Memorandum

To: BCA Clients and Friends
From: Sid Nadkarni, BCA CIO
Date: April 14th, 2020
Subject: Recent Market Events – and Looking Forward

UPDATE OF MARKET DEVELOPMENTS AND OUR VIEWS (Since our previous April 2nd Memo)

Dear BCA Clients and Friends,

We hope you had a nice Easter holiday and that everyone is staying safe and healthy during these trying times. The dramatic market volatility and public health, economic and geopolitical uncertainty continue, so we want to brief you on market developments and our views since our previous April 2nd memo.

Continued Sharp Rally Across Risk Assets Through April 14th

Equity and credit markets have continued rallying in April. Since the market troughed on March 23rd, the S&P 500 has rallied 27.4% through April 14th. Following this rally, the S&P is only 12% lower than at the beginning of 2020 (following the 31.5% increase in 2019) and 16% lower than the February 19th peak. Similarly, credit spreads – which were highly stresssed - have narrowed across corporate bonds and reversed roughly half of the widening from the March lows. While the swiftness of the rally in risk assets has surprised some, we highlighted this likely rally in our April 2nd memo, labeling it as likely "Phase I" trajectory (see p.6 of that memo). In this stage, we surmised that virus health statistics and policy mitigation actions would constitute the key drivers of equity market performance. In both instances, some incremental positive developments have emerged:

- Health-wise, the rate of new COVID-19 case growth is slowing steadily across Europe and now across the US as well. Thankfully, the US has sharply reduced its estimated death toll forecast to 60,000 from 100,000–240,000 and will likely reduce this even further as social distancing mitigation efforts demonstrate their effectiveness. Governors across states, as well as President Trump, are beginning to formulate plans for a staggered reopening of the economy, perhaps earlier than investors' worst-case forecasts.

- Every week, there seems to be additional fiscal support or Federal Reserve action. The Fed has now begun purchasing certain high-yield bonds / ETFs as well as municipal bonds / ETFs. The Fed's foray into these sectors is unprecedented and has continued to bolster liquidity across fixed income markets. The fiscal support has also materialized after initial hurdles; the IRS / SBA are now sending out checks and processing loan applications faster than investors might have initially expected.

The S&P declined 34% from February 19, 2020 through March 23, 2020. It has subsequently rallied 27% since through April 14th. Both the drawdown and subsequent rally have been the swiftest in history.

Where Markets Go From Here?

At some point however, positive virus and policy datapoints will no longer constitute the key drivers of positive market performance. Corporate earnings / fundamentals will increasingly come into focus and this is why we expect high volatility to persist through the remainder of 2020, especially in late summer and through the fall. We describe this period as Phase II in the April 2nd memo (on page 7). At this point, we believe the probabilities are roughly equally weighted as to whether the S&P 500's next move recaptures the prior 3,400 peak or declines to the 2,200 lows.

- Investors have written off 2020 earnings as many view Q2 to be a disaster with modest recovery in Q3 followed by a sharper recovery in Q4. Q1 earnings season is just beginning but we view this as a likely non-event given the already negative investor perceptions regarding near-term earnings.

- The real questions are a) what will be the re-based 2021 earnings forecast and b) the earnings' growth rate across the next business cycle as compared to the cycle that was brought to a screeching halt by Covid-19. As a reminder, S&P earnings were projected at $175 for 2020 prior to Covid-19. Analysts have slashed estimates to $110-$130 for 2020. For 2021 (on which investors are currently focused), estimates average around $150 with a wide range of $130-$170, illustrating the potential degree of U vs. V shaped recovery scenarios.
- We would not expect to start having clarity about a likely range of 2021 earnings until later this fall. Many complex unknowns remain including a) the pace of economic reopening and any degree of virus flare-ups, b) the nature of, as well as continued changes in consumer and business behavior, c) potential protection from a potential vaccine, d) changes in supply-chain configurations and d) pace of labor market recovery.
- The US Presidential election may add volatility as well. While Joe Biden is undoubtedly less liberal than Bernie Sanders, he is currently running on a much less business-friendly platform than President Trump, and as the election approaches, we believe markets will increasingly focus on the potential outcomes.

Should Clients Add to Risk Assets at These Levels?

With the sharp snapback rally in equity markets, we want to update clients on our views regarding asset allocation and risk assets. Three weeks ago, with the S&P near 2,200, we viewed equities as quite attractive given low double-digit annual expected returns over a mid-term time frame despite historical levels of market volatility. Right now, we are much more circumspect.

- At the April 14th closing price of 2,846, the S&P 500 presently trades at 19x 2021 (guesstimated) earnings vs. a 20-year historical average of 16.2x. As a comparison point, at the February 19th peak of 3,386, the S&P 500 traded at 19.3x 2020 expected earnings. Therefore, by some measures, we view the S&P's valuation today as reasonably fairly valued with future returns driven by uncertain earnings growth rather than multiple expansion.
- We do acknowledge that price levels could go higher over the shorter term - equity multiples may inflate above current levels given a) the likelihood that interest rates remain at rock bottom levels for multiple years, and b) 2021 earnings still represent a below-trend level which would imply faster growth through the next business cycle – but again, 2021 earnings levels are still highly uncertain. So from a risk-adjusted perspective, these levels appear to be reasonably fully valued.

From a long-term standpoint (which we define as the next 7-years), we believe equities offer reasonable annual appreciation potential, with returns forecast at 6.0%-8.0%. However, these levels are far lower than the double-digit long-term annualized returns available a few weeks ago. Following the sharp Phase I market rally, with significant risks and likely volatility ahead, we believe investors should reserve dry power for potential equity buys at lower price levels. We recommend utilizing a framework whereby investors deploy reserves in pre-defined tranches across progressively lower price levels. If investors do wish to invest dry powder today, we would suggest allocations to less-correlated alternative strategies such as global macro and long-short credit.

We look forward to discussing these thoughts and to answering your thoughts about these and other topics.