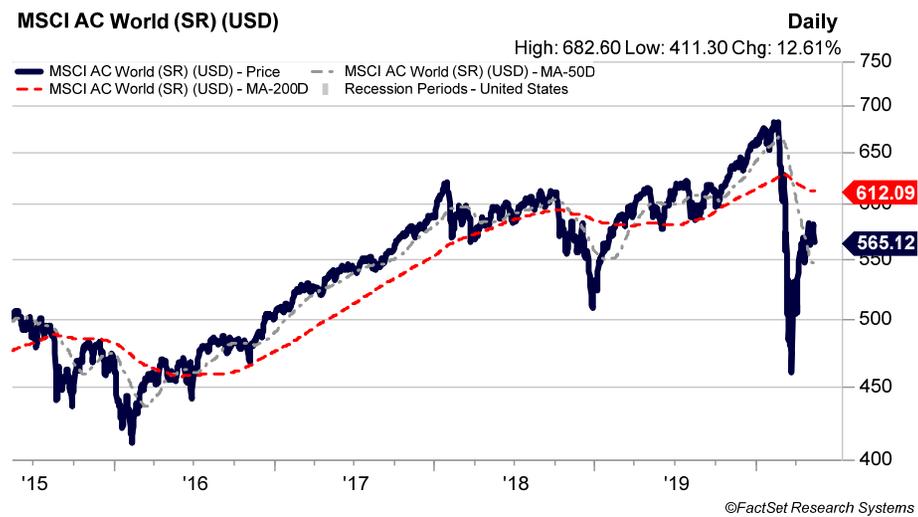


# Observation Deck

Views from the Investment Policy Committee



2<sup>nd</sup> Quarter 2020

# Purpose

- The Observation Deck is a series of pictures designed to communicate points of view and to stimulate discussion and debate, it is NOT a set of recommendations
- Our commentary is not the result of any single data point or graphic, it is a reflection of the weekly conversations within the Investment Policy Committee and a set of perspectives that are derived from many observations accumulated over varying time frames
- Slides that are included in the Observation Deck are a subset of the scores of data points and graphics that the Investment Policy Committee views each week in assessing the status of the business cycle and the health of financial markets
- We hope that you enjoy the Observation Deck and recognize that the views and opinions expressed are capturing a moment in time and are subject to change without notice



Top  
**Financial  
Advisers**  
2019

FT 300 Ranking June 2019

# Macro TIP Chart

## Tactical Investment Positioning

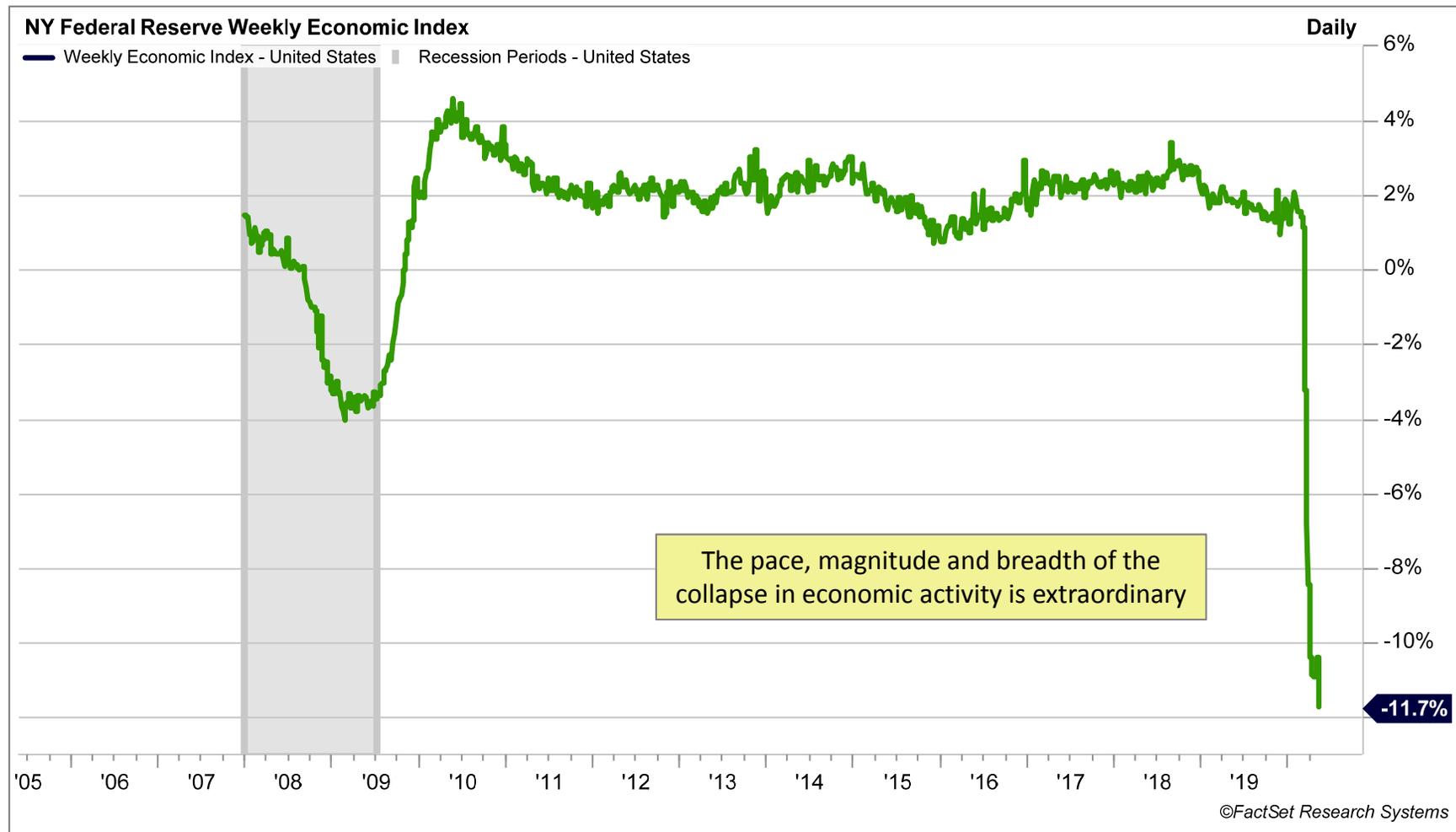
2<sup>nd</sup> Quarter 2020

Strength of Conviction	Chg	Negative	Neutral	Positive	Rationale
Business Cycle	←				Response to COVID-19 arresting all global and local commerce. Near term GDP plummeting. Unemployment moving sharply higher.
Financial Conditions	→				Central Banks bringing maximum liquidity support to financial system. Fiscal programs rolling out to assist payrolls and SMB.
<b>Relative Preference</b>	<b>Chg</b>	<b>Neutral</b>			<b>Rationale</b>
Asset Class	→	Bonds	Stocks		The decline of stock prices and collapse in interest rates make the long-term performance outlook more attractive for shareholders.
Economic Sensitivity	→	Defensive	Cyclical		Near term profit pressures will be most pronounced for cyclicals vs defensives, but stock prices already reflect most of this outlook.
Credit Quality	→	Sovereign	Credit		Credit spreads have moved considerably wider in anticipation of economic contraction creating story specific opportunities.
Duration Profile		Short Maturity	Long Maturity		Yield curve has moved steeper but absolute level of rates is extraordinarily low given monetary policy and low inflation outlook.
Commodities		Below Weight	Above Weight		Severe demand destruction consistent with economic contraction. World awash in extreme oil supply exacerbated by market share war.
Cash		Below Weight	Above Weight		Federal Reserve re-establishes zero interest rate policy. Rate change will require significant change in growth or inflation data.

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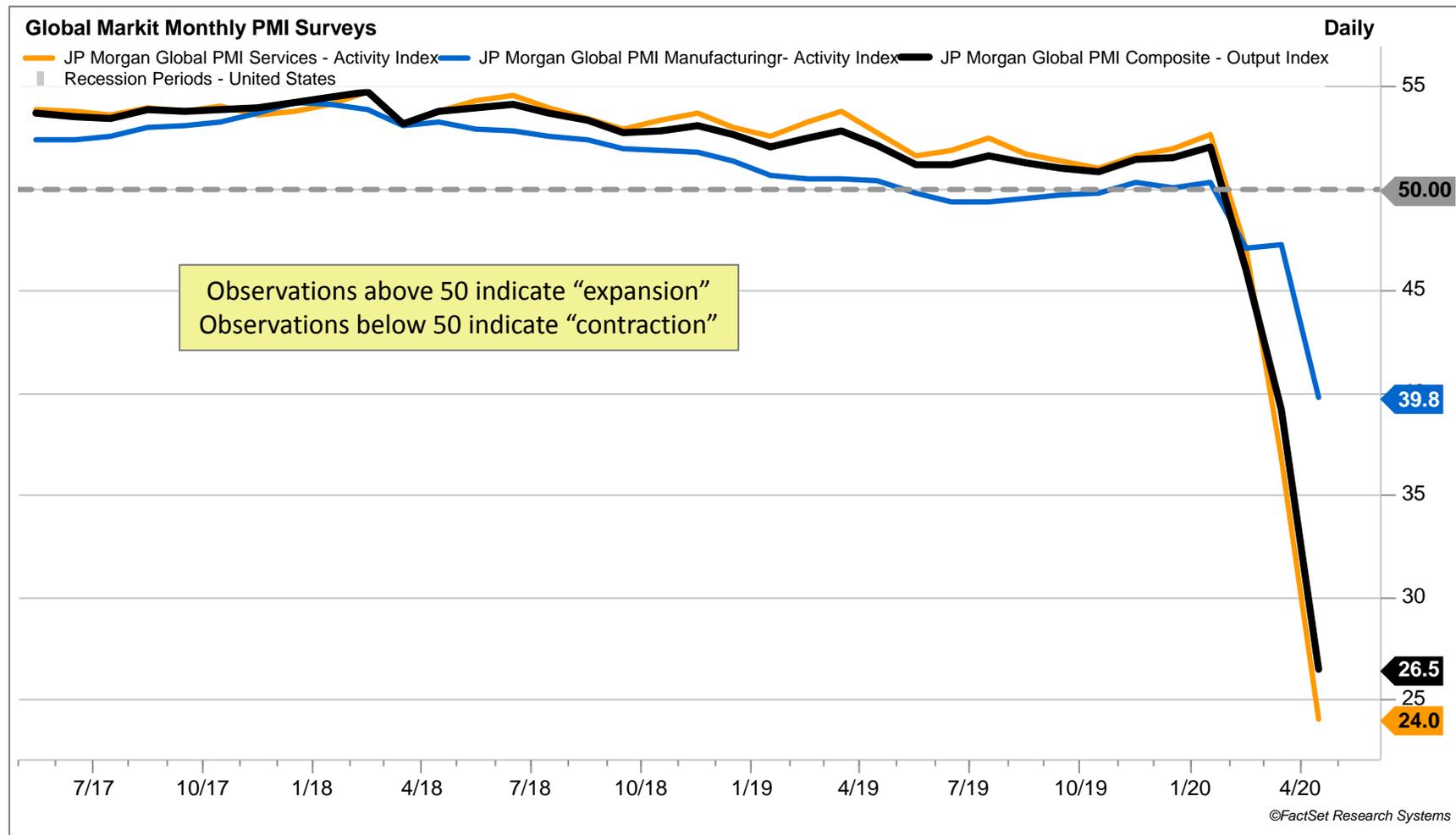
## Shutting Down an Economy

- The pace of economic collapse associated with COVID-19 is unprecedented. The magnitude of change in the economic data is causing enormous distortion in charts; it is critical to acknowledge scale.
- The NY Fed publishes a Weekly Economic Index (WEI) of 10 high frequency economic indicators. The decline is astonishing and eclipses the depths of the 2008-09 GFC.



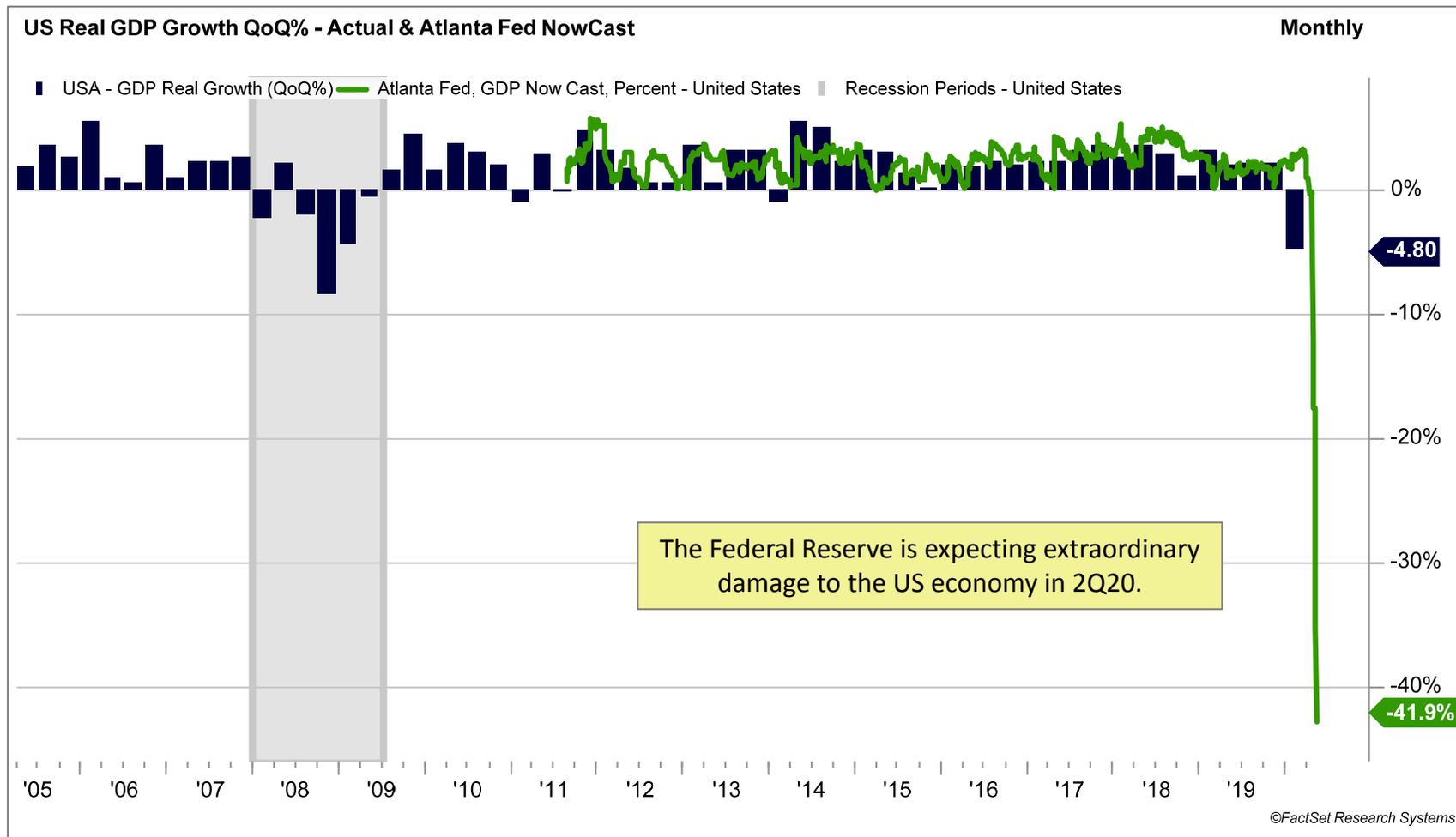
## Shutting Down an Economy - Global

- One of our favorite leading indicators has always been the set of IHS Markit Monthly PMI Surveys, diffusion indexes that are divided between manufacturing and services sectors of the economy.
- The Global PMI's provide a leading indicator view of economic conditions. The manufacturing sector (light blue) typically exhibits greater cyclicality, but the collapse in services (gold) is a new experience.



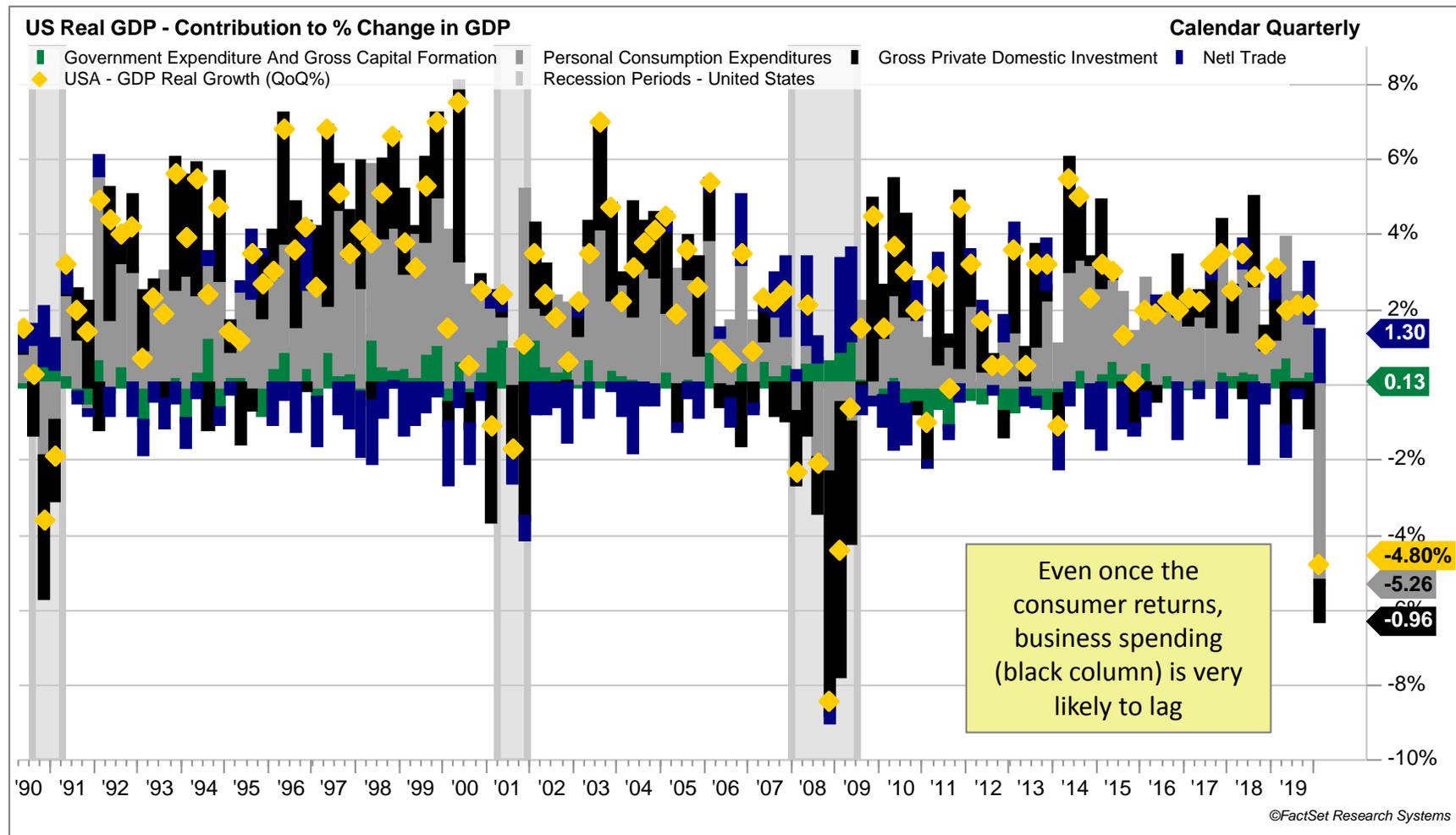
## Significant Business Cycle Damage

- Measuring the totality of economic activity is an arduous task. By the time calculations are complete, the outcomes are akin to looking in the rear view mirror. The results are still insightful, albeit late.
- US quarterly Real GDP (dark blue columns) declined 4.8% in 1Q20 as the economy ground to a halt in March. But the real damage is just occurring as observed in the Atlanta Fed expectations (green line).



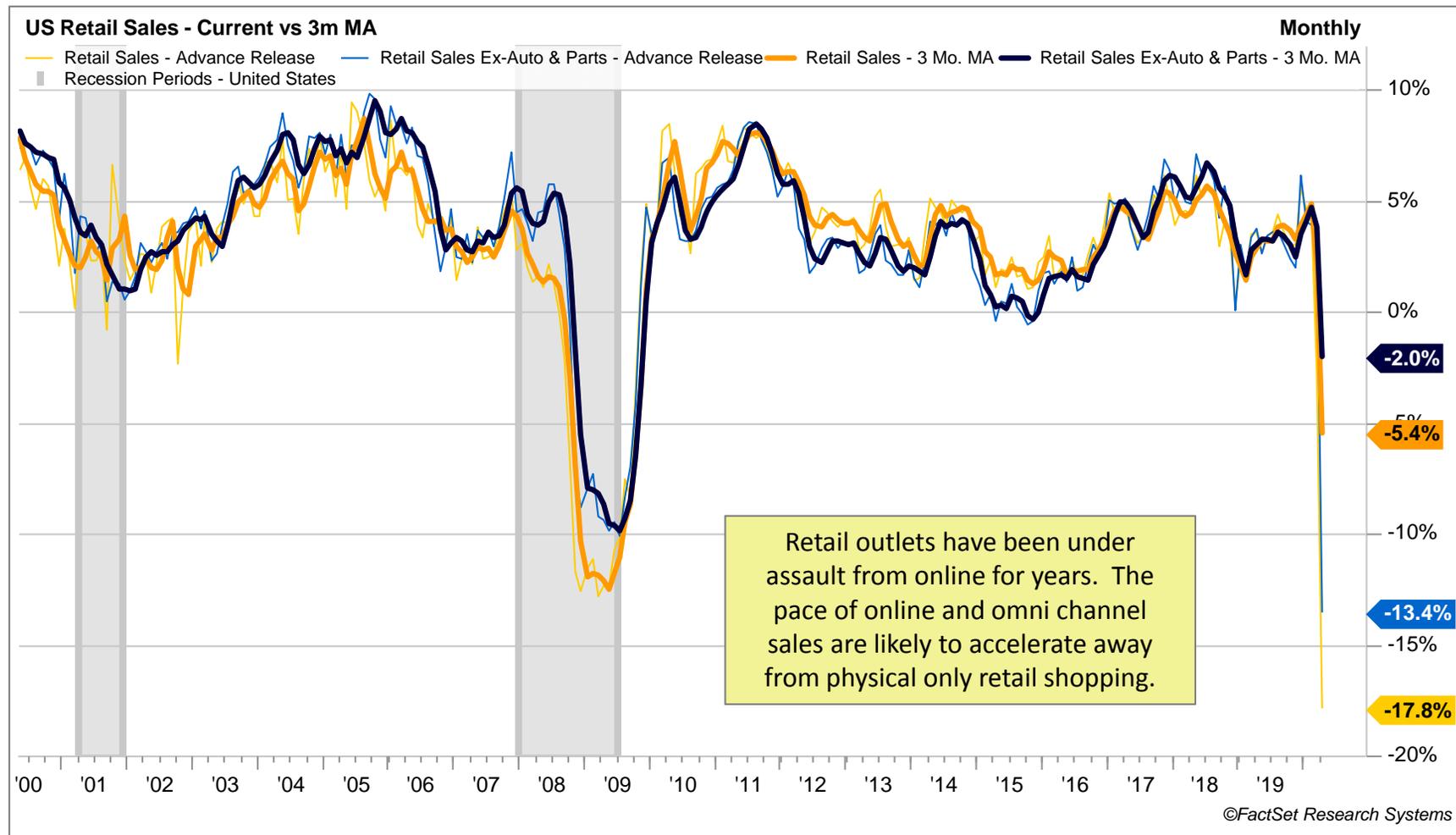
## Significant Business Cycle Damage

- It's a busy chart, but US Real GDP is broken down into four major segments of economic output with PCE delivering the greatest contribution – nearly 70% of US GDP comes from consumer spending.
- Looking back at 30 years of quarterly GDP data, including the 2008-09 GFC, we have never seen consumer spending (gray column) plunge at this magnitude – and the 2Q20 is likely to be even worse.



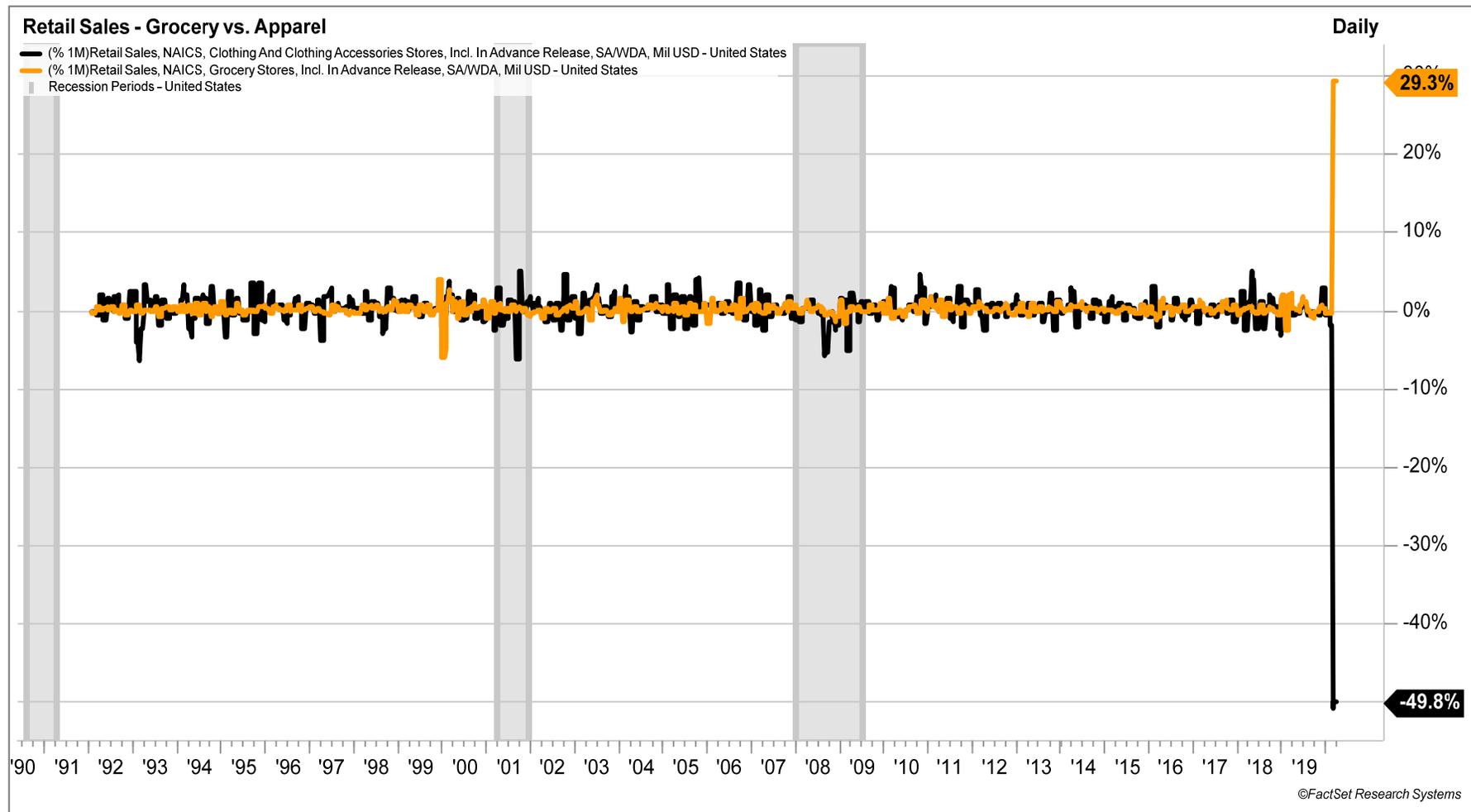
## The Consumption Collapse

- The US economy has transitioned over the decades from production based activities in manufacturing, mining and farming, to its current indulgence in the consumption of goods and services.
- The US consumer loves to shop, but “stay-at-home” has meant considerably less spending. While online sales rose 8.4%, the April retail sales total (light yellow) and ex-auto (light blue) were dismal.



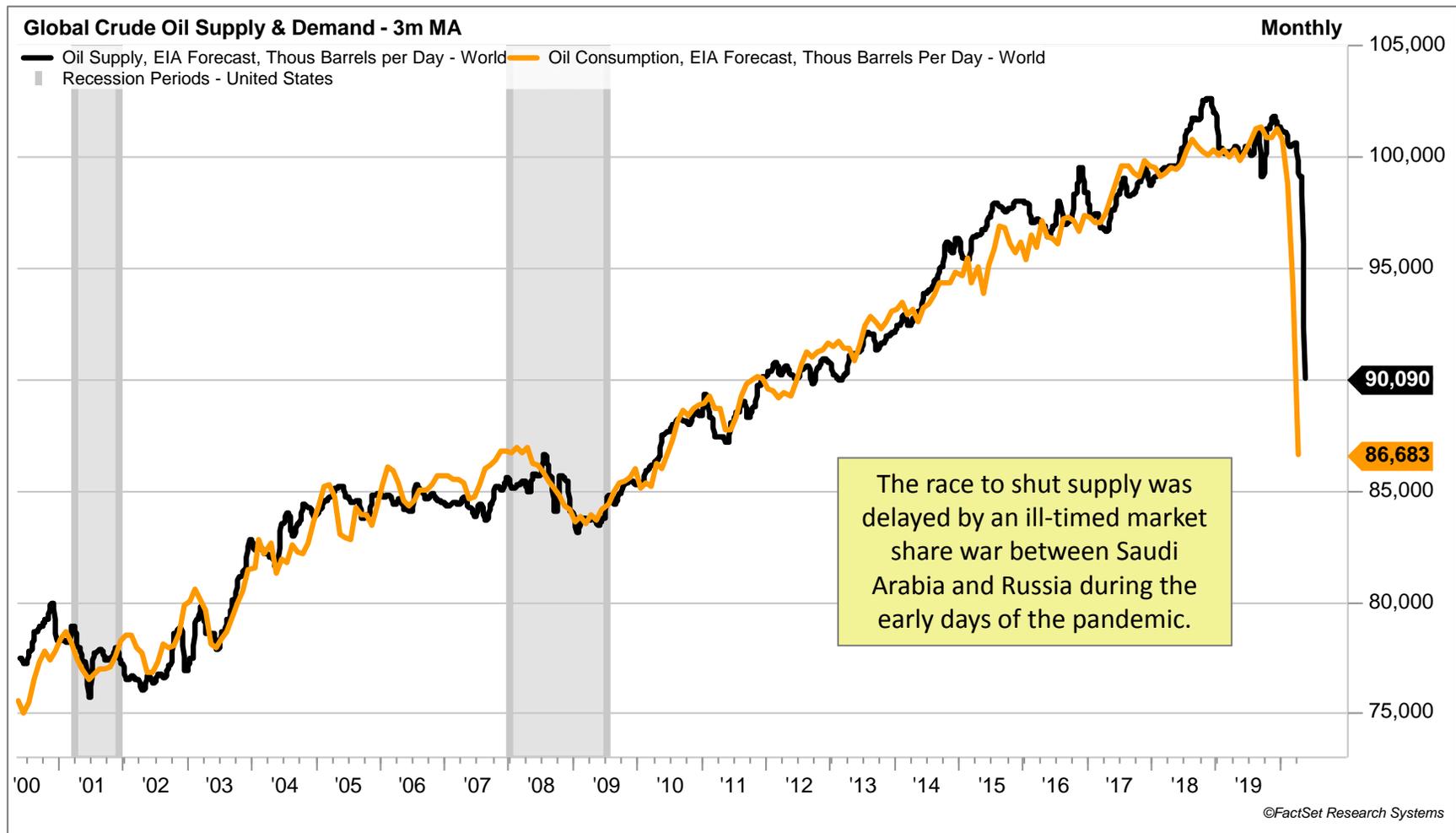
## The Consumption Collapse

- Viewing the details of consumer spending trends during COVID-19 is a fascinating exercise. The accelerating trend in favor of online shopping is to be expected, now approaching 1/3<sup>rd</sup> of retail sales.
- The comparison of Grocery spend (gold line) versus Apparel spend (blue line) in March is a striking view of a pandemic stricken economy.



## The Consumption Collapse

- When consumers are isolated at home, the demand for gasoline, jet fuel and other distillates evaporates.
- The price for crude oil collapsed in April as production levels (blue line) could not be turned down fast enough to match the demand destruction (gold line) and diminishing storage capacity.

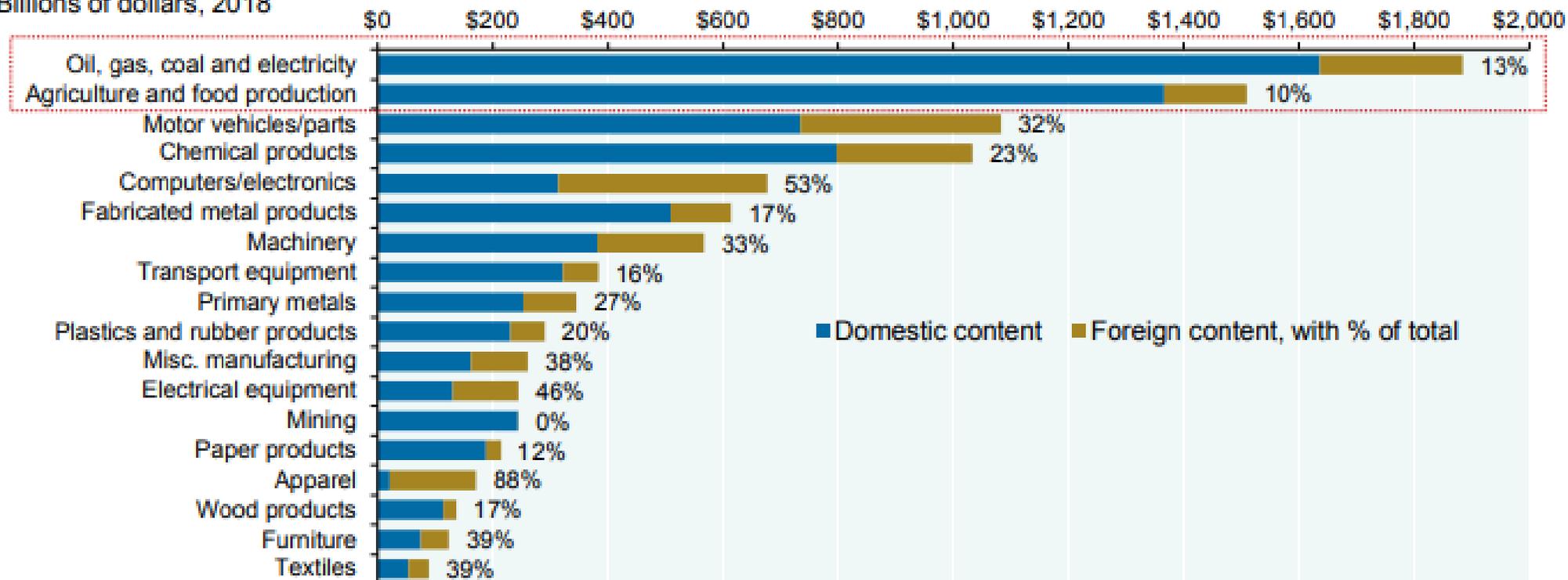


## Food & Energy

- The US economy is dominated by consumption and services, but we still manage to produce a lot of goods. Our ability to produce, store and transport food and energy is of critical importance.
- The Bureau of Economic Analysis shares this breakdown of goods production by domestic versus foreign content. An outcome of COVID-19 may be a change in supply chain management that brings more content production closer to the US consumer across many of these categories.

### Food & energy: the largest goods sectors in the economy, and the ones most reliant on domestic production

Billions of dollars, 2018



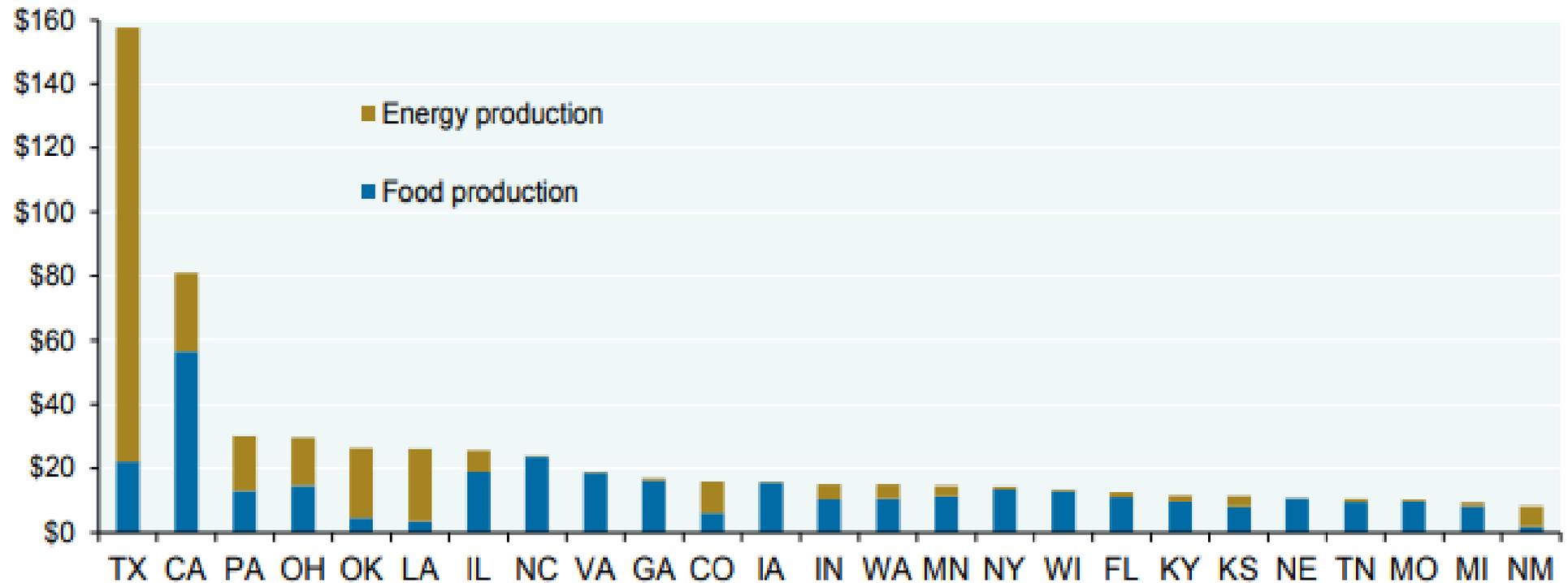
Source: BEA, JPMAM. 2020. Domestic content is derived from BEA Input-Output tables, and includes intermediate value added plus direct final

## Food & Energy

- Countries without domestic food and energy supplies are reliant on geopolitically insecure and costlier imports to support their increasingly urbanized populations.
- Food and Energy prices have always exhibited high volatility, but they have been exacerbated by the COVID-19 pandemic that has placed enormous pressures on shifting supply and demand patterns.

### US food and energy production, top 25 states

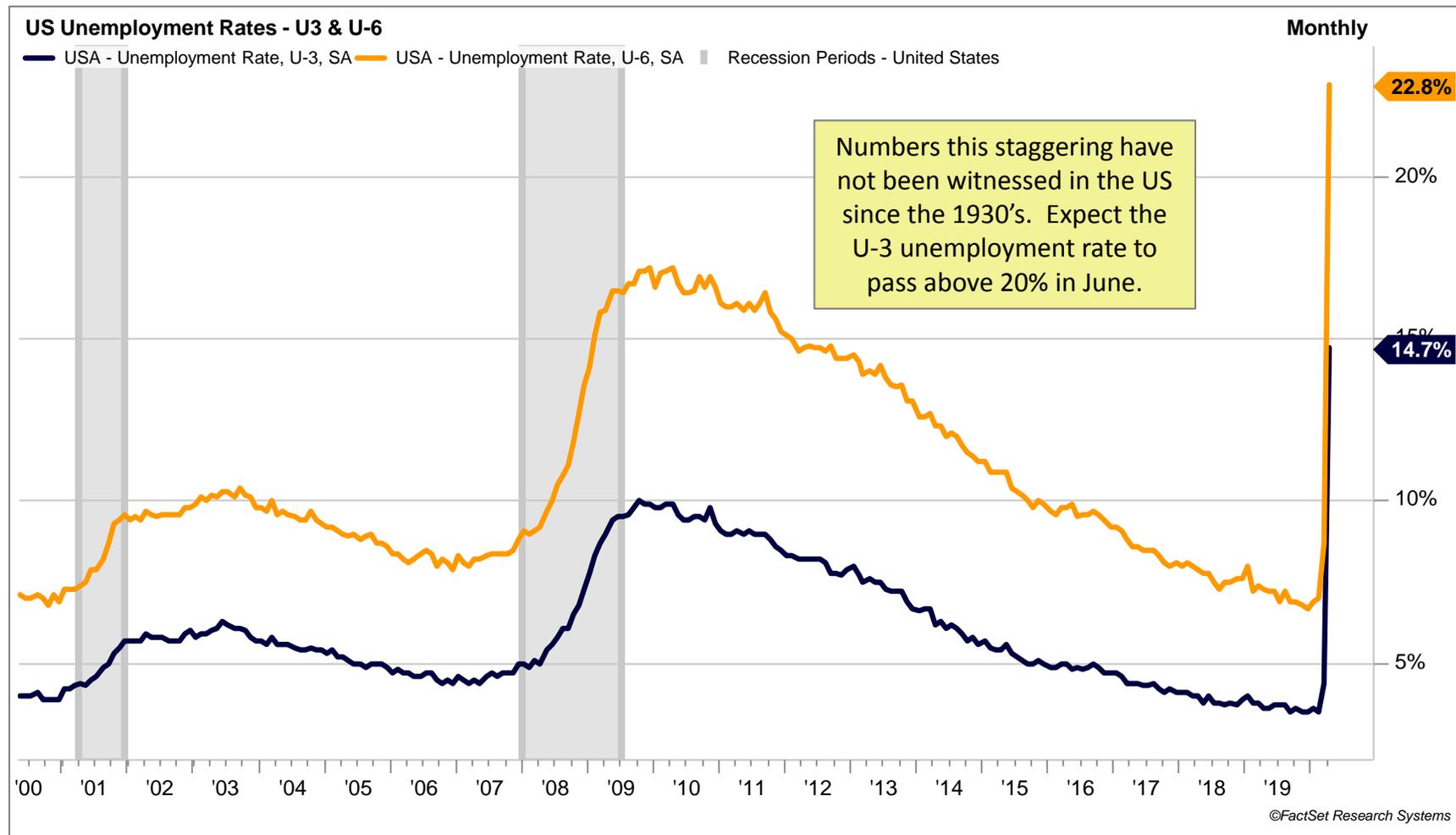
Billions of dollars, 2018



Source: BEA, J.P. Morgan Asset Management. 2020. States shown account for 87% of total US food and energy production.

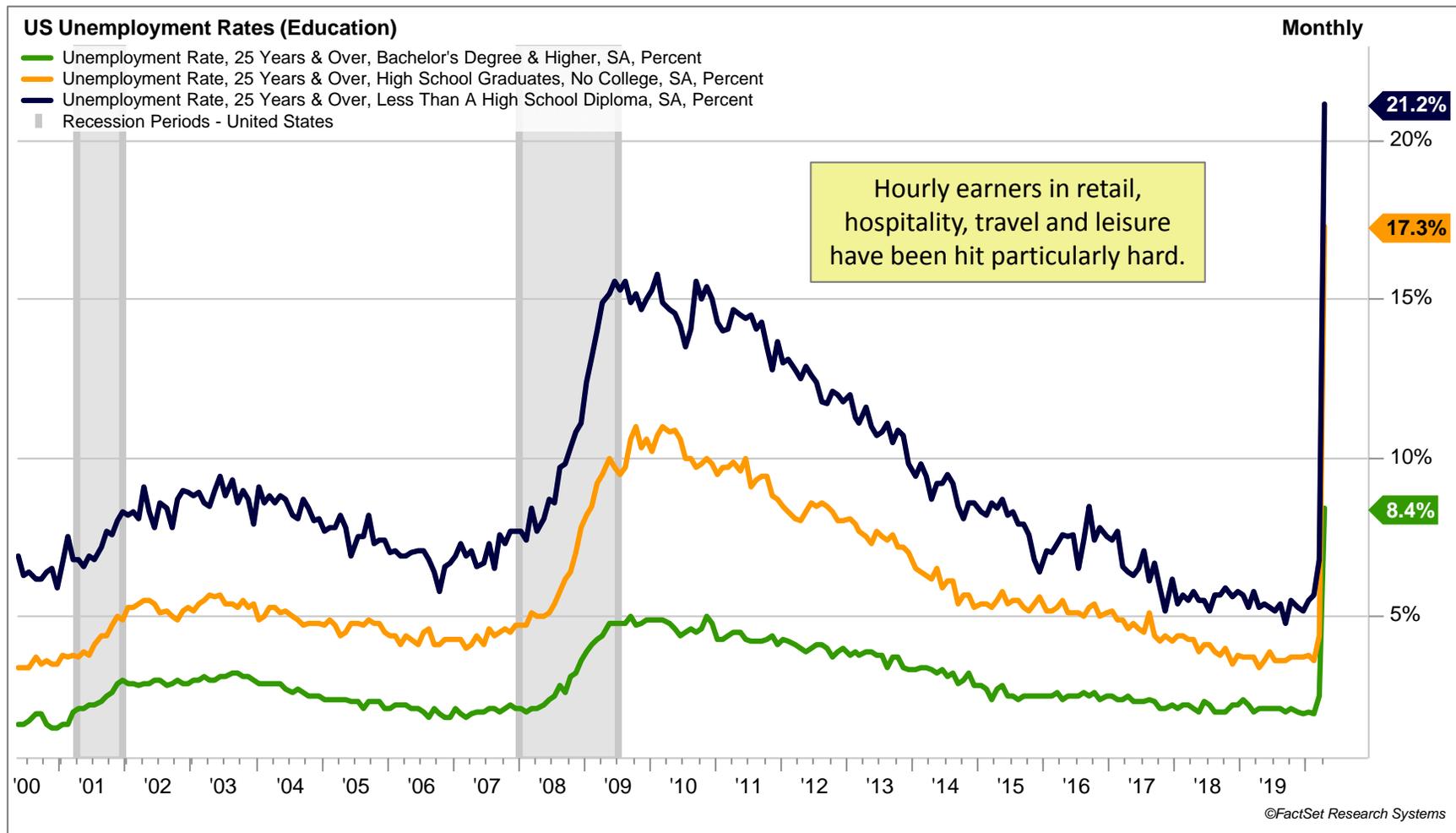
## Employment – The Epicenter

- Nearly 39m Americans have lost their jobs since the beginning of March. The U-3 unemployment rate (blue line) is expected to move above 20% when released in early June.
- The Cares Act and other fiscal programs have preserved disposable income for many Americans so far. The fate of the economic recovery will depend on how many and how quickly jobs come back.



## Employment – The Epicenter

- Hourly earners with lower levels of education have suffered the greatest number of lost jobs so far. The enhanced unemployment benefits are providing significant incomes to this group...through July.
- In the April employment report, nearly 95% of furloughed white collar workers (green line) expected their job to be waiting for them upon re-opening. That appears overly optimistic, in our view.



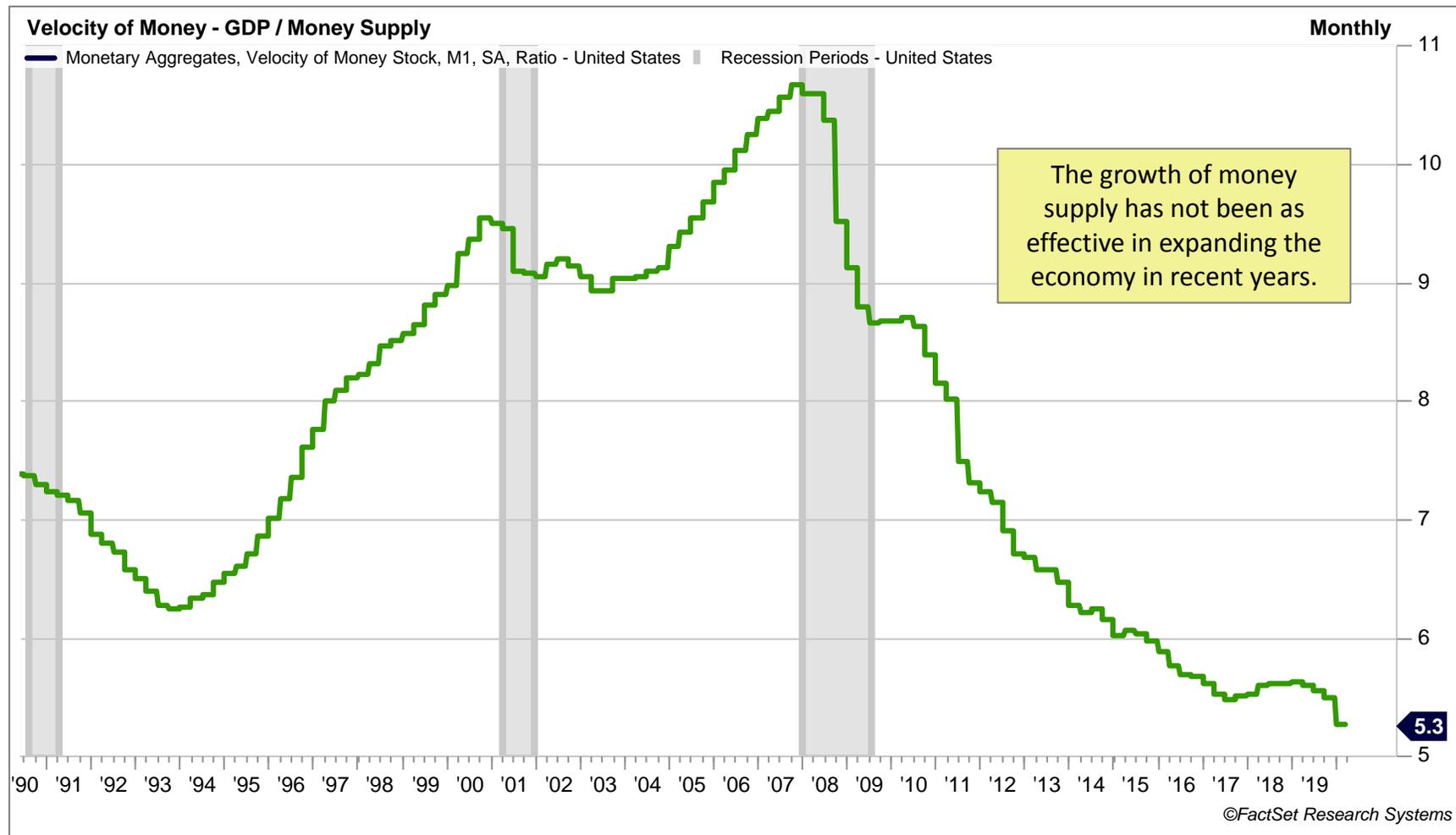
## Money Supply & Velocity

- The response by policy makers has been nothing short of awesome in size and scope. The Federal Reserve has opened numerous programs for providing liquidity and expanding money supply.
- Interest rate policy has been utilized by the Federal Reserve for decades, but the full power of the Fed's balance sheet is bringing substantial liquidity to the economy and financial markets.



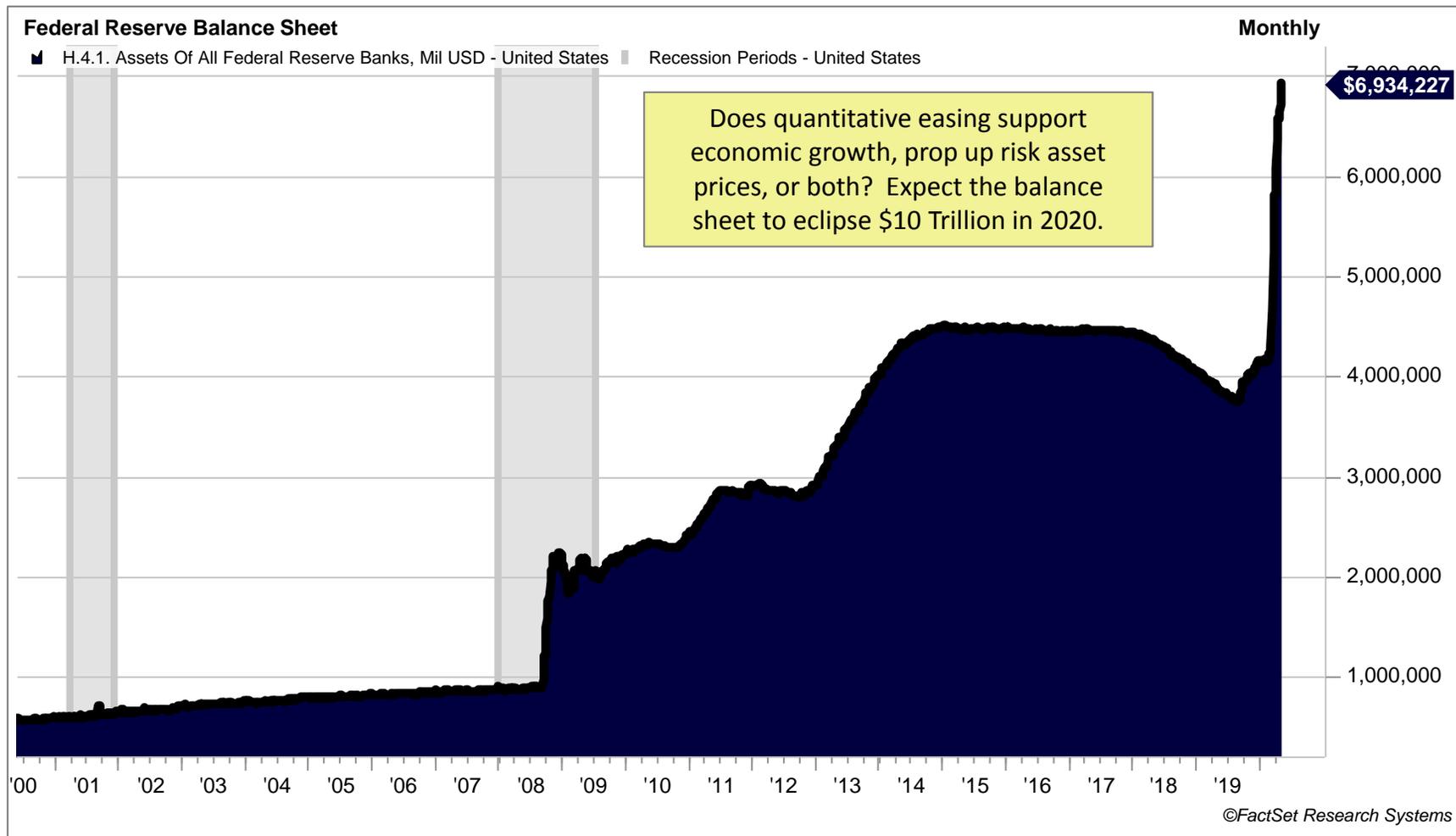
## Money Supply & Velocity

- The Federal Reserve can dramatically increase the availability of money and can inject liquidity into capital markets, but it has a harder time getting the money to exchange hands within the economy.
- Although money supply has exploded higher, the velocity of money remains dismally low. So far, it has had a greater influence on the prices of financial assets than it has the real economy.



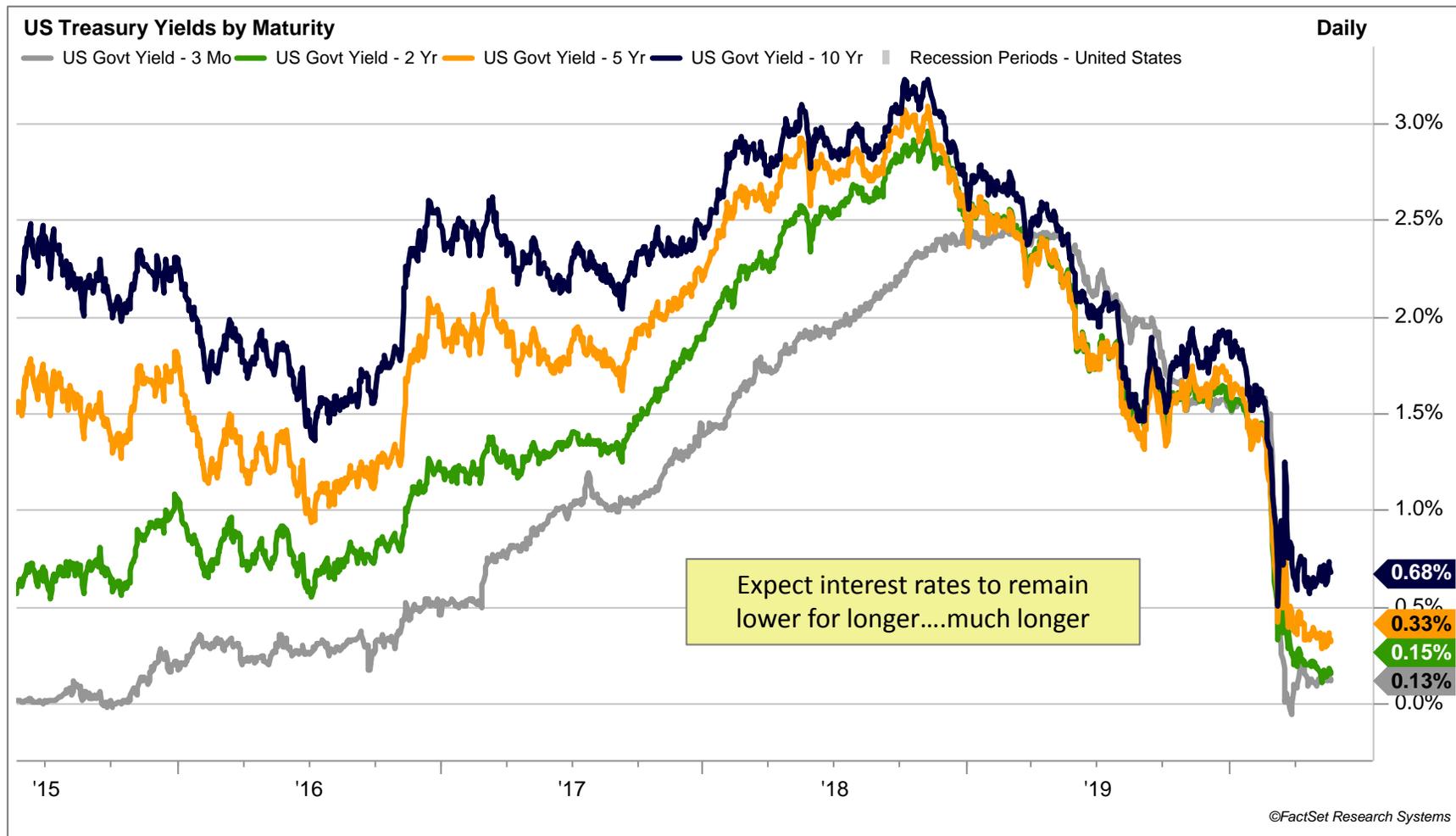
## Money Supply & Velocity

- “Moral hazard”, “Too big to fail”, “nationalized bond market”, there is much to consider when viewing the actions of the Federal Reserve and the use of its balance sheet. It is not “unprecedented”, as similar programs have been active in Japan and the Eurozone for years. Examine their results carefully.
- “Nothing is so permanent as a temporary government program” – Milton Friedman



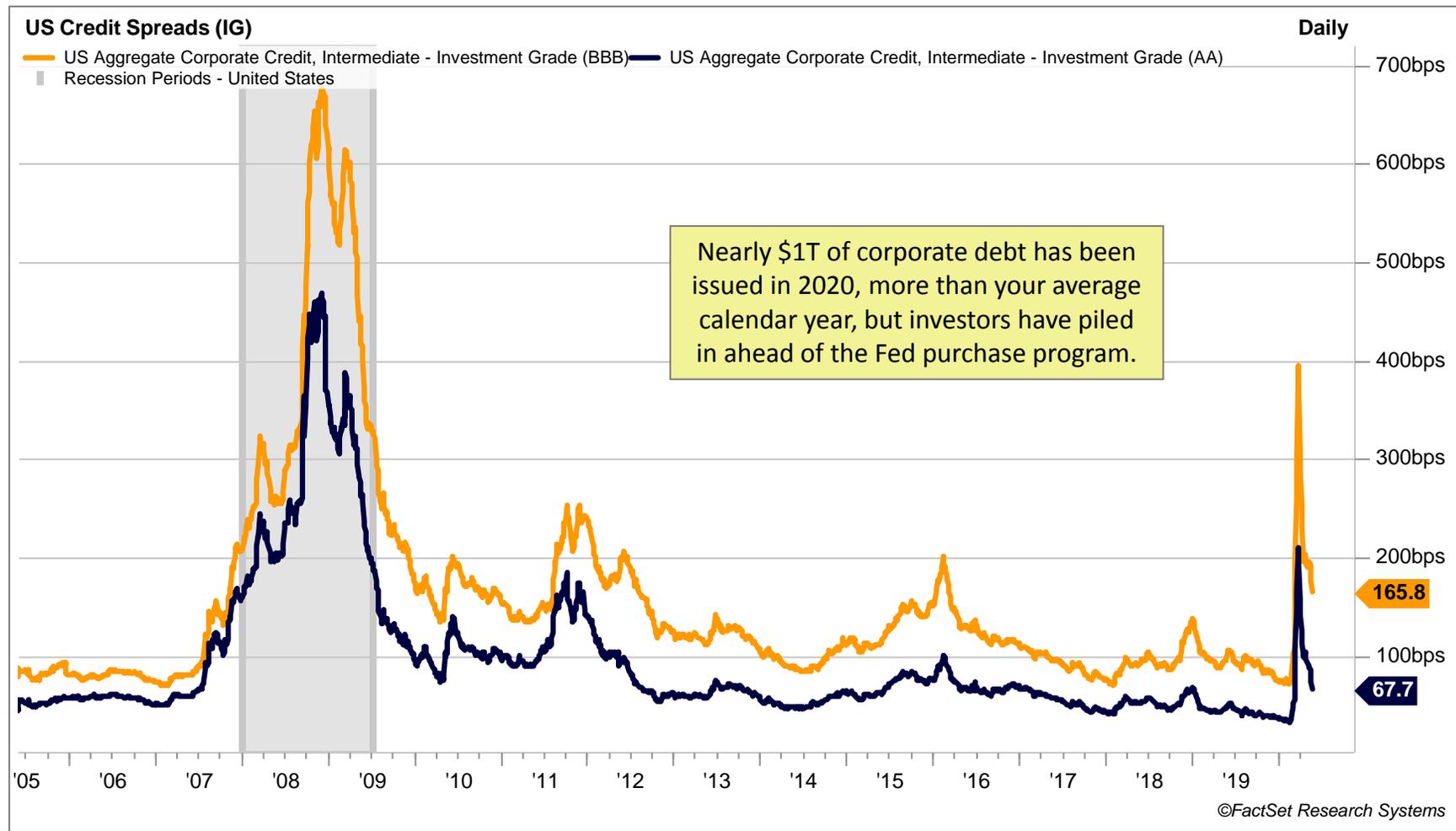
## Federal Reserve & Risk Asset Distortion

- The 'Age of the Central Banker' has become even more pronounced in the monetary policy responses to the COVID-19 pandemic. Central banks around the world have taken extraordinary measures.
- Lowering interest rates to the zero-bound was only one step taken by the Federal Reserve. The scale and influence of quantitative easing is remarkable. Yield curve controls is a logical next step.



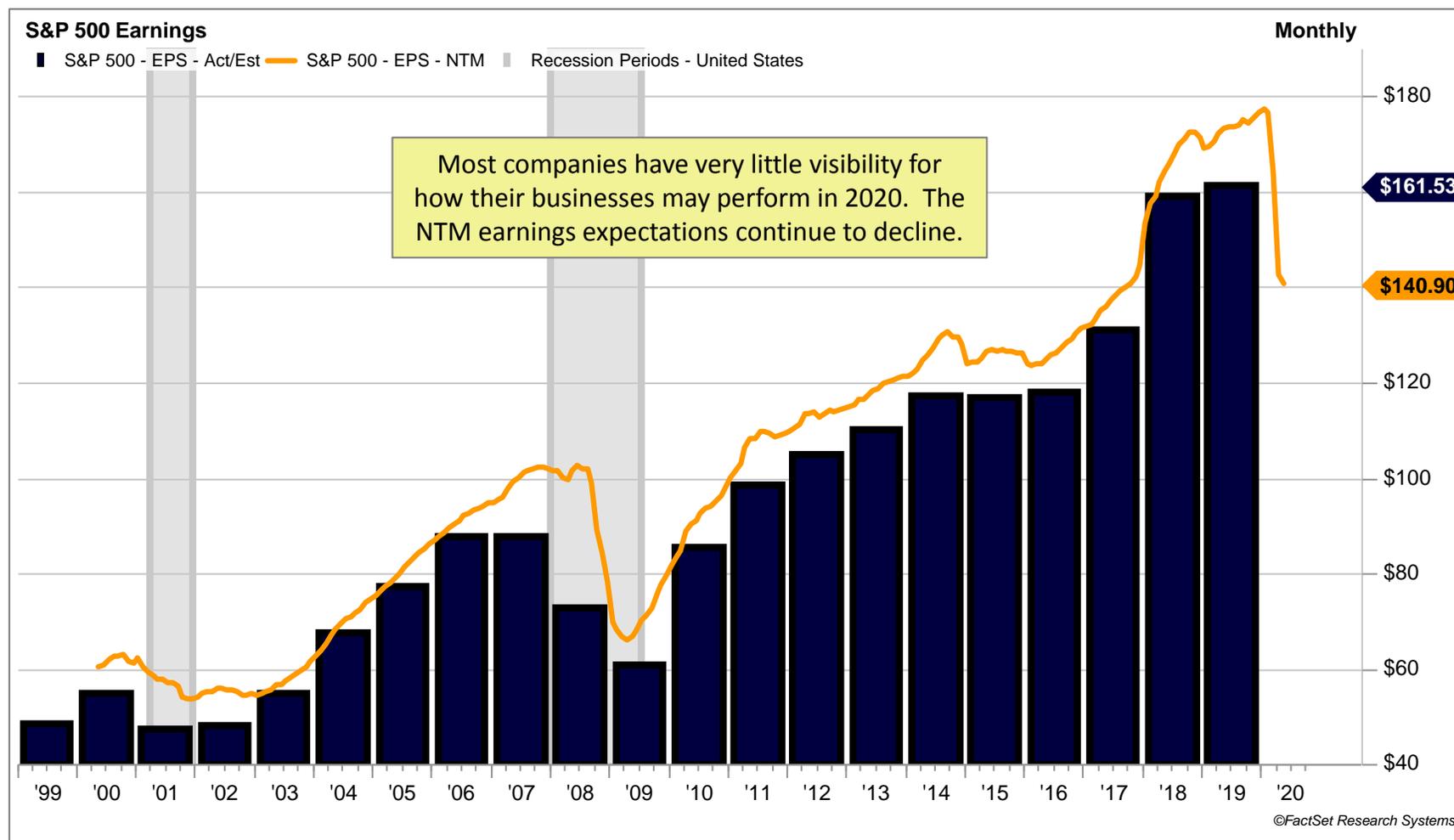
## Federal Reserve & Risk Asset Distortion

- The latest round of quantitative easing by the Federal Reserve, that has extended purchases to corporate issuers and asset-backed securities, has created a tension in bond markets.
- High levels of corporate leverage and an economic recession would normally push credit spreads materially wider, but instead the Fed has effectively supported even greater amounts of debt issuance.



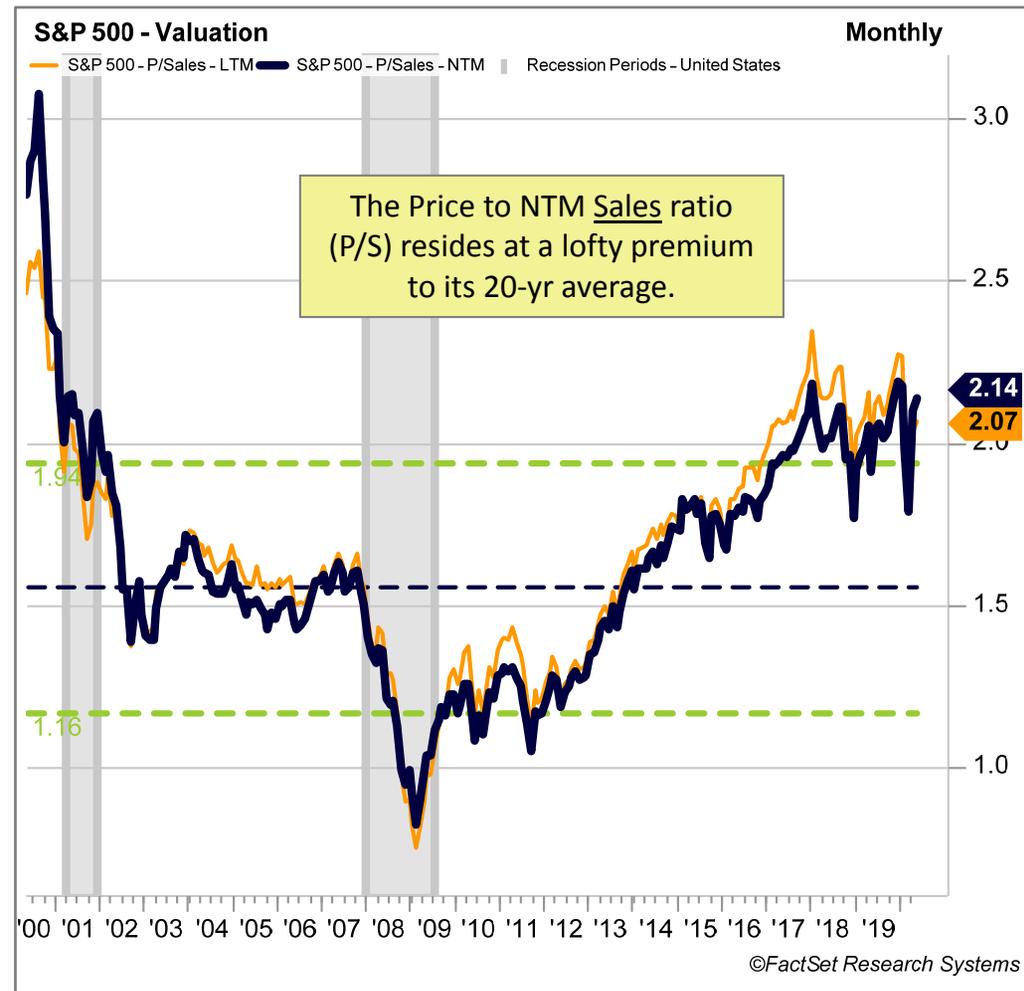
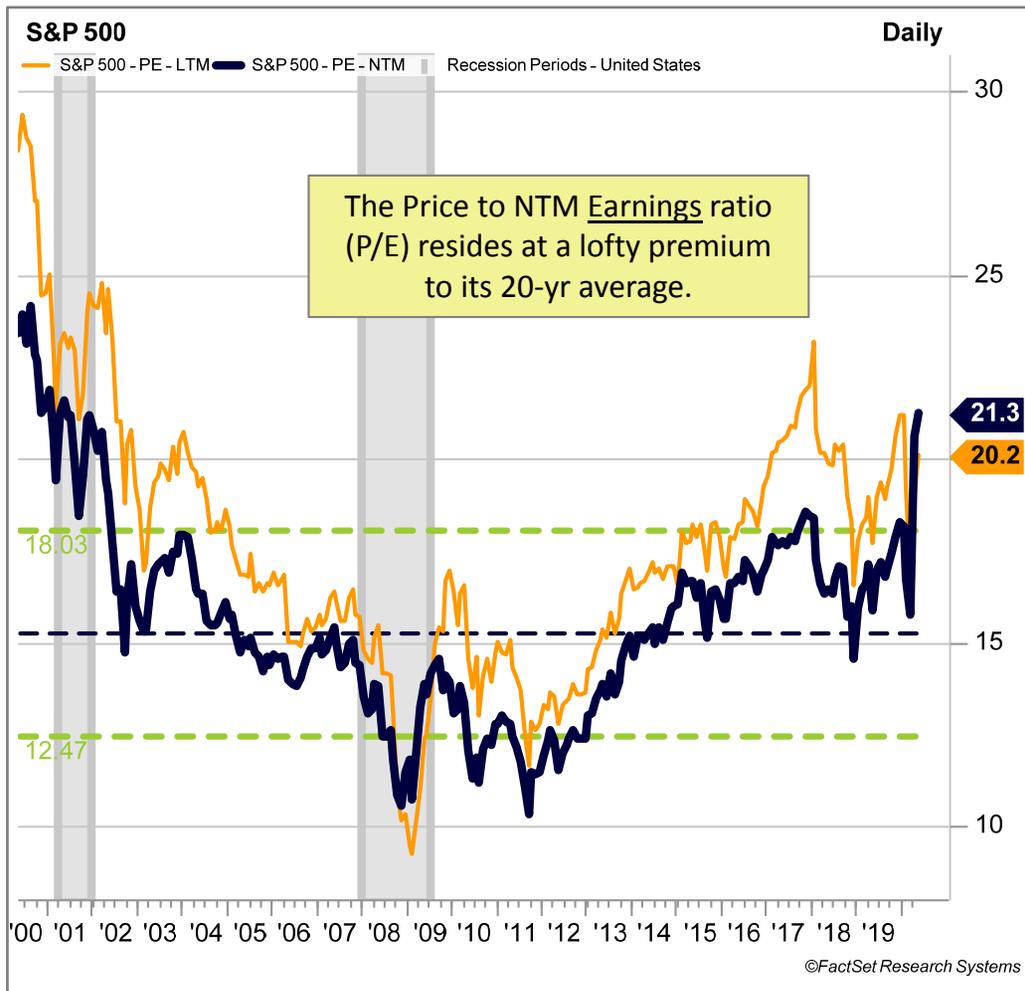
## Stocks Love Sales & Profits

- Economic expansions are great tailwinds for higher sales and growing profits. The near 160% growth in profits over the last 10 years was a great contributor to stock performance.
- The abrupt closing of the global economy is expected to cause a significant decline in corporate profits for at least the next few quarters. The pace of profit recovery is of great debate.



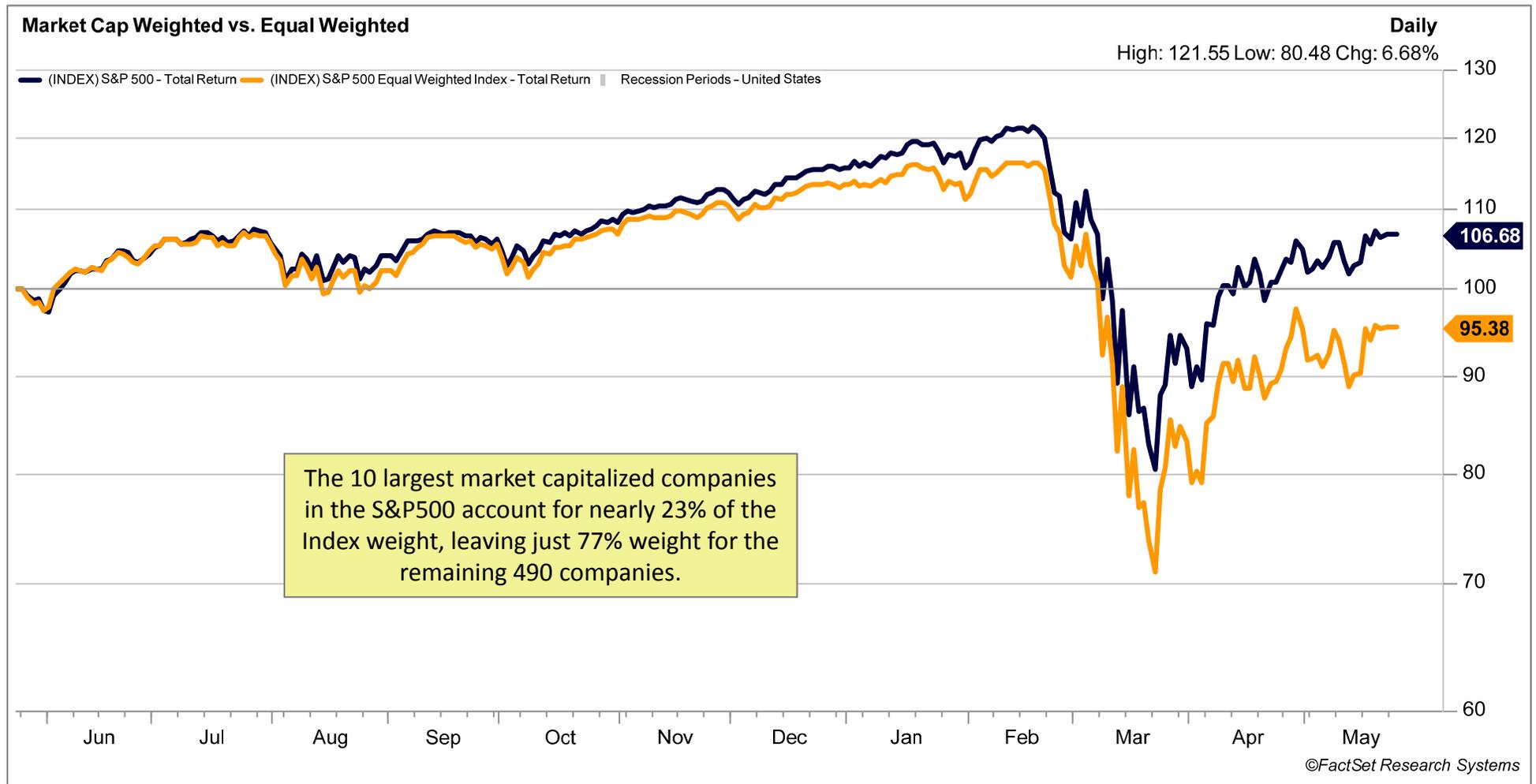
## Stocks Love Sales & Profits

- Investors are often willing to pay a premium for stocks when economic growth is delivering higher sales and profits, but are not as enthusiastic during contractions that bring heightened uncertainty.
- Stocks have not experienced the retreat in valuation ratios that typically accompany falling sales and profits. The extraordinary fiscal and monetary response has been viewed favorably by investors...so far.



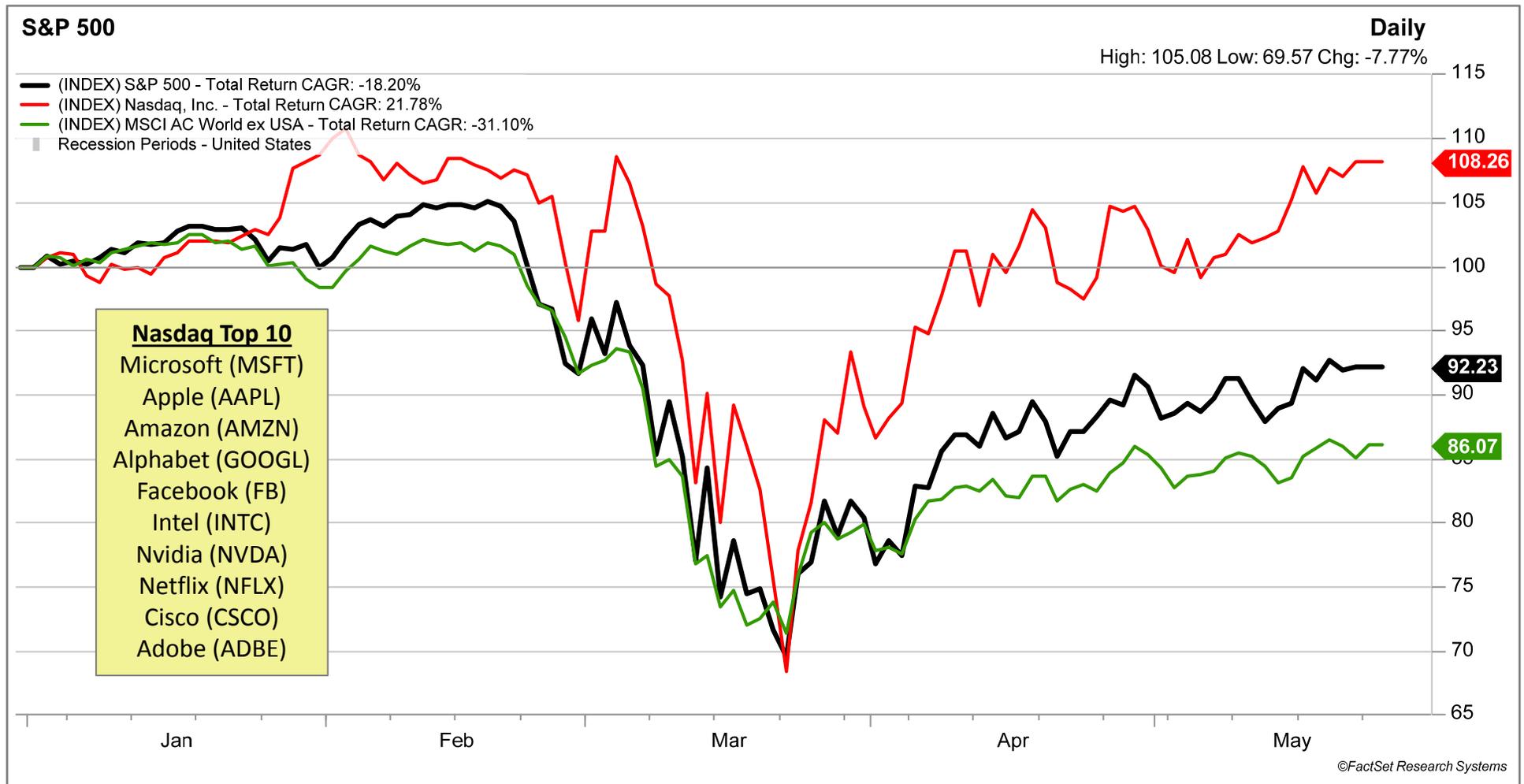
## Know What You Own

- The stock market is caught between two powerful forces. On the one hand, investors acknowledge the nearly \$6 trillion of central bank liquidity that is being injected into the system. On the other, is the recognition that valuations are facing a significant earnings decline in 2020.
- Market breadth has been extremely narrow, meaning that returns are coming from a very select group.



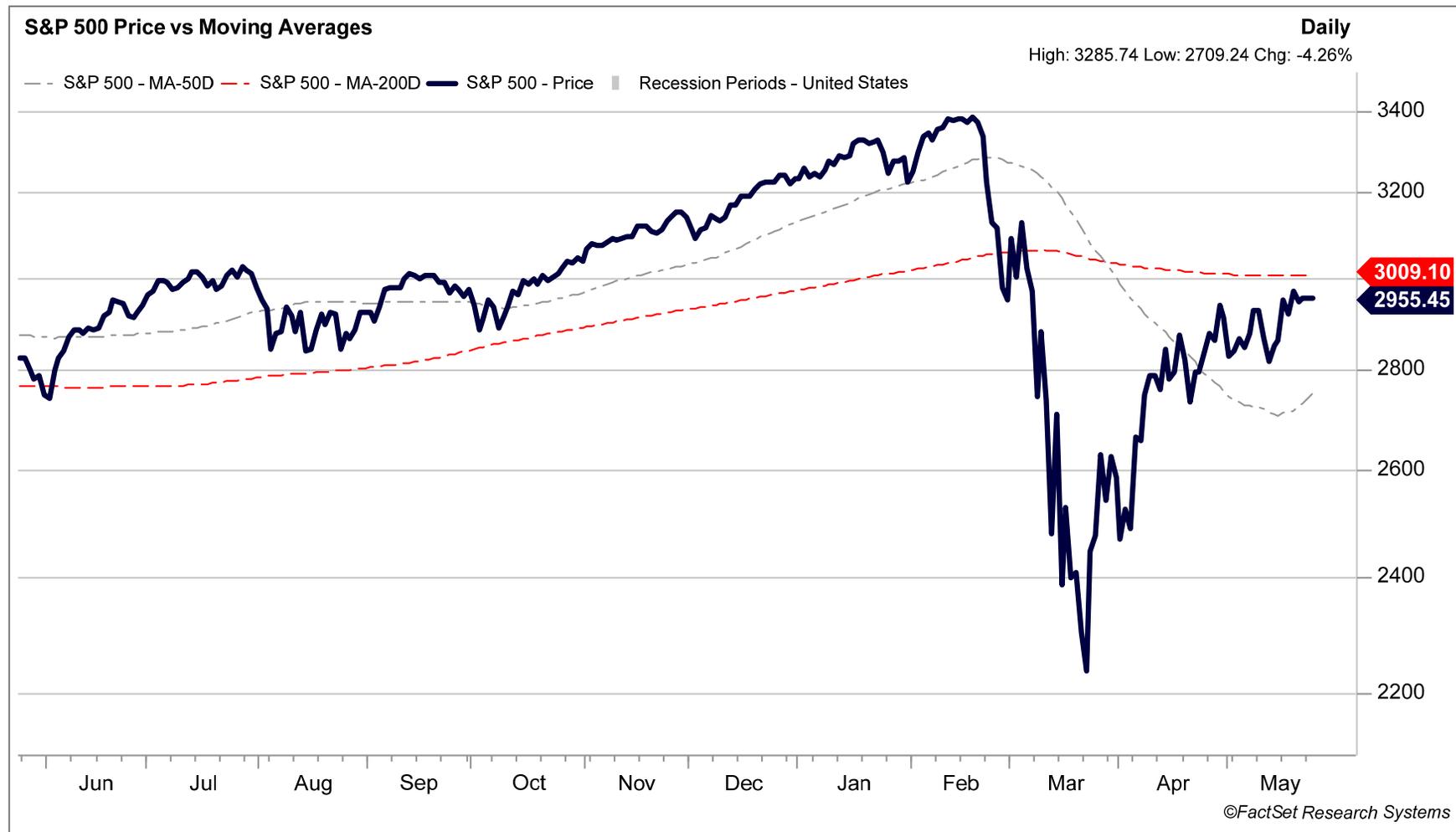
## Know What You Own

- The 10 largest stocks in the Nasdaq have pushed the index to positive returns in 2020. However, the average stock in the Nasdaq index is actually down -19% year-to-date. The top 10 stocks trade at an average Price/Earnings ratio of about 29x, while the average stock trades closer to 16x.
- The concentration in market leadership has resulted in enormous disparity among stock indexes.



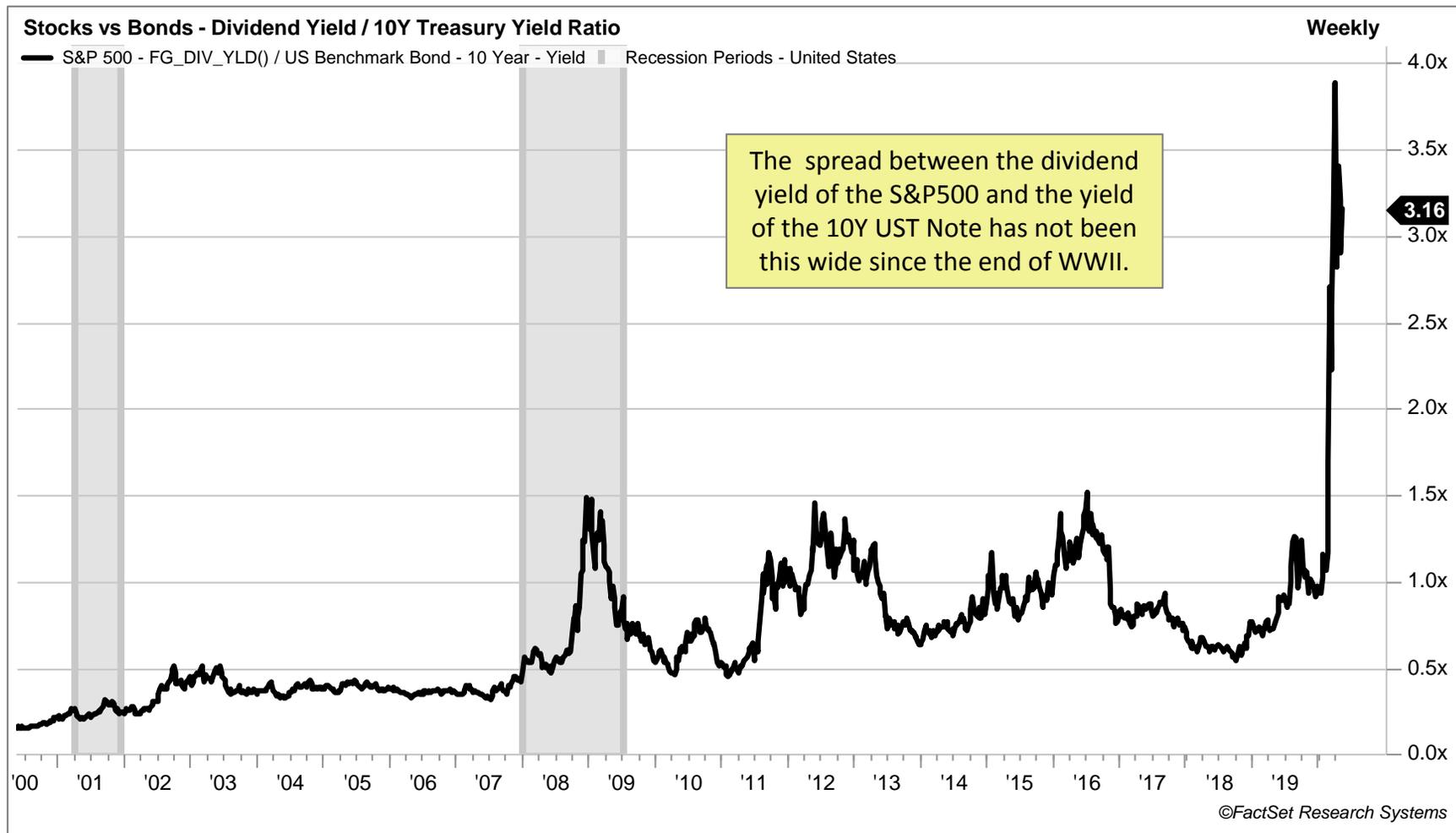
## Stocks – The Short View

- This is just the 30<sup>th</sup> time since 1928 that the S&P500 has remained between the two moving averages for greater than 20 days. In the previous 29 instances, the market fell through the 50-day (gray line) on 21 occasions and rose above the 200-day (red line) the other 8. However, after breaking above its 200-day MA, the index has consistently traded lower over the following six months, on average -12.7%.

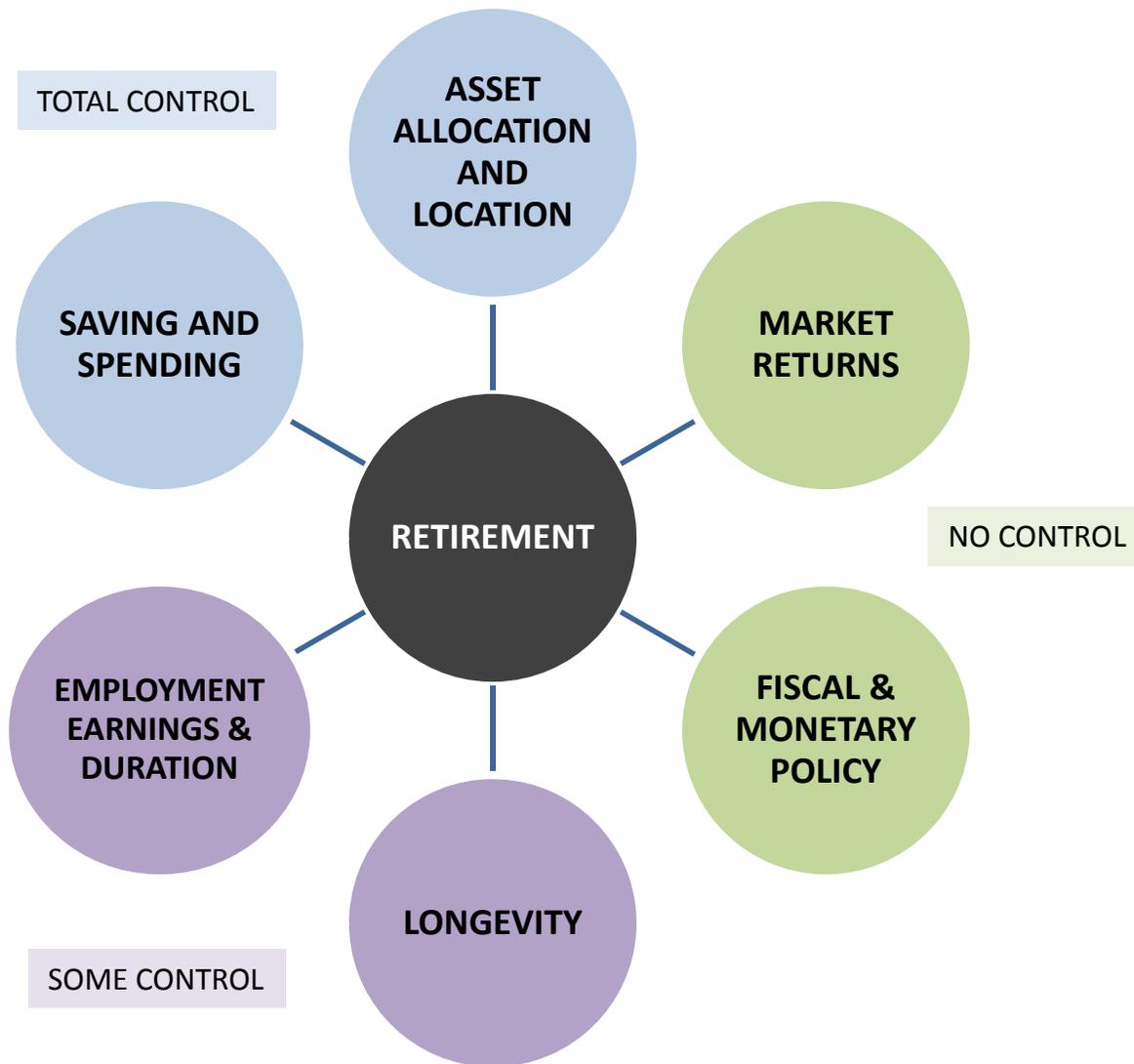


## Stocks – The Long View

- Investors seeking yield in the relative security of US Government bonds have been dealt an enormous blow from Federal Reserve policy on interest rates and quantitative easing programs.
- To find the S&P500 stock dividend yield this far above the yield on US Government bonds, you would need to venture back nearly 75 years to the end of WWII.



# Control Your Retirement



## A SOUND RETIREMENT PLAN

Make the most of the things that you can control.

Select the Investment Advisor that is best positioned to evaluate the factors that are somewhat or completely out of your control.

Review the results with your Investment Advisor at least annually.

JP Morgan Asset Management "Guide to Retirement"

# Disclosure

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