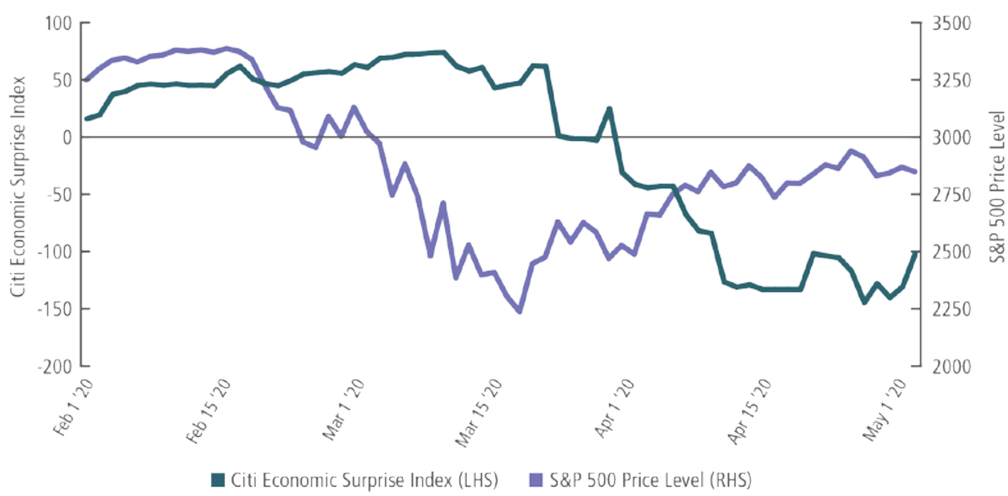
Where Do We Go Now?

It's been more than 50 days since the S&P 500 index reached its market bottom on March 23, 2020, having fallen into bear market territory in a record 16 trading days from its February peak. As of mid-May, the S&P 500 was up 31% since its trough, and in-line with September 2019 levels, while the tech-heavy NASDAQ index was up 7% for the year.*

This is all rather eye popping when one considers the current macro-economic backdrop. The unemployment rate has risen to a historical 14.7%, the highest since records began in 1948, wiping out over nine years of jobless gains in less than a month, while the Citi Economic Surprise Index, which measures the pace at which economic indicators are coming in relative to consensus forecasts, has reached a historical low.

As of mid-May, the S&P 500 index was up 31% since its trough. Meanwhile, the unemployment rate has risen to 14.7%.*

EXHIBIT 1: OPPOSITE DIRECTIONS



Source: Bloomberg, Citi Economic Surprise USA Index, S&P 500 Index.

* As of May 12, 2020

In the recent rally, market leaders have been the large cap stocks that were significantly outperforming before the COVID-19 outbreak, resulting in a surge in already elevated market concentration. As of mid-May, Value (Russell 1000 Value) trailed Growth (Russell 1000 Growth) by 20%, the third widest spread based on calendar year returns going back to the 1970s. While the S&P 500 was 13% below its February record peak, the median underlying stock traded 21% below its historical high. The five largest companies (Microsoft, Apple, Amazon, Facebook and Alphabet) made up 21% of the S&P 500, exceeding the 18% level reached in March 2000.* As a result, prospective earnings multiples, currently based on pre-pandemic estimates, have reached a 19-year high.

EXHIBIT 2: PROSPECTIVE EARNINGS MULTIPLES

Source: Bloomberg, BEST P/E Ratio as of May 2020.

It feels a bit painful to pay a historical premium to invest into an arguably decelerating market with a multitude of economic unknowns, yet maintaining equity exposure during this inflection period is critical to growing assets over the long-term.

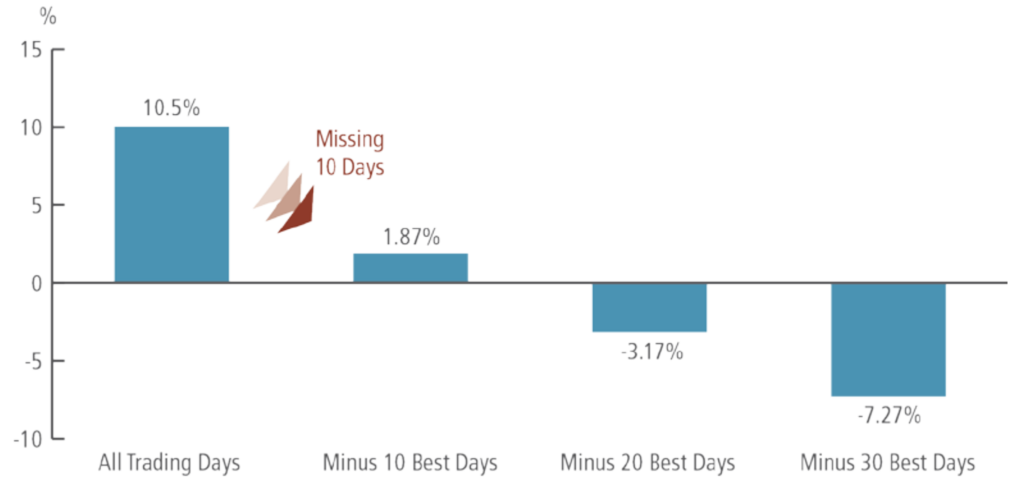
Historically, sharp declines in market breadth have signaled periods of market reversals / drawdowns. Narrow breadth can last for extended periods of time, however past episodes have signaled below average market returns and eventual momentum reversals leading to larger than average prospective drawdowns. In addition to the Tech Bubble, breadth narrowed ahead of the recessions in 1990 and 2008 and the economic slowdowns of 2011 and 2016.

For investors looking to put money to work, where does one go? It feels a bit painful to pay a historical premium to invest into an arguably decelerating market with a multitude of economic unknowns, yet maintaining equity exposure during this inflection period is critical to growing assets over the long-term.

* As of May 12, 2020

EXHIBIT 3: MISSING JUST A HANDFUL OF TRADING DAYS CAN GREATLY IMPACT LONG-TERM RETURN

Annualized 20-year return



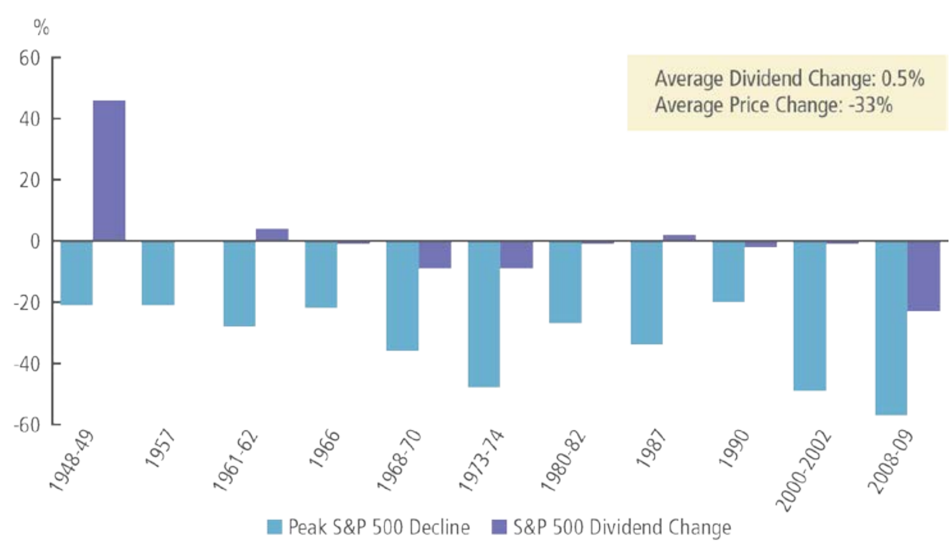
Source: Bloomberg, S&P 500, as of April 1, 2020.

We note that in recessions, the difference in stability (or lack thereof) of prices compared to dividends is striking.

Timing the market "bottom" during this turbulent environment is tempting. However, historically the worst trading days have clustered near the best making market timing nearly impossible for even the most seasoned investors. For example, equities were down 12% overall in March 2020. Yet three of the best days of equity returns since 1933 and six of the best trading days over the last ten years also occurred that month. As the chart above illustrates, missing just a handful of these days can significnatly impair long-term annualized return.

Within equities, allocating funds to sustainable dividend income stocks appears attractive amid the current historically low-rate environment, given the stability and insulation dividends can provide from price fluctuations. We note that in recessions, the difference in stability (or lack thereof) of prices compared to dividends is striking.

EXHIBIT 4: DIVIDENDS PAID ARE FAR LESS VOLATILE THAN SHARE PRICE



Source: Bloomberg.

Together, the Information Technology and Consumer Discretionary sectors make up over 35% of the S&P 500 Index. The trailing dividend yield of these sectors is less than 1.5%. As a result, the S&P 500 Index may not be equipped to provide adequate dividend income for many investors. The largest dividend yields typically come from sectors that make up smaller segments of the broader market, namely Utilities, Real Estate, and Consumer Staples. As one can see in Exhibit 5, over the last two years, dividends significantly helped boost the returns from these sectors.

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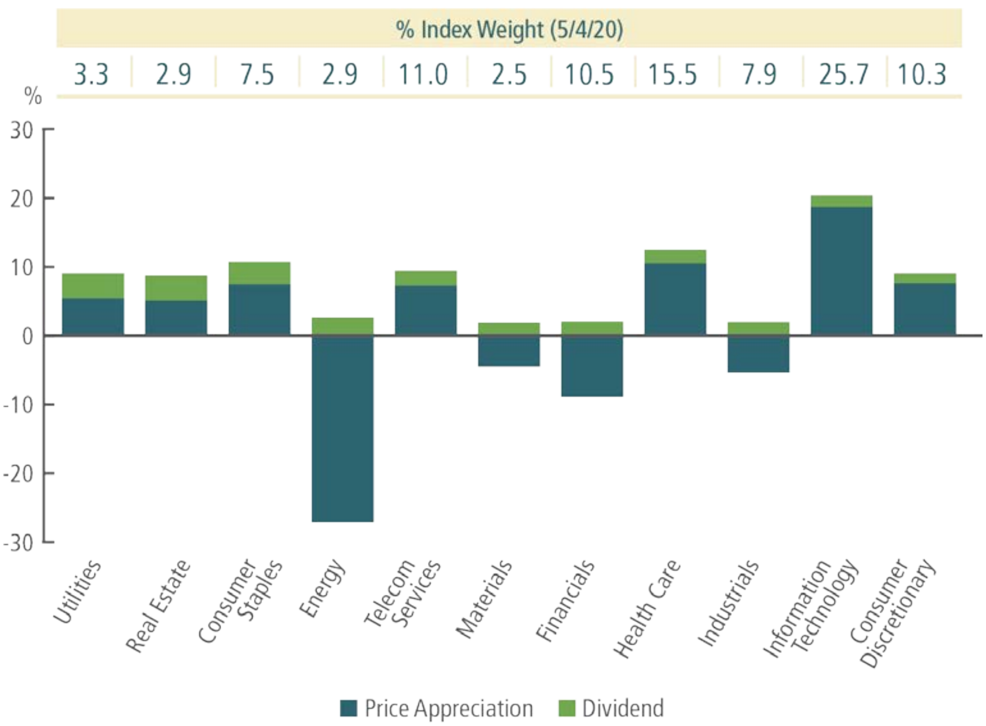
EXHIBIT 5: BIGGER INCOME FROM THE SMALLER SECTORS



Source: Based on 2-year trailing period as of April 30, 2020, eVestment.

Lastly, now more than ever it is critical to consider valuations and the underlying fundamentals of companies you are investing in, particularly when searching for dividend income. It is important to look beyond dividend yield and consider whether a company has the earnings profile to continue to support their dividend payout. A sustainable dividend-aware allocation can bolster equity diversification with respect to sector concentrations inherent in the market cap weighted index. Moreover, it may provide the extra income boost needed for those who are searching for yield in this low-rate environment.