ECONOMIC AND MARKET COMMENTARY

2nd Quarter 2020

SMITH SHELLNUT WILSON

INVESTMENT COUNSEL AND MANAGEMENT

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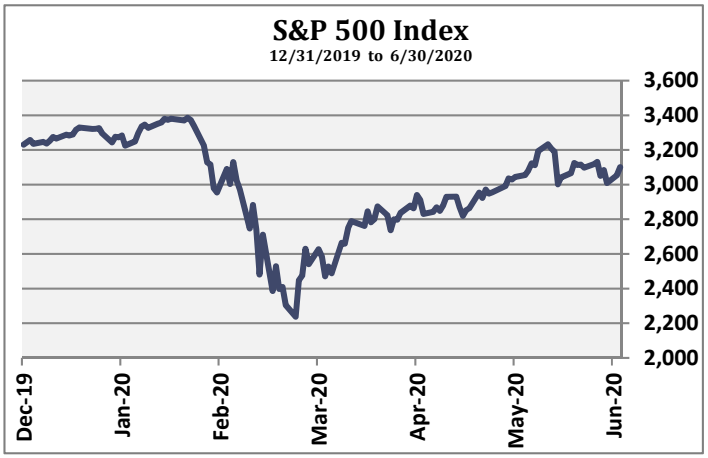
OUR MISSION

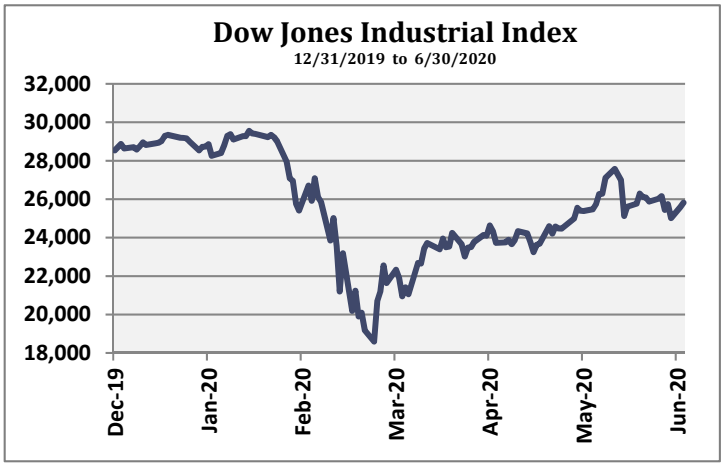
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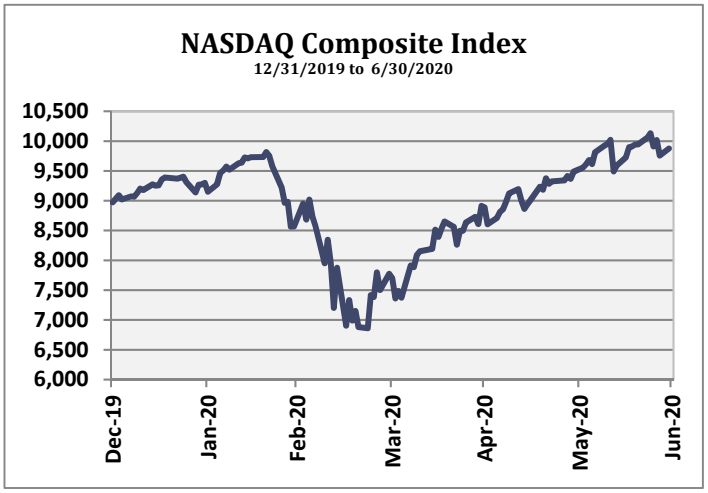
I. SECOND QUARTER 2020 EQUITY MARKET RECAP

U.S. equity indexes posted sharp gains in the second quarter, notching their best three-month performance since 1998, as fiscal and monetary stimulus measures were put in place and the economy began the slow process of reopening across the country.

For the quarter, the Dow Jones Industrial Average rose by 18.51% on a dividends-reinvested basis, while the S&P 500 Index and the NASDAQ Composite Index rose by 20.54% and 30.9%, respectively, despite the fact that the U.S. economy logged its deepest 3-month contraction in modern history.







*Registration of an Investment Adviser does not imply any certain level of skill or training.

It is no coincidence that the speed and magnitude of the fiscal and monetary policy response was matched by that of the market rebound. Fiscal support has helped blunt the record drop in economic activity that has been brought on by the virus, while Fed programs have kept interest rates at record lows and aided credit flow to businesses.

Another factor supporting equity markets is a feeling that this crisis is more "temporary" than the global financial crisis. So far, earnings expectations for this year have plummeted more than -28%, almost the same as the decline seen in 2008. However, back in 2008 markets had a much bleaker view of the future—EPS expectations for 2010 fell -26% from their pre-crisis peak. Market participants believe the hit to earnings this time will be more fleeting, as EPS estimates for two years from now (2022) have only dropped -13% from their pre-COVID levels. This speaks both to policy support and the market belief that activity can rebound more quickly from this exogenous shock.

EARNINGS HIT EXPECTED TO BE SHARP BUT BRIEF
% change in EPS estimates, GFC vs. COVID-19 crises



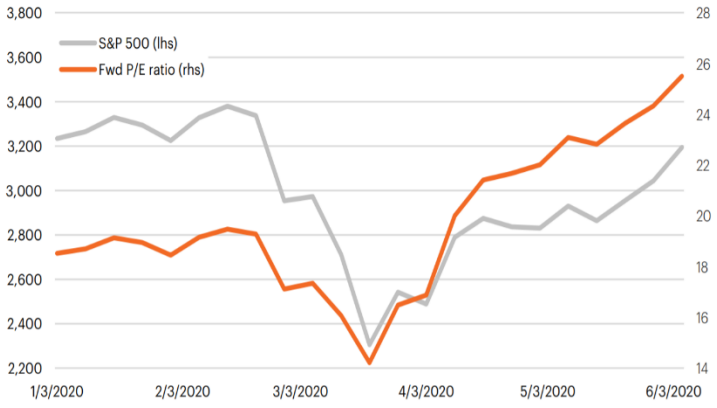
Source: Bloomberg, FS Investments, as of June 19, 2020.

The third major factor supporting equity markets is the growing dominance of mega-cap technology firms. Just six tech firms in the S&P 500 comprise nearly a fourth of the total index market cap. These six companies have together returned 20% year-to-date, compared to -8.4% for the S&P 500 and -10% for the median stock. By and large, these large tech firms have strong balance sheets and resilient business models, and their outsized influence has been the driving force behind the market rebound.

While these are real and significant supports for equity markets, tremendous risks remain. The most obvious is the path of the pandemic. As we've seen on multiple occasions, markets are extremely sensitive to any signs of a renewed outbreak. While it may be unlikely that full stay-at-home orders are reinstated, mobility and airline passenger miles data shows that people significantly reduced their activity in March and April, even in states that never employed a lockdown.

Additionally, equity valuations appear quite high. The S&P 500 is currently priced at over 25x 12-month forward earnings per share, which is near a two-decade high. Record-low interest rates have certainly pushed investors up the risk spectrum, which has benefited equities. However, market pricing should theoretically reflect risks and uncertainty, and there is inherent risk when stocks are at sky-high valuations and economic uncertainty is so pervasive.

S&P 500 PRICES HAVE RECOVERED, BUT VALUATIONS HAVE SOARED



Source: Bloomberg, L.P., as of June 15, 2020.

II. SECOND-QUARTER 2020 BOND MARKET RECAP

U.S. Treasury yields continued their relentless decline in the second quarter, with 2-year Treasury note yields falling by 10 basis points, while 5-year notes fell by 9

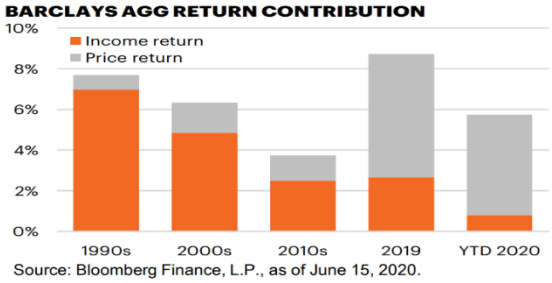
basis points and 10-year notes fell by 1 basis point, capping a first half that saw intermediate-term Treasury rates slump by a sharp 125-140 basis points.

If equity market prices may, on the surface, seem to be nearly back to where they started the year, the interest-rate landscape has radically changed. Interest rates—already on a multidecade decline— have fallen through 2020 as the Fed cut rates and growth expectations cooled. The global pandemic caused a global policy response, with central banks slashing rates and initiating quantitative easing programs that purchased government bonds. All of this sent interest rates down even further. In the U.S., with the short end of the yield curve anchored at zero, the 10-year Treasury has settled into a range of 0.60%–0.75% for most of May and June.

Where do we go from here? Likely not very far. For rates to rise, there would need to be a meaningful surge in inflation expectations. This is unlikely. For now, deflation is a far greater concern, and both market and survey measures of inflation expectations are falling. And if long-term rates did rise appreciably while the economy was still weak, the Fed would likely quickly engage in additional quantitative easing to reduce rates.

However, Treasury rates may be unlikely to fall much further. Yes, they could reach zero if the Fed adopts yield curve control as a policy and decides to peg long-term rates lower. Another deep stock market sell-off could certainly push U.S. Treasury yields down further—even into negative territory—if only briefly.

This leaves the investor with a traditional fixed income investment that has performed quite handily over the past year and a half, but has likely run out of runway for meaningful additional price appreciation. More importantly, with duration rising, the price sensitivity of these bonds to changes in interest rates has risen notably, while income returns remain low.



Source: Bloomberg Finance, L.P., as of June 15, 2020.

III. THE ROAD FORWARD

The third quarter starts off at a weaker place than any quarter since WWII as a result of the COVID-19 pandemic, but with reopening has come optimism. There are important supports for our nascent recovery that could fuel a strong rebound in Q3. However, our economy also faces significant challenges that could intensify and impact growth later in 2020. Investors will need to navigate a vastly altered landscape of sky-high equity market valuations, continued uncertainty about the economic recovery, and shrinking options to find income.

KEY TAKEAWAYS

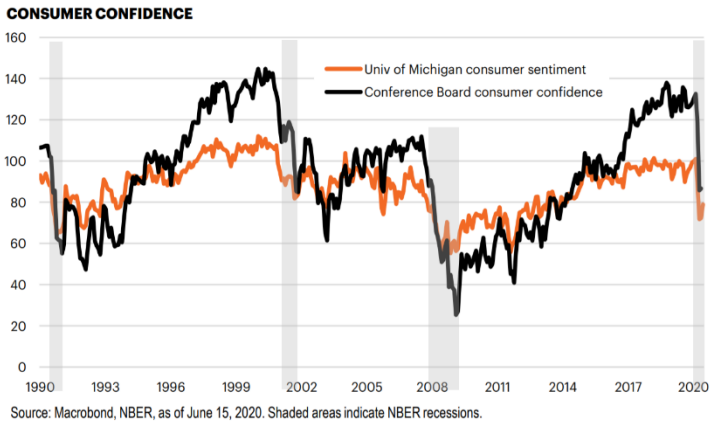
- Reopening has spurred hope that the worst economic news is in the rearview mirror.
- Lingering high unemployment could erode resilient consumer confidence.
- Acute volatility could return, driven by looming uncertainty surrounding the pandemic.

The importance of optimism

While the U.S. economy entered a recession in February and our nascent recovery is starting from a place of unprecedented weakness, there is optimism that the worst is behind us and that the economy will find it's footing in the coming quarter.

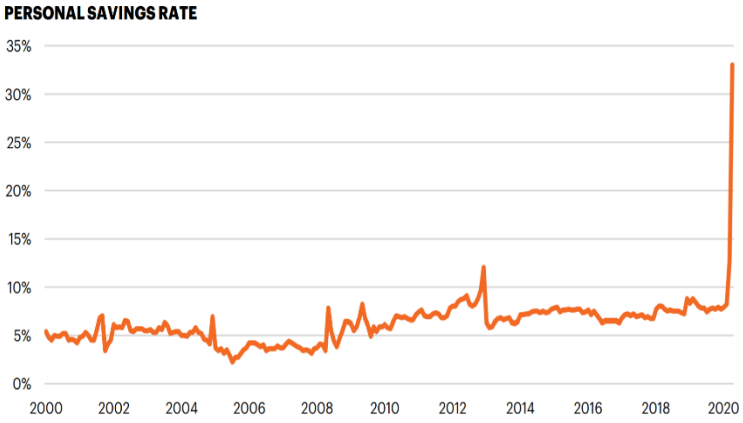
There is good reason to be optimistic. And that's important, because optimism is necessary for traction to take hold on the road to economic recovery. Our economy is the combination of hundreds of millions of households and businesses making decisions about whether to spend or save. As the COVID-19 pandemic caused many states to issue shelter-in-place directives and caused businesses to shutter, consumers and businesses were hard-pressed to spend, even if they wanted to. Now, however, as our economy reopens,

the question of whether consumer demand, in particular, will be strong is paramount.



Source: Macrobond, NBER, as of June 15, 2020. Shaded areas indicate NBER recessions.

There is good news. Household balance sheets are flush with cash as government stimulus sent the household savings rate surging to 33%. Supplemental unemployment benefits have also padded consumer wallets, offsetting some of the severe decline in wages and salaries. This solid financial position may well be helping to bolster consumer confidence. Yet there is a race against time, as supplemental unemployment benefits are set to expire at the end of July. How savings and spending evolve in the face of lingering unemployment will be one of the biggest determinants of the strength and shape of the economic recovery.

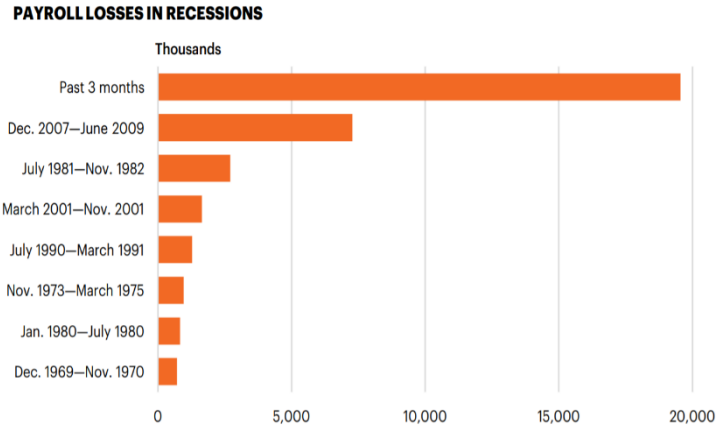


Source: Bureau of Economic Analysis, as of June 15, 2020.

The race against time

The third quarter may in many ways be more important for the longer-term outlook than the second quarter. For investors, economists and households, the almost-surreal suspended animation of the second quarter clearly indicated a growth and demand outcome that would be (some degree of) awful. After contracting -5.0% in Q1, the economy is expected to fall between -20% and -40% in Q2, a record decline. It isn't that this disastrous outcome was dismissed. Rather, most were anxious to move through it, past it and beyond it. It is increasingly hoped that April was the nadir of economic activity and the bounce we have seen so far in May and June data is the beginning of a recovery.

Beyond this optimism, the economy still faces significant weakness. The third quarter is shaping up to be a race against time to overcome these challenges before they become more entrenched and restrain growth further out. First and foremost is the high level of unemployment. More than anything, this is an obstacle that could hobble a robust, sustainable recovery in consumer demand. At the end of July, supplemental unemployment benefits run out, and if a significant share of jobs have not returned or new stimulus is not passed, the decline in income due to lost wages and salaries could become acute. A look at past recessions shows that employment can be slow to recover as businesses are reticent to hire when uncertainty is elevated.



Source: Bureau of Labor Statistics, FS Investments, NBER, as of June 15, 2020.

Another race against time is Paycheck Protection Program funds that helped small businesses retain workers during the shutdown. While recently extended through August, the Program has limited funds remaining. With reopening, it is still unknown how many small businesses will survive. Businesses with 1–19 workers account for a third of all employment.

Deficits

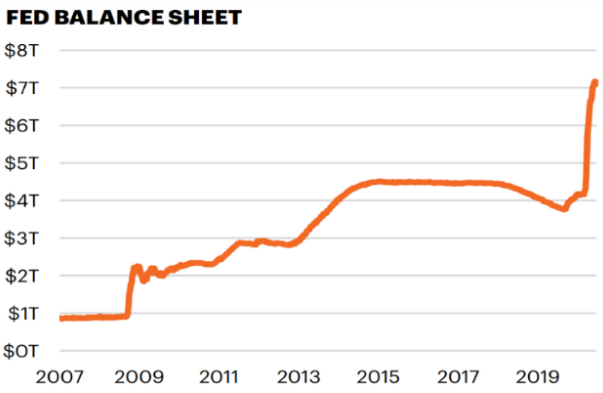
Deficits have risen as a top concern. In the near term, city and state budgets have been shattered by lost tax revenue and high payouts for unemployment benefits. The corporate sector is levered up significantly, and from January to May issued over $1 trillion of debt, double the amount during the same period last year. Finally, the federal government deficit has skyrocketed, with total debt outstanding expected to hit 130% of GDP by the end of 2020.

The Fed

The Fed's policy response to the COVID-19 pandemic was "everything and the kitchen sink." For financial markets, the speedy, aggressive, multipronged support for a variety of asset classes seems to have done the trick. Markets have experienced a strong— some would say almost effortless—rebound in the face of an extremely weak economy.

The Fed's mandate, however, is to achieve full employment and price stability, not a market rally. Given that its estimate of full employment is 4.1%, the Fed is far from declaring victory. This was driven home by Fed Chair Powell's semiannual testimony to Congress in mid-June, where he described some initial economic stabilization but noted that "significant uncertainty remains about the timing and strength of the recovery."

At the June 9–10 FOMC meeting, the Fed issued its first economic projections since the pandemic-induced shutdowns, and its outlook is more pessimistic than the consensus. In 2020, the Fed expects GDP to contract -6.5% and for the unemployment rate to reach 9.3%. Rate projections show that the Fed expects to hold the federal funds rate at 0.00%–0.25% through 2022, at least.



Source: Federal Reserve, as of June 15, 2020.

FOMC economic projections

	2020	2021	2022	Long term
GDP	-6.5%	5.0%	3.5%	1.8%
Unemp.	9.3%	6.5%	5.5%	4.1%
Inflation	0.8%	1.%	1.7%	2.0%
Fed funds	0.1%	0.1%	0.1%	2.5%

Source: Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, June 10, 2020. Median projections shown.

All of this raises the question: Is there a limit to Fed quantitative easing? The short answer is, "apparently not." At the last FOMC meeting, the Fed indicated that Treasury and MBS purchases would continue at least at their current rate of $120 billion per month ($80 billion of Treasuries and $40 billion of MBS). Most observers expect the Fed's balance sheet to continue to grow into 2021.

In addition, there are still some tools left in the Fed's toolkit. The Fed has discussed yield curve control—pegging or driving long-term rates lower or near zero. While Fed officials continue to talk down the likelihood of negative rates, prominent former Fed officials and other economists have kept up a steady drumbeat of raising this as a policy option that could be considered.

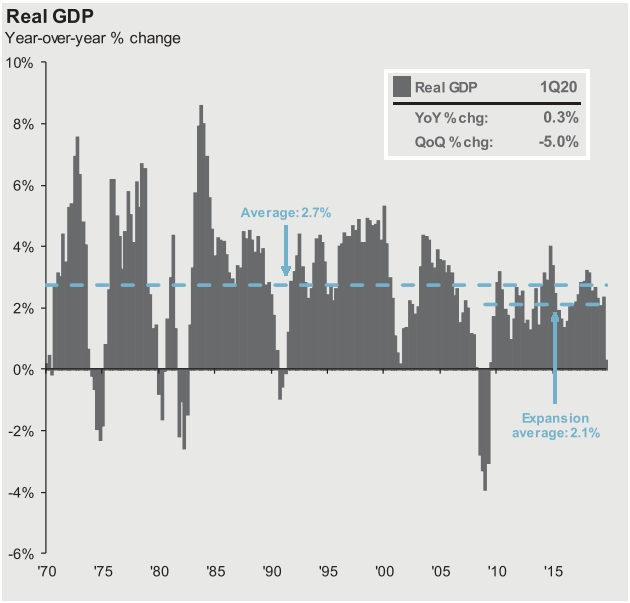
The Pandemic

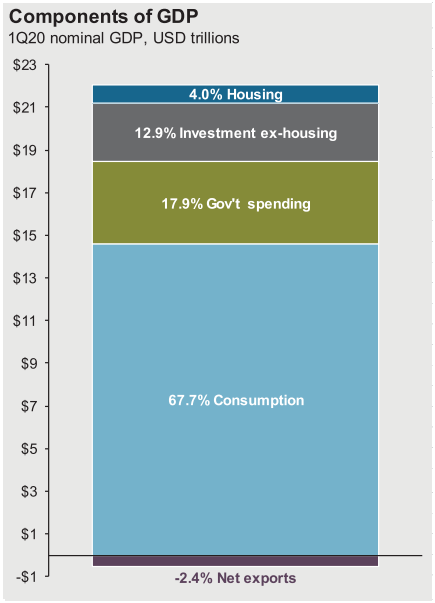
Finally, the COVID-19 pandemic itself looms as an enormous uncertainty, and a powerful reminder that, at its core, our economy is experiencing a health crisis first and foremost. The severity and geography of the pandemic is changing, moving from a high concentration of most cases in the Northeast to more broad-based increases across the country. Issues related to the pandemic—like vaccine development, whether schools will reopen in the fall and successful antibody testing—will greatly impact the arc of our economic recovery.

The source of the information in this commentary is SSW, FS Investments and Bloomberg unless otherwise noted.

Economic growth and the composition of GDP

Economy

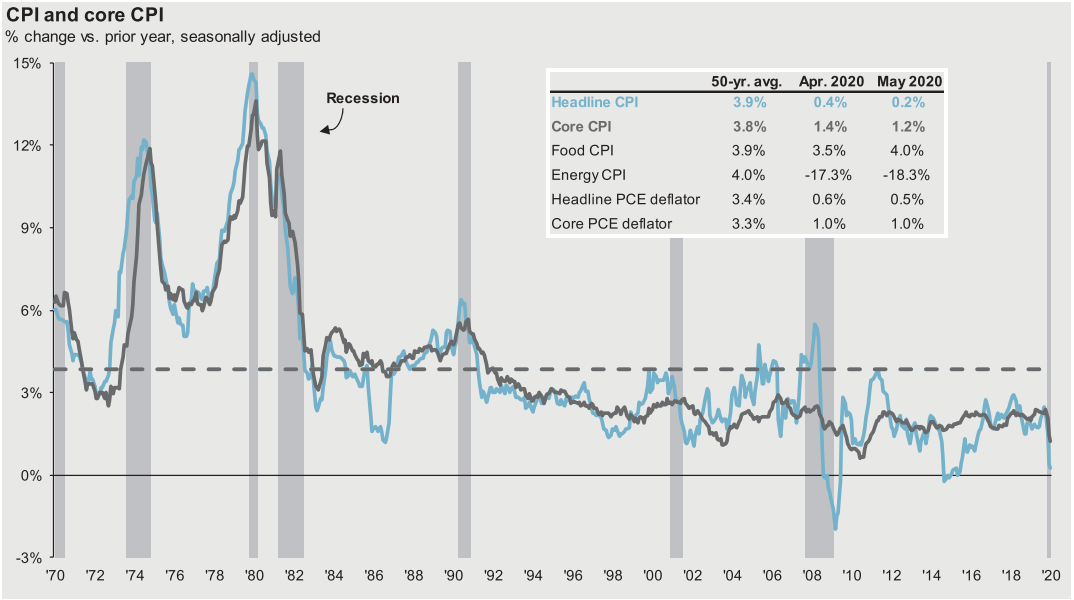




Source: BEA, FactSet, J.P. Morgan Asset Management.
Values may not sum to 100% due to rounding. Quarter-over-quarter percent changes are at an annualized rate. Average represents the annualized growth rate for the full period. Expansion average refers to the period starting in the third quarter of 2009.
Guide to the Markets – U.S. Data are as of June 30, 2020.

Inflation

Economy



	50-yr. avg.	Apr. 2020	May 2020
Headline CPI	3.9%	0.4%	0.2%
Core CPI	3.8%	1.4%	1.2%
Food CPI	3.9%	3.5%	4.0%
Energy CPI	4.0%	-17.3%	-18.3%
Headline PCE deflator	3.4%	0.6%	0.5%
Core PCE deflator	3.3%	1.0%	1.0%

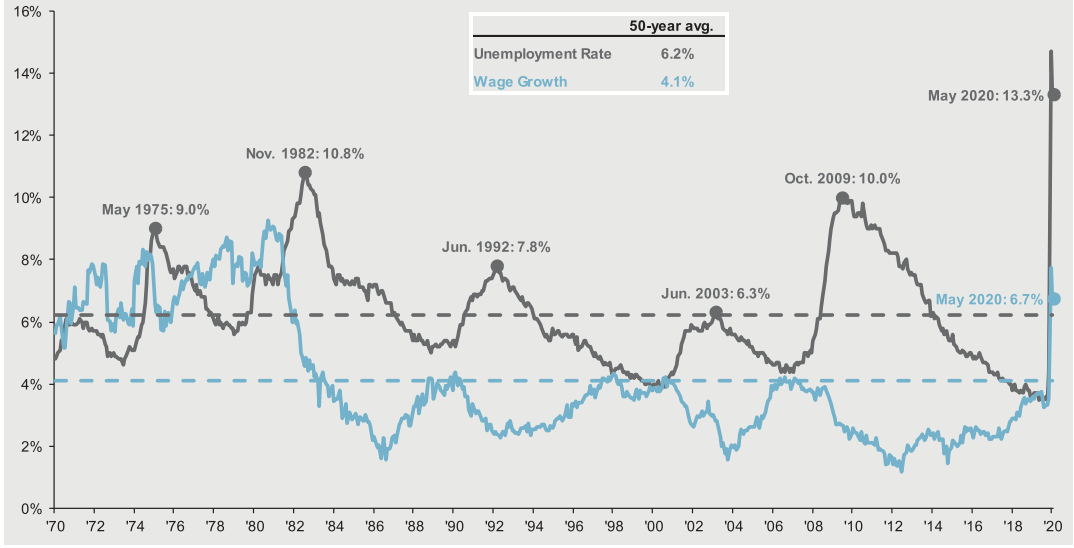
Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.
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Economy

Unemployment and wages

Civilian unemployment rate and year-over-year wage growth for private production and non-supervisory workers
Seasonally adjusted, percent

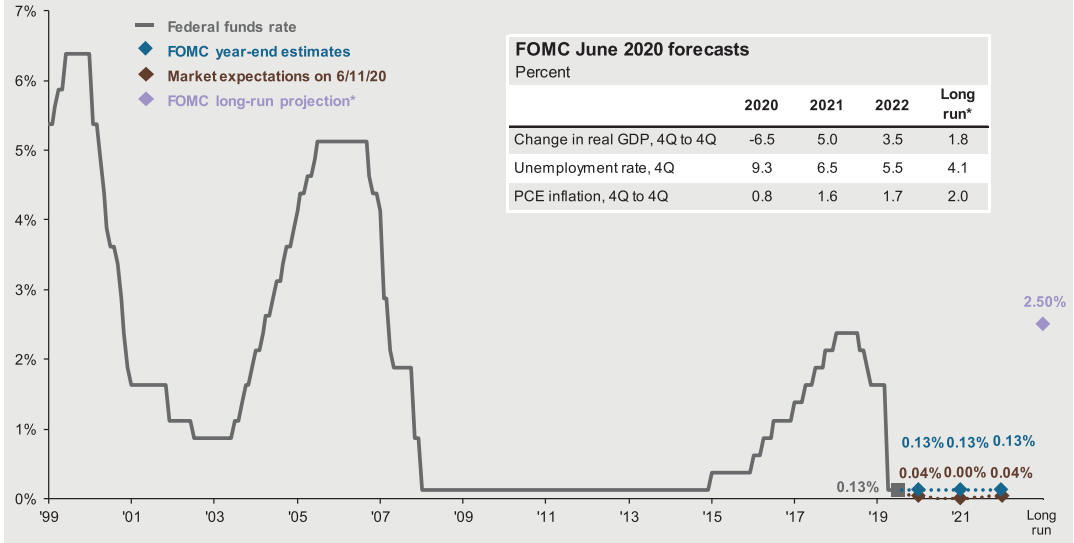


Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30 2020.

Fixed income

The Fed and interest rates

Federal funds rate expectations
FOMC and market expectations for the federal funds rate



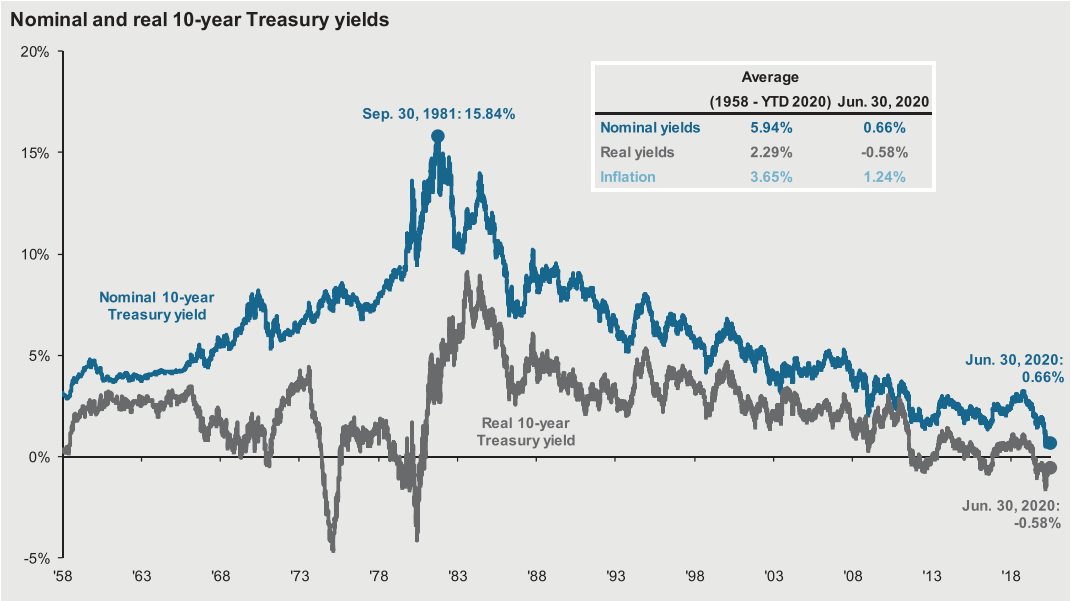
FOMC June 2020 forecasts
Percent

	2020	2021	2022	Long run*
Change in real GDP, 4Q to 4Q	-6.5	5.0	3.5	1.8
Unemployment rate, 4Q	9.3	6.5	5.5	4.1
PCE inflation, 4Q to 4Q	0.8	1.6	1.7	2.0

Source: Bloomberg, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the following date of the June 2020 FOMC meeting and are through December 2022. *Long-run projections are the rates of growth unemployment and inflation to which a policymaker expects the economy to converge over the next five to six years in absence of further shocks and under appropriate monetary policy.
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Interest rates and inflation

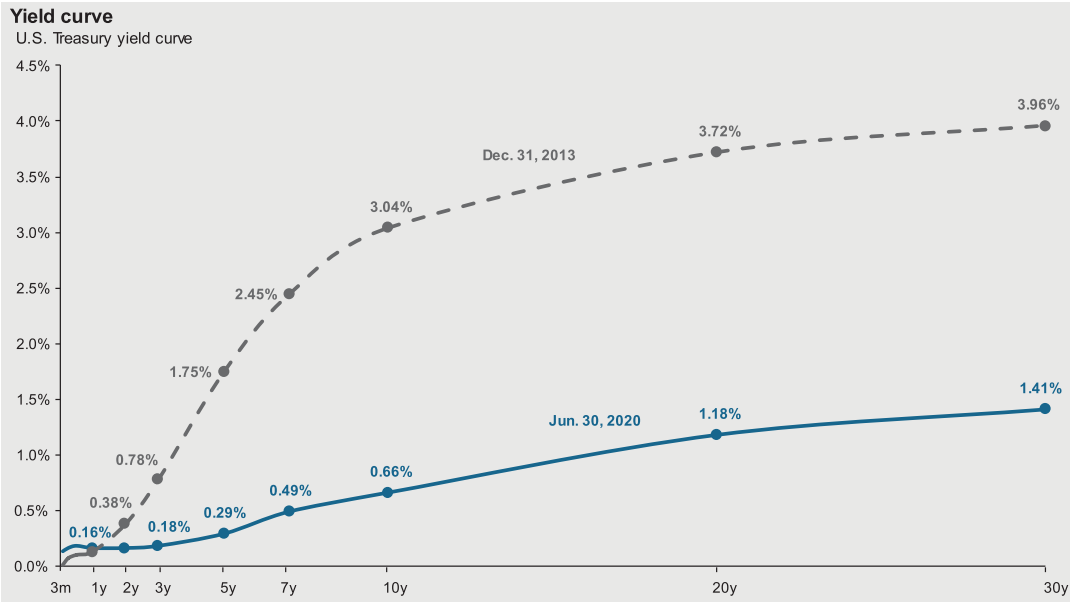
Fixed income



Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for May and June 2020 where real yields are calculated by subtracting out April 2020 year-over-year core inflation.
Guide to the Markets – U.S. Data are as of June 30, 2020.

Yield curve

Fixed income

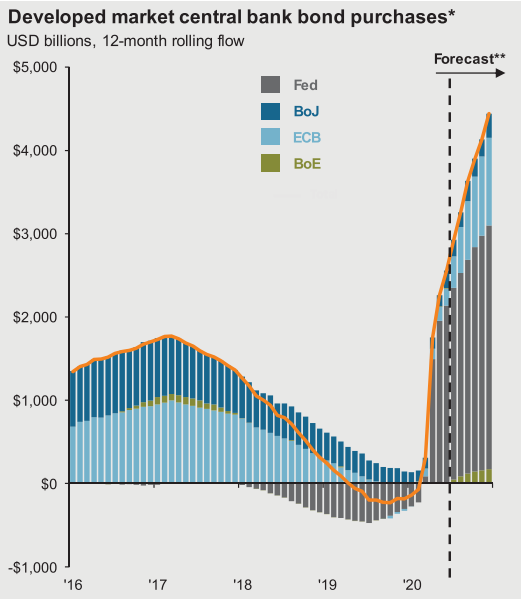


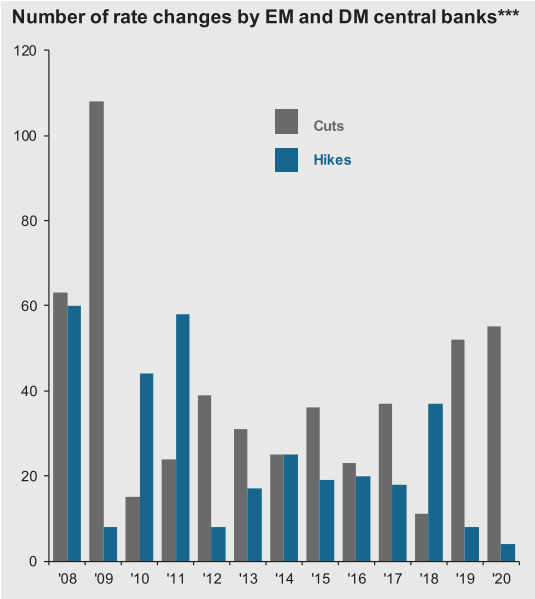
Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
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Fixed income

Global monetary policy

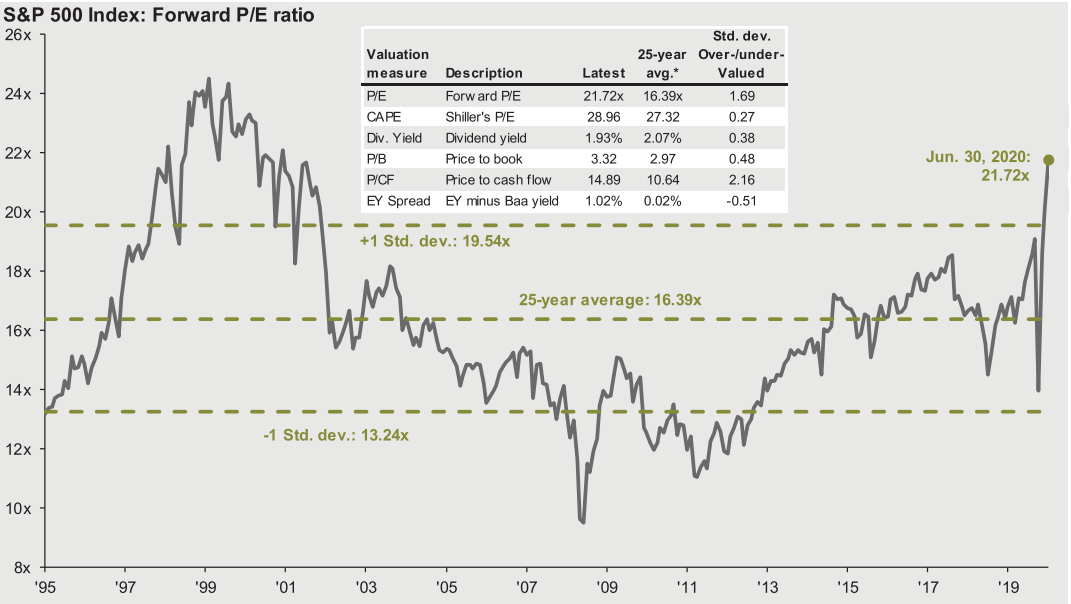




Source: J.P. Morgan Asset Management; (Left) Bank of England, Bank of Japan, European Central Bank, FactSet, Federal Reserve System, J.P. Morgan Global Economic Research; (Right) Bloomberg. *Includes the Bank of Japan (BoJ), Bank of England (BoE), European Central Bank (ECB) and Federal Reserve. **Bond purchase forecast assumes $200bn GBP in net purchases from BoE through August 2021; continued BoJ QE of $50trn JPY ann. for 2020; $1.11trn EUR in net purchases from the ECB through 2020; and the Federal Reserve to purchase $2.5trn of Treasuries, $1.2trn of agency MBS and $50bn of agency CMBS through 2020. Fed assumptions are based on purchase activity in March 2020 and previous QE announcements. ***Central banks include Australia, Brazil, Canada, Chile, China, Colombia, Denmark, euro area, Hong Kong SAR, Indonesia, India, Japan, Korea, Malaysia, Mexico, Norway, Peru, Philippines, Poland, Russia, Saudi Arabia, South Africa, Sweden, Switzerland, Thailand, Turkey, United Kingdom and the United States. *Guide to the Markets – U.S.* Data are as of June 30, 2020.

Equities

S&P 500 valuation measures

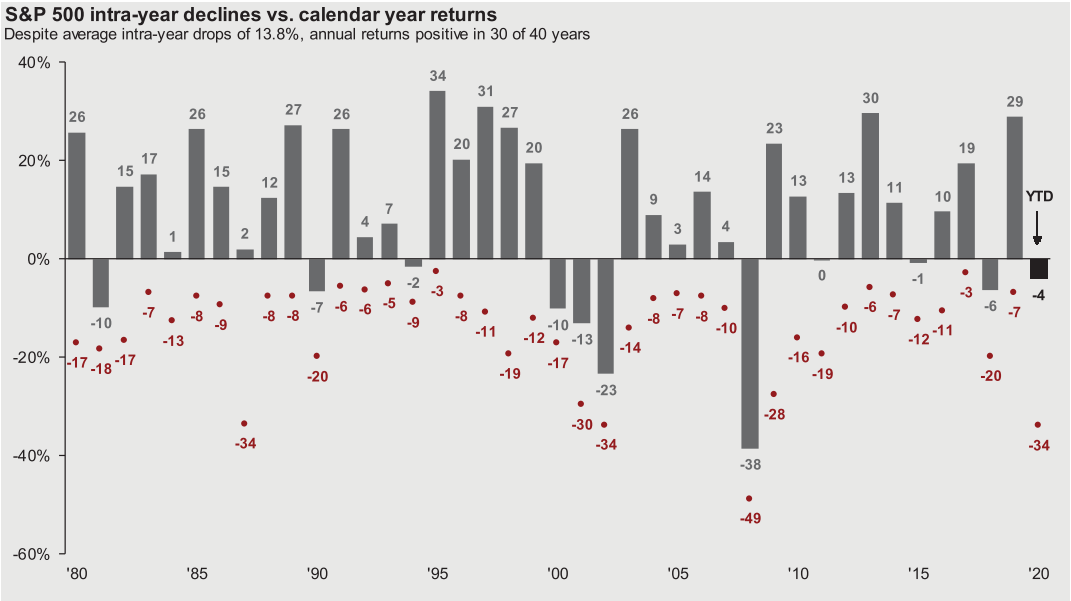


Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.72x	16.39x	1.69
CAPE	Shiller's P/E	28.96	27.32	0.27
Div. Yield	Dividend yield	1.93%	2.07%	0.38
P/B	Price to book	3.32	2.97	0.48
P/CF	Price to cash flow	14.89	10.64	2.16
EY Spread	EY minus Baa yield	1.02%	0.02%	-0.51

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since July 1995, and FactSet for June 30, 2020. Current next 12-months consensus earnings estimates are $143. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
Guide to the Markets – U.S. Data are as of June 30, 2020.

Annual returns and intra-year declines

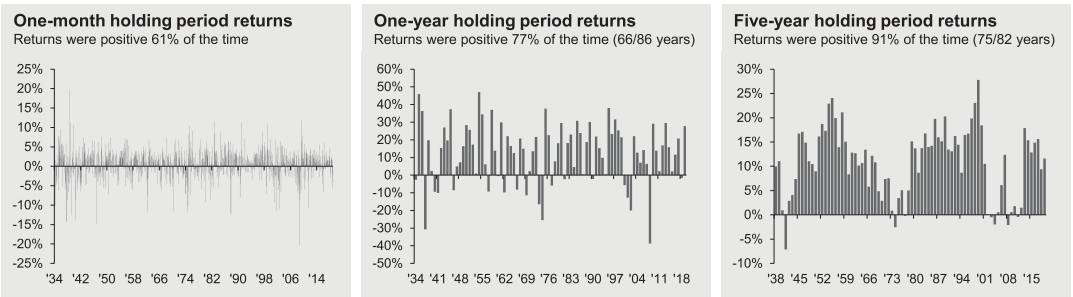
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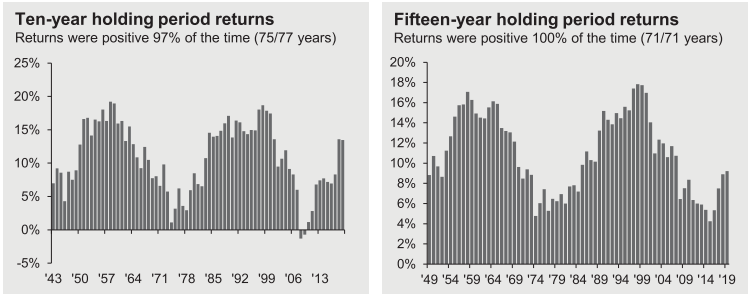


Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2019, over which time period the average annual return was 8.9%.
Guide to the Markets – U.S. Data are as of June 30, 2020.

S&P 500 holding period returns

Equities



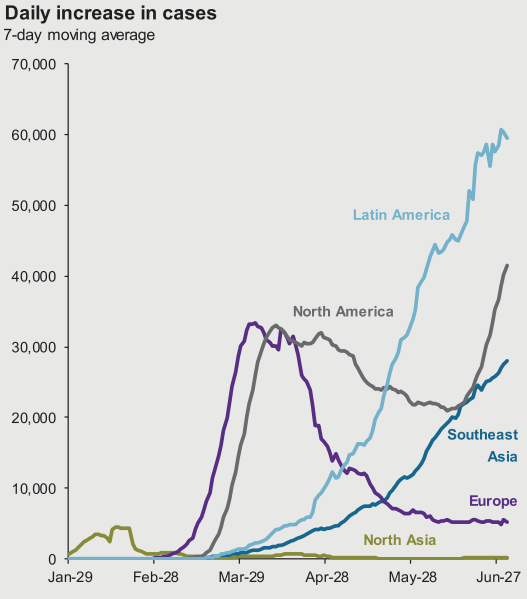


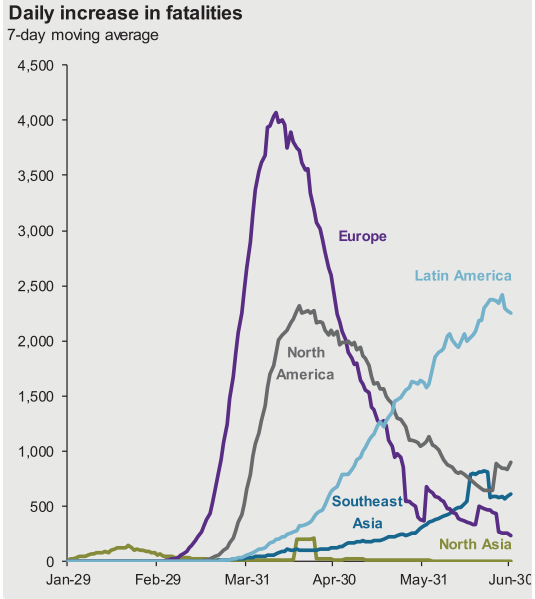
Source: FactSet, Robert Shiller, J.P. Morgan Asset Management.
Returns reflect S&P 500 annual rolling period total returns except for one-month returns which are price returns and do not include dividends.
Represents period from 12/31/1933-12/31/2019. Charts are for illustrative purposes only. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of March 31, 2020.

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International

COVID-19: Global confirmed cases and fatalities





Source: Johns Hopkins CSSE, J.P. Morgan Asset Management.
North Asia countries are China, Hong Kong, Japan, South Korea and Taiwan. Southeast Asia includes Singapore, India, Indonesia, Malaysia, Pakistan, Philippines, Thailand, Bangladesh, Sri Lanka and Vietnam. North America includes Canada and U.S. Europe includes eurozone countries, Bulgaria, Croatia, Czech Republic, Denmark, Hungary, Poland, Romania, Sweden, United Kingdom, and Switzerland. Latin America countries are Chile, Brazil, Mexico, Argentina, Colombia, Peru, Venezuela, Ecuador, Panama, Paraguay, Costa Rica, Bolivia, Uruguay, El Salvador, Honduras, Cuba, Dominican Republic, Haiti, and Nicaragua.
Guide to the Markets – U.S. Data are as of June 30, 2020.

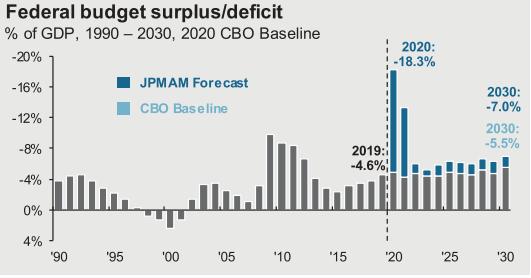
Economy

Federal finances

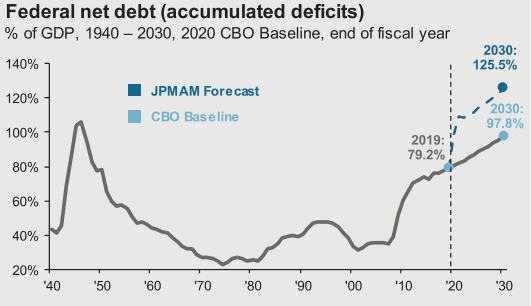
Federal acts to offset impact of coronavirus recession

Amount ($ bn)	Measure
$293	One-time recovery rebates checks amounting to $1,200 per adult and $500 per child up to certain income limits
$268	Boost to unemployment benefits, adding $600 per week to every check until July 31st, expanding program to cover contractors and self-employed and extending program from 26 weeks to 39 weeks
$27	Grants to airlines and businesses deemed important for national security. Non-forgivable loans through Fed are excluded as they are assumed to be repaid
$760	Small business relief, mostly "forgivable loans" for spending on payroll, rent and utilities
$150	Direct aid to state and local governments
$425	Health-related spending
$517	Other spending and tax breaks
$2.441 trillion	**~11.8% of GDP**

Federal budget surplus/deficit



Federal net debt (accumulated deficits)



Source: CBO, J.P. Morgan Asset Management. JPMAM estimates include costs of CPRSA, FFCR, CARES and PPPHCE Acts, signed into law on March 6, 18 and 27 and April 24 as estimated by CBO. Charts on right add impacts of these acts, interest cost of additional debt, an assumed extra $1 trillion in further acts in 2020 and 2021 and recession impacts on revenues, spending and GDP. Congressional Budget Office (CBO) March 2020 Baseline Budget Forecast. Note: Years shown are fiscal years (Oct. 1 through Sep. 30).
Guide to the Markets – U.S. Data are as of June 30, 2020.

SMITH SHELLNUT WILSON