Third Quarter 2020

Whistling Past the Graveyard

Gregory J. Hahn, CFA
ghahn@winthropcm.com
317.663.7510

Adam Coons, CFA
acoons@winthropcm.com
317.663.7502

Lance Bertsch, CFA, FRM
lbertsch@winthropcm.com
317.660.7257

Freddy Lavric
flavric@winthropcm.com
317.663.7505

Charles Kovarik
ckovarik@winthropcm.com
317.663.7503

www.winthropcm.com

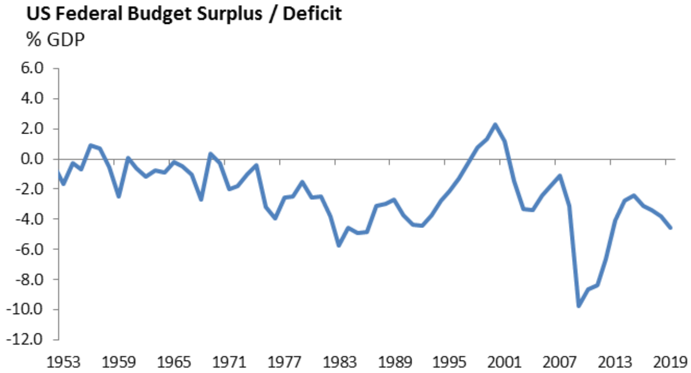
We are currently living through not one, but two experiments that have no precedent or road map for success in society and our life time. The first is surviving a global pandemic and protecting ourselves and loved ones from a terrible virus while, at the same time, not impaling business activity and the economy. The second experiment is the central bank's aggressive use of monetary stimulus, including using its balance sheet to purchase securities in an effort to maintain liquid and orderly capital markets with low interest rates in an effort to mute the negative effects of a sharp slowdown in economic activity.

As we assess current valuations of financial assets against the backdrop of these two separate experiments, we feel like we are "whistling past the graveyard" and ignoring the potential downside risks to a longer economic recovery.

It is important to separate the stock value of the domestic economy from the growth rate. The economic output of the United States, measured by gross domestic product, is near $20 trillion. Roughly $1.4 trillion is represented by sports and entertainment such as concerts, football games, and conventions. *Nearly 7% of the economic output is currently turned off, and there is not a cohesive plan to get it moving over the next six months.*

The United States is the largest, most diversified economy for investors and it has the most sophisticated capital markets in the world. One of the fundamental tenants that allows the machine to operate efficiently is free market capitalism. Capitalism relies on the free flow of credit. Today, our labor market, credit and productivity are sharply constrained, which impacts the level of gross domestic product. *Our Federal Reserve has once again stepped in to provide a safety net for the capital markets and economy. The economic recovery is heavily reliant on massive government assistance and not sustainable on its own inertia. We do not have sustained economic growth at this time, and we expect massive budget deficits to continue in order to maintain consumption and promote fixed investment.*

US Federal Budget Surplus / Deficit



Source: Federal Reserve

We do expect another round of stimulus from congress to help consumers and businesses in the third quarter. Time is running out for many small businesses and we expect to see a staggering increase in bankruptcies in the third quarter. We still have a staggering 17.8 million people unemployed and an unemployment rate over 11%.

Our base case for the domestic economy in the second half of the year is a slow recovery with persistent high unemployment, continued credit deterioration, and slow rate of new business formation. We expect the government will continue to provide assistance as we head into an election in November. Ultimately, we expect an economic recovery will likely take the better part of two years.

The Economy

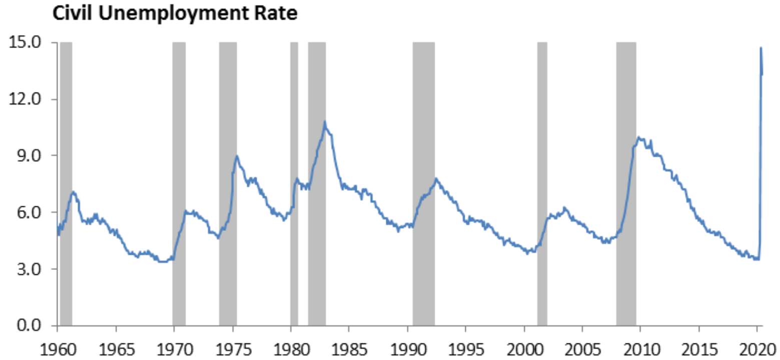
The economy, measured by gross domestic product, contracted by -5% in the first quarter of 2020, and we expect a further decline in Q2 2020 of -5%. The biggest impact came from those industries that were most impacted by Covid 19 including travel, leisure, entertainment and restaurants. The key to the recovery is putting people back to work.

There were nearly 23 million people out of work during the peak of the pandemic. By the end of June, the unemployment rate had dropped from 14.7% to 11.1% with 17.8 million people out of work. The key to the economic recovery will be the ability to create jobs that get people back to work. We are in a transitional phase in which businesses are operating at reduced capacity leaving workers furloughed or permanently unemployed and relying on government stimulus to make ends meet. This transition period will end when the government's desire to provide ongoing stimulus outside of its established programs declines.

We want to be careful not to confuse monetary stimulus with an economic recovery. In addition to massively expanding the money supply, the Federal Reserve has initiated several programs to help provide stimulus and liquidity to the markets. However, in the second phase of dealing with the pandemic, we must now address the growing problems which include:

1. The growing problems in the municipal bond market where projects that rely on proceeds from sales taxes from hotels and restaurants to service the debt are insufficient
2. The $4.5 trillion gap in unfunded pension liabilities which will be difficult to narrow due to inadequately low investment assumptions
3. A chronically high rate of unemployment as lay-offs and furloughs continue
4. The deterioration in the economics of higher education and its impact on state and local economies
5. An airline industry that has too many planes and too few people to travel on them
6. The growing problem in commercial real estate where declining rent payments will no longer cover the interest expense,
7. The uncertainty around the November elections
8. Unresolved trade agreements with China and Europe.

Civil Unemployment Rate



Source: Bureau of Labor Statistics

Unfortunately, this list is not comprehensive. However, the fundamental premise for investors is that there is no coordinated plan to address how to safely re-open the economy and drive economic growth. While earnings expectations are adjusted lower, we are expecting an increase in volatility and lack of patience for earnings misses.

We do believe there will be another round of government stimulus, which we expect will include enhanced financial assistance for the unemployed. While this will likely buoy financial assets, there is a growing portion of the economy that can't afford their rent, groceries and basic living expenses. During the Financial Crisis of 2008, the economy lost 8 million jobs. Today, the rate of unemployment is over 11% with over 17 million people are out of work. We expect it will take up to five years for the economy to produce the jobs to put these people back to work.

Europe

As we consider the euphoric response from the domestic equity market to the government stimulus package, we liken the mood to investors "whistling past the graveyard" and in denial of the downside risk investors face with a protracted recovery and significantly lower corporate earnings. When we consider what Europe is currently facing, we are no longer whistling, we are now singing songs from Hamilton loudly as we run past the graveyard.

The European Union has three major issues that it is currently facing:

1. The EU economy has been slowing and the coronavirus has compounded the economic contraction,
2. The terms of Brexit have not been finalized and the uncertainty compounds the challenges on the economic landscape for the EU,
3. The €750 billion Covid 19 aid package that the EU recently approved will include euro denominated debt that will be a shared obligation of the member countries, compounding the governance challenges the EU currently faces.

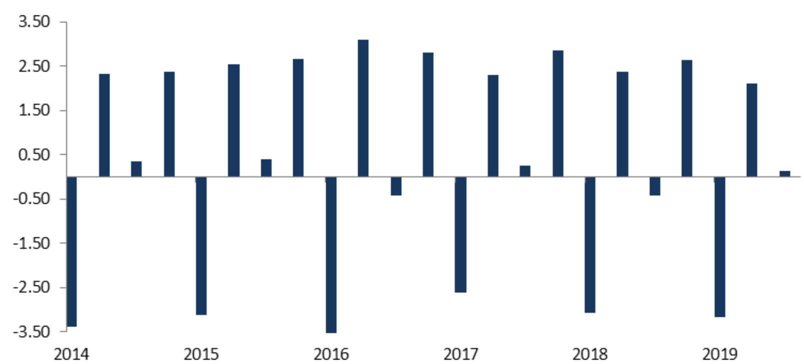
With respect to the first issue, the European Central Bank does not have the same tool kit as the Federal Reserve in its ability to implement monetary stimulus. As a result, the weaker, slower growing countries in the south are in serious contraction and experiencing high unemployment rates over 14%. The current ECB bond buying program has helped to lower rates in Italy and Spain's debt issuance, but that only goes so far to stimulate consumption.

The United Kingdom officially left the European Union on January 31st this year. They are half way through a transition period in which trade agreements, law enforcement, aviation standards and other issues are intended to be resolved. This transition period ends on December 31st and we expect that there will be many unresolved issues which may result in tariffs and additional taxes for Great Britain.

Finally, the most pressing issue facing the EU is the recently approved €750 billion financial aid package that includes for the first time the issuance of Euro denominated debt. In the absence of a central taxing authority, this has tremendous consequences for the EU given its current governance structure. Right now, it simply has a common currency which is supported by agreements of the member countries to maintain fiscal discipline (which many of the countries have not been able to do).

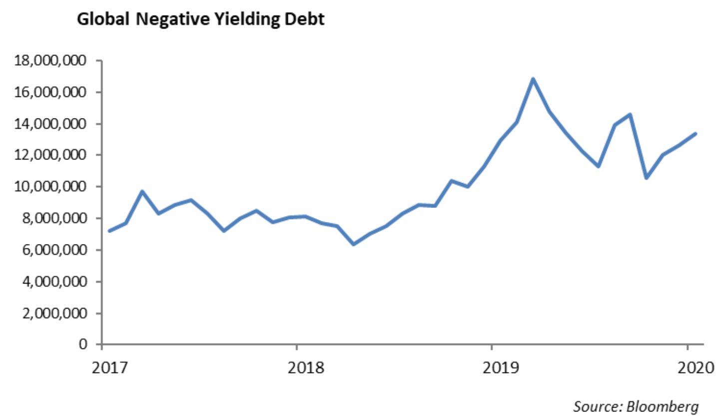
Each issue in itself is a major hurdle for the EU. However, in combination these three issues create serious challenges to sustained economic growth in Europe.

Euro Area GDP Annualized
(% Change)



Source: Eurostat

Fixed Income



US Treasuries continue to price in an extended period of high volatility and low growth. Flatness of treasuries from 1 to 3 years at 15bps demonstrates the markets expectations that the Fed does not raise rates for at least three years. Global negative yielding debt continues to increase, now above $14 trillion. These factors run in stark contrast to the exponential performance in risk assets such as investment grade credit and equities.

The "tale of two markets" across equities is also true in credit markets. While investment grade credit is now up almost 9% in 2020, other components of the market still show signs of weakness. Further down the capital stack, preferred stock spreads have tightened only 25bps since April, while AT1s and BB high yield have tightened 150bps and 100bps respectively. While investor are forced to chase yield, there are obvious limitations to how far down in quality they are willing to go. Yields on 10-year BBB corporate are currently at all-time low's of 2.11%. Municipal bonds are in a similar set, with 10-year municipals at 0.74%. The longer we remain at such low interest rate and tight spreads, the more likely investors are to begin to go down in quality in an attempt to replace income. While levered companies have benefited from refinancing at historically low interest rates, terming out one's debt has become increasingly costly for companies with a murky future.

As spreads have tightened since their wide levels in March, we have been incrementally reducing credit across our fixed income strategies. As spread tightening has stalled, we have moved more aggressively up in quality by swapping corporate bonds for treasuries. If volatility across risk markets begins to rise in the back half of the year, we want defense in portfolios. Both high quality and high liquidity are crucial allocations to give portfolio managers the ability to reposition portfolios.

The next chapter of the pandemic's impact on the bond market will include digesting the massive debt issuance and increase in leverage. We expect more downgrades in credit and additional challenges for companies that took on additional debt in order to weather the storm caused by the coronavirus. The credit cycle has shifted toward deterioration.

Municipal Bonds

The municipal bond market is $3.9 trillion in bonds outstanding representing over one million discrete securities outstanding today according to the Municipal Rulemaking Securities Board. The efforts to control the spread of the coronavirus has had a profound impact on the credit quality and ability for many municipalities to service the debt.

It is critical to understand the sources of revenue that investors are relying to repay the debt. For example, interest and principal for general obligation bonds are paid through the collection of ad valorem taxes within the municipality. Essential service revenue bonds, such as water and sewer bonds are serviced through the revenue associated with the districts water and sewer bills. Both of these types of bonds are considered relatively safe.

However, there are more other municipal bonds that are repaid through incremental sales taxes, hospitality taxes, or lease payments which have a higher associated risk depending on the project. These debt issues might include convention centers, stadiums, universities, hospitals, airports and retail shopping centers.

The Federal Reserve established the Municipal Liquidity Facility as part of the Cares Act, which will purchase up to $500 million of short term municipal bonds outstanding directly from qualifying states and cities. However, the rules for borrowing are not necessarily conducive to supporting all established borrowers.

We expect declining enrollment at colleges and universities this year to negatively impact revenue to make interest payments on debt. Airport authorities around the country have dramatically lower revenue as a result of a 80% reduction in domestic flights. Stadiums, which would normally be filed with concerts and sporting events, are sitting empty and unable to produce the revenue needed to service the interest payments on the outstanding debt.

With tight spreads and low interest rates in today's market, investors are not necessarily compensated for the risk in certain sectors of the municipal bond market. However, if the market dislocates, there should be excellent opportunities to add to the sector.

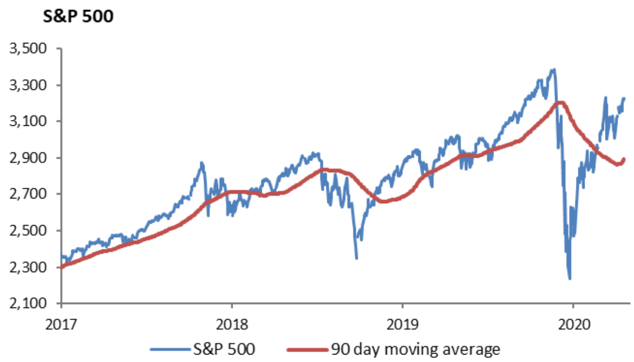
Portfolio Models

With extended valuations in domestic and international stocks, and a plethora of risks heading into the second half of the year, we are working to build defense into our models.

We expect the back-to-school shopping season to be muted given that an increased number of students will be studying from home. In addition, the labor market appears fragile and we expect that job postings will decline as uncertainty around re-opening the economy dampens job creation. As a result, we continue to marginally reduce the large cap domestic equity position and increase the MSCI Low Volatility as part of the Large Cap weight in our Portfolio Models.

The bond portion in a diversified asset allocation is still important because it is one of the lowest correlated asset classes to domestic equities. However, with interest rates at near record low levels, we expect low returns over the near term investment horizon. We are overweight credit based strategies and are adding to mortgage-backed securities.

Equity



Source: Standard and Poor's

The S&P 500 ended the second quarter up nearly 20%, its largest gain since 1998, which erased the dismal performance of the first quarter. Through the first half of the year, the S&P 500 was up a mere 1.84% which is stunning given the turmoil in the economy caused by the coronavirus. To put this more into perspective, the S&P 500 index is only -4% off all-time highs.

We expect earnings will be rough for the majority of companies reporting. The banks will likely increase loan loss reserves and show weaker earnings based on net interest margin compression. Manufacturing will show declines in revenues. Consumer discretionary and staples show be two of the stronger sectors along with technology and healthcare.

Domestic equity valuations appear to be stretched. Assuming adjusted earnings of $147 on the S&P 500, the market is trading at 22x forward earnings at the current level of 3244. Following the Financial Crisis in 2009, valuations hit 26 times earnings, so current levels are not egregious based on recent historic context.

Source: Standard & Poors