March 26, 2020

Equity Outlook

2020 Will Be One For the Record Books

The first quarter of 2020 started in encouraging fashion, as the benchmark S&P 500 gained +5.1% through February 19 on the back of cooling U.S./China trade tensions and a stabilization of global economic growth. Unfortunately, the entire tenor of the first quarter and 2020 overall changed in late February and early March, as the Covid-19 pandemic spread from a largely regional concern and began to wreak havoc on all aspects of global life. We now assume that a short, sharp recession is the likely outcome both domestically and in most developed markets. As we navigate through the challenges for investors, we believe it is critical to consider several factors, namely that equity markets historically bottom before economic data improves, and market timing is not a viable strategy. We are prudently rebalancing and redeploying funds into equities at lower levels, and in the internally-managed equity portfolios, using this historic opportunity to add to structurally-advantaged businesses with attractive longer-term outlooks.

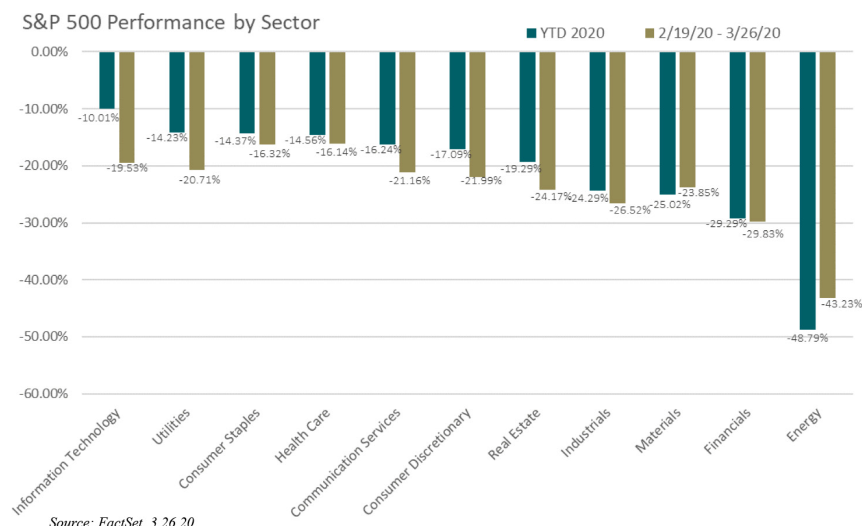
EQUITY MARKET RECAP

Driven by the uncertainty of economic impacts of the pandemic and the high likelihood of recession both in the U.S. and abroad, global equity markets responded in an astonishing manner even relative to the financial crisis of 2008-2009. The S&P 500 entered a bear market from peak levels faster than at any point in history, dropping more than -35% from its peak to its intraday trough. Volatility exploded higher, as the as the CBOE Volatility Index (VIX) reached an all-time closing record of 82.69 on March 16. The average daily move in the S&P 500 has been 5.2% in March, a truly stunning

figure. Equity markets have been characterized by indiscriminate selling with overnight futures hitting *"limit up"* and *"limit down"* levels on multiple occasions. The NYSE closed its physical trading floors on March 23, but the "machines kept moving." Both the Federal Reserve and Congress have responded with unprecedented monetary and fiscal stimulus plans, respectively.

Year-to-date, the S&P 500 has posted a loss of -18.6%, the worst quarter of absolute performance since the fourth quarter of 2008 and the worst first quarter since 1938. Smaller U.S. stocks have struggled even more, as the as the S&P 400 Mid Cap and small cap Russell 2000 have lost -28.8% and -29.5%, respectively. Similarly to the 2017-2019 period, growth stocks outperformed value counterparts, as the Russell 1000 Growth Index has delivered a -13.1% loss versus -25.9% for the Russell 1000 Value Index for the first quarter. International stocks have been battered as well; the MSCI ACWI ex-U.S. index is down -21.7% year-to-date while the MSCI Emerging Market Index lost -21.2%. Among major international markets, there were no country-based indices that posted positive performance.

All eleven S&P GICS sectors entered bear market territory during the first quarter, but performance varied widely. For the year, economically-cyclical



Source: FactSet, 3.26.20

sectors such as Energy, Financials, and Industrials were the weakest performers overall, while leadership was concentrated in Technology and "safer-haven" sectors such as Consumer Staples and Utilities. Given the nature of the current environment, it is not surprising that the Health Care sector has also been among the best performers, although some of that relative strength may be attributable to the recent underperformance by the Sanders campaign in Democratic presidential primaries.

WHAT TO EXPECT IN THE COMING QUARTER

The current market environment is historic and unprecedented. Never before in modern times has the United States or a majority of the developed world

voluntarily shut down much of its economic output and overall activity to deal with the fallout from a global pandemic. Comparisons with the world wars of the 20th century are common but do not seem to accurately reflect the exogenous nature of this shock. New terms such as "social distancing" and "shelter in place" are entering the lexicon daily, and it seems likely this experience will create some permanent changes in behavior that would have been difficult to imagine mere months ago. For example, we believe the ability to productively work remotely/virtually may be one of the changes that could affect a number of market sectors.

Recessions and Market Bottom Timing

Recession Start	Recession End	Recession Length	S&P 500 Bottom	Conclusion
August 1929	March 1933	43 months	6/1/1932	9 months before
May 1937	June 1938	13 months	3/31/1938	3 months before
February 1945	October 1945	8 months	3/26/1945	7 months before
November 1948	October 1949	11 months	6/13/1949	4 months before
July 1953	May 1954	10 months	9/14/1953	8 months before
August 1957	April 1958	7 months	10/22/1957	6 months before
April 1960	February 1961	9 months	10/25/1960	4 months before
December 1969	November 1970	10 months	5/26/1970	6 months before
November 1973	March 1975	16 months	10/3/1974	5 months before
January 1980	July 1980	6 months	3/27/1980	4 months before
July 1981	November 1982	15 months	8/12/1982	3 months before
July 1990	March 1991	8 months	10/11/1990	5 months before
March 2001	November 2001	7 months	10/9/2002	11 months after
December 2007	June 2009	17 months	3/9/2009	3 months before
	AVERAGE	**13 MONTHS**	**AVERAGE**	**4 MONTHS BEFORE**

Source: Strategas, 3.18.20

While enormous uncertainty over the path of the Covid-19 situation and its economic impacts remain, we as longer-term investors can draw on lessons from the past to aid our thinking and decision making in the present. The speed and violence of the current market selloff are shocking, but the fear and panic that has led to such enormous financial moves will subside, even after a likely overshoot. In the fourteen domestic recessions since 1929, the S&P 500 bottomed BEFORE the end of the recession in thirteen of them, beginning its move higher four months in advance of improving economic conditions. This will be important for opportunistic investors to remember in the coming weeks and months as economic data weakens, reflecting the realities of an unprecedented sudden stop.

Forthcoming corporate earnings reports will prove far different from more normalized times. In March, a handful of companies began revealing their cards, primarily suggesting that the start to 2020 was a positive one and unfortunately interrupted by Covid-19. Most are suspending any quantitative financial guidance for both the June quarter and the remainder of 2020, citing too much uncertainty to issue meaningfully accurate estimates; we believe this pattern will hold during April calls. The lack of accurate short-term outlooks may contribute to market volatility, but we believe it could provide an opportunity for longer-term investors and active managers, in particular. With the indiscriminate selling that has occurred over the last month, companies with truly advantaged business models

and longer-term secular opportunities have been sold along with lower quality stocks. In our opinion, advantaged companies with strong balance sheets, high free cash flow generation, and the capital flexibility to navigate this unique period will emerge as stronger competitors over the longer term.

ASSET ALLOCATION – FINDING VALUE

In terms of asset allocation, we are taking advantage of the benefits of diversification and prudently rebalancing from other asset classes that have outperformed on a relative basis, redeploying into equities at lower levels. Specifically, this means moving available funds into our domestic large cap strategies, believing that the current risk and return profile is more attractive than smaller domestic and international counterparts. These are incremental steps, taken carefully as liquidity improves.

The recent downturn may represent the first "official" bear market since the last ended in March 2009, but U.S. equity markets did endure periods of weakness in 2011, 2015/2016, and 2018 over that time period. Our current actions in internally-managed equity portfolios are similar to those periods, making changes and upgrading portfolios in accordance with the risk and reward objectives for each individual strategy. We are mindful of the typical patterns of market recoveries following recessions with cyclically-sensitive, higher beta, and higher short-interest stocks leading early. However, our primary focus will continue to be on companies with true business model advantages who will lead over the longer term.

Calling the inevitable bottom in the equity market has its challenges, but we believe the risk reward outlook is more favorable than it has been in some time. Since 1929, the average decline in a bear market has averaged slightly more than -38% from peak to trough. According to J.P. Morgan, an investor who missed only the ten best days in S&P 500 performance from the beginning of 2000 to the end of 2019 resulted in an annualized return of +2.4% over that period, compared with an annualized return of +6.1% for someone fully invested over the entire period. Over that same 2000-2019 period, six of the best ten days in the S&P 500 occurred within two weeks of the ten worst days. Not surprisingly, a similar pattern has emerged recently - the S&P 500 experienced its third worst day in history on March 16 (-11.9%), but followed that up with its eighth best day ever on March 24 (+9.4%). We strongly believe in the effectiveness of longer-term thinking and investing. Once again, past experience provides a valuable lesson – market timing is simply not a strategy worth pursuing.

During the current market volatility, many clients may have elevated anxiety and worries – we at Franklin Street Partners understand and empathize. We are always available for questions, concerns, or simply to chat. Know that the investment team is very focused on providing you our best ideas.

We thank you for your continued confidence.

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