CHIEF INVESTMENT OFFICE

Investment Strategy Overview — Executive Summary

The Lighthouse and What Lies Ahead

July 2020

AN INTERVIEW WITH CHIEF INVESTMENT OFFICER CHRIS HYZY

Recently, you referred to the concept of the Lighthouse. What do you mean by the Lighthouse and how does it apply to the Chief Investment Office (CIO) team's midyear outlook?

Hyzy: The Lighthouse is our way of describing what we think we are likely to experience for the second half of the year and well into 2022–or what we are calling the New Frontier. We think the Lighthouse is important because it can provide insights for investors in the short and longer term. For example, it might light the way to the next business cycle or to accelerating business themes, such as innovations in healthcare. It might illuminate what the next economic recovery could look like and what's driving that recovery. At the same time, the Lighthouse can help us identify warning signals (storms), related to potential issues and concerns that may continue to overhang the market, and indeed life itself, especially when it comes to the effects of the virus.

In terms of the Lighthouse and the midyear outlook, we believe it's helped us understand that many investors seem more focused on what has already happened during the pandemic, and less focused on possible changes for the better that might lie ahead. What's already happened includes the significant increase in debt rates and the government deficit. It includes the earnings that have been lost so far in 2020 and what's happened on the geopolitical scene. There's also considerable concern about the potential changes to future regulation and taxes. Of course, it makes sense to be concerned about all of that. But we believe investors might benefit more from paying closer attention to possible changes for the better that have come out of or been accelerated by the crisis. Let me list some of those changes for the better:

1. Technological advances.
2. Research and development.
3. Business model resiliency, particularly in the U.S. corporate sector.
4. The changes that the government sector is going to have to go through to become more fiscally prudent, over the next 10 years.
5. Advancements in life sciences.
6. The development of new infrastructure and eventual fast-tracking that relates to the growing need for it.
7. The advancement of environmental, social and governance issues for the sustainability of the future of the economy, the corporate sector and communities.

First and foremost, it's important for investors to have a plan, to think about goals and objectives, and to build a portfolio that is consistently good, not occasionally great. That should provide the potential for better and more effective compounded returns over time.

Christopher Hyzy
Chief Investment Officer

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You've also mentioned something you call the Workout Process. Briefly describe the workout process and its phases. Also where are we now in the process?

Hyzy: A workout process typically entails multiple phases and begins after very difficult times like a recession, a structural change in an economy, a big drawdown or selloff in the market, or a global demographic adjustment, such as the rise of the millennials. It can be almost anything that relies on government support and the broader economy working together, to help the private and public sectors.

The workout process this time around began after three major crises hit almost simultaneously: the human health crisis that resulted from the pandemic, the financial crisis and the economic crisis. Typically, the beginning of a workout process is where elements of support are put in place, some by legislation, some by the financial markets, and others by changes in the private sector. Here's what's shaped the phases of today's workout process.

First Phase: The first phase of the current workout process was the liquidity phase, which began in March, when the Federal Reserve (Fed) acted to create liquidity in the markets. The speed with which the Fed acted was unprecedented, and their actions were greater than anything we've seen in our lifetime. That allowed financial markets to increase liquidity and stabilize themselves, starting with the fixed income market.

Second Phase: The second phase of the workout began when the government acted to reduce the loss of income, initiating the Paycheck Protection Program—a component of Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"),—for example, as a way to support small businesses in continuing to pay employees. The government also sent checks directly to many of those who were unemployed during the pandemic. This helped to reduce the loss of income in households, increased small business lending and, overall, helped support the economy. We called it the Bridge phase or the Buffer.

Interestingly, it seemed to us that the markets thought that the Bridge phase would take many months, lasting possibly through the end of the year; however, the Bridge phase began to shorten as soon as economies started to reopen. Basically, many restrictions were put in place during the shutdown, but as soon as they started to reopen economies, the Bridge period began to shorten. That's basically what's happening right now.

Third Phase: We are just transitioning into the third phase of the workout, the Economic Recovery phase, which itself has multiple phases. Now, there's great debate around what kind of shape the recovery's going to take, when it's plotted on a graph. And that's often expressed in terms of letters of the alphabet. For example, initially, a recovery might look like a "V". Indeed, there are many V-shaped recoveries happening in the U.S. and globally: in the consumer sector, in the manufacturing sector, in housing. At the same time, some experts argue that "V"s often turn into "W"s. Some industries have even had L-shaped rather than V-shaped recoveries.

In the case of this recovery, we think it won't look like a letter at all but rather like a wave. It might start out as a "V" but is likely to develop into a wave, as the workout process continues and as we gather more information on the virus, such as treatment options, more widespread virus and antibody testing, the development of a vaccine, and so forth. As this information filters into consumer and business confidence, we think it will help dictate the overall shape of the recovery.

Fourth and Fifth Phases: The fourth and fifth phases are typically more about post recovery, or the start of a new cycle. What might they look like? The fourth phase is usually a pent-up demand cycle, which we think will come in 2021. And we expect Phase Five—what we are also calling the New Frontier—to start in 2022 and continue for some time thereafter. It's a bit early in the recovery to be more specific. That said, we believe the New Frontier will also bring with it a New Normal, so to speak, in how businesses operate—and, frankly, how people operate.

Past performance is no guarantee of future results.

How do you see industries changing post-pandemic?

Hyzy: We think we will see the introduction and development of new industry groups that in a way will have been created out of their growing importance during the pandemic. They include the cloud, data storage, big data analytics in general, cybersecurity, life sciences, laboratory tools and equipment, and research and development within healthcare. We also see the need for a new infrastructure as public transportation gets used less and less and people turn to other more flexible means of transportation. Also, with people spending more time working, communicating, gaming, and learning online, we think there'll be significant growth in broadband and the 5G wireless spectrum and streaming.

Finally, we anticipate an increase in industry consolidation within old overbuilt industry groups such as retailing and segments of oil and gas; in short, we think they will "consolidate" their way to a new lifecycle. We also think air travel will see some major shifts, with airlines focusing more on consumer travel and less on business travel.

Returning to our analogy of the Lighthouse, you could say that currently the sky is overcast. But as we move further into the recovery, we think the cloud cover will dissipate and the Lighthouse beam will highlight the areas we've been discussing that seem to have attracted more attention during the pandemic, as well as other areas of growing importance, including climate change, the acceleration of the new technologies already mentioned. With the acceleration of new technologies and business models we believe there is scope for positive adjustments to operating leverage across the private sector in the years ahead.

You recently described the market path as having the shape of a square root symbol. Can you take us through that line of thinking?

Hyzy: When market trends are plotted on a graph, they rarely follow any one particular letter. A recovery can move through a variety of shapes because new information comes to us each day. The market is a discounting mechanism, so how it's behaving is going to be at least six to 18 months ahead of what the economy is showing. And the market tends to look at leading indicators for clues as to the production of profit and, ultimately, much of what I described earlier, in terms of the workout process. The market does need help from time to time, and the form of help this time around was record levels of stimulus and liquidity. Therefore, we felt that the market could look more like a square root symbol. As with the symbol, we think the market, after the short expansion to record highs to start the year, then the sharp record plunge in prices, created the left side of the square root. Once liquidity and stability were created the market rebounded in a V-like fashion to create the initial middle of the square root. Now we are in a consolidation zone with a short jagged trajectory at the start before we eventually finalize the sign by having a trend line that extends itself in a narrow but positive angle upward to create the last section of the square root. This is just our view of the shape of the market's path but certainly this does not materialize without bouts of volatility.

This is largely because of the record stimulus that was put in place, and because the workout process is advancing faster than most observers expected, and because of the corporate sector's ability to shift, adjust and maintain operating leverage as it moves into a new expansion.

So, keeping with the square root analogy, we are about half-way through the symbol. We now believe we are once again in a long-term bull market advance. The next few stages of this climb will be a "grind"—they won't be easy—because the wall of worry among investors remains so high. In our Lighthouse analogy, we still have some storm clouds out there, and they're limiting our ability to see perfectly; but we believe the major storms that the Lighthouse gave us the warning signals about, so to speak, are mostly over, in our estimation. There are still clouds, but ultimately there are clearer skies ahead.

Why do you think we are already in a global expansion cycle and the early stages of another bull market advance?

Hyzy: This is a critical question for both the short- and the long-term investor. A global expansion needs to include not just the U.S., it also needs to include other economic zones. And we've seen that happening in Europe and Japan, in parts of the emerging markets (EMs), and in North America, dominated by the U.S.

The Fed has recently made some major changes. They had been fighting disinflation, and in some cases deflation, particularly since the global financial crisis some 12 years ago and, more specifically, in 2015-2016 and 2018. The Fed recently made a major pivot, due initially to the pandemic, and now with the understanding that the greatest concern has switched from producing inflation to actually stopping deflation. Increasing the money supply and subscribing to the "whatever it takes" plan is what they have committed to in order to create an environment that helps foster higher nominal gross domestic product (GDP) and potentially higher revenue growth.

The European Central Bank (ECB) has done something similar, as has the Bank of Japan (BoJ), and at times so has the central bank of China. On the fiscal side, in the U.S., there was the stimulus package with the potential for another fiscal package being announced by the end of July. There was the so-called Game Changer in Europe, or their pivot, which surprised many: outlining a potential future fiscal stimulus framework rather than imposing austerity, as they have done traditionally in years past.

Meanwhile, the inverted yield curve, pre-pandemic, was telling us that deflation was an issue, even though the Fed transitioned back to an easing bias. And now the yield curve has steepened; it is upward sloping and not inverted. That is suggesting that in the years ahead, we could see an expansion.

The dollar was strengthening over much of the past few years and it choked off growth. When central bank activity got too tight, that, combined with the strong dollar, drove equities down, hurting the wealth effect. Ultimately, the authorities had to pivot.

Now, though, it is the opposite. The dollar has stopped strengthening and is on a weaker path, the yield curve has steepened, and there's stimulus and liquidity. This is leading to reflation—and reflation typically leads to higher asset prices, particularly when you go through a global expansion. And that's where we are right now.

Another interesting sign is that while among investors the "wall of worry" remains high, and the list of concerns continues to grow, even so, some positive headlines (outside of the virus) are surprising the overall market and the economy. And that should strengthen investor confidence, if those positive developments come through.

We believe profits have the potential to surprise the broader investor consensus next year, both globally and in the U.S. But again, this does not come without risk or issues or concerns. And certainly the Lighthouse isn't spotlighting any green lights at this point. But we think that over the coming months, and well into 2021, clearer skies are ahead.

Three other important items. We were in a technological advancement cycle, prior to the pandemic. It was designed very efficiently, in our opinion, but it targeted social enterprise with limited or narrow exposure to hardware systems. The next part of the tech advancement cycle will, we think, match many of the greatest advancements in history, because of its relative importance to the overall economy, the private sector, the government sector, and communities. That next wave is likely to be less narrow, more widespread across multiple industries, and ultimately it should feed into another productivity cycle and investment cycle, starting in 2022 and onward, the likes of which we haven't seen in recent times.

This gets to the heart of our enthusiasm for a long-term bull market because it comes at a time when the largest generational cohort, the millennials, will be growing older and entering their highest-spending years. You get good consumer spending, you get advancements in healthcare and in technology, across most industries. And when all of that is combined with what is likely to be a new housing cycle, we believe that the surprise of the next 10 years is higher growth and not lower growth.

Last but not least, let's talk about the Scarcity Principle. This was going on pre-pandemic, and is likely to continue even more intensely in the post-coronavirus (COVID-19) world. In short, that is when there are fewer investments available over a certain time, and there is more money to invest in that same period. And as supply goes down and demand goes up, especially with rates so low, the Scarcity Principle hits at the heart of equities, in our view.

There are likely to be more industry consolidations, more bankruptcies, more leveraged buyouts, and more companies going from public to private than coming public, and still less residential real estate available. With fewer assets and more money available, that's the sort of supply-demand equation that the Lighthouse is more than likely to shine a bright light on.

What new risks do you see developing that could pressure the capital markets through year end? Over the next few years?

Hyzy: Throughout the second half of 2020, with equity markets[1] moving up to about 8%, 10% off market highs in February, with fixed income markets having been more or less re-liquefied, and with credit spreads having come down, we are now in what might be called a "What have you done for me lately?" type of phase.

But the number-one issue for the rest of the year, in our estimation, is new virus outbreaks. Are they manageable or not? Does the virus data suggest that we're heading backwards, with a higher rather than a lower hospitalization rate? What will happen to the fatality rate? Will old restrictions be put back in place or new ones established? Will there be another lockdown? How about the corollary effects of demand shortfalls such as energy capital expenditures, rental payments, and state and local government jobs? Can another fiscal stimulus package address most of these issues and keep disposable income high enough until an effective vaccine is produced? And, of course, one last major question for us is: What does all of that do to the economy overall and, in particular, to the outlook for consumer spending trends? Even though we are experiencing solid V-recoveries at this point, the back half is still unclear. All of that said, we are looking through the clouds and we believe that ultimately, a combination of science (testing, research, and treatment) and technology (data analysis and tracking) should get us through to the other side. There are, however, some important elements that we'll need to see:

- One: Testing, treatment, and the prospect for a vaccination.
- Two: Will there be major policy and/regulatory changes coming out of the November elections? Will investors head to the sidelines over concerns of the potential for higher taxes in the future?
- Three: Overall, how is the profit cycle beginning to show itself? By the fourth quarter we will need to see the elements of a rising profit cycle, to provide momentum heading into 2021.
- Four: As we get to 2021, assuming high savings rates and solid balance sheets in the consumer sector, we will need to see signs that the consumer is not just spending a lot more than during the height of the pandemic, but is starting to spend money on areas that were most harmed: travel, leisure and entertainment. If they do spend more there, that show of consumer confidence should help feed into business confidence and then into a resumption of job growth.

[1] As measured by S&P 500 performance

Past performance is no guarantee of future results.

Over the next few years, some of the biggest risks might be the ones that may've gotten pushed aside due to the pandemic. First is the relationship between the U.S. and China. If tensions continue to rise, might we see the development of true dual supply chains? Is it a manageable relationship? Second is the debt and the deficit and how we pay for them.

What's one final insight you'd like to offer about the remainder of the year and into the next two years, as we move through the workout process?

Hyzy: First and foremost, it's important for investors to have a plan, to think about goals and objectives, and to build a portfolio that is consistently good, not occasionally great. That should provide the potential for better and more effective compounded returns over time. It should allow them to build a more diversified portfolio and to potentially stay away from large drawdowns like the ones that occurred, at a record pace, throughout March. In short, be disciplined with that plan. Rebalance more frequently. Take advantage of volatility in the capital markets.

Traditionally, bull market advances include skeptical moves that have intermittent pullbacks, with some that are sharp and quick, and often more frequent. Rarely do the beginnings of bull markets have a slow trickle up and down. That is emblematic of a market that treads water with little catalysts and an investing public that is complacent or already bullish. If we think longer-term we worry less about year-to-year targets and whether headline risk pressures the broader equity markets from one week to the next. We believe that what is more important is why you are investing and the ability to fund future objectives past the calendar year end.

There is a large wall of worry still in place, at the moment, for obvious reasons. Bull markets tend to climb on large walls of worry. What does that mean? At some point, when skepticism is at its highest level and investor positioning most bearish, positive surprises tend to happen and begin to foster an advance in the markets. At that point, the long-term investor usually begins to deploy capital, and that increase in capital starts to have an effect—and ultimately a bull market forms, in our opinion. We believe we are in the early days of this shift. It will not be without volatility: We still expect choppiness through the remainder of this year. But over the next five years, by our reckoning, a number of factors—technological advances, record stimulus and liquidity, the reflationary tactics of the authorities, as well as the resiliency in the private sector, and ultimately, the creation of new industries—will build and foster the next long-term bull market advance.

In the immediate future, we would be buyers on weakness within equities, with a focus on the U.S. That said, on our watch list for improvement are some of the more cyclical areas outside the U.S. that have not participated much in recent years (particularly relative to the U.S, such as Europe and Japan). We would also pay attention to what we think will be the pent-up demand of the emerging markets consumer and the build-out of healthcare systems in the emerging markets.

We continue to believe that the production of free cash flow in the sectors of healthcare, technology and communications services will be very important, and should help support the next market advance. We would also diversify portfolios with some more cyclical sectors that should benefit from an expansion such as the Industrials. Overall, given the attractiveness of equities relative to fixed income, we would maintain a large equity overweight and use excess cash during periods of weakness in an effort to re-risk portfolios and bring them back to the stated objectives in terms of goals.

For in-depth commentary on our views on specific asset classes and discussion of timely investment topics, see the full-length version of this edition of *Investment Strategy Overview.*

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Indexes are all based in dollars.

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Glossary

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Consumer Price Index (CPI): The Consumer Price Index is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

Variable Rate Demand Note (VRDN): A variable-rate demand note is a long-term municipal bond which is offered to investors through money market funds. The notes allow a municipal government to borrow money for long periods of time while paying short-term interest rates to investors.

Municipal Liquidity Facility (MLF): The Municipal Liquidity Facility is an initiative by the Federal Reserve to provide up to $500 billion of credit to state and local governments that have seen their revenues collapse during the COVID-19 crisis.

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