U.S. EQUITY UPDATE: 03.09.2020

Haruki Toyama, Director of Research & Portfolio manager wrote the following. We are passing along this communication in hopes that you may find value in his perspective on Madison's Equity portfolio positioning and the recent volatility in the markets.

Madison Investments' enduring motto, "Participate and Protect" is ever on our mind. Every downturn is different. In the past, these major downturns are where we've really differentiated ourselves and delivered on our brand promise. While past performance is no guarantee of our future results, we hope to do the same this time around.

Dear Team,

Today was the worst one-day decline for the U.S stock market since December 2008, when stock prices were free-falling in the teeth of the Great Financial Crisis, with Lehman Brothers going under, capital markets in disarray, bank failures about to domino around the world, and the House of Representatives dithering on a rescue package. The S&P 500 is now down 14.68% year-to-date in 2020, and down 18.80% from the all-time peak of three weeks ago.

Let's put this in perspective. The market was up big in the months leading up to this downturn. At today's close, the S&P 500 is back to the level it was just one year ago, in March of 2019. So we've retraced one year's worth of gains. The market was not particularly cheap a year ago – in fact, in the first quarter of 2019, the market had regained the entire amount it had lost in late 2018 and there was a lot of discussion as to whether that was too much too fast. Thus, as much as everyone likes to discuss the peak-to-trough downturn without context, the starting point is very important. The market multiples today are still well above historical norms.

Compared to March 2017, three years ago, the S&P 500 is up 23.21% (Cumulative return from 3/10/2017-3/9/2020). If current estimates for 2020 S&P aggregate earnings are to be believed, then corporate earnings from 2017 to 2020 will have grown 32%. (*factset)* So the market has under-performed earnings growth by a moderate amount, +23% to +32%. However, the 2020 earnings estimate is dropping rapidly, due to the COVID-19 situation, and the latest indications are that S&P 500 earnings will be flattish in 2020 versus 2019. This would mean that at today's level, the stock market (S&P 500) is up just about in-line with earnings growth for the past three years, which includes a big bump in profits from the record tax cuts of 2017. This is a long-winded way of saying that the market's price-to-earnings ratio (forward P/E) of approximately 17x is the same as it was three years ago.

Thus, an argument that the market is cheap must come from one of two sources:

1. Interest rates are lower today, so all else equal, the P/E multiple should be higher today.
2. 2020 earnings are suppressed and below normal due to COVID-19, and there will be a strong rebound in 2021 (or the second half of 2020 even) or in the future.

Both of these are reasonable arguments to make. We believe COVID-19, however large an impact, is a temporary shock. The counter-argument to these two bullish points would be the following two items:

1. The starting point was high – the 17x P/E from three years ago was expensive – so saying that the P/E multiple is the same today is another way of saying the market is expensive, especially every year deeper into the economic cycle we go.
2. The shock from COVID-19 triggers a U.S. or global recession, above and beyond the COVID-19 impact alone.

The second point is the real concern. There are economic headwinds that were not evident in late 2018. Even before COVID-19, Europe was already on the precipice of a recession, at least in some of the Southern countries, and China was slowing sharply. Economic expansions don't die of old age – there is usually a trigger of some sort, to enter into a contraction. Perhaps COVID-19 is the trigger this time around. So the second scenario above is not at all far-fetched.

The increased interconnectedness of global economies and supply chains, way more than even just 10 or 20 years ago, is clearly evident in the impact that the virus is having on consumer behavior and corporate profits. When SARS hit 15 years ago in 2003, China was perhaps 5-6% of global GDP.[1] It's now 19%. Back in 2003, imports from China to the U.S. were about $150 billion.[2] Today, they are about $450 billion, or about 2.3% of US GDP. 2.3% sounds small. But the knock-on effects are much greater – you need to multiply that a few times for the true impact. Items we import from Europe or South America or other parts of Asia, for example, have components in them from China. And if you are a manufacturer or service provider, it doesn't matter if you only get 5% of your components from China, you can't make the whole product or provide the entire service without 100%.

Of course, the fear now is that this is no longer just a China issue. SARS was relatively contained to parts of Asia. Right now, the number of reported COVID-19 cases outside China is still increasing at a rapid pace. The good news is that within China, the growth rate in reported cases seems to be slowing. So despite the alarming headlines of the acceleration outside China, we have some evidence that this will slow down eventually, hopefully in months, not quarters or years.

On top of the supply chain interconnectedness, there's the general increase in human connectivity – global travel, both leisure and business, and so on. For example, global airline passenger traffic has increased from 1.7 billion people in 2003 to 4.2 billion last year.[3] The knock-on impact of that is exponential, so that the 2.4x increase in passengers is in reality a much higher increase in economic activity stemming from the increased connectivity. All that economic ripple effect is shifting into reverse with COVID-19 (not to mention, exacerbating the spread of the virus).

Among the U.S. Equity team, we're assiduously thinking about what the downside is on each of our portfolio companies. We start with the premise that the profit impact is temporary but longer than what we've seen from other viruses in recent decades: Bird flu in 1997, SARS in 2003, swine flu in 2009, MERS in 2012, Ebola in 2014. Those were essentially one quarter events, so we think COVID-19 is probably going to be a major factor on profits for at least two to three quarters. We also start with the premise that the impact will be much deeper, as it already has shown itself to be. But then we think about scenario analysis: What if the impact is much longer? What's the likelihood of that? And even if it's only two or three quarters, what might that do to the company's balance sheet? Any deterioration of the balance sheet would have implications for future earnings power. So the first step is that we're looking at our existing investments, and deliberating: add, trim, or hold. And always with an eye on risk management.

The next step is we're looking at new investments to make. We don't yet have a strong view on current overall market valuations: we still find ourselves neither bull nor bear. Generally speaking, we're finding that the kind of high-quality companies we'd like to buy are still not selling at an attractive price. But we don't need a lot of ideas – just a few would be more than enough, given our concentrated style. So we've got a pretty good line-up of watch-list ideas that we're combing through one by one.

The Madison Small, Mid, and Large Cap strategies all have good cash reserves and we believe are thus positioned well for further dislocations. The Mid Cap and Large Cap portfolios have been putting some cash to work in the past week, on a net basis. But we have plenty of firepower left. Madison Investments' enduring motto, "Participate and Protect" is ever on our mind. Every downturn is different. In the past, these major downturns are where we've really differentiated ourselves and delivered on our brand promise. While past performance is no guarantee of our future results, we hope to do the same this time around.

Consider the investment objectives, risks, and charges and expenses of Madison Funds carefully before investing. Each fund's prospectus contains this and other information about the fund. Call 800.877.6089 or visit madisonfunds.com to obtain a prospectus and read it carefully before investing.

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The S&P 500® is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

P/E (Price-to-Earnings Ratio): measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's earnings per share.

All investing involves risks including the possible loss of principal. There can be no assurance the asset allocation portfolios will achieve their investment objectives. The portfolios may invest in equities which are subject to market volatility. In addition to the general risk of investing, the portfolio is subject to additional risks including investing in bond and debt securities, which includes credit risk, prepayment risk and interest rate risk. When interest rates rise, bond prices generally fall. Securities rated below investment grade are more sensitive to economic, political and adverse development changes. International equities involve risks of economic and political instability, market liquidity, currency volatility and differences in accounting standards.

Equity risk is the risk that securities will fluctuate in value due to general market or economic conditions. Investing in small, mid-size or emerging growth companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity. Contact Madison for more detailed information regarding these risks.

Madison's expectation is that investors will participate in market appreciation during bull markets and be protected during bearmarkets compared with investors in portfolios holding more speculative and volatile securities.There is no assurance that Madison's expectations will be realized.

(1) China: Share Of Global Gross Domestic Product 2012-2024
Statista Research Department - https://www.statista.com/statistics/270439/chinas-share-of-global-gross-domestic-product-gdp/

(2) US Census Foreign Trade: Data Foreign Branch - https://www.census.gov/foreign-trade/balance/c5700.html

(3) Air Transport, Passengers Carried https://data.worldbank.org/indicator/IS.AIR.PSGR

Additional Sources: Factset, Standard and Poors, Madison Investments