Bitterroot
CAPITAL ADVISORS

Memorandum

To: BCA Clients and Friends
From: Sid Nadkarni, BCA CIO
Date: May 1, 2020
Subject: Recent Market Events – and Looking Forward

UPDATE OF MARKET DEVELOPMENTS AND OUR VIEWS (Since our previous April 14th Memo)

Dear BCA Clients and Friends,

We hope everyone is enjoying the start of spring and staying safe and healthy during these trying times. With the quarterly earnings season having commenced and countries globally starting to gradually loosen mobility restrictions, we anticipate potential for significant volatility over the coming months. Therefore, while the magnitude of financial markets' swings have recently subsided in the slightly more than two weeks since our previous April 14th memo, we want to continue to brief you on market and economic developments, and on our views going forward.

Health and Economic Developments

Thankfully, the Covid-19 virus is showing signs of subsiding globally, with curves flattening and the rate of new infections slowing. Anti-viral therapies such as Gilead's Remdesivir are showing incremental promise in aiding the recovery process. The Trump administration has launched "Operation Warp Speed" to focuson fast-tracking a widely available vaccine available by the end of the year. Several US states and many European countries are gradually loosening mobility restrictions in May and are anticipating increasing levels of activity through June, July and August. Clearly, the pace at which this activity increases, as well as any potential spike in re-infections, bears monitoring.

As expected, initial unemployment, GDP and other economic data have continued to worsen. US Real GDP declined by 4.8% annualized q/q, but was essentially flat YOY. Consensus forecasts are for Q2 to show much sharper GDP declines (potentially 30%-40% annualized!), with sequential recovery beginning in Q3 and accelerating in Q4 and into 2021. US Initial

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claims for unemployment have reached 30 million cumulatively, although weekly claim numbers have declined each of the last two weeks. Stimulus payments and expanded unemployment benefits have likely softened the blow for many. However, many small businesses have faced significant administrative challenges associated with procuring loans under the SBA programs.

Internationally, the economic data has also been increasingly grim. In Q1 2020, European GDP declined by 3.8% quarter/quarter (-3.3% year-over-year.). Canadian GDP is estimated to decline 2.6% quarter/quarter in Q1 and 9% month/month in March alone. The unemployment rate in Canada rose to 7.8% in March (the highest level since October 2010) vs. 5.6% the prior month, with some economists forecasting an increase to 14% by June. As in the US, most international governments have implemented different varieties of stimulus programs, attempting to mitigate the adverse economic effects.

Equity Markets Performance

Since our prior April 14th memo, equity markets have appreciated modestly with US small caps (Russell 2000) performing best at up 6.7%. Similarly, credit spreads have remained in a tight range as well. The S&P 500 appreciated 12.8% in April and is up 30.3% from the March 23rd low but remains 13.7% below the Feb 19th peak.

Earnings season has commenced in the US with several bellwethers across various sectors reporting March quarterly results. Company messaging was generally consistent with strong, better-than-expected underlying operating performance through February, followed by sharp declines in March extending into April. Encouragingly, however, several prominent companies (3M, Facebook) stated that results were showing signs of stability exiting April following the initial sharp declines. As expected, most companies have withdrawn both their Q2 as well as full-year 2020 earnings guidance, given the high uncertainty on continued virus-related impacts affecting supply, demand and other factors influencing financial results. In the following table, we highlight the performance of various equity markets since the beginning of the year and during the recent rally.

Equity Market Performance YTD	YTD to 30-Apr	19-Feb to 23-Mar	23-Mar to 30-Apr	23-Mar 17-Apr	17-Apr 30-Apr	% off 52-wk High	% off 52-wk Low
US Large Cap	-9.5%	-33.8%	30.3%	28.6%	1.3%	-14.0%	30.2%
MSCI EAFE (Intl. Dev.)	-17.8%	-32.7%	23.0%	20.2%	2.3%	-19.5%	22.4%
MSCI Emerging Mkt.	-16.6%	-31.2%	22.3%	19.1%	2.7%	-19.3%	22.0%
Russell 1000 Growth	-1.3%	-31.5%	31.7%	29.1%	2.1%	-9.9%	31.6%
Russell 1000 Value	-18.5%	-38.1%	30.2%	28.7%	1.2%	-20.2%	29.8%
US Large Cap	-9.5%	-33.8%	30.3%	28.6%	1.3%	-14.0%	30.2%
US Small Cap	-21.1%	-40.7%	30.9%	22.8%	6.7%	-23.1%	32.3%

During the rally since the March 23rd lows, the US has substantially outperformed international equity markets. This outperformance has been driven by a) US higher weighting to more resilient companies in technology, e-commerce (Amazon, Microsoft) and b) a larger, swifter fiscal policy response. US large-caps and growth stocks have outperformed small-cap and value stocks for the reasons mentioned above as well as having stronger balance sheets. As such, Intl. and Value stocks remain further away from their 52-week highs. This performance dispersion could reverse should a cyclical V-shaped recovery manifest itself.

Equity Markets Valuation – What are Markets' Implied Expectations for Earnings?

Since the March lows, equity markets have rallied roughly 22%-30% despite economic and corporate earnings fundamentals steadily worsening. As we highlighted in previous memos, equity markets tend to bottom 3-9 months ahead of economic fundamentals and corporate earnings, so this initial Phase 1 rally was reasonably expected (in direction, if not in speed and magnitude). *However, as economic activity begins to ramp up, investors' focus will migrate from health and policy-related items to corporate earnings trajectory.*

In the following table, we detail our earnings expectations and calculate prevailing market valuations (based on our earnings expectations), comparing them against historical valuation averages.

	BCA - Equity Market Earnings Est.				Equity Markets Valuation Multiples				
	Index Price	Pre-Covid "Trend"* Earnings	BCA NTM Earnings*	BCA 2021 Earnings*	Pre-Covid "Trend" P/E	NTM P/E	2021 P/E	Last 20 Yr Avg. NTM P/E	Last 10 Yr Avg. NTM P/E
US Large Cap (USD)	2,912	177	131	150	16.5x	22.2x	19.4x	15.8x	15.3x
Stoxx 600 Europe	347	27	16	21	12.9x	21.4x	16.5x	13.8x	13.1x
Japan Topix	1,450	110	72	88	13.2x	20.1x	16.5x	14.8x	13.4x
MSCI EM (USD)	920	78	59	68	11.8x	15.6x	13.5x	11.0x	11.1x

** Trend Earnings based on 2020 est. pre-COVID. BCA NTM and 2021 are lower than current consensus estimates as sell-side analysts have not adjusted 2021 forecasts yet*

NTM and 2021 equity valuation multiples are well above recent historical averages. However, on a trend-EPS basis, valuations are in-line with averages, while interest rates are at all-time lows. Investors' perceptions of how quickly earnings return to trend will dictate equity markets' performance from here onwards.

BCA NTM & 2021Earnings as % of Pre-Covid Earnings

	BCA NTM Earnings*	BCA 2021 Earnings*
US Large Cap (USD)	74.0%	84.7%
Stoxx 600 Europe	60.0%	77.8%
Japan Topix	65.5%	80.0%
MSCI EM (USD)	75.6%	87.2%

Key takeaways from the above table include:

- Equity markets look expensive based upon valuation multiples associated with Next-Twelve-Months (NTM) or 2021 earnings estimates.
- However, when looking at Pre-Covid "Trend" earnings, multiples appear much more reasonable and in line with historical averages
    - Investors are looking past 2020 (given the shutdown of many economies and the "one-time" lost earnings). Most investors likely understand that 2021 earnings may also be below-trend as the recovery will not have fully picked up steam. *Hence, we believe that investors are pricing in a recovery to pre-Covid "Trend" earnings by 2022. At this point, it is far too early to determine whether this assumption is likely to be met or not.*
    - Interest rates are at all-time lows and are likely to remain low for the next several years. One can certainly argue that given that interest rates are well below historical averages, equity market multiples should trade at premiums on normalized earnings to history (i.e. a 20x multiple of $177 trend earnings is more appropriate for the S&P 500 instead of 16x).
        - We expect equity multiples to trade well-above historical averages over the next two years, given the combination of depressed earnings, extremely low interest rates, and unprecedented fiscal stimulus and central bank intervention.
- We reiterate our prior view that the S&P 500 has roughly equal probablities of moving upwards towards the prior $3,400 high or retesting the March lows of $2,200 over the

next six to twelve months. Furthermore, we anticipate continued bouts of volatility. *As such, we recommend investors keep dry powder to opportunistically purchase equities at lower prices.*

Large-Cap Tech / E-Commerce Stocks vs. Levered Small-Mid Caps

As seen in the table below, many high-quality companies across multiple sectors are up YTD and have recovered to trade near all-time highs, while several smaller-to-mid cap companies are still trading 35%-50% below 52-week highs (especially those with weaker balance sheets and exposed to industry sectors more affected by Covid-19).

- While we still advocate exposure to higher-growth, high-quality stocks for the long-term, we acknowledge that shorter-term upside potential is more limited following 30%+ appreciation for many since the March lows.
    - In contrast to the initial panicked stages in March, the market has become much more discerning between sectors that may benefit and those that may be harmed (both short-and-mid-term) under these conditions.
- With stimulus and Federal Reserve programs continuing to expand, we would suggest investors consider a barbell approach that includes selective tail exposure to certain small/mid-cap stocks likely to emerge from the COVID-19 crisis with earnings power intact. Well-off their 52-wk highs, these stocks still have significant appreciation potential (50% to 75%) but also have much higher risk. Active management with in-depth research around debt levels and liquidity stability will be crucial in selecting these stocks.

Large Cap Tech / E-Commerce vs. Levered Small/Mid Caps					
	YTD - 30-Apr	19-Feb 23-Mar	23-Mar to 30-Apr	% off 52 Wk. High	% off 52 Wk Low
Large Cap Tech / E-Commerce					
Amazon	31.4%	-12.3%	30.0%	0.0%	47.6%
Apple	-0.9%	-30.7%	31.1%	-10.2%	31.0%
Microsoft	13.3%	-27.4%	31.8%	-5.0%	32.6%
Alphabet	-0.6%	-30.9%	27.8%	-11.7%	27.7%
Facebook	-0.8%	-31.9%	38.2%	-8.5%	40.0%
Levered-Small and Mid Caps					
	YTD 30-Apr	19-Feb 18-Mar	18-Mar 30-Apr	% off 52 Wk. High	% off 52 Wk Low
Boyd Gaming	-44.2%	-77.0%	112.9%	-52.0%	112.9%
US Foods	-48.7%	-75.6%	121.2%	-49.8%	121.2%
Aercap Holdings	-54.2%	-75.9%	85.7%	-55.2%	85.7%
Colfax	-29.1%	-60.0%	76.2%	-33.7%	76.2%
Marriott Vacations	-35.5%	-71.0%	125.5%	-35.9%	115.6%

The Large-Cap tech and ecommerce stocks have largely recovered their losses and trade only slightly below their 52-week highs. However, small-to-mid-cap levered stocks, especially those oriented towards industries affected by COVID-19 declined massively over a one-month period. Although several are up 75%-120% since, many still remain well below their 52-week highs.

Asset Allocation Outlook

We reiterate our views as stated in our previous April 14th memo. Long-term annual equity returns (we define as the next seven years) are modestly attractive at 6%-7%, with potential upside in a lower-for-longer interest rate regime. However, given the 30% appreciation since the March lows, we advocate a patient approach to adding exposure when volatility-driven opportunities present themselves. We continue to recommend adding allocations to liquid global macro and long-short credit hedge funds. Finally, we are increasingly interested in highly attractive opportunities emerging in direct lending and distressed credit (a topic we will cover in depth in our upcoming quarterly capital markets and economic review).

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