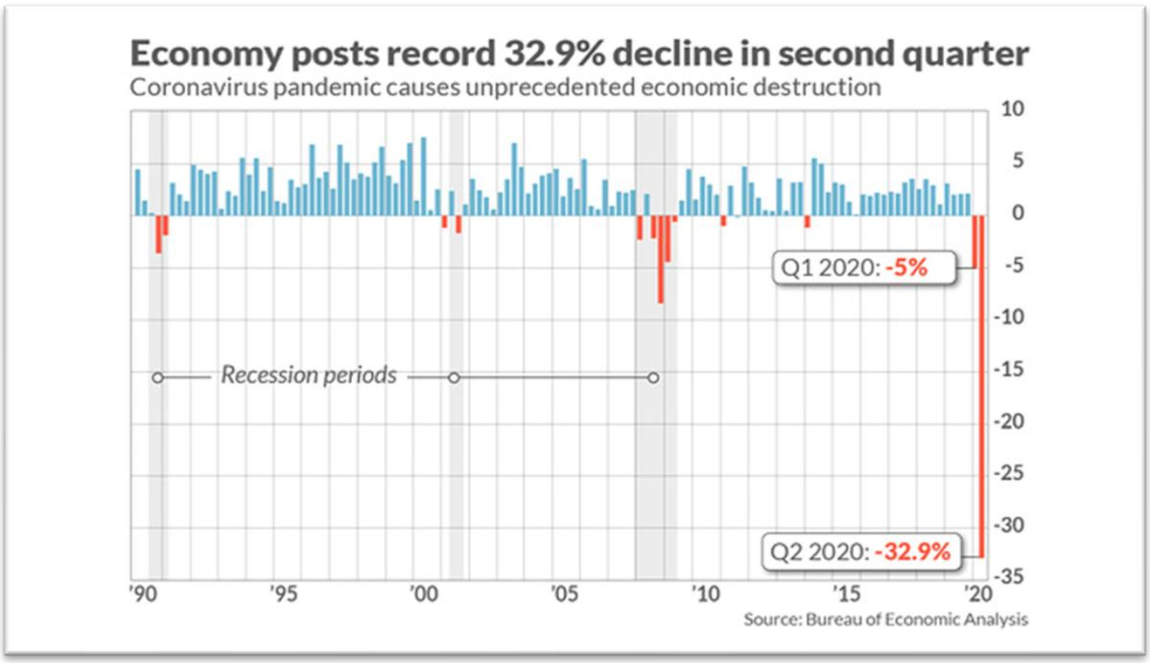
BROOKMONT CAPITAL MANAGEMENT

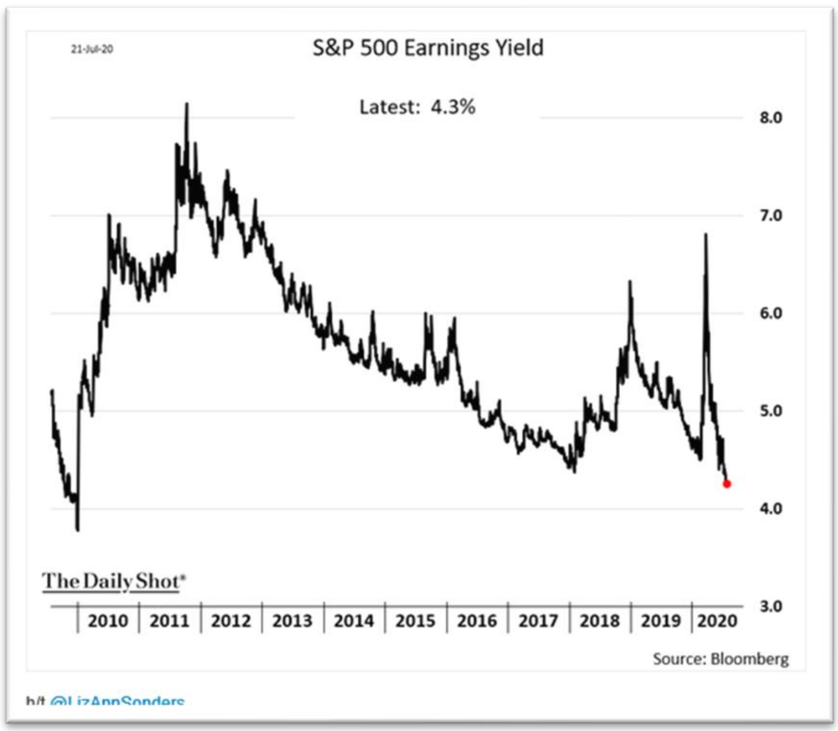
Fed induced Disconnect Between Market and Fundamentals

During the second quarter of 2020, the S&P 500 returned 20%, its best performance since 1998. The market performance was fueled by hopes of recovery and massive amounts of federal stimulus. This is, of course, on the tail of one of the most rapid declines in market history that occurred in the first quarter. The market optimism flies in the face of the largest quarterly GDP contraction on record, -32.9% annualized—nearly four times worse than any quarterly report during the Great Recession. Relative to current market conditions, we think that the most important trend right now is increasingly bullish sentiment that lacks the support of fundamentals. For 2020 in total, GDP is expected to decline between 4.6% and 5.6%.



The recovery of the market has been correlated to positive news of COVID daily case counts as the situation in NYC improved. Now, as case counts continue to rise in several states, the market has seemed to largely ignore the resurgence of COVID-19 and a second wave. This is likely due to the assumption of many investors that states will not be willing to reimplement shelter-in-place orders. Generally, we agree with this sentiment but with two caveats. First, we believe that if hospitals are completely overwhelmed (meaning that even surge capacity has been reached), local officials will push for another stay-at-home order. The actual passing of these orders is ultimately dependent upon the dynamic between state and local governments; we can see this playing out currently between Sylvester Turner, the mayor of Houston, who is in favor of another order and Gov. Greg Abbott, who refuses to grant local officials the power to implement a new stay-at-home order. Given this dynamic and the fact that only one of the states with a steepening curve has a democratic governor (California), outside of California we think it is unlikely that large-scale stay-at-home orders are issued again. The second caveat is that though stay-at-home orders are unlikely and have become a partisan issue, slowing reopening plans is less politically divisive and because of that, far more likely to occur. Though the slowing or complete halting of a reopening plan would not be as severe as another stay-at-home order, it would still have significant impacts on particular industries. As we mentioned in our March 27th COVID update, the interconnectivity of society makes it hard to imagine the global economy quickly flipping a switch; the recovery will likely be more like lights gradually turning on. Consider how long and disjointed it took the United States and the global community to get to “flatten the curve”. However, we believe the importance of the presidential election relative to market response is becoming increasingly less important as whomever is elected will focus on the pandemic response along with the associated economic impact in a roughly similar fashion. We are hopeful that post-election the pandemic will be addressed in a more productive and less politicized fashion.

The Rise of Speculation



Similar to the growing difference between overall market performance and macroeconomic conditions, there is a growing chasm between the performance of individual companies. This is shown with numerous companies, especially those in the Nasdaq 100, reaching all-time highs despite their declining earnings per shares (EPS). Earnings yield, the inverse of a price to earnings ratio (PE), for the S&P 500 is now the lowest that it has been since 2009, when there was a massive decline in earnings that were reported after market prices had begun to recover. It is important to recall that the market recovery period for the Great Recession was approximately four years; suggesting that investors were not comfortable with purchasing shares until fundamentals strengthened. The 2008 crisis was precipitated by structural issues created from poor underwriting standards in mortgage securities and structured products. The lasting social implications of the current recession are far less clear, with the potential for structural implications across a broad array of industries, making handicapping the recovery more treacherous.

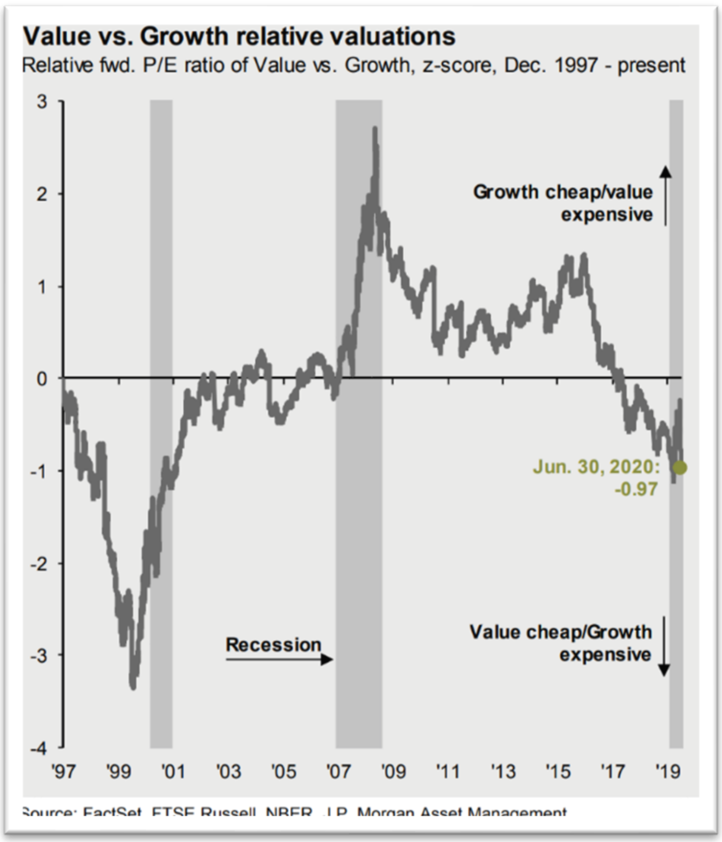
Relative to our outlook for the third quarter of 2020, we believe that there are several uncertainties that will ultimately result in overall market performance that is relatively range-bound. These uncertainties, which could be either positive or negative, are: the rate of COVID-19 recovery and reopening, the emergence of a second wave and the government's ability to contain it, the possibility of further quantitative easing from the Fed, additional stimulus bills, presidential poll numbers and additional clarity on the candidates' economic policies, and geopolitical tensions—specifically US-China relations. Given the large number of potential risks and the rapid recovery of the market to near record highs, we have positioned ourselves in a somewhat defensive position, such that we have exposure to the continued recovery of the US economy but are limited in our cyclical exposure to the business cycle, which may experience a period of contraction. Any further contraction is dependent upon the amount of artificial expansion caused by government stimulus.

This range is bounded on the top by extreme valuations and on the bottom by the Fed's unwillingness to allow another large market decline. The valuations currently seen in the market are a result of a surge in demand from retail investors and tech bulls without any growth in earnings to justify the increased valuations. We addressed the implications in "Rise of the Quarantined Day Trader". This flood of non-traditional investors has resulted in odd performance discrepancies, such as money-losing companies outperforming profitable companies by 32% since the market trough of March 23.

The graph below illustrates the historical relative discount of value verses growth stocks, as measured by forward PE ratio. The chart on the right illustrates that Value PE is roughly five points above the 20-year average where Growth PE is nearly double the 20-year average. This is especially irrational given the importance of both a strong balance sheet and stable market position if a company is going to continue its existence and maintain performance in the long-term. As noted in one of our insights, "Not All Dividends Are Created Equal," the use of cheap debt in order to distribute cash to shareholders is not a sustainable process and results in the risk of bankruptcy and cost of debt growing further with each additional dollar that is borrowed.

Current P/E vs. 20-year avg. P/E

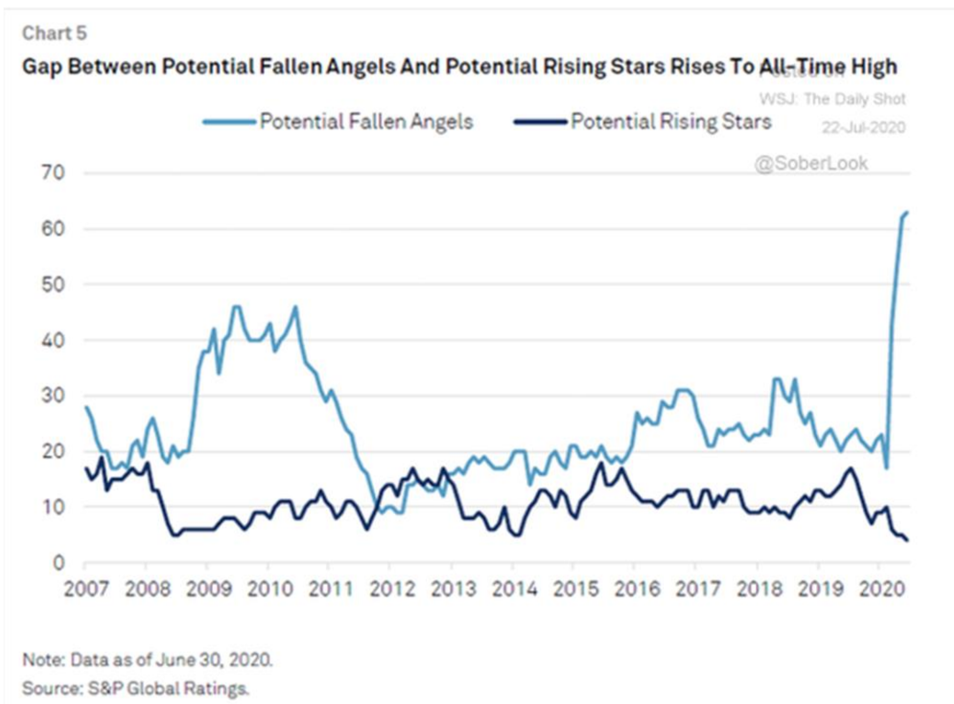
	Value	Blend	Growth
Large	18.1 / 13.6	21.7 / 15.4	29.8 / 18.8
Mid	19.8 / 14.2	23.9 / 16.1	39.2 / 20.4
Small	27.7 / 16.5	55.0 / 20.7	- / 30.1



We believe that the market cannot push significantly higher due to the speed of the recovery and market growth. The last time that the market grew as quickly as it has over the past 83 days (March 23 to July 15) was in May 1938. In these years following the Great Depression, the economy was slowly recovering, dependent on support from increased government spending and additional jobs from the New Deal. In 1937, two large parts of the New Deal jobs program had their budgets drastically decreased. Additionally, the Roosevelt Administration's goal of keeping a balanced budget was restricting government spending. This sent the economy into another recession, which was only ended through the government announcing a $5 billion spending program in the spring of 1938. The $5 billion in 1938 dollars is equivalent to over $90 billion in 2020.

Another key aspect of today's market is that a large number of companies had their liquidity positions compromised and are no longer low risk investments. This is why Brookmont's investment philosophy when evaluating and monitoring companies is so important. When initially evaluating companies for our portfolios, a couple of the key factors that we look at are a company's balance sheet strength, as well as their current valuation. These are aspects that we continue to monitor once a company has been added as a holding. Our focus in fundamentals is a result of the belief that a company cannot artificially inflate its dividends indefinitely.

Because of this, we carefully evaluate a company's cash flows from operations, while looking at a company's investing and financing cash flows to understand the ability of a company to meet its capital allocation needs. We do not believe that any of our holdings are short-term holdings, and continuously evaluate them to provide assurance that their fundamentals align with our prioritization of long-term growth and stability. The surge in the number of companies at risk of debt rating downgrades, (illustrated below) demonstrates the gap between potential fallen angels (e.g. debt rating downgrades) vs rising stars (upgrades), is far wider than that witnessed during the Great Recession. This highlights the importance of Brookmont's process and its success in accomplishing its goal of participating in market upside while having relatively low downside capture due to the strong fundamentals of the companies in our strategies. We continually evaluate the portfolios to understand and limit the exposure each has towards segments of the economy that could see structural impairment, including hospitality, airlines, restaurants and traditional brick and mortar retail.



Source: S&P Global Ratings, @lisaabramowicz1

Brookmont's philosophy of investing in companies with strong balance sheets, disciplined management with well covered dividends continues to represent an attractive allocation for strategic investors in the equity market. This coupled with sinking yields, represents greater relative value to fixed income alternatives. The team at Brookmont are happy to share additional thoughts on the markets and our portfolios.

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