

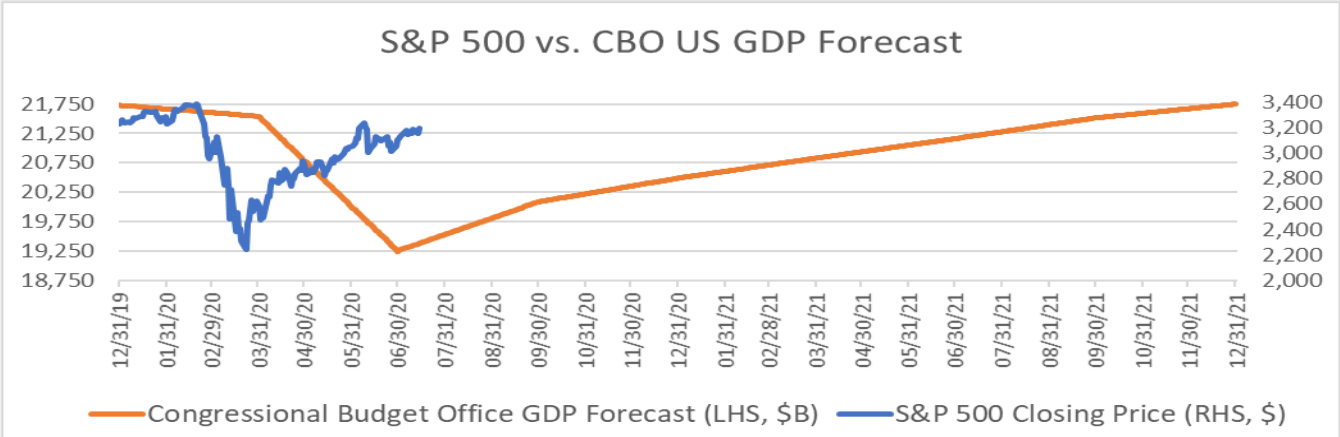
Rockefeller Insights

In Focus: Looking back to look ahead

After a roller coaster financial markets ride thus far this year, replete with a gut-dropping market descent in March, a corkscrew turn and rapid ascent in April and May and then a subsequent grinding climb into June, many investors are understandably asking whether they should disembark from this crazy ride before the next steep drop, given the warning signs still flashing all around. For example, early US reopening efforts in the South and West have resulted in a massive reacceleration in US COVID infections, US economic data has begun to bounce back but could be at risk as States pursue targeted reclosing strategies, many stocks are expected to report record Q2 earnings drops in the coming weeks and a potential Democratic sweep of the White House, Senate and House of Republicans may result in material changes to US corporate and income tax policy in 2021. A rational investor might ask themselves “does the market rebound make sense” and “where do we go from here?”. Looking back at the events of the recent past and revisiting what we’ve learned in recent months provides context for our view on where we go from here.

Q: Why has the market rebounded so sharply? A: The market is a discounting mechanism, continually adjusting valuations based on the market’s expectation of future developments.

One of the self-evident truths about the market is that market participants, particularly in this era of constant, real-time financial news flow, tend to be myopic, seizing on nearly every headline as a validation of an existing thesis or a risk that needs to be hedged or mitigated in a portfolio. This trend was noticed as early as 1934 by Benjamin Graham¹, who stated the market was a voting machine, not a weighing machine and later refined by Warren Buffet in a 1973 interview² where he credited Graham with saying “in the short-run the stock market is a voting machine, in the long run it is a weighing machine”, but the trend has intensified since with the advent of “always on” financial news. While it is very easy to focus on the dramatic rebound in the S&P 500 Index from the March bottom even though economic data remains grim and conclude the market is ahead of itself, comparing the market with forward looking US GDP estimates clearly illustrates the market is doing it’s best to factor in evolving expectations for economic recovery as shown in the chart below. The market fell precipitously as it



Source: www.cbo.gov, Factset; as of 7/2/2020

¹ Graham and Dodd, “Security Analysis”, 1934

² 1973 March 18, Sunday Journal and Star, Warren Buffett, Omahan In Search Of Social Challenges by Sam Thorson

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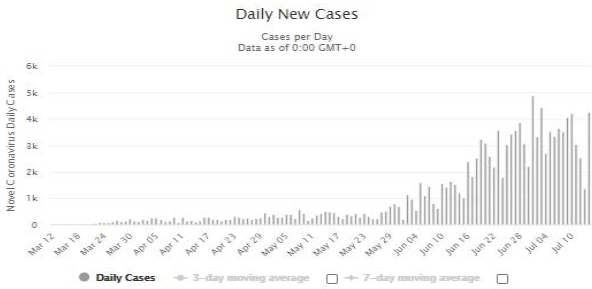
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tried to grapple with the economic aftermath of shutting down the economy and has rebounded as it begins to focus on the path forward.

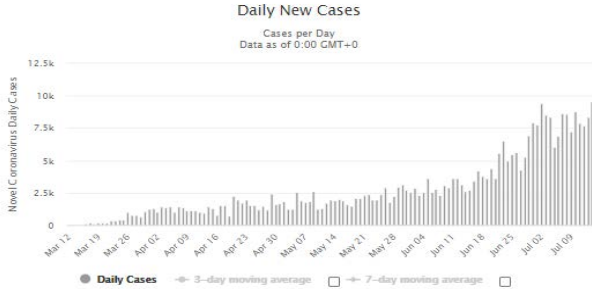
Q: But isn't the rebound too far, too fast? A: We don't think so, we think the market is appropriately looking through the short-term impact of COVID and focusing on longer-term earnings power.

Media reports abound pointing out the bid to reopen the economy is leading to a resurgence in COVID infections and renewed shutdowns will continue to strain the economy. Both are true points, but they miss the main point in our view, that these are short-term and manageable disruptions and ultimately the world will return to "normal" post vaccine or therapeutic treatment. One of the things pointed out in our last *In Focus* publication, "Seeking Certainty in an Uncertain World", was that reductions in new COVID case activity lag shutdowns by a couple weeks. After stay-at-home orders were issued in New York and much of the Northeast, new COVID-19 cases peaked on 4/2 and began to rapidly decline. Since then, multiple studies have been produced that show that social distancing in conjunction with mask-wearing can achieve many of the same health benefits as stay-at-home orders but with lower economic impact. Four of the earliest and most populous states to reopen (Arizona, California, Florida and Texas) have all seen dramatic increases in COVID-19 infection rates following reopening, due to lack of social distancing and mask wearing. However, all four states took targeted closure actions mid-late June and increased encouragement to wear masks broadly. Several weeks later, what does new case activity look like? While clearly premature to declare victory, it's also clear from the charts below that more targeted closings and encouragement (if not enforcement in all cases) of social distancing and mask wearing in these states appears to have led to slowing infection rates in recent days after the

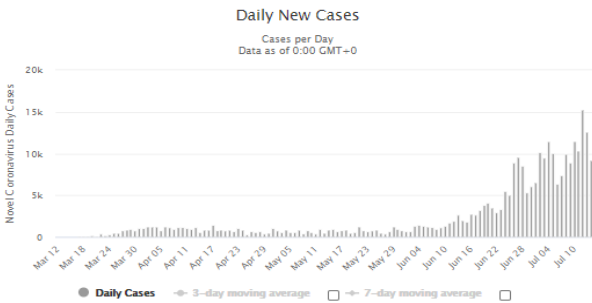
Daily New Cases in Arizona



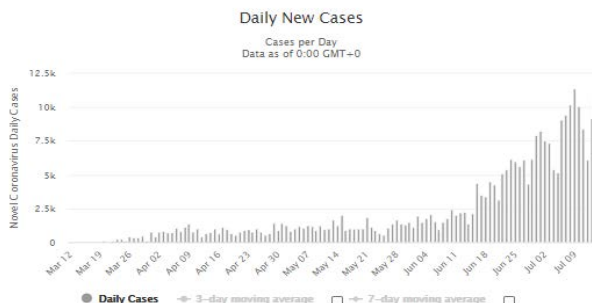
Daily New Cases in California



Daily New Cases in Florida



Daily New Cases in Texas



Source: www.worldometers.info/coronavirus, as of 07/15/2020

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several week lag to account for pre-symptomatic cases. Since these are softer shutdowns, we do not expect to see the sharp dropoff in infection rates we saw in NY, but rather a gradual decrease. Meanwhile, we believe other states in the US are in the process of or will eventually incorporate these practices, leading to broad based albeit gradual declines nationwide by the end of summer.

Q: Doesn't the fact that targeted shutdowns or restraints are required to control the disease prove the point the economy can't return to pre-COVID levels until there is a vaccine or a therapeutic? A: Yes, we believe the economy will remain below pre-COVID levels prior to the delivery of an effective vaccine, but post vaccine that the world will return to "normal".

Two notable but overlooked changes in market perception are worth highlighting. In mid-March, there was significant debate around whether a vaccine would be able to be developed, and another question around whether people would *ever* go back to pre-COVID spending patterns once a vaccine was found. Several months later, we now know there are multiple therapeutic agents that can reduce the severity of COVID as well as literally over 100 vaccine candidates globally, several of which have been shown to elicit antibody and potentially T-cell immune responses. Manufacturing, distributing and delivering the vaccines are normally a lengthy part of the vaccine development life-cycle, but multiple governments across the globe are picking up the financial costs of manufacturing and distributing the most promising vaccine candidates prior to successful approval to encourage development and reduce time to delivery. On the consumer spending side, what has become crystal clear over the last few months is that many people are more than ready to return to pre-Covid normal spending patterns, even when it is not safe to do so (hence the rapid proliferation of COVID in the reopened economies). In fact, having initially dropped 40% during the March shut-downs, US combined credit and debit card spending across all sectors of the economy has recovered to being down just 13.8% on a year-over-year basis, and improved by over 4% in the first week of July despite the higher infection rate in the US South and West.³ Once a vaccine is delivered, we believe spending will largely return to pre-COVID levels.

Q: Will the expiration of the enhanced \$600/week unemployment benefit negatively impact spending? Will high unemployment levels next year restrain spending? A: Not materially in our view.

At this point, it's premature to conclude the entire enhanced benefit is going away, as there continue to be discussions around program modification at the White House and in Congress. However, if it were to go away, and contemplating the impact of higher than desired unemployment levels next year, it's important to recognize the disparity in spending by income levels in the US and what's driving the current weakness in spending. Most of the unemployment has been concentrated in lower income households as higher skilled professions have been more able to work remotely. As shown in the table on the following page, in 2018 the lowest 20% income households in the US (average annual household income of \$16,848 or lower) accounted for less than 10% of total

³ 1010data.exabel.com, as of July 8, 2020

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spending, whereas the highest 20% (average household income above \$138,383) accounted for nearly 40%. 85% of the lowest 20% households’ income was spent on non-discretionary items, resulting in an even larger difference in spending at the household level for discretionary items, with lowest income households accounting for just 2% of total discretionary spending whereas the top 20% of households account for nearly half. Since much of the current decline in spending is related to discretionary items (dining out, travel, hotels, etc.) and households that have had a low unemployment impact drive that spending, the spending decline is a function of wealthier households’ confidence, not ability, to spend, which explains why total US spending has been able to increase recently even when targeted state lockdowns at the county level have been increasing.

2018 Consumer Spending by Household Income level

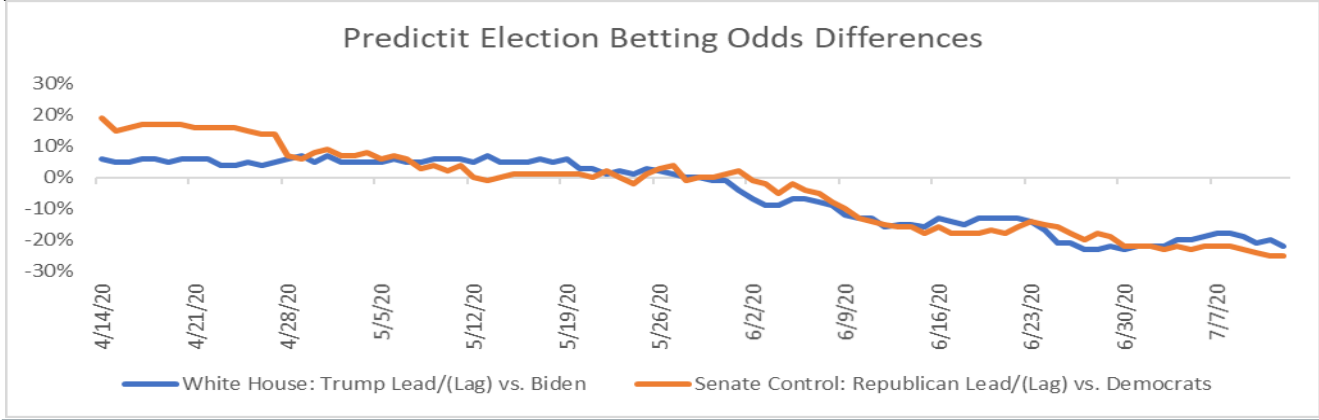
	Spending as % of all Households	
	Lowest 20% Income Household	Highest 20% Income Households
Total Spending	8.6%	38.8%
Discretionary spending	1.8%	49.0%

Source: www.bls.gov

Discretionary spending: Food away from home, Alcoholic beverages, Household operations, Public and other transportation (travel), Entertainment Fees and admissions, Cash contributions, Personal insurance and pensions

Q: If the White House and Senate change to Democratic control, will that drive higher corporate and income tax rates? Won't that result in a market sell off? A: We do think higher tax rates would result but think the market may be factoring in that outcome more than perceived.

First, it's useful to look at the market's expectations around political change this election year. The chart below shows the betting odds of which party will win the Senate (orange) and White House (Blue). In April, betting odds were strongly skewed towards Republicans staying in control. However, with the recent COVID outbreak, there has been a meaningful shift in odds, with betting markets now predicting Democrats take control of the Senate and White House (source: www.predictit.com).

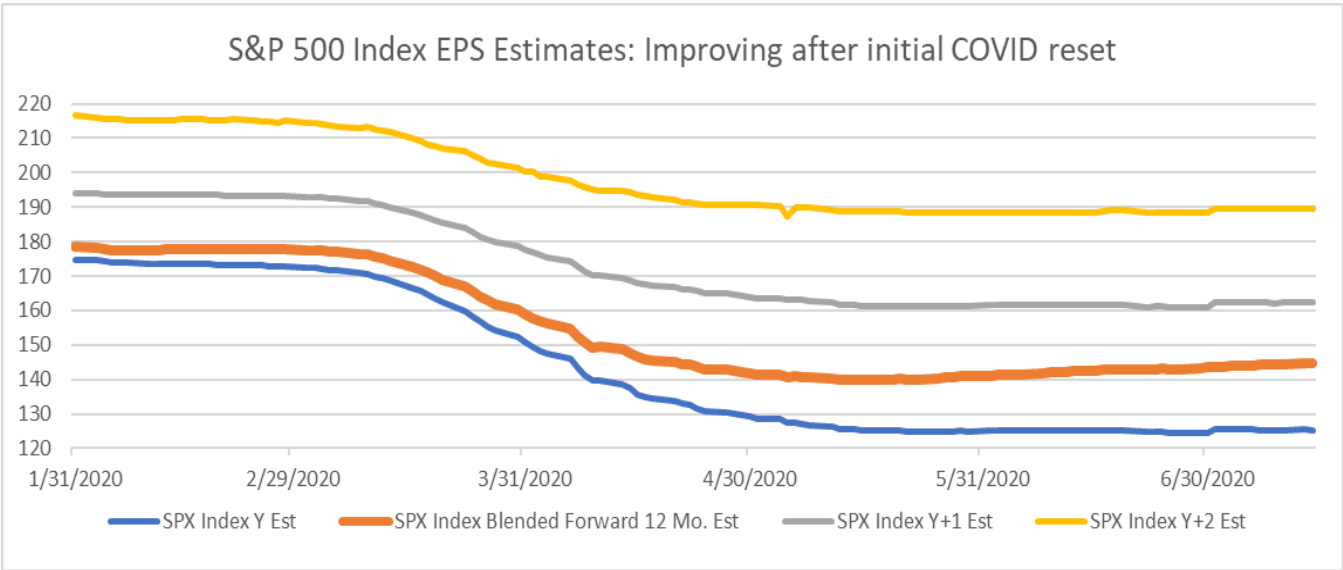


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What’s most interesting about the chart in our view is not who is or who isn’t ahead, but rather that relative standings are widely known information at this point. To the degree the market is efficient in factoring in new data, there should be some level of expectations baked into the market that there will be political change and tax law change as a result.

The second and more compelling point in our view is that a normal earnings recovery post recession allows much of the impact of any corporate tax increases to be offset if you look out a couple of years. While it’s very dangerous to apply historical precedent to this market and subsequent recovery, given its unique nature, one fact pattern we believe can be looked at is earnings progression following periods of weak earnings. Typically in recessions, companies’ earnings are depressed well below their peak capacity, allowing relatively rapid expansion in earnings during economic recovery. Looking at S&P 500 Index estimates, at the beginning of the year the market’s average earnings expectation for 2020 year-end was roughly \$175 per share. Currently, 2020 year-end estimates are about \$125, with the market expecting 2021 and 2022 estimates to increase to \$160+ and \$190, respectively. A brief aside for two additional market supports not often discussed: 1) blended forward 12 month estimates have been growing as depressed earnings for 2020 drop-off and are replaced by a higher proportion of 2021 months at a higher earnings estimate; and 2) earnings estimates appear to have overshot the impact of COVID and recent earnings estimates revisions have been modestly positive.



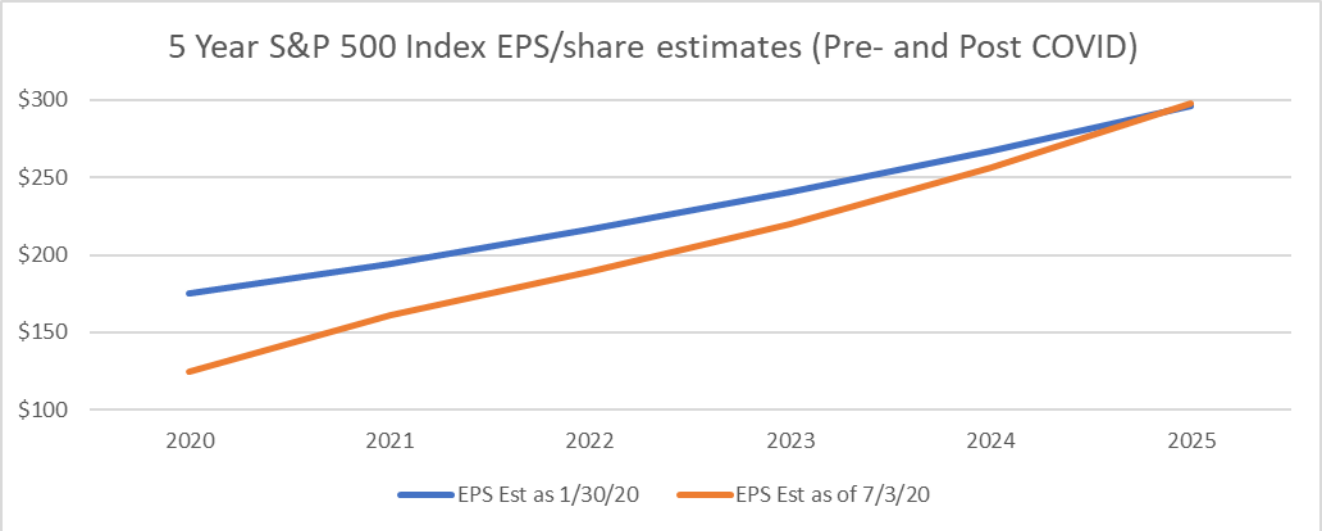
Source: Bloomberg, as of 7/14/2020

The depressed earnings expectation of \$125 versus the pre-Covid earnings power of corporations (\$175+) provides meaningful leverage for earnings to rebound when demand improves post-COVID

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vaccine. Looking at the Shiller historical S&P 500 earnings data (econ.yale.edu), we note that since the US abandoned the gold standard in 1934, the five year average EPS growth rate following any unique period with a 20% decline in S&P 500 earnings (which captures all the well known market sell-offs: 1937, 1941, 1990, 2000, 2007 and now 2020) has averaged 19%. As shown on below, applying that 19% growth rate to the current 2020 earnings estimate of \$125/share results in a 2025 year-end EPS estimate of \$298. Perhaps not coincidentally, growing the EPS estimates prior to COVID by pre-COVID growth rate assumptions of 11% would also have resulted in a 2025 EPS estimate of \$298. In other words, the market appears to be projecting it will take five years to close the gap to the EPS estimates it had in place prior to COVID.



Source: Bloomberg as of 7/3/2020. Assumes 2020-2022 average growth rate of 11% per year as of 1/30/20 extended through year-end 2025; Also assumes total EPS growth rate of 19% per year for 7/3/20 estimates, using published consensus estimates for years 2020-2022, growing at 16% per year thereafter.

From a valuation perspective, adjusting those 5 year earnings estimates downwards by 12% to reflect the impact of potentially higher corporate taxes and applying an 18-22 forward multiple results in a year-end 2024 S&P price range of \$4,725-\$5,775 and potentially attractive return outcomes from today’s levels, implying the market may have more ability to overcome a corporate tax increase than commonly believed.

<u>12/31/24 S&P 500 ending value w/ higher tax rate</u>	CAGR from today*
18x multiple = 4,725	10.6%
22x multiple = 5,775	15.6%

* includes 1.8% dividend yield and 7/15/2020 S&P 500 starting value of 3,227

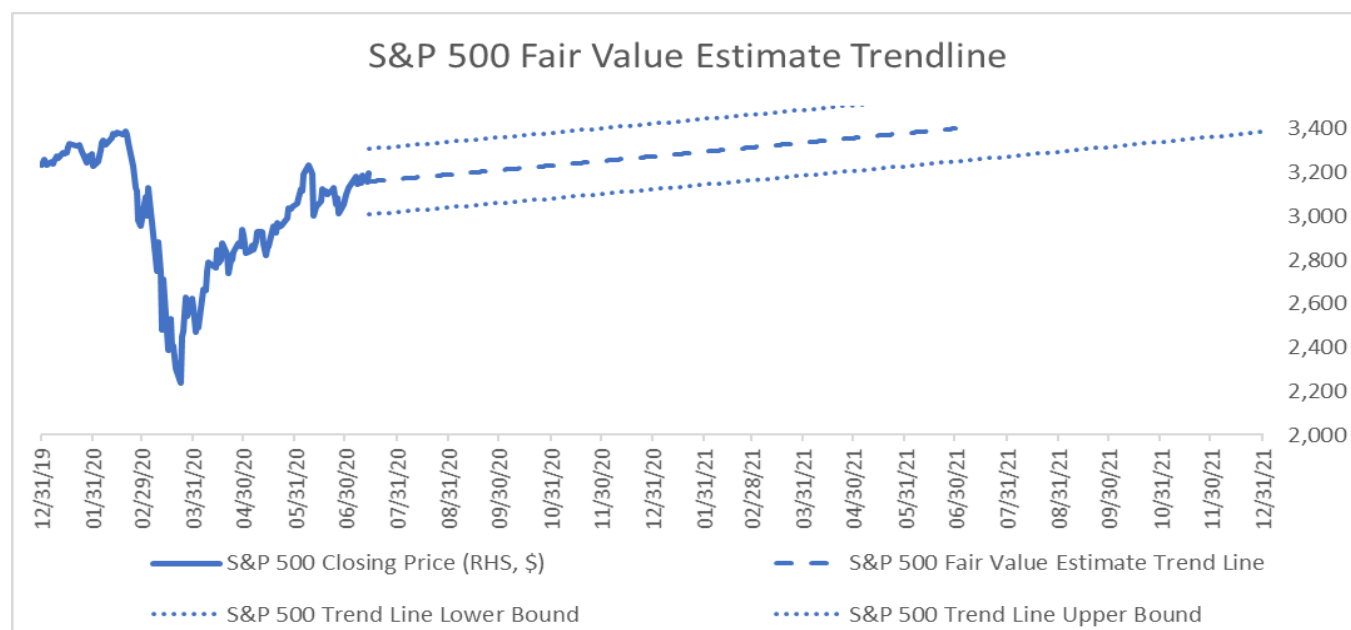
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Q: Where do we go from here? A: Our base case is developed world vaccine delivery sometime mid-year 2021, which implies the market can return to peak in the next 12 months, but is likely to fluctuate around its fair value trendline along the way.

While there is a tremendous degree of uncertainty around the timing of delivery of an effective vaccine, there is less uncertainty every day that a vaccine will be delivered. Estimates around the timing of development and delivery range from early Q1 2021 to end of year 2021 or longer. We think early Q1 is too optimistic, however, given the global government investment in infrastructure, we believe mid-year 2021 for broad based delivery is achievable. With vaccine delivery providing the all-clear for people to return to “normal” life, we think the market can return to pre-COVID peak levels at that time if not sooner. Looking at a June 2021 S&P 500 Index 3,400 price target, and discounting back by an 8%/year historical average price return implies a fair value estimate today of roughly 3,150, growing by about 2% per quarter.

However, we expect market volatility to remain high as daily trading swings are influenced by potential good news (e.g., potential for accelerated vaccine developments, better than expected earnings and economic development) or potential bad news (e.g., accelerated COVID short-term, return to school COVID fears). As a result, we would expect the market to trade within a band of +/- 150 points of fair value any given day depending on the news, but note that a true acceleration of vaccine delivery towards front of year 2021 would adjust the trendline up and a meaningful delay would push the trendline down.



Source: Factset, RCM FO view as of 07/14/2020.

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While we remain concerned and are closely watching how the coronavirus impacts the economy and the stock market over the next several months, we remain optimistic about the longer-term direction and stability of the economy as highlighted in this report. Extending time horizons and focusing on longer term trends vs. shorter-term news flows is one of the most valuable investment decisions individual investors can make. Portfolio construction decisions are inherently individual decisions due to differences in taxation, spending requirements, risk aversion and time horizon among other factors. Please contact your advisor to discuss your individual situation, at a minimum, be sure to stress test your downside tolerance in the event there is a larger market sell-off and to re-examine your estate gifting plans in the event current law changes next year.

Sincerely,



Sean Leonard
Chief Investment Officer
Rockefeller Capital Management Family Office

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