



LEVEL FOUR[®]

Capital Management

A DIVISION OF
CARR, RIGGS & INGRAM CAPITAL, LLC

QUARTERLY NEWSLETTER **2Q 2020**

Global Economic Shock

 **Chart 1.** Index Performance 2019/1Q2020



Source: 2020 Bloomberg Finance L.P.

As we come to you with this communication, we trust that you and your loved ones are safe and healthy during these very uncertain times. Indeed, as many of us are working from home and adjusting to what our new normal is in the short-term, we also continue to maintain our attention and focus on the future when we emerge from this health crisis. We are not going to re-hash the details and status of the COVID-19 landscape due to the ever-evolving and fluid nature of the updates, but rather the emphasis of this newsletter will be on education, with a focus on the economic backdrop during the crisis and the **shocks** to the global system.

INDEX PERFORMANCE

1Q 2020 Return

S&P 500 (SPX)	-19.60%
Dow Jones Indus. Avg (INDU)	-22.73%
MSCI U.S. Value	-25.74%
MSCI U.S. Growth	-13.62%
MSCI EAFE (Non-U.S.) (MXEA)	-22.83%
MSCI ACWI (Non-U.S.)	-21.27%
U.S. Corp High Yield	-12.68%
Alerian MLP	-57.19%

Source: 2020 Bloomberg Finance L.P.

SHOCKS

An economic shock is defined by as:

- Random, unpredictable events that have a widespread impact on the economy that are caused by things outside the scope of economic models.
- Economic shocks can be classified by the economic sector that they originate from or by whether they primarily influence either supply or demand.
- Because markets are connected, the effects of shocks can move through the economy to many markets and have a major macroeconomic impact.

A **supply side shock** is one characterized by a disruption in the supply chain, commodity prices, or perhaps weather events. We have seen many examples of this amidst the COVID-19 crisis, including the lack of supply in everyday items such as toilet paper. We have also seen supply disruption in more crucial items like Personal Protective Equipment (PPE) and Ventilators; as well as supply disruptions to important parts of our economic engine including Apple's ability to produce iPhones, energy production, and distribution to name a few. These sort of disruptions usually work themselves out with time, and in general, the demand side could become more of an issue the longer this crisis lasts.

Demand shocks happen when there is a sudden and considerable shift in spending. For example, an economic downturn or a significant and sudden decrease in home values like we saw in the great recession of 2008. Each can cause a significant reduction in spending by consumers. The current crisis is causing very large demand disruption with airline travel and restaurants having virtually shut down. In addition, the jury is still out on how permanent the job loss and therefore demand will be. This will most likely be related to the length of the shut-down.

Most economic recessions or crises are either driven by the demand or supply side. The current crisis appears to be affected by both, but more so by, the demand side. In our opinion, the length of the shut down and the effect on demand is what will have the largest influence on the shape of our economic recovery.

Christine Smith, Public Affairs Staff, for the St. Louis Fed wrote a great article regarding the current shock. She interviewed St. Louis Fed economists Dave Wheelock, David Andolfatto and Bill Dupor. According to Dupor, "The demand aspect may be more important than supply. There are supply-chain disruptions and those could be addressed; however, in two months it may be more likely that new car sales will be down because people are not buying, rather than because cars are not on dealers' lots because producers couldn't acquire parts for production." (www.stlouisfed.org/open-vault/2020/march/supply-demand-shocks-coronavirus)

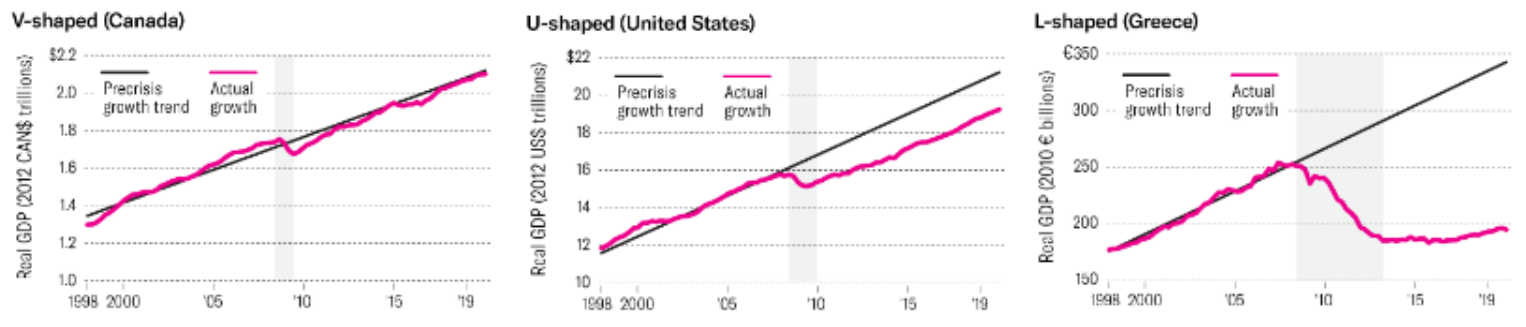
RECOVERY

There are multiple types of economic recoveries and we will cover the three most common here. From a GDP perspective, the "shape" of a recovery does not necessarily fit the words used to describe it. Below are a series of insightful illustrations from the Harvard Business Review showing what each type of recession and recovery looked like during the 2008 financial crisis and great recession.

Economic Shock: 3 Examples

The concept of a recession is binary and blunt. The bigger-scenario question revolves around the shape of the shock and its structural legacy. To illustrate, consider how the 2008 global financial crisis delivered recessions in three sample countries, yet followed vastly different shapes in terms of shock progression and recovery.

Chart 2. Real GDP Growth



Source: Statistics Canada, NBR, Hellenic Statistical Authority, BCG Center for Macroeconomics Analysis

Chart 3. U.S. GDP and SPX Index



Source: 2020 Bloomberg Financial L.P.

As you can see, the U-shaped and L-shaped recession illustrated in chart 2 led to permanent loss in growth, which is not good. But in chart 3, we see a close up look of the U.S. U-Shaped Correction of 2008 with the S&P 500 overlaid. In this image, we see that the U.S. market bottomed (yellow arrow) about four months before GDP. While only time will tell what type of a recovery, we will see in the U.S., we know that we came into this crisis on firm ground from a fundamentals standpoint and we believe this will ultimately help us as we navigate forward.

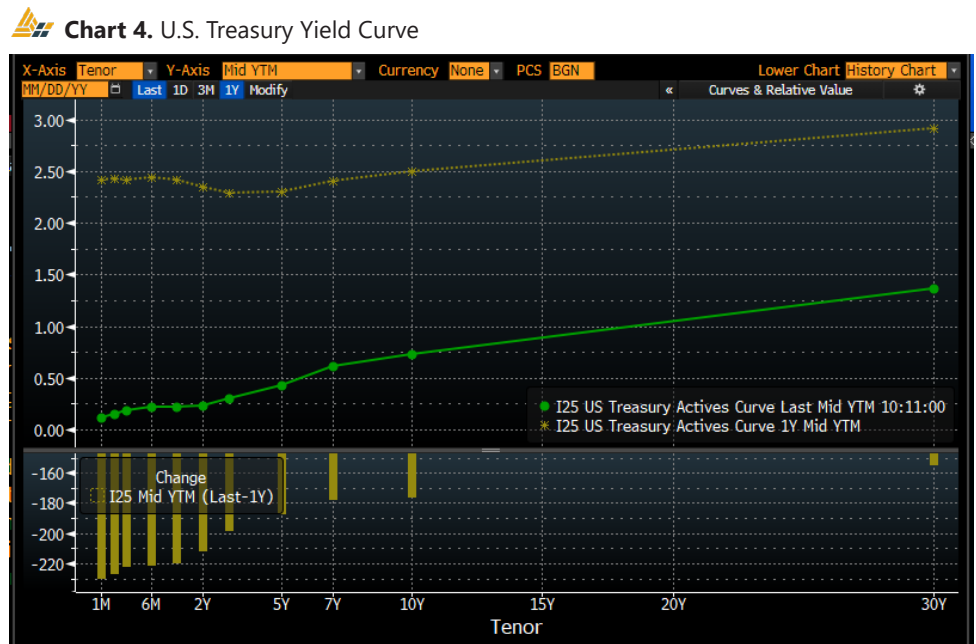
RESPONDING TO THE SHOCKS – Equity Portfolios

The LFCM equity investment process adheres to a philosophy of buying high quality individual companies that represent ownership of real assets that generate real cash flow, and which have proven results those cash flows at high incremental returns. So, if we have a good estimate of the intrinsic value that is based on the present value of future cash flows, and we believe that the intrinsic value will grow over time, then our confidence and conviction is greatly increased. We, however, do not buy GDP, inflation, or the unemployment rate. Even if we could, it is near impossible to accurately predict how those metrics will report. What we can reasonably and safely project is that earnings and economic data are likely going to get much worse over the short-term, but we also expect longer term recovery as it has occurred during every other crisis.

We went into this correction with a little extra cash due to higher valuations, and we continue to position the portfolio by continually trying to upgrade the quality and confidence in what we own; think of pulling weeds and planting flowers. We are also deploying cash when opportunities present themselves. The main goal is, when we look back from the next high, we want to be happy with what we are doing during these tumultuous times.

RESPONDING TO THE SHOCKS – Asset Allocation Portfolios

The key to the LFCM asset allocation process is to first identify the areas of potential alpha and risk the market provides, and then to employ best investment practices to exploit the alpha opportunity while attempting to minimize areas of risk. Due to the current COVID-19 pandemic, the Federal Reserve, and fiscal government responses, the landscape has changed significantly. Below is a U.S. Treasury yield curve chart comparing the current yield curve (green line) with that of one year ago (yellow line). Note that there is a downward shift of the curve and some steepening.

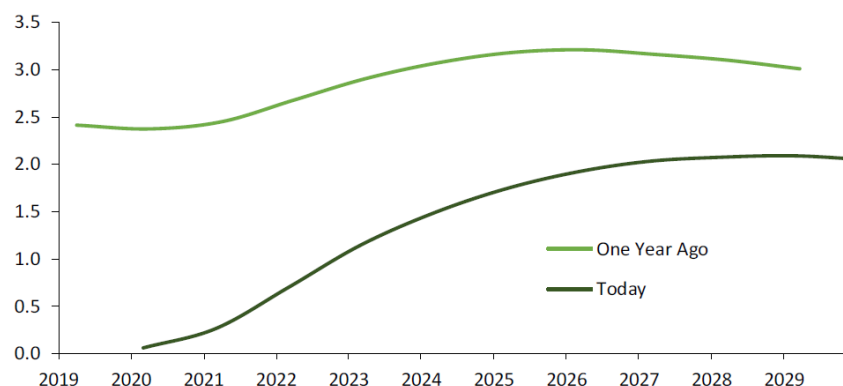


Source: 2020 Bloomberg Financial L.P.

Implications of this shift, especially for the fixed income markets, are as follows:

- There is an increased chance rates stay lower for longer in our opinion, especially for high quality fixed income. This presents challenges regarding fixed income returns as the yields paid will remain low, opportunities for capital gains due to further rate moves are lowered, and risks from a rise in interest rates (a tail scenario, not the base case) are increased. Chart 5 below shows the changes in expected Fed Funds rates over the longer term.

Chart 5. Expected Fed Funds Rate

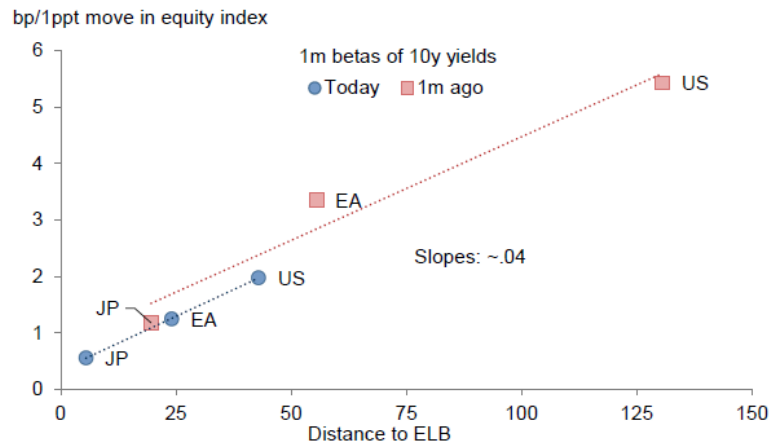


Source: Cornerstone Macro

- As government bond rates decrease and approach what is known as the Effective Lower Bound (ELB which is basically the point where the rates will drop no more), government bonds lose some of their effectiveness as an equity hedge. Chart 6 from Goldman Sachs illustrates this point. Once rates cannot fall further, bond prices consequently cannot rise as capital seeks safety in times of market uncertainty.
- Finally, there is great uncertainty in the area of the market that offers greater returns due to higher spreads. Historically, bond default rates in times of recession have increased, adding risk to investments in the lower credit quality area of the fixed income market.



Chart 6. Effective Lower Bound



Source: Goldman Sachs Global Investment Research

IMPLICATIONS FOR ASSET ALLOCATION

Current global market conditions factor into, and have the following implications for asset allocation:

General Allocation – Most asset allocation classes have been roiled by the COVID-19 pandemic. **Equity** markets have been driven lower by lack of revenue and earnings visibility, and by general risk-off market behavior. Many areas of fixed income have also been affected by widening yield spreads. For a well-balance portfolio, we recommend a quality core of equity focusing on companies with strong balance sheets and strong cash flows. We also maintain a factor exposure to low volatility, and for **fixed income**, we recommend a mix of conservative and multisector allocations. Going forward, we believe the equity markets continue to have greater potential for return than the fixed income markets. We believe that the Fed will continue to remain active, directly affecting the fixed income markets and indirectly affecting all other markets. We remain vigilant regarding our indicators and will modify overall allocations as these indicators and market environment dictates.

Equity Allocation - We continue to monitor financial conditions and market returns to determine our optimal equity asset allocation. Relative to benchmarks:

- We are neutral equities relative to fixed income, but are looking to overweight equities as the markets stabilize due to limited potential for returns and decreased risk return metrics regarding fixed income.
- We remain slightly overweight U.S. equities, and are cautious regarding small/mid-cap equities.
- We continue to emphasize high quality and high cash flow equities which we believe will emerge from the current crisis in the most favorable condition to take advantage of the recovering economy.

- We continue to hold some low volatility factor exposure, coupled with some exposure which is opportunistic to upward market movement. We will continue to evolve our factor exposure as markets dictate.
- We continue to monitor developed international markets, but are cognizant of the uneven response to COVID-19 overseas. We are also watching emerging markets closely for opportunities while maintaining a neutral weighting on this asset class.

Fixed Income Allocation – We believe fixed income going forward will be challenging. In response to the current crisis, the Federal Reserve has cut the Fed Funds Rate to 0% and has executed or announced purchases of USD 3,100,000,000,000 (\$3.1 Trillion) of bonds of various type and credit qualities, adding in excess of \$1 Trillion to their balance sheet over the last few weeks. The effect of these actions will likely be to lower rates in the short-to-medium term. The Fed will basically begin managing the U.S. Treasury market as a large amount of issuance will likely require the Fed to continue to increase the size of their balance sheet to ensure stability in these markets. Due to the lower rates seen in 2020, higher quality and higher duration fixed income have limited upside and provide lower yields. We believe the Fed continues to manage overnight liquidity issues in the REPO markets well, as those spreads remain tight. There is an unlikely tail risk of much higher rates in the event of a Fed miscalculation. Longer term rates may rise simply with the improving economy, the existing debt level, and increased future debt needed to fund Social Security and Medicare as more Boomers retire. All of this indicates a more tactical approach of fixed income management as we expect limited opportunities and significant risks in this area. We continue to monitor company health and interest rate movements closely and will adjust positioning in accordance with the evolving economic and interest rate environment.

Liquid Alternatives – Liquid alternatives may help to lessen portfolio volatility and improve risk adjusted returns. This was certainly the case in 1Q20 as an equally weighted average of all the alternative investment in the LFCM asset allocation models returned +1.65% during the quarter, versus an S&P 500 return of -19.6% during the same time period. The max drawdown on the LFCM Alts basket was 3.43% versus 30.43% for the S&P 500.

INTERNATIONAL VIEW

2020 started with unfinished business regarding 2019 themes such as Brexit, U.S./China trade agreement, and the health of European financial institutions in a negative yielding debt environment. The pandemic tide washed away these themes and market participants took notice. Without surprise, no index finished in the green despite the quarter-end global rally.

- Euro STOXX 600: Down 33.23% in Q1, rallied +13.74% after 80-month low on March 18th
- FTSE 100: Down 32.86% in Q1, jumped +11.95% after 101-month low on March 23rd
- Shanghai Composite: Down 10.9% in Q1, up 3.28% since the 13-month low on March 23rd
- Hang Seng: Down 19.43% in Q1, recouped 8.03% since the 39-month low on March 19th
- Nikkei 225: Down 25.05% in Q1, rallied +12.5% since the 41-month low on March 19th
- KOSPI: Down 25.25% in Q1, jumped +16.93% since the 11-year low on March 19th
- MSCI LATAM: Down 85.06% in Q1, up 12.28% since the 16-year low on March 23rd

Source: 2020 Bloomberg Financial L.P.

China and South Korea are leading the rest of the world in the pandemic recovery; therefore, we will keep an eye on them given they will probably provide a roadmap for the world. China's manufacturing activity returned to expansion territory in March with a better than expected manufacturing PMI print (Chart 7).



Chart 7. EPS Estimates for S&P 500

	Mar-20	1M % Chg	3M% Chg	1Y % Chg
IHS Markit Eurozone Composite PMI	29.7	-42.4%	-41.7%	-42.4%
Manufacturing	44.5	-9.6%	-3.9%	-6.3%
Services	26.4	-49.8%	-50.0%	-50.5%
Caixin China Composite PMI	46.7	69.8%	-11.2%	-11.7%
Manufacturing	50.1	24.3%	-2.7%	-1.4%
Services	43.0	62.3%	-18.1%	-21.0%
Jibun Bank Japan Composite PMI	36.2	-23.0%	-25.5%	-28.2%
Manufacturing	44.8	-6.3%	-7.4%	-8.9%
Services	33.8	-27.8%	-31.6%	-35.0%

Source: 2020 Bloomberg Financial L.P./ LFCM

Besides South Korea, exports of semiconductors declined 2.7% year-over-year in March amid slower demand. This is another signal of slowing global growth that we will follow closely over the next few months.

We also monitor activity in offshore hubs for business outsourcing services such as India and the Philippines. Services PMI for India dropped to 49.3 in March, down from an 85-month high of 57.5 in February. IHS Markit cites deteriorating global demand as the catalyst for the output and improvement in India's service PMI will signal progress in global recovery. In the Philippines however, the services sector index had a V-shaped recovery in the last two weeks and is now trading well-off the recent lows, signaling a boost in business confidence.

In Europe, we are looking at developments in the bond market to gauge market sentiment. After a sell-off that sent high yield bonds into bear market territory, we recently saw a stabilization in the spreads and a "normalization" of yields.

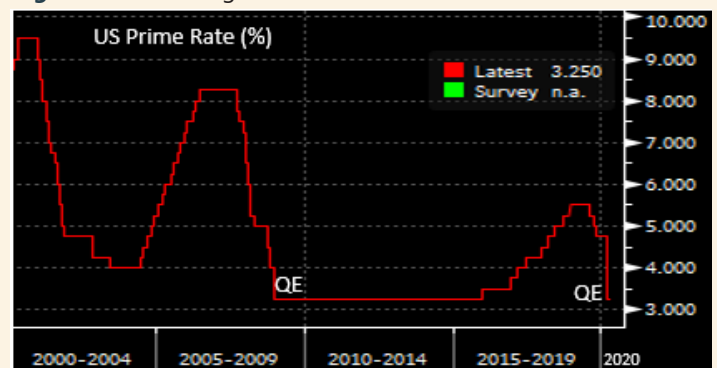
ECONOMIC INSIGHT

BANK LOANS

The U.S. Prime rate, which is the effective interest rate of large banks' best clients, dropped to a level comparable to rates during QE programs post 2008 crisis. The chart to the right shows that as of April 2, the Bloomberg Prime Rate Index was 3.25%, a five-year low.

The appeal of low rates did not go unnoticed. In fact, President Trump talked about "borrowing at basically no cost" to finance his infrastructure plan. It did not take long to empirically see the effect of low rates in the economy.

Figure 1. Bloomberg U.S. Prime Rate Index

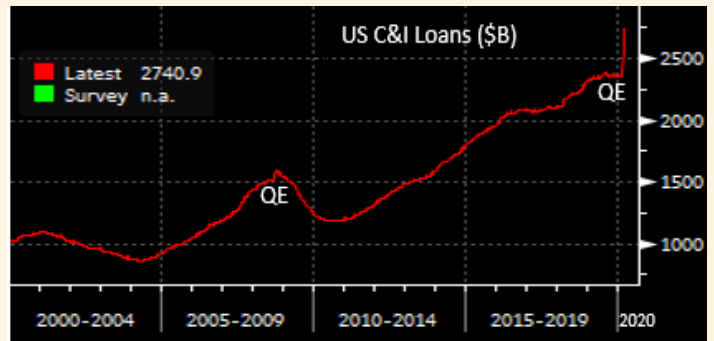


Source: 2020 Bloomberg Financial L.P.

While in 2008 the crisis tightened the credit market and commercial and industrial (C&I) loans slid slightly, we witnessed a different scenario in the week ending March 25th. In fact, C&I loans soared by \$190 billion to \$2.741 trillion as shown in the chart to the right.

This type of loan is usually short-term, backed by collaterals and used to finance working capital or capital expenditures. The surge in C&I loans is a sign of health and liquidity within the banking system and confidence in the 24-month outlook.

Figure 2. U.S. C&I Loans (FRED Bank of St. Louis)

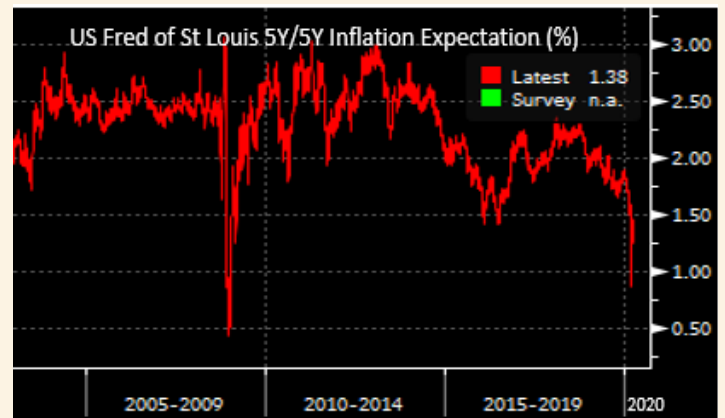


Source: 2020 Bloomberg Financial L.P.

INFLATION

One of the recurring themes of Fed Chairman Jerome Powell last year was bringing inflation close to the “symmetrical target” of 2%. Indeed, last decade’s correlation between unemployment and inflation proved that their implied inverse relationship theorized by the Phillips curve was not a foregone conclusion. With COVID-19 stealing the headlines, few are focusing on inflation, but it will influence monetary policy action in the coming weeks. The U.S. Federal Reserve Data (FRED) of St. Louis 5-Year/5-Year forward inflation expectation eroded in the first quarter, reaching an 11-year low of 0.86% on March 19th. Since then, inflation expectation has rebounded and stands at 1.33% as of April 2nd. This index measures average expected inflation over the five-year period that begins five years from today. As soon as businesses get the green light from the government to resume, we anticipate this will gradually increase as consumers regain faith in the country’s economic outlook.

Figure 3. U.S. FRED of St. Louis 5Y/5Y Forward Inflation Expectation



Source: 2020 Bloomberg Financial L.P.

OUTLOOK

As we conclude, thank you for allowing us to partner with you. We will continue to work through this period of uncertainty, diligently employing our investment process and managing portfolios on behalf of our advisor partners and clients. We know times are challenging. Please contact us with questions.

THANK YOU,

Capital Management Team

IMPORTANT INFORMATION

The opinions articulated in this document are for general information only. This information is not intended to provide specific advice or recommendations for any individual. The economic forecasts set forth above may not develop as predicted and there can be no guarantee that strategies promoted will be successful. All performance referenced is historical and is no guarantee of future results. No strategy including asset allocation assures success or protects against loss. All indices are unmanaged and may not be invested into directly.

Stock investing involves risk including loss of principal. Value investments can perform differently from the markets as a whole. They can remain undervalued by the market for long periods of time.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor's 500 index is a market capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries--excluding the United States. With over 1,000 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. The CBOE Volatility Index® (VIX®) is meant to be forward looking, showing the market's expectation of 30-day volatility in either direction, and is considered by many to be a barometer of investor sentiment and market volatility, commonly referred to as "Investor Fear Gauge".

The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. Price-weighted means stocks with higher share prices are given a greater weight in the index. The DJIA is a stock market index that shows how 30 large, publicly owned companies based in the United States have traded during a standard trading session in the stock market. The value of the Dow is not a weighted arithmetic mean and does not represent its component companies' market capitalization, but rather the sum of the price of one share of stock for each component company.

The Russell 1000 Index is a market capitalization weighted stock market index that tracks the highest-ranking 1,000 stocks in the Russell 3000 Index, which represent about 90% of the total market capitalization of that index. The Russell 1000 is a subset of the Russell 3000 Index. It represents the top companies by market capitalization. The Russell 1000 typically comprises approximately 90% of the total market capitalization of all listed U.S. stocks. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

The Bloomberg Barclays U.S. Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

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