TFC FINANCIAL
The Financial Counselors

MARKET UPDATE
May 7, 2020

OUR VIEW

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Market Update

Equities rallied dramatically in April, continuing the recovery that started in late March. The S&P 500 Index gained more than 12% for the month, rebounding more than 30% from its March lows. Non-U.S. equities also rebounded.

The stock market rally may seem inconsistent with the economic reality of skyrocketing unemployment and collapsing GDP growth. However, the divergence between economic indicators and stock market performance is not unusual. Stock prices are forward-looking indicators and often rise in advance of an economic recovery. Aggressive policy actions by the Federal Reserve and fiscal assistance provided by the CARES Act played an important role in stabilizing investor expectations. Government and central bank support reduces the near-term risk that liquidity challenges will create a wave of personal bankruptcies and business failures. Optimism about progress in slowing the pace of Covid-19 infections and the mobilization of efforts to identify therapeutic treatments also boosted investor sentiment.

Despite the recovery from the market's March lows, we remain cautious about the near-term outlook for equities. Being "allowed" to go to stores, restaurants and airports is an important start, but many people will hesitate to do so until the health risks have been reduced. Economic activity should pick up with a gradual easing of social distancing measures, but many businesses will re-open at less than full capacity. Consequently, the rebound in employment and economic activity may be slower than hoped and the bleak economic indicators reported in March and April are likely to get worse before getting better.

With a vaccine likely to be a year or more away, progress in containing the Covid-19 pandemic is a necessary condition for the stock market rally to continue. Without widespread and reliable testing, rapid contact tracing, and effective treatment capabilities, it will be difficult to resume activities we used to take for granted. A careful return of social interaction, progress in testing for Covid-19, isolating and treating the sick, and contact tracing would be a recipe for markets to rise during the rest of the year.

There are a variety of risks we are monitoring. A second wave of infections is possible as social distancing requirements are loosened. The CARES Act offsets some of the economic damage caused by the economic "lockdown" resulting from the first wave of infections but would be insufficient if another shutdown becomes necessary in the fall. Election-year politics may make additional fiscal support harder to negotiate, magnifying the market risk if the pandemic isn't contained.

Although we have shared our favorable opinion of the support provided by the Federal Reserve and U.S. Congress, some governments are falling short of what is needed to combat the economic damage caused by the pandemic. Spain, Italy, and France are among the countries that may need to do more to support their ailing economies. The flawed structure of the Euro Area – which has monetary union without fiscal union – creates political complexity that makes it difficult to respond with the necessary speed to an economic crisis. Throughout the world, we worry that the longer that social distancing lasts, the greater the likelihood that "temporary" job losses become permanent.

Of the wide variety of possible future events, two extreme scenarios are possible: a severe bear market in equities that lasts longer than currently forecasted or a rapid recovery in equities that leads the markets to new highs. Although we think the most likely outcome lies somewhere between the

Our expectations about the timing, nature, and magnitude of the recovery from the pandemic led us to make changes that we think will better balance risk and return in a volatile and uncertain environment. Notably, we have reduced our holdings in small company stock funds and to funds that have significant holdings of highly cyclical and/or highly indebted segments of the

two extremes, in positioning portfolios we are attempting to strike a balance between protecting further downside risk and the risk of missing opportunity. Consequently, our portfolio adjustments have been gradual in nature and we are not trying to "time" a market top or bottom.

The economy seemingly shifted overnight from expansion to recession. Our expectations about the timing, nature, and magnitude of the recovery from the pandemic led us to make changes that we think will better balance risk and return in a volatile and uncertain environment. Notably, we have reduced our holdings in small company stock funds and to funds that have significant holdings of highly cyclical and/or highly indebted segments of the stock market. In these uncertain times, it may be appropriate to prioritize liquidity and capital preservation over investment options that offer the highest but most uncertain potential returns. Recent portfolio additions include funds that are quality-focused – seeking companies with strong business models, balance sheets that can hold up under stress, and the ability to rebound in what is likely to be a very different world when the pandemic ends. We believe there will be a significant performance dispersion between high quality companies and weaker, higher leveraged, less profitable companies during and after the recovery.

TFC will be adding two actively-managed international large cap growth funds to the portfolio: Baillie Gifford International Growth fund and ClearBridge International Growth fund. Baillie Gifford is a fund manager headquartered in Scotland, that believes their distance from financial centers allows them to screen out "market noise". Their investment philosophy is to seek long-term growth; they allow themselves the opportunity to invest outside of the benchmark to find high potential investment opportunities. Baillie Gifford has low turnover in the portfolio, investing 50% in rapid, transformative, and disruptive names, and 50% in durable, compound growth names. This concentrated portfolio focuses on disruptive innovation and should pair well with ClearBridge's core "growth at a reasonable price" orientation.

ClearBridge believes in the short term, markets are inefficient in accurately valuing growth companies, and believe investing in high quality companies with attractive growth characteristics will yield superior returns over time. Using both qualitative and quantitative analysis, ClearBridge researches companies, their management team, and their financials to identify growth companies that may be underpriced by the market. Quality managers have held up well in this volatile market, and ClearBridge's focus on high quality companies with low leverage makes their fund a desirable addition to TFC portfolios.

It is important to avoid overreacting to the latest headlines, as the coming weeks (and months) are likely to be an emotional rollercoaster. In that spirit, we want to share a reminder from Artisan Partners' Portfolio Manager Dan O'Keefe: "the value of a business is the present value of all future cash flows, not just those over the next few months." That context is important as we think about the long-term outlook for markets and positioning of client portfolios to achieve lifelong financial goals. Things may get worse before they get better, but dislocations like what we're experiencing have often been buying opportunities. In portfolio terms, we continue to balance between "offense and defense."

Please contact me or your TFC advisor with any questions.

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