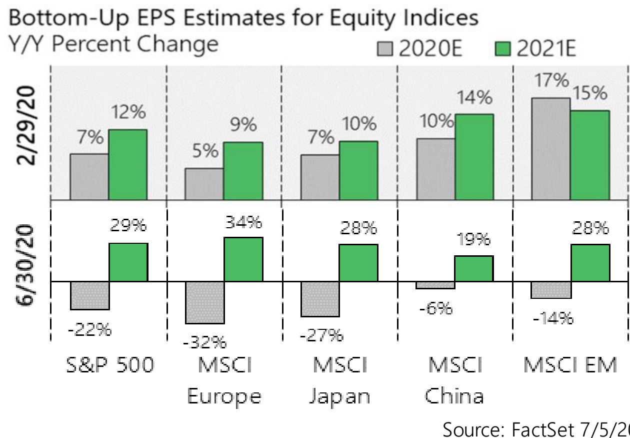
GLOBAL INVESTMENT OUTLOOK AND STRATEGY UPDATE

July 9, 2020

- **Does the Equity Market Reflect Irrational Exuberance?**
- **Growth Underpinned by Massive Global Monetary & Fiscal Stimulus**
- **Global Economic Activity Slowly Normalizing as Pandemic Ebbs**
- **Intervention Lifts All Bond Sectors, Masking Elevated Default Risks**
- **Stock Fundamentals and Earnings Growth Key to Future Outperformance**

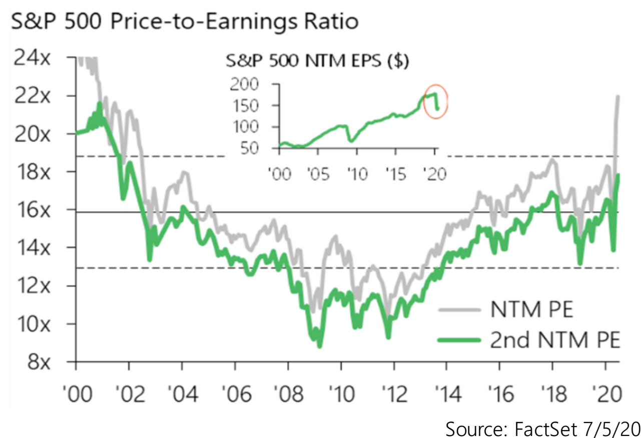
The S&P 500 Index ended 2Q20 at a level of 3,100, rallying +39 percent off its late-March low of 2,237 and placing it within striking distance of topping its mid-February high of 3,386. The strong gains came on the heels of the Index's quickest ever -30 percent correction (22 days). The equally sharp stock market rebound has been driven by massive global stimulus, credit market stabilization, promise of a coronavirus vaccine, signs containment efforts were reducing the rate of new infections, short covering, asset rotation, and anticipation of better corporate earnings. Due to the deep COVID-19-led economic contraction in 1H20, forward bottom-up earnings estimates for the S&P 500 Index have been slashed (Exhibit 1). The calendar 2020 consensus earnings per share estimate has been cut -29 percent thus far this year (representing a -22 percent decline vs 2019), while the 2021 estimate has decreased -17 percent (+29 percent vs 2020). The price-to-earnings (PE) multiple for the S&P 500 has expanded to approximately 22 times next-twelve-month earnings versus the long-term average of 16 (Exhibit 2). As a result, some fear the stock market is in a bubble, driven by easy money and/or overly optimistic expectations.

Exhibit 1: EPS Estimates Slashed Around the Globe



Source: FactSet 7/5/20

Exhibit 2: PE Multiple Expansion Due to Depressed EPS



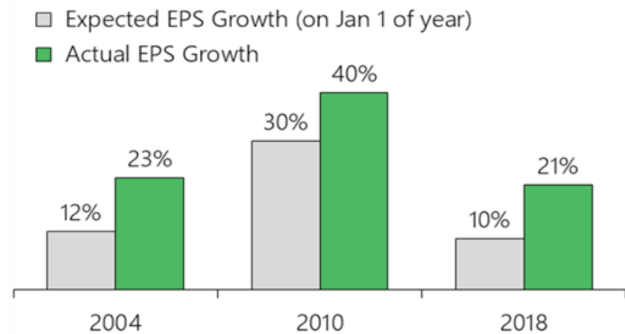
Source: FactSet 7/5/20

The unprecedented speed and depth of the recession has contributed to especially depressed next-twelve-month earnings projections, notably in the industrial sector. As a result, investors are looking out even further to value stocks. The S&P 500 is now trading at roughly 18 times calendar 2021 projected earnings, below its mid-February pre-COVID next twelve month's peak of 19.4 times. While not cheap, we believe the recent rebound has brought the S&P 500 Index closer to fair value, as opposed to implying a bubble – particularly when record low interest rates, benign inflation, and elevated equity risk premiums are considered. Further earnings multiple expansion for the overall market is not our base case. Instead, earnings growth (and upward surprises) will be the primary driver of equity gains going forward. Consensus earnings estimates have often proved too high initially, then revised downward as time passes. Positive economic inflection points, such as

now, are a key exception (Exhibit 3 & 4). Coming out of a recession, sell-side earnings estimates are historically overly cautious. It is also a time when stock selection is paramount, as choosing companies positioned to beat expectations drives portfolio outperformance.

Exhibit 3: Estimates Often Too Low at + Inflections

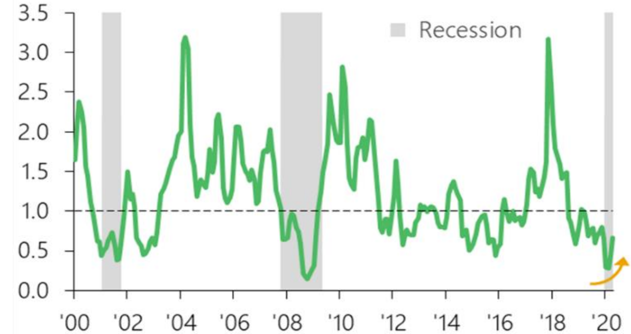
S&P 500 Bottom-Up EPS Growth, Expected vs Actual
Y/Y Percent Change



Source: FactSet 7/5/20

Exhibit 4: Earnings Revisions Now on the Upswing

S&P 500 Earnings Revision Ratio
Number of Up Revisions ÷ Number of Down Revisions



Source: FactSet 7/5/20

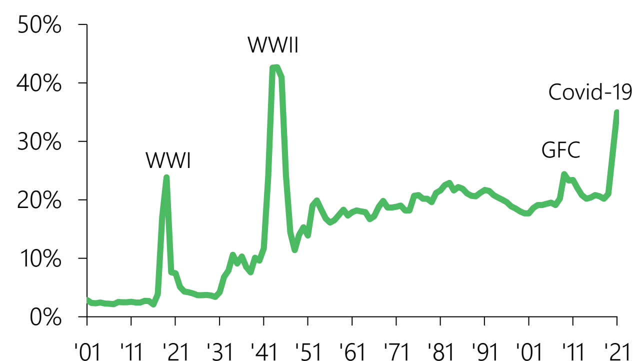
Investor sentiment has swung wildly from euphoria in February, to panic in March, and now back to euphoria. As a result, equity markets are vulnerable to a near-term consolidation on disappointments. A continued surge in new coronavirus cases is likely the largest risk to the V-shaped economic recovery that equity investors appear to be, at least partially, discounting. However, economic/market weakness is expected to be met with more stimulus. A possible Democratic election sweep is another sizable risk to corporate earnings and equities given the promised partial rollback in Trump-era tax cuts. Still, as the Fed continues to utilize measures to keep interest rates low, the T.I.N.A.-effect (i.e., there-is-no-alternative: a lack of investment options other than stocks that offer attractive return potential) may push investors out on the risk curve and contribute to elevated equity valuations. Historically high cash balances and excess liquidity, along with the often-cited "fear of missing out" phenomenon, may also fuel an upward momentum trade in the case of better-than-expected economic, earnings, or virus-related trends.

Expect Uneven Recovery Post Initial Bounce as Virus-Related Risks Persist

Led by massive global stimulus, U.S. economic output is poised to improve in 2H20 post a deep, but short-lived, technical recession sparked by the coronavirus outbreak and measures to contain its spread. With the lingering fallout from the 2007-2008 financial crisis a not too distant memory, policymakers continue to pump enormous amounts of liquidity into the economy to short-circuit a series of events that could precipitate a lengthier downturn. The Federal Reserve's renewed asset purchase program (now minus an explicit size limit) and emergency lending facilities have stabilized financial markets, keeping credit flowing and borrowing costs low. The Fed's balance sheet has ballooned to over $7.1 trillion from $4.2 trillion at the end of 2019, chiefly through purchases of Treasuries and mortgage-backed securities – the consensus is for assets to top $9 trillion by year end. Plus, only a fraction of its emergency lending facilities has been deployed to date, implying not only that the mere launch of the programs was enough to stabilize credit markets, but also that the Fed still has lots of dry powder left to bolster financial markets and economic growth. On the fiscal side, Congress has so far enacted emergency spending legislation of $3.3 trillion, bringing projected federal outlays to levels not seen since WWII (Exhibit 5).

Exhibit 5: U.S. Federal Government Outlays

Percent of GDP



Source: U.S. Office of Management & Budget, BofA (2021 est.) 6/30/20

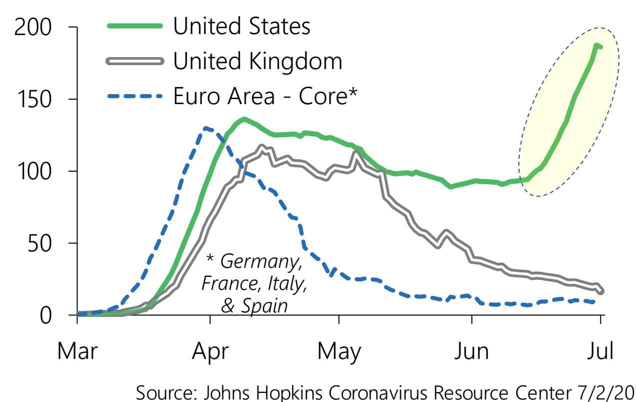
The combined U.S. fiscal and monetary stimulus allocated, but not fully deployed, thus far equals about 45 percent of GDP. As a result, money supply, growth in which has traditionally presaged improved economic activity, is expanding by historic proportions (Exhibit 6). The swift and substantial policy response, along with the largely self-inflicted nature of this contraction, signals an initial rebound as restrictions are lifted. However, risks abound – the pace of new coronavirus infections is re-accelerating, bankruptcies are surging, and trade tensions are on the upswing. The outcome of the U.S. elections also has major implications for corporate profitability and legislative priorities.

Exhibit 6: U.S. Money Supply (M2)

Source: U.S. Federal Reserve

Nationwide efforts to slow the spread of the coronavirus appear to have had some success. Still, a surge in new infections as states began to lift restrictions shows the U.S. is still not out of the woods (Exhibit 7). Despite the surge, future containment measures will likely be more targeted given the severe economic harm caused by largescale lockdowns. Yet, with a vaccine not expected before 2021, less-than-favorable virus-related headlines could slow the recovery if consumers remain housebound and businesses do not fully reopen. Although headline consumer confidence has plunged, digging deeper into the data reveals relative optimism about economic and job prospects. Household balance sheets are also in good shape, and excess savings may ultimately fuel higher spending as jobs return.

Exhibit 7: New Confirmed Coronavirus Cases



Source: Johns Hopkins Coronavirus Resource Center 7/2/20

Elections a Risk; More So for Equities and Select Sectors Than Overall Economy

Political analysts, public opinion pollsters, and oddsmakers, by and large, currently favor Joe Biden to win the U.S. presidency. Biden's policy agenda includes a partial rollback in corporate tax cuts; taxes on the wealthy; spending on infrastructure, social programs, and clean energy; protections for workers and the environment; controls on drug pricing; and expansion of the Affordable Care Act. Based on estimates from Cornerstone Macro, the agenda's major components will create around $6 trillion in new spending over ten years, offset by $4 trillion in higher taxes (Exhibit 8). Still, big policy shifts will be tempered in the likely case of a divided government. The GOP is expected to eke out a slim majority in the Senate, with Democrats retaining control of the House. Yet, a Democratic sweep is a real possibility. Based on betting odds, the implied probability of a GOP-controlled Senate in the 117th session has decreased to 42 percent from a March high of 73 percent. A Democratic government could dent business confidence given the potential for higher taxes and regulation. Key offsets, however, include infrastructure spending and policies to promote onshoring, both of which could contribute to a revival in domestic investment.

Exhibit 8: Key Components of Biden's Agenda

	Component	
Revenue	Raise Corporate Rate to 28%	1,300
	Apply 12.4% Payroll Tax Above $400k	962
	Raise Top Rate & Limit Itemization	520
	Tax Cap. Gains as Ordinary Income	448
	Other Tax Changes	764
	Total Revenue	**3,994**
Spending	Public Option, Expand ACA, Other	2,250
	Pre-K, K-12, & Higher Education Plans	1,600
	Infrastructure Plan	1,300
	Expand Social Security/Paid Family Leave	880
	Clean Energy Research & Innovation	400
	Drug Pricing Reforms	-400
	Total Spending	**6,030**

Source: Cornerstone Macro 6/29/20

Europe: Do Whatever it Takes, Part Two

Economic activity across much of Europe has begun to improve against abnormally easy sequential comparisons as the pace of new coronavirus cases slows, allowing restrictions to be relaxed. Despite an expected second-half recovery, we project full-year real GDP will drop around -8.0 percent year over year in 2020 for both the Euro Area and the United Kingdom. Fortunately, the European Central Bank's fast response has kept credit flowing and another Euro Crisis at bay. Through June 30, it has purchased €345.5 billion in assets under its freshly launched €1.35 trillion Pandemic Emergency Purchase Programme, with total assets increasing 33 percent from end of February to €6.2 trillion. So far, fiscal stimulus has generally been in the form of furloughing schemes, direct loans to companies, and loan guarantees. Nonetheless, to stimulate demand, we expect tax cuts and spending initiatives will be increasingly emphasized going forward. If the pandemic and associated economic fallout were not enough, the European Union and United Kingdom must also negotiate all the terms of a post-Brexit relationship by yearend or risk subjecting the region to further turmoil come 2021, as the United Kingdom has refused an extension.

Stimulus Limits Japan's CY20 GDP Decline to -5 Percent, but Recovery Faces Headwinds

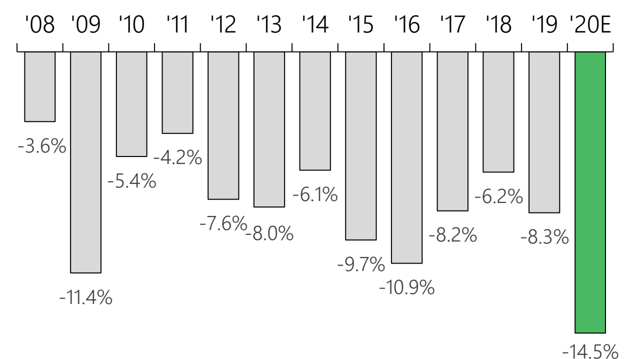
Japan should participate in the global economic recovery following the coronavirus shock. Still, we expect an uneven recovery restrained by ongoing structural challenges. Aggressive stimulus measures, including two ¥117 trillion spending packages, will help fill the demand void created by virus-related shutdowns and lay the groundwork for growth in the quarters ahead. While headline fiscal stimulus figures are inflated to a degree, the real spending portion totals a meaningful eleven percent of GDP and outstrips the 2008-2009 response by four times. The Bank of Japan, though already stretched thin, has marshaled enough added measures to rebut tighter financial conditions and keep the yen competitive. However, continued coronavirus uncertainties will likely temper consumer and corporate appetite to spend, further depressing confidence in the wake of last autumn's consumption tax hike. The recovery may also be complicated by structural issues, such as the country's rigid labor system, as the economy looks to adapt to post-virus realities.

China Is on Track for Full Economic Recovery, but other Emerging Economies Challenged

We believe China will return to the pre-pandemic level of GDP in second-half 2020 and achieve positive low-single-digit GDP growth for the full year. The coronavirus outbreak looks broadly under control in China thanks to effective public health containment efforts. Hence, domestic demand has gradually improved since late February, with manufacturing activity largely returning to pre-virus levels. Second-half 2020 growth is underpinned by 1) policy support, 2) a progressive recovery in consumption, and 3) better export demand. Monetary policy remains accommodative, but added measures have been modest relative to those initiated by developed market central banks. Policymakers have instead focused on fiscal stimulus to support economic growth. The augmented fiscal deficit is expected to reach a record high of roughly 15 percent of GDP, providing support for infrastructure investment and small businesses (Exhibit 9). The recovery in consumption, which has lagged, should also continue as reopening's in the service sector broaden. Plus, the worst could be behind for external demand as the European Union and U.S. economies continue to reopen. Finally, the Phase 1 trade deal with the U.S., while fragile, appears intact. Key risks include a re-escalation in U.S.-China trade tensions and a second wave of infections.

Exhibit 9: China's Augmented Fiscal Deficit

Percent of GDP

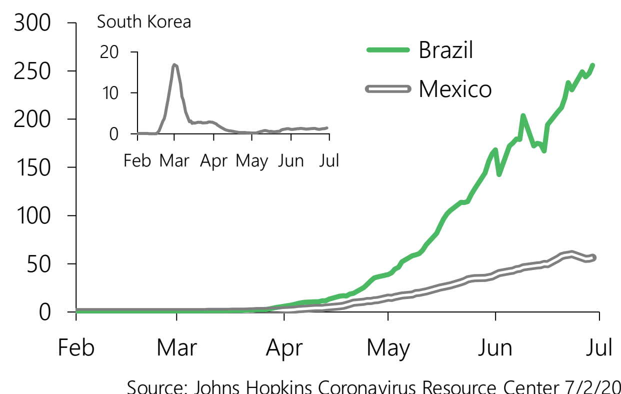


Source: Deutsche Bank 6/11/20

The coronavirus outbreak has been painful for emerging market economies. However, South Korea and India both went into lockdown early and were able to better control the coronavirus (Exhibit 10). Restrictions have since eased in both nations, which should allow the respective economies to recover sooner than those where new infections continue to rise. We forecast South Korea's GDP will decline -0.5 percent in 2020, before rebounding +2.5 percent in 2021. Prospective growth is supported by the government's supplemental budget of 100 trillion won (5.2 percent of GDP), which includes measures to support distressed corporations, assist the poor with emergency cash, and create jobs. In India, we forecast GDP growth of -4.5 percent in fiscal 2021 and +6.0 percent in fiscal 2022. Stimulus measures to date include an -115-basis point repo rate cut and a 20.97 trillion rupees (+1.1 percent of GDP) fiscal package. We anticipate India to implement further fiscal and monetary support to help the economy. Brazil and Mexico did not go into strict lockdown, resulting in a continued rise in new infections. Consequently, we project 2020 GDP will decrease -6.0 percent in Brazil and -8.0 percent in Mexico. We remain wary over Brazil's and Mexico's economic recovery in 2021, with estimates of only +3 percent for both countries.

Exhibit 10: New Confirmed Coronavirus Cases

Per Million of Population, Five-Day Moving Average



Source: Johns Hopkins Coronavirus Resource Center 7/2/20

Investment Strategy

We remain constructive on U.S. equities over the intermediate- and longer-term. Still, we recognize that the strong rebound in stock prices has, at least to some degree, discounted the uptick in economic activity and corporate earnings growth likely over the next several quarters. A key challenge is assessing appropriate valuations when earnings and revenue forecasts are highly uncertain and subject to the path of the coronavirus pandemic, consumer sentiment, and further fiscal support. Valuations for many companies on forward earnings are now higher than prior to the shutdown, and we suspect that investors will need more clarity on near-term earnings power for equity markets to move meaningfully higher from here. Our investment focus remains on companies that can deliver above average earnings growth, regardless of the economic backdrop. Our preferred sectors include technology (e.g., 5G, cloud computing, e-commerce, software) and healthcare.

Dividend-paying stocks have posted disappointing total returns so far in 2020, for two key reasons. First, investors have opted for high growth technology stocks, including 'stay at home' beneficiaries and FAANG tech stocks. Second, the severity of the economic decline has made investors question dividend sustainability for many companies, negating the usual defensive attributes in volatile/uncertain markets. We believe, however, that fears over dividend cuts will subside as the economy slowly re-opens. In addition, relative valuations for many dividend paying stocks have not been this attractive in many years and yields are compelling, particularly relative to bonds. As of June 30, 2020, we calculate over 78 percent of S&P 500 stocks currently offer dividend yields above the 10-year Treasury yield. We believe, however, that selectivity is critical, and our investment focus remains on companies with strong balance sheets, experienced management teams, and growth potential. We continue to believe that a diversified portfolio of high quality, dividend paying growth stocks can provide investors with an opportunity to participate in market gains, but also provide downside protection if market fundamentals deteriorate.

Within international portfolios, we currently prefer exposure to investment opportunities in China, South Korea, and India. We remain positive on China given its first in, first out position amid the global economic recovery and attractive relative valuations – we favor investments in the new economy, along with domestic-demand-driven sectors. South Korea's 100 trillion won financial measures, which focus on providing money

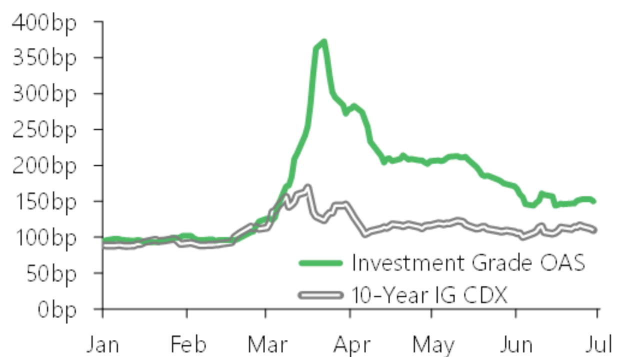
to both consumers and corporations, will be positive for consumer and financial companies. Improving exports will also benefit semiconductor, electrical machinery, and smartphone manufacturers. Our investments in India are biased toward economically sensitive sectors such as consumer, financials, energy, information services, and industrials.

Corporate Conundrum

Investment grade corporate bond spreads ratcheted 122 basis points tighter throughout the Q2 as the Fed's intervention allowed investors to shrug off poor economic data, low corporate earnings, and the impending wave of rating downgrades and high yield defaults that is to follow (Exhibit 11). The Fed implemented its secondary market corporate bond purchasing program resulting in cheers from the market, which drove the spread tightening and ignited new issue volumes. New issue volumes hit over $700 billion in the second quarter, a 148 percent increase from the prior year, putting year to date issuance already ahead of full year 2019 (Exhibit 12). S&P and Moody's are both forecasting high yield default rates to climb from 6 percent today to 12 percent by March 2021, and there have been 75 bankruptcy filings in the last 3 months from firms of $50 million of liabilities or more, matching the same period from 2009. Nineteen fallen angels this year have resulted in $250 billion of downgrades to high yield, and another $300 billion of investment grade debt remains on the cusp for falling to high yield. Despite these heightened risks, we expect spreads to be stable or grind tighter going forward with the Fed's large presence and the broader economy beginning to recover. We will continue to take advantage of opportunities as the country navigates the phases of re-opening by rotating between companies that benefit from the shut down and more cyclical consumer companies that benefit from re-openings.

Exhibit 11: U.S. Corporate Bond Spreads

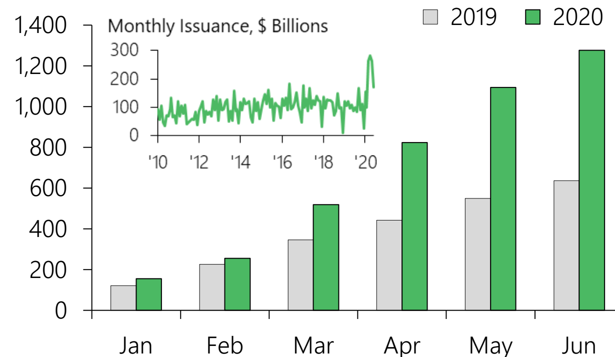
Corporate IG OAS vs IG CDX 10-Year Spreads



Source: Bloomberg 7/1/20

Exhibit 12: U.S. IG Corporate Bond Issuance

Year-to-Date Issuance, $ Billions



Source: Bloomberg 7/1/20

Housing: Refinance or Forbearance?

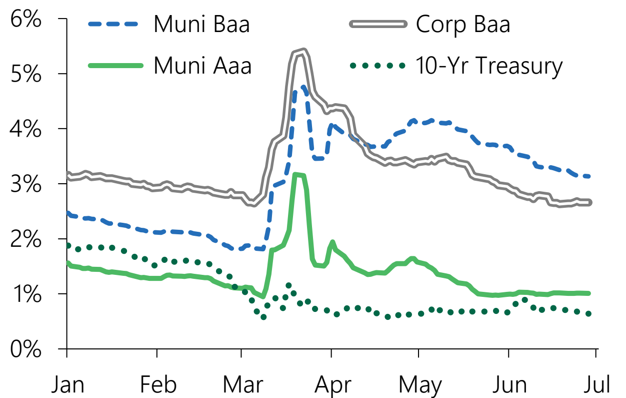
With mortgage rates near all-time lows for conventional borrowers, those that can refinance have benefitted. Recent trends towards digitization of the mortgage process have also accelerated, with e-closings and virtual open-houses gaining attention. With renewed emphasis on working from home and safer in place measures, interest in single family homes and less densely populated areas have increased. For those less fortunate, the forbearance programs instituted via the CARES Act has been swiftly implemented with a high degree of ease and efficiency for borrowers to access. To date, the delinquency rates have not been as high as many investors feared. While the necessity of such quick and broad measures is rarely questioned during an emergency, time will tell how the larger impacts unfold. We remain constructive on securitized mortgage products, within both agency and non-agency, and continue to execute our trading strategy opportunistically.

There and Back Again

The municipal bond market has largely recovered in the second quarter from a very sharp but brief dislocation in early Spring. The specter of the COVID-19 economic shutdown and large budgetary shortfalls sparked a sudden flight to quality in mid-March, including a panicked flight to cash at its height. This powerful surge of selling gripped the market and ran about four weeks. It snapped a prior streak of 63 weeks of net inflows into municipal bond funds that had totaled $120.1 billion. A tsunami of net outflows of -$47.5 billion occurred in just five weeks. The Fed turned the tide decisively by activating facilities to buy short municipal securities and lend to large issuers. The existence of these programs restored calm and confidence, even though little has been expended by the Fed to date. Inflows resumed by late May; net flows are -$8 billion for this year through June. A return to normalcy was also marked by $45 billion in new issues in June, a monthly high for 2020.

The municipal market is still recuperating from certain effects of the sell-off. Historically, yields on high grade municipal bonds are usually lower than those of corresponding Treasury bonds due to the value of tax-exempt interest. However, ratios of municipal yields to Treasuries remain well over 100 percent, signaling further potential for spread narrowing (Exhibit 13). Lower rated and high yield municipal bonds experienced the most severe sell-off; BBB-rated municipal bonds are now considerably cheaper than corporate BBB bonds. More aggressive buying by the Fed in other fixed income markets is a major factor. Total returns for mid-to-high grade municipals turned positive for 2020 as a result of Q2 performance (Exhibit 14); BBB and high yield credits regained some of their losses. In coming weeks, performance will be enhanced by seasonal peaks for reinvestment of bond coupon and maturities.

Exhibit 13: Bloomberg Barclays Index Yields



Source: Bloomberg 7/1/20

Exhibit 14: Municipal Bond Index Returns

	2Q20	YTD		2Q20	YTD
Muni Bond	2.72	2.08	GO Bond	2.86	2.98
3-Year	2.28	1.91	Revenue Bond	2.73	1.69
5-Year	3.26	2.18	Electric	2.87	2.80
7-Year	3.31	2.28	Hospital	2.41	1.12
10-Year	2.88	2.47	Housing	1.72	1.84
Long	2.93	1.70	IDR/PCR	5.68	1.14
			Transportation	2.76	1.04
AAA	2.86	3.42	Education	2.55	2.58
AA	2.69	2.73	Water & Sewer	3.01	3.35
A	2.70	1.36	Special Tax	1.77	1.67
BAA	2.79	-2.05	Tobacco	3.42	1.52
Muni High Yld	4.55	-2.64	Minnesota	2.46	2.62

Source: Bloomberg 7/1/20

The path of COVID-19 and the economic recovery will influence returns over the coming year. We expect the Fed to remain extraordinarily accommodative. We expect a marked increase in cyclical municipal downgrades, although we continue to attempt to look through the immediate impacts of the shutdown. We believe that active investment management can excel in this environment. Our income orientation and positioning in defensive sectors should differentiate our performance. We continue to view the current environment as a good opportunity to add tax-exempt municipal exposure selectively.