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INVESTMENT MANAGEMENT

SLIMMON'S TAKE > TAKEAWAYS & KEY EXPECTATIONS

Andrew Slimmon April 2020 Equity Market Commentary

SOLUTIONS & MULTI-ASSET | APPLIED EQUITY ADVISORS TEAM | SLIMMON'S TAKE | APRIL 2020

1. In August 2019, the 2-10 year US Treasury bond yield curve inverted. As I have highlighted in almost every market outlook discussion since then, a yield curve inversion has always presaged a recession. Check the box again. In full disclosure, I thought the economic problems were going to be a 2021/22 event. Covid-19 accelerated that. Did the yield curve know about this health scare? *Highly unlikely.* But the inversion did send a signal that all was not as well as the current economic data suggested, which is a great lesson. This time was not different. (A huge shout-out to my friend Mike Wilson, Morgan Stanley's US Equity Strategist, who was a lone voice in 2019 warning that dangers were brewing...and took a lot of heat for it.)
2. Bear markets normally take a long time to form. In the Great Financial Crisis of 2007-2009, the S&P 500 peaked in October 2007, but the initial panic low was not until November 2008, another 13 months later. This recent peak-to-trough took *one month*. The key difference, in my opinion: understanding the economic ramifications of a subprime mortgage mess was much more difficult than the obvious outcome from shutting down an economy and immediately sending tens of millions to the unemployment line.
3. The stock market is a forward predictor. The economy literally fell off a cliff, and naturally, the speed of the selloff was unprecedented.
4. Likewise, because the economy could recover more quickly than any other past economic declines, the speed and magnitude of the recovery rally has also been unprecedented. *I think the market has substantially completed the process of pricing in the reopening of the US economy.*
5. As the media begins to refocus on the "reopening of America", I believe the stock market will have moved on. I suspect the uncertainty surrounding the long-term impact to corporate fundamentals will cause the rally to stall somewhat. I doubt 2020 earnings will mean much, but there must be some repercussions for 2021 and beyond. Still, it's only April, which allows plenty of time for conjecture. *At least for now, I have a hard time envisioning the S&P 500 north of 3,000.*

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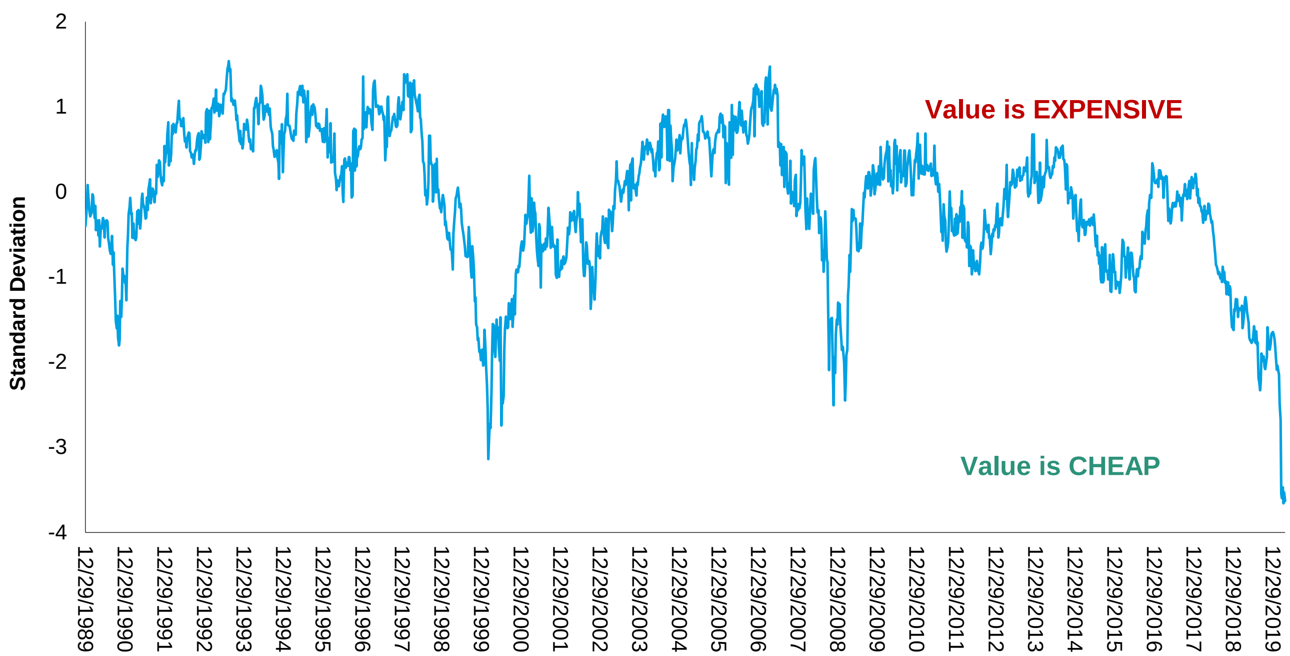
6. Nevertheless, I do not believe we will have a substantial retest of the lows. The regular news flow about the advancements in virus testing and vaccines will likely keep bearishness in check. Also, so far, new outbreaks in Asia have not caused substantial pullbacks in equity prices.

7. At the stock level, *we believe there are excellent long-term investment opportunities for those comfortable with the prospect of continued short-term uncertainty*. Take a look at the following chart. The "value spread" measures how cheap the 100 cheapest stocks are relative to the market versus history.[1]

DISPLAY 1

Value Spread

December 29, 1989 – April 17, 2020



Source: Factset. Value spread as defined by the valuation differential between the cheapest decile of the Russell 1000 versus that of the market average. Valuation is based upon price-to-book, price-to-earnings, and price-to-free cash in terms of standard deviation.

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8. By definition, value stocks are always cheap, but sometimes they get *really* cheap - as in the recessions of 2000, 2008, or especially **now**. But notice what happened to the "value spread" coming out of the recessions in 2000 or 2008: *value stocks offered big returns, as they repriced back to a more normal valuation.*

9. As I said earlier, the "value spread" is measured by the 100 cheapest stocks of the Russell 1000. But why are they so cheap? Is it purely some company-specific weakness, or is there a broader macroeconomic reason? Inevitably, when the "value spread" becomes this wide during a recession, there are broader macro reasons imperilling this group of companies. In 2009, the bucket consisted of mostly banks, credit card, or auto related themes.

10. There is a very clear theme to the bucket today: *the businesses that have all been extremely affected by the government mandated "stay at home" shutdown.* This includes hotels, restaurants, airlines, cruise ships, retailers, and real estate.
11. Today it is emotionally easier to buy the "stay at home" stocks. The companies that make hand sanitizers, wipes, masks, deliver your packages or allow you to have Internet cocktail parties. But remember, the stock market is a forward predictor, and just like the perceived "safe" stocks lagged as the economy recovered in 2009, we think this time will not be different.[2]
12. Building exposure to companies more dependent on the "reopening of the economy" and lessening the "stay at home" theme is the message of the magnitude of the current "value spread". Restaurants, banks and housing are examples of three sectors that have been hit hard by the economy shutting down and we think are attractive opportunities at current prices for the reopening. As I said on CNBC last Friday, when the green light flashes, "All Clear", we believe stocks in these sectors will already be priced much higher.
13. The tricky part of buying depressed names that offer potential rewarding upside is the short-term timing. As we built our exposure to the "reopening theme" in March, the resulting positions *hurt our relative performance just at the tail end of March.*
14. We know it can be difficult to keep clients invested in value strategies because most of the time value, as a strategy, does not outperform.[3] But as evidenced by the "value spread" chart, *when it does outperform*, the returns can be quite significant. This is why we consider Applied Equity Advisors to be "an opportunistic value investor". Exiting recessions has historically proven to be an optimal time to consider increasing value exposure. We doubt this time will be different.

Andrew

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[1] Factset data based on a combination, price to book value, price to cash flow and price to earnings ratio.

[2] During the first three months after the low in March 2009, the financial sector (as measured by the XLF) was up 102%, the S&P 500 40% and the consumer staples (XLP) +22%. Bloomberg.

[3] As measured by the periods of outperformance, not the magnitude. Factset.