SILVERCREST
ASSET MANAGEMENT GROUP

U.S. ECONOMIC & MARKET REVIEW—MARCH 2020

This was an atypical month and we believe communication is critical in times of uncertainty. At Silvercrest, we quickly convened conversations with medical experts as well as our Investment Policy & Strategy Group. What follows is our best assessment of the state of affairs in the U.S. and global economy, the U.S. stock market, and our understanding of the coronavirus—COVID-19. We expect volatility and disruption to the economy and earnings in the near term and for positive trends to emerge as the effects of the virus diminish. We encourage all readers to reach out with comments and discussion with our deeply experienced roster of investment professionals.

VIRAL FEARS

Until recently, the equity market covered a lot of ground without a meaningful correction. A decline of this magnitude has not occurred since late 2018. The pace of descent is reminiscent of the late days of 2018, when complex trading strategies were attributed as causing the sharp moves lower. More fundamentally, recent potential widespread disruption from the COVID-19 virus drove a downward adjustment of economic and earnings expectations. There only have been four other weekly declines of −10% since World War II, according to Bespoke Investment Group. These were during the 1987 crash, the 2000s tech bubble, the 2001 terrorist attacks, and the 2008 global financial crisis. One must ask if COVID-19, while scary, merits comparable fear. A more likely assessment is that the fear of a global pandemic collided with equity markets that were at all-time high levels and contending with a heated election season. That a correction ensued is no surprise and likely overdue following a 2019 calendar year where the S&P 500 was up 31.5%. The S&P 500's decline this week follows a long advance and, as of Friday, February 28, leaves stocks down 8.3% on the year of 2020; up 7.9% over the past 12 months; and up 32.8% over the past three years (cumulative).

	YTD	12-Month	3-Year
S&P 500 Total Return	-8.3%	7.9%	32.8%

FEBRUARY & ONWARDS

February was a cruel month for equity investors, yet the drivers of the long-lived U.S. expansion remain in place. U.S. economic data from prior weeks and months was increasingly strong, following a slowdown. We expect upcoming economic releases will be volatile and confusing. Stock valuations have declined, and earnings expectations will adjust downward, although stocks continue to offer a good value proposition relative to bonds. COVID-19 will probably spread and linger, contributing to volatility, but as we learn to manage the disease, we expect a more normal economic environment to return, and with it, continued slow growth for the economy and earnings.

COVID-19

COVID-19 is new in many locations. We do not know how long it will last, how many people it will infect, or how severe and deadly the outlook. The *South China Morning Post* reports 65,914 cases of COVID-19 in Hubei and 78,959 cases throughout China. Without minimizing the suffering and death caused by COVID-19, it is perhaps not readily apparent to those of us in the Western Hemisphere that

Hubei has a population of 58 million and China's population is 1.4 billion. In other words, roughly one person in every one thousand has been infected in Hubei province. Overall, in China, the infection rate, to date, barely registers.

At the outset of this pandemic, we knew little of the disease's severity, and the Chinese responded forcefully. This bought the world valuable time to learn more, to prepare defenses, and to investigate treatments and vaccines. While treatment and a vaccine are too far off to play a role this winter, learning has increased. To that point, we are familiar with the flu, which kills tens of thousands of Americans each year. We have learned to cope with and take measures against its recurring annual season. It is incorrect, however, to dismiss COVID-19 as simply another version of the flu. For instance, a report in the *Journal of the American Medical Association* now estimates a fatality rate of 2.3%, with strong differentiation between older and younger age groups. For those under the age of 60, and with no pre-existing respiratory issues, the prognosis is less frightening. A recent *New York Times* piece was headlined "Most Coronavirus Cases Are Mild. That's Good and Bad News."

We are fortunate at Silvercrest to have access to and rely on a wide network of expertise. Drawing on discussions with experienced professionals, our understanding is that it is highly probable that COVID-19 spreads further, with an expectation of it being less common than the flu, albeit somewhat more severe, especially for at-risk groups. The best advice here is to practice good personal hygiene at a level of vigilance above and beyond a normal cold and flu season.

THE ECONOMY

Presently, pure U.S. domestic measures are holding up, although we expect a dip as a result of the virus's influence. This will depend on the spread of the virus, the magnitude of behavioral changes, and whether COVID-19 becomes widespread in the U.S. A reasonable working assumption would be for maximum disruption to be reflected in Q1 and mid-Q2 data, with a slow grind to normalcy thereafter.

Recent economic data points have been mostly positive. The University of Michigan Index of Consumer Sentiment registered a reading of 100.9, an increase over January and just near peak levels for this expansion. Labor participation rates continue to increase and job growth as reported in early February was strong—nonfarm payrolls rose 225,000, while participation rates inched higher to 63.4%—the highest since 2013.

The Empire State and Philadelphia Fed Manufacturing Indices posted significant gains, pointing to positive momentum. While measures of activity in housing data released in February were mixed—permits up, starts down—the overall trend in housing has been favorable. After four years with little change, housing starts have been improving since late summer 2019. Producer prices rose in January and posted a 2.1% advance over the last 12 months.

Core prices, excluding food and energy, rose 1.7%. Those figures are well within the Federal Reserve's tolerance ranges and consistent with its current no-action stance on interest rates for 2020, although it may look to ease in reaction to upcoming data. Nonfarm productivity was up in Q4 2019, with the full year seeing an advance of 1.8%. Productivity is an important driver of economic growth, so this metric's improvement is encouraging.

Yet challenges abound. The group IHS Markit publishes a services index which declined 4 points to a six-year low, just below expansion territory. Markit's Chief Economist stated that "the deterioration was in part linked to the coronavirus outbreak, manifesting itself in weakened demand across sectors such as travel and tourism, as well as via falling exports and supply chain disruptions."

Most reports from China indicate slow progress, but progress nonetheless toward re-opening supply chains and the economy. Markets will face a challenging time sifting through a mix of messy data. Prior to COVID-19, the U.S. economy was clearly on sound footing, if not accelerating a bit.

The Wall Street Journal reported on February 27 that Starbucks has re-opened 85% of their 4,000 stores in China. Apple has also been re-opening stores and factories. Anecdotes and charts of various Chinese economic metrics show similar moves off the bottom. They are all still a long way from full recovery but are moving in the right direction. Below is a table of data obtained through Macrobond, provided via the Chinese Passenger Car Association. It shows a small but visible uptick in Chinese vehicle sales and registrations.

CHINA, DOMESTIC TRADE, VEHICLE SALES & REGISTRATIONS, RETAIL SALES, PASSENGER CARS, AVERAGE OF PERIOD

Date	Sales
12/30/2019	111,421
1/13/2020	86,372
1/27/2020	38,611
2/3/2020	811
2/10/2020	4,101
2/17/2020	5,411

Source: China Passenger Car Association (http://www.cpcaauto.com/news.asp?types=csjd&anid=11)

MARKET VIEWS

The S&P 500 currently sits around 17 times 2020 expected earnings as reported by S&P, though earnings are likely to adjust downward. Over time stock returns derive from a combination of advances in earnings; changes in the multiple paid for those earnings; and dividend yields. (Buybacks are captured by earnings, as they influence the rate of earnings growth per share.) The dividend yield on the S&P 500 is about 2%. Expected buybacks are likely to create a boost to earnings of 2–4% in 2020; this is often referred to as shareholder yield. This combination of dividend and buyback activity creates a total "yield" of 4%+. Earnings expectations for 2020 are questionable, and we assume pressure on Q1 and Q2 as the effects of COVID-19 influence economies around the globe. It is not yet clear whether Q3 and Q4 will recover some of that downdraft as inventories are rebuilt and pent up demand unleashed. Further, it is not clear how long it will take for the health and confidence problems caused by COVID-19 to dissipate.

While earnings remain in question over the near term, our expectation is that earnings will return to their long-term growth trend in the second half of the year. Valuations on stocks are reasonable, especially compared with the high price of bonds and other safer assets. While noise and volatility will dominate the short-term conversation, low interest rates continue to support valuations, particularly after COVID-19 fears become less novel and more normal. There is ample market chatter regarding Central Bank policy easing, as well as potential fiscal stimulus. While neither would immediately affect the economy, it would help quell fear and may support a cyclical rebound later in the year.

It is hard to believe that it was only five weeks ago that the city of Wuhan was placed under quarantine. Upcoming weeks and months may feel similarly challenging. We believe the best way to produce solid returns over the long haul is to operate with a time horizon that extends beyond the hyperintense news

cycle. We think that the downward pressure on stocks and the economy is a reasonable one-time event, reflecting negative but not permanent effects of the virus. There may be further volatility and adjustments, but attempts to time the virus and related exogenous events are a recipe for failure. The U.S. economy will weather the storm, a return to normalcy will emerge, and with it, continued forward progress for the U.S. economy, earnings, and for stocks.

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Robert Teeter
Managing Director
Investment Policy & Strategy Group

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