Video Transcript
Economic Review & Outlook

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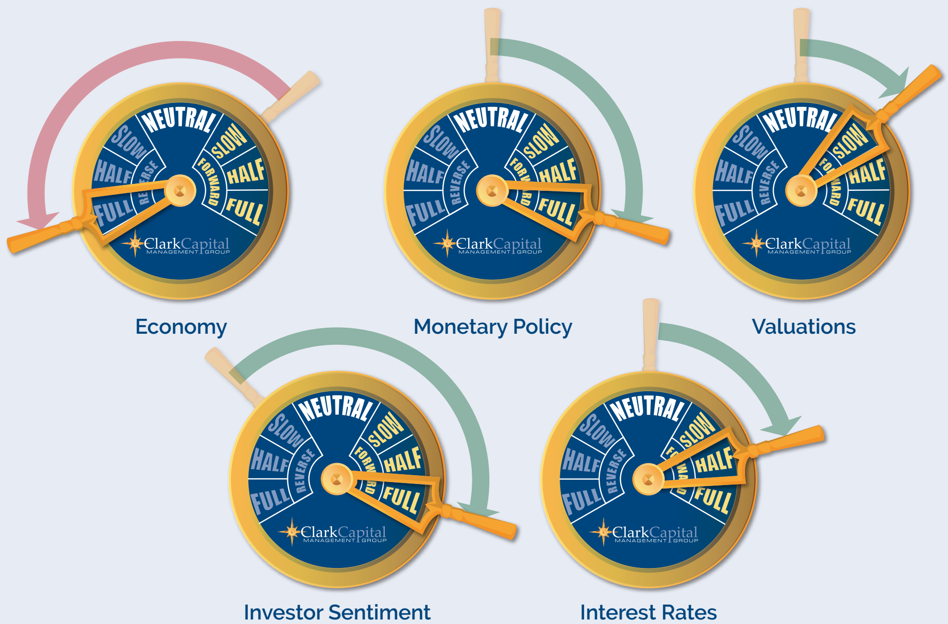
First Quarter 2020

Thanks for joining me during these difficult and uncertain times for a special update to review the changes we made to our 5 gauges covering the major areas that help shape our view for the overall economic environment. These gauges in turn drive our expectations for the stock market. Recall 12:00 is neutral, anything to the right of 12:00 is positive for stocks, anything to the left of 12:00 is negative.



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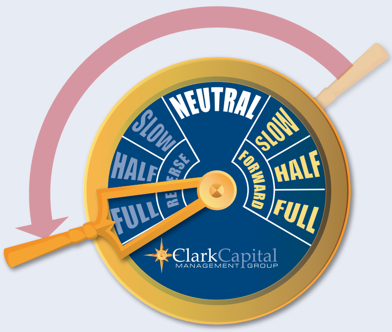

Economy

U.S. Economy

Our first gauge is the U.S. economy, which we move back 4 spots to a Full Backward position. In reaction to the coronavirus and in order to help slow its spread, unprecedented actions are being taken that are significantly impacting several segments of our economy. Non-essential businesses in several states are being forced to temporarily close, major industries like travel and leisure are seeing significant slowdowns, sporting events have been cancelled and life for many Americans has focused on staying at home. As a consumption led economy, we expect a significant slowdown in the economy in the second quarter of 2020 – the likes of which could be unprecedented.

Although the early part of the first quarter began strongly, the impact of COVID-19 started impacting the economy as we moved into and through March. First quarter GDP will be rear-view looking, and we expect it to marginally positive, showing about 1.0% annualized growth, but it is important to remember our economy was in a solid position prior to being impacted by this exogenous coronavirus event regardless of what the final first quarter GDP turns out to be. As we get to the other side of this pandemic, we believe that the strength the economy showed early in the year will help in our recovery down the line.

We expect the second quarter will bear the brunt of the economic slowdown and that the weakness will be widespread. Wall Street estimates vary widely, but our expectation is a decline somewhere between 10%-15%. We expect unemployment to spike, retail sales to plunge and travel-related businesses to grind to a near standstill. The drop in GDP could be unrivaled.

We believe the third quarter is an unknown and will likely be a period of transition as the economy gets re-started. This will largely depend on how quickly we get to and through the peak of active cases and make progress against this virus. GDP might be positive or negative depending on that progress in the third quarter, but we believe that the fourth quarter should be a rebound quarter that we estimate will show at least 5.0% GDP growth. Pent-up demand will be unleashed, inventories will be replenished, and above trend growth should begin during this period of recovery. We anticipate that 2021 will be the year of the rebound.

The economic slowdown we expect in the months ahead will be unprecedented. Not in our lifetimes have we been through a period when the economy went from such solid footing to such a dramatic self-imposed shutdown in many industries in order to slow the spread of this virus and save lives. We know the coming months (and maybe quarters) will be rough, but we also believe in the American economy and would not bet against it overcoming this obstacle in the long run.

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Monetary Policy

Monetary Policy

This leads us to Monetary Policy, which we take to a Full Forward position.

The Fed has been front and center trying to do what it can to address this crisis. Following an emergency 50 basis point rate cut on March 3rd, the Fed slashed rates to zero (technically 0 to 25 basis points) in another emergency meeting on Sunday, March 15th. Furthermore, a new quantitative easing program was announced, which originally had the Fed targeting to buy $500B in U.S. Treasury securities and at least $200B in agency mortgage-backed securities. However, about a week later, the Fed removed the dollar amounts and stated it would buy these bonds “in the amounts needed” unleashing the Fed to buy as much as they deem necessary during this period.

This is in addition to the massive amounts of liquidity the Fed is supplying through repurchase agreements or the Repo market. Reserve requirements have been suspended for banks and a facility has been put in place for the Commercial Paper market, a key funding source that large companies use to help manage short-term cash needs.

This crisis did not stem from the financial system and the Fed seems determined to do what it can to keep the financial system operating properly so a health crisis does not become a financial crisis.

A fiscal stimulus package was also signed into law in late March that will total about $2 trillion dollars. Although this is not a monetary policy endeavor and comes from the fiscal side, this package includes a variety of provisions including sending money directly to U.S. citizens based on income levels, boosting unemployment insurance, creating a $500 billion dollar pool for loans to companies, states and municipalities and support for industries directly impacted by this crisis, like airlines. The goal of this package is to bridge the period when the economy slows down significantly until the country starts to re-open businesses more broadly.

Added together, we can say trillions and trillions of dollars of government support are being deployed to not only combat this crisis, but also support workers, companies, industries and the economy through these challenging times and eventually help kickstart the economy as things begin to normalize.

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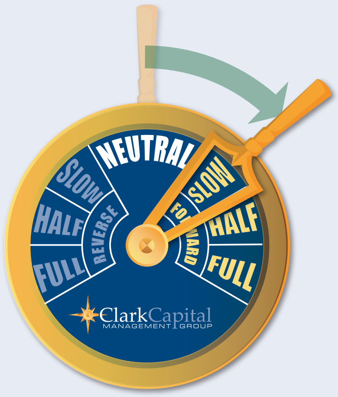


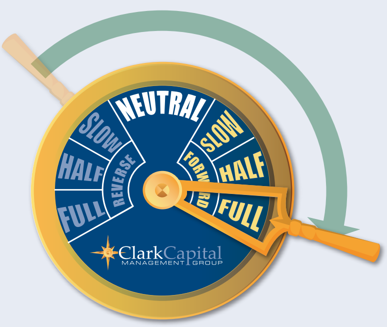
Valuations

Valuations

Next are valuations, which we move to the Slow Forward position. We understand that corporate earnings in the quarters ahead will be lower and the actual numbers are unknown. We are in a situation where uncertainty is so elevated, that many companies are pulling their own guidance because they don't even know what revenues and income will look like in the months ahead. When quarterly earnings are expected to be bad, we often see companies write off a variety of other items in what is termed a "kitchen sink" quarter, with the thinking that a company might as well get out all of its bad news in a single quarter.

So, right now the market's P/E ratio is rather meaningless. We do not know what the "E" or earnings will be at this time. However, we do know that the significant sell-off in equities has dropped the "P" or price of stocks dramatically.

During this period of negative information and weak earnings, it is important to remember that stocks are forward looking. We believe that stocks will start to go up before the bad news stops coming in. Stocks will begin to anticipate earnings coming back as the economy begins to recover and while we know it could take several months for this to evolve, we remain resolute in our belief that the U.S. economy and corporate America will come back from this crisis.



Investor Sentiment

Investor Sentiment

The next gauge is Investor Sentiment, which can be thought of as a measure of speculation or pessimism in the market. It won't surprise anyone to hear that pessimism is extremely high in this current environment and as a result, we move this gauge to a Full Forward position. Recall this gauge is a contrarian indicator meaning that excessive pessimism is a positive for our stock outlook. We are seeing levels of fear and pessimism that are historic extremes.

First, we can look at market action itself to see this pessimistic behavior. The Dow dropped over 28% in a 5-day period and that type of sell-off has only been rivaled a few times in history. The other times were the outbreak of WWI, the crash of 1929, the crash of 1987 and the 5 days following the Lehman Brothers bankruptcy in 2008.

While these are indeed scary times, we do not believe the conditions today approach the levels of uncertainty associated with those 4 historic events. Keep in mind that WWI lasted from 1914 until 1918 and that millions of lives were lost. In fact, the Spanish Flu outbreak that started in 1918 ultimately led to 50 million deaths.

Even more recently with the Lehman bankruptcy in 2008, there was significant worry that the entire financial system was going to collapse. Those were very uncertain times. Today, we feel there is a much clearer path to recovery than at those times as preventative measures like social distancing, limiting gatherings and telecommuting take hold. There are even some encouraging test results that might lead to effective treatment of COVID-19. Again, we believe it is easier to see the light at the end of the tunnel today than it was during those 4 world-changing events.

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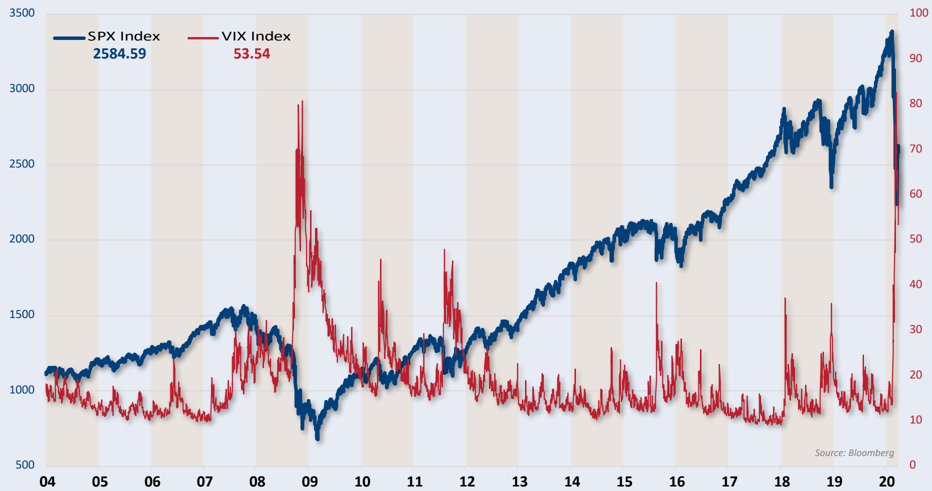
The CBOE Volatility Index, or VIX Index, is another measure of volatility in the market. The VIX index and its predecessor have data going back to January 1990, which tallies over 7,600 trading days. For this index, the higher the number the more uncertainty is being priced into the market.

S&P 500 vs. Volatility



Of those 7,600 trading days, the VIX has closed above 80 three times. On March 16th, 2020 the VIX closed at 82.69, its highest closing level ever. The last time the VIX closed above 80 prior to March 16th was November 20th, 2008, right in the jaws of the financial crisis. Six months later, the S&P 500 was up +20.1%. We are not necessarily saying that will be the path this time (stocks could go lower from here), but these types of extremes have historically occurred as the market is going through its bottoming process. By the end of March, the VIX Index had moved lower from those elevated levels in the middle of the month and closed around 53.5.

Fund flow data is telling us the same story of panic selling taking place from the bond side as well. According to Lipper, investors yanked $16 billion from equity mutual funds for the week ending March 25th. Even more astonishing is that investors pulled $62 billion from taxable bond funds and $13 billion from municipal bond funds over that same time period. All of the outflows from bonds were weekly records. So where did all this money go? $260 Billion was added to money market funds, also a weekly record.

Another source looking at bond flow data and the significant recent outflows can be seen in this chart as well.

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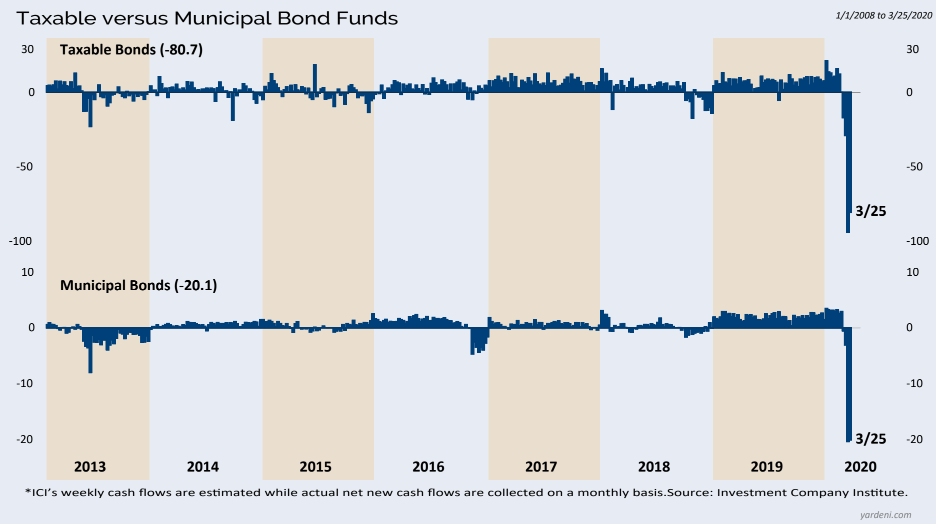

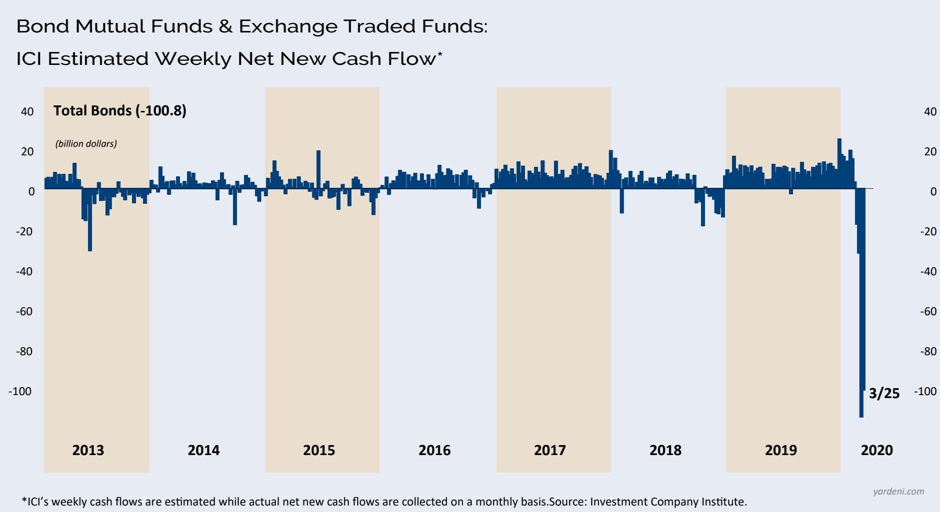

This makes no sense. Investors usually turn to bonds to provide stable cash flow and offset the volatility of stocks. Bonds are viewed as investors' safe money, and with good reason. Since the inception of the Bloomberg Barclays U.S. Aggregate Bond Index in 1976, there have only been 3 calendar years in which the Index had a negative total return—the worst of which was in 1994, which experienced a negative return of -2.92%.

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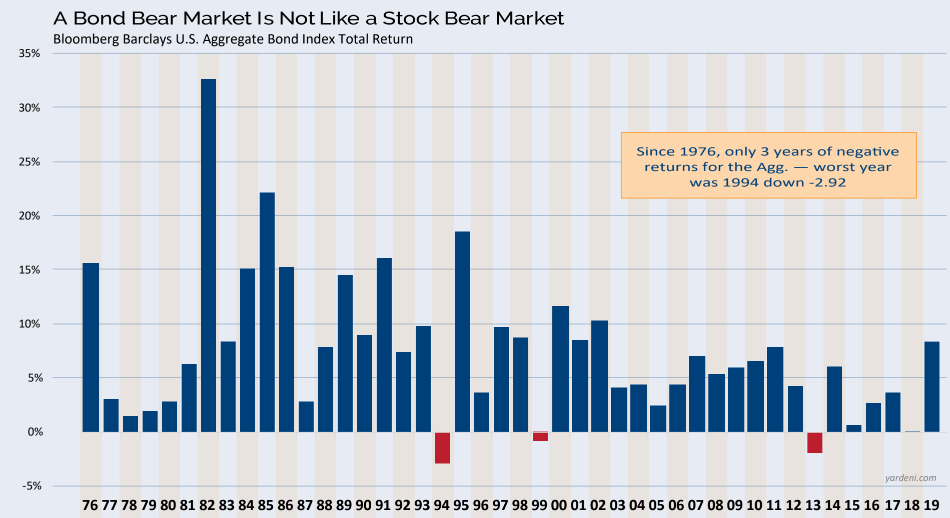
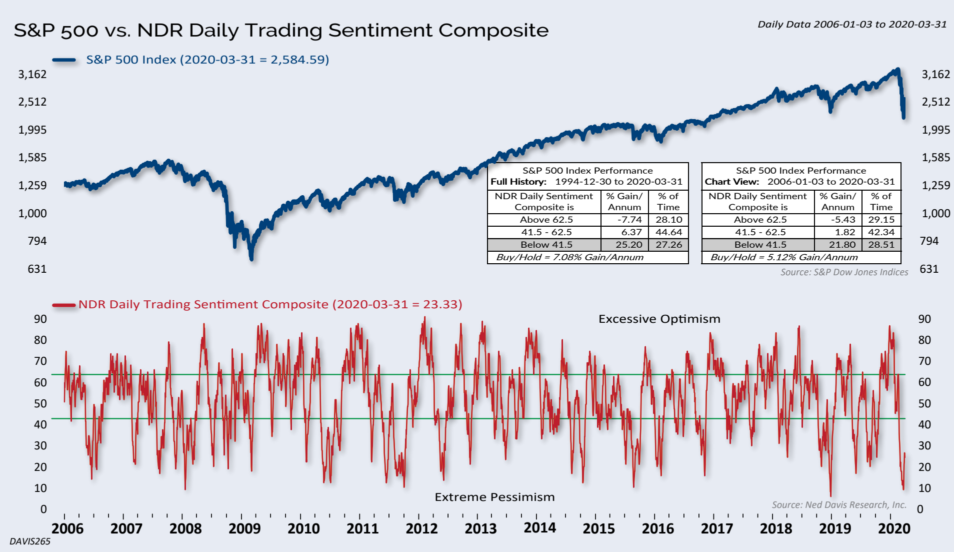


A sell-off in the fixed income markets or a rise in rates may temporarily lower the account value for the individual bond holder. However, if held to maturity, and the issuer does not default, bond holders will receive 2 interest payments per year and par value when the bonds mature.

In technical terms, when indiscriminate selling happens across multiple asset classes – stocks, bonds, commodities – it is said that their correlation has gone closer to 1. In plainer terms, we say that investors have thrown the baby out with the bath water.

Sentiment readings like Trading Sentiment and Investor Sentiment have also reached extreme pessimistic levels. Again, we believe these are contrarian indicators and readings in this extreme pessimism zone are like others that we tend to see historically during times when the market is going through its bottoming process.



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Interest Rates

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We have just walked through several readings that show how pessimistic and volatile this market has become. Historically, we see these high levels of volatility and pessimism during a market bottoming process. Remember, it's always darkest before it's dawn, and these extreme levels of pessimism compel us to move the contrarian sentiment indicator to its Full-Forward position.

Interest Rates

Interest rates are the final gauge and we move this forward two notches to the Half Forward position. The yield on the 10-year U.S. Treasury dropped dramatically during the latter part of February and early March as there was a clear flight to safety occurring in the market. At one point, the 10-year yield closed at a historic low of 0.54% (and traded well below that during the day) and the 30-year yield closed below 1.0%. Although the 10-year yield was volatile in March, it ended the first quarter with a yield around 0.7%.

Massive monetary stimulus, which I previously described, has also pushed rates down, especially at the front end of the curve following the Fed's return to a zero-interest rate policy. Although the Fed is doing what it can to keep rates low, which is stimulative to the economy, other rates have not followed Treasury yields down to the same degree. "Credit spread" is the term we use to describe this difference between Treasury yields and the yields of other bonds that are not issued by the federal government.

Right now, credit spreads have widened, meaning investors are demanding higher rates to hold other types of bonds like investment grade, high-yield and municipal bonds. So, lower Treasury rates are not necessarily making it cheaper for companies or municipalities to borrow money.

Ultimately, lower rates should be helpful to the economy and we therefore improve this gauge by two notches. If consumers can refinance their mortgage and free up some cash for themselves, we believe that would be a positive for consumer spending. Additionally, if consumers see the interest rates on their credit cards drop, that could help as well.

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We know these are difficult and challenging times. We also know that we will see bad news in the short-term, which is causing some of the extreme volatility we are seeing in the capital markets today. However, stocks are forward looking, and we maintain our stance that fundamentals are what matter in the long run. We believe that the U.S. economy and corporate America will come through this crisis, although it might take some time. We would not bet against the resiliency of U.S. economy, corporate America and U.S. citizens to fight their way through this challenging period.

As always, we believe it is imperative for investors to stay focused on their long-term goals and not let these short-term swings in the market derail them from their longer-term objectives.

Please contact your CPM Team or your Investment Consultant to discuss how we can help you during this difficult time. We are here to support you and your clients in any way we can.

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Disclosures

This video was filmed in April 2020

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The Dow Jones Industrial Average is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

The VIX Index is a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

The S&P 500 Index is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

The Bloomberg Barclays US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

The S&P U.S. Treasury Bond Current 10-Year Index is a one-security index comprising the most recently issued 10-year U.S. Treasury note or bond.

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