



March 10, 2020

Dear Clients and Friends,

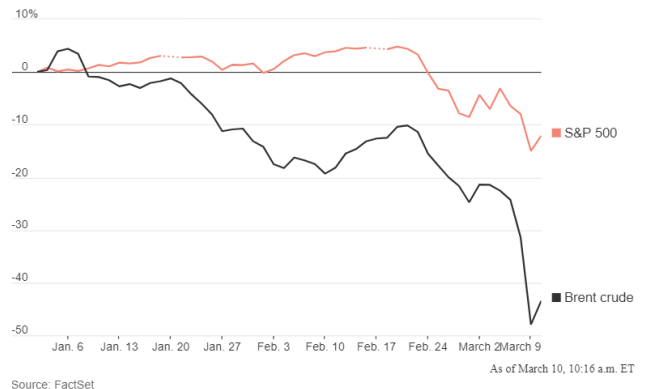
It has been a wild couple of weeks. We thought you would like an update from us.

- I. What has changed since our memo two weeks ago?
 - 1) The virus –
 - a) The virus has expanded around the world and is now spreading across the US. School and event closings have begun and will likely increase.
 - b) At the time of writing this memo, there are about 108,000 known cases and 3,800 deaths. That implies a 3.5% death rate, but that number is probably high since there are assumed to be many unknown cases.
 - c) We know now that the virus affects older people and people with weaker health more. That is not much of a surprise as it is the same as the flu. It is interesting that children seem to be affected less.
 - d) Italy has just announced travel restrictions for the entire country.
 - 2) The US government's response –
 - a) The government was slow to respond to the health risks but appears to be mobilizing.
 - i. There is still a shortage of test kits, but they are coming quickly. We will need millions of tests, and now have maybe 100,000. Reportedly, millions will become available this week. Testing is arguably the most important thing the government can do. Uncertainty is bad for public health, the economy, and the markets. It's stoking unease and eroding confidence. Once we know the extent of the problem, and can better track the virus, we will regain confidence.
 - b) Congress has appropriated \$8 billion. That money will be directed toward the health side of the crisis.
 - c) Governmental response to economic risks:
 - i. The Federal Reserve has lowered rates by 0.5%. This is not going to have a major effect on the economy but will help some. Mortgage brokers are under siege responding to refinancing requests. It also sends a signal to the markets that they will respond.
 - ii. Nothing definite has been done, that we are aware of, to directly help businesses, but there is talk. The National Economic Council stated it is considering micro forms of assistance and the Mayor of Seattle commented they were considering methods to aid small businesses. This type of assistance is likely to be more important than the Fed lowering rates.
 - iii. Financial Regulators (FDIC, CFPB, State Bank Supervisors, Federal Reserve, Credit Unions, and the Comptroller of the Currency) all signed a letter directing banks to assist "borrowers and other customers in affected communities". There is not any precedent to this, so it is hard to know the effect it will have; but this is exactly what they need to do.

- iv. After some early missteps, the National Institute of Health and the Center for Disease Control appear to be on the right path. Anthony Fauci at the NIH has decades of experience and advised the last six US Presidents. The Federal Reserve and the Treasury Department also have seasoned leaders. There is recent institutional knowledge with both financial and health crises.
- v. The White House has hinted they will announce stimulus measures such as a payroll tax cut, but nothing definitive has been proposed and Congress will have to approve.

3) The economy –

- a) There are obvious economic effects.
 - i. Travel is being cancelled. Travel represents about 3% of US GDP.
 - ii. Conferences and sporting events are being cancelled.
 - iii. Consumer spending will also be affected, which is the biggest slice of the economy. It is too early to estimate the effect.
- b) US GDP could slow to an annual rate of 1% - 1.5% from 2.3% last year according to Goldman Sachs and PIMCO reports we read this week. Obviously, the risk of recession has risen, but the economy was quite strong coming into this. GDP was growing at close to a 3% rate according the Fed's GDP NOW tool. Employment is strong. The February jobs report was better than expected and the unemployment rate is 3.5%.
- c) The length of the virus's impact on the economy may be longer than previously estimated. If it takes until May or June to get the virus under control, the economic effects will also last into the 2nd quarter; but it is still anticipated there would be a fairly quick economic recovery and probably faster growth in the 3rd quarter, and maybe 4th quarter, as pent up demand is satisfied.
- d) Our trade deficit actually improved over the last few months, partly due to Covid-19 related shutdowns and supply chain interruptions, and partly due to the US-China trade war. A smaller deficit increases GDP numbers.
- e) While employment is strong, there has been a little deterioration in trends, and uncertainty will increase. This is the most important variable to watch.
- f) Falling interest rates have led to massive re-financing applications. This will be a positive for consumers and businesses in coming months. If you haven't considered it, you may want to check with your bank or mortgage broker.
- g) Oil prices fell initially in anticipation of lower economic growth. Then, over the weekend, Russia and OPEC failed to agree on cutting supply and we appear headed for a supply glut. Supposedly, Putin wants to pressure US frackers into reducing supply. There are several implications:
 - i. While this spooked the market, lower oil prices mean lower gasoline prices. This is economically positive for most countries and consumers.
 - ii. There may be employee layoffs, and there will be lower earnings from oil and gas companies, but they represent less than 4% of the S&P 500 now – much lower than during previous oil price collapses.



- iii. Oil and gas companies have a higher weighting in the high yield bond markets. There will be more pain there, but it was only four years ago when oil had an even bigger fall. Lenders should be better insulated than they were in 2016.
- iv. Whether the theory about an attack on the US fracking industry is true, it is unknown, and whether it will work is also questionable. The US government could decide to support the industry with loans or tax benefits, and the technology they employ continues to advance. After some disruption in 2016, the industry came right back as soon as oil prices recovered.
- h) Finally, recession is a possibility, but if it occurs it is expected to be short and not too deep.

4) The markets –

- a) The stock market has had extreme volatility over the last two weeks, but it looks like what a correction normally looks like. First, there is a steep sell off. Then comes a bounce and a re-test of the low.
- b) Monday had a further drop. Arguably, it had more to do with the oil price collapse than the Coronavirus.
- c) It is impossible to know how much of the current volatility is being caused by machines rather than humans, but computer trading makes up the majority of volume these days. In the long run, economic fundamentals win out over the machines.
- d) The biggest changes in the market, and perhaps hardest to understand, are the moves in the bond market. Interest rates have fallen to levels not seen before in the US. Some pundits argue this is a prediction of recession and a collapse in inflation. Directionally, this may be accurate, but we



think there is more going on. For example, as

| COUNTRY | YIELD |
|------------------|--------|
| Germany » | -0.79% |
| United Kingdom » | 0.22% |
| France | -0.31% |
| Italy | 1.30% |
| Spain | 0.28% |
| Netherlands | -0.58% |
| Portugal | 0.41% |
| Greece | 1.57% |
| Switzerland | -0.95% |

For example, as mortgage refinancing is accelerating, related bankers and lenders hedge their mortgage risks by buying US Treasury bonds. We note that the CPI rate for the last twelve months was 2.5%. While this will surely come down, the level of rates today doesn't come close to providing a real return above the likely inflation rate going forward. There is also unquestionably a cause and effect from foreign rates. The rules may have changed temporarily, but longer term these rates cannot hold.

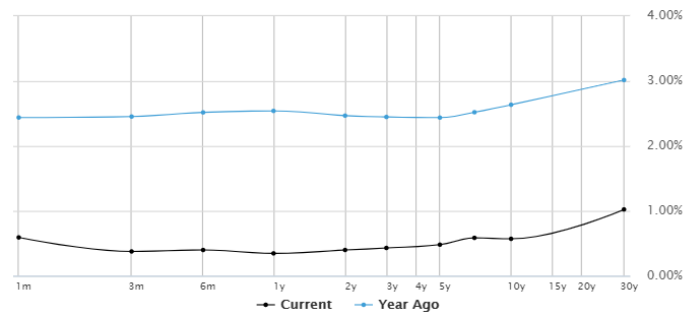


Figure 1 - Yield Curve

- 5) Valuation is getting better, but we can't yet say the market is cheap because we don't know what the 'E' in P/E is.

Shown in this table is the 'E'arnings estimates for the S&P 500. The consensus estimate for 2020 has fallen from \$186 to \$173. It is likely that it will fall further. Goldman Sachs is estimating \$165, which would still be a 5% increase over 2019. This uncertainty contributes to the market volatility. At yesterday's close of 2,746 the P/E would be 16.6 on \$165 of earnings. That's an attractive level.

| QUARTER END ESTIMATES | YOY Change | 12 MONTH OPERATING EARNINGS (ests are bottom up) |
|-----------------------------|---------------|--|
| 12/31/2021 | 11.4% | \$192.78 |
| 9/30/2021 | 13.2% | \$187.97 |
| 6/30/2021 | 14.2% | \$183.29 |
| 3/31/2021 | 12.9% | \$178.36 |
| 12/31/2020 | 10.1% | \$173.04 |
| 9/30/2020 | 8.6% | \$166.06 |
| 6/30/2020 | 3.8% | \$160.45 |
| 3/31/2020 | 3.2% | \$157.92 |
| 12/31/2019 | 3.7% | \$157.15 |
| 9/30/2019 | 1.7% | \$152.97 |
| 6/30/2019 | 10.1% | \$154.54 |
| 3/31/2019 | 15.7% | \$153.05 |
| 12/31/2018 | 21.8% | \$151.60 |
| 9/30/2018 | 26.9% | \$150.42 |

II. Have we changed our strategy? No, not really. We came into this correction close to or slightly underweighted equities relative to client targets. With the drop, we believe re-balancing to targets is appropriate. However, we recognize we won't get the timing exactly right. With this much volatility we will probably re-balance once or twice.

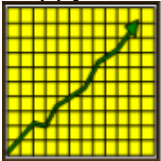
1) Rebalancing is a natural process of buying low and selling high. Bonds have increased in value.

Imagine a portfolio of 50% equities and 50% bonds. In order to re-balance the portfolio after stocks have fallen 10% and bonds have risen 5% requires selling bonds and buying stocks. Similarly, if one stock has fallen 20% (JP Morgan) and another has risen 5% (Amazon), rebalancing means selling a little of one and buying a little of the other.

2) We try to upgrade portfolios during these times. We have added some new stocks to our Core Equity portfolio because their prices have come down to levels we haven't seen before.

These are uncertain and busy times for us; but we have been through crises before. We are working to not only help protect your portfolio but to help make it better for when we come out the other side. Finally, if you would like to meet, but either for health concerns or convenience would like to set up a video conference, let us know. We use Zoom for video conferencing and would be happy to meet with you that way. As always, call your Advisor if you have any questions or want to delve into these topics further.

Happy returns,



Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

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S&P 500: The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization.