THE VIEW FROM HERE

MARCH 2020

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POLITICS & PANDEMICS: TWO REALITIES YOU DON'T WANT INVADING FAMILY DINNERS

As February 2020 drew to a close, markets experienced the most rapid decline of greater than 10% from all-time highs since the Great Recession of 2008-2009. The S&P 500 Index closed at 3,386.15 on February 19th, a new all-time high. By February 28th, it had fallen-12.8% in just seven trading sessions – all of which saw the index dropping further and further. Volatility has broken out of the historical doldrums of the past several years and spiked to what some market pundits deem "panic-levels". To be sure, risks abound across the global economic and investment landscape, but panic is not the proper or intelligent response. Instead, as always, an objective, measured approach is required to prudently evaluate real and potential risks as well as real and potential opportunities that may present themselves. As evidenced by our communications over the past weeks, clients are rationally and justifiably concerned with recent market developments. And it is incumbent upon us as trusted advisors to proactively address these concerns with our views and a cogent plan of action for navigating more volatile waters. For this reason, we are including a flash market commentary along with this quarter's outlook. We encourage all our clients to reach out to us should they have any questions, concerns, or just want to discuss these topics in greater detail.

FLASH MARKET COMMENTARY: CORONAVIRUS FEARS AND PORTFOLIO POSITIONING

By the end of February, all 11 of the S&P 500 industry sectors were showing year-to-date losses, with fully 95% of S&P 500 companies down 10% or more from their recent highs. Flows of capital were instead allocated into perceived safe-haven assets, driving U.S. Treasury two-year yields to 0.878% and 10-year U.S. Treasury yields to a new record low of 1.127%. Even as Federal Reserve Chair Jerome Powell inspired a Friday

intraday rally when he indicated that the Fed was prepared to lower interest rates to protect the economy from the spreading slowdown, the Chicago Board Options Exchange VIX volatility index spiked to 40.11, its highest close since August 2015. Monday, March 2nd saw a strong 4.6% rally as markets began pricing in this news. When the interest rate cut arrived the next day, however, the relief rally proved to be short-lived as the market popped in the morning but ultimately finished the day down almost-3%. The yield on the benchmark 10-year U.S. Treasury note fell below 1% for the first time in history on March 3rd.

Although the rate of new COVID-19 infections in China has slowed, it should be apparent that a series of rather draconian restrictions (including quarantines, isolation, travel bans, lockdowns, contact tracings, and other strict measures) have been necessary to attempt this within the world's second largest economy and most populous nation. Such measures have led to harmful consequences for Chinese — and thereby global, due to a much more intertwined worldwide economy than 10-15 years ago — manufacturing, logistics, and just-in-time inventory management (on the supply-side) and travel, leisure, bricks-and-mortar commerce, and other forms of economic activity (on the demand-side).

In our opinion, the continuing flight-to-safety decline in bond and money market yields and the further sell-off in equity prices is being driven by increasing concerns over the spread of the coronavirus within and between other countries in Asia, the Middle East, and Europe, coupled with emerging realizations that (i) an effective vaccine will take longer than generally anticipated to test, develop, and administer; and (ii) it is only a matter of time until the United States experiences outbreaks followed by deleterious effects on individual, corporate, and governmental behavior — producing hitherto unanticipated downward revisions to GDP growth and profit forecasts. For example, on February 27th, Goldman Sachs predicted that earnings for S&P 500 companies would show zero growth this year, after earlier predicting that they would increase 5.5%. As of now, we believe a reasonable expectation is low- to mid-single-digit S&P 500 earnings growth in 2020, based upon some likely further policy stimulus and a more V-shaped economic contraction and recovery.

It is important to keep in mind that our cautious and conservative stance in early January before this market correction – which included, among other things, raising an approximate 5% cash position above strategic levels via a reduction of equity exposure – has been based upon four main factors, among others:

(i) lofty price-earnings and price-to-sales valuation levels, many of which were in the 95th to 99th percentile relative to historical experience;

(ii) heavy concentration of market leadership in a limited number of companies (with the top five stocks representing a record 19.0% of the S&P 500 aggregate market capitalization, even higher than the 18.5% previous all-time high, reached at the peak of the 1999 dotcom exuberance);

(iii) the more than a decade-long age of the equities price advance and U.S. economic expansion;

(iv) a significant degree of complacency and nonchalance as evidenced in persistently bullish investor survey readings and low volatility metrics; and

(v) the very material risk of an adverse outcome in the 2020 U.S. election cycle that could lead to anti-growth economic, market, and fiscal policy measures that we've outlined in previous papers.

For now, we envision three possible scenarios going forward:

Base Case (50-60% probability in our opinion): The following factors: warmer weather; various preventive epidemiological and public health measures; some degree of measured monetary stimulus; and the experienced realization that – even with a possibly high infection rate and quite unpleasant side effects – the coronavirus mortality rate is quite low; lead to a short and meaningful decline in the economy in 2Q20. This followed by a similarly rapid recovery that brings economic growth back to or slightly below earlier forecasted levels. Cash levels can be slowly and judiciously deployed into diversified portfolios, continuing our emphasis on attractively-valued areas of the market with solid earnings prospects and dividend protection.

Optimistic Case (20-25% probability in our opinion): The above scenario occurs but with large scale stimulus measures launched across a broad front to counteract increased worries over the potential negative economic and financial impacts of the spread of the coronavirus globally and in the United States. Such measures may include:

(i) massive monetary, fiscal, and deregulatory stimulus by the Chinese Authorities;

(ii) immense monetary stimulus by the Federal Reserve in the form of swift and larger-than-expected reductions in policy interest rates and a potential resumption of large-scale Quantitative Easing; and

(iii) extensive fiscal stimulus in the form of across-the-board corporate and individual tax cuts and additional federal government spending.

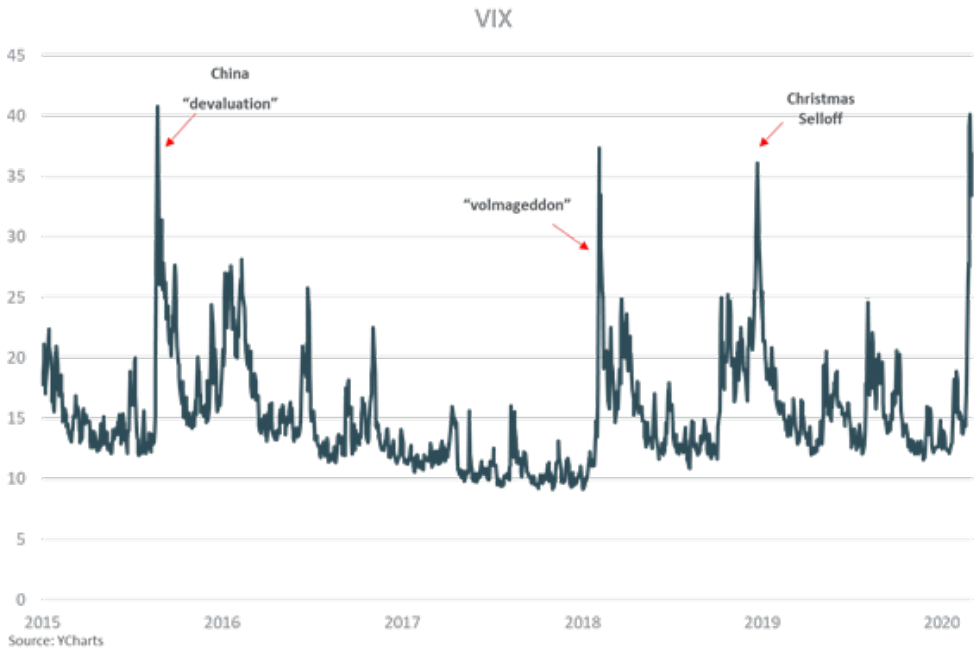
These actions are followed by sudden and sharp equity price recoveries, in which we would emphasize technology, consumer discretionary, industrial, materials, and energy sectors.

Unfavorable Case (15-20% probability in our opinion): High levels of indebtedness and lingering economic and psychological aftereffects of the coronavirus crisis, lead to a broad decline in hours worked, employment, wage growth, consumer confidence, and personal consumption, bringing on a recession in the second half of 2020, which is then exacerbated by late and/or ineffectual policy responses and fears (unfounded, in our view) that it is a replay of the global financial crisis of 2008-2009. In such a scenario, emphasis should be placed on money market instruments, high-quality fixed income securities, and defensive equity industry sectors such as utilities and high-quality companies paying well-protected dividends.

Overall, we stand by our call over the past several months. We have been counseling and continue to counsel diligence, caution, and conservatism. While the 10%+ pull back from all-time highs over the past week might typically present an attractive buying opportunity, it does not change our view of the major risks present over the short-term horizon. In fact, the recent sell-off over coronavirus fears only works to intensify the potential negative economic shocks over the next 9 months. Indeed, we do not view the threat of a coronavirus pandemic as a significant risk from a global health standpoint – considering the mortality rate is less than 2% in developing countries and likely less in developed nations – but rather as a material risk to near-term economic growth. Should the negative economic impact be transitory, as we expect, it would likely place the U.S. and global economies on weaker footing as the U.S. enters the final stages of the 2020 elections. As mentioned earlier, this was a major concern of ours heading into 2020 and a substantial factor in the calculus of our rationale for adding a defensive 5% cash position during the January rebalance. Should the election proceed down what we believe to be an economically adverse path, any potential consequences from anti-growth policy decisions of the new administration would likely be magnified in their intensity due to an already vulnerable global economy recovering from the transitory impacts of the coronavirus. A 10%+ pull back over the past weeks does nothing to assuage our *a priori* concerns. Thus, client portfolios with cash positions – due either to tactical positioning or transition to our discretionary management – will not see that cash reinvested right away. Instead, we will be more patient in our approach and wait for opportunities that present the asymmetrical risk/return profile we seek. One small caveat would be perceived positive developments arising from the results of the Super Tuesday primaries. Early indications imply a resurgence of the more moderate Biden campaign – who won a broad swath of states in the South, Midwest, and Northeast – which, in our opinion, potentially reduces the risk of a far-left presidential nominee.

VOLATILITY SPIKES: PANIC OR OPPORTUNITY?

The "VIX" represents the ticker symbol and the popular name for the Chicago Board Options Exchange's CBOE Volatility Index, a popular measure of the stock market's (and financial markets' more broadly) expectations of volatility, as calculated based on S&P 500 Index options. The VIX is computed and disseminated on a real-time basis by the CBOE and is sometimes referred to as the "fear index" or "fear gauge." Traders on the floor of various options and futures exchanges have for several years employed a shorthand expression regarding the VIX volatility measure: "When the VIX is low, it's time to go slow, and when the VIX is high, it's time to buy." In other words, a low VIX reading usually indicates a fair degree of investor quiescence, complacency, and nonchalance. While sharply elevated readings generally reflect widespread concern – sometimes, even panicked selling – associated with equity market washouts that may signal a cyclical bottoming in asset prices. Mindful of the continuing degree of uncertainty relating to the impact of the coronavirus on the global economy, our recommendation is that investors should remain aware of the VIX level as a general barometer (rather than a precise thermometer) of financial market sentiment, viewing a series of too-low readings with ongoing skepticism and by contrast, considering significantly high readings as potential signposts for adding funds to the equity markets.



EQUITY PERFORMANCE IN PRESIDENTIAL ELECTION YEARS

Widespread wisdom concerning U.S. equity market performance in the four years of a presidential term – promulgated by, among other market prognosticators, Yale Hirsch in *The Stock Trader's Almanac*, with his "Presidential Election Cycle Theory" – usually holds that:

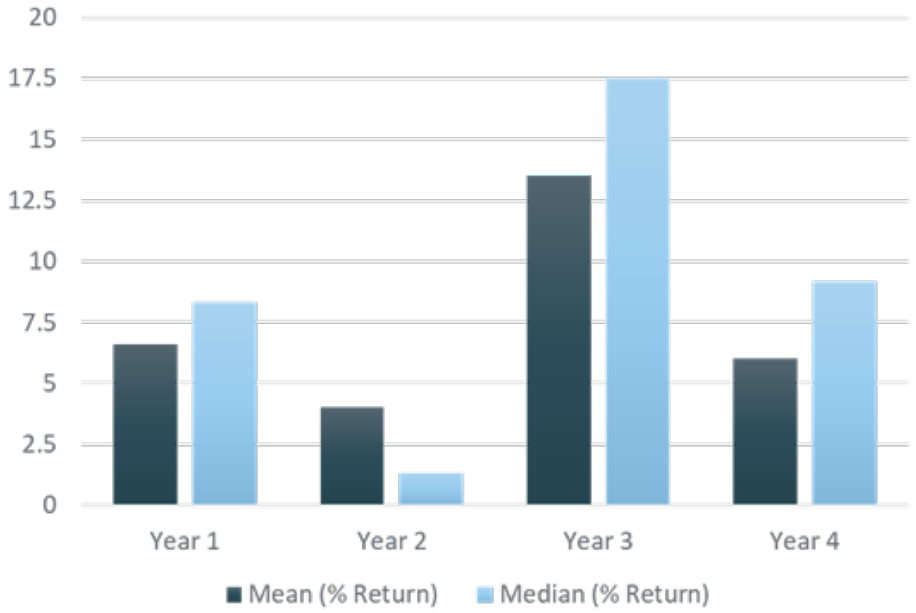
(i) the best year is year three; followed by

(ii) year four, as various forms of economic stimulus may be applied in advance of the election itself;

(iii) year one, characterized by the good feelings after a national election; and lastly,

(iv) year two, when the effects are felt of whatever economic and policy "housecleaning" has been effectuated.

For the 23 presidential election cycles since 1928, the upper panel shows the mean (which is the conventional arithmetic average) and the median (defined as the midpoint) of the S&P 500 average returns in each year of a presidential term. We caution that these outcomes reflect average performance, and a given presidential cycle can deviate, sometimes meaningfully, from the results generated over the past 92 years. This can be seen in the lower panel, which shows the S&P 500 performance for the 42nd, 43rd, 44th, and 45th U.S. presidencies. For example, in year four of President Bush's second term, the S&P 500 substantially lagged the performance of the other three years, and in both of President Obama's terms, the first two years produced the best performance. As calendar year 2020 progresses toward Election Day on Tuesday, November 3, we advise clients to be aware of the psychological and sentiment impact that is likely to be felt on quite a number of industry groups during the upcoming presidential campaign. With corporate taxation, industry dominance, and market power likely subjects of discussion and debate, sectors expected to be in the spotlight include, among others, oil, gas, coal, and hydraulic fracturing; pharmaceuticals, biotechnology, and medical devices; and social media and other technology-enabled companies. Investors would be wise to give careful consideration to the intermediate- and longer-term implications of this year's elections for specific holdings in these and other industries.



Source: WSJ Daily Short, Longview Economics, Macrobond

MAKING YOUR "FAIR-SHARE", "FAIRER": TAX PROPOSALS OF PRESIDENTIAL CANDIDATES

Regardless of one's political persuasion and tax bracket, we think it is quite important from an investment standpoint to pay close attention to the likely post-election contours of the top marginal tax rates on labor and investment income. Investor psychology, consumer behavior, and corporate profitability are influenced to a significant degree by the trend and level of federal (as well as state and local) taxes on labor income. In addition, taxes on capital (investment income) affect investment, a major determinative factor influencing productivity growth, and thus, wage growth.

Quite apart from the media and debate attention given to several Democratic presidential candidates' proposed single-payer health care and wealth taxes, the table below sets forth the current federal top marginal tax rates on labor and investment income under current law. In addition, it shows the size of the much-less-publicized tax increases on labor and investment income proposed by three of the Democratic presidential candidates. The top marginal federal tax rate on labor is currently 40.2%, (including the 2.9% Medicare tax) with the top marginal tax rate proposed by the three cited presidential candidates ranging from 51.8% to 69.2% (Buttigieg suspended his campaign on 3/1/20). The table also shows that the top marginal tax rate on investment income is 23.8%, with the top marginal tax rate proposed by the three cited presidential candidates ranging from 43.4% to 58.2%. Our counsel is to pay particular attention to these and other candidates' tax proposals, focusing on their impact on corporate, consumer, and investor behavior.

RAISING TAXES ON WORK

Federal Top Marginal Tax Rates on Labor and Investment Income

Labor Income	Current Law	Biden	Buttigieg	Sanders	Warren
Top Individual Tax Rate	37%	39.6%	39.6%	52%	39.6%
OASDI Payroll Tax Rate	0%	12.4%	12.4%	12.4%	14.8%
Medicare Tax	2.9%	2.9%	2.9%	2.9%	2.9%
Additional Medicare Tax	0.9%	0.9%	0.9%	0.9%	0.9%
M4A Income- Based Premium	0%	0%	0%	13.5%	0%
Top Marginal Rate	40.2%	51.8%	51.8%	69.2%	53.5%
Investment Income					
Top Capital Gains Rate	20%	39.6%	39.6%	52%	39.6%
Net Investment Income Tax	3.8%	3.8%	3.8%	3.8%	3.8%
Payroll Tax on Lowest Investment Income	0%	0%	0%	0%*	14.8%
Top Marginal Rate	23.8%	43.4%	43.4%	55.8%*	58.2%

Note: Top marginal rate on labor income is calculated as (Income Rate + Employee Rate + Expense Ratio) / (1 + Employer Rate).
The * reflects the low end of the range for Sen. Sanders given a lack of clarity as to whether the payroll tax increase would apply to investment income as it does under Sen. Warren's proposal.
Source: Cornerstone Macro

For additional perspective on the evolution and complexity of the U.S. federal tax code, we share the following thoughts:

Approaching the annual April 15 due date for tax filing, we offer the following reflections relating to the history of federal income taxation and the size of the federal tax code. The United States tax system has evolved through the nation's history, from an initial revenue-generation reliance on tariffs, with new income taxes and other levies generally introduced during times of war to raise additional revenue, then being allowed to expire once the war was over. In the years after 1900, popular and legislative support began to build for a continual income tax, and in February 1913 the Sixteenth Amendment was ratified to the Constitution, granting Congress the power to collect taxes on personal income.

According to Thomson Reuters-Refinitiv and Wolters Kluwer CCH (the latter of which has analyzed the federal tax code since 1913), in the first 26 years of the federal income tax, the code only grew from 400 to 504 pages, and even during President Franklin Delano Roosevelt's New Deal,

the tax code came in comfortably under 1,000 pages. Changes implemented during World War II increased the total code (including appendices) to 8,200 pages; by 1984, it had swollen to 26,300 pages, and as of early 2018, several Congressional and media commentators have pointed out that the federal tax code exceeds 80,000 pages. The length of the actual current actual tax code itself runs in the neighborhood of 3,000 pages, with over 75,000 additional pages devoted to the inclusion of: all past tax statutes; Internal Revenue Service regulations and revenue rulings; and annotated case law covering court proceedings surrounding the tax code.

As we have discussed previously on several occasions, it is most often an ill-advised or poorly timed policy that brings about recessions. In our opinion, the policy proposals espoused by a majority of the Democratic presidential candidates – along with the internalization of these ideas by the Democratic party – present an unfortunate opportunity for history to repeat itself.

EQUITY VALUATIONS STILL ABOVE AVERAGE, DESPITE PULLBACK

The fundamental drivers of all asset prices — including stocks; bonds; real estate; agricultural, industrial, and other commodities; precious metals; and even such asset categories as jewelry, art, and collectibles — are driven by various combinations of:

(i) *fundamental forces* (such as earnings, economic trends, and dividend, interest, and rental payments);

(ii) *valuation measures* (relating prices to revenues, earnings, book values, and other measures); and

(iii) *psychological, sentiment, and technical factors* (such as surveys of bullish and bearish views, initial public offering and merger and acquisition volume, aggregate trading activity, charts of price trends, new highs compared to new lows in prices, advance-decline lines, and moving-average computations).

While fundamental factors tend to be the preeminent forces on asset prices during extended upward or downward moves, and psychological, sentiment, and technical factors tend to exert a dominant influence at major turning points (with extreme euphoria and optimism characterizing market tops, and extreme despondency and despair characterizing market bottoms), valuation metrics are used as a reality check and to provide useful and much needed historical perspective on asset pricing. Prior to the recent coronavirus-driven changes in equity, fixed income, precious metals, energy, and currency prices, it can be seen from the below table that many valuation measures of the Standard & Poor's 500 composite index as of year-end 2019 were registering in the 88th to 99th percentile of their historical valuation readings. Such elevated valuation measures have been an important influence on our multi-month message of caution and conservative portfolio positioning. Even though the S&P Earnings Yield (the inverse of the Price/Earnings ratio) minus the 10-year U.S. Treasury yield was only at the 28th percentile (due to ultra-low interest rates), in our view, the recent pullback in most of these valuations still leaves them at well-above-average historical levels. This underscores our continued counsel of a vigilant, careful, and cautious investment strategy and asset allocation.

S&P 500 Valuation Metric	Dec 2019	Historical Percentile
US Market Cap/ GDP	199%	99th
Enterprise Value / Sales	2.5x	99th
Enterprise Value / EBITDA	12.7x	93rd
Price / Book	3.6x	90th
Cyclically Adjusted P/E	27.8x	89th
Forward P/E	18.4x	88th
Cash Flow Yield	7.2%	85th
Free Cash Flow Yield	4.1%	53rd
S&P Earnings Yield- 10Y UST	362 bps	28th
Median Metric		89th

Source: Goldman Sachs Investment Research. EBITDA = earnings before interest, tax, depreciation, and amortization. December 16, 2019

THE BATTERED "BAD BOY" OF EQUITY MARKETS: ENERGY STOCKS NEAR MULTI-DECADE LOWS

U.S. energy stocks have recently plumbed to their lowest price relative to the Standard & Poor's 500 in almost 80 years. This underperformance has taken place against the backdrop of:

(i) elevated coronavirus-related concerns over the 2020 trajectory of global growth (thereby putting downward pressure on demand for energy products);

(ii) an oversupplied global energy market, meaningfully augmented by the significant increases over the past 10 years of U.S. oil and gas output driven by hydraulic fracturing (a well stimulation technique, also known as "fracking," in which oil- and gas-bearing rock is fractured by a pressurized liquid); and

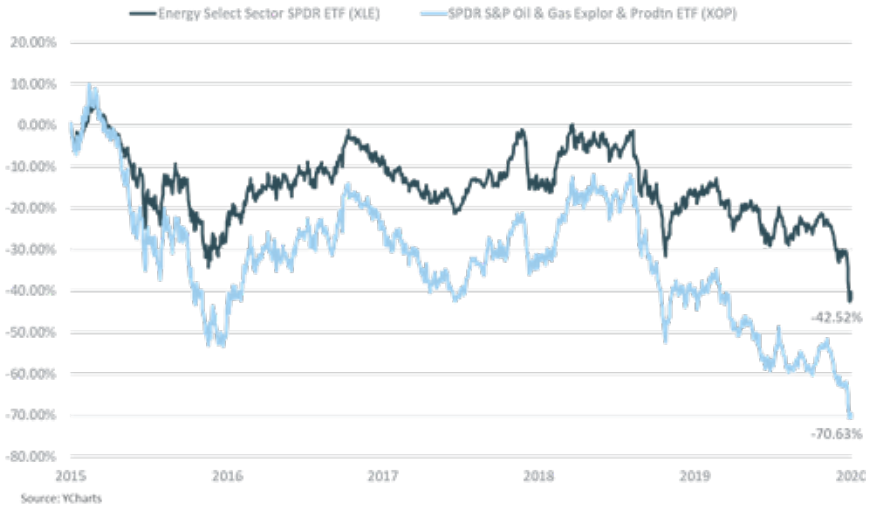
(iii) rising antipathy toward hydrocarbon-producing companies and/or divestments of some or all categories of fossil fuel assets by a number of institutional investors, including endowments, foundations, pension funds, and certain large sovereign wealth funds.

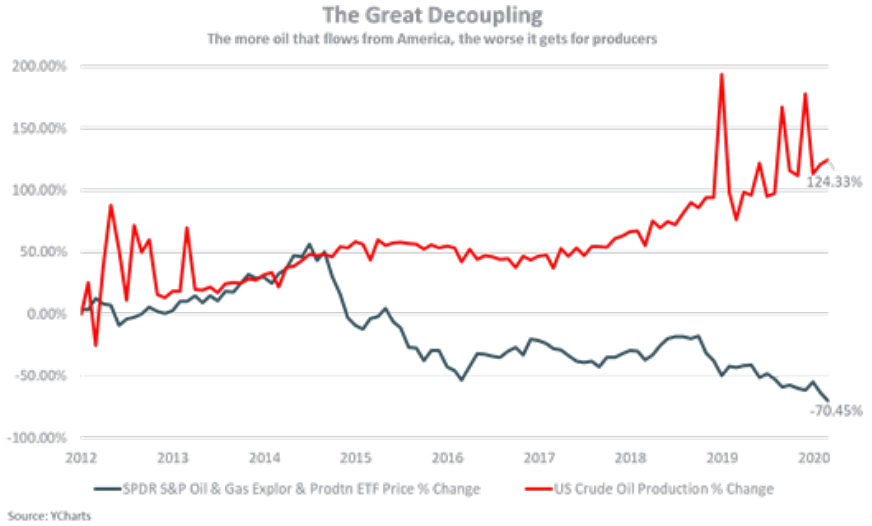
Noting the tendency for cyclical rebounds to gradually unfold following such extreme readings in energy stocks' versus the S&P 500's relative price performance, we think that value-oriented, somewhat contrarian-minded, mean-reversion-aware investors may consider carefully building some exposure to this sector in a disciplined manner, focusing on companies with:

(i) capital discipline;

(ii) meaningful plans to encompass renewable energy; and

(iii) dividend maintenance strength.





CONCLUSION

Over the past months, we have espoused the view that the global economic and market landscape appeared quite binary in nature. Several significant risks posed the potential to end this historic period of expansion. Should they subside, however, the fundamental drivers of growth remained in place to push us higher for longer. While we still hold this binary outlook, the recent coronavirus outbreak and its tangible economic impacts have skewed our probabilistic forecast to the downside, at least in the near-term. This does not imply we are pessimistic, by any means. Periods of heightened volatility and increased dispersion in asset class performance often provide attractive opportunities for the astute observer – especially in circumstances where uncertainty and panic cloud the envisaging of how outcomes may unfold. For this reason, we continue to wade through the fog – guided by objective facts and rational reasoning – with the goal of uncovering any underlying opportunities, mitigating or avoiding potential downside risks, and deftly steering through these choppy waters.

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