Market Update

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Worries over the impact of COVID-19 on the global economic environment continue to expand, driving financial market volatility higher and the value of most risk assets lower. Similar to most developed markets around the world, U.S. stocks have entered bear market territory, trading down more than -20% from their peak on February 19. Global fixed income securities remain volatile, as the U.S. Treasury rate complex continues making large moves nearly daily. The announcement of a travel ban between the U.S. and Europe exacerbated investor concern over increasing chances of recession both domestically and abroad, as well as the efficacy of potential fiscal stimulus to calm both financial markets and economies. The S&P 500 traded down -9.5% off the travel ban news, the largest decline since the crash of October 1987.

The probability of a recession both in the U.S. and internationally has become more likely. While the length and tenor of a potential recession remains uncertain due to constantly changing impacts from COVID-19, we currently believe any weakness should not remain long-lived. Importantly, the U.S. economy was in sound structural shape before COVID-19 began dominating headlines – inflation was limited, unemployment was near historic lows, payrolls were expanding, and domestic consumer confidence was sound. In addition, major U.S. financial institutions remain well capitalized and well prepared for economic challenges. The longer-term outlook for economic growth remains intact provided impact from the virus is short-lived.

In managing client portfolios, we believe diversification is a key factor in successfully managing risk during periods of uncertainty and unrest. While we are not currently making any changes to the Franklin Street Partners asset allocation framework, we will actively rebalance client portfolios to take advantage of the extreme low levels of equities.

An example – our asset allocation models each have a specific target weighting to global equities; the equity percentage in portfolios has declined due to the drawdown in stocks over recent weeks. To bring the portfolios back into line with our target asset allocation, we will need to purchase equities with the sale proceeds from other asset classes, namely appreciated fixed income.

In addition to our asset allocation rebalancing, we believe equities offer a compelling risk vs. reward profile over the long term, and we will use the current period of uncertainty to upgrade portfolios with our traditional focus on advantaged companies that have opportunistic and attractive valuation profiles. In fixed income, our focus entering the year was on capital preservation and liquidity. We are now beginning to see attractive opportunities across several areas of the bond market with credit spreads on corporate bonds approaching the widest levels in over a decade and municipal bond valuations, as a percentage of U.S. Treasurys, at the cheapest levels ever. However, we are cognizant of the volatility which is currently present in markets and will look to be opportunistic as we adjust exposures.

2020 is proving to be a significant challenge for investors, but we remain confident in the longer-term outlook for risk assets. We will be vigilant in monitoring the currently volatile environment and will make changes as necessary; however, we believe it is most important to maintain a longer-term focus and will emphasize our investment decisions to reflect this conviction. Our relative performance in internally-managed strategies has been very solid year-to-date, and we continue to believe in our core competencies that include actively-managed, relatively-concentrated portfolios.

If you have any questions or concerns, please do not hesitate to contact us.

Market Update

Macro

Economics Outlook: Unsurprisingly, economic growth forecasts have been revised lower for 2020, and the potential for the U.S. and/or the global economy to enter a technical recession in the first half of the year is increasing as the coronavirus has impacted both supply and demand. However, in the absence of major domestic economic imbalances, the downturn or technical recession should be relatively mild and short. Before the recent spread of the coronavirus, economic data in the U.S. suggested growth was relatively strong. Therefore, we expect the medium-term outlook for growth to remain intact, provided the impact of the virus is short-lived and does not result in a substantial rise in unemployment. Stimulative monetary and fiscal policies have already been announced with the potential for additional policies to be announced.

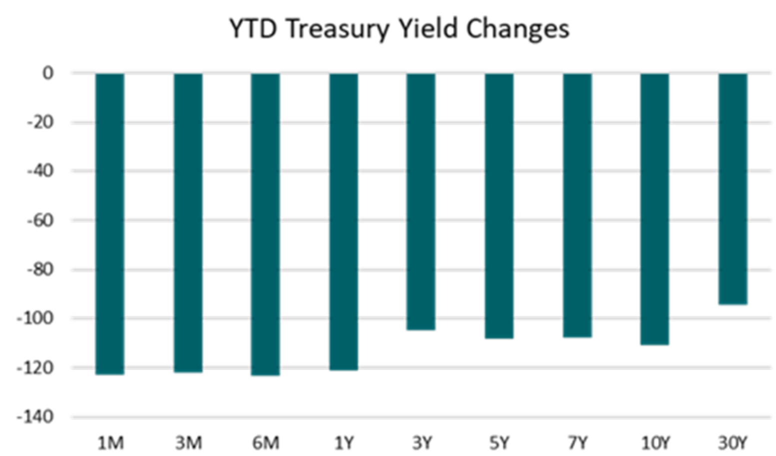
A Transition: We expect financial markets to begin the process of repricing towards a more optimistic view as signals appear that the virus is contained and immunity goes up – which may occur as we move out of the peak flu season and into spring. While there may be some lag time between containment and the economic data recovering, financial markets tend to look ahead and, therefore, reprice before the improvement shows up in underlying economic data.

The Fed/Rates

Yields: As concerns over the virus have increased, the price on U.S. Treasury bonds has moved significantly higher as yields have repriced sharply lower. At certain times, the entire U.S. Treasury curve has traded with yields below 1%, with the 10- and 30-year Treasury bonds reaching the lowest yields on record.

Rate Cuts: After an emergency 50 basis point (bps) reduction in the policy rate on March 3, market participants are expecting the Federal Reserve will lower rates by at least another 50 bps at its March 17-18 meeting. Given the sharp tightening in financial conditions, many market commentators expect that the Fed could cut the policy rate to zero in the coming months.

The return of QE: There is also an increased potential that the Fed restarts large scale asset purchases of bonds (aka quantitative easing or QE), and/or revives some of the tools which they established during the 2008 financial crisis to help small businesses that are facing cash flow disruptions.



Source: Bloomberg. Through COB 03.12.2020

Equities

Equity Update: At 2711.02, the benchmark S&P 500 is down approximately -19.9% from its closing high of 3386.15 on February 19 and -16.1% on a YTD basis. The recent weakness follows a total return of +47.4% that took place between Christmas Eve 2018 and February 19, 2020. Since the beginning of the current expansion in March 2009, U.S. equity markets have endured prior periods of extended weakness in 2011, 2015/2016, and 2018. However, this is the first instance in which the S&P 500 has actually closed down more than -20% from its peak, the traditional definition of a bear market.

Volatility: Not surprisingly, equity market volatility has exploded higher with the CBOE Volatility Index (VIX) settling at 75.47 on March 12, its highest close since a record 80.86 on November 20, 2008. The VIX is calculated based on S&P 500 index options and is often referred to as the "fear gauge" of the stock market. Valuation is how we ultimately price risk, but equity markets are currently trading on fear – this will eventually transition back to more fundamental analysis.

Sectors: Sectors that are typically considered cyclically-sensitive have been the worst performers since February 19: Energy, Financials, and Industrials. Not surprisingly, sectors considered to be lower-risk, less economically sensitive areas have outperformed: Staples, Real Estate, and Utilities. Health Care has also been a relative outperformer, which may be a function of both response to COVID-19 and political developments in the U.S.

S&P 500 Sectors	YTD Change	Change from 2/19
Information Technology	-8.30%	-18.00%
Real Estate	-9.30%	-14.70%
Consumer Staples	-10.00%	-12.10%
Health Care	-11.30%	-12.90%
Utilities	-11.50%	-18.20%
Communication Services	-13.20%	-18.30%
Consumer Discretionary	-17.50%	-22.40%
Industrials	-23.10%	-25.40%
Materials	-24.60%	-23.50%
Financials	-25.50%	-26.00%
Energy	-47.10%	-41.40%

Source: FactSet 3.12.20

International: Not surprisingly, given the global nature of the COVID-19 pandemic, international equity indices are also down significantly, most joining the U.S. in bear market territory. YTD, the S&P 500 is outperforming most international developed and emerging market counterparts.

U.S. Presidential Election: While the ongoing coronavirus saga continues to dominate market-related headlines, it is important to note that other factors remain – namely, the race for the Democratic Party's nomination for U.S. President. Joe Biden's emergence as the front-runner provided equity markets with some relief over fears of a Bernie Sanders presidency and its implications for risk assets.

Valuation: The current S&P 500 bottoms-up estimate for 2020 EPS is $172.55, implying a 15.7x P/E multiple. However, this 2020 estimate is nearly certain to drop as more information regarding the impacts of the coronavirus emerge and sell-side analysts adjust their estimates accordingly. Several macro/top-down strategists have been implying a 2020 EPS estimate of approximately $160.00, which would represent a YoY decline of -1.4% and a P/E multiple of 16.9x. Determining 2020 EPS is only half of the struggle; debates over the proper multiple to place on 2020 earnings will continue to percolate. The 25-year average forward P/E is 16.4x; however, the absolute low levels of interest rates and the gap between the benchmark 10-Year U.S. Treasury Yield (0.99%) and the current S&P 500 dividend yield (2.25%) could justify paying a higher-than-average multiple when markets calm.

Following Corrections: Prior to this recent downturn and since 1980, there have been 31 “corrections” in the S&P 500 of at least -10% from the closing high. One year after the lows of those corrections, the S&P 500 has been higher in 28 instances (90.3%) with a median return of +25.3%.

Summary: We remain confident in the advantaged companies that we own and the longer-term outlook for equities, but the short-term environment is clearly uncertain. We do expect volatility to stay elevated for the near-term, particularly as uncertainty over the impacts of COVID-19 on both global economic growth and corporate profitability continue. Our relative performance to the S&P 500 continues to remain strong, and we will use periods of weakness and volatility to identify additional opportunities that fit both our overall framework and valuation discipline.

Fixed Income

Fixed Income Update: Risk sentiment in fixed income markets has deteriorated sharply over the past couple of trading sessions after being quite subdued in late February and early March. Even municipal bonds, traditionally viewed as a safe haven asset, have come under pressure this week, particularly revenue bonds tied to airports or sporting arenas. Meanwhile, market liquidity, even for U.S. Treasury bonds – the world’s most liquid instrument – has deteriorated noticeably and has added to the volatility.

Downside risks to growth posed by the coronavirus outbreak – coupled with collapsing oil prices – have rekindled concerns about pockets of vulnerability in corporate credit. These concerns can be classified into two broad categories:

- The potential for a material uptick in financial distress (ratings downgrades or defaults) as non-financial corporations struggle to withstand a potentially severe earnings shock.
- The risk of an abrupt contraction in the supply of credit, akin to a credit crunch that would constrain funding for otherwise creditworthy firms.

These concerns have resulted in the risk premium – or credit spread – of corporate bonds increasing. For the first time in over a year, we are beginning to see more attractive valuations in high-yield corporate bonds. However, given the potential for liquidity to continue to deteriorate if fixed income traders are forced to work remotely, we believe that it is too early to begin adding exposure.

Preferreds: As one of the more volatile sectors of the bond market, preferred securities have been impacted by the sell-off in risk assets. We are now beginning to find some interesting opportunities within the space.

Municipal Bonds: The municipal bond complex has seen outflows over the past two trading sessions. The need for portfolio managers to raise cash has resulted in indiscriminate selling and, in some cases, selling their highest quality holdings as they have experienced the least price decline. The recent price action has resulted in the valuation of municipal bonds, relative to U.S. Treasurys, reaching levels only previous experience in the fourth quarter of 2008.

Positioned Well: Heading into the year, we structured fixed income portfolios with a mindset of capital preservation and liquidity. This process included adding intermediate (5 and/or 7 year) U.S. Treasury Bonds and intermediate AAA-rated Agency commercial mortgage backed securities to portfolios at the expense of investment grade corporate bonds. The addition of these security types has been accretive to performance. Our focus within the municipal portion of a portfolio has always been on general obligation and essential revenue bonds (water, sewer, etc.) rather than what we view as riskier portions of the market, such as revenue bonds tied to airports or arenas.

Investment-Grade Corporates: Within investment-grade corporate bonds, our focus has been on securities with maturities of less than 5 years. Given the proximity to the maturity date, these securities tend to exhibit less spread widening and price volatility *relative* to similar bonds with longer maturities. From a sector perspective, our focus has been sectors which are *traditionally* more defensive (banks, communications, insurance, REITs and utilities). Within portfolios, we continue to limit exposure to sectors which were more cyclical in nature (autos, airlines, energy, and retail) as the additional compensation an investor was receiving for moving into riskier sectors of the market was insufficient.

Active Management: The recent market volatility has shown the importance of active management within fixed income markets. We remain comfortable with our positioning outlined above and are not looking to add to risk sectors at this stage. However, we are keenly watching the price action across the bond market as periods of volatility and forced selling, such as we are currently experiencing, often provide attractive opportunities.

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