EQUITY STRATEGY FOCUS

APRIL, 2020

IN VIEW: The Economic Landscape

A Global Perspective from the Great Recession: While there is no precedent for the current pandemic, the 2008-2009 recession provides perspective on the earnings implications of a "sudden stop" in economic activity. Global 12-month forward earnings estimates were slashed by 40% between August 2008 and April 2009, as the global composite PMI plummeted. For perspective, the preliminary March reading for the PMI is close to the 2008 low. Global ex-U.S. forward earnings were cut more sharply than U.S. estimates during the period, after having risen abruptly in the preceding years. The snapback in earnings expectations was rapid in 2009, in response to an aggressive policy and a quick revival of economic activity. By the end of 2009, 12-month forward earnings had increased nearly 25% from their low, while the composite PMI measure rose solidly into expansion territory. There was a clear V-shaped earnings recovery for both the U.S. and global ex-U.S. benchmarks. Less favorably, global ex-U.S. forward earnings did not regain their 2008 peak at any point in the past decade, while U.S. earnings steadily trended higher, underscoring their greater earning power.

Fiscal Policy Response: The U.S. has begun a massive fiscal support package, roughly equivalent to 10% of GDP in the form of wage support, business loans/grants and debtor forbearance. Other countries in the G7 have also provided aggressive fiscal support of worker wages and businesses. Europe so far has had a piecemeal set of national proposals, which are comparatively modest in scope. Lastly, China has not committed to an aggressive fiscal support plan yet, but has firepower if the economy struggles to gain traction.

Current Monetary Policy: The Fed is out front on policy, given its comprehensive program of government and corporate bond purchases, as well as liquidity provision. The ECB has also moved aggressively to ensure regional sovereign debt markets function smoothly, but there is still a lack of certainty that authorities have the flexibility to do whatever is necessary to protect the monetary union. Elsewhere, the monetary policy throttle is fully open, even though it is ill-suited to dealing with the viral pandemic. That said, the Fed's greater capacity for effecting outcomes provides an underlying advantage for the U.S. market in the near term.

CLOSE-UP: Equity Investment Overview

Market Performance:

The S&P 500 ended the first quarter down -19.4%, thus concluding the bull market that began in March of 2009. The magnitude and severity of the sell-off took the investment community by surprise, given that the economy was growing at 2.1%, unemployment reached 3.6%, wages were beginning to recover, the U.S. Purchasing Manager's Index (PMI) level was still indicating an expansion, commodity prices were rebounding, and the consumer was strong. Global GDP was anticipated to slow somewhat, but certainly not to the degree we have reached now with the economy basically halted as a result of the global response to the Coronavirus.

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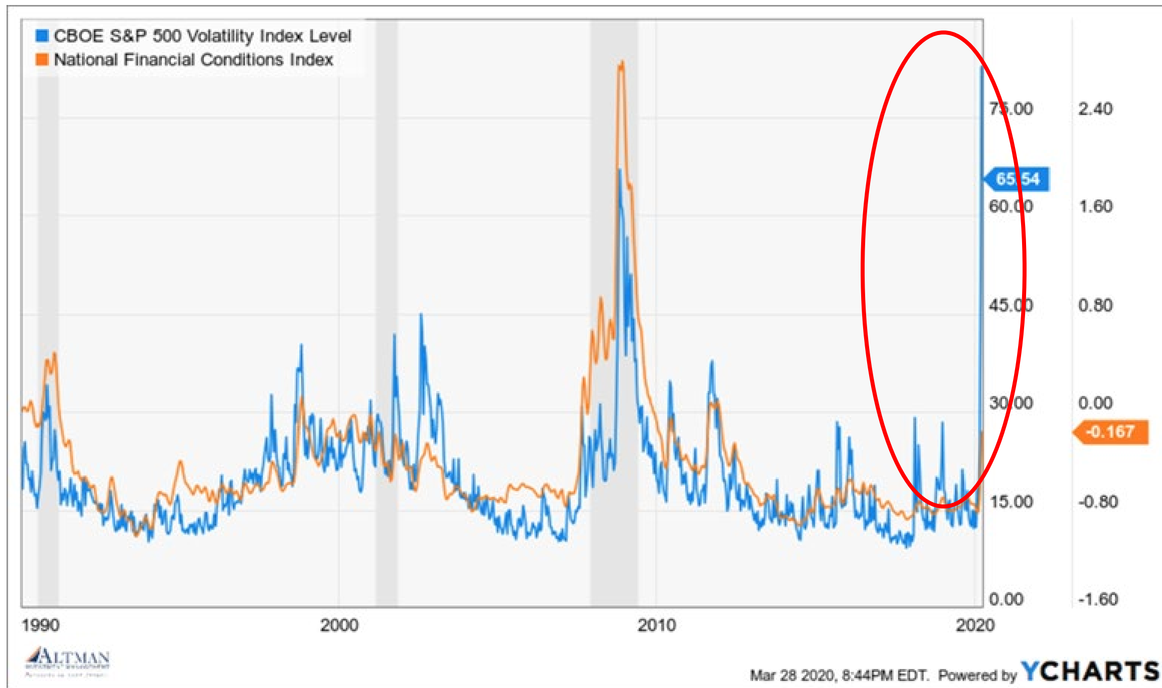
EXHIBIT I:
S&P 500 Volatility Index (blue line)



The growth stocks in the market have significantly outperformed their value counterparts this year, despite the bear market. Market downturns normally crush fashionable stocks. However, growth stocks have maintained their market leadership as the COVID-19 pandemic has reinforced the essential role that technology plays for businesses and consumers, and stoked expectations that the recession could see many of the largest growth companies become even more dominant.

In our estimation, growth stocks have become extremely overbought relative to their value counterparts. Morgan Stanley has confirmed that measured on a price momentum basis, growth stocks are more than 3 standard deviations above the historical average relative to value stocks. The only other time that growth stocks have been overbought, to this degree, was during the dot-com mania in the late-1990s. Overbought technical conditions imply that the risk of an inevitable setback in the relative performance of growth stocks has significantly risen in our view.

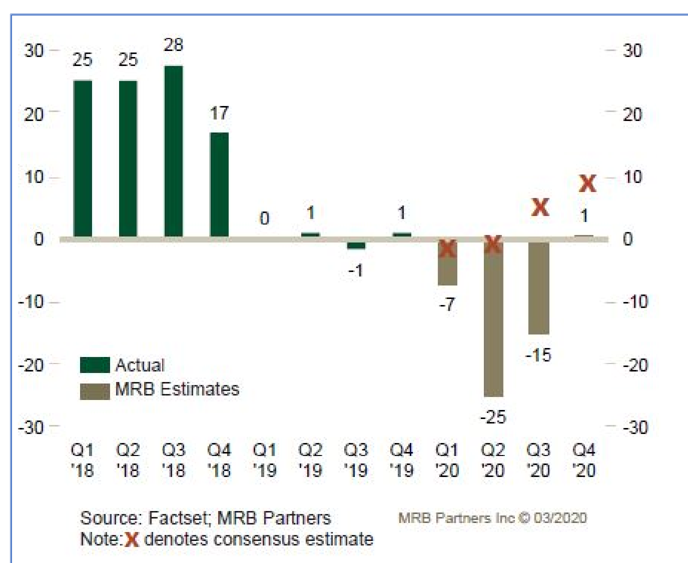
As we've alluded to before, expectations are driving the markets right now. In the absence of control over the spread of the virus or an effective therapy/vaccine, volatility has surged well past levels reached during the financial crisis.

Earnings Uncertainty Expected:

Assessing equity valuations during these uncertain times is challenging given the lack of earnings visibility. Yet investors need some framework or basis for judging valuations which are now at a 20% discount to long term averages. We may even see valuations contract from here before they get better, as the market reacts to guidance on dividends and profits as they are revealed during the Q1 earnings season.

There appears to be little clarity on a short-term basis about absolute and relative earnings across key industries and markets, until there is evidence that COVID-19 is being contained and countermeasures no longer threaten the global economy. The collapse in global economic activity in the near term indicates a dramatic downgrading of earnings expectations over the next several months. Our base-case scenario remains that the global economy will expand later this year, eventually lifting forward earnings anew, with continued upside in 2021. We would expect the U.S. market will exhibit greater earnings resilience in the near term given macro and sector factors which, combined with higher overall quality, warrant a continued equity overweight stance in balanced portfolios.

EXHIBIT II:
S&P 500 Quarterly EPS Growth (% YoY)



- S&P 500 earnings will contract sharply in Q2 and Q3, due to the sudden stop in global economic activity caused by the COVID-19 outbreak.

- Forecasting S&P 500 earnings is subject to considerable error given the unknown progress of the virus. Under our base-case scenario of a temporary, albeit significant, contraction in economic growth, we expect 2020 calendar year EPS to decline 5-10% to US$145 from US$163 in 2019.

- The large share of overall earnings from the Technology, Healthcare, and Communication Services sectors - coupled with the balance sheet strength of the banking industry - should keep overall earnings from completely collapsing.

- We expect earnings growth to rebound later this year and into 2021, assuming control measures succeed in halting the spread of COVID-19 and economic activity resumes in due course.

- There is the possibility for 2021 EPS to recover to US$160 or close to levels that prevailed prior to the health crisis. However, this forecast has a wide confidence band given the fluidity of events.

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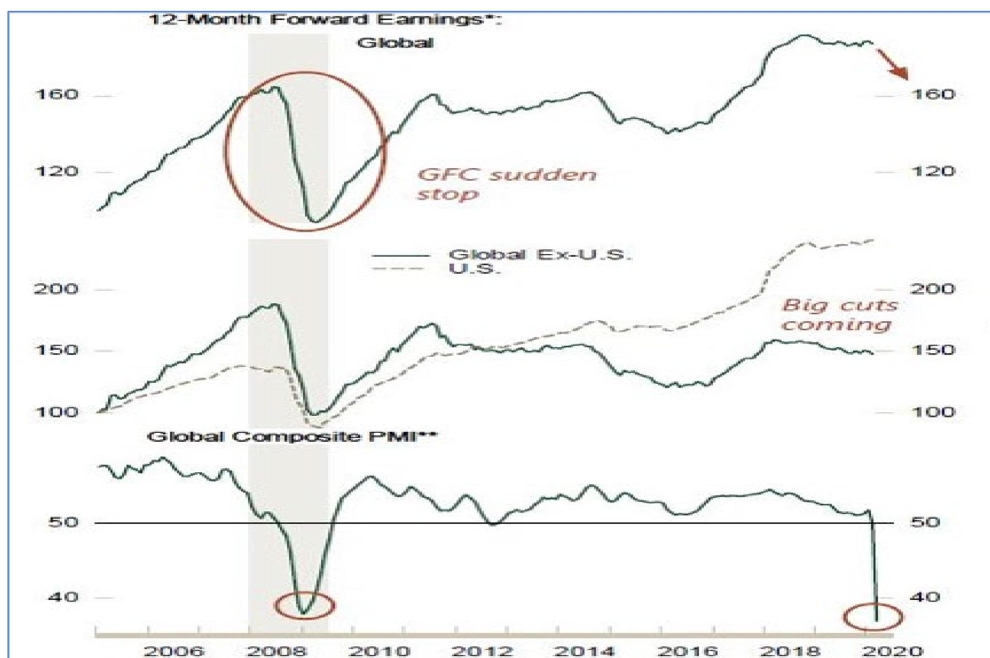
Earnings expectations over the next 6-12 months are the primary driver of our equity allocation strategy. Our traditional framework for expected earnings incorporates domestic economic growth, policy, external factors and sector composition. Forward earnings estimates for 2020 will be cut aggressively in the coming months, but it is less clear to what extent next year's earnings will also be marked down. The evolution of 2021 earnings expectations will ultimately determine the path for equities as markets move toward yearend.

EXHIBIT III:
Downgrades for Earnings Are Inevitable



* U.S. dollars, source: MSCI
** March data estimated, smoothed, source: IHS Markit
Note: Shaded for NBER-designated U.S. recessions

Portfolio Attribution:

The AIM composite declined during the first quarter. Broad market declines were evident in total returns of -26.7% for the Russell 1000 Value Index, -25.3% for the S&P 500 Citigroup Value Index and -19.4% for the S&P 500 Index.

- Top performing stocks during this period were Microsoft, Baxter International, Cardinal Health, Oracle, and Mondelez.
- The worst performers in the portfolio were among the Energy and Financial Sectors.

Portfolio Strategy: The Timetable for Shifts in Allocation:

U.S. stock prices have recently bounced from their lows. To a large degree, the performance of the equity market going forward will be a function of sentiment towards the 2021 earnings outlook, rather than the now widely expected plunge in profits over the next couple of quarters. Fiscal and monetary authorities are providing a buffer against the economic fallout from the crisis, but the key to next year's economic and earnings outlook lies primarily in the progress of the virus.

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The U.S. equity market is deeply oversold, but a sustained upturn in stock prices awaits signs that infection rates in the U.S. and Europe are peaking. Our stock selection will be selective and gradual. We will continue to reinforce higher quality companies given the extraordinarily low interest rate environment, keeping equity exposure in balanced accounts at the higher end of our range by the end of Q2.

Given the extent of the market selloff, we've been researching new ideas across a range of sectors including Communication Services, Financials, Healthcare, Industrials, Information Technology and Utilities, with the goal of finding opportunities to improve the portfolios' overall quality, valuation, and risk-reward profile. Our interest is in populating the portfolio with companies that we believe have the potential to be long-term winners coming out of the downturn.

Although Tech stocks are likely to emerge as the biggest beneficiaries in a post-COVID-19 world, we recognize the sector is relatively overbought and trades at a large premium to the broad equity market, thus warranting a neutral stance versus the S&P 500 for now. We remain cautious on the Materials sector, are maintaining a neutral stance towards Industrials, and continue to underweight Consumer Discretionary stocks.

We recently began adding another holding in the Communication Services sector, one that we see as being a uniquely positioned market leader with high-quality attributes and attractive long-term earnings power. Overall, our positioning remains fairly defensive by underweighting Financials relative to our performance benchmark, overweighting in Healthcare, and less cyclical exposure in Consumer Discretionary. It's our belief that our portfolios' defensive tilt and higher-quality companies should enable our investments to hold up better in the later stages of a potential selloff. This is consistent with what we've seen in the past.

We are inclined to be cautious given the uncertainty associated with COVID-19 and the severe countermeasures being taken to contain the pandemic. This justifies our wait and see approach towards building up equity allocations in portfolios in the near term.

What about the FAANG Stocks?

The market has another issue to worry about other than the coronavirus. It's that the FAANG+M stocks haven't really suffered since the pandemic. Most of us have our daily lives intertwined *to some degree* through Facebook, Amazon, Apple, Netflix, Google, and now Microsoft has been added to the mix. While these companies may be immune to the coronavirus, they are certainly not immune to government regulation.

While we have all become even more dependent on the products and services provided by the FAANG+Ms during the "Great Virus Crisis", investors should be wary especially given the valuation premiums that these companies may have when it comes to greater government oversight. Not too long ago in early 2019 this issue surfaced as Congressional hearings were underway on the use and potential misuse of information by tech companies. These companies have great balance sheets and generate lots of cash flow. They also have lots of lobbyists in Washington. In other words, they are perfect investments in an era of greater crony capitalism, a subject we broached last year.

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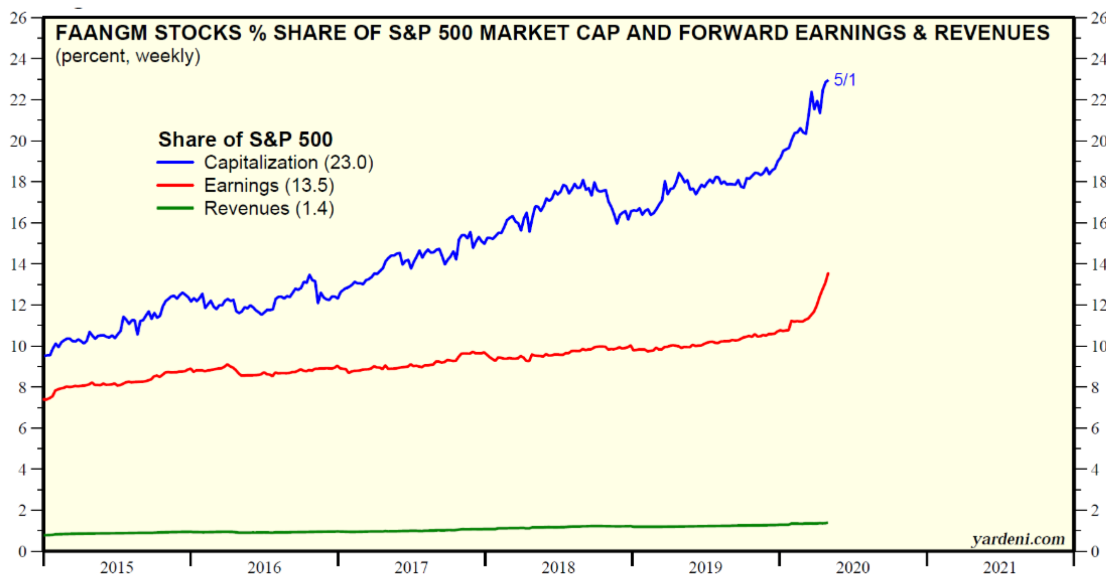
The market capitalization of the FAANGMs peaked at a record $5.7 trillion this past February - but recovered almost all of the losses by the end of April, posting a record 23.0% share of the S&P 500's total market-capitalization.

EXHIBIT IV:
FAANGM Market Capitalization of Standard and Poor's 500



From a valuation perspective, the forward P/E of the FAANGMs rebounded from a recent low of 26 times in mid- March to over 35 times today. Of course, Microsoft has the lowest price earnings multiple of the group at 28.7 times forward earnings. In comparison, excluding the FAANGMs, the S&P 500's forward P/E is now 18.7 times from a low of 12.4 times in mid-March.

AT A GLANCE: A Look at Sector Weights

Technology: Technology has traditionally been a highly cyclical and large sector weight in the U.S. market. The composition of the U.S. sector has changed substantially over the past decade, with more defensive software and services now comprising more than 50% of the total market cap. There is also significant tech-related exposure in the U.S. Communications Services and Consumer Discretionary sectors that provide comparative earnings stability. This should be a major benefit for the U.S. in the near term, as revenue and earnings streams will be especially resilient compared with the broader global sector. Emerging market technology is more cyclical than U.S. tech, although we expect demand for semiconductors to suffer less downside than in past recessions, while offering considerable upside whenever global economic activity recovers.

Energy: Crude oil prices have collapsed, hampered by both demand and supply shocks, while broad commodity price indexes have fallen by as much as 30%. Earnings in these sectors will continue to be under pressure in the near term, as both output volumes and prices suffer. Many of the global markets have roughly twice as much exposure to Energy and Materials stocks as the U.S. - Australia, Canada and the U.K. have significant relative overweights in these sectors, which will weigh on performance until cyclical conditions improve. EM also has above-average exposure, while Japan and the U.S. are underweighted in the two sectors.

EXHIBIT V:
U.S. Long Term Interest Rates
Versus
Inflation and West Texas Crude Oil

Traditional Cyclicals: Consumer Discretionary (including autos) and Industrials have traditionally been highly cyclical, with earnings closely correlated with global trade and manufacturing activity. Preliminary economic data indicates that manufacturing is suffering less than the services sectors, although it's unclear whether that will bolster earnings in the cyclical sectors. Historically, these sectors have extremely high earnings beta to revenue growth, implying they will remain vulnerable in the near term.

Financials: This sector remains our preferred value/economic recovery play, especially large money center banks. Bank stocks face significant near-term relative earnings pressure, due to declining net interest margins and credit losses; but these headwinds have been fully discounted in their relative valuations, which are near all-time lows based on the Price-to-Book ratios. Provisions for loan losses are likely to be significantly front-loaded, implying that bank relative earnings should recover quicker than for most other cyclical sectors, once economic growth resumes later this year. The Financial sector will be the biggest beneficiary of a rotation into value stocks (or a more balanced style performance environment), once confidence in the economic outlook improves and the overall profit cycle re-accelerates.

Healthcare: We continue to like the healthcare sector, which offers exposure to both growth and value. The sector is also a relatively inexpensive quality play. Our preferred healthcare sub-groups include pharmaceuticals and health care providers & services. Healthcare stocks are relatively overbought on a short-term basis. Thus, we would await a pullback before adding to positions. Technical considerations aside, the outlook for the sector remains positive as governments increase spending on health care to fight the COVID-19 pandemic and prepare for future virus outbreaks. The one caveat is that the sector is defensive and exposed to policy risk. Hence, we will likely re-assess our overweight stance later this year, depending on the outlook for the November elections and the expected strength of the economic rebound in 2021.

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IN CONCLUSION:

The unique nature of the health crisis and its impact on the global economy undermines a traditional approach to equity allocation. Health care policy is the crucial driver for assessing how deep and lasting the economic recession will be at the global and national level, and by association how corporate profits will perform. The U.S. is by far the deepest, broadest and most profitable major market. By virtue of its huge comparative size, it is also taking the largest share of any equity portfolio strategy and remains the most important allocation decision. The U.S. quality is favored by its consistently above-average ROE, although we recognize that it is bolstered by its high level of share buybacks. The U.S. with its 14.2% average ROE over the past 20 years, warrants above average Price-to-Earnings ratios and bolsters U.S. large cap stocks in managing portfolios.

Overall, the extent of the earnings downturn hinges on the depth and duration of the economic recession, which is highly uncertain and will vary by sector. Our base-case scenario is that the global peak infection rate will occur in late Q2/early Q3 and that investors will gain confidence that aggressive countermeasures will prevent a major second wave later this year. The second quarter will represent the worst period for global growth and business conditions - and should then rebound beginning in Q3, aided by aggressive monetary and especially fiscal support. The level of global real GDP should be somewhat lower at the end of 2021 than previously forecast, but markets will eventually anticipate improvement next year rather than the fallout in mid-2020.

We are staying in line with our philosophy and process, as we've done in past downturns. Given the uncertain economic and humanitarian implications of the pandemic, we are closely monitoring sources of potential risk in the portfolio while also looking for attractive investment opportunities. We expect to remain patient, always keeping our long-term investment horizon in mind. From the U.S. stock market peak on February 19, 2020 through the end of the quarter, portfolios have held up better than our benchmark, the Russell 1000 Value Index. Eight of the eleven sectors contributed to relative returns, more than offsetting the hit to relative performance from our investments in the Energy sector.

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Any performance reference represents a hypothetical composite compiled from actual equity, fixed income or balanced client portfolios and includes cash. These three composites reflect aggregated returns that address differing objectives. As such, the performance of each composite does not reflect the actual total portfolio returns earned by our clients. The investment performance records are compiled from a capital weighted average of the equity, bond and cash components of a broadly representative group of discretionary accounts that meet certain minimum size thresholds.

No gross performance returns that are referenced that are calculated after brokerage commissions but before investment counsel fees are presented without the comparable net performance figures after both commissions, investment counseling fees and other custodial charges. The net counseling fees are the actual average counseling fee calculated across all the portfolios included in the composite. All performance figures are presented on a time-weighted total return basis and assume all income is reinvested. The investment advisory fees are disclosed in Part II-A of the Investment Form ADV. Some clients may benefit from available discounting in the management fee schedule associated with the overall size of the portfolio. Management fees will reduce overall returns to the client.

The composites were created in 2001 and the inception dates start on August 17th, 2001.The composites include only discretionary fee-paying accounts managed in the strategies, and additional information associated with the composites are available such as: dispersion in individual portfolio results as well as the % of the firms AUM in the strategy. All performance calculations are presented within the GIPS® guidelines of the CFA Institute. The CFA institute does not endorse or promote this organization nor does it warrant the accuracy of the content herein.

Investing entails inherent risks and results may be altered by material market or economic conditions. Investment returns and principal values may fluctuate, and losses are possible. Past results are not a guarantee of future comparable results or trends. Our process benchmark is the S&P 500 Index with dividend reinvestment, and our performance benchmark is the Russell 1000 Value Index with dividends reinvestment.

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