COMPASS INVESTMENTS LLC

Monthly Investment Update

March 3, 2020

Markets declined sharply in February, particularly during the last week of the month which was the largest decline for US equities since the global financial crisis of 2008-2009. The sell-off was primarily driven by fears that the coronavirus epidemic poses a bigger threat outside of Chinese borders than previously thought. Based on estimates, approximately 90,000 cases of COVID-19 have been confirmed and approximately 3,000 deaths have been reported globally[1].

Equity markets had proven relatively resilient in weathering negative news related to the coronavirus for the first half of February. The narrative of the virus being predominantly contained in China with cases and deaths plateauing was enough to support stocks on their upward trajectory to start the year. Investors seemed content to price-in a modest economic slowdown in China, with some residual first quarter impact to large multinational companies with Chinese ties and certain travel-related industries.

However, a spike in cases in Italy, South Korea, and Iran raised the prospect of the virus becoming a global epidemic. A surge in cases in other countries a few days later, including the US, along with news of border closings only amplified investor concerns regarding the global economic impact. The news sent major stock indices into negative territory for the year and dropped bond yields significantly as investors searched for safety. Many industries have been hit particularly hard, including hotel and airline stocks, some of which are down more than 20 percent from recent highs.

While last week's decline was painful, it's important to remember that market declines are normal. Despite average intra-year declines of 14%, US equities have produced gains in 30 of the last 40 years (Chart 1). It's also important to remember that equity valuations were above long-term averages leading into this period. In fact, this pullback brought the S&P 500 back to its 25-year average price-to-earnings ratio (Chart 2).

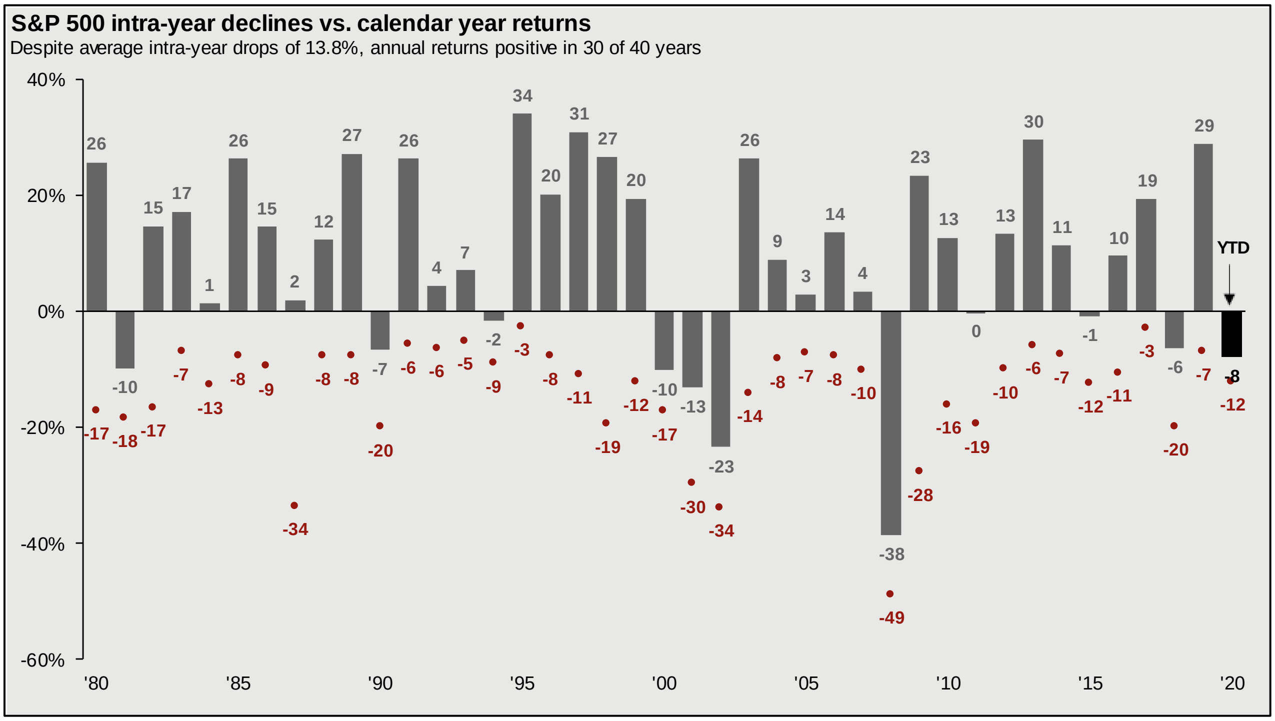
It is worth noting that the market correction has resulted in an inverted yield curve, reflecting bond investors' expectations of additional rate cuts from the Fed[2]. In addition, central banks in England and Japan have publicly announced that they would take necessary steps to combat the economic impact from the virus and to provide liquidity to maintain financial order.

Lower interest rates tend to help rate sensitive sectors such as housing, commercial construction, and automotive which may help to offset some of the weakness expected in other sectors. We will be closely monitoring whether central bank actions are enough to calm markets in the near-term and whether lower interest rates potentially support continued global economic growth longer-term.

[1] Coronavirus COVID-19 Global Cases by Johns Hopkins CSSE
https://www.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6

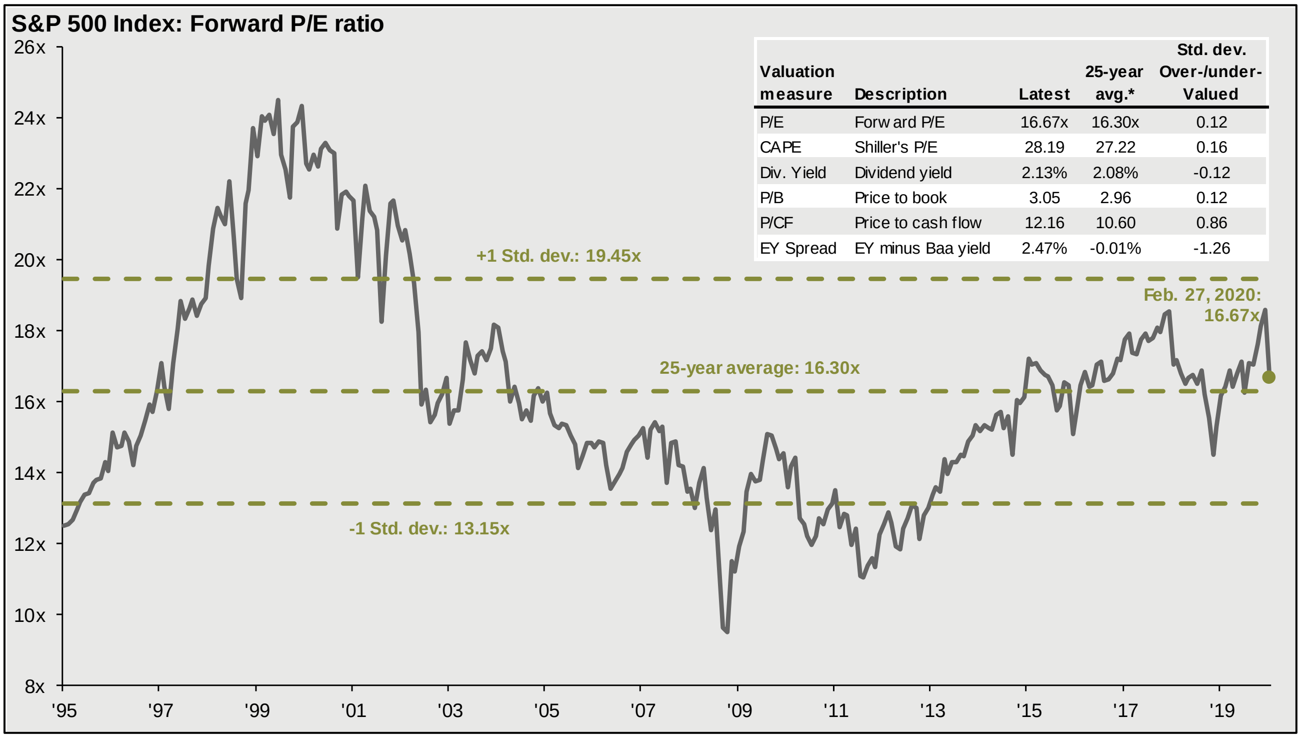
[2] As of this writing on March 3rd, the Fed announced a rate cut of 50 basis points

Chart 1: Equity Market Declines Are Common



Source: JPMorgan Guide to the Markets

Chart 2: U.S. Equities Near 25-Year Average Valuation Following February Decline



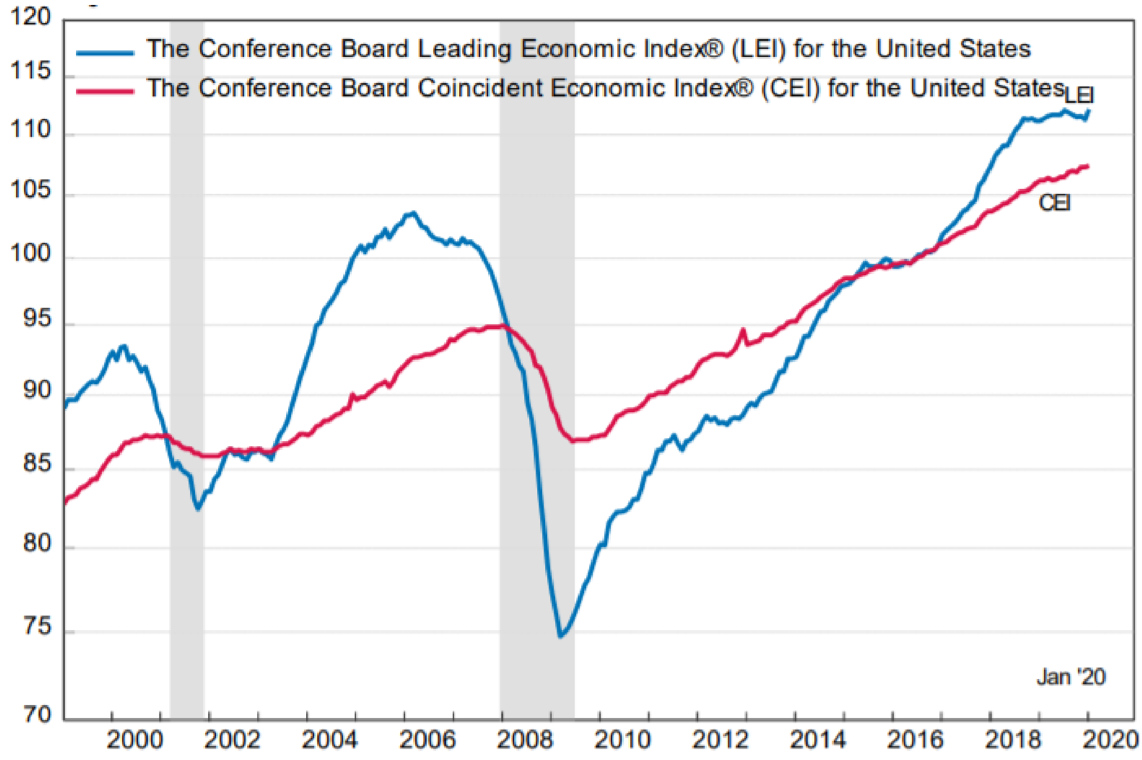
Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.67x	16.30x	0.12
CAPE	Shiller's P/E	28.19	27.22	0.16
Div. Yield	Dividend yield	2.13%	2.08%	-0.12
P/B	Price to book	3.05	2.96	0.12
P/CF	Price to cash flow	12.16	10.60	0.86
EY Spread	EY minus Baa yield	2.47%	-0.01%	-1.26

Source: JPMorgan Guide to the Markets

Economic Update
In January, the US economy saw a 225,000 increase in non-farm payrolls, led by the construction (44,000 jobs) and hospitality industries (36,000 jobs). In addition, the labor force participation rate increased to 63.4%, the highest level since mid-2013. Average hourly earnings also increased at a healthy level of 3.1% year-over-year to $28.44 per hour. Additionally, the Conference Board's Leading Economic Indicator Index increased 0.8% in January (Chart 3) following declines in November and December. Of the index's ten components, employment, housing, and household sentiment made positive contributions. The index's six-month growth has also moved back into positive territory.

While these results were encouraging, it is important to note that January's results were likely unaffected by the coronavirus outbreak. It will be important to monitor financial conditions and the sentiment of investors and households to determine if the virus will have a lasting impact on US economic activity and corporate earnings.

Chart 3: Conference Board Leading Economic Index

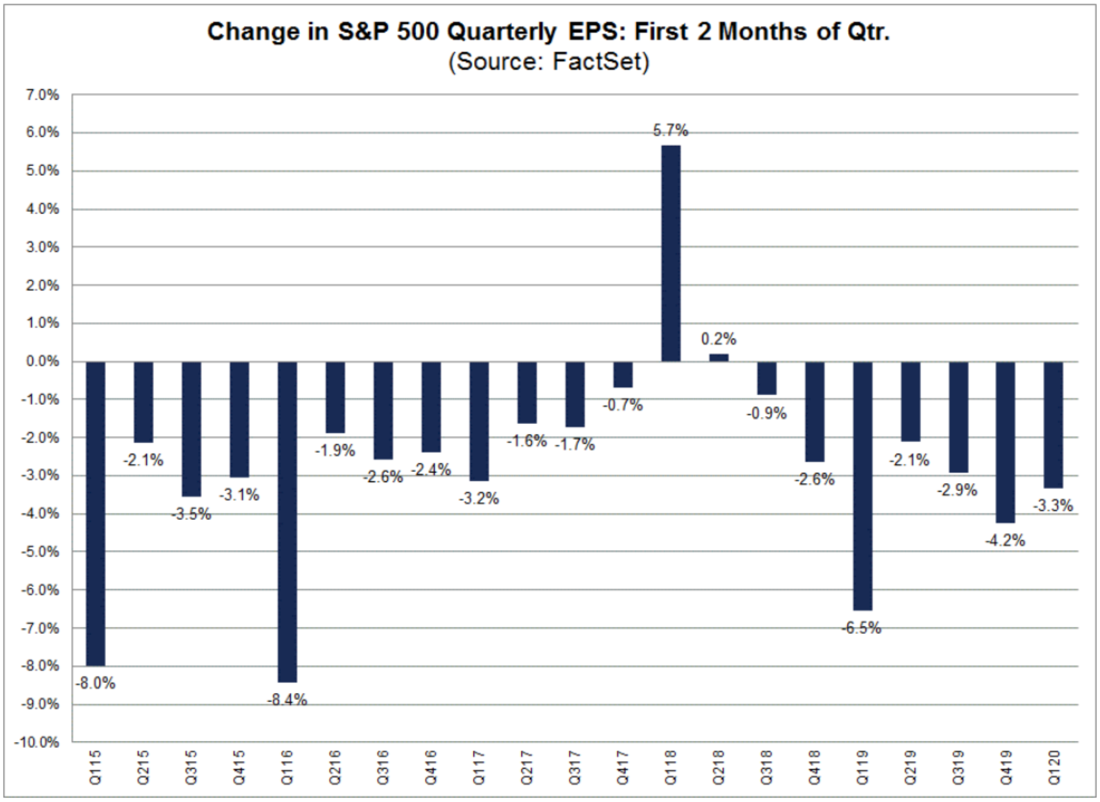


Source: Conference Board

Corporate Earnings
The coronavirus has begun to impact analysts' expectations for future earnings. During the first two months of 2020, expectations for first quarter aggregate S&P 500 earnings has dropped 3.3% from $40.68 to $39.33 (Chart 4). It is not uncommon for analysts' expectations to decline as time passes as estimates tend to be overly optimistic at the beginning of each quarter. According to Factset, the average decline over the past 15 years in expected earnings during the first two months of a quarter was also 3.3%.

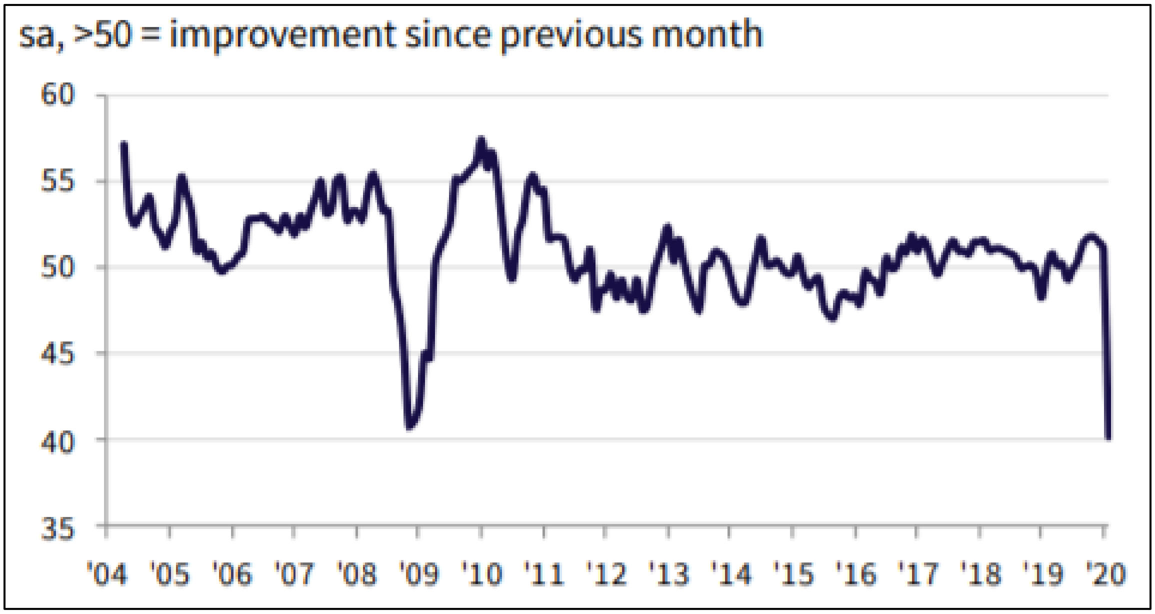
This begs the question: are analysts being too slow to decrease expectations as a result of the coronavirus? Initial estimates of February Chinese manufacturing activity were published in early March (Chart 5), and initial estimates from economists significantly underestimated the challenges. The Chinese Caixin Manufacturing Purchasing Managers Index (PMI) plunged from 51. 1 to 40.3, its lowest level since first published in 2004. The index's components on trade and employment fell sharply implying that a recovery may take time, though encouragingly, manufacturers surveyed were confident that output would rise again over the year as virus-related restrictions were lifted.

Chart 4: Average Change in Analysts' Earnings Expectations



Source: FactSet

Chart 5: Chinese Manufacturing Activity



Source: Caixin, IHS Markit

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Asset Class Returns

Category	Representative Index	February 2020	YTD 2020	Full Year 2019
Global Equity	MSCI All-Country World Index	-8.1%	-9.1%	26.6%
US Large Cap Equity	S&P 500	-8.2%	-8.3%	31.5%
US Small Cap Equity	Russell 2000	-8.4%	-11.4%	25.5%
Foreign Developed Equity	MSCI EAFE	-2.1%	-8.1%	22.0%
Emerging Market Equity	MSCI Emerging Markets	-5.3%	-9.7%	18.4%
US High Yield Fixed Income	ICE BofAML High Yield	-1.6%	-1.6%	14.4%
US Fixed Income	Barclays Aggregate Bond	1.9%	3.0%	8.7%
Cash Equivalents	ICE BofAML 3 Mo Deposit	0.1%	0.3%	2.2%

Prices & Interest Rates

Representative Index	Current	Year-End 2019
S&P 500	2,954	3,231
Dow Jones Industrial Avg.	25,409	28,538
NASDAQ	8,567	8,973
Crude Oil	$45.26	$61.21
Gold	$1,587	$1,520
2 Year Treasury	0.86%	1.58%
10 Year Treasury	1.13%	1.92%
30 Year Treasury	1.65%	2.39%

Source: Morningstar, Bloomberg, US Treasury (total returns shown gross of fees)
As of February 28, 2020

The Boston Team

Stuart Feinzig, Senior Relationship Manager
Geoffrey Caber, Investment Advisor
Martin Wildy, CFA