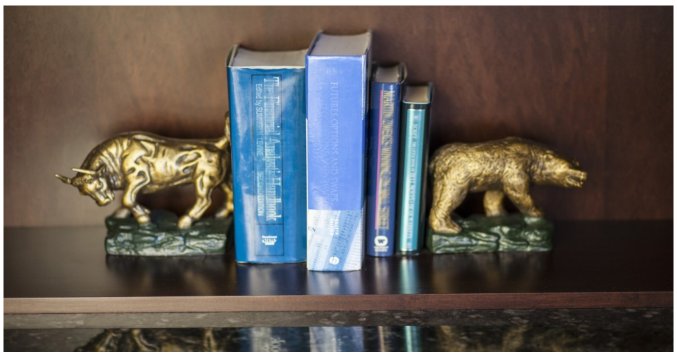
Wallington ASSET MANAGEMENT

INDEPENDENT INVESTMENT COUNSEL

QUARTERLY NEWSLETTER

2020: SECOND QUARTER **126TH EDITION**



"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you to where you want to go."

~Benjamin Graham

TABLE OF CONTENTS

CAPITAL MARKETS SCOREBOARD

Equities					
Indices	2Q20 Total Return (%)	2020 Total Return (%)	Index Characteristics		
Domestic			NTM P/E	P/B	Div. Yld. (%)
S&P 500	20.5	-3.1	21.9	3.5	1.9
DJIA	18.5	-8.4	20.4	3.8	2.5
NASDAQ	30.9	12.7	33.0	5.4	0.9
Russell 1000 Growth	27.8	9.8	29.8	11.0	0.9
Russell 1000 Value	14.3	-16.3	18.1	2.0	2.8
Russell 2000	25.4	-13.0	57.2	1.8	1.8
International*					
MSCI EAFE	15.1	-11.1	17.8	1.6	3.1
MSCI Emerging Markets	18.2	-9.7	14.4	1.7	2.3
MSCI United Kingdom	7.8	-23.2	15.8	1.4	4.3
MSCI France	16.5	-15.5	18.9	1.5	3.5
MSCI Germany	27.2	-7.1	17.7	1.5	2.9
MSCI Japan	11.6	-6.9	17.6	1.3	2.4

Fixed Income		
Indices**	2Q20 Total Return (%)	2020 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	1.2	2.8
U.S. Corp - Gov (3-5 Years)	2.7	5.3
U.S. Corp - Gov (10+ Years)	5.4	13.0
U.S. Treasuries Master	0.2	9.0
U.S. Corporates Master	9.3	4.8
U.S. Municipals Master	2.7	2.0
U.S. High Yield Master	9.6	-4.8
International*		
Developed Markets Sov Bond	1.4	4.1

Commodities		
Resource	2Q20 Total Return (%)	2020 Total Return (%)
Precious Metals		
Gold	13.2	18.0
Silver	28.1	-1.1
Industrial Metals		
Copper	21.1	-2.9
Aluminum	7.6	-11.0
Energy		
Brent Crude Oil	177.9	-39.1
WTI Crude Oil	91.5	-35.8
Natural Gas	6.8	-20.0

Key Rates				
Rates	6/30/2020	3/31/2020	12/31/2019	6/30/2019
U.S. Target Fed Funds Rate	0.25	0.25	1.75	2.50
2-Year U.S. Treasury	0.16	0.23	1.58	1.75
10-Year U.S. Treasury	0.66	0.70	1.92	2.00
30-Year U.S. Treasury	1.41	1.35	2.39	2.52
10-Year German Bund	-0.48	-0.49	-0.19	-0.31
10-Year Japanese Bond	0.02	0.02	-0.02	-0.16
30-Year Fixed Mortgage	3.16	3.45	3.72	3.80

Currencies				
Indices/ Exchange Rates	6/30/2020	3/31/2020	12/31/2019	6/30/2019
ICE U.S. Dollar Index	97.39	99.05	96.39	96.13
USD per EUR	1.12	1.10	1.12	1.14
USD per GBP	1.24	1.24	1.32	1.27
JPY per USD	107.89	107.96	108.68	107.74
CAD per USD	1.36	1.42	1.30	1.31

*Returns denominated in U.S. dollars

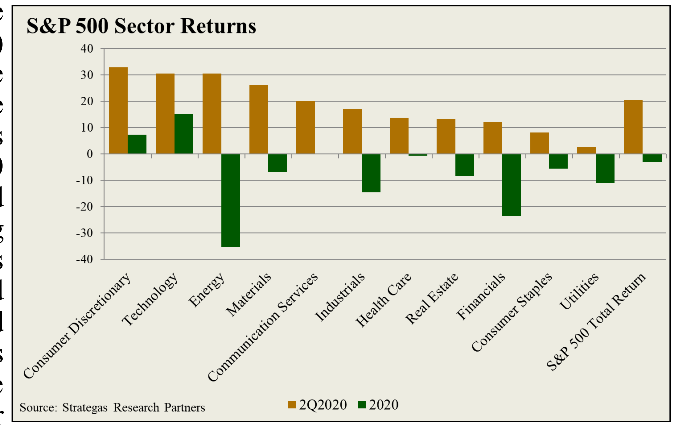
**ICE Bank of America Merrill Lynch (BofA-ML) indices

EQUITIES

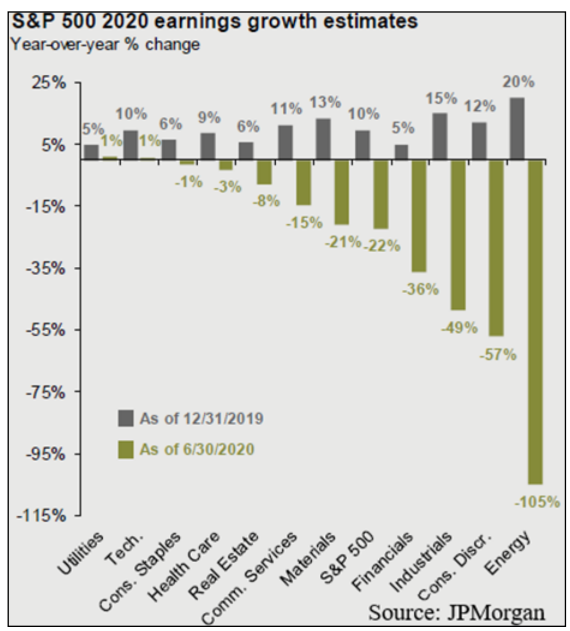
- The Standard & Poor's 500 (S&P 500) index generated a total return (price appreciation plus dividends) of 20.5% in the second quarter. The index began April in the midst of a sharp recovery, closing the month more than 30% above its March 23 pandemic low before tempering through May and June. Despite its strongest quarterly return since 1998, the index has returned -3.1% year-to-date (YTD) through the close of the second quarter. Consumer Discretion Sector stocks led the way, up 32.9% for the second quarter, followed by Technology and Energy Sector stocks both up 30.5%. Consumer Staples and Real Estate were the only sectors not to post double-digit returns for the quarter, up 8.1% and 2.7% respectively.

- Although still trailing for the year, U.S. small cap stocks outperformed their large cap counterparts in the second quarter with the Russell 2000 Index returning 25.4%. Broad-based international indices underperformed domestic stocks for the quarter. The MSCI Europe, Australasia, and Far East (EAFE) Index, which tracks developed international markets, returned 15.1%, and the MSCI Emerging Markets Index returned 18.2% when denominated in U.S. dollars.

- Equity valuations once again reached levels above historical norms during the second quarter rebound, although interest rate-inclusive valuation models generally suggest fairness in current market prices. The S&P 500's price-to-earnings (P/E) ratio closed the quarter at 21.9x next twelve months (NTM) earnings. Of note, valuations of growth and value stocks reached their widest disparity since September 2003 in late June as growth stocks continued to be the primary driver of S&P 500 performance. Some consternation exists around valuation metrics, however, as forward-looking numbers remain muddled by a lack of earnings predictability. The widespread uncertainty derived from the COVID-19 pandemic has impacted guidance of over 40% of S&P 500 companies according to the Wall Street Journal. As of June 26, 218 companies in the index had suspended or entirely withdrawn quarterly or annual guidance, largely due to the unknown longevity and potential permanence of both supply chain changes and consumer behavior shifts.

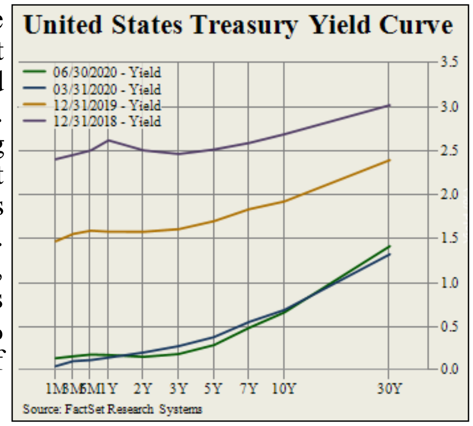


- After a first-quarter exodus from nearly all risky assets, investors' appetite for risk picked up once again in the second quarter. In addition to small cap stock outperformance, the IPO market also signaled an increase in risk-on sentiment. Only 35 companies issued initial public offerings (IPOs) in the first quarter according to FactSet. While the IPO market remains well under 2019 in terms of both total offerings and total proceeds, it gained steam in the second quarter with 186 companies going public. In June alone, IPO mispricing relative to demand, attempted equity issuance by a company in bankruptcy (Hertz), and a small electric truck manufacturer (Nikola) temporarily surpassing Ford in market value all signified investors' willingness to once again assume risk.

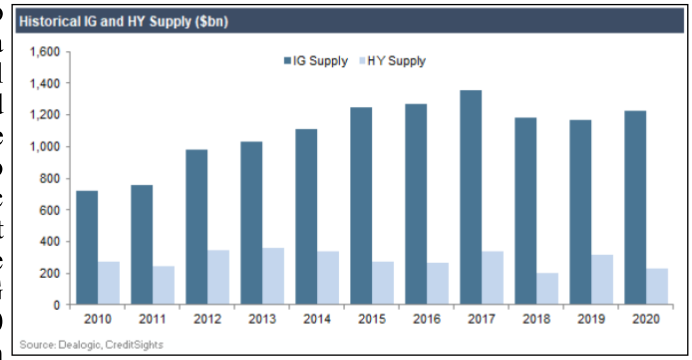


FIXED INCOME

- U.S. Treasuries (USTs) remained remarkably stable throughout the second quarter despite volatile economic data. After ending the first quarter yielding 0.70%, the 10-year UST yield briefly increased above 0.90% in early June before finishing the month at 0.66%. This lack of volatility kept the performance of already low-yielding government bonds contained, and USTs in aggregate returned just 0.2% in the second quarter as measured by BofA-ML indices. This brought their YTD performance to 9.0% after a strong first quarter. The Federal Reserve (Fed) did their part in anchoring UST yields, as 15 of 17 Federal Open Market Committee (FOMC) members projected they would keep the fed funds rate in the range of 0.00% to 0.25% through at least 2022 with the goal of keeping the cost of debt low and the economic recovery on track.



- Increased optimism over the depth and duration of the recession helped elevate the return of corporate bonds in the second quarter. Investment grade (IG) corporate bonds returned 9.3%, erasing the first quarter's losses and bringing their YTD return to 4.8%. This performance was generated by a reduction in credit spreads, the yield differential between corporate and government debt, and companies were quick to take advantage of the lower rates. Corporations have been looking to stockpile cash to weather the economic downturn, and IG bond issuance through the first half of 2020 was 95% higher than the same time period in 2019. In fact, the $1.2 trillion of IG corporate bonds issued in the first half of 2020 has already surpassed the amount issued through the entirety of 2019. Although issuance is expected to slow down in the second half of the year, it appears the 2017 record for IG bond issuance of about $1.4 trillion will be surpassed by a wide margin.



- The level of recent corporate bond issuance in conjunction with degradation of revenue and profit metrics for the second quarter has led to concerns about credit rating agencies downgrading many IG bonds. While the agencies are expected to exercise some leniency given the unique nature of the recession, many downgrades will be unavoidable given expected long-term balance sheet deterioration. This is particularly concerning as debt holding the lowest IG rating, BBB, had already grown to 50% of the IG bond index. "Fallen Angels," or companies downgraded to a high-yield (HY) rating, generally have a higher cost of debt and less liquidity in the market compared to their IG counterparts. CreditSights estimates that $300 to $400 billion of IG debt could be downgraded to HY over the next 24 months on top of the $218 billion already downgraded through the first half of the year. This compares to $18.5 billion of debt downgraded to HY through all of 2019 in the U.S.

- Concerns over state and local government balance sheets have been amplified due to the recession and subsequent delay and reduction of tax revenues. The Fed's Municipal Liquidity Facility has helped fund short-term cash flow needs. The facility became operational in May by purchasing $1.2 billion of General Obligation (GO) bonds directly from the State of Illinois. Unless extended, it will have the ability to purchase up to $500 billion of eligible securities through 2020 to help municipalities issue debt through the crisis. Long-term issues such as pension funding have been exacerbated, however. Illinois currently has a $140 billion unfunded pension liability which equates to about 200% of government revenue. New Jersey, whose unfunded pension liability is over 150% of government revenue, went so far as to skip a $950 million funding payment in May as it seeks to deal with more immediate cash flow concerns. Even at current levels, state unfunded pension levels are likely understated as many funds assume 7-8% forward returns on funded assets. Returns of this magnitude will be nearly impossible to generate prospectively with relatively safe income-generating assets restrained by a low global interest rate regime.

- The U.S. money supply surged during the pandemic lockdown and the COVID-19 recession. M1, which consists of currency in circulation, demand (checking) deposits, and traveler's checks, increased 30.3% from the end of February to mid-June. M2 is a broader definition of money and consists of M1 plus savings deposits, money market funds, certificates of deposit less than $100,000, and other time deposits. This measure of money supply, which is more closely followed than M1, increased 18.2% from the end of February to mid-June. As of June 15, M1 was $5.225 trillion and M2 was $18.329 trillion, both seasonally adjusted numbers. The increase in money supply during this recession has been larger than in any full year in the last six decades officials have tracked the data. How did this happen? There has been a dash for cash by firms and households. Unlike the Great Recession of 2007-2009, when money piled up mostly in banks' accounts at the Fed, funds have been pouring into business and household checking accounts. Because of the uncertainty of COVID-19 and the recession, corporations have tapped out their lines of credit, whether needed or not, and sold record amounts of bonds. Household spending has decreased, while personal income has increased since March, increasing the personal savings rate to 33.2% in April and 23.2% in May, both records that date to 1959. Everyone has seemingly become more frugal and cautious, worried about insolvency.

M2 Money Supply – YoY Growth

Source: Board of Governors of the Federal Reserve System

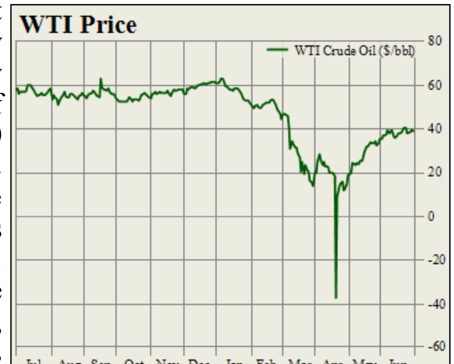
- Lockdowns and the recession had a dramatic impact on housing sales. Annualized sales of existing homes plunged after hitting a 13-year high of 5.52 million in February, falling to 3.91 million in May. This was the slowest annualized sales pace of existing homes since 2010. Surprisingly, the median existing home price in May of $284,600 was 2.3% higher than a year earlier due to limited supply and historically-low mortgage rates. New home sales in May show the market has improved as an annualized 676,000 new homes were sold compared to 580,000 in April. New home sales are based on contract signings while existing home sales are based on delayed closings. Thus, new home sales are a better indicator of the current strength of the housing market. Other data also support a housing rebound; housing starts rose 4.3% in May from April and residential permits for future home construction rose 14.4%. Pending sales of existing homes rose a record 44.3% in May and the mortgage applications index has increased for nine straight weeks to an 11-year high.

New Home Sales

Source: Piper Sandler & Co.

- Oil received much publicity in April when the May futures price of West Texas Intermediate (WTI) fell to an intraday low of -$39.44 per barrel, the first negative price ever, before closing at -$2.72. This was the last trading day of the May contract. Buyers of futures contracts take delivery and sellers make delivery, but most futures contracts are closed out in the futures market so not much delivery takes place. Because of the negative price for the May contract, sellers who did not make delivery were obligated to pay (not receive) $2.72 per barrel to buyers. The intraday price of -$39.44 was panic selling because global oil demand fell by 30 million barrels per day in April while supply only decreased by 12 million barrels. Storage capacity was at a premium and in some cases nowhere to be found. The WTI futures contract requires delivery in Cushing, Okla., which had no storage capacity. Investment in oil production has plunged causing future supply to be lower while global demand picked up in May and June. As a result, WTI futures prices increased to $39.32 at the end of June, which is still not a high enough price for North American oil producers to make a profit.

WTI Price

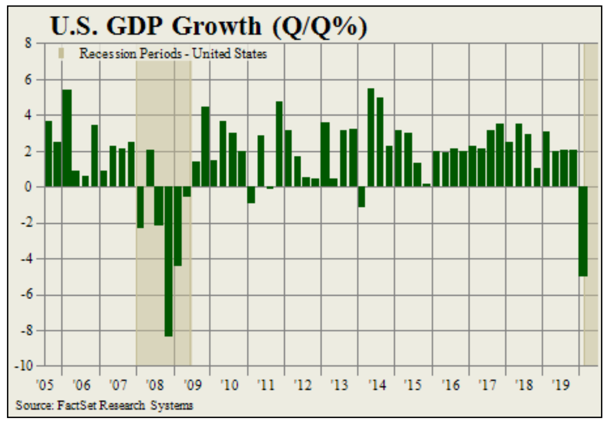


Source: FactSet Research Systems

The COVID-19 Recession

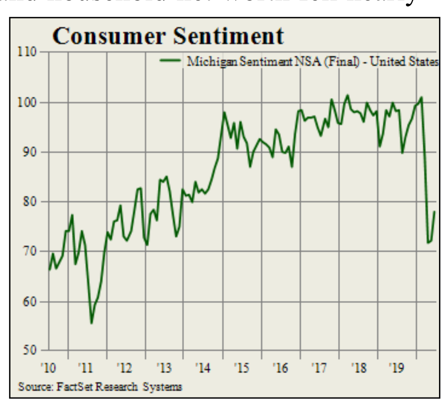
Remember the good old days? That would be February. The economy had grown for 128 months – the longest economic expansion on record, the unemployment rate was at a 50-year low of 3.5%, 22.5 million jobs had been created over 10 years, and the S&P 500 hit a record closing high of 3,386. Even then, it was considered a "new normal" as average annual Gross Domestic Product (GDP) growth was just 2.3%, the slowest-growing economic expansion since World War II.

On June 8, the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) declared that economic activity in the U.S. had peaked in February 2020, formally marking the start of the first recession since the Great Recession of December 2007-June 2009. The NBER's declaration holds official status and is accepted by all government agencies and the Federal Reserve (Fed). Economic activity was so bad in March and April, some might wonder why it took so long to make an official declaration on the start of a recession. But the four-month lag between the event and the committee's declaration was the shortest since its founding in 1978. The average time lag had been 11.7 months for the 10 cyclical turning points, recession and recovery, of the five prior recessions since 1980. The panel of economists on the committee consider a wide variety of economic indicators in making their decision, unlike economists in other countries who define a recession as simply two consecutive quarters of negative GDP growth. For the committee members to declare a U.S. recession, it is not just the duration of the economic contraction but also its depth and breadth, and the COVID-19 pandemic has caused one of the sharpest economic contractions on record. On a global basis, the International Monetary Fund (IMF) also declared the global economy entered a recession with a severity not seen since the 1930s' Great Depression.

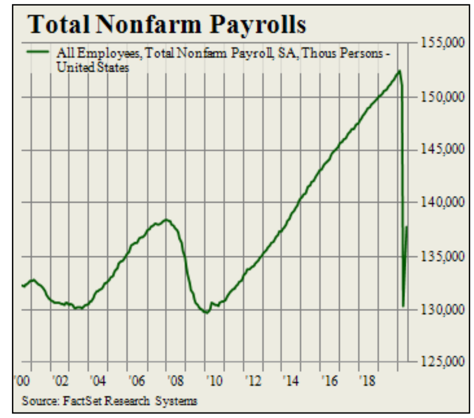


Lockdowns and other measures taken as a result of the COVID-19 pandemic led to one of the steepest losses of jobs on record as millions of workers filed initial unemployment claims and the unemployment rate jumped to its highest level since the 1930s. Store closures caused retail sales to fall and industrial production fell because of closed factories. First-quarter GDP fell at an annual rate of -4.8% relative to the fourth quarter of 2019, its fastest decline since the fourth quarter of 2008, primarily due to a steep drop in economic activity in March. Economic activity in the second quarter will not show any improvement as GDP is forecast to fall 35-40% on an annualized basis. In most recessions, the durable goods sector bears the brunt of the downturn but this one has spared no sectors. While industrial production fell 12.5% in April and rose a disappointing 1.4% in May, even the service sector of the economy has been hit particularly hard.

The coronavirus recession had an early and significant impact on consumers. Personal consumption expenditures fell 6.9% in March as personal income declined 2.2% and household net worth fell nearly $7 trillion, mostly because of the stock market decline. Some of the spending decline in March was involuntary due to lockdowns and other restrictions, which also had a huge impact in April as personal spending declined another 12.8%. Unlike past recessions, personal income actually rose 10.5% in April as a result of government stimulus checks and enhanced unemployment benefits. Government social benefits accounted for one-third of personal income for the month. This increase in personal income caused consumers to turn cautiously optimistic in May as personal spending increased 8.2%, the largest monthly increase on record. Personal income fell 4.2% in May but was still above February levels. Increased personal income and subdued spending took the savings rate to a record 33% in April and 23% in May. Consumers have money to spend but uncertainty makes them cautious. This is reflected in the University of Michigan's Consumer Sentiment Index which fell from close to historical highs of 101 in January to 71.8 in April before rebounding to 78.1 in June.



Nonfarm payrolls were 152.5 million at the end of February and 130.3 million at the end of April. The loss of more than 22 million jobs over two months wiped out the 22 million jobs created from October 2010 to February 2020. Between mid-March and the end of June, more than 48 million workers, 30% of the workforce, filed initial unemployment claims. There were 25 million people at the end of April who were receiving continuing unemployment benefits, the highest on record. During the Great Recession of 2007-2009, 6.6 million was the peak number. Fewer people were receiving those benefits in June, but it was still at an extreme level, 19.5 million. The unemployment rate, which increased from 3.5% in February to 4.4% in March and 14.7% in April, began to decline, falling to 13.3% in May and 11.1% in June. These unemployment rates were misclassified because people not working but being paid should have been classified as unemployed, but they were not. Adjusting for the misclassification increased the unemployment rates to 5.4% in March, 19.7% in April, 16.3% in May, and 12.1% in June. For comparison, the highest unemployment rate since World War II was 10.8% in 1982. In the "recovering" job market, 2.7 million jobs were added in May and 4.8 million in June. Still, the number of workers employed in June was 14.6 million, or 9.6% below February levels. Looking to the future, the Congressional Budget Office (CBO) forecast that the unemployment rate will be 10.5% at the end of 2020 and will not approach February's 3.5% for the rest of the decade. One short-term problem in getting people back to work is the extra $600 paid each month in unemployment benefits in addition to normal benefits. Nationally, the unemployed are receiving $978 monthly on average, a level which is higher than 70% of those claiming benefits make working. The extra $600 in benefits is set to expire on July 31 but there is discussion in Congress on a possible extension. Opponents argue that with the extra benefits, there is not much incentive for some of the unemployed to return to work.



The second quarter economic data will look like the data from the 1930s, but there are vast differences between the economy then and now. Unemployment lasted longer as the unemployment rate was above 20% in 1931 and 1932 before peaking at 25.6% in May 1933, and there were no safety nets in the early years of the Depression. States did not have unemployment insurance programs and there were no food stamps or other relief programs. Social Security and the Works Progress Administration, two of the most impactful New Deal programs, were not signed into law until 1935. Consumer prices fell 32% from late 1929 to early 1933 and wages tumbled an estimated 34% in manufacturing. Many workers who still had jobs could not keep up with expenses. Today, there is disinflation but no evidence of deflation. The Fed did its part to prolong the 1930s depression by raising interest rates in 1929 to stop speculation in stocks, again in 1932 to defend the value of the dollar, and again in 1937 to slow the economy and inflation. The only tool the Fed had at that time was interest rate changes compared to the vast array of programs today. Monetary policy was more of a problem than a solution in the 1930s. Government fiscal policy was also not much help in the 1930s as the government ran a budget surplus in 1930 and a deficit of just 0.5% of GDP in 1931. Today, Congress and the administration have acted much more quickly and aggressively; the CBO forecasts the government deficit to be around 18% of GDP for the fiscal year ending in September.

There has rarely, if ever, been an economic downturn quite like the COVID-19 recession. Most recessions are cyclical in nature whereby the Fed raises interest rates because the economy is growing too rapidly, causing rising inflation. Higher interest rates dampen aggregate demand and production. Growth slows and may turn negative and thus a recession. The Fed (monetary policy) would then lower interest rates and the government (fiscal policy) increases spending to stimulate the economy. The other kind of recession is structural and involves excesses in the credit markets and/or the financial system. This was the cause of the Great Recession of 2007-2009. The current contraction would be considered an event recession which is rarer – the last one being the oil shock of 1973-74. Event recessions tend to end when the event ends, but the economy can still take months to recover. Therefore, a vaccine or even a therapeutic treatment for COVID-19 would be a big help for economic recovery from this event-driven recession.

The huge question in the minds of many people is what happens to economic growth for the remainder of this year and what type of recovery will we eventually experience. The IMF forecast is for global GDP to contract 4.9% in 2020 compared to a contraction of just 0.1% in 2009. Their forecast is for U.S. GDP to decline by 8% and Eurozone GDP to decline by more than 10%. World trade has been responsible for most global economic growth since the 1990s. However, world trade declined 2.4% in March and 12.1% in April, making world trade 16.2% lower than a year earlier. The World Trade Organization (WTO) has forecast that world trade will decline 15-30% in 2020. The era of globalization may be over. Much of the growth in global trade was due to the growth of world-encompassing supply chains. The pandemic has exposed their Achilles' heel; supply chains were built for cost effectiveness and not resiliency. Most multinational companies and countries are reexamining the role of their supply chains and this has been particularly true for medical supply chains making personal protective equipment and generic drugs. The U.S. trade deficit fell in 2019 for the first time since 2013, and continued down in January and February. It has increased each month since then, hitting $54.6 billion in May, the widest deficit since December 2018. The U.S. usually runs a deficit in goods and a surplus in services which were more impacted by the recession.

Fortunately, the U.S. and global economies have been showing some signs of recovery. The IHS Markit U.S. Purchasing Managers Composite Index (PMI) was 46.8 for June, up from 27.4 in April and the highest in four months. A reading under 50 still reflects an economic contraction but the severity of the contraction has diminished. Both manufacturing and services registered in below 50 for the month. In the Eurozone, the June composite PMI rose to its highest level since February (47.6) from an all-time low of 13.5 in April. From this data, expectations are that global economic activity has gained momentum and the second half of 2020 will have positive economic growth. That will all depend, though, on which one of the many hypothesized economic scenarios for an eventual recovery will actually prevail. There is the V-shaped model which anticipates a quick and total recovery after the sharp contraction with GDP moving back to 2019 levels at the end of 2020. The U-shaped model hypothesizes it will take longer for GDP to reach 2019 levels; maybe even as long as 2022-2023. The W-shaped model visualizes a sharp economic recovery, but then another downturn in GDP before a second recovery. There is also the "Nike Swoosh" which estimates continuous, gradual improvement in GDP taking several years to recover. Finally, there is the K-shaped model, which has some sectors of the economy making a strong recovery but others lagging behind. Which recovery model prevails is difficult to predict due to the extreme level of uncertainty related to COVID-19 and its wide-ranging impact on the global economy.

What is much more certain is COVID-19 containment will be necessary for consumer confidence to reach pre-COVID levels. It goes without saying, a vaccine with substantial supply capabilities would be a game changer, most importantly for humanity in general, but also on global economic growth. Over two-thirds of U.S. GDP is consumption based. The consumer carried the U.S. economy during its 128-month expansion and will need to be the foundation for the next economic recovery. Consumer behavior will largely determine which recovery model prevails. Early evidence from consumer surveys and the savings rate indicate consumers are cautious and may not spend as much of their disposable income as in the past. As a result, there is a low probability for a V-shaped recovery and a much higher probability that the "Nike swoosh" model will prevail. This is consistent with the Congressional Budget Office's forecast for U.S. GDP to be 5.6% smaller in the fourth quarter than a year earlier and the road to full recovery will be much longer. Until COVID-19 containment occurs, governments and central banks will continue bearing the brunt of the load in supporting global economies. To date in this recession, they have provided unprecedented fiscal and monetary stimulus. According to the IMF, governments (fiscal policy) have announced nearly $11 trillion in fiscal stimulus globally. Even Germany, which has run fiscal surpluses for the past five years, agreed to run a fiscal deficit of 4% of GDP. The U.S. has provided $2.8 trillion in three fiscal stimulus packages and is contemplating a fourth. Central banks (monetary policy) around the world have provided liquidity to protect the plumbing of the financial systems, provide for the free flow of credit, and ensure solvency does not become a problem. Most central banks have started quantitative easing programs by purchasing government debt and other bonds, and have become lenders of last resort. Many of their programs have been unprecedented, indicative of the fact that the coronavirus recession has had, and will continue to have, a deep and lasting impact on the U.S. and global economies. As the world ultimately moves out of recession and back to growth, what is also certain is there will be structural changes to the U.S. and global economies causing investors to face once again, another "new normal".
