

Investment Strategy Outlook

March 25, 2020



Please refer to Appendix – Important Disclosures.

Evidence Argues For Patience In Face Of Coronavirus Weakness

Highlights:

- Fed Steps Up As Lender of Last Resort
- Economic Data Turning Sharply Lower
- Valuations Becoming More Attractive
- Sentiment Reflects Bear Market Realities
- Seasonal Patterns Supportive Of Strength
- Broad Selling Weighing On Breadth Trends

So much is unique about the current crisis. While the focus here is primarily on the economic and financial market implications, looking past the real life toll of coronavirus discredits our humanity. As of this writing, the total number of confirmed cases of COVID-19 is approaching half a million and nearly 20,000 have lost their lives to it. While some areas are seeing numbers level off (China, Japan, South Korea), in other parts of the world (notably the US) the number of cases continues to climb rapidly.

Outlook Summary

Weight of the Evidence is holding at neutral

Cyclical declines feature rallies and re-tests, but usually end before economic data improves

Recession-like conditions will supply host of negative headlines

To get more constructive, look for evidence of strength beneath the surface

Indicator Review

Macro Factors (What Could Happen)

- | | | |
|--------------------------|---------|----|
| • Federal Reserve Policy | Bullish | +1 |
| • Economic Fundamentals | Bearish | -1 |
| • Valuations | Neutral | 0 |

Market Factors (What Is Happening)

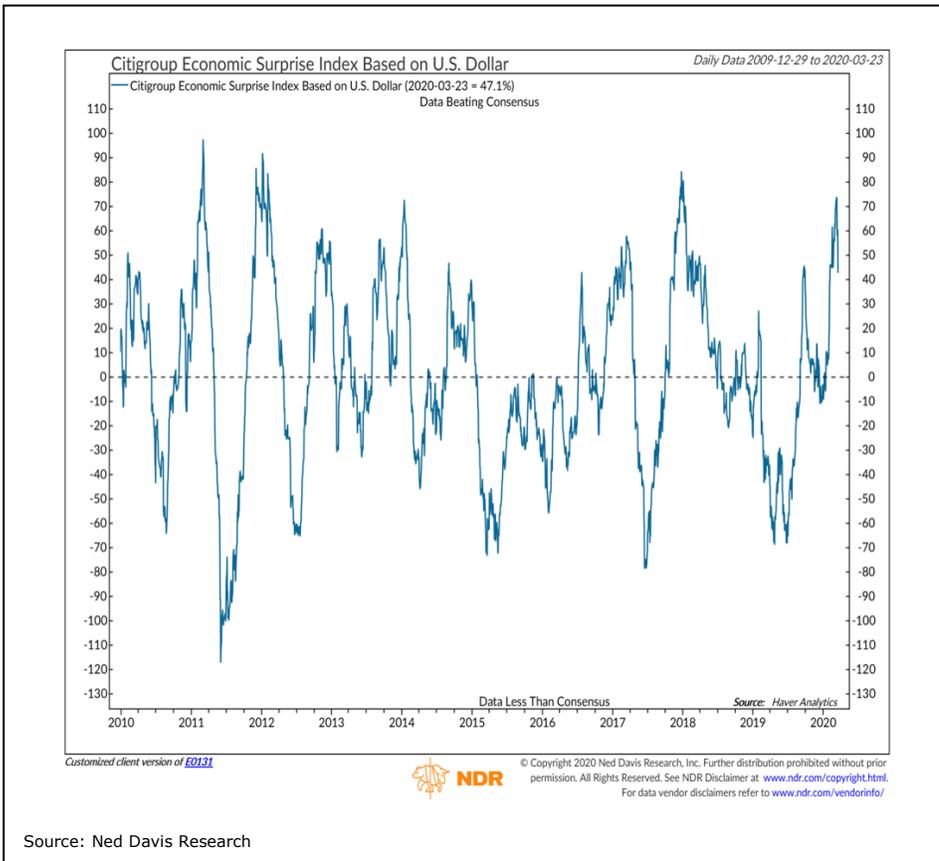
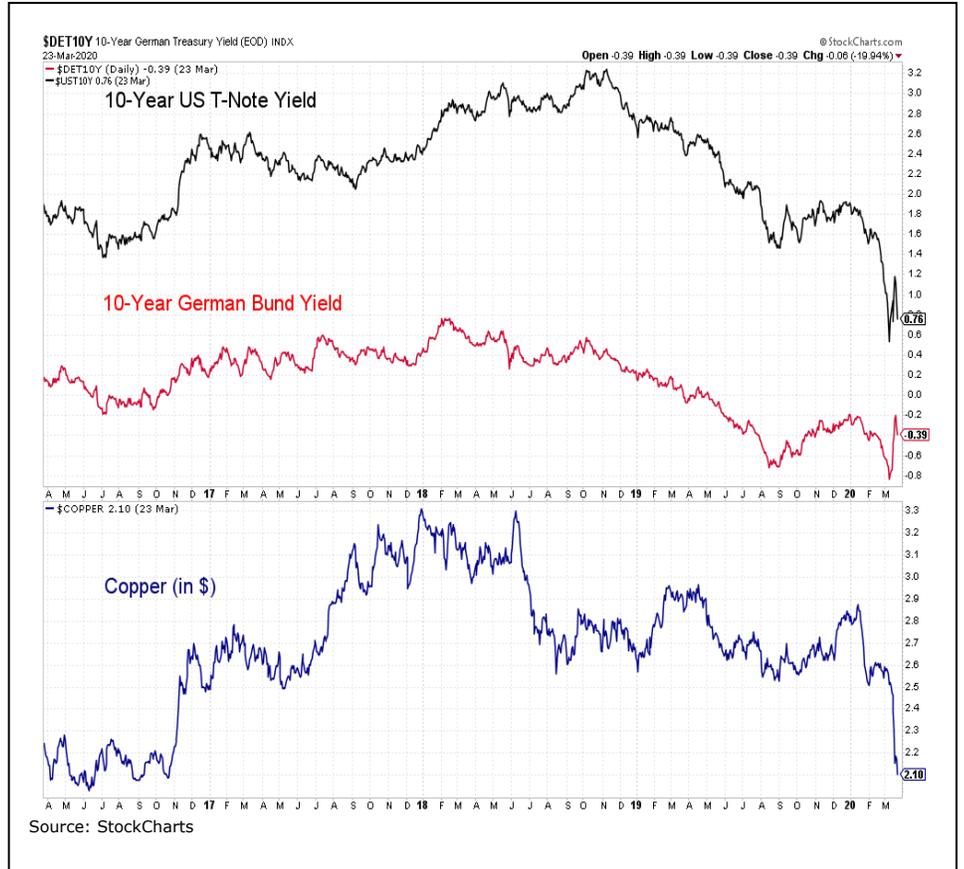
- | | | |
|----------------------------|---------|----|
| • Investor Sentiment | Neutral | 0 |
| • Seasonal Patterns/Trends | Bullish | +1 |
| • Tape (Breadth) | Bearish | -1 |

Weight of the Evidence =	Neutral	0
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Efforts to limit the spread of the virus have necessarily meant less economic activity now, with many areas in the US and around the world seeing businesses being shuttered, streets emptied, and residents encouraged to stay home.

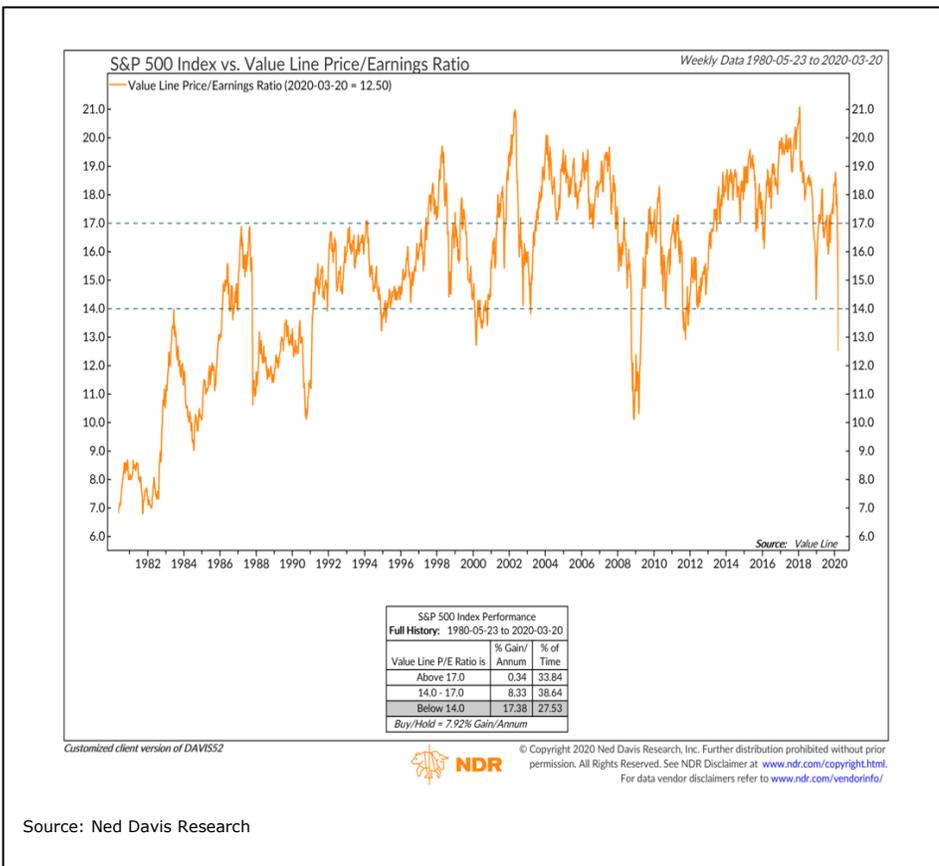
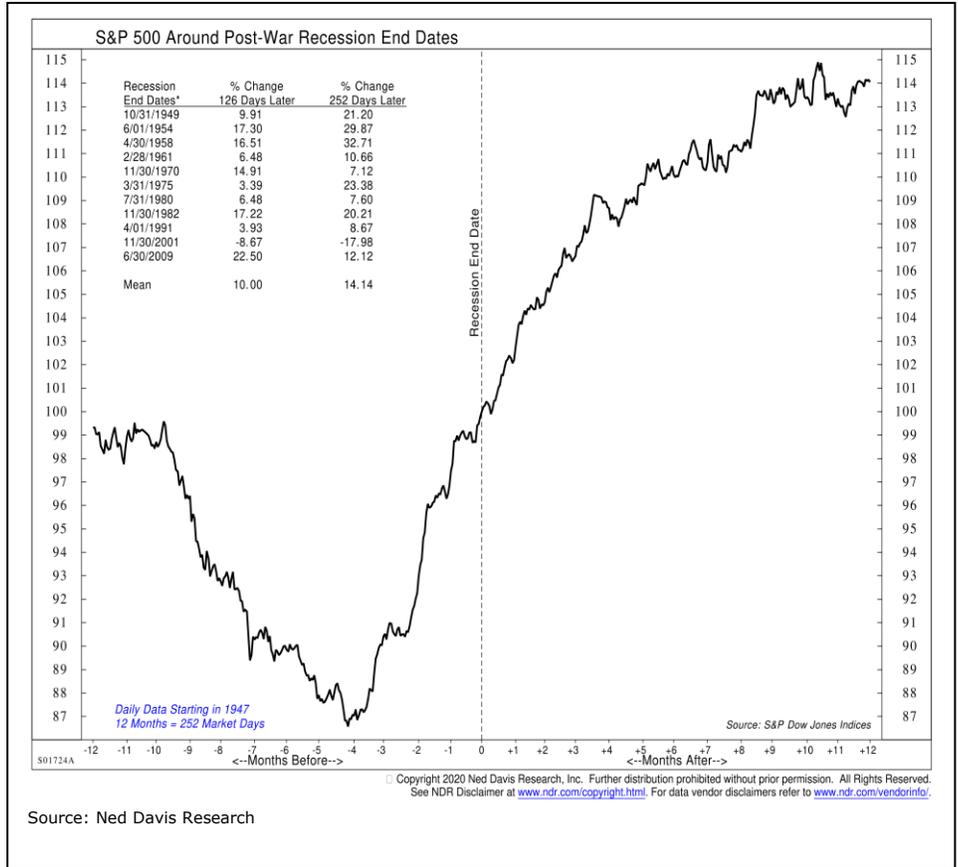
To fight off the virus, the doctors have suggested putting the economy into something of an intentional coma. In this metaphor, monetary stimulus is the respirator that helps keep the organs functioning while fiscal stimulus will help shock it back to life when risks of infection have ebbed. Given the noise in the headlines and uncertainty of the outlook, now more than ever is a time to keep a disciplined and non-emotional perspective.

Federal Reserve Policy is bullish. Coming into this year, we argued that if the Fed had to cut rates in 2020 after providing 75 basis points of easing in 2019, it would be a sign of economic difficulty. With the events of the past month as perspective, that is now something of a moot point. Of greater importance now is that in the face of economic weakness and credit market strains, the Fed has stepped up in its role as lender of last resort. It has cut rates to zero and re-established a number of the lending and liquidity programs it established in 2008. This reaction by the Fed reflects a simple truth about liquidity – when it flees in the face of trouble it is hard to re-capture. Proactive efforts can corral it where it is needed. History shows that recessions become depressions when central banks fail to provide liquidity – that seems unlikely to be an issue in the current case. Stable bond yields would suggest these efforts are working.



Economic Fundamentals are bearish. As we mentioned at the outset, stocks have been volatile as the economic backdrop has shifted dramatically over the span of weeks. We have moved from evidence of global green shoots after growth slowed in 2019 to a discussion of a rapidly evolving recession (or at least a period of recession-like conditions). For example, in the span of two weeks, initial jobless claims are expected to move from near 50-year lows (near 200,000) to their highest level on record (2 million or higher). The silver lining in this period is that the economy was doing better than expected at the beginning of 2020, as seen by the economic surprise index moving to its highest level in two years.

For at least a brief period, evidence of economic weakness can be seen as evidence of epidemiological success – the less activity in the near term the better the chances of slowing the spread of the coronavirus and preserving the longer-term health of the economy. Expectations for the economy are being ratcheted lower, and that provides some opportunity for data to continue to exceed expectations. The caveat is that for the next few months, incoming economic data will likely be as volatile as stocks have been over the past few weeks. As we look forward, while the economic data and the potential rebound in activity could be uneven, all previous recessions have come to an end, and on average stocks bottom four months prior to the economy. Negative headlines on the economy are to be expected, and most likely, stocks will bottom while the news is still bad.



Valuations have improved and we now rate them neutral. Price/earnings ratios that look at trailing earnings are approaching their long-term averages. The ValueLine P/E ratio (which blends six months of trailing earnings with six months of forward earnings) has dropped sharply over the past month and in the past 30 years has only been lower than its current level in late 2008 and early 2009. Two caveats are worth mentioning. First, the 2008/2009 valuation lows were quite a bit lower than current levels. Second, forward earnings estimates are notoriously untrustworthy at important turning points. For example, the current ValueLine P/E is at the same level it was in March 2000.

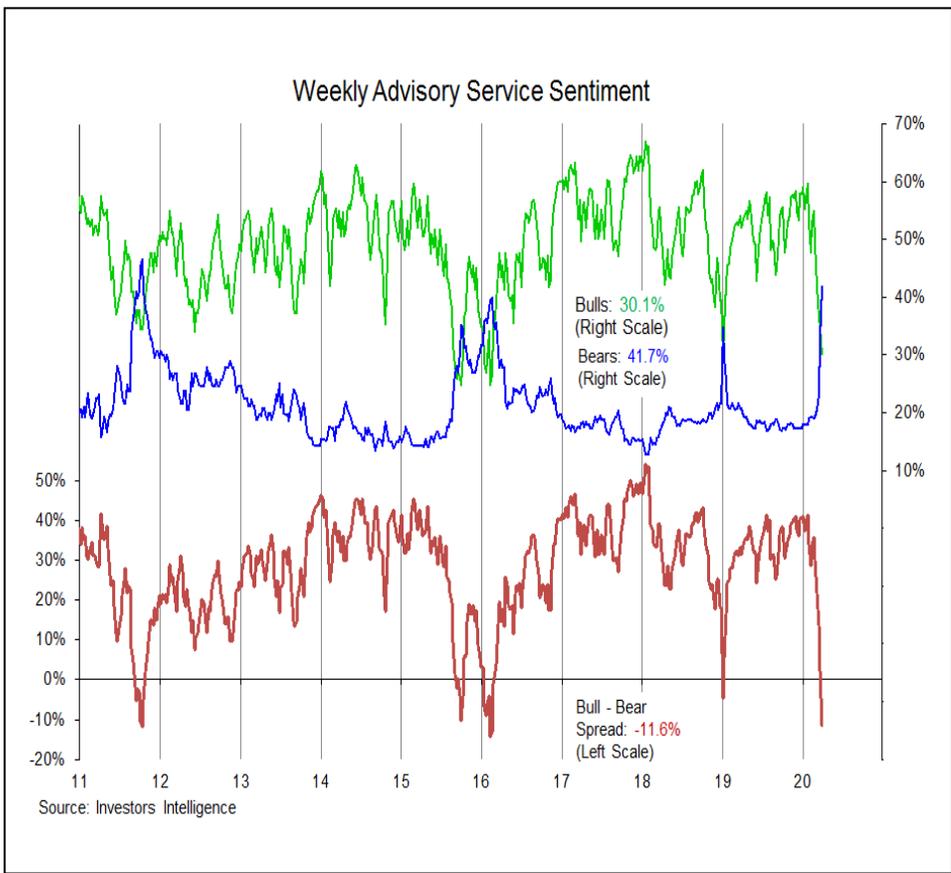
While it is encouraging to see the valuation improvement, to grow more constructive on this in the near term we would like to see stability emerge in earnings estimates. As the data from The Earnings Scout shows, earnings estimates for 2020 were already moving lower prior to the coronavirus outbreak, but the pace has accelerated in recent weeks. As companies and analysts grapple with the effects of economic weakness on corporate profitability, these estimates are likely to move lower. We want to see this downward revision cycle run its course before leaning too heavily on earnings estimates. Either way, one of the notable headwinds we highlighted coming into 2020 is being quickly alleviated and could soon be a tailwind.

S&P 500 EPS growth estimate changes => Coronavirus shutdown will crush growth in 1H20

Date	1Q20E EPS Growth	2Q20E EPS Growth	3Q20E EPS Growth	4Q20E EPS Growth
7/1/2019	8.54%	12.48%	13.25%	15.01%
8/1/2019	7.31%	8.19%	13.22%	15.02%
9/1/2019	7.48%	7.75%	13.01%	14.91%
10/1/2019	7.23%	7.33%	12.97%	14.85%
11/1/2019	5.68%	6.11%	9.94%	14.76%
12/1/2019	4.25%	5.57%	8.83%	14.72%
1/1/2020	3.68%	5.34%	8.46%	14.35%
2/1/2020	2.45%	4.64%	8.36%	11.36%
3/1/2020	-0.55%	3.48%	7.98%	8.84%
3/17/2020	-2.34%	0.26%	5.09%	7.53%
3/23/2020	-3.63%	-3.31%	2.05%	5.17%
3/24/2020	-3.90%	-4.32%	1.33%	4.76%

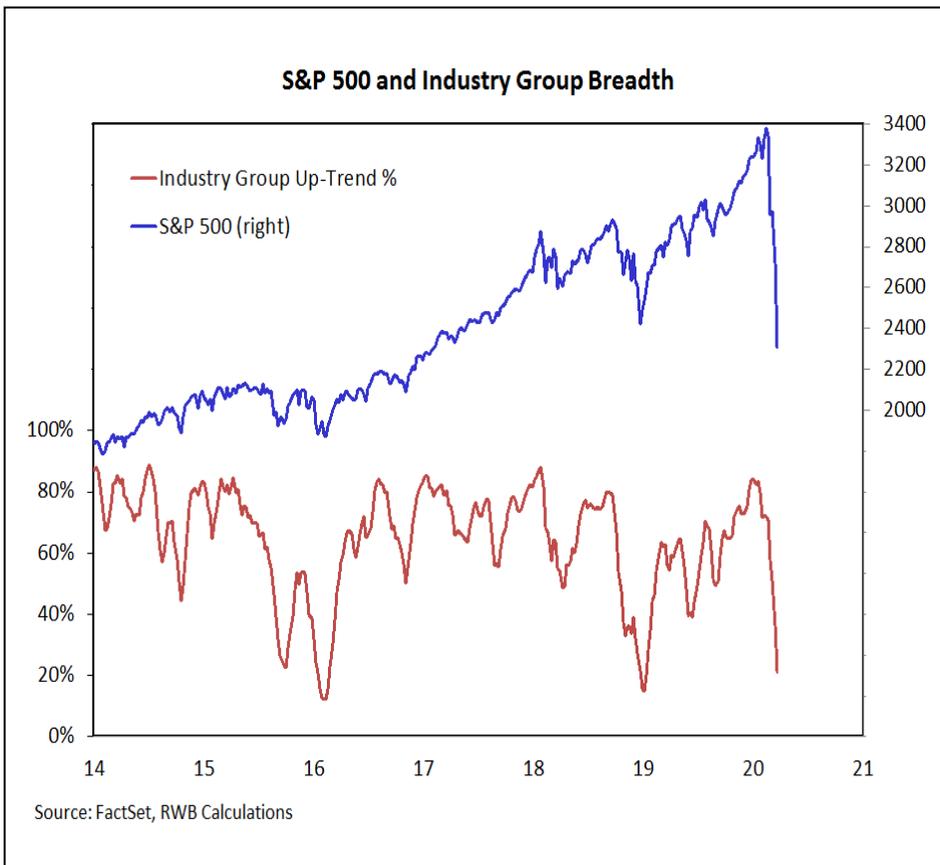
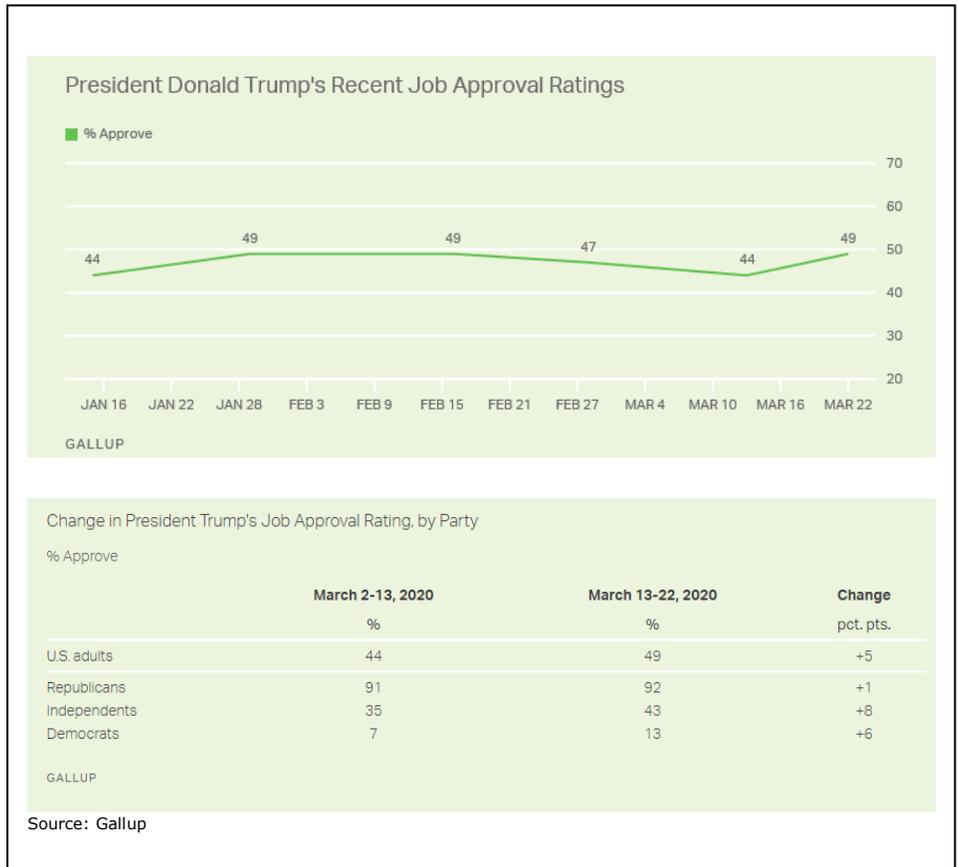
2020 EPS estimates will continue to drop as America and the world close businesses to prevent the spread of COVID-19.

Source: The Earnings Scout



Investor Sentiment is neutral. The waterfall decline in the S&P 500 off its February 19 high (a 34% decline over the course of 23 trading sessions) has had a not unexpected effect on investor sentiment. The latest data from Investors Intelligence shows more bears than bulls for the first time since early 2019, the bull-bear spread is its most negative since 2016 and bears are at their highest level since 2011. Other weekly sentiment surveys show similar shifts. In other words, investor sentiment is behaving the way it typically does in bear markets. This can also be seen from a fund flow perspective, with equity funds seeing \$60 billion of outflows over the past four weeks (only December 2018 saw more outflows). The best signals from a contrarian sentiment perspective come after extremes have been reached and sentiment starts to reverse.

Seasonal Patterns & Trends remain bullish. We upgraded this indicator earlier this year on evidence that Americans were feeling increasingly satisfied with their financial situation. In such environments, incumbent presidents tend to get re-elected and election year patterns tend to be bullish when incumbents get re-elected. The outbreak of the coronavirus and economic uncertainty that is now emerging are likely to weigh on perceptions of financial security, especially if weakness drags on for months and not just weeks. Nonetheless, the president's approval rating rebounded this week and at 49% it is at the highest of his presidency. This does not seem consistent with an incumbent whose re-election chances are fading.



Breadth is bearish. The cyclical decline off of the February highs (by our count, the fourth cyclical bear market in the past decade) has been accompanied by extreme levels of volatility, intense selling pressure and rapid deterioration beneath the surface. While the initial downside pressure may be yielding to a period of rallies and re-tests, an important and healthy development would be a decline in volatility and the wide price swings that come with it. Over the past four weeks, the S&P 500 has experienced both two of the top 10 single-day gains and two of the top 10 single-day losses since 1950. In addition to seeing volatility ebb, we are looking for evidence of improving trends beneath the surface. We would expect to see improving trends from an industry group perspective and other evidence that longer-term trends are improving.

What To Do Now:

The cyclical decline may be entering a period of enticing rallies and frustrating re-tests that can challenge investor patience. Absent a more bullish message from the weight of the evidence, we would generally discourage chasing rallies.

Rather than thinking about putting new money to work at this juncture, investors should consider using the rally to re-position away from cyclical laggards and toward defensive areas (notably Health Care and Consumer Staples) that have been showing leadership and have a historical tendency to do well during periods of broader weakness.

Industry Groups		Improving/Deteriorating			Top/Bottom		
		S&P 500	S&P 400	S&P 600	S&P 500	S&P 400	S&P 600
Energy	0/3				BOT	BOT	BOT
Materials	1/0		IMP				
Capital Goods	0/0						
Commercial Services & Supplies	0/0						
Transportation	0/1		DET				
Automobiles & Components	0/1				BOT		
Consumer Durables & Apparel	0/3		DET			BOT	BOT
Hotels, Restaurants & Leisure	0/1						BOT
Media	0/1						BOT
Retailing	0/1						BOT
Food & Staples Retailing	3/0			IMP	TOP	TOP	
Food, Beverage & Tobacco	2/0		IMP	IMP			
Household & Personal Products	2/0		IMP		TOP		
Health Care Equipment & Services	0/0						
Biotechnology	2/0		IMP		TOP		
Pharmaceuticals	2/0			IMP	TOP		
Banks	0/0						
Diversified Financials	0/1						BOT
Insurance	0/0						
Real Estate	0/0						
Software & Services	1/1		DET		TOP		
Technology Hardware & Equipment	1/0				TOP		
Semiconductors & Semiconductor Equipment	0/1			DET			
Telecommunication Services	2/0				TOP		TOP
Utilities	1/0						TOP

Source: StockCharts



This may also be a time for a renewed focus on global diversification and leaning toward those areas that are showing relative strength. Japan and China, for example, are improving versus the US.

Portfolio managers from Baird Advisors note that with the recent dislocation in the fixed income market, they see pretty compelling value in investment grade spread sectors on the short end of the yield curve.

The combination of equity market weakness and credit market stress is putting a new emphasis on portfolio liquidity and appropriate levels of cash. Investment losses tend to be greatest for forced sellers and even patient investors cannot weather periods of volatility if they need to raise cash. Portfolio management is not just about return expectations but also about pro-actively managing risk.

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

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Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	75%	55%	35%	15%	0%
Normal range	90 – 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	15%	35%	45%	50%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 – 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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