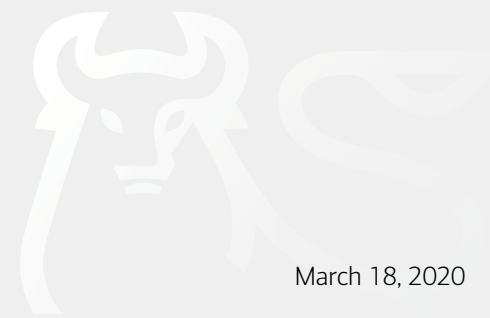


CHIEF INVESTMENT OFFICE

Investment Insights



The Process Begins

March 18, 2020

The opinions are those of the author(s) and subject to change.

WHATEVER IS NECESSARY

Markets are expected to trade up and down in a sawtooth fashion based squarely on confidence of the human health crisis management policies and the resulting data as well as monetary and fiscal responses. This is the first phase of the bottoming process, as the market attempts to price in the health and potential financial fears.

The next phase is more likely to be determined by the size of the economic and corporate profit adjustment. As this materializes the markets should price in the second bottoming phase. These collective episodes combine together to create the eventual bottoming process within the capital markets.

- Policy responses need to be coordinated globally and in three avenues: health, financial (monetary) and economic (fiscal).
- This is already happening each week but more is needed as insulation and support to build back confidence and cushion the pressure in cash flows.
- Social distancing and containment policies state-by-state are just beginning to filter into the broader economy so the economic data has yet to show the latest impact.
- The key questions are: How long will the containment management actually be in place? How will the consumer and businesses manage through this? This will determine the depth of any economic contraction.
- In addition, this will determine the magnitude of earnings-per-share adjustments for corporate America, in our view.
- Asset valuation has declined by over 25% since the market peak in mid-February for the S&P 500. With the newly adjusted earnings of \$138 for the S&P 500 by BofA Global Research, the market is trading at about 16.6X at current levels around 2300. With the data still fluid and the “unknown” length of the virus containment procedures and policies still uncertain, the bottoming process in the broader equity markets is going to take some time. We highlight five signs to watch to assess the bottoming process:
 - Capital needs to flow freely. This is being addressed by the various facilities put in place by the Federal Reserve and Treasury. We are watching credit improvement and liquidity in the daily funding markets.
 - The relationship between stocks and bonds needs to shift back to somewhat normal inverse relationship.

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Data as of 3/17/2020 and subject to change.

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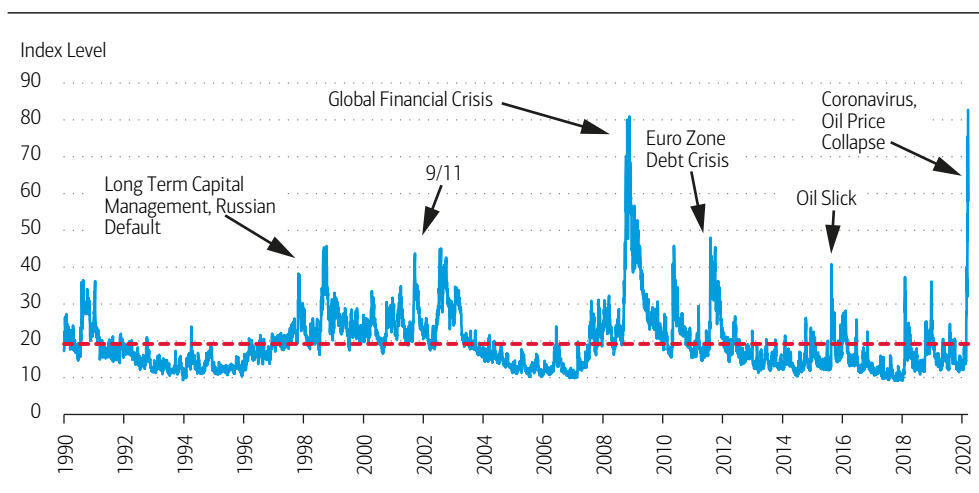
- Volatility as measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX) needs to recede when the markets are experiencing down days.
 - Strength of the U.S. Dollar needs to slow down and crest.
 - News flow regarding the virus and the overall economy/corporate profits begin to slow and be ignored by the broader market.
- In prior economic contraction environments that last a couple of quarters, a typical earnings decline would be 20%; at \$138, we see earnings declining 15% year-over-year, just below the typical 20% decline in a recessionary environment.

We caution, however, given the fluidity of data and unprecedented measures taken plus the weekly emergency policy responses, the base line profit estimates for corporate America and the eventual level of growth, in the economy, the U.S. and globally is subject to frequent adjustments in the coming weeks and months.

While this process unfolds, certain asset classes can potentially trend toward extremes. The U.S. Dollar has been strengthening and is now back to April 2017 highs on a trade-weighted basis. A sharply strong U.S. Dollar can negatively impact the economies and finances of the emerging markets given their high U.S. dollar debt exposure. This could delay the eventual recovery overseas. Gold prices reached a seven-year high in mid-March, oil prices fell below \$30 per barrel from above \$50 in February, according to West Texas Intermediate (WTI), as the oil price shock took hold this month, and credit spreads have widened out over growing concerns over the ability for lower-quality companies to service their debt. In addition, U.S. Treasury bond yields dropped to record low levels as the 10-year Treasury yield fell below 0.4% for the first time ever. The Federal funds rate is back to zero percent. The equity markets in the U.S. have experienced their largest drop since October of 1987 and are now close to a three-year low and the Dow Jones Industrial Average has fallen more than 30 percent (the fastest move to a bear market ever) from its high, which places it at or close to the median drop of prior cyclical bear markets (an approximately 35% decline). Markets are attempting to price in the extent of the health crisis and economic contraction.

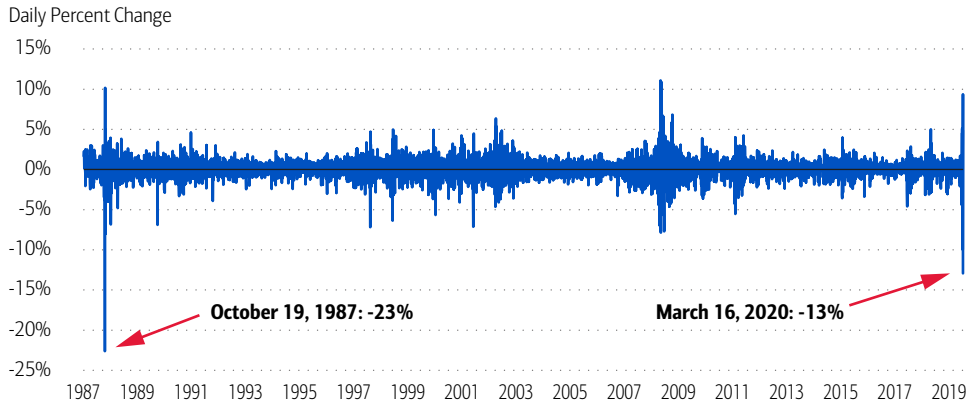
2020 MARKET MOVES IN CONTEXT

Exhibit 1: Chicago Board Options Exchange Volatility Index



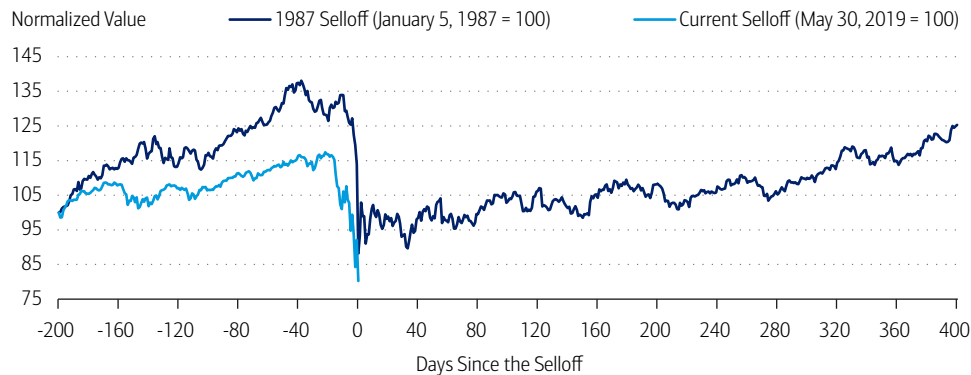
Source: Bloomberg as of March 16, 2020.

Exhibit 2: Dow Jones Industrial Average



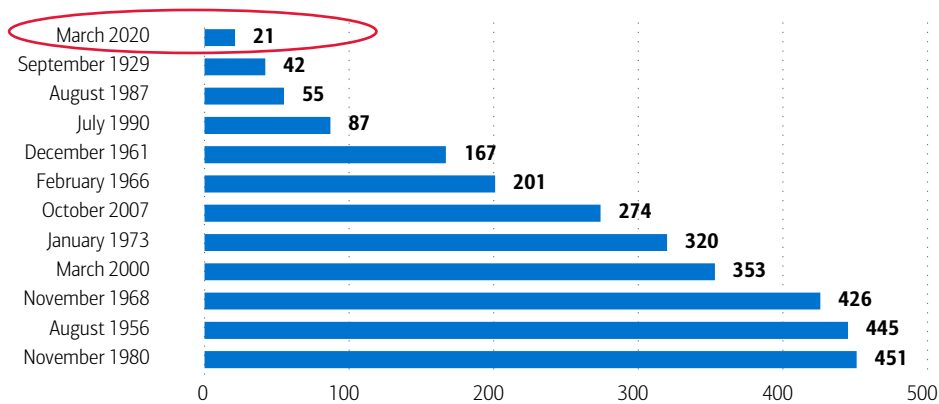
Source: Bloomberg as of March 16, 2020.

Exhibit 3: Dow Jones Industrial Average



Source: Bloomberg as of March 16, 2020.

Exhibit 4: Days from Market Peak to Bear Market (-20%)



Source: Bloomberg as of March 16, 2020.

What is the timing of the recovery process and how long can this potentially take place?

The timing is still quite unknown as it is dependent first on the length and depth of the health crisis containment period and second on the size of the economic and financial response as we previously stated. Large concerns need very large responses across all three verticals of Health, Financial and Economic, in our view. The added difficulty of

this major exogenous shock is that it has a large “unknown” magnitude to it, given its biological nature, versus prior crisis periods that were more financial and/or singularly economic in nature.

We expect more insight each week on the three fronts. In the Global Financial Crisis of 2008-2009 it took from October 2008 through March of 2009 to fully price in the total economic downdraft. Back then there were much more daunting questions encircling the financial system and the consumer was not on solid footing. Today, however, the financial system itself is very healthy and the consumer heading into this shock was in much better shape overall. It remains to be seen how much of a cushion these important factors are going to be. But it is important to understand this as the various policy responses unfold.

Economic and market recoveries take time. We anticipate a U-shaped type of economic recovery while the equity markets are more likely to exhibit more of a square root shape (with a sawtooth bottom) given their discounting nature, in our opinion. The recoveries need appropriate responses to instill confidence in the consumer and business sector. As valuations correct to attractive levels and confidence begins to build through the transparency of improved data, markets ultimately begin their recovery. Throughout history this has been known as “climbing the wall of worry.” This bottoming process can take weeks or months depending on the size of the ultimate contraction. Investors need confidence. Confidence comes this time around with, first, better health data while stability occurs initially with financial and monetary responses. We believe we are in this process currently.

We believe long-term investors should consider rebalancing portfolios back to the strategic and/or tactical weights in order to maintain portfolio diversification and adherence to long-term goals. A rebalancing plan can take place across and within asset classes. At present, we emphasize higher-quality investments across asset classes and prefer large caps in the United States. Dividend yields at the index level in the U.S. as measured by the S&P 500 widened out to 4.4x relative to the 10-year Treasury yield at the lows in mid-March and are currently 2.8x with a 10-year yield of 0.79%. The long-term investor has the potential to access high-quality yield in equities relative to fixed income as we work through this volatility. In terms of fixed income, we continue to expect this asset class to remain a “ballast” for portfolios that can help mitigate the decline in risk assets such as equities, in our opinion. Maintaining a well-diversified portfolio while rebalancing over time is an important core element of asset allocation and goals-based investing.

Index Definitions

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

Chicago Board Options Exchange Volatility Index (VIX) is the ticker symbol and the popular name for the Chicago Board

Options Exchange's CBOE Volatility Index, a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

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