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Bailard's Quarterly Review of Economic and Market Developments*
Q2 2020

Chat with the CIO: In Search of Perspective

In this quarter's Chat with the CIO, Eric P. Leve, CFA reflects on the tumultuous past few months with Thomas J. Mudge III, CFA (Director of Domestic Equity Research) and they both share thoughts on the outlook ahead.

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Eric P. Leve, CFA: There is no doubt that these are unusual days. And it's not just the perplexing juxtaposition of a declining economy with rallying markets or the pervasive uncertainty, but the impacts on our lives, families, and communities. Within that context, we as portfolio managers can pause to evaluate the current conditions in search of opportunities that align with the values-driven approach that Bailard and our clients hold dear.

So, Tom, the U.S. stock market's rise since late March has been described as the "most hated bull market in history." What explanation do you have for how the market could rally in the face of an overabundance of bad news?

Thomas J. Mudge III, CFA: Studying human behavior reveals numerous instances where sentiment reaches extreme levels. Historically, investors have tended to overreact to bad news and they perpetually hate uncertainty. We have been awash in both bad news and uncertainty. Yet, this created potential opportunities for the disciplined investor, particularly once valuations dropped to exceptionally-low levels in the spring.

Eric: Do tell!

Tom: As an example, when the panic-selling increased in the second half of March, stock prices were driven down, in some instances as much as

*Please see important disclosures on page 19.

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90% off their pre-COVID-19 levels. A number of companies in impacted industries like hotels and restaurant suppliers were trading as though they were on the verge of bankruptcy even when they had cash reserves sufficient to keep them solvent for a year or more. With this kind of behavior from the market, we felt that much of the bad news was already priced in, potentially creating buying opportunities.

Eric: But, how do investors operate with that kind of uncertainty? Were there concerns at that time about the possibility of the stock market dropping further, and the danger of buying prematurely?

Tom: That possibility always exists. In the stock market, there is a spectrum that runs between opportunity and certainty. In general, the more certain the outcome, the smaller the opportunity and vice versa. One of my favorite quotes is, "There is simply no room for certainty in investing." This is because once an outcome is known, any advantage to be had by investing based upon it is diluted.

Eric: Agreed. While the future is uncertain and any situation could always get worse, examining the historical odds and past outcomes of similar events helps investors put the risk in context.

Tom: You got it. For example, the same Florida city could be hit by two hurricanes in a single season but, based upon a long history of observations and improved weather monitoring and forecasting, we know the odds of that happening are very low. Similarly, COVID-19 could have proved (and could still prove) to be the worst pandemic in recent history. But, should that come to pass, what are the potential implications?

Eric: Comparing the economic and stock index performance during past viral outbreaks can help shed light on possible market outcomes stemming from COVID-19. The economic impact of recent flu and other viral epidemics proved in each case to be minor; there was little flu-specific market reaction to either the Asian Flu pandemic of 1957 that killed 1 to 2 million people, or even the Hong Kong Flu pandemic of 1968, which killed an estimated 1 to 4 million people worldwide. While the current crisis has not reached that scale, we readily acknowledge that we are nowhere near knowing the outcome of this pandemic and it is not the same as those above.

Tom: Make no mistake, it is impossible to reconcile the effect on lives and families and communities with the economy and the markets. Yet, in search of silver linings, we can look for opportunities for the long-term.

When in late March the S&P 500 had fallen almost 34% in just over a month, all due to COVID-19 fears, it was clear that investors were discounting a very bad outcome. However, the resulting attractive relative valuations alone could not manufacture a stock market bottom. For a market to reverse course and head higher, a shift in investor sentiment is also required. While far from certain at the time, there were some early indications that the odds for a positive sentiment swing were improving. And, Eric, those green shoots first sprouted outside of the U.S.

Eric: They certainly did. Investors in the United States had a small but significant informational advantage due to the virus spreading through parts of Asia and Europe first. Additionally, the U.S. entered the pandemic with a robust economy, record low unemployment, and a generally bullish business climate and investor outlook. Just as a healthy person is typically more resilient to disease, in our view, a healthy economy pre-COVID-19 boded well for a more rapid recovery.

Once an outcome is known, any advantage to be had by investing based upon it is diluted.

Tom: And, it's important to note that Congress and the Federal Reserve took reasonably swift and decisive actions to provide both fiscal stimulus and monetary liquidity to cushion the economy and calm the financial markets.

Stock prices are primarily driven by investors' expectations about the future and not by the current reality. This is why the stock market has historically always begun rising long before the economy shows signs of recovery. With investor expectations very low in late March regarding COVID-19 and the economy, it did not take much good news to begin driving stocks higher.

Eric: So, Tom, what's your perspective on the U.S. stock market for the remainder of the year?

Tom: There are always too many unknowns to forecast the stock market with any accuracy, but we can lean on current valuations and earnings estimate revisions to get a sense of a possible range of outcomes, if there are no significant unforeseen developments between now and year end (an admittedly very large "if").

Looking at valuations, large cap growth stocks (as represented by the S&P 500 Index) appear close to fairly valued at this point, given the prevailing outlook for interest rates and inflation. Wall Street analyst earnings expectations have been rising steadily in recent weeks for stocks both large and small; as long as that outlook prevails, it may act as a tailwind driving the market higher.

Finally, the U.S. consumer has bounced back toward normal much more quickly than was expected earlier in the year, with measures of mall traffic, airport security checkpoint pass-throughs, and hotel stays all surprising to the upside. At the same time, much COVID-19 fear and economic recovery skepticism remains, hence your "most hated bull market in history" designation.

Eric: At risk of over-using quotations, another investment adage is that "markets climb walls of worry." This gem suggests that, as long as doubters remain on the sidelines, there are potential investors that may finally be convinced to join in and drive stock prices higher. Although the economic news is generally trending better and there are glimmers of hope for an end to the pandemic, we still see lots of people worrying, and the market continuing to climb that wall.

While this has been a time like none other in our investment careers, I am proud to see Bailard's portfolio managers, across all asset areas, looking to one another for guidance, pursuing investment results with the discipline that has been our hallmark, and doing so in a manner consistent with the values we hold to as a firm. Thanks Tom for a lively conversation!

Wall Street analyst earnings expectations have been rising steadily in recent weeks for stocks both large and small.

The Technological Transformation of Working from Home

Dave Harrison Smith, CFA, Senior Vice President of Domestic Equity Research

"What's happening to the office? Technology has made it possible to redefine where work is done. The traditional notion of an office as the place where someone goes to work seems to be going the way of the buggy whip, the eight-track tape, and the stenographer."

This introduction to the article "Two Cheers for the Virtual Office," published in the MIT *Sloan Management Review*, could have been written last week. In fact, it was published in July of 1998. A literature review reveals a number of similar articles from notable sources over the intervening two decades, including the *Harvard Business Review*, *Management Review*, and *The New York Times*.[1] Until now, the adoption of remote work has been a rather slow-rising tide in the modern economy.

Fast forward to 2020, we are seeing a massive change in adoption rates as the COVID virus reshapes office life. Slack (2,045 employees), Square (3,845 employees), Shopify (5,000) employees, and Facebook (48,000 employees) are just a handful of the household names that recently announced either complete or expanded remote employee policies. This article, written remotely from your author's living room, is a thought exercise in the staying power of this technological transformation, its potential impact on the workplace, and the potential beneficiaries in this new world.

Before getting carried away by the hype, it's worth recalling that despite all its benefits, remote work has historically been close but out of reach for the majority of American workers. In 2018, the Bureau of Labor Statistics reported that 29% of the U.S. workforce had the ability to work from home, yet only 15% had recently worked from home for at least one full day per week. Further, only about 4% of U.S. workers averaged three or more days from home.[2] A 2016 Gallup poll pointed to a slightly higher figure, with about 13% of employees spending 80% or more of their time working from home.[3] That figure was up from 9% four years earlier but still reflected the fact that the vast majority of American workers regularly made the trek into the office for their nine-to-five. And, it should be noted that this data does not delve into whether working from home is driven by an employee's personal preference, corporate inertia, or even the very nature of the work.

Until now, the adoption of remote work has been a rather slow-rising tide in the modern economy.

With respect to the ebb and flow of corporate culture, one shouldn't forget that we saw several notable companies reverse existing remote work policies only a few short years ago. CEO Marissa Mayer, at the time entrenched in the Yahoo turnaround effort, cancelled the company's long-time remote work policy in 2013 stating, "Some of the best decisions and insights come from hallway and cafeteria discussions, meeting new people, and impromptu team meetings. Speed and quality are often sacrificed when we work from home. We need to be one Yahoo!, and that starts with physically being together." IBM made a similar move in 2017 to reverse the work from home policy for 5,500 of its marketing employees in favor of small satellite offices.

Critics of remote work point to the potential of lower productivity or lower creativity… less chance of a 'spontaneous idea' from a casual conversation around the water cooler. There is some evidence to support this: a study from Harvard Medical School[4] found that papers with authors close in proximity to each other tended to produce more impactful work.

A similar criticism is that employees can struggle with the lack of distinction between work and home life,

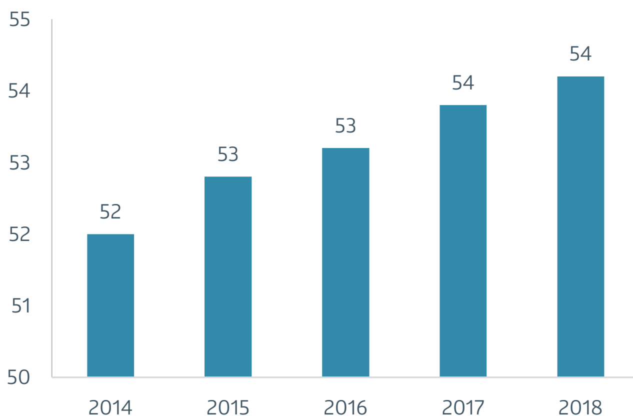
perpetuated by our 'always on' culture. Charlie Warzel summed this issue up succinctly in a recent opinion piece for *The New York Times*, "Work on weekends? Why not?! I'm already at the office. No commute didn't mean a leisurely morning walk or exercise; it meant waking up, grabbing my phone in bed and punching the clock. My productivity was through the roof, but I found myself burning out every few weeks, desperate for a vacation or anything that could help demarcate work from leisure."

Yet the potential upside is real. In addition to time saved from not commuting, research has found that allowing employees to work from home can increase productivity. A 2019 survey of 1,200 remote and on-premise workers found that the ability to work remotely fostered happiness and loyalty to their employer.[5] The survey further determined the major contributing factors included better work-life balance, increased productivity and focus, less stress, and avoiding a commute. Indeed, according to a recent Gallup poll, 59% of employees working from home during COVID reported they would like to continue working remotely as much as possible going forward, while the remaining 41% planned to return to the office when available.[6] Under the right circumstances, the benefits of remote work can be real and material for both workers and their employees.

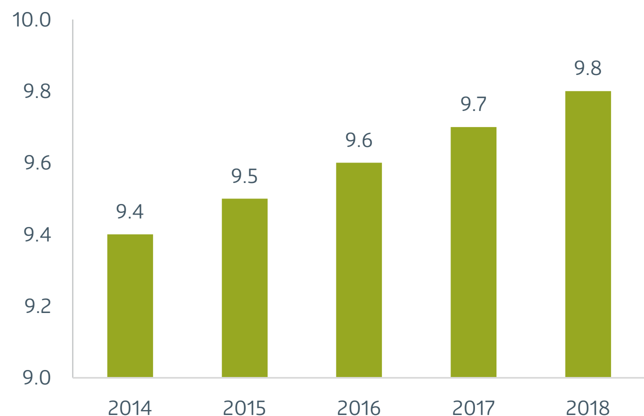
Our current belief is the trend toward remote work has been meaningfully accelerated and that for many companies and employees, this will have a lasting impact on how they operate. The pandemic represents a massive live test of costs and benefits. Remote work is no longer considered a fringe benefit confined to technology companies. Companies that would not have previously considered remote-work friendly policies are realizing benefits and grappling with challenges in real time. Employees that may have complained for years about their commute are finding out that time gained can mean breakfast with their children rather than rushing out the door. CEOs are analyzing corporate budgets and pondering if spending enormous sums on rent still makes sense.

Thus far, collaboration technology tools have been the most obvious immediate beneficiary. This has been well covered by both investors and the media and, while one can argue about barriers to entry and technological differentiation, there is little doubt of the massive increase in adoption for many popular platforms. We believe that the pandemic will also result in meaningful, long-lasting pressure for enterprises to adopt modern cloud technologies and redefine their businesses for the digital age. Further, the category known as Unified Communication as a Service (UCaaS)—which encompasses technologies providing

U.S. Average Minutes Spent Commuting per Day



Estimated Days Lost to Commuting per Year



Source: https://data.census.gov/cedsci/table?q=S08&d=ACS%201-Year%20Estimates%20Subject%20Tables&tid=ACSST1Y2018.S0801.

cloud based telephony, messaging, video conferencing, and other communication methods—appears poised to show a long-lasting acceleration in growth. The pandemic has shifted a work-from-anywhere option from a corporate perk to a critical need. Even companies that plan to return to the office will need to be prepared for the event of another shelter-in-place order. In this world, digital transformation and enabling remote employees will likely be ubiquitous, even for companies with primarily on-premise operations.

In this world, digital transformation and enabling remote employees will likely be ubiquitous.

Additionally, we see an interesting opportunity for cyber security. The number of cyber-attacks has not relented: the old model of a 'walled garden' is less meaningful when employees are permanently outside of the walls. This trend was already in place as evidenced by the steady march of applications moving from owned datacenters to cloud services. The shift of the employee base has increased pressure on these old-school models and dramatically increased the value proposition of modern, cloud-based security solutions. Similar to mobility solutions for remote work, we see this as less of a stair-step increase in growth, and instead believe growth will reflect a longer-term secular shift commensurate with increased value.

On a recent Microsoft earnings report, CEO Satya Nadella said that the company's customers had seen "two years' worth of digital transformation in two months." Companies are grappling at rapid speed to compete and function in a distributed world. Eventually, offices will reopen. The question remains, what will they look like?

1 The Alternative Workplace: Changing Where and How People Work, Mahlon Apgar, IV, May-June 1998, Harvard Business Review; Have Modem, Won't Travel, Eileen Davis, April 1995, Management Review; It's Unclearly Defined, but Telecommuting Is Fast on the Rise, Alina Tugend, March 7, 2014, The New York Times.
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3 https://www.gallup.com/workplace/283985/working-remotely-effective-gallup-research-says-yes.aspx
4 https://harvardmagazine.com/2011/05/water-cooler-effect
5 https://www.owllabs.com/state-of-remote-work/2019?hs_preview=jWDXIXgj-13385250578
6 https://news.gallup.com/poll/306695/workers-discovering-affinity-remote-work.aspx

How Will China Emerge?

Eric P. Leve, CFA, Executive Vice President and Chief Investment Officer

It's not geology, but the Pacific Ocean feels wider than ever. In mid-January, Presidents Donald Trump and Xi Jinping signed phase one of a trade deal that rolled back the tariffs put in place late last year, suspended planned tariff increases, and agreed to increases of purchases of U.S. goods by the Chinese. The equity markets loved the deal and it was the strongest symbol that both sides wanted to resolve the nearly two-year-old trade fracas. At the same time, the World Health Organization had identified a virus in Wuhan, China that had infected several dozen people and was potentially spreading person-to-person. The catalyst of COVID-19 will likely overshadow the trade deal, again widening the rift between China and the United States.

These unprecedented past few months have heightened the polarized relationship between the two countries under Presidents Trump and Xi. In most every arena—from political and economic to financial and technological—both leaders have reason to be suspicious of the other as well as credible means to enhance self-sufficiency.

So, a simple question: does China come out of this crisis hobbled or with a new spring in its step?

China's meteoric economic growth of the past three decades came crashing down with the rest of the global economy, falling 6.8% for the year ended March 31st. China was ground zero for COVID-19. Its economy was hit first but, after some dithering by the government, the eventual response was vigorous and allowed its economy to "reopen" before the rest of the world.

China is renowned for grandiose and costly plans that are often inefficiently or ineptly enacted. Its Belt and Road Initiative (an effort to build infrastructure around the world to increase access to gas, oil, and other raw materials) was a foreign policy centerpiece until many participating countries began to balk at the economic arrangements perceived more as economic colonialism than as aid with bilateral benefits. The country has shifted focus to its "Made in China 2025" plan. This one fits neatly into China's (and many countries') desire to shorten supply chains, driven by COVID fears and nationalistic rhetoric to bring jobs home. China outlined the plan's framework five years ago: invest in the critical technology infrastructure of the future (e.g., 5G, internet of things, ultra-high voltage power transmission, high speed rail, EV charging stations, and data centers) to transform the country from a follower into a global leader. China plans to spend more than $500 billion this year, only one-third of the $1.5 trillion investment expected by 2025.

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Even so, China will likely never achieve its extraordinary growth rates from the past generation. It became one of the world's lowest-cost exporters and enjoyed increasing domestic demand as more than 400 million people joined its middle class. Both of these historic tailwinds will be more muted moving forward and, unfortunately, demography is catching up with China. With relatively more people aging out of the workforce than entering it, China is likely to "grow old before it gets rich."

It comes as no surprise that China is acting out at its neighbors during the COVID downturn, both politically and militarily; if less likely to become a global hegemon, it is increasingly clear that China wants regional dominance. The country has dramatically increased its activity in the South China Sea, an area where Vietnam, the Philippines, Taiwan, Malaysia, and Brunei all face competing claims with China. And, for the first time in decades, China and India had a deadly clash over a disputed border during the quarter.

And perhaps most critically, the "one country, two systems" policy with Hong Kong rings increasingly hollow.

A new national security law passed in late June (notably in Beijing and therefore bypassing Hong Kong's legislature) would essentially put the Hong Kong judiciary under control of the island state's executive branch, an area already under de facto Mainland control.

The lone positive in U.S.-China relations comes with a big caveat. While U.S. authorities reinstated American companies' ability to work with Chinese tech giant Huawei, the rationale was only because of Huawei's 5G network technology dominance and a desire to avoid getting left behind. Other than that, the two superpowers spent the last few months shooting across their respective bows, volleying blame and sharp critiques related to the COVID crisis. Further evidencing the state of affairs: the U.S. moved to cancel visas for some Chinese graduate students in the U.S., the Senate passed a bill to delist Chinese companies on U.S. stock exchanges that don't meet audit standards, and both nations expelled a number of the other's journalists.

China's quick economic rebound from its early pandemic-related contraction will lead to full-year results that will be the envy of the world. Still, its economic activity is a far cry from the nation's historical standards as annual economic growth below 6% is expected to become more the rule than exception. China will be a formidable technological and economic rival, and the nation's rise will lead to continued efforts to expand its political influence over the Western Pacific. But, we believe China's poor demographics and inefficient economic policies will likely keep it far from the U.S. horizon over the long run.

Office Property Dynamics in a Post-Pandemic World

Preston R. Sargent, Executive Vice President of Real Estate and
Ronald W. Kaiser, CRE, Director of Real Estate Research

When the novel coronavirus landed in the United States late in the first quarter of 2020, office space fundamentals were quite strong: vacancy was 9.9% and just shy of its 20-year low, net absorption was in a healthy balance with new supply, and rental rates were at all-time highs (~20% higher than the previous market peak in 2008 on the eve of the Great Financial Crisis).

Office property performance has historically been a good proxy for the state of the economy. If vacancy rates are low and leasing is strong, that's a sign that users of office space are optimistic about the economy and prospects for their businesses. The converse is also true. If businesses are not confident, they are not likely to take on new lease obligations and, in fact, may look for ways to lower costs by either shrinking their "footprint" through sub-leasing and/or moving to less expensive space.

If businesses are not confident, they are not likely to take on new lease obligations.

As noted above, market conditions were solid at the end of the first quarter, and there was approximately 8 billion square feet of office space inventory across the country. CoStar, a nationally recognized real estate data aggregator and research firm, predicts that data for the second quarter will show 13.8 million square feet of ***negative*** absorption (meaning, demand is less than supply and vacancy increases). This will be the first time that absorption has been negative since the first quarter of 2010, which marked the end of a seven-quarter run where office properties suffered an aggregate total of ~55.5 million square feet of negative absorption.

Clearly, office tenants reacted very quickly to the nationwide shutdown triggered by the pandemic and the resulting economic contraction. At this point, it is impossible to predict how deep the current recession will be, how long it will last, and/or the contours of the recovery once the economy turns. One thing is for certain, the U.S. is not in a "normal" recession. Therefore, some of the rules of thumb that might help track the path of an expansion—and the positive impacts on the office market that have historically followed—are not likely to apply.

Since the imposition of nationwide "stay-at-home" orders this spring, the vast majority of office workers have been working remotely. Bailard is aware of a multitude of examples where multi-tenant office properties have remained 85% to 95% leased during the lockdown, but only 10% to 20% of the tenants' employees are present in the office. During this period, employees and employers alike (including Bailard) have been overwhelmingly surprised and pleased that technologies like Zoom, Teams, and WebEx have enabled everyone to work effectively and efficiently and stay connected and engaged (albeit remotely).

During the pendency of the stay-at-home orders we've all learned new behaviors. It is hardly possible to know which ones will become habitual, but it is safe to say that when a reliable vaccine is available and we're able to "get back to normal," that "normal" will have new rules and protocols for socializing, travel, entertainment, dining, and working.

What does this all mean for office space utilization, both near- and longer-term?

There are several shifts that point to a need for less office space in the future. It is possible that work-from-home and shift-working trends have become

engrained, which would generate cost savings for companies embracing the trend and enhance employee productivity by avoiding commutes and in-office interruptions. Furthering this trend, there will likely be at least some near-term trauma and anxiety about potential for another outbreak.

On the other hand, there are powerful factors driving the need to maintain, or even expand, office space needs. Recruiting is enhanced when the interview process is in-person and new employees are on-boarded in a traditional manner with one-on-one mentoring. In-office and near-office amenities are also important to attract and retain talent. And company culture thrives on in-person interaction. Humans are social beings; team members working together in a collaborative (non-virtual) setting promotes productivity and innovation. Finally, the trend toward "de-densification" necessitates that companies increase their footprint, and provide more space for office workers.

It's futile to speculate which trends will have the stronger pull and, therefore, whether office space demand will suffer or grow because of the changes in behaviors forced on us by the pandemic. It is likely that many companies will embrace elements of both, i.e., let many/most employees work-from-home with greater frequency (perhaps permanently as in the case of Twitter, Shopify, Zillow, and Facebook), while at the same time reconfiguring offices to provide much more space to achieve sensible social distancing. For example, a "Fortune 100" tenant that Bailard spoke with plans to have 20% of its staff work-from-home on a rolling basis, but will expand individual workspaces from 225 square feet to 400 square feet... a net increase of 40% overall. It is important to remember that some companies can afford to "de-densify," while many others cannot.

Advocates for the view that the work-from-home paradigm thrust upon us by the pandemic will be short-lived are quick to point to some notable "telecommuting" failures, including Yahoo, IBM, AT&T, and Aetna. However, remember that these "experiments" were voluntary and attempted during times when it was not the norm. The mass work-from-home edict that was mandated by federal, state, and local authorities this year is entirely different. Nearly everyone was similarly situated and nobody was "left out." Moreover, the technology today is vastly superior and tech-savvy millennials are the largest cohort of office workers in the economy today. The potential "stickiness" of work-from-home strategies appears to be much greater today than in the recent past.

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What Does it Mean for Office Property Investment?

With uncertainty swirling about the course of the pandemic from the timing of a reliable vaccine and the direction of the U.S. economy to the adoption of new socializing, shopping, and work protocols, it's impossible to accurately forecast office utilization dynamics. That said, the Bailard team believes there are a number of shifts ahead:

- Office buildings will experience negative absorption until the economy turns, causing vacancies to increase and rental rates to go down.
- Once an economic expansion resumes, there will be positive net demand for office space but at a lower volume. Even if the work-from-home phenomenon causes a 25% decline in leasing volume, as long as developers modulate their deliveries, office fundamentals can be in good balance.
- During the recession, office buildings in dense urban areas will, on a relative basis, suffer greater loss of occupancy and diminution of rents than suburban properties.
- Many companies with office footprints exclusively in central business districts (CBD) will embrace a "hub and spoke" model whereby they retain a significant presence in the urban core but add a suburban location(s) to accommodate employee preferences.
- The multi-decade trend toward office densification (from a nationwide average of ~250 square feet to ~190 square feet per employee) will reverse, as

companies accommodate the needs of office workers for greater distancing.

- Operating costs for office buildings, both urban and suburban, will increase as a result of additional cleaning of common areas and tenant suites, higher utility costs driven by more air changes and higher filtration requirements, and increased elevator trips due to fewer occupants to meet social distancing requirements.
- Co-working providers that require maximum densification to be profitable (e.g., WeWork) will either have to adapt their business model or they will fail.
- Mass transit systems in major urban markets will suffer huge losses in ridership as people retreat to their automobiles… making some CBDs less accessible.

The path forward will become clearer as the U.S. economy regains its footing after a COVID-19 vaccine is developed and deployed and we all attempt a return to more normal times. From an investment strategy standpoint, the Bailard real estate team feels it prudent to underweight the office property type. The trend of recent years toward clustering downtown, relying on public transit, and enjoying the exciting lifestyle offered by the big city is being severely challenged by the pandemic. Living, socializing, recreating, and working in densely-populated urban cores has had immense appeal for the past 15 to 20 years for both millennials coming of age and entering the workforce and also baby boomers downsizing from large suburban homes and returning to culture-rich urban centers. However, at this moment and for the foreseeable future, working in a low-rise building in a convenient and amply-parked easily accessible suburban location seems to offer greater safety and flexibility.

Closing Brief: Bailard's View on the Economy

Jon Manchester, CFA, CFP®, Senior Vice President and Portfolio Manager - Sustainable, Responsible and Impact Investing

COVID Contraction

The longest U.S. economic expansion on record came to a rather sudden end in February, undone by the hard frost of stay-at-home directives. The National Bureau of Economic Research (NBER) declared the expansion over after a gaudy 128 months: eight months longer than the prior record dating back to 1854 and double the average length of economic expansions since World War II.

It didn't appear to be a particularly challenging call for NBER due to the severity of the downturn. Consumer spending—the domestic economy's growth engine—sputtered in March (-6.9%) and wouldn't start in April (-13.6%). The official U.S. unemployment rate spiked from 3.5% in February to 14.7% in April, its highest level since the Great Depression, and even that may have understated the payrolls problem. Millions of workers had their hours reduced, taking the "underemployment" rate up to 22.8%. At the aggregate level, U.S. Real Gross Domestic Product (GDP) sank 5% annualized in Q1, and will no doubt confirm the recession declaration when the second quarter numbers roll in. Although steadily improving, the New York Federal Reserve's estimate for Q2 U.S. GDP "growth" stood at -15% as the third quarter got underway.

COVID-19 has left its crown prints all over the globe, of course. The employment picture appears brighter in other developed economies, although various structural and cultural impediments to layoffs arguably casts that picture in artificial light. In the eurozone, the unemployment rate edged up to 7.3% in April. This was helped considerably by the fact that France, Germany, and other countries have subsidized the furlough of millions of workers. In April, for example, about 2.6 million Germans were officially unemployed, but another 10 million were furloughed and didn't count as unemployed.[1]

Somewhat flattering job statistics aside, the eurozone suffered a 3.6% Q1 GDP decline, and the International Monetary Fund (IMF) is projecting a 10.2% contraction for 2020 in full. The European Central Bank (ECB) has responded aggressively, including offering a borrowing rate of -1% to commercial banks if passed along to businesses and consumers, or -0.25% with no strings attached.

> Consumer spending—the domestic economy's growth engine—sputtered in March and wouldn't start in April.

Meanwhile, in Japan, the unemployment rate in April shot up to... 2.6%? This despite a 2.2% annualized Q1 GDP decline, which followed a steeper 7.1% slump in the fourth quarter of 2019. The discrepancy between Japan's rather rosy employment data and other major economies can be partly explained by the "social contract" whereby Japanese companies are more or less expected to retain workers permanently. Social media in Japan reportedly erupted in March following the evidently controversial news that companies had rescinded job offers to 21 recent graduates because of the pandemic.[2] Demographics certainly play a role as well, with a fairly tight labor force resulting from the world's oldest population. Although Japan's employment outlook may remain relatively sanguine due to these factors, generating economic growth may continue to prove elusive. Japan has only managed >2% annual Real GDP growth once since 2010, with three of the last four years at sub-1%. The Japanese government is throwing yen at the problem: roughly the equivalent of $2.2 trillion in stimulus spending to combat the recession and pandemic, or a staggering 20% of GDP.

Indebted to the Fed

With large swaths of the global economy on ice, policymakers have been exceedingly busy attempting to bridge the numerous fissures opened up by this pandemic. In total, fiscal stimulus measures of around $11

trillion have been announced worldwide.[3] COVID-19 appears to have arrived at a fairly inconvenient time—not that there is a convenient time for a global health crisis—given that a number of government balance sheets were already stretched. In the U.S., federal debt held by the public soared during the credit crisis and its aftermath, and has only drifted upward since, moving north of $17 trillion or approximately 80% of GDP in the first quarter of 2020. Those numbers will clearly continue higher this year, and it is worth noting that when intragovernmental debt (i.e., Social Security) is included then federal IOUs already exceed GDP.

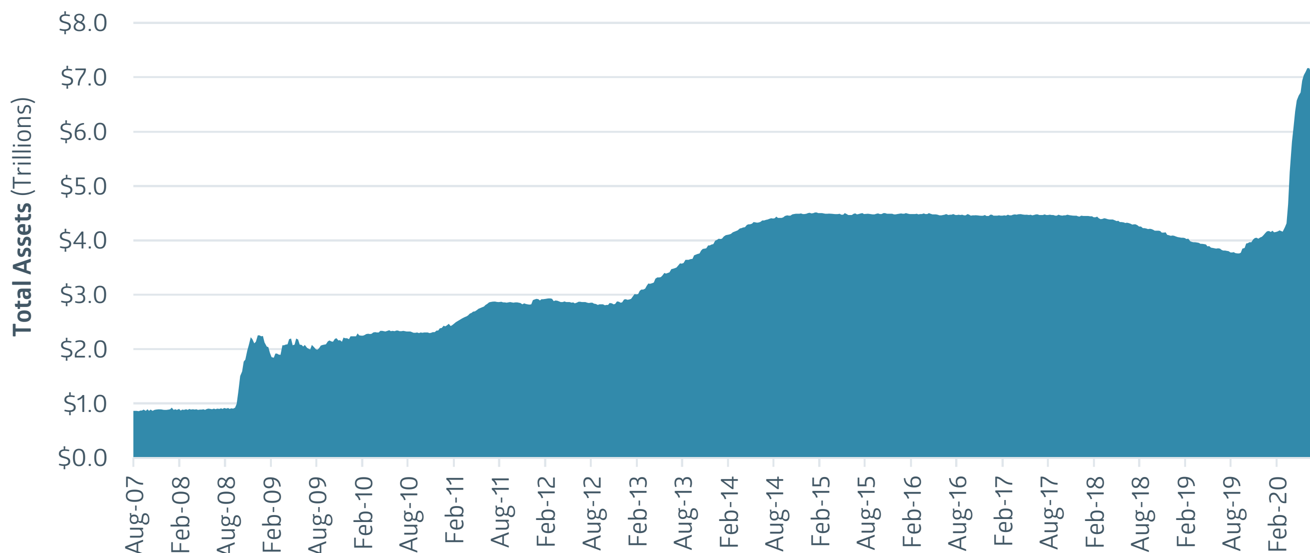
Before we press the panic button, there are a couple of interesting twists to the federal debt story. The Federal Reserve (the Fed) has committed to buying essentially an unlimited amount of Treasury bonds, and Morgan Stanley estimates the central bank may purchase $2.5 trillion worth in 2020 alone.[4] When Congress approved the $2 trillion CARES Act in late March, therefore, it already had a ready buyer to fund the spending. Further, by law, the Fed has to pay its profits to the Treasury. You can see where this is going: the Treasury pays the Fed interest on the bonds, but eventually nearly all the money ends up back with the Treasury. As Stony Brook University economics professor Stephanie Kelton puts it: "Once the central bank buys them, it's as if the Treasury never issued them in the first place. For all intents and purposes, they're retired."[4] A bit of accounting magic, perhaps, but also a pretty big advantage of being able to print your own money – as long as inflation remains contained.

The second twist is simply that borrowing rates are astoundingly low. In May, the U.S. Treasury issued 2-year notes at 0.178%. It borrowed $32 billion at 0.70% for ten years. The Treasury even issued 20-year bonds for the first time, and is paying 1.22% on that debt. Needless to say, it's an extremely undemanding interest rate environment for the government; meaning that this fairly compelling affordability story may encourage borrowers across the world to continue extending credit to Uncle Sam.

Buying Time

The massive fiscal and monetary fireworks show around the globe is meant to bend the economic curve, in a sense. Similar to the concept of flattening the COVID-19 curve via social distancing, policymakers are trying to buy time for economies to recover and normalize. There are some signs it's working. Domestically, the employment report indicated 2.5 million jobs were added in May, and another 4.8 million in June, taking the official unemployment rate to a still elevated 11.1%. Retail sales jumped nearly 18% in May, and durable goods orders rose more than expected. These reports have buoyed the "V recovery" crowd that argues for a quick reversion once the economy

Total Assets of the U.S. Federal Reserve, August 2007 - June 24, 2020



Source: www.federalreserve.gov.

reopens. Goldman Sachs analyst Jan Hatzius speculates this could be the shortest U.S. recession ever, envisioning a strong Q3 rebound; but he does express concern that we are now a clear underperformer on virus control.

Others are more skeptical, believing a "U" or maybe "W" shaped recovery is more likely. The Fed itself is cautious and expects to maintain the Fed Funds target rate near zero through at least 2022. That should be supportive for markets, but the economic impact is less clear given we've been in a low interest rate environment for most of the past decade. The best bet might be that economic growth will experience fits and starts until we have an effective vaccine or at least a proven therapeutic drug that definitively short circuits the most adverse outcomes. Until then, economic activity may misfire for stretches, running below potential. A certain portion of business is able to shift online, but U.S. retail e-commerce sales still only accounted for ~12% of total sales in the first quarter, according to the Commerce Department. In the meantime, some companies have fallen by the wayside: Hertz, J. Crew, Neiman Marcus, Chesapeake Energy, and others have filed for bankruptcy.

The IMF estimates the "Great Lockdown" will inflict a cumulative loss of over $12 trillion to the global economy during 2020 and 2021. A big question is how long it will take to fully recover. The Congressional Budget Office (CBO) projected it will be 2030 before the U.S. economy returns to its inflation-adjusted, pre-pandemic level. Following the Credit Crisis, it wasn't until 2017 that the U.S. unemployment rate declined to pre-crisis levels. In other words, patience may be required for those expecting a near immediate return to normalcy.

The U.S. economy is innovative and resilient but faces additional challenges, including our own demographic headwinds and widening wealth disparities. This health crisis has exacerbated some of these structural economic deficiencies. According to a recent *Barron's*

The IMF estimates the "Great Lockdown" will inflict a cumulative loss of over $12 trillion to the global economy during 2020 and 2021.

cover story, around 40% of the people who have lost their job during the pandemic were earning less than $40k per year, compared with 13% of those earning $100k or more.[5] Fed Chairman Jerome Powell acknowledged the downturn "has not fallen equally on all Americans."[6]

Further fiscal support is likely—targeted to those most in need—with the hope that we can buy enough time to navigate this latest "new normal" iteration and emerge stronger on the other side. Until then, thank the nearest health scientist and/or epidemiologist, for it's their work that will ultimately allow the global economy to shift into a higher gear.

1 *"European Slump Is Worst Since World War II, Reports Show," www.nytimes.com, 4/30/20*
2 *"Why Japan's Jobless Rate Is Just 2.6% While the U.S.'s Has Soared," www.nytimes.com, 6/20/20*
3 *"IMF Projects Deeper Global Recession on Growing Virus Threat," www.bloomberg.com, 6/24/20*
4 *"How the Government Pulls Coronavirus Relief Money Out of Thin Air," www.nytimes.com, 4/15/20*
5 *"Why the Widening Wealth Gap Is Bad News for Everyone," www.barrons.com, 6/19/20*
6 *"Semiannual Monetary Policy Report to the Congress," www.federalreserve.gov, 6/16/20*

Source: Bloomberg, Bailard. Past performance is no indication of future results. All investments involve the risk of loss.

A History of Giving & the Bailard Foundation's First Annual Update

"Doing what is right. Right by the client, by each other, by the firm and by society." This is what Ron Kaiser—one of the three co-founders of Bailard, Inc.—said last October when speaking about what it takes for a company to last 50 years. This idea of "doing right" exemplifies what the company and its late founder and long-time CEO, Tom Bailard, stand for to this day. And, in honor of its first 50 years and with excitement for the future, last year Bailard set about creating a list of values that it views as defining for the company. One of these six core values is ***Compassion***, which Bailard strives to demonstrate through understanding and improving its communities.

Charitable Gifts throughout the Years

Bailard has long been involved with numerous charitable groups. This support has come in a variety of ways and has often been associated with those causes closest to our employees and clients.

Donations: Bailard has consistently provided support for a number of Bay Area non-profits including AbilityPath, United Way Bay Area, Boys & Girls Club of the Peninsula, and Community Housing Partnership. Employees have organized volunteer days with Rebuild Together and Second Harvest Food Bank. Bailard recognizes the power and impact found in academic sponsorships as well, and has supported research prizes including the University of California Berkeley Moskowitz Prize. Over the past five years alone, Bailard has provided over $500,000 in charitable donations and sponsorships.

Employee Matching: The culture at Bailard lends itself to attracting employees who are passionate about community engagement and charitable causes. To provide support for its employees, Bailard has long offered an annual match on employee donations.

Emergency Fundraising: As we are now experiencing with the COVID-19 pandemic, the world is unpredictable and situations often arise that fall outside of Bailard's normal targeted giving. Bailard has reacted to these extra needs through company-wide matching initiatives in addition to its annual per employee match limit. Donations have been given to support victims of wildfires, foodbanks during the onset of COVID-19, and most recently a match to employees for any organization that seeks to address and end systematic racism and oppression of Black, Indigenous, and People of Color (BIPOC).

The Next Step Forward: The Bailard Foundation

Serving the community in which we live has long been engrained in the values of Bailard and the mindset of its employees. The desire and effort of helping our communities was foundational for the company, but there had never before been a channel to organize or amplify Bailard's service. To solidify the company's commitment to our communities and increase the impact of what Bailard, its employees, and clients support, the Bailard Foundation was created in 2019. We are pleased to provide the Foundation's first annual update on the following page.

Community Partnership over the Years: AbilityPath

Mission: To empower people with special needs to achieve their full potential through innovative, inclusive programs and community partnerships. Together, we are creating a world where people of all abilities are fully accepted, respected and included in all aspects of life: in the classroom, the workplace, and in our communities.

Services: Range from early intervention for infants to play therapy for children, social activities for teens, and employment training for adults along with support and counseling for families. All programs are designed to help children and adults thrive at school, at work, at home, and in the community.

Bailard's Involvement: Bailard has supported AbilityPath through both financial donations and employee volunteer days. The company continues to act as a major sponsor for AbilityPath's largest annual fundraiser and other events throughout the year.

Bailard Foundation Annual Update

The Bailard Foundation was launched in May of 2019, in celebration of the firm's 50th anniversary. The Foundation's aim is to centralize Bailard's robust history of charitable giving and promote impactful donations that align with the Foundation's mission statement and focus areas.

> ***Mission Statement:***
> The Bailard Foundation supports initiatives that the Firm, its employees, and clients value as we seek to collectively improve the communities in which we live, work, and engage.
>
> ***Four Focus Areas:***
> Affordable Housing, Financial Literacy, Homelessness & Poverty, and International Impact Initiatives.

In the year since its launch, the Foundation has worked to expand connections with local and international charitable organizations. As of June 30, 2020, the Foundation will have provided over $70,000 in grants to 24 organizations within its focus areas, as summarized below.

A Look Forward

In its second year, the Foundation plans to further build out its operational base to better serve the charitable organizations chosen by the Foundation Board as well as the company and Bailard employees. The newly-launched Bailard Foundation website (www.bailard.com/foundation) includes information on the mission, focus areas, and grants awarded to date. We also hope to expand our relationships with some of our grantee groups through volunteer days and specific fundraising drives. The Foundation is open to all suggestions from employees, clients, and friends on organizations in our focus areas.

Grantee Highlight – JobTrain

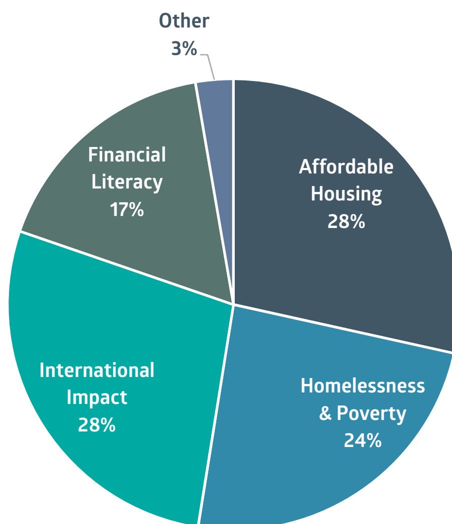
Mission: Committed to helping those who are most in need to succeed. JobTrain aims to improve the lives of people in the community through assessment, attitude and job skills training, and high potential career placement.

Services: Career training through 11-week programs at no cost for students with four focus areas: Healthcare, Culinary Arts, IT Service and Support, and Carpentry. Other offerings include youth services, job seeking services, onsite daycare, and evening classes all aimed to provide those looking to better themselves and their careers with the tools and support to do so.

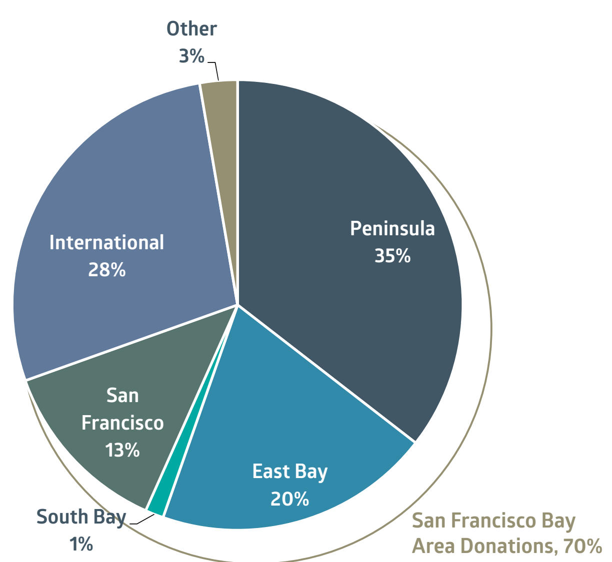
Why JobTrain: The Bailard Foundation was impressed by the array of services offered and core focus on skilled training offered. Relevant job skills are so important for unemployed and under employed to increase their options for employment.

Bailard Foundation Giving, May 2019 — June 2020

By Foundation Focus Area



By Location



Source: Bailard.
The Bailard Foundation supports initiatives that the firm, its employees, and its clients value, as we seek to collectively improve the communities in which we live, work, and engage. The Bailard Foundation has a board of directors that is led by chairwoman Terri Bailard, widow of firm co-founder Tom Bailard, and features both select friends of Bailard, Inc. and employees.

Market Performance
As of June 30, 2020

U.S. Interest Rates	9/30/2019	12/31/2019	3/31/2020	6/30/2020
Cash Equivalents				
90-Day Treasury Bills	1.81%	1.55%	0.09%	0.14%
Federal Funds Target	2.00%	1.75%	0.25%	0.25%
Bank Prime Rate	5.00%	4.75%	3.25%	3.25%
Money Market Funds	2.00%	1.71%	1.08%	0.19%
Bonds				
10-Year U.S. Treasury	1.66%	1.92%	0.67%	0.66%
10-Year AA Municipal	1.73%	1.85%	2.40%	1.25%

Source: Bloomberg, L.P.

U.S. Bond Market Total Returns (US$) through 6/30/2020	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Bonds				
Bloomberg Barclays U.S. Treasury Index	0.48%	8.71%	8.71%	10.45%
Bloomberg Barclays U.S. Corporate Index	8.98%	5.02%	5.02%	9.50%
Bloomberg Barclays U.S. Aggregate Index	2.90%	6.14%	6.14%	8.74%
Bloomberg Barclays U.S. 1-15 Municipal Blend Index	2.69%	2.18%	2.18%	4.18%

Source: Bloomberg, L.P.

Global Stock Market Total Returns (US$) through 6/30/2020	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
U.S. Stocks				
S&P 500 Index	20.54%	-3.09%	-3.09%	7.49%
Morningstar U.S. Small Value Index	22.29%	-25.89%	-25.89%	-20.47%
Morningstar U.S. Small Growth Index	32.84%	4.35%	4.35%	8.79%
Morningstar U.S. Large Growth Index	26.60%	12.03%	12.03%	23.28%
Morningstar U.S. Large Value Index	13.01%	-14.97%	-14.97%	-5.23%
International Stocks				
MSCI EAFE (Europe, Australasia, Far East) Index, net dividends	14.88%	-11.34%	-11.34%	-5.13%
MSCI Emerging Markets, net dividends	18.08%	-9.78%	-9.78%	-3.39%

Sources: Bloomberg, L.P. and Morningstar Direct

Alternatives (US$) through 6/30/2020	QUARTER	SIX MONTHS	YEAR TO DATE	ONE YEAR
NFI-ODCE Index*	0.98%	1.97%	1.97%	4.87%
Gold Spot	12.92%	17.38%	17.38%	28.66%
WTI (West Texas Intermediate) Crude Oil	91.75%	-35.69%	-35.69%	-32.84%

Sources: Bloomberg, the National Council of Real Estate Investment Fiduciaries
**Q2 data not yet released. The second quarter return assumed to be same as first quarter 2020 return.*

Past performance is no indication of future results. All investments have the risk of loss.

DISCLOSURES

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ABOUT *THE 9:05*

Since 1978, we've held a weekly company-wide meeting during which we talk about the prior week's activities and those anticipated in the week to come. We refer to this meeting, which begins just after nine each Monday morning, as "the 9:05." Just as the 9:05 enables us to share our knowledge and insights with each other, this newsletter provides us with a valuable means of communicating with our clients. Hence its title: *the 9:05*.

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