to a peak of more than 24 million. The good news? Continuing claims have fallen by 6 million. The bad news? That still leaves 18 million people unemployed and collecting benefits.



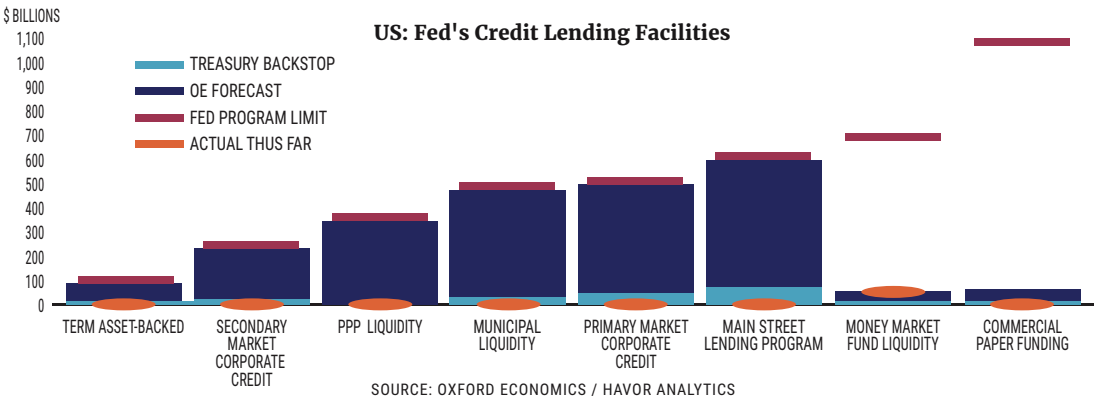
This good news/bad news, it-depends-on-how-you-look-at-it, push-pull phenomenon plays out across myriad economic datapoints. Purchasing managers' indices (PMIs) for the manufacturing and service sectors have been abysmally low, contractionary levels—but they've bounced off the bottom and are improving. Ditto for consumer spending. For restaurant bookings and flight reservations.

So we return to our question: which matters more—absolute level, or change at the margin? Market participants are forced to choose, to have a point of view, to take a stance. This is a world of either/or, not this AND this. It's as if investors suffer from amblyopia, commonly called lazy eye. It's a disorder of sight in which the brain fails to process inputs from one eye and over time favors the other eye. And it results in decreased vision in an eye that otherwise typically appears normal. Investors' lazy eye failed to look at woeful, worrisome absolute data; their good eye saw the positive rate of change.

MONETARY AND FISCAL POLICY: THIS IS WHAT ALL IN LOOKS LIKE

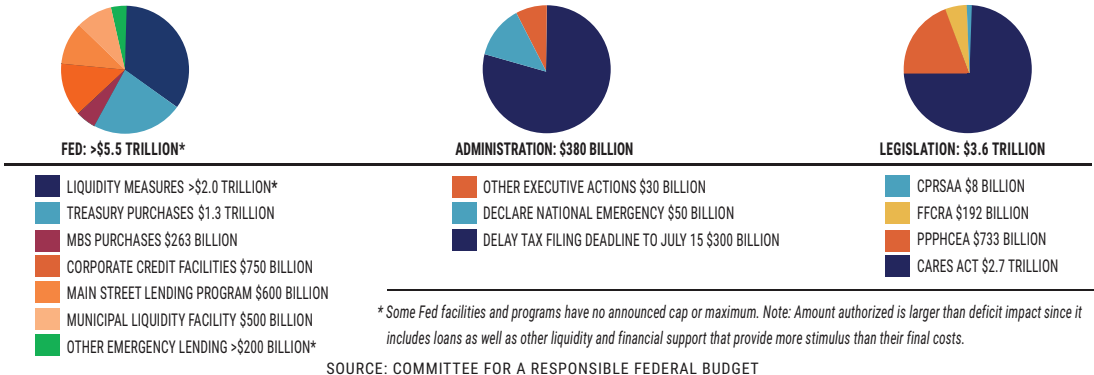
*If you see with innocent eyes, everything is divine.
- Federico Fellini*

With the global pandemic raging and lockdowns becoming the order of the day, policymakers stared into the abyss in March, terrified. After all, who wants to preside over an economy tumbling into a second Great Depression? So, whipped up into a frenzy, Jay Powell and company at the Federal Open Market Committee promptly dropped interest rates to zero, scooped up trillions of dollars of securities, and devised nine different credit facilities in an urgent, not to say desperate, bid to prevent markets from seizing up and to keep credit flowing.



Not to be outdone, in a display of remarkable and unlikely bipartisanship, the legislative and executive branches, Republicans and Democrats, teamed up to pass and sign, in rapid order, three major pieces of legislation to provide support and relief to the faltering economy. (Cynics might point out that with the Presidency, all 435 House seats, and 1/3 of Senate seats up for election this fall, this 'whole of government' effort might just support re-election bids as well as cushion the economic pain of a rapid and deep recession.)

Aggregate Monetary and Fiscal Policy Initiatives



Together, these fiscal policy responses total \$3.6 trillion. Add in the Fed facilities and we're looking at an economic lifeline of over \$9 trillion—a whopping 43% of the US gross domestic product. These actions dwarf the scale of the policy response to the global financial crisis of 2008, when monetary stimulus amounted to \$3.7 trillion and fiscal stimulus amounted to \$787 billion. In short, policymakers have acted aggressively and pre-emptively, and markets were not insensitive to both the swiftness and the magnitude of these policy moves.

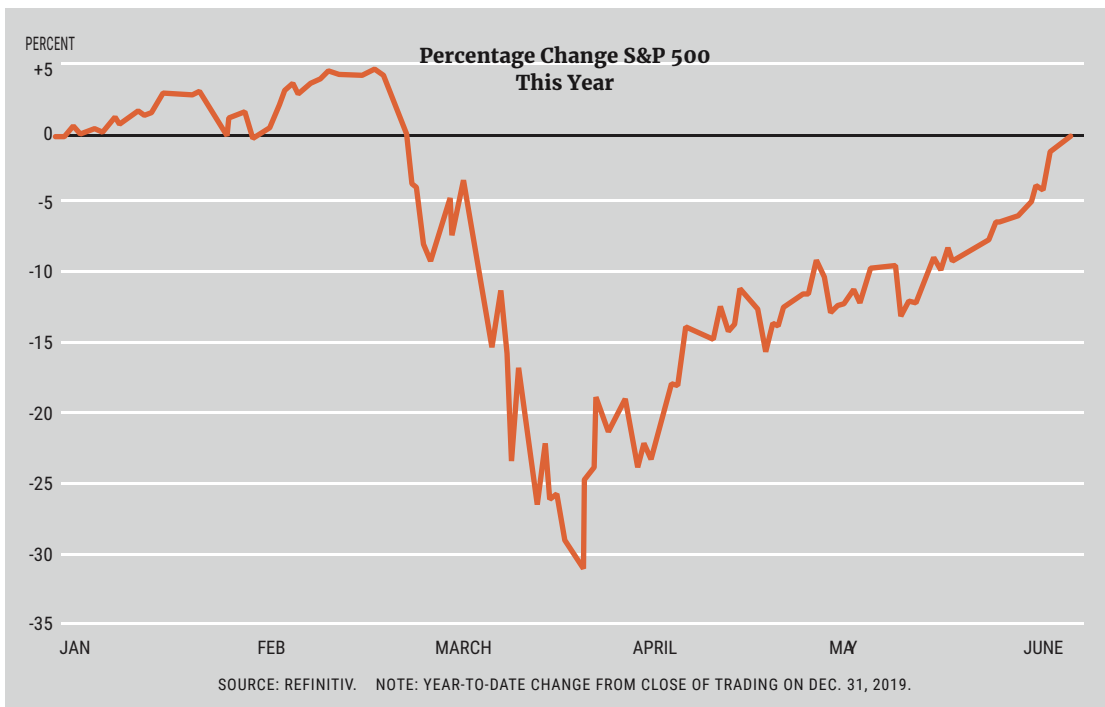
Market observers of these moves, dazzled and made dizzy, cannot resist the temptation to describe them as 'unprecedented,' noting that we are in 'uncharted waters.' Bowled over by the boldness of the wizards at the Fed and in Congress, they choose not to see the many risks that accompany such hasty and audacious policy-making. Indeed, they appear to suffer from amaurosis fugax—a temporary loss of vision, usually in just one eye, that lasts from seconds to minutes. (It is also called episodic blindness.)

The more sober-minded, eye-shade-wearing wonks at the National Bureau of Economic Research suffer no such vision loss. They determined that the longest post-war economic expansion ended in February when the US economy entered recession. Many economists believe that this will prove to be the sharpest recession we've experienced but also the shortest, that the economy bottomed in April and that we are entering a new expansion cycle. Let's hope so. But the minutes from the recent FOMC meeting are sobering, warning that "voluntary social distancing, precautionary saving, and lower levels of employment and income" might impede economic recovery—all that, as well as the risk of potential spread of the coronavirus if the economy is re-opened too quickly. That does not sound like a prescription for a V-shaped recovery.

MARKET VISION: WHEN SEEING IS NOT NECESSARILY BELIEVING

*There are various eyes.
Even the Sphinx has eyes: and as a result there are various truths,
and as a result there is no truth.
- Friedrich Nietzsche*

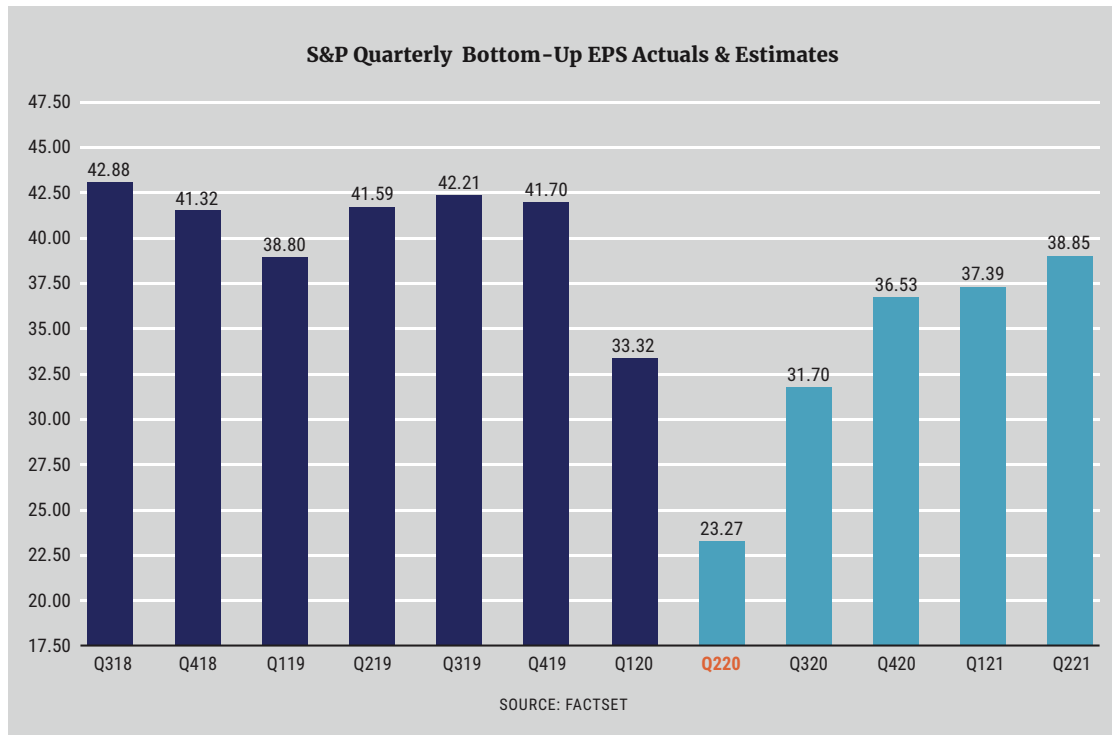
Do our eyes deceive us? The markets stared the pandemic and the recession in the eye, blanched, panicked, plummeted, and then stared down its fear. With virtually a complete recovery in early July from the first quarter's drop, the market is singularly focused on the reopening economy narrative. That narrative concludes like a classic fairy tale, with the end line "And they all lived happily ever after."



But the narrative appears to be a trick of the eye—a *trump l’oeil [sic]*, as the French would say. It is a truism on Wall Street that markets are forward looking. And a lot of the ultra-gloomy economic data are backward looking. Looking ahead, investors eye lifting of the lockdowns that at one point covered more than 95% of the US population. They focus on the enormity of the monetary and fiscal policy efforts and conclude that the worst-case potential—a full scale, durable depression—has been neutralized by these initiatives. They glom onto the positive change in direction of economic data and not the absolute level. They foresee progress on developing both therapies and vaccines for the coronavirus. The jury has seen the evidence and rendered its verdict: not guilty. The economy is not guilty of failing to achieve a robust recovery. Markets are not guilty of failing to anticipate that recovery.

The next question is just how far into the future the market is peering. Is it near-sightedly looking at the coming weeks and months—suffering from myopia (a vision condition in which people can see close objects clearly, but objects farther away appear blurred)? Are investors too focused on the immediate, on the kneejerk economic bounce that logically follows a shutdown of the economy, and not on the cyclical and structural risks over the longer term?

According to FactSet, analysts have estimated that earnings declined 44% in the just-ended second quarter, to be followed by an estimated earnings decline of 25% in the third quarter and 12.7% for the fourth quarter. (Revenue is estimated to have fallen 11%, 5.5%, and 2% in the respective quarters). And for all of 2020, they report an expected earnings decline of 21.5%. Sure, earnings are estimated to grow each successive quarter from the nadir of the second quarter. But looking at the big picture, even a year from now quarterly earnings will not have recovered back to levels reached in 2019—a year that saw no earnings growth.



FactSet also reports that analysts expect S&P 500 profits will rise 28% in 2021, and a further 16% in 2022. But those distant 2021 and 2022 earnings estimates are blurry—in analyst-speak, we have poor earnings visibility for the next couple of years, given pandemic and economic uncertainties. In other words, markets are pricing in substantial but highly uncertain profit growth well out into the future.

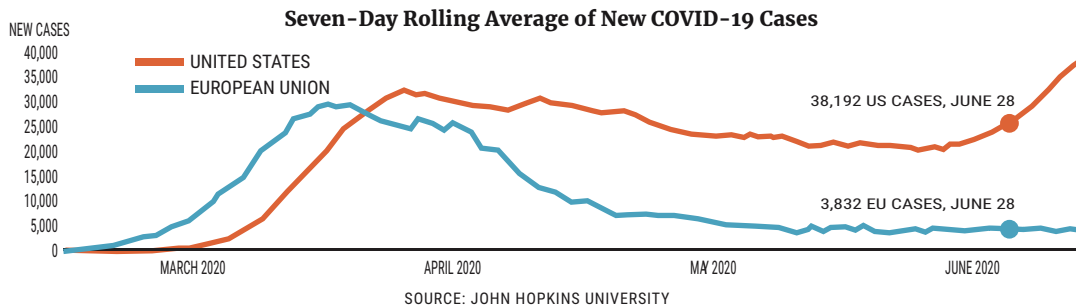
COVID-19: INVISIBLE BUT EVERYWHERE

*But the fool on the hill
Sees the sun going down
And the eyes in his head
See the world spinning 'round
- The Beatles*

How, now? Ultimately, of course, it's all about the virus. Globally, over 13 million people have contracted the coronavirus and over 500,000 people have died. The US accounts for approximately 25% of each of those grim statistics, despite constituting only 5% of the world's population.

Where do we stand now on the pandemic? From the vantage point of early July, the news is worrisome and encouraging.

Worrisome is the failure nationally to bend the case curve. The US stands in stark contrast to the successes that have been achieved in Asia and Europe.



This chart shows clearly that the lockdowns in April and May helped reduce the number of new cases in the US, but not nearly to the degree that Europe succeeded in reducing the spread of the virus.

More recently, the substantial rise in new US cases, particularly in the South and the West, is deeply concerning, as it coincides with re-opening the economy.



A POLICEMAN TAKES IN A CITIZEN FOR NOT WEARING HIS FLU MASK PROPERLY IN SAN FRANCISCO IN 1918. PHOTO COURTESY OF CALIFORNIA STATE LIBRARY.

It also raises questions about our ability as a nation to both learn from the past and to follow accepted wisdom as to how to limit the spread of the disease. We all know the drill: social distancing, wearing a face mask, frequent hand washing. But do we collectively have the will to take these precautions?

When the Spanish flu was raging in 1918, there was an anti-mask rebellion in San Francisco and other cities. It resulted in a spike in new cases and thousands of deaths. Let us hope that this is one history lesson we have learned, and taken to heart.

Encouraging is the news from scientists and researchers as they toil tirelessly to develop therapies and vaccines. Substantial knowledge has been gained to better treat the disease, the FDA has approved a drug (Remdesivir) to treat severe cases, and blood plasma treatments are being implemented. Multiple pharmaceutical companies and public health authorities are racing to develop vaccines across numerous platforms—it has been estimated that there are 150 vaccines in various stages of preclinical and clinical trials. While it may be overly optimistic to hope for a preventative vaccine by year end, there are good reasons to believe progress is being made.

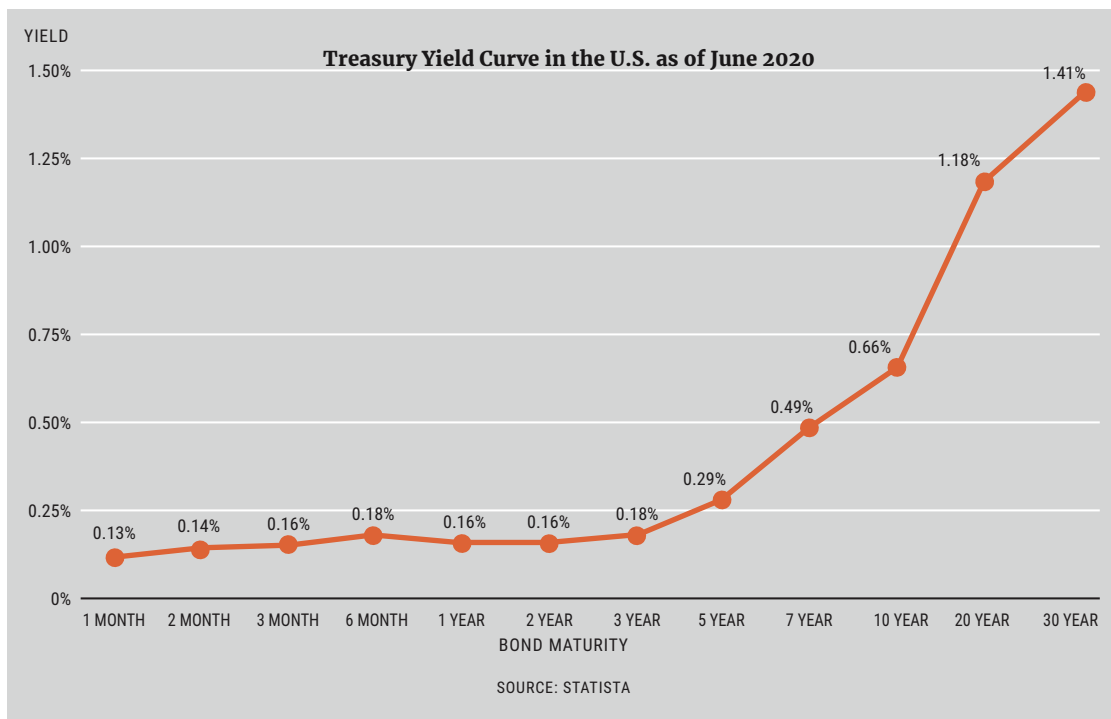
INVESTING IN THE AGE OF COVID

*I am interested in relating the things we see with
the things we see with our eyes closed.
- James Turrell*

Our sober-eyed view of the investing landscape is a combination of cautious optimism and plain caution.

Even with our eyes closed, we can see that a very wary Fed is likely to sustain interest rates at a very low level for a very long time to come. At the same time, the economic fragility that underlies this policy positioning suggests that bankruptcies will rise, leading to loan defaults and credit losses. We view inflation risk as muted presently, and for the foreseeable future, notwithstanding accommodative government policy, as the economic recovery comes in fits and starts.

We note, too, that the yield curve has normalized, albeit at low levels.



This suggests that fixed income investors can accept moderate duration risk but may need to be conservative with regard to credit risk. Bond owners will need to confront the likelihood that fixed income will generate less income than it has in the past.

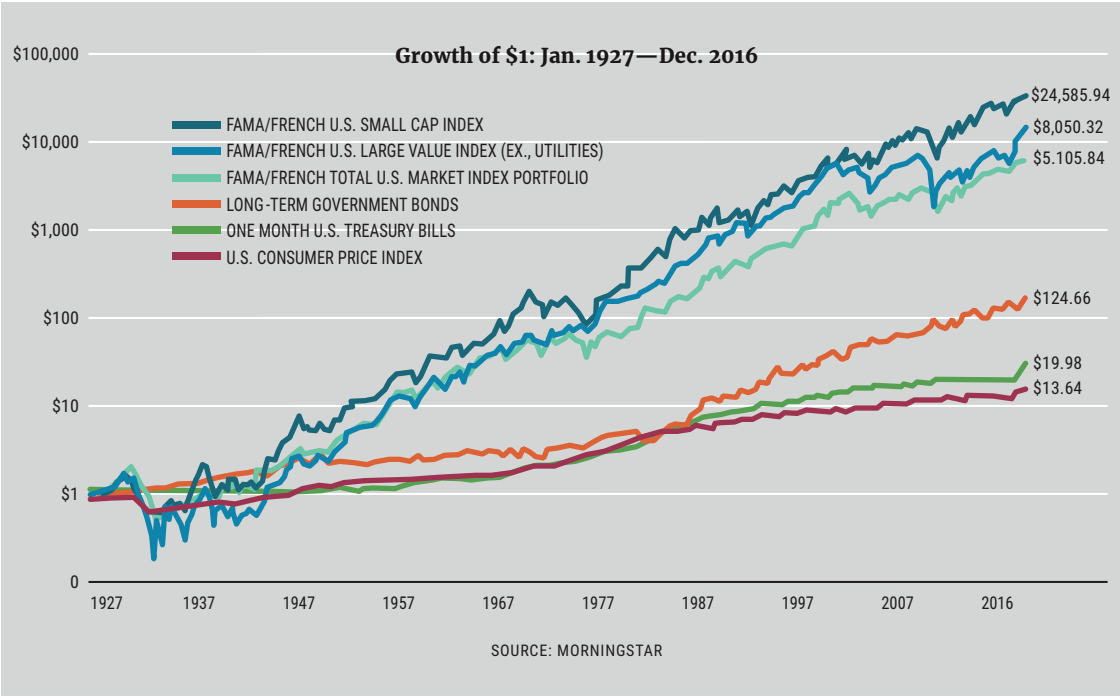
Equity investors need to maintain a long-term perspective. Especially in uncertain times like the present, stockholders need to remind themselves of the old adage that it's time in the market, not market timing, that produces the best long-term investing results.

And it does get easier, with time. After all, commonly, sometime in your 40s, it gets harder to see close up, but you can see things far away just fine. This is called presbyopia. (Presbyopia happens when the natural lens in the eye gets less flexible.) Equity investors need to look through the volatility we are likely to experience in the near term. Despite our current reservations about the pace of economic recovery and corporate profits, equities continue to represent the best long-term choice to grow capital over time.

The country, and the world, face considerable challenges. The pandemic is spreading in numerous countries, notably the US and Brazil. The need to address social justice issues, following the death of George Floyd, is urgent

and compelling. Partisan division in the US is large and getting larger. The November elections will magnify these divisions. Globalization, international trade, and the liberal world order are under assault. Geopolitical tensions are running high.

But this is hardly the first agglomeration of large challenges the nation and the world have faced. Monetary and fiscal policies are aligned to support economic recovery and relieve financial pain. They also inflate asset prices and drive investors to take more risk. Under such conditions, equities represent a not unreasonable alternative. Said differently, low interest rates rationalize higher valuations for equities and other risk assets like high yield bonds and real estate. When we gaze into the future—the distant future, beyond highly visible near-term volatility—we can perhaps have more confidence than we do about the near future. After all, the long term growth of capital achieved through equity ownership has proven itself, through world wars, depressions, panics, assassinations, and natural disasters.



It helps to know that, even as we look far away (and with less clarity close up), presbyopia isn't a disease. It's a natural part of the aging process. And it's easy to correct. (Myopia is also easy to correct.) Portfolio managers aren't ophthalmologists, and like other people lack crystal balls to see into the future. But we can combine foresight and insight, with our corrected eyesight, to construct portfolios of high-quality assets that enable investors to realize their visions.



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