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2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

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Review of Q2 and First Half of 2020 and Outlook for Remainder of 2020

Executive Summary

- Fears of the virus in Q1 were replaced in Q2 with fears of missing out on the massive rally in assets. After Congress and the Federal Reserve (along with their foreign counterparts) came through in a big way at the end of March, asset prices were off to the races. The S&P, which fell 19% in Q1, jumped 21% in Q2. With cash yielding nothing and income levels in the US actually higher despite record unemployment, money found its way into assets the world over.
- While the future is highly uncertain, we expect this overall trend will continue. Cash is over-owned and delivers negative yields after taxes and inflation. Bonds across the risk spectrum offer higher yields. US markets are rich on many metrics, but still yield more than cash. International markets offer even higher yields and Europe's recent relief package is a noteworthy and positive change.
- In alternative asset classes, we continue to be highly selective. We have improved the liquidity and reduced the manager fees in our hedge fund vehicles. We added just two new private equity managers and recently received one large distribution. In real assets, we have been discriminating in real estate favoring investments in high-growth niches, and began stepping into gold.

Cash and Bonds

The Federal Reserve continues to work very hard to make cash unattractive. The Fed increased its balance sheet and money in circulation by nearly $3 trillion. It has kept short term rates near zero with the three-month US Treasury bill yielding just 0.1%. Fed Chair Jerome Powell expects cash rates to stay here through at least 2022, noting that the Fed is "not even thinking about thinking about thinking about raising rates." So far, all of this excess cash has not found its way into the real economy. Investors are still sitting on record high allocations to short-term money market funds despite the fact that these funds are guaranteed to lose value after taxes and inflation. In fact, cash as percentage of the value of the stock market sits at a ten-year high. We think this cash will continue to look for higher yields and we will use volatility to continue to work down our fading overweight to the asset class. At the very least, we expect to move the bulk of our cash not earmarked for clients' immediate use to short-term high-grade municipal bonds, since we can currently earn close to 1% tax-free and the market is supported through purchases by the Fed.

Moving out in the risk spectrum to bonds, more generally, we added capital to the space on the quarter and are now close to neutral on the asset class. "Safe-haven" US Treasury bonds were extremely quiet on the quarter with the 10 Year US Treasury Yield declining ever so slightly from 0.68% to 0.65%. This calm and lack of movement from historically low interest rates stood in stark contrast to the "risk-on" rally witnessed in pretty much all other asset classes. The Federal Reserve, through its massive purchases, certainly helped keep volatility low in Treasury bonds, but many other investors are still hesitant to sell these low-yielding bonds even in the face of rising global debts and deficits.

For taxable clients and accounts, we prefer the tax equivalent yields offered by high-grade municipals over Treasuries. AAA rated municipals still deliver yields that are on par with Treasuries, but they produce tax-free income. State and local governments are seeing unprecedented near-term financial stress with 88% of cities expecting revenue shortfalls, but most voters favor some federal support and the Federal Reserve has the capacity to purchase $500 billion of municipals.

Stepping out even further in terms of risk, we are also neutral on high-yield municipal and corporate bonds. High-yield municipals offer 5% tax-free yields and their corporate counterparts offer 6% taxable yields. There is certainly a wave of bankruptcies and defaults coming, but we think the opportunity is ripe for active managers to find solid credit issuances at attractive yields.

US Stocks and the Economy

We were reminded in Q2 that the stock market is not the economy and the economy is not the stock market. Corporate profits cratered and 20.5 million jobs were lost in April alone, but the stock market jumped 13% that month and 20% in Q2. Part of this move higher was due to the actions of the Federal Reserve, mentioned above. Earnings and dividend yields on stocks have rarely been more favorable compared to yields on cash and bonds. While stocks appear relatively rich on many other metrics, they are still under-owned with record cash earning nothing on the proverbial "sidelines."

Congress also helped keep the US economy in suspended animation through its various stimulus packages. Although real personal income excluding government transfers, like unemployment payments, fell by over $1 trillion, total personal income including such government payments actually jumped by over $1 trillion. More than three-in-four unemployed workers received more in unemployment benefits than they previously received in wages. Poverty rates actually fell despite record unemployment. While this has led to a remarkable rebound in retail sales, consumption and day-trading stock accounts, the future is much less certain. Congress is currently debating the continuation of enhanced unemployment benefits, the Paycheck Protection Program and the moratorium on foreclosures.

As we inch closer to the 2020 election, economic policy uncertainty stands at record highs. This is likely to contribute to less consumer and corporate spending and slower job creation. With the vast majority of households holding less than three months of savings to cover expenses and the loss of employment falling disproportionately on low-paid workers, rising populism is not surprising. The rally in markets (despite all the Robinhood accounts) has again increased wealth inequality and, interestingly, President Trump's approval ratings are no longer moving in lock-step with the market. A Democratic sweep in November is looking more likely, and with that, we would expect eventually higher taxes in some form.

We conclude that these factors suggest a slow recovery with more volatility ahead, but we are likely to be buyers of US equities on any significant weakness. The Federal Reserve remains the 800-pound gorilla in the room, capable of exerting even more force on markets. The abundance of cash earning no yield will likely continue to bid up asset prices in the near-term. Investors are still skittish, as evidenced by low bond yields, high cash levels and other sentiment surveys, but are likely to use cheaper prices to leg into markets. It is important to remember again the market is not the economy. Markets more than doubled from the time Alan Greenspan warned of irrational exuberance in 1996 to the highs of 2000. More importantly for long-term investors, a dollar invested at the peak of the tech bubble outperformed cash by a wide margin over the next two decades. While that margin is likely to be slimmer over the next decade, we think that betting on America businesses long-term is still prudent.

International Markets

Turning outside the US, we have become more optimistic for various reasons and have positioned our international vehicles a bit more aggressively. First, as noted earlier, the Federal Reserve and Congress are both working hard to make the US dollar less desirable. The Fed has increased the number of dollars in circulation and offers paltry yields while Congress has amassed historic levels of deficits and debt. This should continue to put pressure on the dollar versus its global peers, and a weakening dollar helps to amplify

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international equity market returns. Next, while the number of new virus cases in the US continues at record levels, Europe and Asia have largely stemmed the tide. The number of seated diners in Germany is actually higher than levels last year according to Opentable. Third, despite large social and fiscal differences between northern and southern Europe, the European Union just passed an unprecedented 750B Euro COVID-19 recovery package. Historically austere countries like Germany, after years of resistance, have finally agreed to a European-wide fiscal mechanism that allows the bloc to issue debt together to disproportionately support weaker countries. While Europe has also increased Euros in circulation, cut rates into negative territory and is running up its own record deficits and debts, the Euro actually rallied, or strengthened, on this news as it decreased the chances of EU breakup.

Turning outside of Europe and developed international markets, we also remain selectively optimistic. We remain cautious on Brazil, India and many other emerging economies that continue to struggle with both their medical and fiscal response to the virus. We are, however, optimistic on Asian emerging economies who, like Europe, have handled the virus well and are seeing some return to normalcy. We do think that "Cold War 2.0" between China and the US will continue to heat up, but do not see this derailing the Chinese consumer nor its equity markets long-term. The country has the potential to double the size of its massive middle class in the next decade alone. This type of growth coupled with relatively cheap valuations should help propel Chinese markets forward long-term even in the face of Cold War 2.0.

Hedge Funds

While we are pleased that hedge funds rebounded strongly in Q2, we still have work to do to accomplish our long-term goals in the space. We have stated consistently that our goals within the hedge fund complex are to reduce our overall overweight allocation and our underlying manager fees, improve liquidity and concentrate on the handful of managers deserving of higher fees (relative to other asset classes). We strongly believe that the burden of proof on whether we should invest in hedge funds is squarely on the space's managers whose high fees and illiquidity create an extremely high bar compared to other assets.

To wit, in Q2 we received $20 million of redemptions from managers we are exiting from our Sentinel Hedged Equity Fund, plowed $12 million back into low-fee, liquid vehicles and invested just $2 million into two high-conviction biotech specialists. Similarly, in the Sentinel Uncorrelated Fund we received over $10 million in redemptions from high-fee managers, purchased liquid gold instruments and made just one investment into a fund we have admired for years. Again, we recognize that there is more work to do, but have been extremely busy working toward a more neutral allocation to hedge funds via vehicles that are more liquid, less expensive and more concentrated in high-conviction ideas.

Private Equity

In private equity, where fees are comparable to hedge funds but producing liquidity takes much longer, we continued to be highly selective in putting capital to work. We made just two new commitments on the quarter. We re-upped with a large pan-European buyout strategy and made a new commitment to an early stage European venture fund focused on data, analytics, fintech and cybersecurity. Concurrently, some of our older funds began to receive in-kind distributions of Cloudflare, a recently listed cloud-based firm providing internet security services. Our initial investment of $636,000 was worth $8.9 million at the end of 2019, and the stock has jumped 100+% in 2020. We have been actively selling the position, which garners the extremely tax-efficient qualified small business stock treatment.

Outside of Cloudflare, we have seen the pace of capital both called and returned slow considerably. Deal activity in private markets is well down to date in 2020 from prior years. Buyers are loathe to jump on planes to conduct due diligence and still expect some fire-sale pricing, while sellers are hoping for pricing closer to pre-COVID levels. We continue to be patient and highly selective, but also continue exploring opportunities that we believe can compound well above their public market equivalents.

Real Assets

With the massive amount of money printed and rising debts and deficits, we have received quite a few questions on inflation, real assets and gold. We recently posted a piece with our more extensive thoughts on the subject. To reiterate, we do not see runaway or even above average inflation coming any time soon, but are vigilant to this risk. As noted above, we have been accumulating gold within our uncorrelated vehicle and expect to continue to do so for the foreseeable future. The lack of yield on cash and the potential for a weaker dollar is generally beneficial to gold and other real assets, but we must also keep supply and demand in mind. Gold has limited supply, while the supply of paper currency grows exponentially.

Turning to other real assets, the supply and demand picture is murkier. We remain underweight real estate broadly, largely due to an abundance of supply in office, retail and hotel space, coupled with declining demand. Even industrial real estate, buoyed by e-commerce, has recently seen supply outstrip demand, and we have focused on smaller, strategically important, last-mile logistics. Multi-family housing (apartments) may also come under pressure in the short-term with the foreclosure moratorium ending and roughly 30% of households having little to no confidence in making their rent payment next month.

Not surprisingly, these dynamics have made real estate one of the worst performing assets year-to-date. We have been largely underweight the space and again are highly selective. Residential housing, in contrast, looks relatively attractive. Record low borrowing rates, rising household formation, and an extreme lack of inventory and new construction are all tailwinds. Similarly, cell towers, data centers and health care real estate are in high demand. Given these wide divergences, we think being choosy and active in real estate can lead to outperformance moving forward.

Finally, turning to energy, we are again reminded to focus carefully on supply and demand. The second quarter saw oil prices fall into negative territory with robust supply still forthcoming and demand dropping off a cliff. As one of our longstanding managers noted, “the cure for low prices is low prices.” Rig counts in the US are back to their 2010 level and the Saudis (after initially hiking production) will pump the fewest barrels in 18 years. Demand should pick up strongly as we head into 2021. We think this is a relatively favorable backdrop and continue to explore select opportunities in the space.

Conclusion

In sum, assets the world over climbed the wall of worry in Q2. Despite record levels of unemployment, investors bid up assets with their abundant cash that otherwise offered negative real yields. While the future as always remains uncertain, we will generally be working to put our excess cash to work moving forward.

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