Independent Investment Advisory

GKV Capital Management

Quarterly Update

Second Quarter 2020

Second Quarter Review

Uncharted

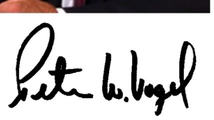
Opening Thoughts

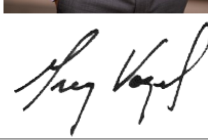
Unprecedented. Uncharted. Certainly unexpected. The first half of 2020 was volatile. The long-term impact and even the short-term economic impact of the pandemic is uncertain. Market participants are trying to “look through” the economic interruptions to determine what the long-term picture should look like coming out the other side. For 2020 the damage is done. And while it seems strange to many- the science of investment is based on long-term cash flows. Economic output over the next 10 years is far more important than this year. In this pandemic one can assume one way or another, there will be an end to forced interruptions. Successful investments will depend on identifying trends that are likely to persist beyond the pandemic and avoid those businesses that will never recover.

In the darkest days of mid-March, if you panicked and sold, you locked in your losses and missed out on the best single quarter performance in 20 years. The markets have a tendency to overcorrect, like the arc of a pendulum trying to find the middle but always over shooting between fear and greed. In our practice we look to economic and company fundamentals measuring growth and earnings in an effort to find reliable investment opportunities. Without any real visibility into economic or company performance, we are forced to take a step back, look at the big picture and make educated guesses on the more likely scenarios to come.

Stock prices have crashed and rebounded in only four months. Depending on the headlines of the day we have gone from fearful to hopeful, depressed to optimistic. Quite honestly it’s been a draining year. Government stimulus has been massive driving asset prices higher. Countries have shown that there are effective responses to the pandemic. Businesses will reopen but the economic cost is significant and at this early stage, immeasurable. The International Monetary Fund forecasts 2020 U.S. GDP to decline 8% for the full year. Unemployment is around 15%. We are counting on improvements.

There are reasons to be optimistic and there are significant risks that don’t seem to be appropriately discounted in the price of many stocks. The pendulum will continue to swing creating opportunities at the highs and lows. No one can accuse us of being bored in 2020.





GKV Capital Management is an independent registered investment advisor.
For more information about us please call (805) 497-2616 or visit **gkvcapital.com**

2Q20 Data Points

DJIA YTD	**-9.5%**
S&P 500 YTD	**-4.0%**
NASDAQ YTD	**12.1%**
US Bond YTD	**6.1%**
10-Year Treasury Yield	**0.64%**
S&P 500 LTM Dividend Yield	**2.3%**
S&P 500 EPS Next 12-MTH	**$141.75**
S&P 500 P/E	**22x**

Second Quarter Review

The S&P 500 down 4%. The Dow Jones Industrial Average down 10%. The Nasdaq Composite up 12%. The year-to-date performance of the major indexes at the close of the second quarter belie the truly shocking volatility in the capital markets this year. Investor uncertainty manifests itself as volatility as investors are reduced to speculation placing bets on rapidly changing anticipated outcomes for companies. At the close of the first quarter, the S&P 500 was down 20% only to gain 20% in the second quarter. The Nasdaq Composite index, which is skewed toward the technology and healthcare sectors fell 14% in the first quarter only to gain 31% in the second quarter.

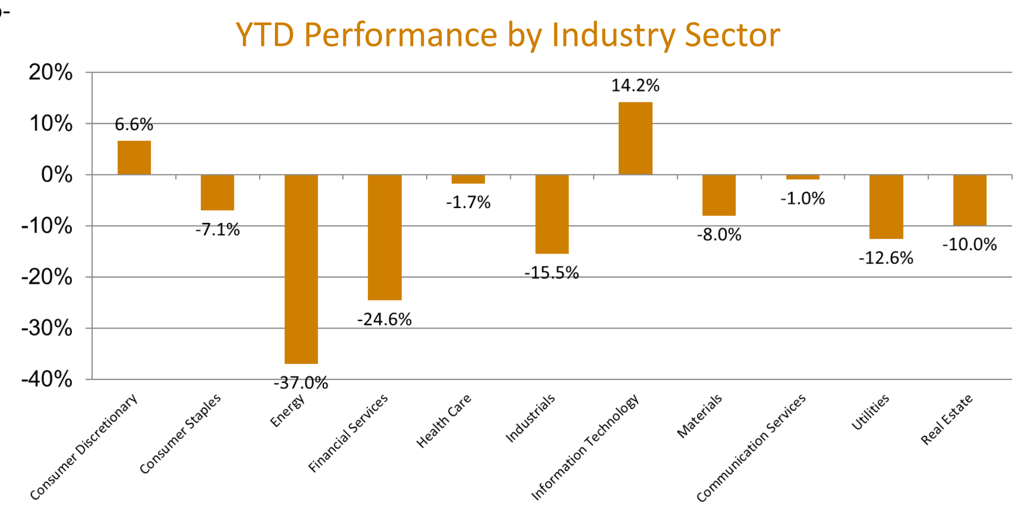
The large dispersion in performance between the 11 sectors highlights which areas of the economy the market has deemed pandemic winners and losers. The best performing sector through the close of the second quarter was information technology. Many technology companies have not experienced a material slowdown in sales or earnings and in fact many have benefitted as more employees were forced to work from home driving further use of technology. Second best performing sector was consumer discretionary. One might suppose that in a pandemic consumer staples would outperform discretionary, at least until you look at the larger companies that comprise the consumer discretionary sector. Amazon, Home Depot, McDonalds, Nike, Starbucks, Lowes and Target. Amazon is up nearly 50% in the first two quarters of 2020. Home Depot gained 16%. The worst performer was the energy sector losing 37%. Suddenly the world is awash in a glut of fossil fuels as travel ceased and roads emptied.

The benchmark 10-year Treasury bond started the year at a 1.92% yield reflecting a positive economic outlook and the possibility of strong economic growth and low unemployment moving inflation higher. In response to the forced shutdowns the Federal Reserve cut its target rate to zero and the 10-year yield collapsed to a low of 0.61%. The 10-year yield ended the June quarter at 0.64%. The 30-year fixed mortgage rate ended June 30th at 3.28%.

At the beginning of the year, the earnings forecast for the combined companies in the S&P 500 in 2020 was for $175.52. For the March quarter, S&P 500 companies earned a cumulative $19.50 versus $42.29 forecast at the beginning of the year. A 53% shortfall. With many businesses shutdown and consumers stuck at home, revenue per share declined from $369 to $332 or 10% resulting in dramatically lower profitability. Operating margins declined to 5.86% from 10.6% at the close of 2019. Wall Street assumes that the June quarter results will be similar to March. Declines should stabilize and begin to show a reacceleration for the September quarter.

This is where things start to get tricky for investors. There are many important unanswered questions. It is unclear how long many businesses will be partially shutdown. There is an assumption that the consumer has cash ready to spend, but there is uncertainty of whether shopping will return to "normal" this year at all. We may find that consumer tastes and priorities are forever altered in the wake of the pandemic. Most importantly is employment. We started the year with only 3.5% of workers looking for jobs. We now have approximately 15% out of work. Surely many of those jobs will return with the lifting of restrictions but the uncertainty of when that might be is problematic. If workers are denied a paycheck for too long and stimulus runs out there will be significant lasting economic repercussions.

With high prices for many "pandemic proof" businesses and significant economic uncertainty, we are holding back some cash reserves. We ended the quarter with 16% in cash, 51% in equities and 31% in fixed income.



Dow Jones LLC, June 30, 2020

Uncharted

"The market can stay irrational longer than you can stay solvent."

- John Maynard Keynes, Economist (1883-1946)

Growth of the United States economy depends on the American consumer. In our lifetime, the American consumer has never experienced a "shutdown" economy due to a highly contagious health threat. As the shelter-in-place orders throughout most of the country are removed, the rate of recovery of the domestic economy will depend upon the rapidity of the American public to return to its former, pre-pandemic, shopping and spending patterns. One can only hypothesize the psychology of the American consumer after quarantine edicts. A correct assessment of the American psyche towards daily life after restrictions of movement are removed will be paramount to an investor in determining the fate of the stock market for at least the rest of this year. There are no historical precedents in the last 100 years to guide investors regarding American consumer behavior during a pandemic. We are all in uncharted territory for this extremely important component of the United States economy.

It is expected in some quarters that consumer spending will only grow slowly from now to the end of the year, but the expectation is for steady growth, i.e. June is better than May, July is better than June, August is better than July. Other economists and market pundits think the return to historical normalcy by the consumer will be swift and propel the economy to a fast recovery. Their thesis is that the spending habits of the American public are deeply ingrained and during the quarantine period of the last few months, there has arisen large pent-up demand for products and abundant cash and savings for spending. On the more pessimistic side, rising infection rates may accelerate as distancing guidelines are reduced causing consumer spending to be erratic, volatile, and tepid. Which scenario, or combination, that emerges is unknown and any opinion is based on conjecture and unsubstantiated speculation, including ours.

A key variable to formulating the expected path of behavior by the American consumer is the discovery of an effective vaccine and treatment of Covid-19. Such a discovery would remove the shackles of uncertainty from the public and accelerate a return to normal. At the present time, many major drug companies and medical research labs are experimenting with various vaccine therapies. Several promising vaccines are being tested now directly in humans and have been allowed to bypass the normal protocols for determining the effectiveness of a drug. The pressure by society and governments to find a treatment is enormous. If a workable vaccine is proven soon, the economy will show a much quicker acceleration in growth. Consumers are generally flush with cash now, but as time passes stimulus will run out and high unemployment will take its toll. If testing drugs goes on into the fall before an effective vaccine is discovered, then any recovery in spending and in the economy may be sluggish this year, and the enthusiasm of investors should be muted. If research efforts are unsuccessful by year-end, we would expect further declines in stock prices from today's levels. Again, we are in uncharted waters regarding the probability of any of these outcomes, but incorrectly forecasting the probabilities of likely scenarios will be punitive to investment performance.

Since the beginning of this year, the United States has increased its federal deficit by more than $4 trillion dollars. The Federal Reserve has pumped trillions more into most of the credit markets to create stability in the country's bond, commercial paper, and U.S. Treasury markets. The country's federal deficit has ballooned to approximately $25 trillion. The Federal Reserve, because of its emergency efforts in 2008/2009 and now in 2020 to save the economy, owns about 8 to 10% of the country's assets. Fifteen years ago, its ownership interest was almost zero. We now have a quasi-government run economy. From the Great Recession and the COVID-19 pandemic experiences, the country's financial system is evolving away from capitalism with an uncertain future. The trend towards greater socialism has strong momentum as each crisis creates greater fear and less perceived opportunity. The financial markets are now government dominated as financial inequality and massive debt levels in all sectors require greater and greater government intervention and control of the economy. Currently both Republicans and Democrats support these policies as any other course would be political suicide. Unfortunately they have become necessary to keep the country from sinking into a depression, but textbook capitalism is gone. With the Federal Reserve controlling capital markets, with an unprecedented expansion of the money supply, and with the federal government attempting to backstop business and individuals from financial ruin with stimulus checks and loans, we are again in uncharted territory. We do not know the longer term consequences of these short-term emergency policies. Domestic protests over racism and inequality and an advocacy for a system change have further clouded predictability of the economic future.

Interest rates are close to zero in the United States. Again, this unprecedented and historically abnormal low level of interest rates has placed the country into the realm of the unknown. Interest rates should be thought of as the price of money. Money is a product. On the surface, free money with zero borrowing costs sounds great but there are dislocations and undetermined consequences below the surface. Markets are being distorted from their normal operating efficiency. Capital allocation is no longer being controlled by the marketplace. The pandemic has precipitated for us accelerated entry into the unknown world of government-controlled markets.

The nation's unemployment rate is currently between 13 and 16 percent. The pandemic has created difficulties in accurately collecting data. Weekly unemployment claims have remained stubbornly high above 1,000,000 new filings per week even though gradual re-openings of the economy are occurring. These numbers have shown some improvement, but it is very possible that rehiring of terminated or furloughed workers will be more problematic and slower than hoped. A successful broad re-opening of America will allow for a quick decline in unemployment, but even so, we do not expect the rate to decline below 8% within the next 12 months. It will certainly not fall to the 3.5% rate at the beginning of the year. Tens of thousands, maybe hundreds of thousands, of jobs have been permanently lost. Thousands of small businesses have been permanently shuttered across the country. Business supply chains have been disrupted from the small restaurant owner to the large department store to the industrial complex. A consequence of the pandemic will be that more of America's gross domestic product will be slowly produced in the United States. The American service economy will not return to its former self for years and employment in that area will not quickly reach 2019 levels.

We have frequently espoused that corporate earnings are a primary determinant of stock market prices, especially in the long-term. Before the pandemic, the accuracy of corporate earnings projections was usually within 10% of median forecasts. Because of COVID-19, corporate earnings forecasts are anyone's guess for 2020 and perhaps 2021. Based on the absence of any meaningful earnings forecasts, it is impossible to determine if stock market prices are high or low. Is the market attractive and ripe for investment, or grossly overpriced? The stock market is a future discounting mechanism. Are present stock market prices discounting a strong recovery in corporate earnings in 2020, or reflecting an earnings surge in 2021? It is possible both scenarios are wrong. Was the strong second quarter recovery in stock prices based on an extrapolation of a post COVID-19 recovery in earnings back to 2019 levels or is the rally simply driven by speculators with too much cash and too few investment ideas? There is presently no factual basis for making any realistic assessment of corporate earnings for 2020-2022. In the financial and published media you are hearing spacious reasoning drawn from the past if you are optimistic, and similar unsubstantiated reasoning from the "this time is different group" if you are pessimistic that semi-permanent adverse changes are occurring in our economy's future which will take years to correct.

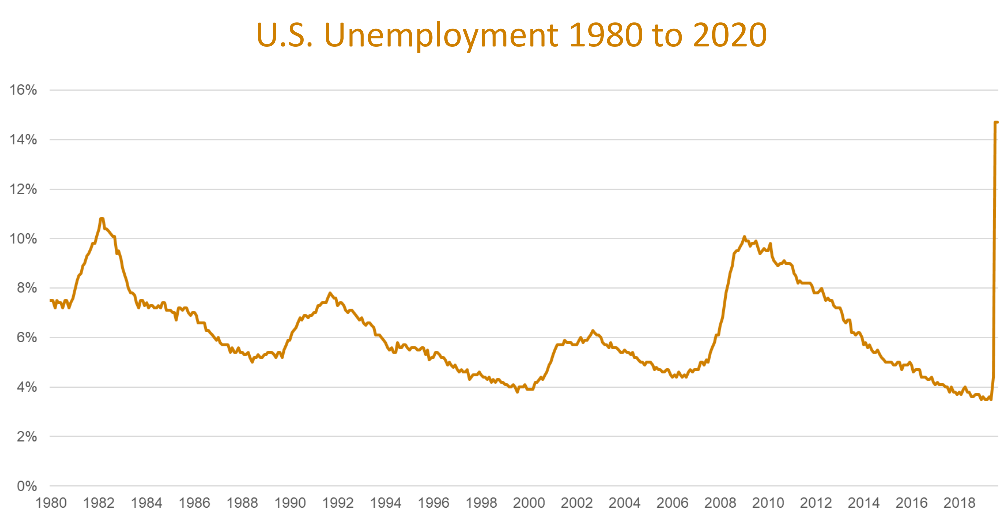
The strong stock market rally from the end of March lows is attributable to three events: massive, unprecedented government and Federal Reserve stimulus, a hope for a vaccine and the re-opening of the economy. In April and May to invest based on these three events was rational. Now in July, we are entering the litmus test of these hopes, and in our opinion, they are overextended. Economic numbers will look good in the third quarter compared to March and April, but they will be subpar compared to a normal period of 2019. We do not believe they will equal 2019 numbers even by the end of the fourth quarter and 2021 may still not get us back to 2019. Yet the stock market is at or near all-time highs as if there never was a pandemic or the decimation of corporate earnings. The stock market's price earnings ratio based on yearend 2019 figures is a historically high 18x while data on the economy reflects a depression. Again, the stock market is a forward discounting mechanism, not a reflection of the past. It is a distillation of the wisdom of the crowd about the future. It is an expression of future confidence, or the lack thereof. But the stock market with its current high price is assuming we will be back to the normal times of 2019 within 6-12 months. This requires a big leap of faith. A jump we do not believe has any rational footing. We do believe there will be erratic improvement in economic fundamentals and corporate profitability, but today's high stock prices imply that the pandemic and its adverse effects are soon-to-be completely behind us.

It is true that major parts of the stock market have lagged the excellent price appreciation seen in other areas. The basic industries and cyclical companies which comprise most of our economy have only gained modestly in market value from their March lows. High technology and health care companies, on the other hand, have in very many cases reached all-time highs in their stock prices. The high technology and healthcare industries have been considerably more immune to the fallout from the pandemic. Consequently, investors have poured money into these two sectors regardless of price, deeming them to be a hedge, a safe harbor, if optimistic forecasts about the re-opening of the economy prove wrong. We have focused our investments in both high technology and healthcare companies all year, which has resulted in our significantly outperforming the Dow Jones Industrial Average and S&P 500 index through the second quarter. Current prices have been stretched too high by a herd mentality of investors narrowly focused on a few companies deemed to be pandemic proof even if their prices are irrational. As the preeminent economist Keynes pointed out, "the market can stay irrational longer than you can stay solvent". There is always a reversion to the mean overtime, and we believe the stock prices in these sectors are too high, especially if the optimistic forecast for a quick recovery from the pandemic does not materialize. There is the real risk that these favored few stocks will suffer price corrections if the expected economic recovery momentum does not occur. Historically, when investors all want to own the same things, subsequent performance results are disappointing. The difficulty is getting the timing right. Certainly, the market can become even more irrational before it corrects.

Sometimes investors become too involved in their political biases when making investment decisions. In economic policy there has been a blending of economic thinking by both the Republican and Democratic parties, by both conservatives and liberals. If one had been in a coma for the last four years and awakened today, viewing the massive government spending that has taken place since 2016 along with increased social spending, almost zero interest rates and an almost complete disregard for the ballooning federal deficit, a newly awakened investor referencing historical tradition would think 2016 resulted in a complete victory for the Democratic party and not the opposite. Statistically the stock market does better when one party controls both Congress and the White House. Since 1945 the S&P 500 index has risen 16% under an all-Republican government and 14.3% under all-Democratic governments. Blue waves or red waves in major elections have not produced significant differences in subsequent investment results. Both parties have differences on issues such as the magnitude and type of immigration reform, inequality reform, trade, taxation policy, international treaties and the direction of the judiciary, but deficit reduction, social welfare reduction, a restrictive monetary policy bias are almost universally rejected by both parties. It took time but both parties recognize that these areas of the economy cannot be altered if they expect to be re-elected.

There will be some economic changes proposed if a democratic majority and President are elected. Tax policy is the major area which in our opinion will be affected by the 2020 election. In this era of increased inequality conscientiousness, a higher tax burden on the super wealthy could happen. A higher corporate tax rate could also be imposed. A change to a higher corporate tax rate should have a modest negative impact on market prices, but the details would be important. An additional tax on the super wealthy billionaire class will not have more than a momentary impact on the stock market. It is important to realize that almost all the wealth of the middle class and upper middle class in this country is now dependent on the stock market and real estate market. The Federal Reserve has for 33 years guaranteed by its actions to protect the stock market from falling far. Additionally, the government will not let a repeat of 2008/2009 occur particularly when the economic shutdown was government imposed this time around. Both political parties recognize the importance of protecting these two pillars of the populace's wealth if they want to get re-elected.

Inequality is a key issue in this country, both socially and economically. We believe with an enlightened dialogue, this issue can be addressed without a major tax increase. Times are changing, Modern Monetary Theory for example was ridiculed and laughed at only three years ago. Now in some variation it is being unofficially practiced. Recently the concept of a Universal Fund was proposed. In simple terms, it calls for major corporations and the super wealthy to contribute some portion of their profits to a fund and dispersed to provide a Universal Income for the good of society. This is just a general concept. There are no details. We have no opinion on it, but the point is inequality solutions will be proposed and some form may be implemented in the next ten years. Their impact,



good or bad, is unknown. Increased social awareness adds another unknown variable which could positively or negatively affect the stock market.

The unprecedented fiscal and monetary stimulus has created an environment that is awash with money. Interest rates are extraordinarily low and there are few easily accessible historically reliable investment vehicles. The investments of choice are the stock and bond markets and real estate. When the supply of goods is constrained but there is more and more money available to buy them, prices go up. For proof, just ask a homeowner in Silicon Valley. The number of stocks to buy and the amount of real estate to own is finite. Money creation can be infinite. Consequently, stock and real estate prices will go up without external mitigating factors. This is exactly what has happened in both markets, and since 1987 investors have taken this phenomenon to be a certainty.

Because of the Fed massively interjecting itself into the financial markets, investors are effectively flying blind as to true asset value. Will rising asset values create steadily increasing inflation because of excess money and will it spread throughout the economy? Or will the external mitigating variables, such as COVID-19, and the cheapening of commodity prices due to abundant capital at almost zero cost result in deflation and reoccurring recessions as experienced by Japan for the last 30 years? Again, the extremes of the current times in our country has put us in an uncharted world regarding the future and, therefore, the appropriate level of stock prices.

When there is a strong distribution of wealth in an economic system accompanied by equality and opportunity, it is a strong system. When the top 0.01% own 20% of a nation's entire wealth and this amount exceeds the total wealth ownership of the bottom 70% of the country, the system is inherently precarious. The top 1% of earners account for 20% of total income in the U.S. and the bottom 40% account for just 13%. The top 10% of households financially in the U.S. own 84% of all stocks. The bottom 90% own 16%. The middle class in the U.S. is shrinking. It now represents 50% of the population. This is about the same as Russia and Turkey and much less than Germany, France and Japan. According to the Federal Reserve, the bottom 80% of earners in the U.S. have seen their total share of the country's income and wealth decline since 1989. The economic inequality is increasing. These numbers and this trend do not mean social upheaval is necessarily eminent. Regardless, they will have little effect on the stock market, but longer-term asset valuations will be affected as the political system tries to address the situation. It is difficult to know how these issues may affect valuation and as a result, investors are generally ignoring these risks. If a growing population is losing out in terms of health, income and wealth inequality, there is a rising probability that the average voter will have different views on how society should be organized. Possibly the tectonic plates are shifting underneath according to one Wall Street investment bank.

The stock market is at an infliction point. Good news must continue to justify current high valuations and to provide an environment for additional gains. Economic recovery, a strong consumer and massive stimulus could be enough. However, we have posted herein the argument that regardless of your predilections there are number of unknown factors facing the economy and the investor and they could go either way. We do not believe the stock market has been willing to recognize that investors and the country are in an uncharted environment on almost every important variable to be considered in assessing our future. This also pertains to the country's leadership. There are divisive voices propounding different choices and facts and direction on an array of issues. The voice for moderation and unity has been small. This too is a cause for concern and, in our judgment, will manifest itself in a more cautious outlook for stock prices if it continues.

We have moved to a more cautionary stance in our current investment thinking. At high valuations, the risk/reward outlook for the equity markets tilt more toward risks. There are too many unknowns which need more clarity of direction. We do not want the irrationality displayed in security prices within the context of so many unknowns to become a punitive force affecting investment performance. The country is in uncharted waters on too many issues. The long-term effects on the economy and financial markets are completely unknown. One can only speculate which is not a good way to invest. Thus, although the momentum of the stock market is for the moment erratically positive, cautionary lights are blinking for the longer term. It is possible with all the government's novel financial policies to prevent a depression precipitated by the pandemic, we have not only borrowed from our future as a nation but we have unleased forces that will alter our social system, and the management of the economy by the government and its agencies. We think patience, in conjunction with observation and analysis and a healthy respect for the unknown will allow us to benefit our clients with continued superior relative investment performance. Our aggressive commitment to the stock market in the spring was correct, but now increased cash, caution and patience are warranted. The country is in an economic and social experiment that no one as recently as five months ago imagined, and its unknown consequences will be felt for years to come. We should respect the unknown and not proceed blithely with irrational optimism. The stock market is pricing in the expectation of normalcy soon, but we do not know what the new normal will be over the next decade.

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Independent Investment Advisory

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