MALVERN CAPITAL MANAGEMENT

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Second Quarter 2020 Review and Market Outlook

June 2020

Second Quarter 2020 Review

The bear market of 2020 has ended. A bear market is defined as a drop of 20% or more which we had seen in the first quarter 2020 for all major equity indices. In the second quarter 2020 all major equity indices rebounded sharply. Investors viewed the outlook for the economy as half-full instead of half-empty and bid equity prices higher in the anticipation that we would see a "V" shaped recovery. A "V" shaped recovery referring to an economy that quickly dips followed by a quick rebound. Investors also believe that the nationwide shutdown is only going to be temporary and hopes are high for a vaccine for the Covid-19.

The S&P 500 Index rose by 20.54% in the quarter. The technology heavy NASDAQ 100 Index jumped by 30.30% in the quarter and is up 16.89% for the year so far. The market snapback was not just in the United States but was seen globally as well. Developed International stocks surged by 14.88% in the quarter while emerging markets rallied ahead by 18.35%.

Federal Reserve actions helped ignite the bond market as the broad bond market was up 2.90% in the second quarter (as measured by the Bloomberg Barclays US Aggregate Bond Index). Lower quality bonds (which did poorly in the first quarter) were up as well for the quarter but are still negative on the year.

Not all on Wall Street believe that the selling is done yet. The doomsayers' numbers are dwindling but their voices cannot be completely ignored. We do not share in their pessimism or rationale for further selling. As positive economic numbers are released there is more reason to look forward to an economy soon to be expanding.

Index Performance

Category	Representative Index	2nd Qtr 2020	Y-T-D	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	18.51	-8.43	-0.54	9.08	10.62	12.99
Broad US Large Companies	S&P 500 Index	20.54	-3.08	7.51	10.73	10.73	13.99
US Small Cap Companies	Russell 2000 Index	25.42	-12.98	-6.63	2.01	4.29	10.50
US Mid Cap Companies	Russell Mid Cap Index	24.61	-9.13	-2.24	5.79	6.76	12.35
Largest 100 NASDAQ Companies	NASDAQ 100 Index	30.30	16.89	33.78	22.92	19.58	20.69
Developed International	MSCI EAFE Index	14.88	-11.34	-5.13	0.81	2.05	5.73
Emerging Markets	FTSE All Emerging Markets	18.35	-10.32	-3.60	2.47	2.57	3.29
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	2.90	6.14	8.74	5.32	4.30	3.82
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	10.18	-3.80	0.03	3.33	4.79	6.68
Commodities	Bloomberg Commodity	5.08	-19.40	-17.38	-6.14	-7.69	-5.82
Total US Market (all cap stocks)	Russell 3000 Index	22.03	-3.48	6.53	10.04	10.03	13.72
Real Estate Investment Trusts	Wilshire US REIT Index	10.56	-17.77	-12.30	0.23	3.98	9.22
Cash	US T-Bill 90 Day	0.04	0.31	1.20	1.62	1.12	0.59

** 3 year, 5 year and 10 year returns are annualized. All periods ending June 30, 2020.*
All returns include the reinvestment of dividends.

The country is far from normal but as time moves on Americans have been able to assess the damage and at least see things as not as bad as originally perceived. In contrast to the first quarter, investors have more clarity as well.

The Federal Reserve Provides a Solid Backstop

As the old saying goes, "don't fight the Fed". In response to the economic shutdown as a result of the Covid-19 crisis, the Federal Reserve has taken bold action to ameliorate the situation.

Among the various actions the Fed took, it has again lowered the Fed Funds rate to near 0%, which it last did right after the 2008 financial crisis. It kept rates near 0% for about seven years before raising them in 2015. In addition to lowering interest rates it has given forward guidance stating that it will keep interest rates low for as long as is necessary.

On March 15th, the Fed reinstituted Quantitative Easing which was widely used during the financial crisis. In the current program it said it would be buying $500 billion of Treasury securities and $200 billion of mortgage backed securities. On March 23rd it modified the program and said the purchases would be open-ended and it would buy whatever was needed. With improving conditions, it again modified the program and said it would taper purchases in April and May. In June it said it would then begin buying a set monthly amount of Treasury securities and mortgage backed securities, $80 billion and $40 billion respectively.

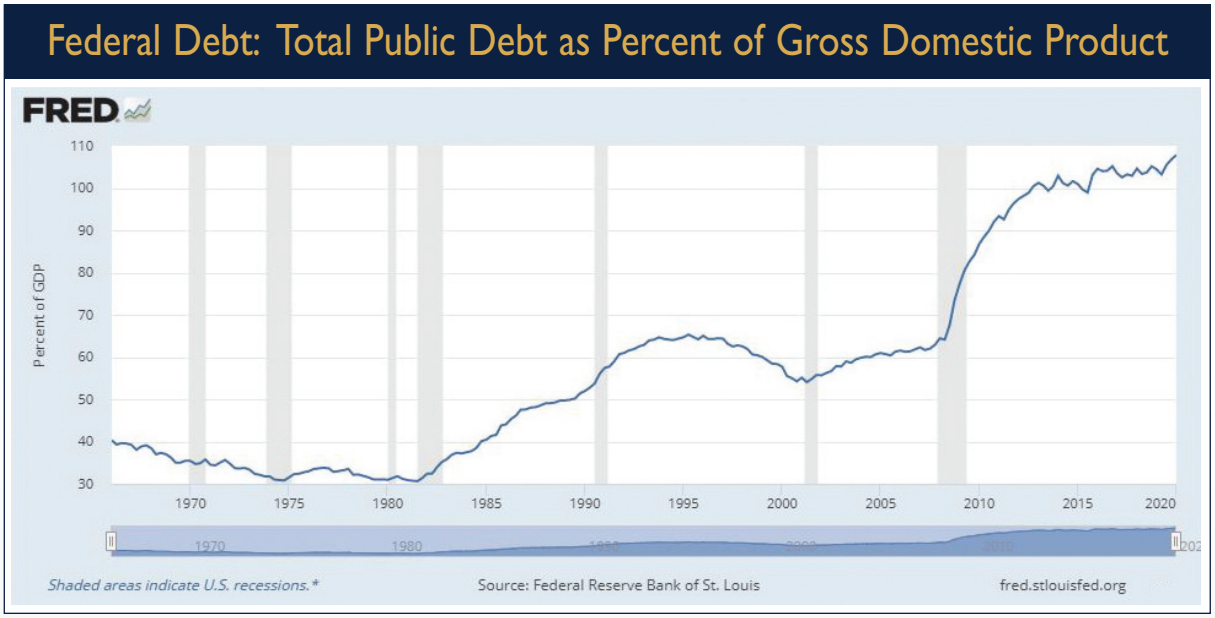
Between May 12 and June 16 2020, the Fed said it would buy, in an unprecedented move, corporate bond exchange traded funds (ETFs). It would buy both high quality bond funds and lower quality bond funds to provide liquidity to the bond markets. It also took many other steps to provide liquidity to the financial system.

What does all this liquidity mean? In our opinion it makes it very difficult for the markets to sell off in any significant way. Despite any short-term economic slowdown, such slowdown should be short-lived and the economy and financial markets have room to further advance.

Debt and Deficits

The last time the United States ran a budget surplus was the year 2000 following the dot com bubble and technology boom of the late 1990s. Since then, through two wars, the financial crisis in 2008 and the latest pandemic, the U.S. has run a deficit each year. All of those deficits accumulate and are added to the national debt. The National debt as a percentage of Gross Domestic Product (GDP) was 107.8% at the end of first quarter 2020. With a national debt expected to climb higher than $25 trillion in 2020 compounded by the government's response to the Coronavirus outbreak with fiscal spending, and with a GDP that is projected to contract, the percentage of debt to GDP will most certainly climb higher this year. The nation with the highest percentage of debt to GDP is Japan at 253% (June, 2019) followed by Greece at 181.1%. Nations with the lowest debt to GDP percentage are Brunei at 2.4% and Afghanistan at 7.1%.

It is difficult to take a current position that the debt and deficits are really a problem, at least right now, given that interest rates are historically low and there is great demand for our U.S. Treasury securities. However, large budget deficits and a high amount of debt has the potential to "crowd" out other demand for debt such as debt needed by businesses and consumers. Such crowding out can and will lead to higher interest rates and inflation down the road.



It doesn't appear that there is much appetite for cutting spending or raising revenue by Congress or the White House. As for spending cuts, what programs can Americans stand to see cut and who has much desire to pay higher taxes? It will likely take a crisis before any action takes place such as skyrocketing inflation, a sudden spike in interest rates or lack of demand for our Treasury securities.

Civil Unrest and The Markets

A nation already anguishing in 2020 due to the Coronavirus pandemic was hit hard by widespread civil unrest sparked by the police killing of George Floyd in Minneapolis on Memorial Day. Despite all of the damage, both materially and economically, the stock market shrugged it off. Hundreds of businesses nationwide were forced to close, many of them permanently, due to the riots and looting; if it wasn't enough for these businesses to survive the pandemic. But we can look to past civil unrest and see that the equity markets were virtually untouched by the turmoil happening in the nation's cities. Looking back at 1968, when many cities burned due to the assassinations of both Martin Luther King, Jr and Robert Kennedy, markets were then unmoved. In 1992 following the acquittal of four police officers in the Rodney King beating case, markets again went unfettered while cities burned and people rioted. Although any mayhem across the country is unfortunate, the markets seem to remain calm and focused on the bigger economic picture. But wherever this chaos leads, if things really heat up there is always a possibility of our democracy becoming fractured. The markets may not be prepared or capable of shrugging off that scenario.

Election Year and Politics

As an election year, 2020 may be unique compared to previous election years. In one corner stands President Trump who is strongly supported by his base voters but carries very negative ratings outside of his base. In the other corner, is Vice President Biden. If elected, he will be older on inauguration day than Ronald Reagan was when he left office. Biden has been leading by large margins in most of the polls recently, but if the last election taught us anything, it is to not put too much faith in the polls.

2020 may turn out to be one of the most divisive elections in history. It seems as if there is real detestation between the Republicans and Democrats. That loathing is not just limited to the politicians, but Americans against other Americans because of who they support for President.

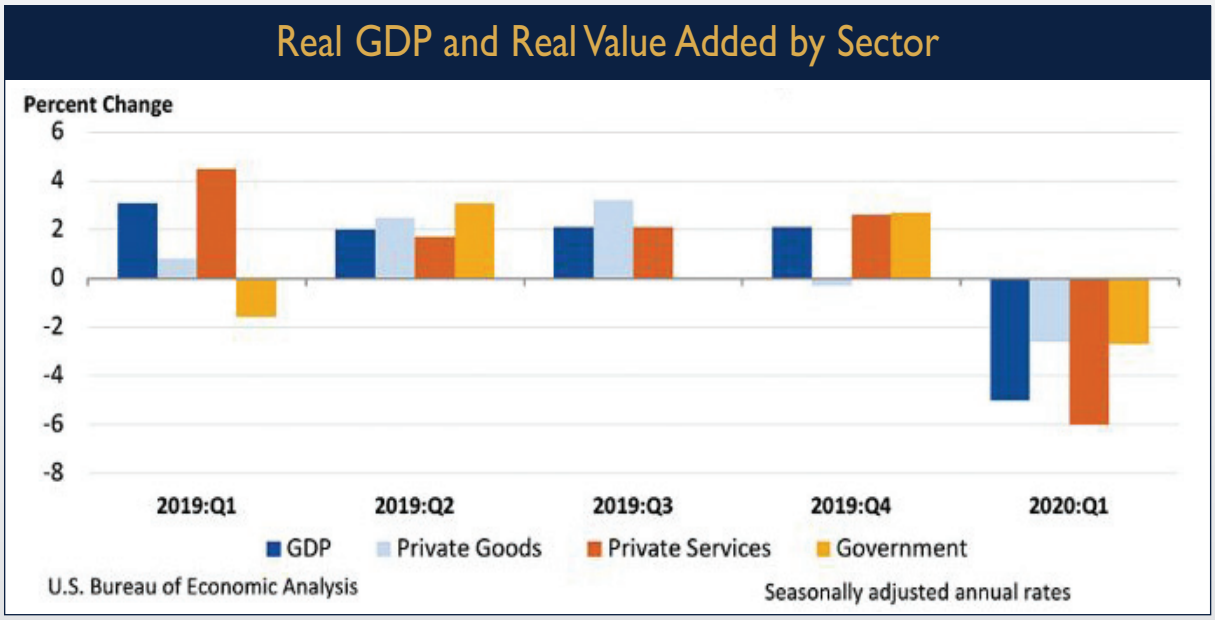
Crisis brought on by the global pandemic lead to Congress actually getting some important legislation passed with the CARES act earlier this year. But further meaningful legislation is not likely to happen this year. Politics can be blamed for the lack of action although bills are making their way through Congress. Neither political party wants the opposite party to get any credit for championing any laws that could benefit the country. But, if forced to act by an emergency reaching the level of the Coronavirus, we could see something happen.

The Supreme Court is also very much in play with the next election. At least two justices will likely by appointed during the term of the person who is inaugurated in January 2021.

Political power is what appears to be the culprit; those out of power will do anything to gain it while those in power will do anything to hold onto it.

The U.S. Economy Falls Into Recession

The U.S. economy is in a recession. The National Bureau of Economic Research (NBER) declared in early June that the economy was officially in recession and that the recession began in February 2020. This ended the longest peacetime expansion in history which had lasted for 128 months. A recession is defined as two consecutive quarters of negative growth in Gross Domestic Product (GDP). Usually the NBER takes a lot longer before it declares a recession but the magnitude of the decline led to the quick declaration.



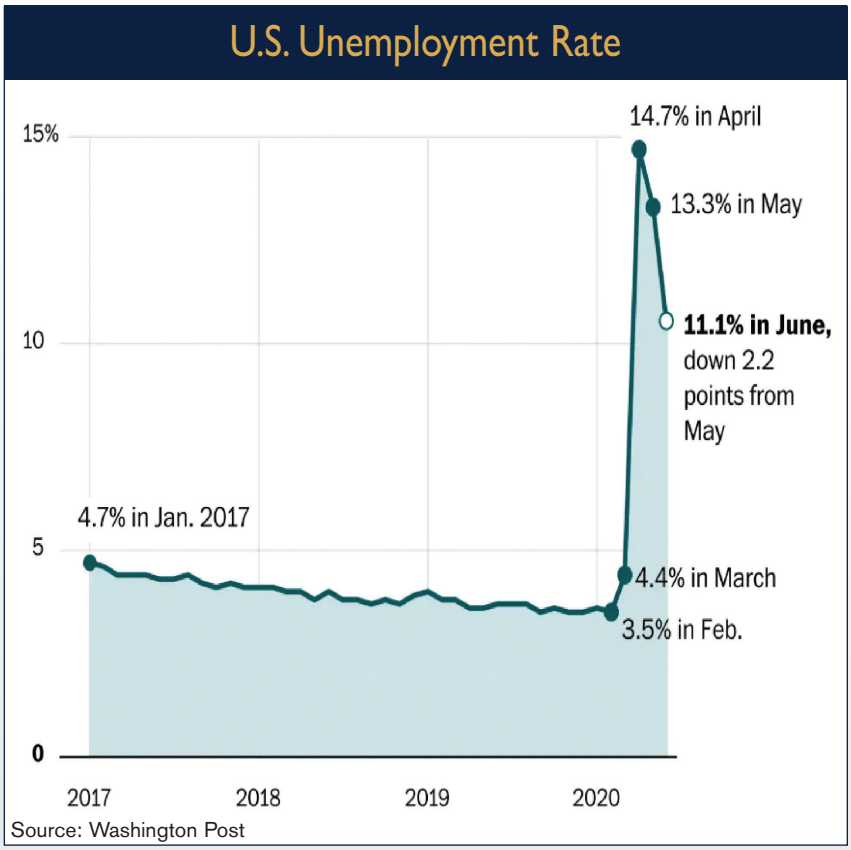
Nearly 42 million people have lost their jobs; an unprecedented number of Americans becoming unemployed. With the nationwide shutdown in place the weekly jobless claims quickly added up. However, there have now been two monthly government jobs reports showing record levels of job creation. 2.7 million new jobs were

created in the month of May and 4.8 million new jobs were added in the month of June. The percentage rate of unemployment fell from a high of 14.7% in April to 11.1% in June. The monthly jobs reports give hope that the economy will quickly bounce back.

It is our view that the recession will be short-lived and we will see a "V" shaped recovery with positive economic growth again soon, perhaps as soon as the fourth quarter 2020.The unemployment rate will continue to drop in the upcoming months but it may be a long time for everyone to return to work and for the unemployment rate to get back to the pre-Covid-19 low rate of 3.5%. There are many businesses that have closed their doors for good so it will take time for those dislocated workers to become employed again.

Reopening The Economy

Many Americans are living in fear of contracting the virus and remain hunkered down in their houses, not spending money in the economy. Others have ventured out as parts of the economy gradually reopen. Some parts of the country are more open than other parts. Along with the economy re-opening we have seen a spike in new cases of Covid-19. However, the encouraging news in recent months is that despite the high number of new cases, new fatalities have slowed significantly. But there is concern that the rise in new cases will force Governors to again close down their respective economies. We believe that as long as new fatalities do not rise, states should be able to stay open.



The ebb and flow of the economy will swing based upon the consumers ability to spend and businesses' ability to reopen and hire people back into the workforce. It is encouraging to see people hired back as reflected in the two most recent government employment reports. But there is a long way to go as the unemployment rate remains very high.

The economy is not likely to return to the pre-Covid-19 levels until we see much more improvement in the unemployment rate. As individual states reopen things on different schedules the economic data will reflect uneven improvement.

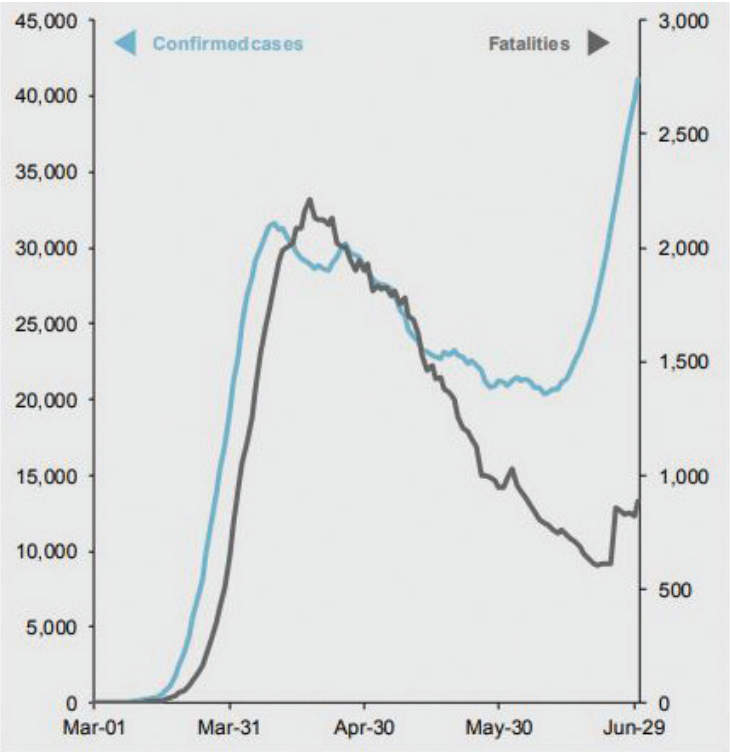
Until a vaccine is found and fear subsides, we will not fully return to normal. But that does not mean we can't experience positive economic growth.

Corporate Earnings Slide

Before anyone had heard of Covid-19 back at the end of 2019, analysts at the Standard & Poor's Corporation projected earnings on the Standard & Poor's 500 Index for the calendar year 2020 at $175.52 per share. At present those analysts have taken down their estimates for full year 2020 to $109.05 per share, a cut of nearly 38%. With actual earnings for full year 2019 at $157.12 per share, this estimate cut represents a drop in earnings of about 31% year-over-year. Stock prices are driven by earnings and the S&P 500 Index fell by around 33.9% from late February to late March 2020. The Standard & Poor's analysts project that earnings will start to increase by the first quarter 2021 to $126.35 per share. Further, they project steady earnings growth through calendar year 2021. Although earnings have collapsed in 2020, as the economy reopens, we should see an earnings recovery.

Change in Confirmed Cases and Fatalities in the U.S.

7-day moving average, as of June 30, 2020



Source: Johns Hopkins CSSE, JP Morgan "Guide to the Markets" June 2020.

Market Valuation

The market appears to be expensive right now. The current "trailing" price/earnings (P/E) ratio of the S&P 500 Index is 25.54 as of the end of the second quarter 2020 (closing price of $3,100.29 divided by trailing 12-month earnings of $121.41). The 25-year average trailing P/E ratio of the S&P 500 Index is 19.56 (average of quarter ending P/E ratios for the past 25-years). The 12-month "forward" P/E ratio of the S&P 500 Index is 21.93. The 25-year average "forward" P/E ratio of the S&P 500 Index is 16.49 (JP Morgan *Guide to the Markets*, June 30, 2020). Both of these measures of market valuation indicate that the market is expensive.

However, (as mentioned earlier) the Federal Reserve is pumping a lot of liquidity into the financial markets and economy. Bonds are very expensive also as an alternative to equities. The dividend yield on the S&P 500 Index is greater than the 10-year U.S. Treasury yield by a wide margin (1.93% versus .653% as of June 30, 2020). Usually, the 10-year U.S. Treasury yield exceeds the dividend yield on the S&P 500 Index.

Although the valuation of equities seems to be expensive or overvalued right now, we believe that there are reasons to be cautiously optimistic for further market advancement given the Fed's liquidity and the high valuation of bonds.

Conclusion

The U.S. fell into a recession which officially began in February. After a short-lived bear market in March 2020, the equity markets rebounded sharply in the second quarter. The Federal Reserve has been working overtime pumping liquidity into the banking and economic systems. We are reminded of the old saying "don't fight the Fed." Besides monetary stimulus, the economy has seen fiscal stimulus as well with little or no regard for the deficit and the growing national debt.

We have been hit by civil unrest in cities across the country but such unrest has had little or no impact on the markets. It is an election year and politics will likely get in the way of anything meaningful happening the rest of the year.

The economy will likely emerge from recession by the fourth quarter this year experiencing a "V" shaped recovery. This assumes that Governors are satisfied by the drop in new fatalities despite a spike in new Covid-19 cases in parts of the country. We will likely need to see a vaccine before everything completely returns to normal.

There has been an earnings recession as well. But analysts are expecting that we start seeing improvement in earnings as soon as the first quarter 2021. Likewise, the markets look ahead. Despite looking overly expensive right now, investors look forward by six to nine months and foresee an earnings recovery making current valuations look less stretched. This is encouraging for the market but we still exercise caution at these lofty levels. The current market and economic environment will try the patience of most investors. Although we remain cautiously optimistic, there is no guarantee that earnings or the economy will recover. We will continue to manage our clients' portfolios based on our long-term economic and investment thesis.

As such, we are here to listen, counsel and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer

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