First Quarter of 2020, not perfect vision

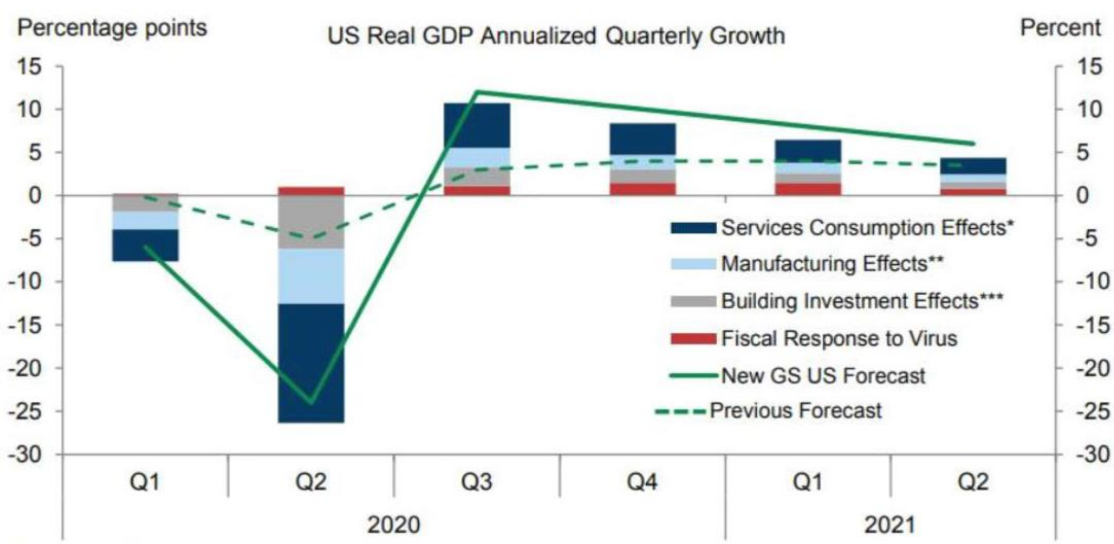
Unprecedented Modern Pandemic leading to Market and Economic Uncertainty

The first quarter of 2020 was defined by the COVID-19 global pandemic and extreme rates of change, as central banks around the world moved rapidly to contain the fallout. We believe echoes of this pandemic will reverberate in our society, economies, and markets for years to come. Little is known about the virus other than that it is extremely contagious. Symptoms vary widely along with severity. This, combined with a lack of testing volume and reliability has led to divergences in how authorities handle the pandemic, creating further uncertainty for when and how various global and local jurisdictions exit social distancing policies which are needed before the economy reawakens. Due to the interconnectivity of our global supply chain, we believe the cadence of the economic restart will be disjointed.

An Economy sheltered in place

The social uncertainties arising from this pandemic have had a devastating effect on the economy. To illustrate the uncertainty, second quarter GDP growth rates for the US range from -5% to -35%; typically, these estimates are within basis points of one another. The graph below illustrates the composition of the likely economic impact on US GDP.

Exhibit 3: A Sudden Stop in Q2, Followed by a Gradual Recovery



* Includes cutbacks to consumption categories requiring face-to-face interaction.
** Includes reduced domestic and foreign demand for goods, supply chain disruptions, and plant shutdowns.
*** Includes cutbacks to structures investment, homebuilding, and home sales.

Source: Goldman Sachs Global Investment Research

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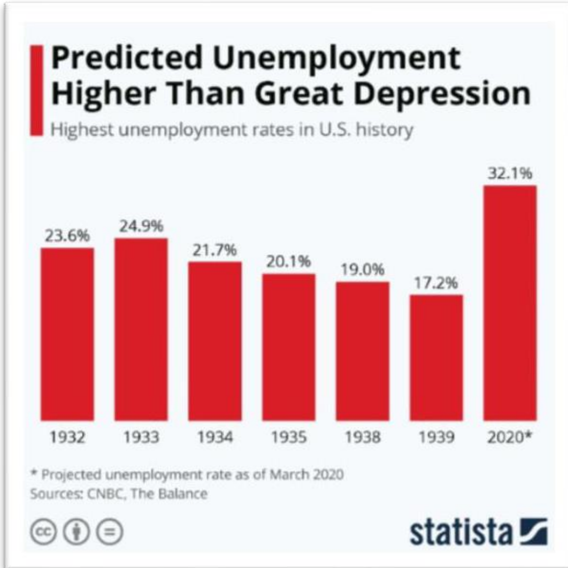
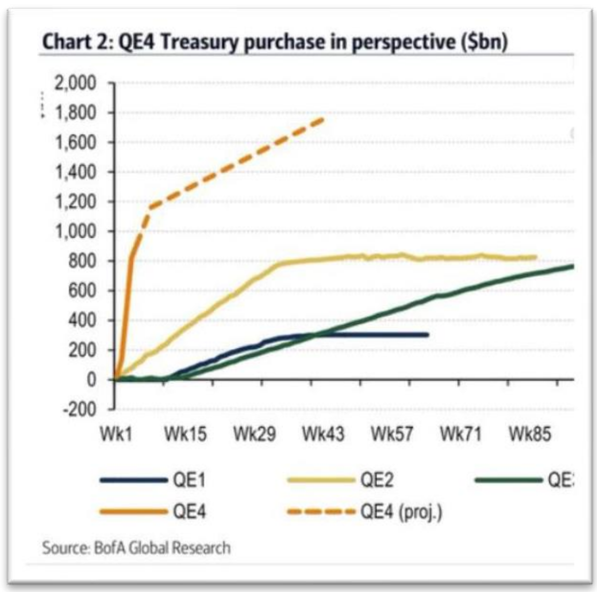


Unprecedented Unemployment

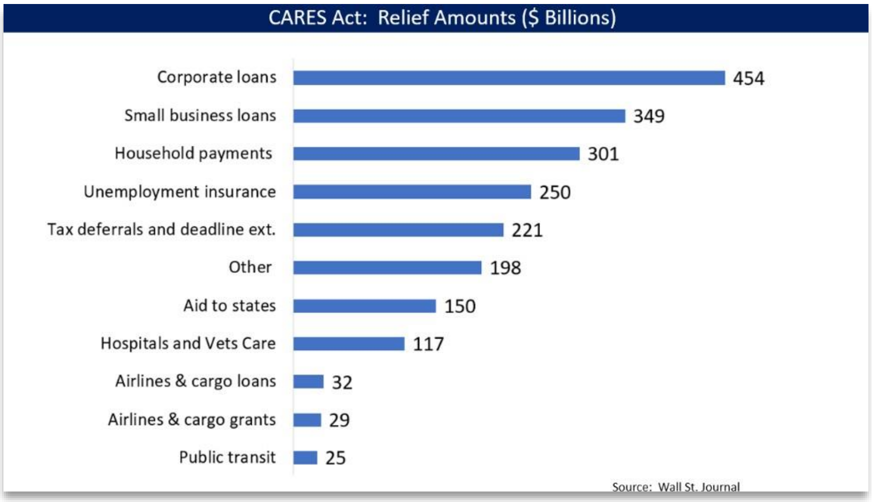
In a matter of weeks, unemployment has spiked to levels we would expect to see over years in a typical recessionary environment. While the peak unemployment rate might be the highest ever seen (including the Great Depression) it is due to a temporary economic freeze rather than a decline in business conditions. Given the fiscal and monetary stimulus, combined with coordinated efforts to forgive delinquent payments, the economy should avoid a rash of bankruptcies. This presumes quarantines largely end by early to mid-summer.

Massive Monetary Stimulus

The Fed and other Central Banks have demonstrated a willingness to do 'whatever it takes.' In the US this includes: lowering the Fed Funds, lending to securities firms through the primary dealer credit facility, backstopping money market funds, backstopping commercial paper and overnight repo markets, direct lending to banks, relaxing regulatory requirements, direct lending to large employers, lending to asset backed securities investors, backstopping munis, providing international swap lines of credit to foreign banks, and purchasing treasuries through their quantitative easing programs. To provide some context on the level of quantitative easing, the chart to the right illustrates how today's QE program surpasses prior programs both in size and speed.



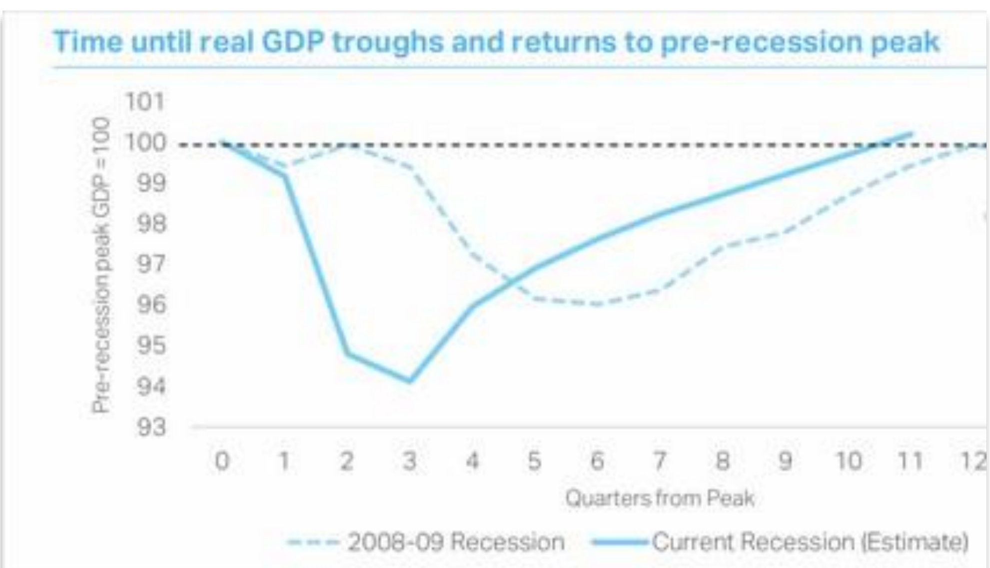
Global Wartime Fiscal Stimulus



Likewise, economic stimulus programs that existed as little more than theory at the end of last year are now being rolled out en masse. The United States' $2 Trillion fiscal stimulus package is the largest of G20 countries' efforts, which exceed five trillion in total. These packages are primarily designed to stimulate consumption not business bailouts. This level of federal spending, similar only to world wars, has previously led to inflation. In an inflationary or reflationary environment, stocks are typically the best performing asset class.

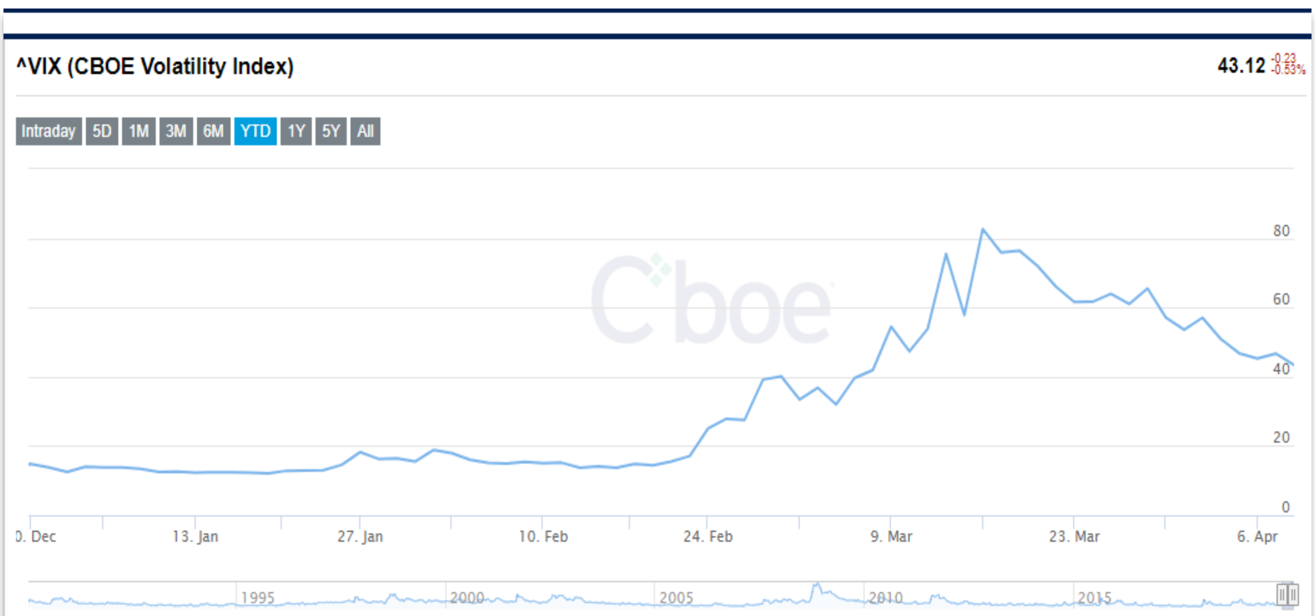
Anatomy of a Bear Market

Bear markets are generally classified into one of three categories: event driven (like 9/11) which are short lived (9 days) and quick to recover (15 days), cyclical which have slightly longer length (27 days) and recovery (50 days), and finally structural which has the longest length (43 days) and recovery time (111 days). The challenge we face today is that a cyclical bear market, could result in structural unemployment, particularly in vulnerable sectors such as hospitality and transportation. The below chart illustrates the depth and length of the current recession relative to the 2008 financial crisis.



A market's reaction to little clarity

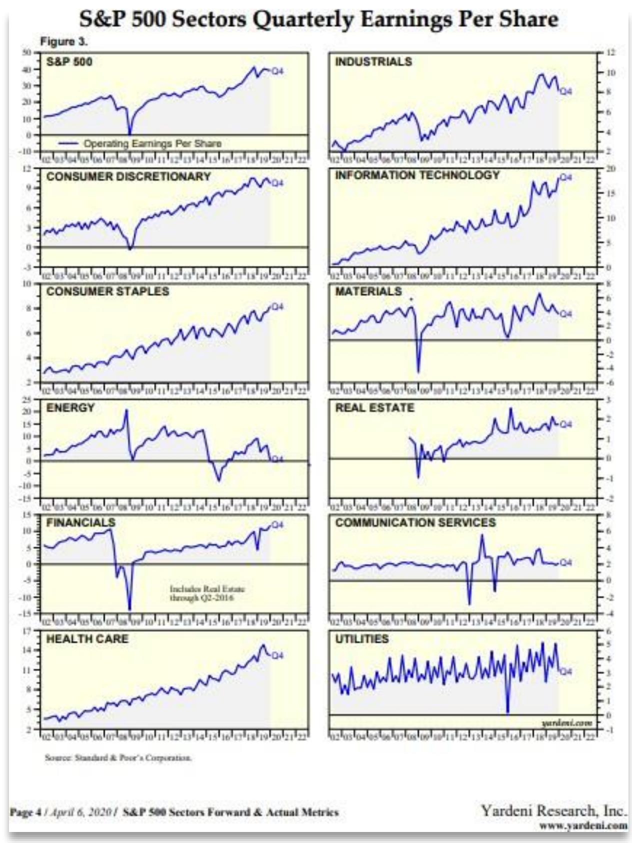
Lack of clarity surrounding the lasting economic and social implications have left market participants in the dark in developing their own estimates and hypotheses. The CBOE Volatility Index (VIX), known as Wall Street's fear gauge, is the market's expectation for volatility of the S&P 500. The VIX traded between 43 and 65 from late March to early April after a record closing high of 82.69 on March 16. We are monitoring the VIX and believe that the market could continue to exhibit wild daily fluctuations until the VIX stabilizes below 40. Based on April 9th trading levels the market doesn't expect the VIX to drop below 40 until the April 22nd contract expires. To provide context, the historical average VIX closing price is in the mid-teens. Additionally, the market doesn't expect the VIX to trade below 30 (or twice the standard levels) until the end of the year. This implies further volatility, creating opportunities for the strategic investor to pick entry points in a disciplined and intentional manner. The upcoming Presidential election and potential tax and regulatory rollbacks further create market uncertainty and the business climate.



Symbol	Expiration	Last
^VIX	-	43.23
VXJ20	04/15/2020	42.15
VX16J20	04/22/2020	39.40
VX17J20	04/29/2020	0.00
VX18K20	05/06/2020	0.00
VX19K20	05/13/2020	0.00
VXK20	05/20/2020	37.95
VX21K20	05/27/2020	0.00
VXM20	06/17/2020	35.55
VXN20	07/22/2020	33.10
VXQ20	08/19/2020	31.60
VXU20	09/16/2020	30.80
VXV20	10/21/2020	30.65
VXX20	11/18/2020	29.27
VXZ20	12/16/2020	28.50

Not all Earnings are Created Equal

The current crisis has highlighted to many investors what we have known (and implemented) for years – portfolios tilted towards Consumer Staples, Healthcare, and Technology stocks are built to withstand a variety of economic scenarios. These are the top three performers year-to-date, down only 14.5%, 15.9% and 16.1%, respectively. Much of this outperformance can be attributed to the *consistency* of earnings. In the graphic below, those three sectors – Consumer Staples, Healthcare, and Information Technology – clearly standout due to the smooth trajectories of their earnings per share. In times of uncertainty, investors 'pay-up' for stable and projectable businesses. An additional benefit of owning such companies is the security of their dividend, a paramount consideration in our stock selection process.



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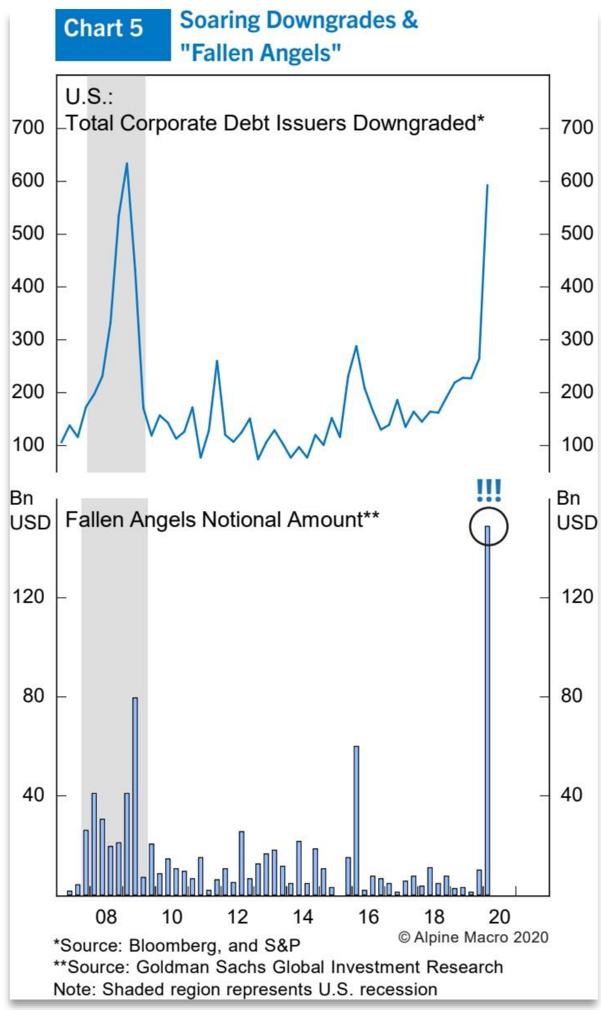
Quality matters

In recent weeks, almost every money management firm has been running tests on their portfolio companies, identifying those with 'high quality' and 'durable' balance sheets to ride out this lockdown. Since the epidemic began there have been six hundred corporate credit downgrades with a record amount of $150 billion in notional value. Additionally, roughly half of investment grade debt is one notch above junk. However, as dividend-focused investors, balance sheet strength is a requirement for our portfolio companies and one of the first factors we examine at the beginning of our research. Yet, it would be unwise to solely look at balance sheet strength to determine a company's ability to withstand an elongated business interruption; it is inefficient drag on any company to hold more than a few weeks' worth of cash on hand. What *really matters* is the durability of revenues, earnings and cash flow. Today, many companies are conserving cash by eliminating share buybacks, dividends, and discretionary purchases. But our investors can take solace in the fact that, our portfolio companies should be able to maintain their capital allocation policies largely because of the consistency of their revenue and earnings streams.



As an example, take two companies that often fall into our investment universe, Nordstrom (NYSE: JWN) and Tyson Foods (NYSE: TSN). Both companies have similar leverage and payout ratios, and both have a strong history of maintaining dividends through crises, demonstrated by over 25 years of consecutive dividend payments. However, Nordstrom eliminated its dividend and suspended share buybacks on March 23 in order to preserve cash. Tyson, on the other hand, announced over $60mm in bonus payments to frontline employees on March 31, a stark contrast to Nordstrom's capital allocation. Tyson's ability to maintain its dividend, and even increase pay for their workers during a crisis is a function of their business model and operating consistency – two critical components that we analyze during our research process. Rest assured, our focus on dividend safety and downside protection continues to be an indispensable portion of our philosophy and it is reflected in our portfolios.

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What does the Second Quarter bring

We are prepared for a long bottoming process (a U or L shaped recovery vs a V shaped). It is likely S&P March lows in the range of 2200 to 2400 will be tested again. We are encouraged by of the slowing rate of growth in new COVID-19 cases in critical areas like NYC and Italy, however, we are monitoring data for reinfections and an ensuing policy response related to relaxing lockdown restrictions. Additionally, for the market to signal a lasting bottom in risk assets we believe the VIX must fall below 40. During the second quarter we will look to continue to deploy cash and reposition the portfolio opportunistically. We do so through our consistent research process resulting in a portfolio of companies with durable balance sheets and sustainable earnings.

Try to enjoy the additional time with your loved ones or the opportunity to explore new endeavors and above all else stay safe. Know that the team at Brookmont is focused on navigating these markets and are happy to answer any questions or share additional thoughts on the markets and our portfolios.