OCEAN PARK
ASSET MANAGEMENT

Q2 2020

Risk Matters. Defense Matters. Discipline Matters.

WHAT HAPPENED:
THE FIRST HALF OF 2020

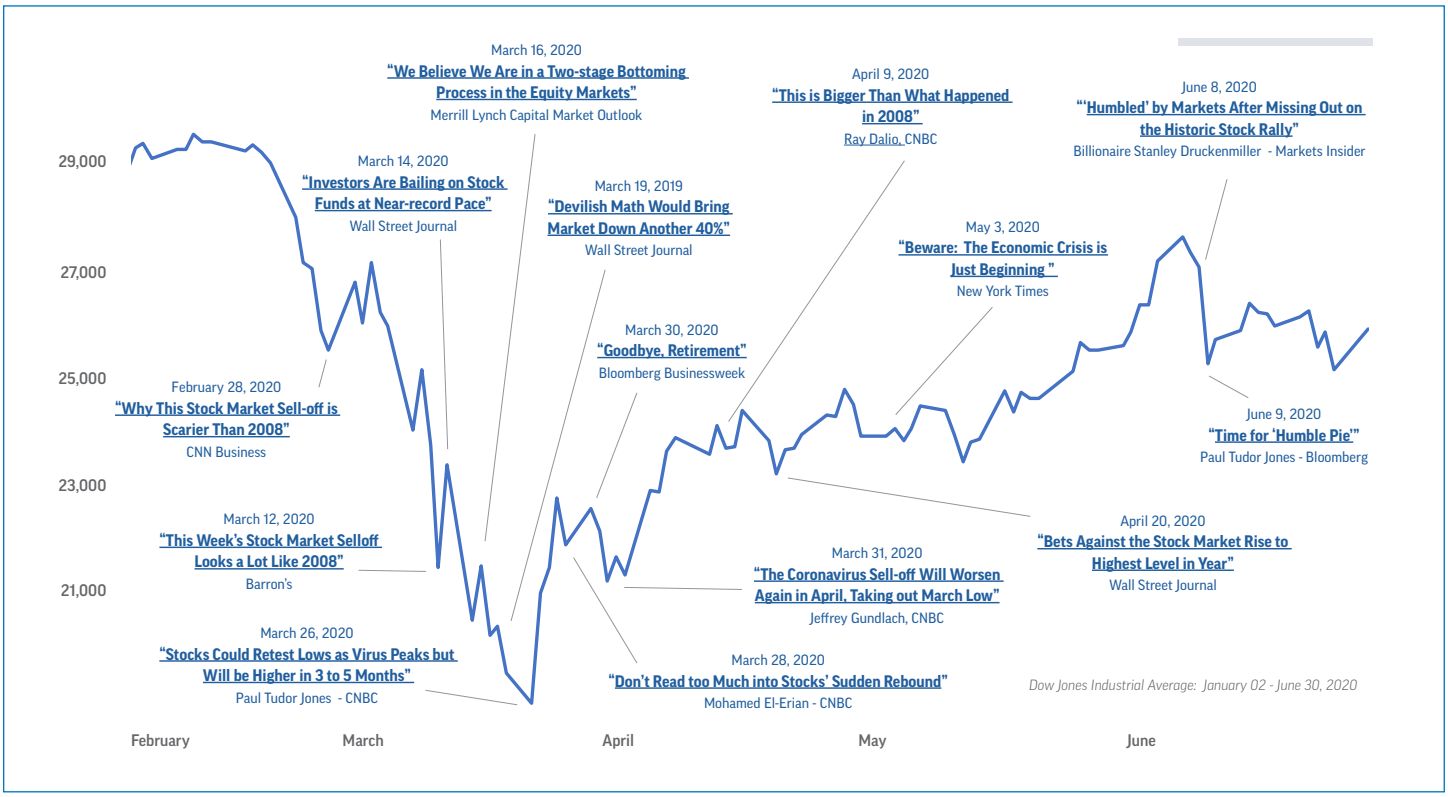
Like a black swan flying against a dark night sky, virtually no one called the ups and downs of 2020 so far.

Following the stock market declines in Q1 that were at or near record size for a calendar quarter, the U.S. stock market reversed upward, and Q2 was one of the best in decades. But as we all know, gains and losses are not symmetrical.

Recent months provide a classic illustration: From its all-time high in February, the S&P 500 fell 33.8% into its low of March 23, then rallied 45.1% to its recent recovery high of June 8. Sound good? Nope. A 45.1% gain on $66 does not get you back to $100, much less back on track for a good return: The S&P on June 8 was still 4.5% below its February high – and at this writing (July 7) is 7.3% off its high.

The Dow Jones Industrial Average fell even harder from its February record high to its March 23 low, down 36.7%, and even after a 48.3% rally (yup, 48%!) to its recovery high on June 8, the Dow was still 6.1% below its February high – and as of July 7 is 11.8% below that high.

Who got that pattern right? We like to cite a favorite quote by Lao Tzu: "Those who have knowledge don't predict. Those who predict, don't have knowledge." Here is a graph of the Dow Jones Industrial Average in the first half of 2020 with some embarrassing media predictions.



Source: Creative Planning

Economic growth dropped sharply to start the new decade. First quarter GDP dropped a nauseating 5%, marking the end of the longest U.S. expansion on record. The impact on Americans, aside from the pure health impact of COVID-19, was swift and painful. U.S. initial jobless claims spiked to a record 6.867 million for the week ended March 28. Given this metric, one can gauge market conditions in the U.S. economy with respect to employment; as more new individuals file for unemployment benefits, fewer individuals in the economy have jobs.

The painful job losses are not good news for future economic growth. The U.S. consumer makes up nearly 68% of the $21.54 trillion U.S. economy (at March 31, 2020) so that cohort cannot be easily relied on to pull the economy out of its current depths.

So it's puzzling that market participants have acted as if the U.S. economy, corporate profits and valuation of the stock market should be reflected in stock prices as if the outlook has not changed.

Economic Comments

The U.S., and most of the world, officially collapsed into recession in March 2020 and even a nearly full recovery seems a long time in the future. Tens of millions of Americans lost their jobs or were laid off for indefinite periods, and millions of others have seen their incomes cut. Small businesses are the worst hit, and it is estimated that many will close permanently.

Even with several million people resuming their jobs over the past two months, unemployment is still at a higher level than at the worst months of the 2008 Great Recession. And all this in a country where almost 68% of GDP (Gross Domestic Product) is from household spending, which by some estimates will not recover to pre COVID-19 levels for at least three years.

To protect homeowners who may not be able to pay their mortgages, the federal government set a moratorium on foreclosures and evictions as to Fannie Mae and Freddie Mac mortgages, and recently extended those to "at least" August 31. And like some other states, California suspended judicial foreclosures and there are bills pending to delay pre-foreclosure steps for more than six months. These steps are very helpful in the short run, but the interest is not forgiven, and continues to accrue.

Similarly, as to renters, who may not be able to pay their rent, the CARES Act provided a moratorium on evictions from properties financed by Fannie Mae, Freddie Mac and HUD loans, and renters who live in federally assisted housing. And California's Governor Newsom made an order that allows cities and counties to enact moratoriums and other tenant protections. Again, however, tenants will continue to owe back rent, and the moratoria will end at some point.

On another level, the financial burdens of dealing with COVID-19 are costing states, counties and cities huge sums of money, at the very time that their tax revenues are being hit hard with no recovery in sight. They will have no choice but to lay off hundreds of thousands of public employees over the coming months, since the White House has stated that the federal government will not provide emergency funding for those deficits.

In response, the Federal Reserve responded swiftly since March, embarking on large-scale programs in order to help restore order and confidence for investors and Americans.

So why are such matters of interest to us as investors? For one reason, because during the second quarter the U.S. stock market has rallied almost back to its record highs of February (and the NASDAQ to new all-time highs), as if COVID-19 never happened. We see risks ahead for the stock market and other risk-on asset classes such as high-yield corporate bonds, emerging market debt, REIT securities, etc.

WHAT WE DID:
A TRULY TACTICAL RULES-BASED APPROACH TO NAVIGATING MARKETS

Turning to the high yield corporate bond market, Q1 saw the largest (and fastest!) drop since the global banking crisis of 2008, with the ICE BofA US High Yield index down 21.5% in less than five weeks. A 23% rally brought the index back within 3.5% of its February high, but since then the HYCB market has declined moderately, bringing new Sell signals in some of the funds we held, as described below.

By the end of February, our quantitative and truly tactical rules-based system generated sell signals and we exited all high yield corporate bond funds by the end of that month. In our Tactical Bond Strategy, those rules signaled Buy signals in long-dated Treasury bonds by early March as the "risk-off" trade led to a stampede into safe bonds. The 30-year Treasury bond plummeted to an all-time low of 99 basis points (0.99%).

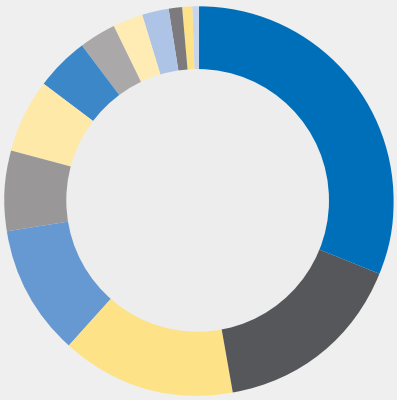
As fear dissipated in late March and optimism continued into early April, the loudest pundits shouted that further drops were inevitable (see the first chart above). Our truly tactical rules-based system listens to the market, though, and indicated it was time to put money back to work for our clients.

In fact, by the end of June our diversified Strategies – Ocean Park Conservative Allocation and Strategic Income – re-invested in a number of asset classes including preferred stocks and municipal bond funds, as well as high yield corporate bond and U.S. equity funds.

As an example of the broad diversification of asset classes that are used tactically to moderate drawdown, the pie chart below shows the asset allocation of the Conservative Allocation Strategy at the end of the first half:

Conservative Allocation Strategy:

As June 30, 2020



High Grade U.S. Bonds	31.3%
Cash and Equivalents	16.0%
Preferred Stock	14.6%
Tax Free Municipal Bonds	10.6%
High Yield Corp. Bonds	6.8%
Domestic Equities	6.2%
Emerging Markets Bonds	4.4%
Intermediate-Term Bonds	2.9%
Multisector Bond Funds	2.5%
International Bonds	2.3%
Alternative Strategies	1.1%
Convertibles	0.8%
Managed Futures	0.5%

Asset Allocation are subject to change.

The Municipal Bond Strategy was fully invested at the end of the second half, after holding large cash positions at the end of the first quarter. This Strategy recorded a small loss in the first half (before fees), with that coming primarily as a result of losses in March.

The High Yield Corporate Bond Strategy sold out of all high yield corporate bond holdings by late February, but some HYCB funds gave new Buy signals in March and April. At the end of the second half, that Strategy held approximately 60% in cash and the rest invested in high yield corporate bond funds.

The Tactical Bond Strategy recorded an impressive gain (before and after fees) in the turbulent first half of 2020 as, notably, the shift into long-duration Treasury bond funds was very productive in March, then the shift back into some HYCB funds in May also resulted in gains productive. At the end of the half, that Strategy still held positions in both of those asset classes.

WHAT WE ARE DOING NOW:
DISCIPLINE MATTERS.

As noted above, the great enigma is why do global investors apparently believe that corporate America is pretty much as valuable as it was in February, before the global crash in oil prices (which by the way have not recovered) and the human and economic devastation caused by COVID-19? We are not mind readers, so we are glad that our long-proven defensive disciplines simply have us watch for actual trend reversals rather than predict the markets. You can rest assured that we are highly attentive every day to protect your accounts in the event the Bear Market resumes.

As a reminder, at Ocean Park we adhere to strict rules-based disciplines that first and foremost serve our goal of limiting drawdowns, while also generating satisfactory returns. We want to assure you that, despite these challenging times of our public health crisis with its significant impact on the economy and the investment markets, Ocean Park will continue to manage your accounts to mitigate risk, just as we have done throughout our 32-year history.

HIGHLIGHTED STRATEGY:
OCEAN PARK TACTICAL BOND

The Ocean Park Tactical Bond Strategy gained 7.8% (before fees) in the first six months of 2020, in a market environment where the roller coaster of the S&P 500 ended with a more than 3% loss. This Strategy uses a rules-based approach to shift between high yield corporate bond funds and long-maturity Treasury bonds, depending on the trends in the HYCB funds. We encourage you to consider diversifying a portion of your investment portfolio into Ocean Park's newest strategy.

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