JOHNSON FINANCIAL GROUP®

Banking. Wealth. Insurance.

ECONOMIC & MARKET OUTLOOK

SECOND QUARTER 2020

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EXECUTIVE SUMMARY

Efforts to contain the spread of the COVID-19 virus abruptly plunged the economy into a likely recession and sent financial markets reeling to end the longest expansion on record. Facing tremendous uncertainty, many investors raced to reduce risk and increase liquidity, causing broad declines in nearly all asset prices [Exhibit 1].

Global monetary and fiscal authorities have reacted swiftly to support individuals and businesses and keep financial markets operating. Investors seem to have taken heart, as asset prices firmed through early April.

Given the uncertain outlook, we have generally positioned portfolios with a conservative posture and an eye on future investment opportunities.

- **Cash** – above average levels for liquidity and to be opportunistic
- **Equity** – underweight given high volatility and greater downside risks
- **Fixed Income** – low rates are unattractive long term, but warming to credit
- **Complements** – adding where appropriate

Economic Outlook

- Economic impacts from the global health crisis are nothing short of staggering. As the U.S. economy convulses and contracts, unemployment levels may reach 20%.
- Around the world, central banks and governments responded with policies unprecedented in their scale.
- In the U.S., the Federal Reserve quickly implemented essentially its entire 2008 crisis playbook—and then some.
- On the fiscal side, the $2.2 trillion CARES Act may be followed by hundreds of billions of dollars of additional stimulus and aid.

U.S. Equity Outlook

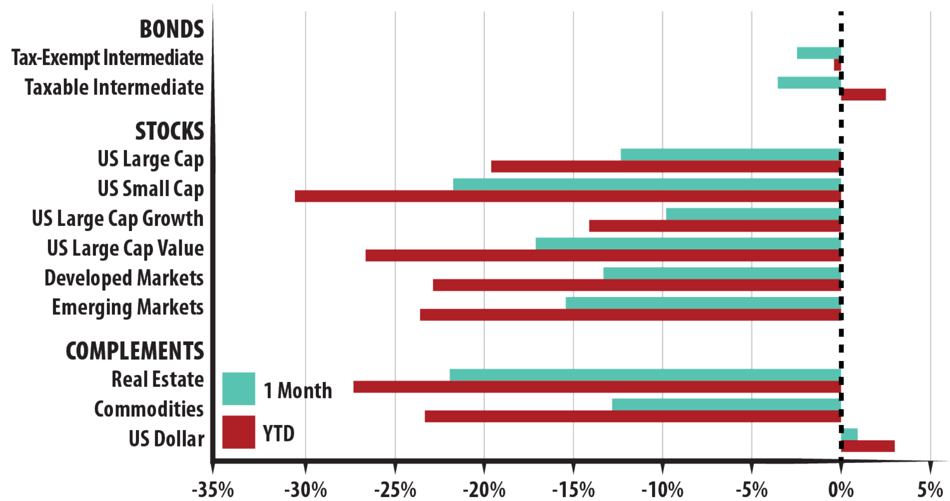
- The S&P 500 Index of U.S. large-cap stocks declined -19.6% during the first quarter, making it the worst quarter since the end of 2008. The decline into bear market territory was the shortest on record.
- U.S. large-cap growth stocks showed more resilience than other areas of the stock market, thanks to stronger balance sheets and lower economic sensitivity.

U.S. Fixed Income Outlook

- Like stocks, the reaction in the bond market was also dramatic. Investors fled to U.S. Treasuries and cash while prices in credit markets became untethered from fundamental values.
- To address the ensuing liquidity crisis, the Federal Reserve went "All In" to support smooth market functioning and facilitate the availability of credit during the COVID-19 shutdown.
- Pockets of value are now emerging and, for investors who understand the risks, these may present attractive opportunities.

Exhibit 1

ONE MONTH & YEAR-TO-DATE PERFORMANCE
As of March 31, 2020



Source: Morningstar Direct

ECONOMIC OUTLOOK

Stunning Impacts…

As we enter into our fourth week of "social distancing," the health crisis' effects on the global economy are mushrooming. Initial unemployment claims exceeded three million the first week and ballooned to over six million the next two weeks. Some economists are forecasting the unemployment rate may approach 20%, a level not seen since the Great Depression. That rate would be fully double the 10% peak during the Great Recession of 2008-09. Given rising unemployment, the outlook for consumer spending is bleak. Since consumer spending accounts for two-thirds of our economy, it's no surprise that expectations for second-quarter GDP range from -10% to -40%. Among full-year estimates, "flat" is optimistic. Some range down 6%.

…Met by Unprecedented Interventions

The response from the Federal Reserve and other central banks around the world is beyond anything seen since the end of World War II. Combined with fiscal stimulus from most developed countries [Exhibit 2], total stimulus approximates 14% of global GDP. This stimulus is meant to support people and businesses until the containment measures are lifted. The great hope is to bridge people to the other side of a government-induced economic coma.

Massive liquidity injections from central banks have had a positive effect on financial markets, facilitating daily market functions. Interest rates in overnight lending markets have now fallen from panic levels. The fiscal policy plans are just now getting capital into the hands of small business owners and individuals.

Most market watchers expect containment measures to be phased out gradually, beginning in mid- to late May. Whether the economic recovery is quick or drawn out will be key. As testing for the virus expands and helps us contain its spread, the more comfortable we'll all feel about resuming our normal behaviors. At this point, it is too early to say when a vaccine will be available, but suffice it to say efforts to develop and approve one will be "fast-tracked."

Exhibit 2

GLOBAL MONETARY & FISCAL STIMULUS

February to April 2020

	Central Bank Liquidity Injection		Government Fiscal Stimulus		Both	
	$ Tln	% GDP	$ Tln	% GDP	$ Tln	% GDP
U.S.	$2.50	11.7%	$2.71	12.7%	**$5.21**	**24.3%**
Eurozone	$1.10	8.3%	$0.48	3.6%	**$1.58**	**11.9%**
Japan	$0.20	3.9%	$0.99	19.2%	**$1.19**	**23.1%**
U.K.	$0.25	9.0%	$0.07	2.4%	**$0.31**	**11.4%**
China	$1.27	8.9%	$0.54	3.8%	**$1.81**	**12.8%**
Others*	$0.62	-	$1.63	-	**$2.25**	-
Total	**$5.94**	**6.9%**	**$6.42**	**11.7%**	**$12.36**	**14.3%**

*incl RoW and ADS, IMF, WS. Source: Cornerstone Macro as of 4.3.20

U.S. EQUITY OUTLOOK

Stock Market Descends into Bear Market

The 2019 calendar year's return of 31.5% was the largest since 1997. In a dramatic turnabout, the S&P 500 Index fell -19.6% during the first quarter—the worst since the fourth quarter of 2008.

The peak-to-trough figure for the S&P 500 was even larger. Its decline of -34% from the February 19 peak to the March 23 trough included a 16 session trip into bear market territory, making it the shortest in history [Exhibit 3].

Investors were caught off guard when a seemingly optimistic 2020 outlook turned recessionary in a matter of days as economies shut down to contain the spread of COVID-19.

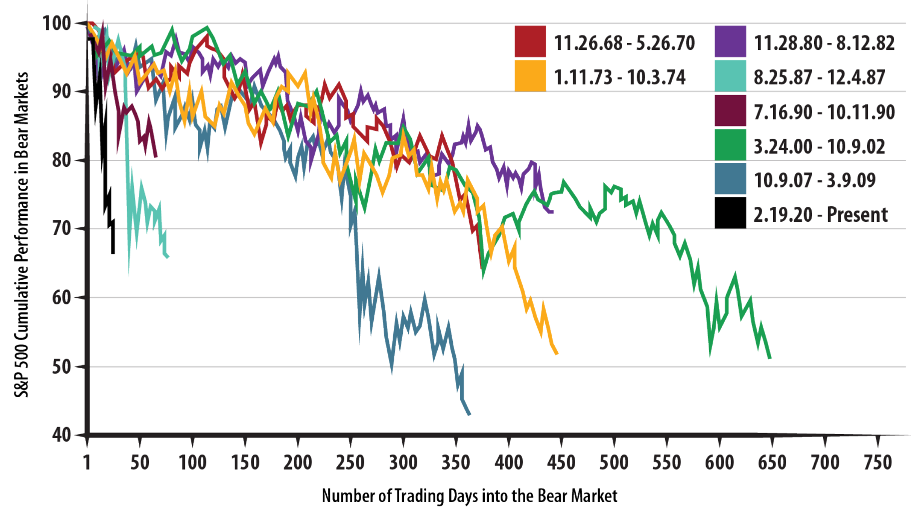
While no markets were spared, the least economically sensitive stocks, and those with strong balance sheets, generally fared best. All sectors were down, but on a relative basis Technology, Healthcare and Consumer Staples dropped the least, and Energy, Financials, Materials and Industrials dropped the most.

Given that growth investing styles are weighted toward those relatively better-performing sectors, it's no surprise that growth outperformed value. The margin here was wide: 12 percentage points separated growth's -14.1% YTD return from value's -26.6% YTD return. A similar but less dramatic differential occurred between U.S. stocks -19.6% YTD return and international stocks -22.8% YTD return. Like the value style, international stocks as a whole have more exposure to cyclical sectors.

Exhibit 3

RECORD DESCENT INTO BEAR MARKET TERRITORY

S&P 500



Source: Bloomberg Finance LP

The Road Ahead

Record-breaking volatility rocked markets over the past month, as investors sought to calibrate prices to a multitude of potential economic scenarios. Market behavior in the coming weeks and months may provide a signal as to whether economic health is improving.

> **"While no markets were spared, the least economically sensitive stocks, and those with strong balance sheets, generally fared best."**

In our portfolio weightings, equities are generally at lower levels than long-term targets due to a lack of clarity about the depth and duration of the coming recession. We have also reduced the economic sensitivity of the portfolio by adding to U.S. large and mid-cap growth exposures and reducing international and U.S. value.

Our current forecast is for a sharp initial rebound followed by a gradual recovery to pre-crisis levels, but we fully recognize that downside risks remain elevated. We expect equity market volatility to remain high, given continuing high uncertainty, and a revisit of the March 23 low would be normal.

That March 23 low may or may not be the ultimate bear-market low, but, in any case, the -34% decline seems to price in a recovery with a shallow U-shape. In this scenario, S&P 500 earnings may end 2020 near $150, which would represent a -8% decline from 2019 levels.

In a more severe downside scenario—one with a deep U- or even L-shaped recovery—we could see S&P 500 earnings decline to $110 (-33% from 2019 levels). In that case, it wouldn't be unreasonable to expect a peak-to-trough stock market decline of -40 to -50%.

Whether the drop is -34% or -40% or -50%, long-term investors know it's vital to keep the eventual recovery in mind. Consider Exhibit 4, provided by BlackRock, which provides a historical context of returns after bear market bottoms:

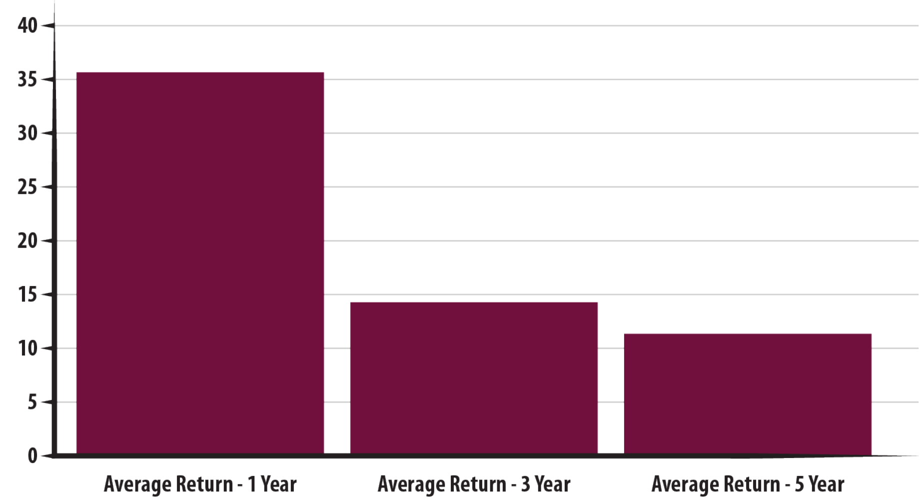
- History shows that the initial move off the bottom can be fierce, with an average one-year return of more than 35%, albeit with a wide range from 15% to 68%.
- Furthermore, since 1950, the average full recovery from a bear market decline was 453 days, or about five quarters. Here, too, the range is wide. The shortest recovery was just 61 days, while the longest was 1,462 days, or just over four years.

While uncertainty may remain high for many weeks, investors with a multi-year time frame are likely to be rewarded for staying the course.

Exhibit 4

AVERAGE PERFORMANCE FOLLOWING A BEAR MARKET

13 Bear Markets Since 1950



Rebounds From Bear Markets Since 1950

Bear Market Low	10.22.57 -21.5%	6.26.62 -8.0%	10.7.66 -22.2%	5.26.70 -36.1%	10.3.74 -48.2%	3.6.78 -19.4%	8.12.82 -27.1%	12.4.87 -33.5%	10.11.92 -19.9%	8.31.98 -19.3%	10.9.02 -49.1%	3.9.09 -56.8%	12.24.18 -19.8%
Break-even Return	27.3%	38.8%	28.5%	56.4%	93.1%	24.1%	37.2%	50.4%	24.9%	24.0%	96.6%	129.5%	24.7%
Days Since Low	233	299	143	451	1,462	366	58	414	148	61	1,166	1,008	81
1 Year Return	31.0%	32.4%	32.9%	43.7%	38.0%	12.6%	58.3%	22.5%	14.5%	37.9%	33.7%	68.6%	37.1%
3 Year Return	15.2%	16.7%	8.3%	27.3%	15.8%	14.3%	22.4%	16.4%	12.9%	5.8%	15.5%	10.4%	?
5 Year Return	9.9%	11.9%	6.4%	27.3%	12.0%	2.1%	26.6%	17.4%	19.2%	1.0%	15.0%	7.9%	?
10 Year Return	8.3%	7.5%	3.5%	27.3%	10.1%	11.9%	15.1%	18.9%	7.6%	3.0%	6.4%	15.0%	?

Source: BlackRock, Morningstar as of 12/31/19

U.S. FIXED INCOME MARKETS

Quality is King

In our January 2020 Fixed Income Outlook, we noted that bond investors were not being adequately compensated for taking corporate credit risk. We wrote it was time to "preserve capital, temper expectations, and seize opportunity when it presents itself."

While we claim no clairvoyance about what was to come, we are nonetheless pleased that our steady upward move in credit quality over the past year has contributed meaningful stability to client portfolios during this unprecedented shock to the economy.

What we have seen over the last several weeks will likely go down in history as the quickest and most vicious hit to credit markets in modern times. The panic that struck markets in mid-March hit virtually every bond market sector save for U.S Treasuries. As prices plummeted, bond yields surged [Exhibit 5] among investment grade corporate bonds, lower-quality high yield bonds and, to a lesser extent, government guaranteed mortgage backed securities. Meanwhile, the 10-year U.S. Treasury yield fell from 1.12% on February 29 to 0.70% on March 31 in a massive flight to quality.

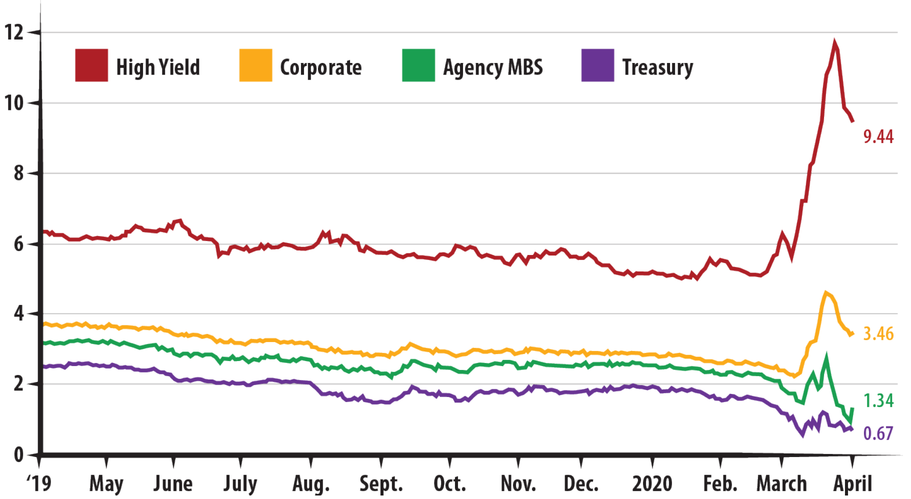
The primary culprit behind the yield spikes in all but Treasuries was indiscriminate selling of bond mutual funds by worried investors. Selling pressure even led to a rare dislocation in the municipal bond market.

Investors pulled over $200 billion from bond funds in March, including over $90 billion for the week ending March 25 [Exhibit 6], causing a liquidity crisis. Usually, the gap between what a buyer will pay and a seller will accept is narrow. That gap widened into a vast gulf. For example, yields on AAA-rated municipal bonds backed by the full faith and credit of states, cities and counties across America rose to levels five or more times that of equivalent-maturity Treasury securities, even before accounting for these municipal bonds' exemptions from federal taxes.

Investors wanted cash at any price, and they got it. Government money market fund assets rose by a stunning $790 billion during March to reach $3.5 trillion.

Exhibit 5

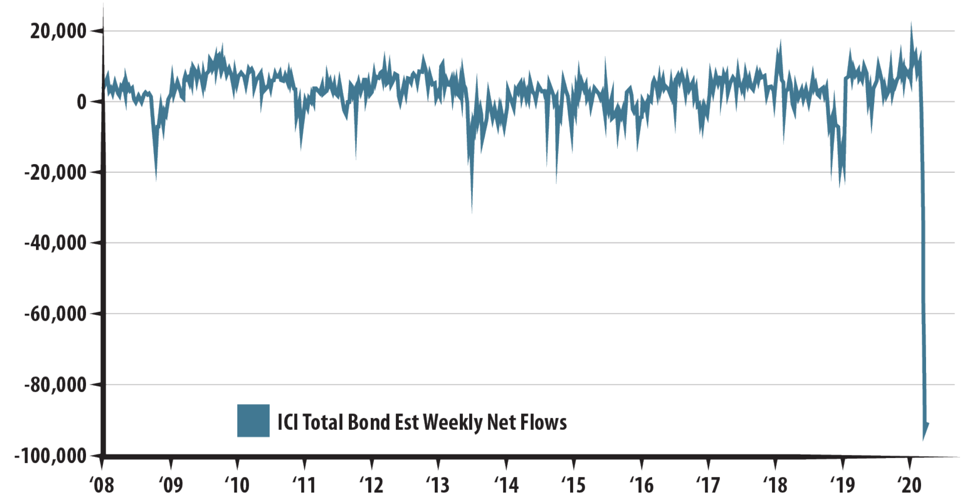
BOND YIELDS SURGED



Specific indexes include: High yield - Bloomberg Barclays US Corporate High Yield Total Return Index Value Unhedged USD, Corporate - Bloomberg Barclays US Corporate Total Return Value Unhedged USD, Agency MBS - Bloomberg Barclays U.S. MBS Fixed Rate Total Return Index Value Unhedged USD, Treasury - US 10-year Treasury Bond. Source: Bloomberg Finance LP

Exhibit 6

RECORD BOND MUTUAL FUND OUTFLOWS



Source: Bloomberg Finance LP

In a crisis, what you do *not* do is sometimes more important than what you do. As credit markets seized up, our first priority was *not* to sell securities at a discount to their fair value. Our second priority was to buy quality bonds from sellers who were willing to accept a discount because they needed liquidity. As markets recover, these decisions are already bearing fruit.

Helicopter Jay?

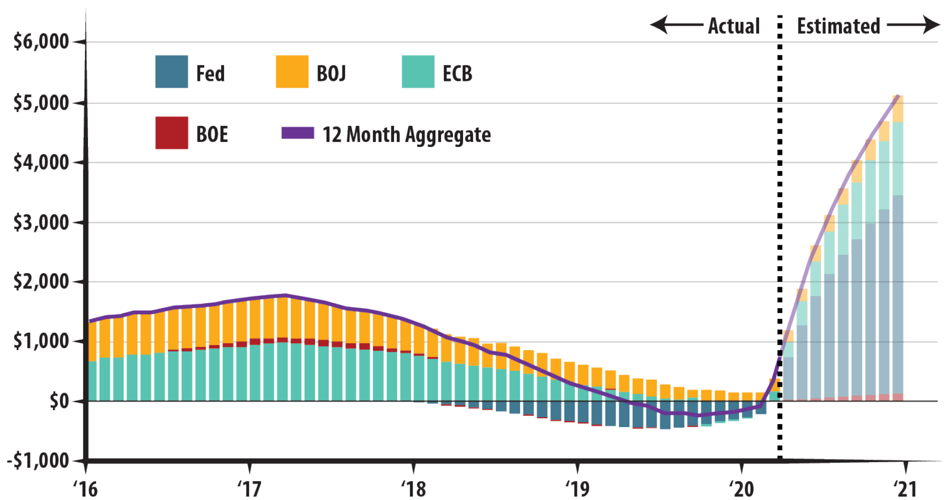
If there is a blessing that came out of the 2008 mortgage meltdown, it is a crisis-management playbook for policymakers. Back then, former Fed Chairman Ben Bernanke was dubbed "Helicopter Ben" for his strong views on the need to avoid deflation—even if it meant, metaphorically, dropping dollars from helicopters.

Current Chairman Jay Powell has received no derisive nicknames and has met little resistance in executing the Bernanke playbook and going, in fact, far beyond it.

Exhibit 7

AGGRESSIVE FED BOND BUYING

USD Billions, 12 Month Rolling Flow



Source: J.P. Morgan Asset Management

> **"In a crisis, what you do *not* do is sometimes more important than what you do."**

The Fed's goal, in partnership with the Treasury Department and Congress, is to stem the liquidity crisis and prevent it from becoming a second financial crisis. In our latest investment commentary, BOOM!, we wrote about the extraordinary monetary and fiscal measures underway which amount to some $5 trillion in stimulus through Federal Reserve action and federal government spending.

Among the most important measures is the Fed's commitment to buy Treasury and agency mortgage-backed securities in whatever "amounts needed" [Exhibit 7].

These purchases increase the size of the Fed's balance sheet and inject liquidity into the banking system. Other important market supports include new facilities such as the Primary Dealer Credit Facility(PDCF), which can provide $100 billion in liquidity for dealers to buy new-issue, investment-grade corporate bonds. Another is the Secondary Market Corporate Credit Facility (SMCCF), which will serve as an additional source of liquidity to markets for previously issued corporate bonds. For the first time, the Fed will also buy bond ETFs, which we expect to help maintain confidence in their structure.

Each of these actions will not only increase liquidity but also provide a lower cost of capital to borrowers who may need to roll over existing debt as their normal cash flows are interrupted by the economic shutdown.

We have already seen positive effects of the Fed's extraordinary resolve, with buyers returning to the market and yields on high quality corporate and mortgage-backed securities falling. Corporate bond issuers raised a record $110.5 billion in new issuance for the week ended April 3 according to Refinitiv. This is a welcome sign that credit markets are accessible for worthy borrowers.

Opportunities Emerging

Our emphasis on high quality in recent months has put us in a position from which we can assess the investment landscape dispassionately and begin to take advantage of today's better valuations and broader opportunity set.

Yield spreads over Treasuries for most bond sectors have gone from historically narrow to historically wide. But there is significant risk of a bifurcated bond market, as the Fed is currently pledging to support only investment grade bonds and select "fallen angels" – bonds that were until the recent crisis rated investment grade.

Besides those limits to the Fed's largesse, there's also the matter of downgrades and defaults. Economists expect that as much as 15-20% of the investment grade corporate bond market could be downgraded to junk. As much as 10% of the junk bond market could eventually default; a particular problem spot is over-leveraged oil services firms struggling with the collapse in the price of oil.

As always, credit research and security selection will remain paramount in our investment process as we seek to add value to client portfolios. We are ready to seize the opportunities we have been waiting for.

CONCLUSION

The word "unprecedented" is in common use right now. It's both absolutely correct and entirely inadequate. It may be fair to say that apart from the very eldest among us—those who lived and even served through World War II—the coronavirus pandemic and ensuing economic shutdown is the biggest thing any of us has lived through. It's too soon to know where the bottom is, with respect to financial curves, just as it's too soon to know where the top is, with respect to the COVID-19 curve.

With respect to both, though, we salute the resilience and ingenuity of people rising up to meet these generational challenges. That includes those on the front lines of the health crisis and those working to lessen the hammer-blow to people's livelihoods. We hope and expect to see increasing success on both fronts.

We will know much more in the coming weeks. We will start to see some results from individuals, families and businesses receiving aid under the CARES Act. We will get a better sense of the unemployment picture. Perhaps, by midway through the second quarter, we will once again see bustle in the streets and "Open" signs in windows. Obviously, the longer the shutdown continues, the greater the difficulty in bridging-over to what lies beyond it.

We have no question, though, that recovery will come. Our current expectation is a rebound as soon as summer followed by a gradual recovery to pre-crisis levels.

Regardless, we believe investors are best served by a disciplined approach to finding opportunities. Thank you for the opportunity to seek those opportunities in support of your own long-term objectives.

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