WHAT WE'RE WATCHING

MARCH 2020

HAMILTON POINT INVESTMENT ADVISORS

SOME OBSERVATIONS, SANS EMOTION

- Given the large drop in the markets & heightened volatility, we'd like to offer up some observations across all of the markets that we track.
- There is no "silver bullet" in the attached slide deck. We like to think of this data as pieces of a large jigsaw puzzle. Each piece has value, but examined in isolation, it's not particularly useful.
- And much like with any complex jigsaw puzzle, we hope that you either find the attached intellectually stimulating, thoroughly enjoyable, or a useful aid to help you fall asleep should you find yourself restless some night soon.

Note: in the interest of efficiently analyzing and commenting on a series of charts for a broad audience, there are some technical terms and acronyms that those outside of the investment world may not be familiar with; thus the following page includes some terminology if you need to reference it as you review.

TERMINOLOGY AND ACRONYM REFERENCE (IF NEEDED)

- **Basis Point(s) or bp(s) for short**: 1 bp = 0.01% so 65 bps is another way of saying 0.65%.
- **Credit Spread**: refers to the incremental yield, expressed in basis points, received for a bond or group of bonds compared to a Treasury Bond of similar duration. As an example, if a 5-year Treasury Bond had a yield of 1%, and a 5-year high yield bond had a yield of 5%, that high yield bond would trade with a credit spread of 400bps (5%-1%)*100 = 400.
- **ETF**: An Exchange Traded Fund is a group of securities that tracks an underlying index.
- **Forward Breakevens**: a measure of inflation expectations derived by comparing the yield of a Treasury Bond to an inflation-linked bond of the same maturity.
- **Fund Flows**: a measure of the net cash flows into and out of a mutual fund, ETF or group of funds.
- **P/E**: Price/Earnings multiple is a valuation measure reflecting the price paid for a stock relative to the actual or projected earnings per share of that company; a "high multiple" generally implies a higher valuation for that stock.
- **Treasury Yield Curve**: the yield on a U.S. Treasury Bond over different time periods, typically shown from 1-month Treasuries to 30-year Treasuries.
- **WTI**: West Texas Intermediate is a crude oil price commonly used to track oil prices; quoted per barrel (or "bbl").

THE QUICK DESCENT

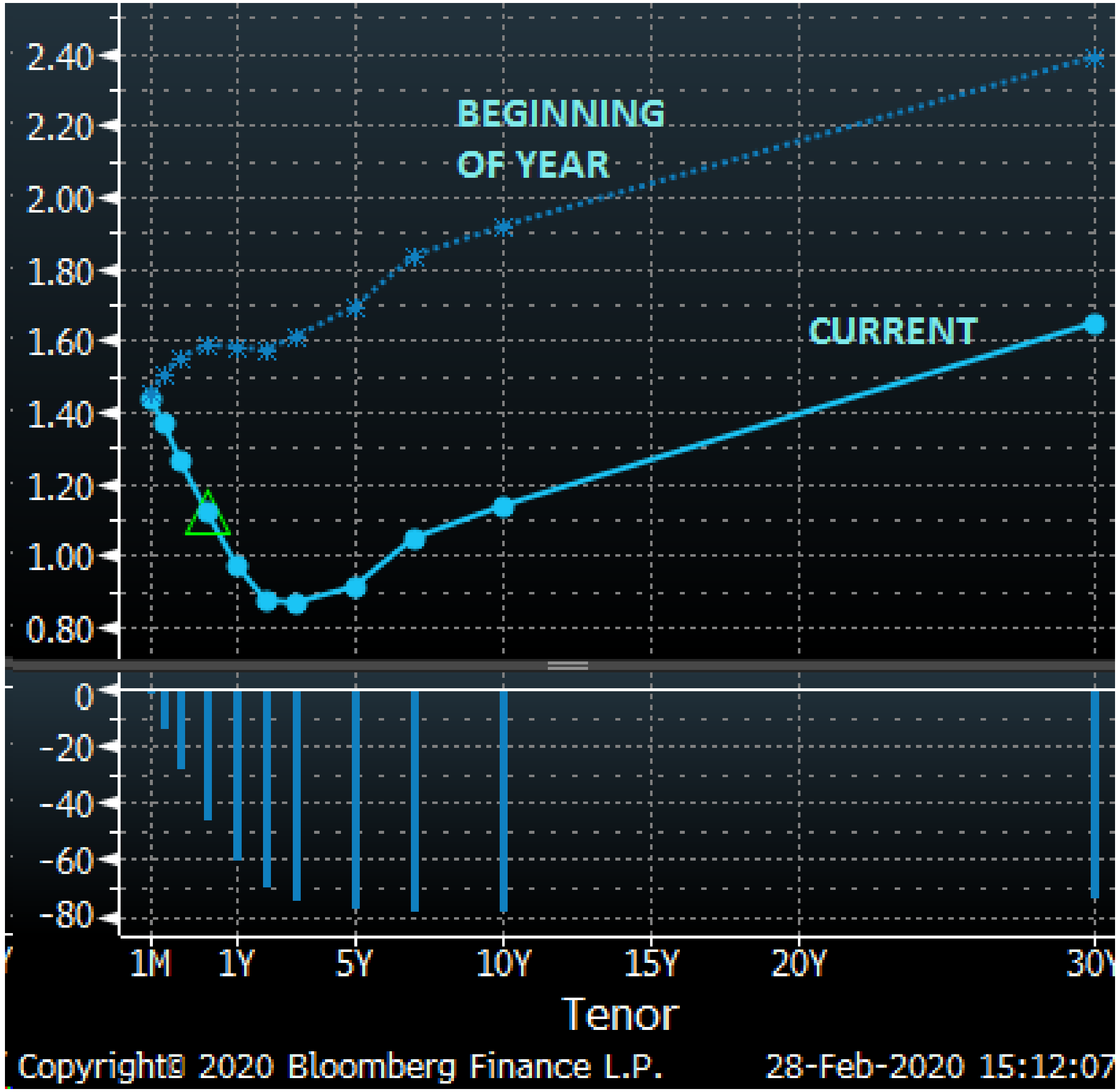
- After reaching all-time highs mid-month, the S&P 500 quickly plummeted ~15%.
- Other major indices followed in near lockstep, with the Euro Stoxx 50 & the Nikkei down mid-teens from recent highs.
- Interestingly, and far from what one might logically suspect, the Shanghai Composite Index is down just 5.6% so far in 2020.

PAUSE, BREATHE, AND PULL BACK THE CHART

- Yet if we pull back the chart a little bit, we see just how good investing in stocks has been in recent history, despite this recent 15% drop.
- Total returns of the S&P 500 (assuming dividends are reinvested) are as follows:
  - 1yr = 6.4%
  - 3yr = 35.9%
  - 5yr = 61.8%

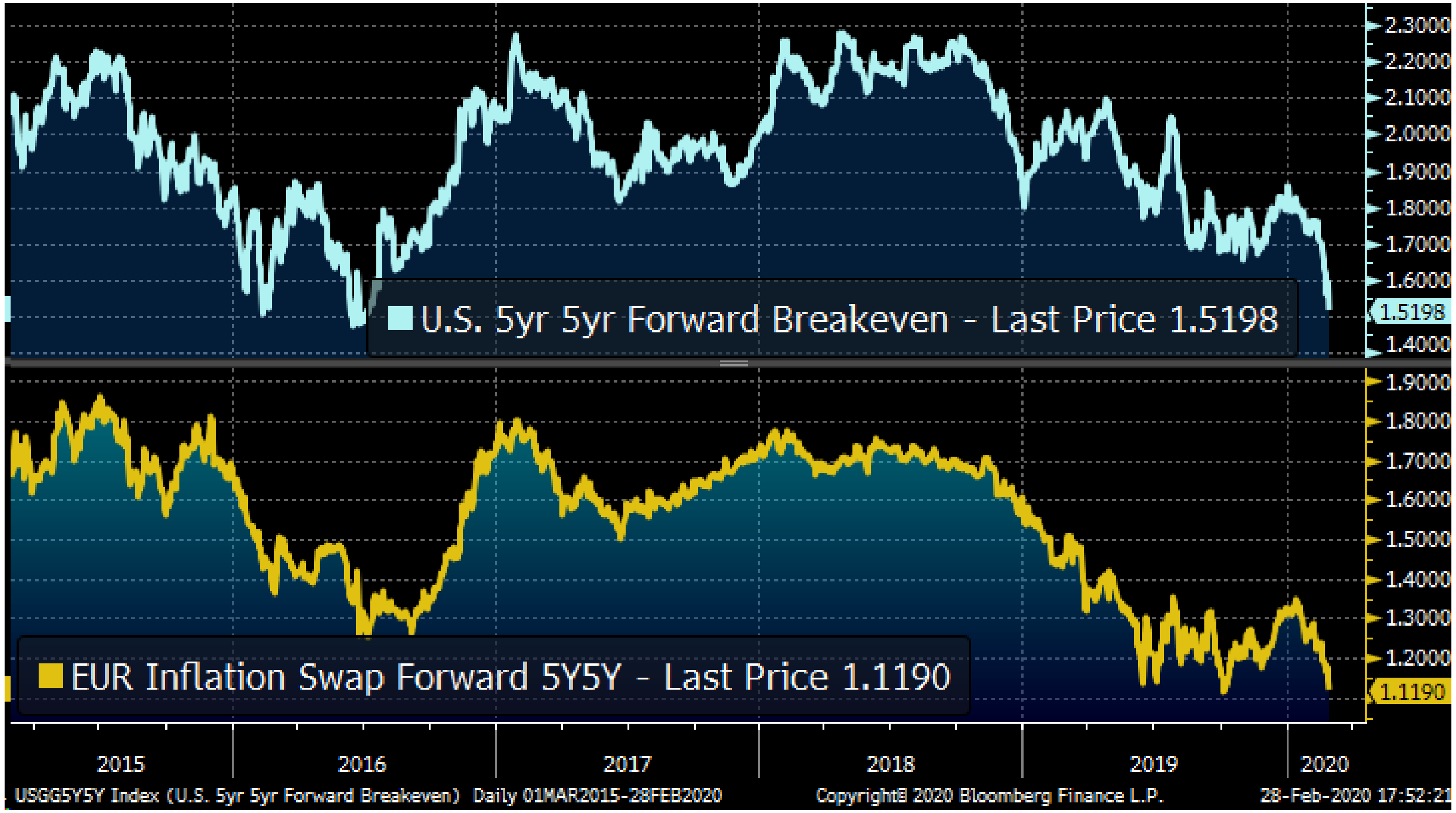
STOCKS MAY BE THE SECOND BIGGEST HEADLINE

- Here's the change in the US Treasury Yield Curve from the beginning of the year to today.
- The graph at the bottom shows you the change (in basis points) in yields at each maturity from one month to 30 years.
- You can see that there was a fairly uniform drop in yields from 5yrs and beyond of almost 80bps – quite a move!
- The sharp dip between 1-5yrs in the current curve is the market baking in expected interest rate cuts in 2020.



YIELDS RESPONDING TO LOWER INFLATION EXPECTATIONS

- Inflation expectations across the globe are cratering, as reflected here by 5-year forward breakevens in the US (top) and Europe (bottom).
- It should be noted though, that even though the fixed income market is often right, it is also quick to change its mind (2016). In the words of John Maynard Keynes, "When the facts change, I change my mind."



NO YIELD TO BE FOUND

- Cratering rates and low yields are not just a US story.
- Here are 5-year government bond yields from some of the biggest sovereign bond markets in the world.
- Note how yields (shown in the last column) are negative for 8 of the 18 countries listed.

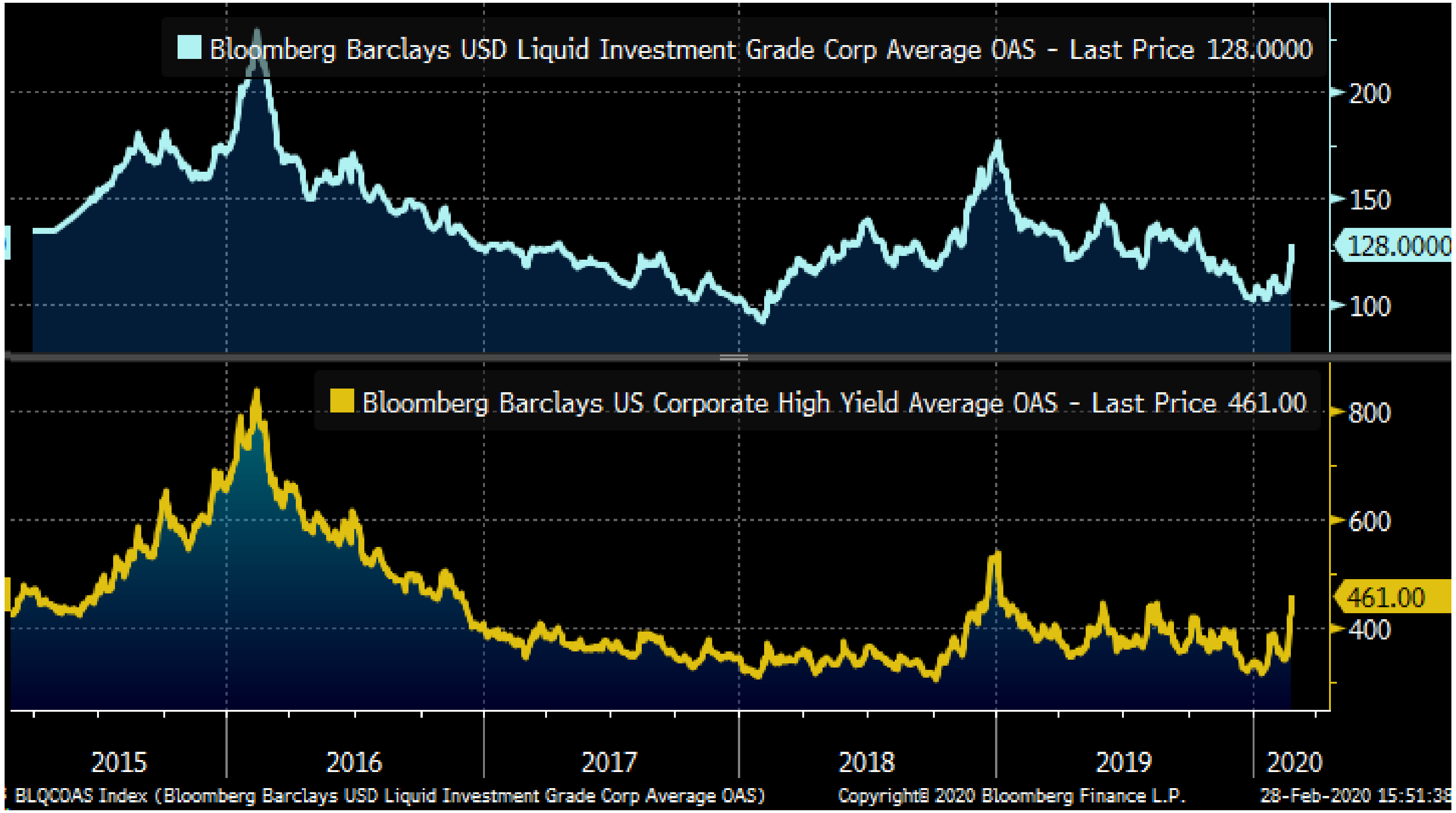
Maturity: 5 Year

Region	RMI	Security	Price	Chg	Yld
1) Americas					
10) United States		T 1 ⅛ 02/25	101-01+	+ 24¾	0.910
11) Canada		CAN1 ¼ 03/25	100.885	+0.329	1.068
12) Mexico (USD)		MEX 3.6 01/25	106.501	-0.025	2.195
2) EMEA					
19) United Kingdom		UKT0 ⅝ 06/25	101.568c	+0.128	0.324
20) France		FRTR 0 03/25	102.960c	+0.143	-0.575
21) Germany		OBL0 04/11/25	104.018c	+0.208	-0.768
22) Italy		BTPS 0.35 25	99.227c	-0.240	0.510
23) Spain		SPGB 0 ¼ 24	102.001c	+0.028	-0.202
24) Portugal		PGB2 ⅞ 10/25	116.376c	-0.003	-0.037
25) Sweden		SGB1 ½ 11/23	107.532c	+0.191	-0.514
26) Netherlands		NETHER2 07/24	112.063c	+0.133	-0.710
27) Switzerland		SWISS 1 ½ 25	113.481c	+0.124	-0.927
28) Greece		GGB3.45 04/24	112.031c	-0.191	0.467
3) Asia/Pacific					
29) Japan		JGB 0.1 12/24	101.811c	+0.261	-0.272
30) Australia		ACGB 2 ¾ 24	109.086c	+0.218	0.525
31) New Zealand		NZGB 2 ¾ 25	109.543	+0.437	0.841
32) South Korea		KTB1 ½ 03/25	101.779c	+0.642	1.128
33) China		CGB2.94 10/24	101.947c	+0.196	2.487

Source: Bloomberg as of 2/28/2020

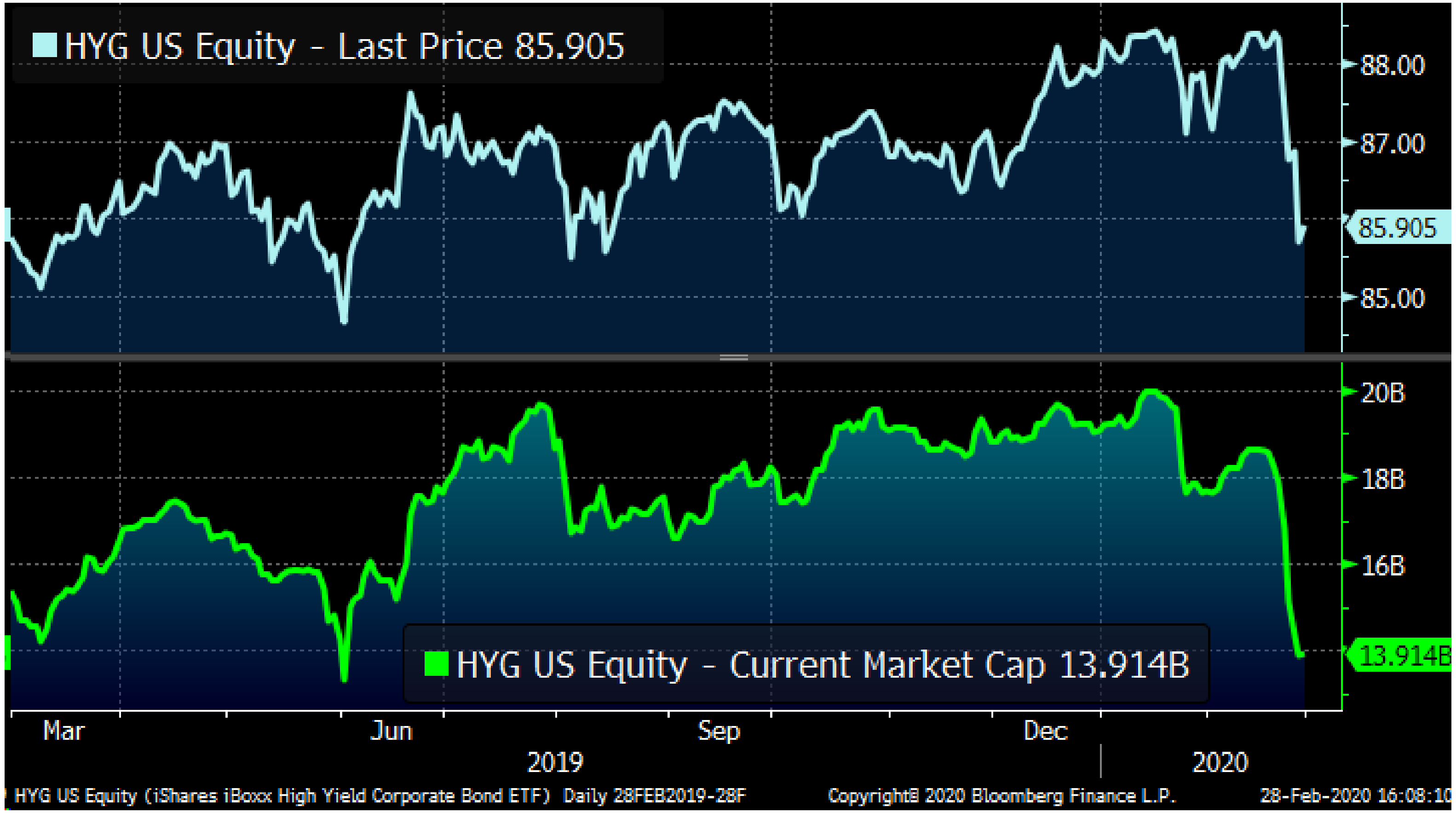
CREDIT SPREADS ARE WIDER BUT STABLE

- Both investment grade corporate bond spreads (top) & high yield bond spreads (bottom) have moved higher in recent weeks, as one would expect given the risk aversion in the markets.
- However, spreads remain well within "normal" levels of the past 5 years and are not elevated by any means.
- The market's interpretation is that any slowdown from the Coronavirus will not likely permanently impair the creditworthiness of US corporations.



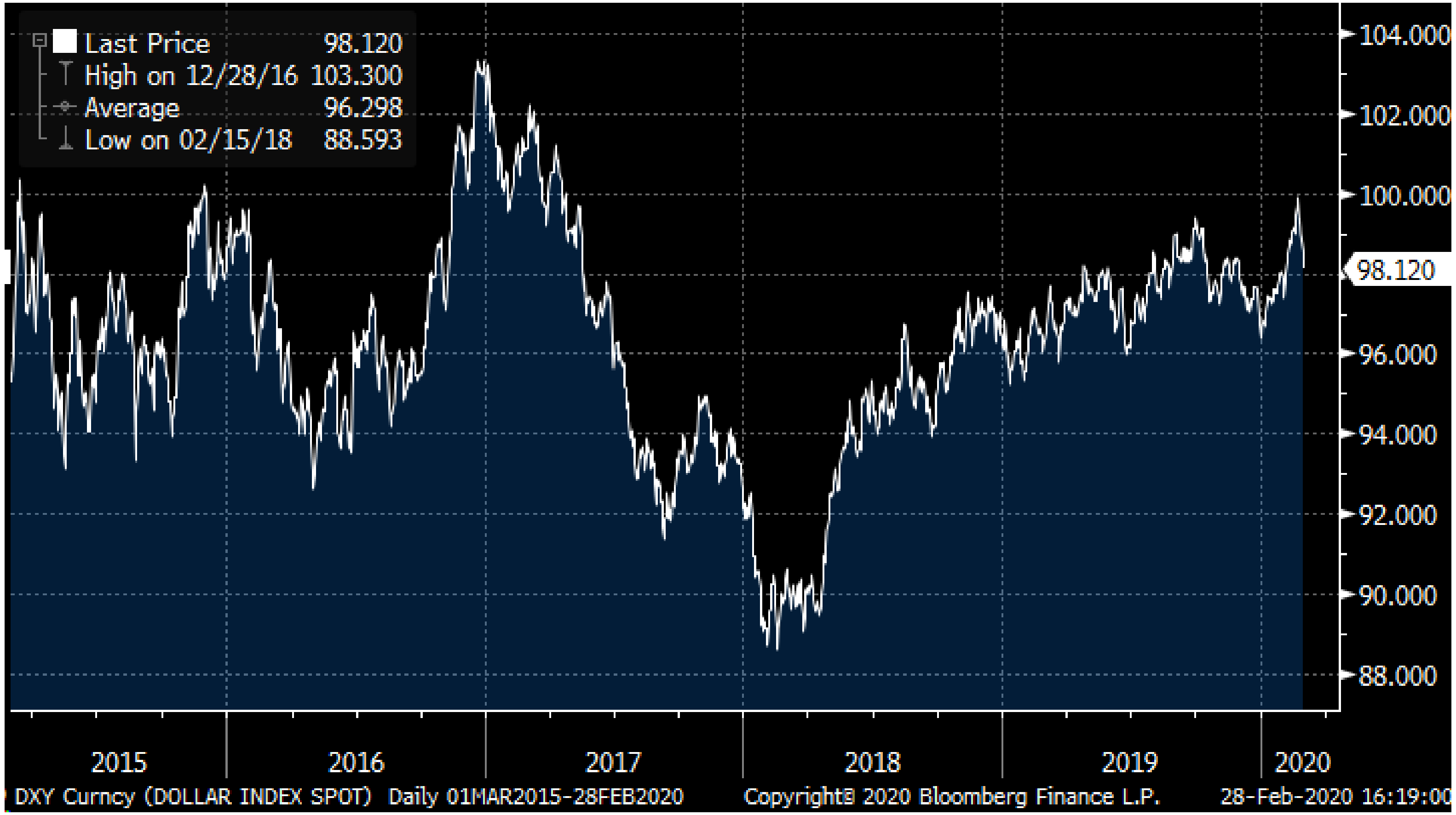
BUT FUND FLOWS…

- While credit spreads have been relatively resilient, fund flows in riskier credit have not.
- In this graph, we show the price performance (top) & fund size (bottom) of the largest high yield bond ETF .
- Note that despite the strong price performance (only down ~3% from peak), the ETF has lost over a third of its assets in a matter of weeks.



KING DOLLAR…NOT SO REGAL

- The US Dollar (reflected here in the Dollar Index) often outperforms during periods of major market stress.
- This time however, the Dollar has weakened. We'd offer 2 explanations for this move. First, the market is now assuming 3 to 4 interest rate cuts by the end of this year, weakening the dollar relative to other major currencies. Second, this is further evidence (along with the stability of credit spreads) that this market move is not a full-blown panic across all asset classes, despite the big moves in the equity and rates markets.



AS YOU'D GUESS…

- The Bloomberg Commodity Index is reacting as you'd expect when global growth is slowing – the index is down 13% on the year.
- The primary driver behind this fall is oil. Crude oil (measured by price of WTI) is down from $65/barrel in January to $45/barrel now.
- The dramatic slowdown in factory activity in Asia is likely to keep pressure across the commodity complex for the near future.
- Here again though, we'd describe this move as contained and not indicative of a full-blown market panic.

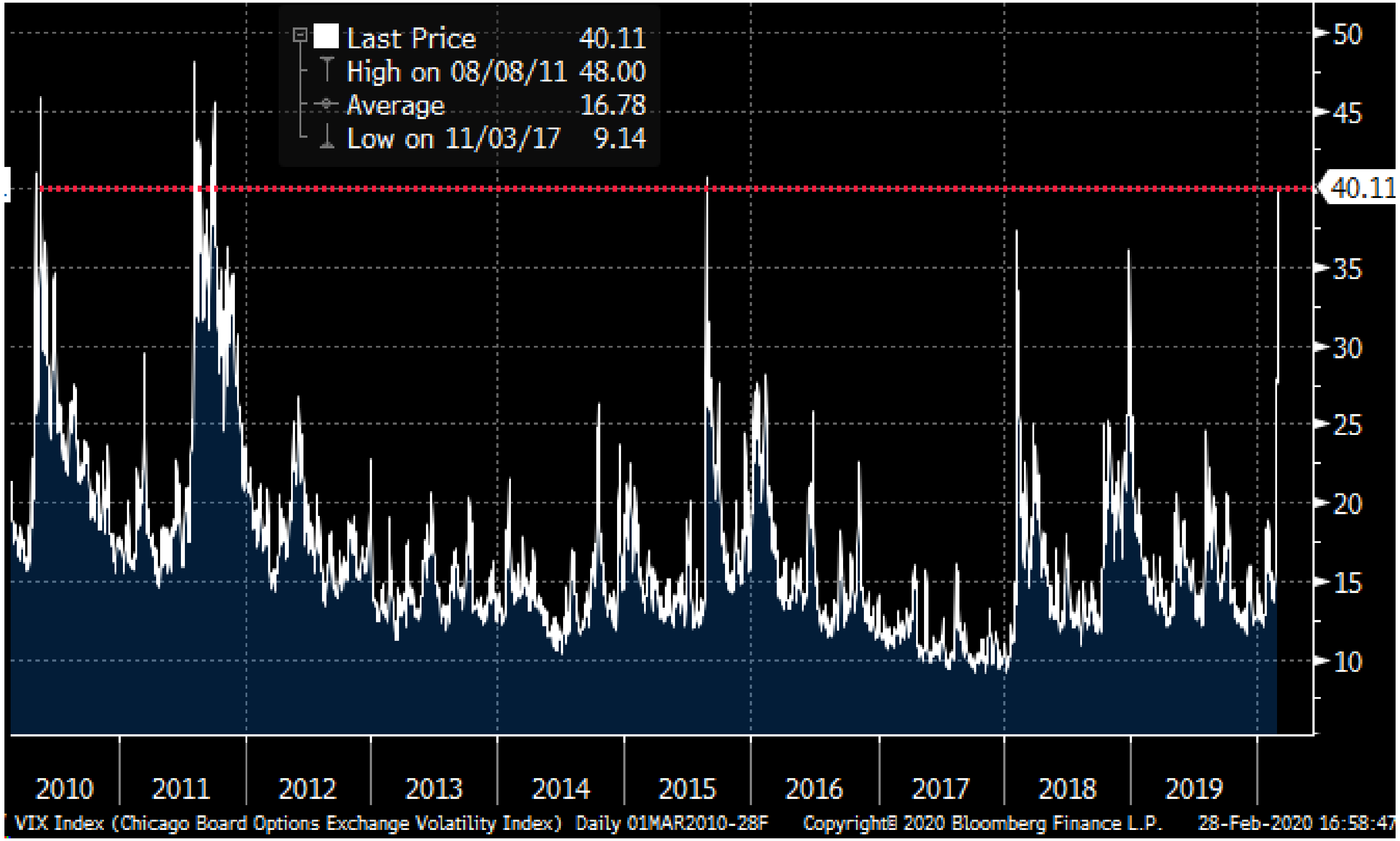
WHAT'S REALLY STRESSING US OUT

- Courtesy of Yardeni Research, here are the S&P 500 corrections since 2008.
- In the parenthesis at the bottom of the graph, you can find the average length (in calendar days) of each correction.
- Going all the way back to 1950…the average correction length was 196 days.
- In early 2018, the market corrected in a record 13 days – actually we should say former record; stocks corrected this time in only 8 calendar days!

Note: Corrections are declines of 10% or more, while minor ones are 5%-10% (all in blue shades). Bear markets are declines of 20% or more (in red shades). Number of calendar days in parentheses.
Source: Standard & Poor's.

AND SO THE VOLATILITY FOLLOWS

- The record quick correction has caused volatility in equity markets (as measured by the VIX index) to explode.
- There have only been 3 other instances in the past 10 years where the VIX has reached current levels.
- There are numerous reasons for the record-setting pace of the correction & explosion in volatility. We'll name a few: the rise of algorithmic trading, a market coming off of a 30%+ year, the rise of indexation….



STRICTLY OBSERVING THE NUMBERS…

At the beginning of this year…

- 2020 S&P 500 EARNINGS EST = $178/share
- S&P 500 Index = 3230
- Implied S&P 500 P/E = 18.15x

Now…

- 2020 S&P 500 EARNINGS EST = $175/share
- S&P 500 Index = 2954
- Implied S&P 500 P/E = 16.88x

It's worth noting…

- These are only estimates and Wall Street has not yet started to substantially reduce 2020 earnings estimates. We anticipate that the $175/share estimate is lowered. Obviously, how much that number is lowered matters a lot.
- The duration of that earnings impact also matters a lot. Is this a 1-month, 1-year, 2-year, or 5-year event? We are guessing to the shorter side based on models projecting the spread and eventual containment of the coronavirus…but guessing should be emphasized; scientific models have been wrong before.
- In addition, lower interest rates are supportive of higher earnings multiples (in theory at least).

AND NOW THE EDITORIAL SECTION - THERE ARE REASONS TO BE WORRIED…

- The market does not have much experience dealing with global pandemics.
- IF (note it's a big if) major metropolitan centers are effectively shut down across the globe, we imagine the hit to growth would be dramatic.
- While the market is asking for interest rate cuts (and we imagine that those cuts will be delivered), we are not celebrating US rates trending to zero. Other countries have had little success in escaping from zero, once zero is breached.
- The political climate is volatile. We recognize that different candidates may present different challenges and opportunities to investors. At the same time, we observe that US markets have prospered under a variety of different Presidents and Congresses for a very, very long time.
- Several leading indicators, such as copper and the Dow Transports, are giving bearish indicators on the market's future direction.
- We are almost certain that the news on the virus & its impact globally will get significantly worse before it gets significantly better.

BUT ALSO MANY REASONS TO BE OPTIMISTIC…

- Historically speaking, 15% drawdowns & VIX levels at 40 have presented strong opportunities for investors to put money to work.
- If the virus is a short-lived event (under ~1 year), we speculate that aggregate demand globally will quickly recover.
- Central banks globally will be aggressively easing monetary policy over the next several months. Historically, friendly monetary policy has translated into friendly returns for investors.
- The $20/barrel drop in oil will act as a further stimulus on the global economy.
- The Fed is unlikely to be raising interest rates anytime in the foreseeable future.
- During severe market drops like the one we just witnessed, we see many strong companies trading down in-line with weak companies. Opportunities to buy good companies on sale are always welcome opportunities.
- Credit spreads tell us that company balance sheets and borrowing abilities are not being impaired by this global growth scare.
- Some of the smartest minds at the world's leading companies and universities are diligently working on finding a vaccine for the Coronavirus.

IN CLOSING…

- As always, we welcome further discussion on any of these topics should you have questions or comments.
- We'll continue to search for more pieces to the puzzle & will keep you apprised of our findings.
- For more observations, follow us on Twitter (@HamiltonPoint) and LinkedIn (Hamilton Point Investment Advisors)

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