Video Transcript
Economic Review & Outlook

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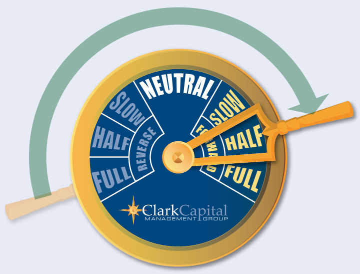
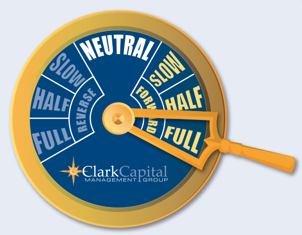
Second Quarter 2020

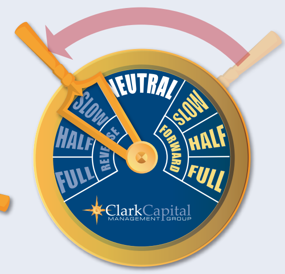
Thanks for joining me during these challenging times to review the changes we made to our gauges covering the 5 major areas that help shape our view for the overall economic environment. These 5 gauges in turn drive our expectations for the stock market. Recall 12:00 is neutral, anything to the right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



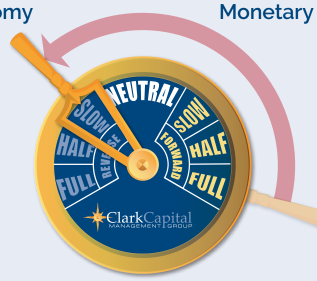
Economy



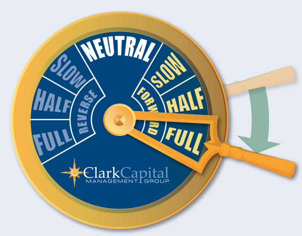
Monetary Policy



Valuations



Investor Sentiment



Interest Rates

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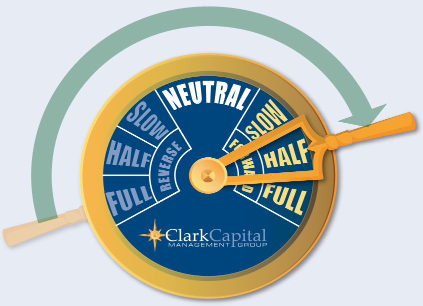

Economy

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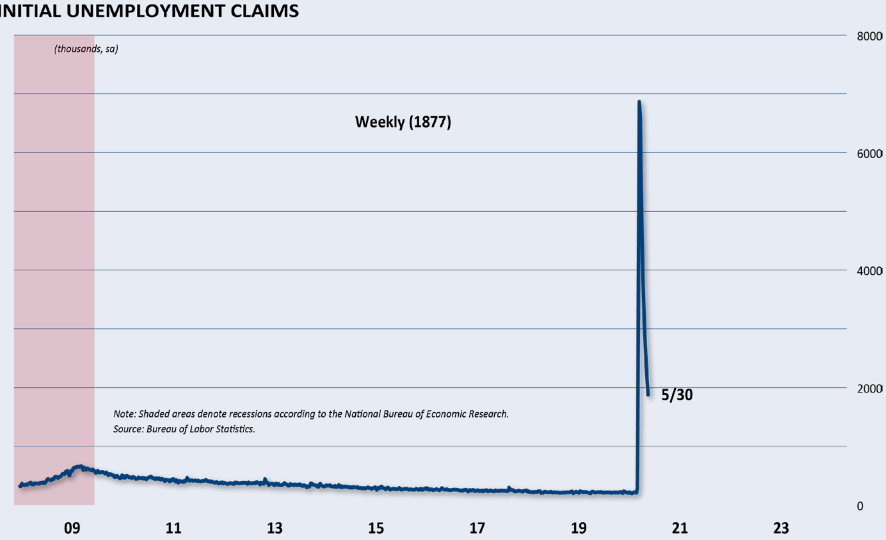
U.S. Economy

Our first gauge is the U.S. economy which we move to a Half Forward position heading into the third quarter. The National Bureau of Economic Research has already declared March as the beginning of this pandemic-driven recession. We had moved this gauge to a Full Backward position moving into the 2nd quarter because we knew there would be a severe drop off in economic activity in Q2 as large portions of our economy were shut down and many citizens were under stay at home orders to help stem the spread of the coronavirus. Our expectation is that when Q2 GDP is reported, which will be on July 30th, the economic decline for the quarter will be around 40% the sharpest economic drop in our history. The good news is that we expect this recession to be the shortest on record as well.

During the second quarter, the reopening process began, and we believe this process will continue in the 3rd quarter. As sharp as the decline was in the second quarter, we anticipate a powerful rebound in the 3rd quarter as businesses reopen and many Americans go back to work. We believe that the economy will not return to pre-pandemic levels until late 2022 or early 2023, but we do expect a strong rebound in the second half of this year. At this point, our expectation is the U.S. economy will grow around 20% in the third quarter with above trend growth of 5% in the fourth quarter to follow.

Labor market data has done a good job of reflecting this rollercoaster economic environment that we have been in over the last several months. We started the year with a job market that showed the unemployment rate and initial jobless claims were near their lowest or best levels in about 50 years. In just over 3 months following the economic shutdown, about 45 million people filed for unemployment benefits, the unemployment rate went from 3.6% in January to 14.7% in April and about 20.7 million jobs were lost in April alone when looking at payroll data. The good news? Initial jobless claims have fallen steadily over the last 12 weeks from a weekly high of 6.9 million to around 1.5 million, the unemployment rate unexpectedly dropped in May to 13.3% defying expectations of a further increase to 19%, and over 2.5 million jobs were added back to payrolls in May when an additional 7.5 million job losses were expected. The last data point for the second quarter showed June payrolls increased by 4.8 million, well ahead of estimates, and the unemployment rate fell to a better-than-expected 11.1%. We anticipate job market data will continue to rebound in the third quarter.

INITIAL UNEMPLOYMENT CLAIMS



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We moved this gauge only to the Half Forward position as challenges to the economy clearly remain. As the second quarter was ending, the U.S. was experiencing a resurgence in COVID-19 cases in several states and some governors began pausing their reopening efforts. We believe the economic recovery will take a long and bumpy path, but as we concluded in our last quarterly video, we would not bet against the resiliency of the U.S. economy, corporate America and U.S. citizens to fight their way through this challenging period.

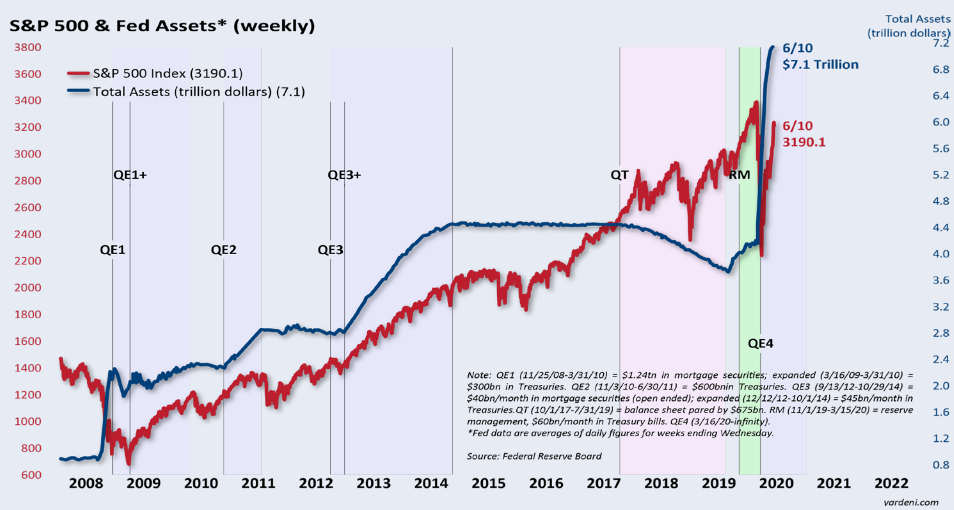
Monetary Policy

Monetary Policy

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

The Fed has been front and center trying to do what it can to address this crisis. In March, the Fed cut policy rates to a range of 0 to 0.25% and announced unlimited quantitative easing and a host of other programs to provide liquidity to the market. Not only did the Fed deploy the playbook from the credit crisis quickly, but they added some new plays as well. The Fed is now buying bond ETFs and individual corporate bonds – with capacity to purchase both investment grade and non-investment grade bonds. The Fed's balance sheet, which had been slowly declining prior to this crisis, increased by more than $3 trillion dollars in just a matter of months, pushing the total balance sheet to over $7 trillion dollars.

Ultimately, this massive stimulus by the Fed helped support capital markets from the early days of the pandemic crisis period. We have seen over the past decade that when the Fed is increasing its balance sheet, stocks have reacted favorably and subsequently, both stocks and bonds enjoyed a powerful rebound during the second quarter.



Moving into the third quarter, the Fed shows no signs of letting up on this support. Recent comments by Fed Chairman Powell indicate the Fed's willingness to keep rates low for the foreseeable future and deploy any and all of its monetary policy tools for as long as necessary to support the economy.

Combine this monetary stimulus with fiscal support with the already enacted $2.1 trillion CARES ACT and an expected additional fiscal stimulus plan that could come later

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Valuations

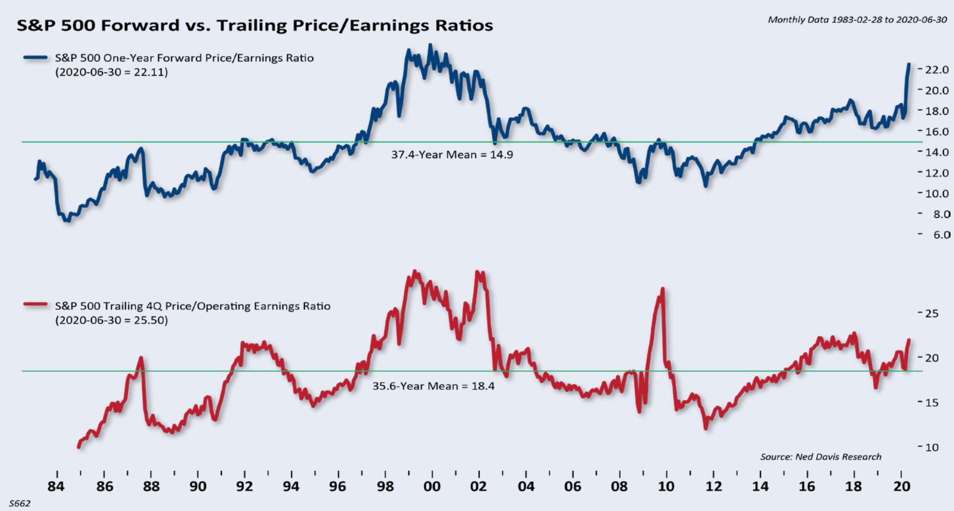
in July, the government has deployed trillions of dollars. The goal of this support is to help workers, businesses, and hard-hit industries bridge this recessionary period until the economy can get back up and running again.

We know this will be a choppy reopening period, but the Fed is providing unwavering support and we therefore keep this gauge in the Full Forward position.

Valuations

Next are valuations, which we move from a Slow Forward to a Slow Reverse position. Moving into the second quarter, we were comfortable increasing this gauge into positive territory because of the tremendous decline in stock prices that occurred. Looking at the market's P/E ratio, we felt the Price or P had dropped to such a degree, that valuations had improved, although we acknowledged that Earnings or the E was still an unknown.

Fast forward one quarter and we have had a stock market that enjoyed its best quarterly results in decades as prices rallied sharply, while earnings have clearly not kept up. The rally in prices has been so strong, that the forward P/E ratio of the S&P 500 is at its highest level in about 20 years.



Recall that the stock market is forward looking, and stocks are looking beyond the near-term weakness in the economy and earnings and toward 2021 when we believe a sharp rebound in earnings is expected. That does pose a risk if earnings growth disappoints, but at this point we believe the market is anticipating those earnings bouncing back in 2021 with consensus estimates looking for a 47% rebound in S&P 500 operating earnings next year.

So, why not bring this gauge further back into Reverse territory? We need to analyze stocks in relation to other asset classes, with the primary alternative asset class for most investors being bonds. With the Fed pushing interest rates down, fixed income yields across most maturities are being suppressed. Some areas in the front end of the yield curve hit historical low yield levels in the second quarter, while the 10-year U.S. Treasury yield itself closed the second quarter at only 0.66%. We can compare

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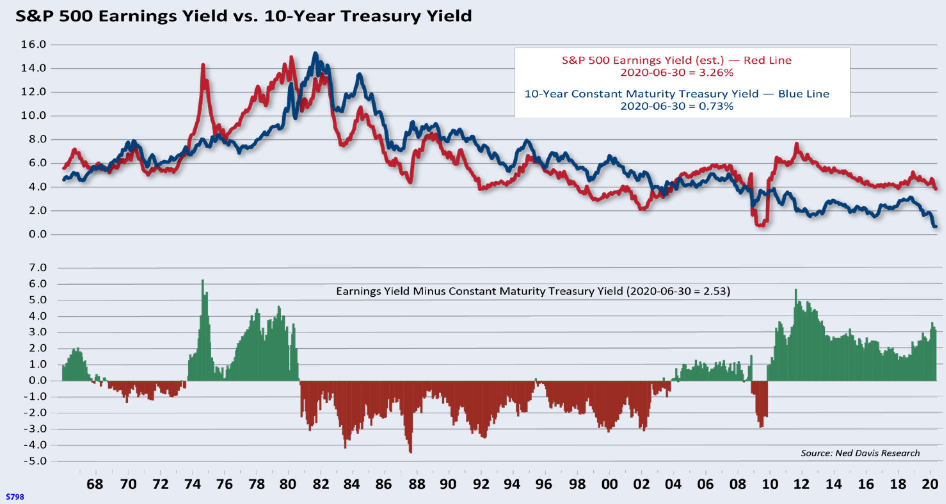
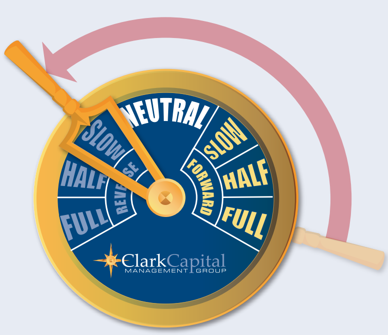
the earnings yield of the S&P 500 (which is the inverse of the P/E ratio) to the yield on the 10-year Treasury and it shows on a relative basis, stocks are more attractive than bonds.



When interest rates are low, it supports higher stock market valuations. Simply said, bonds are not providing a lot of competition to stocks and with the Fed focused on keeping rates down for the foreseeable future, this dynamic will likely remain.

We anticipate a choppy economic recovery and likewise expect higher equity market volatility moving forward. We remain resolute in our belief that the U.S. economy and corporate America will come back from this crisis but acknowledge there will be turbulence along the way and investors should be prepared for this bumpier ride.

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. We move this gauge from a Full Forward position, which reflected extreme pessimism in the market, to a Slow Reverse position as the strong stock market rally has reversed some of that negative sentiment. Recall this gauge is a contrarian indicator, so extreme pessimism is a positive from a market perspective and extreme optimism is just the opposite.

In our last video update at the beginning of the second quarter, we said that we did not believe the current conditions approached the levels of uncertainty associated with the 4 historic events that triggered a similar market sell off like we experienced in March. Those 4 events were the outbreak of WWI, the crash of 1929, the crash of 1987 and the 5 days following the Lehman Brothers bankruptcy in 2008. We believed and stated in the last video that there was a much clearer path to recovery in this current crisis compared to those other historic events.

We did not anticipate the speed of this market recovery, but investor sentiment was giving a clear signal that extreme pessimism abounded and we historically know that those types of extreme readings tend to occur as the market is going through a bottoming process.

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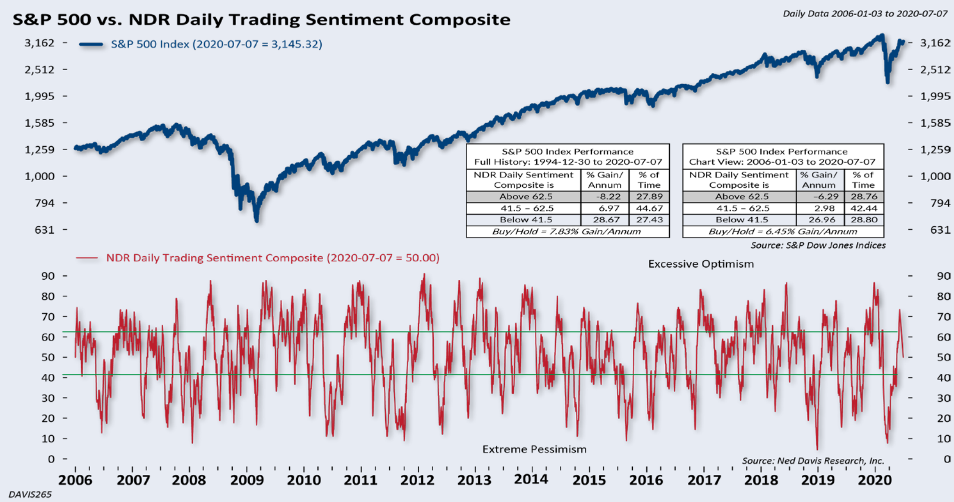
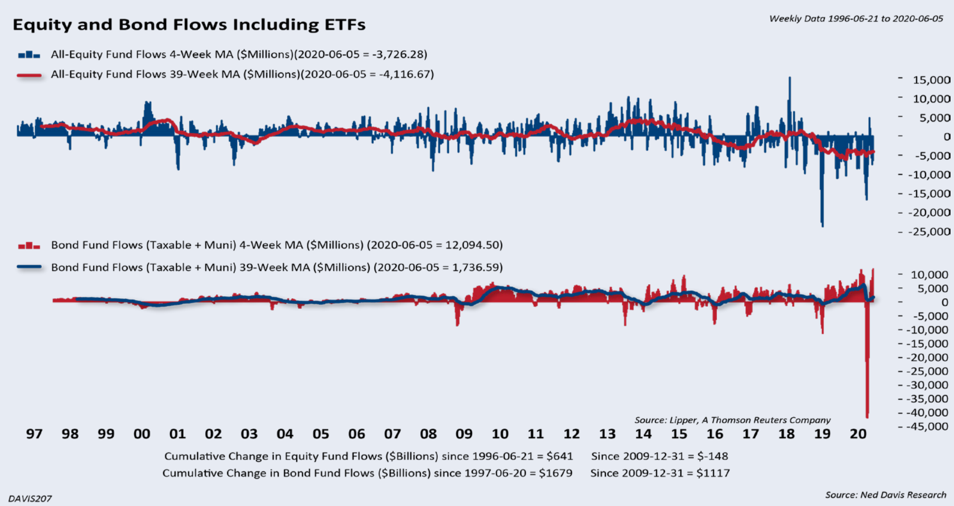
Trading sentiment, one of the indicators we look at, has reversed from the extreme pessimism zone in March to excessive optimism in June.



We also know that put/call ratios fell to multi-year lows as the market rallied, which can be seen as a sign of complacency building in the market.

However, other sentiment readings are not overly optimistic at this point. Equity funds have continued to see steady outflows in recent months, while bonds have enjoyed recent inflows. This could indicate some pent-up demand for stocks is building as the stock market rallies and those fund investors are missing out on those gains. This fund flow information does not indicate long-term equity market excesses.



Another indicator, which we have discussed a lot in recent months is the CBOE Volatility Index or VIX Index, which is often referred to as the Fear index. The VIX Index ended June above 30, which indicates an elevated level of fear and volatility currently in the market. The VIX is above that 30 mark less than 10% of the time historically and it hovers in the 10 to 30 range over 90% of the time.

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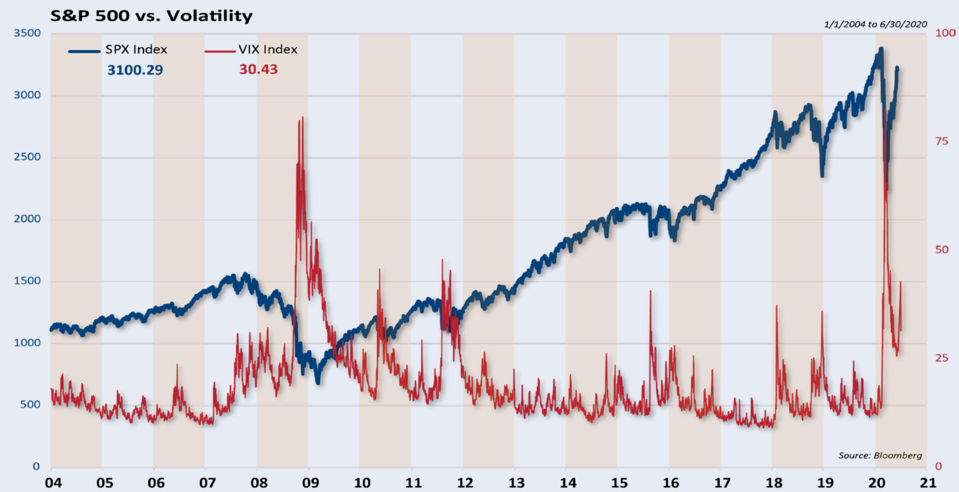

Due to some of these conflicting measures of investor sentiment, we bring this gauge back to a Slow Reverse position. As strong as the signal was of extreme pessimism at the beginning of the second quarter, sentiment is not providing as powerful of a sign as we move into the third quarter. We believe investor sentiment leans slightly optimistic (again a modest contrarian negative sign in our world), but there are some conflicting signals out there that we will continue to monitor to see if this measure becomes stronger in either direction.

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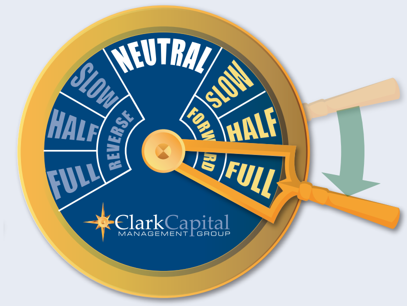
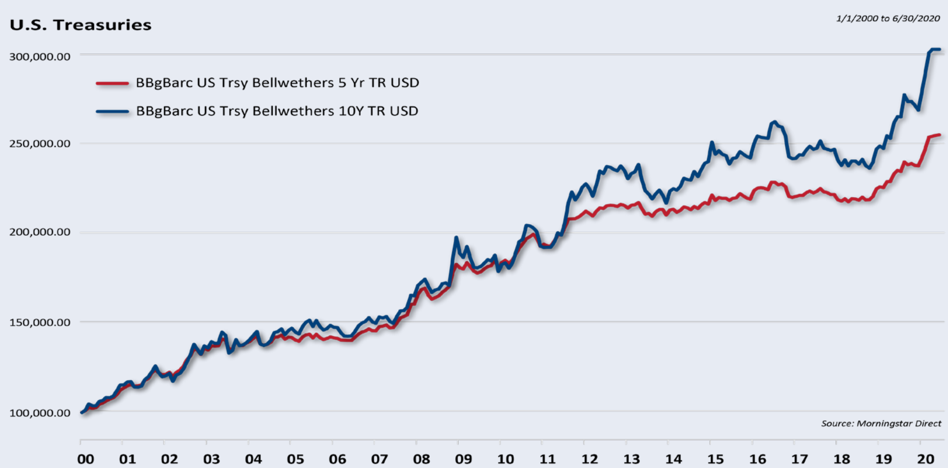


Interest Rates

Interest Rates

Interest rates are the last gauge and we move this forward one final notch to a Full Forward position. Recent comments by the Fed, along with actions it is taking in the market lead us to believe we will be in a lower for longer interest rate environment for the foreseeable futures.

The yield on the 10-year U.S. Treasury ended 2019 at 1.92% and subsequently it put in an all-time closing low in March at 0.54%. Although the 10-year yield did not achieve a new low in the second quarter, the yield on 3- and 5-year U.S. Treasuries did, and they closed the month with yields of 0.18% and 0.29%, respectively.



With the Fed's return to its Zero Interest Rate Policy and shorter-term yields at their lowest historic levels, the yield curve has steepened. The yield on 30-year U.S. Treasuries remains subdued and closed the second quarter at 1.41%, but this is well above its historic closing low in March at 0.99%. Although U.S. government debt levels are increasing, which is being exacerbated by this pandemic spending, the cost to service this debt remains low.

After widening dramatically in the first quarter, credit spreads did decline in the second quarter as pockets of fixed income other than U.S. Treasuries rallied. The more "risk on" environment of the second quarter saw credit outpace Treasuries. For businesses, it means that the interest rates they must pay to borrow money came down, which is a clear positive. And businesses have certainly been selling a lot of bonds with investment grade issuance up 90% and high yield issuance up 57% on a year-over-year basis.

Ultimately, lower rates should be helpful to the economy as it reduces the cost of capital and it appears rates will remain low for the foreseeable future driven in large part by the Fed. Therefore, we put this gauge into the Full Forward position. If consumers can refinance their mortgages and free up some cash for themselves, or if consumers see the interest rates on their credit cards drop, that could be helpful to consumer spending as well.

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We know these remain challenging times. We continue to believe that the U.S. economy and corporate America will come through this crisis, although it will take some time. We also anticipate a bumpy road to recovery from both an economic and stock market perspective. Clearly, it has helped that stocks and bonds rallied so dramatically in the second quarter after the significant declines in the first quarter. As is often the case, the worst periods of market performance, like Q1, are often followed by some of the best times in the market, like Q2. That is why we continue to urge clients to stick to their financial plans and not make decisions based on short-term movements in the market

Please contact your CPM Team or your Investment Consultant to discuss how we can help you during this challenging 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 July 2020

The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The CBOE Volatility Index (VIX) is a measure of expected price fluctuations in the S&P 500 Index options over the next 30 days.

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