Risk off!

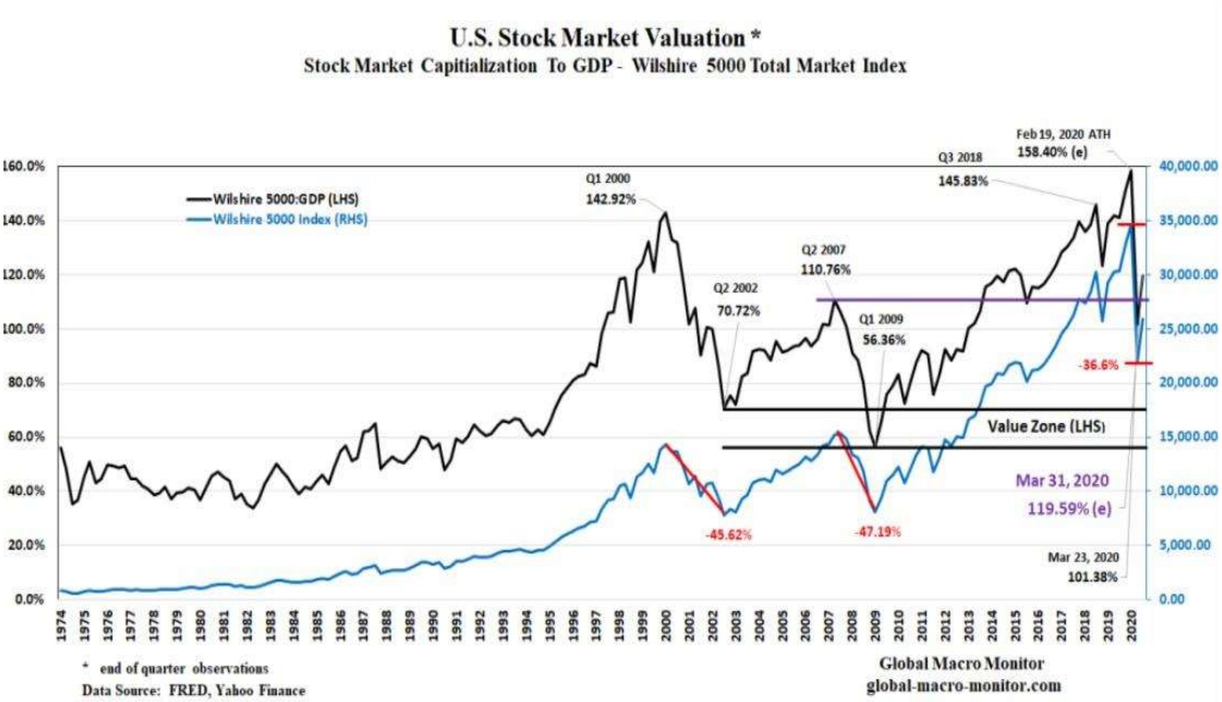
Trivia Question: How many funds were positive in 2000, 2008 and so far in 2020?
(Hint: Look at our track record)

The markets were hit hard in Q1 2020 as the Coronavirus has led to quarantines across the US. Governments and Central Banks have reacted with extreme fiscal and monetary stimulus. Will we see a "V" bottom and then off to the races or malaise? While the Coronavirus is a huge shock, we believe the economy and stock market were showing signs of stress before the virus outbreak.

We have been noting that the global economy was weakening. Stocks were at extreme valuations while earnings in the US were falling and GDP growth had slowed. Even the Fed had started acting in Q4. The market was being propped up by Fed money printing and continued company stock buybacks. Now the Fed has hit the turbo on money printing and companies are stopping buybacks to conserve cash.

Valuation

It is said that Warren Buffett's favorite valuation metric is Market Cap to GDP (MCAP/GDP). As seen below, in February, MCAP/GDP was at its all-time high. It was above the 2000 high and well above the 2007 high. Needless to say stocks valuations were at extremes. At such levels, it does not take much to hit exhaustion and send the market back to more normal levels. This time the market ran into a tsunami (the virus). Some speculate that the market should bottom somewhere between the levels found at the bottom in 2002 and the bottom in 2009. According to the table below that would be between a MCAP/GDP of 70% and 56%. As of 3/31/20 we were at 120%. So potentially, there could still be a ways to go. We expect the Fed and the government to throw the kitchen sink at the economy to spur a quick recovery.



Relative Valuations - Stock Market Capitalization to GDP

	Date	Mkt Cap to GDP	Percentile Rank *
Today's Close	3/31/2020	119.59%	84.9%
Recent Low	3/23/2020	101.38%	73.0%
All Time High	2/19/2020	158.40%	99.5%
Q4 '19 Close	12/31/2020	151.31%	98.9%
Value Zone			
dot.com Crash Low	6/30/2002	70.72%	47.0%
GFC Low	3/31/2009	56.36%	31.9%

* Based on 185 quarterly observations since Q1 1974

Global Macro Monitor

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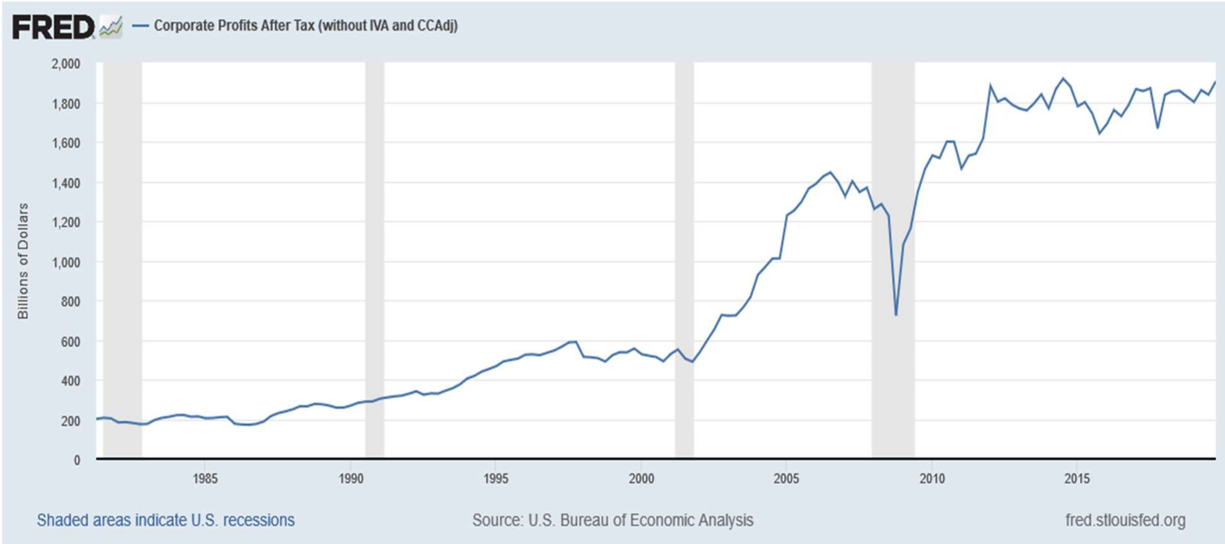
Earnings growth

According to the US government, after-tax corporate profits have been flat since about 2012. This measure of earnings tends to track more closely to GAAP earnings, while analyst earnings are pro forma and leave out some expenses like compensation paid in stock and some so-called one-time events. So if earnings were flat, why did the market go up? We think it was largely due to stock buybacks, Fed QE money printing and China's growth.



Stock Buybacks

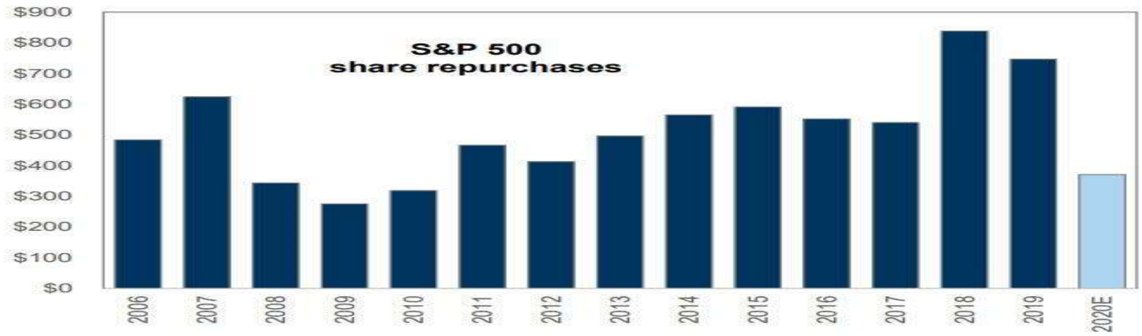
Companies buying back their own stock have become the largest buyers of stock in the US. Buybacks accounted for about $600 billion of stock purchases in 2018. They were the largest net buyer by far. Households, Mutual Funds and Pension Plans were all net sellers. Half of stock buybacks are being financed with debt. With the Fed keeping rates low for the past 12 years, it seemed like an obvious move. What could go wrong?

Companies levered up. With the share count going down, even flat total earnings lead to growing earnings per share. The problem is, if anything goes wrong, the companies do not have a rainy day fund to weather the storm.

One complication of the bailout act is that companies that borrow money from the fund cannot buy back stock. Depending on how many companies use the borrowing facility, this will remove some portion of the largest buyer of stocks.

In fact, companies have been using all of their free cash flow to buy back stock and pay dividends. With lower free cash flow something will have to give. Either buybacks or dividends get cut or both. In fact, Goldman forecasts that S&P 500 dividends will fall by 25% and buybacks will fall by 50% in 2020 compared to 2019. The graph below makes clear that corporate buybacks and foreign investors were the only large equity buyers over the past several years. Obviously, this will have a negative impact on stock prices.

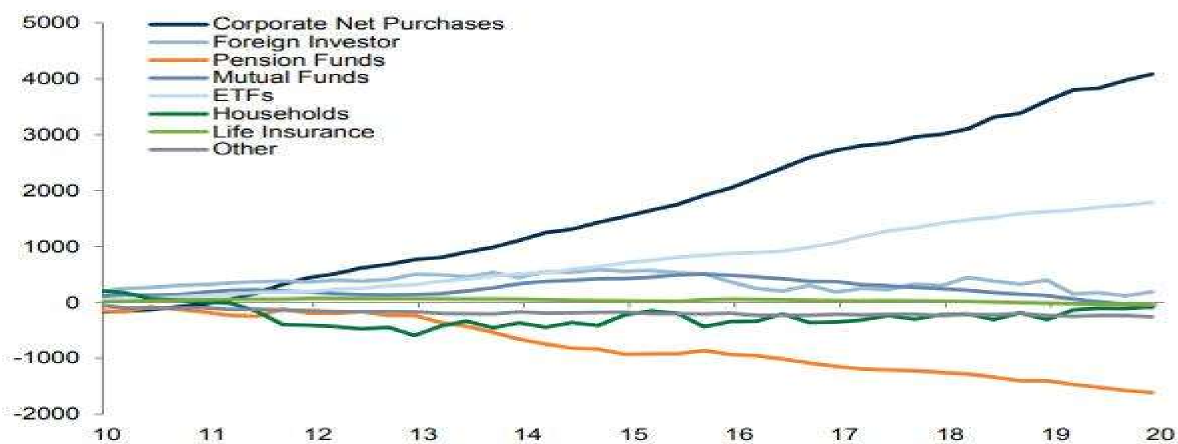
Exhibit 1: We expect S&P 500 share repurchases to fall by 50% during 2020



Source: Compustat, Goldman Sachs Global Investment Research

Exhibit 12: Corporate share re-purchases have been a key source of equity demand in this cycle

Cumulative US equity demand by source



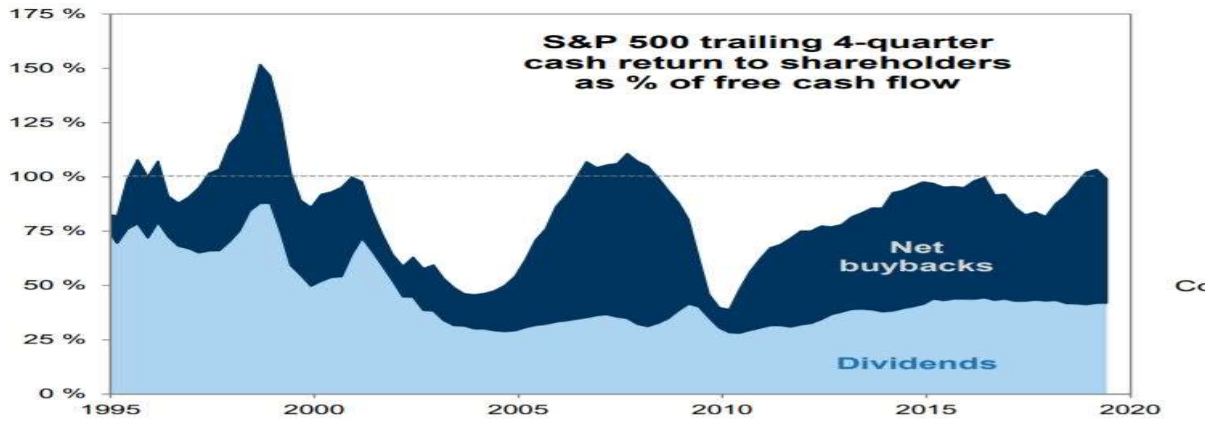
Source: Haver Analytics, Goldman Sachs Global Investment Research

Corporate buybacks are dominant source of equity demand

	Net US equity demand ($ billions)				
Category	**2016**	**2017**	**2018**	**2019E**	**2020E**
Corporations	$ 677	$ 288	$ 598	**$ 480**	**$ 470**
Foreign Investors	(186)	121	99	**(175)**	**50**
Households	(13)	121	(93)	**145**	**30**
Mutual Funds	(112)	(134)	(120)	**(150)**	**(100)**
Pension Funds	(213)	(109)	(148)	**(200)**	**(250)**
Life Insurance	(25)	(6)	(44)	**-**	**-**
Other	(12)	(19)	3	**-**	**-**
less					
Foreign equtiies by US	22	140	194	**(100)**	**100**
Credit ETFs	96	123	100	**200**	**100**
Included among holders above are:					
Equity ETF purchases	188	347	210	**100**	**150**

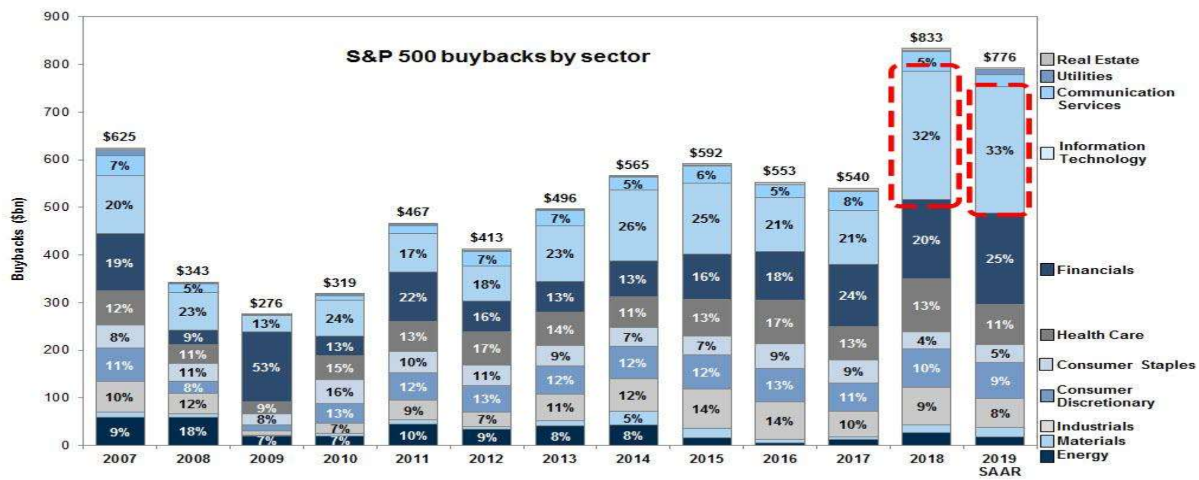
Source: Goldman Sachs

Net buybacks and dividends represent more than 100% of FCF



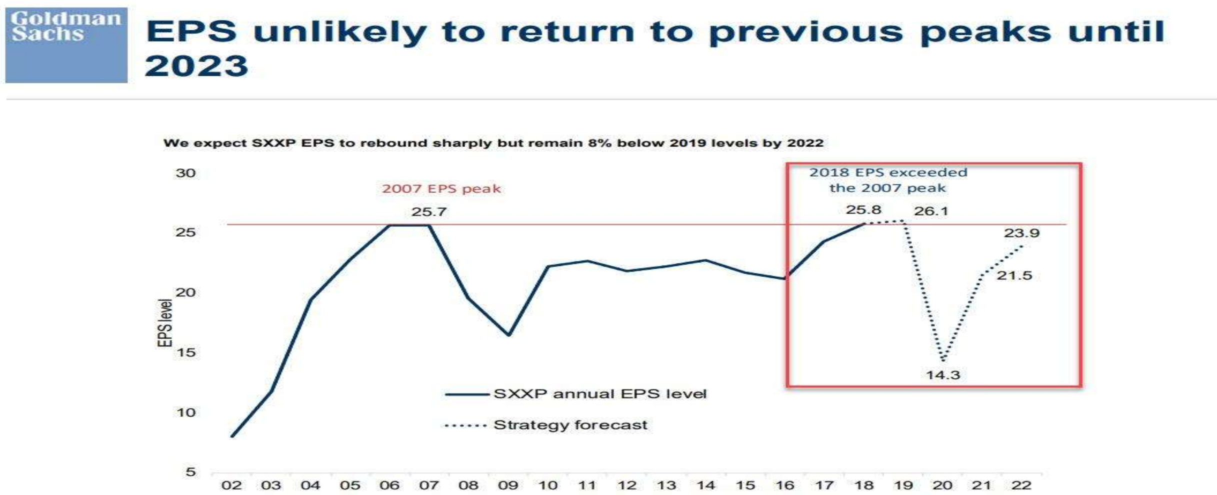
Source: Goldman Sachs

Exhibit 31: S&P 500 buybacks by sector
as of 2Q 2019



Source: Compustat, Goldman Sachs Global Investment Research

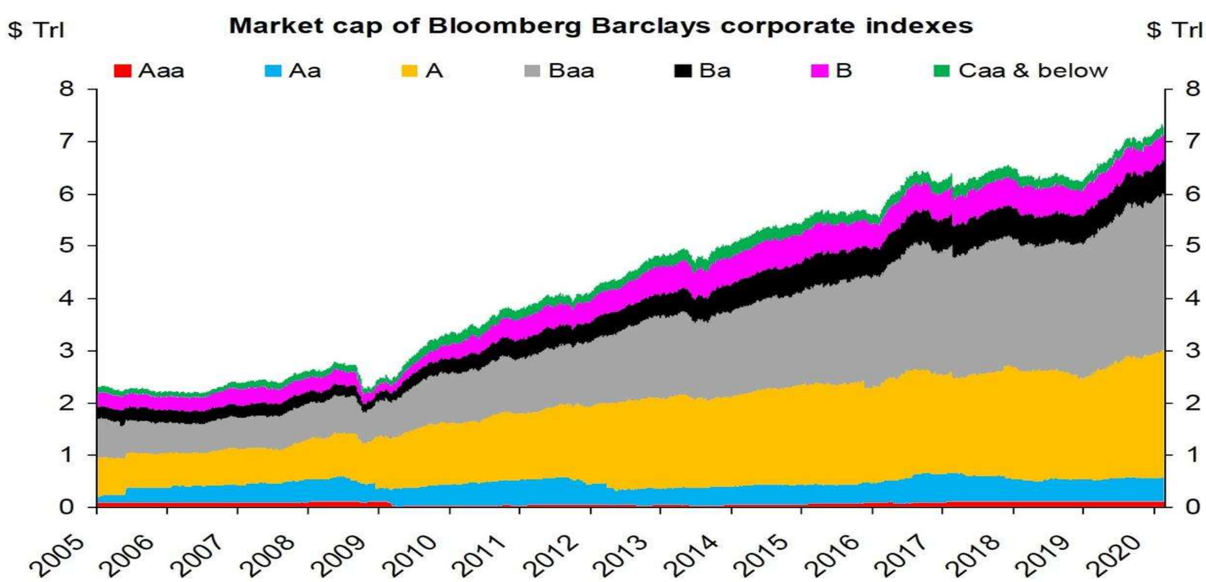
So how long will it take for earnings to return to Q4 19 levels? Goldman suggests 2023.



BBB debt

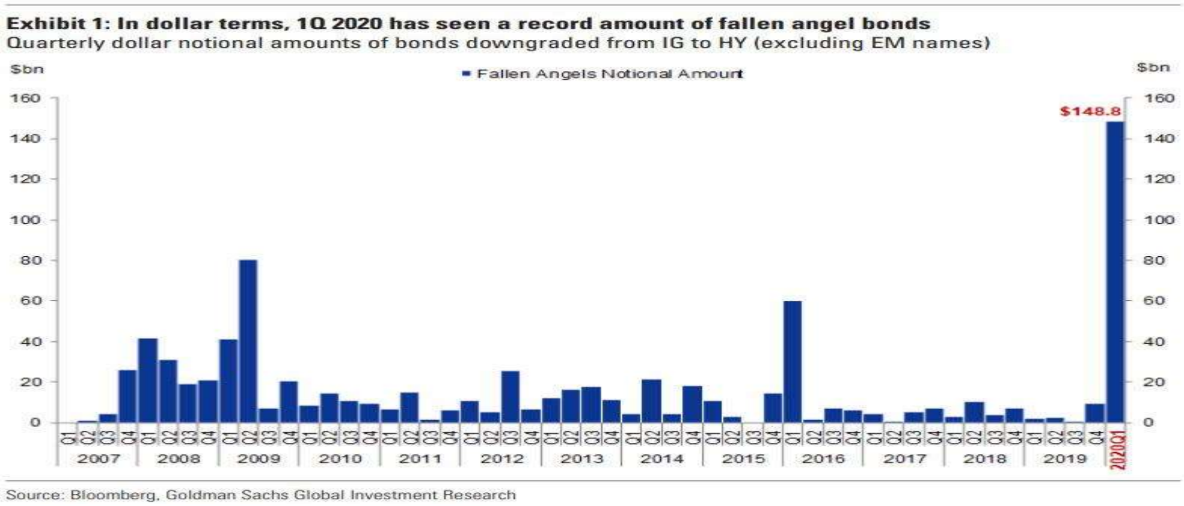
With the Fed keeping rates low for the past 12 years, companies have loaded up on debt, especially BBB debt. In 2008, BBB debt stood at about $1 trillion. Currently it stands around $3 trillion. If you look at the graph below you will note that all non-investment grade debt of all credit ratings totals less than $1.5 trillion. Many pension plans can only own investment grade debt. Even when they can own non-investment grade debt (high yield-HY) those amounts are small in relation to investment grade debt.

The problem arises when there are downgrades from BBB- to BB+, the top HY rating. Pension plans and other institutional investors have to sell the debt because of the downgrade. If the total amount of downgraded bonds is fairly small, investors can generally digest the increased supply. However, if the amount of downgraded bonds is large enough, it will cause severe problems in the HY bond markets.



Source: Bloomberg Finance LP, DB Global Research

Already in 2020 large companies such as Ford, Kraft Heinz and Occidental Petroleum have been downgraded to HY. These downgrade amounts surpass the levels from 2009 and 2016. The recent stimulus act may provide financing to some of these companies, but at what cost and for how long?

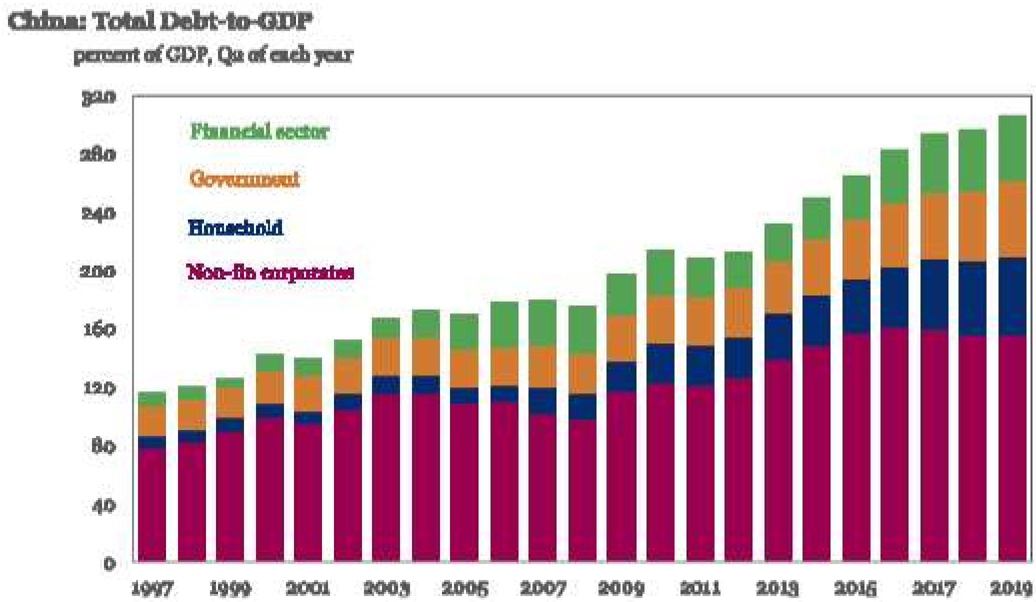


China

Last quarter we looked at China and how its profits were already falling before the Coronavirus.

We have contended before that the US QE last decade was successful partially (or largely) due to China's stimulus. That's because China ramped up its lending (as evidenced by its debt levels) from 2008 to present. Much of the earnings growth of US companies over the last decade was due to growth in China, which in turn was due to Chinese debt growth.

China's total debt now surpasses 300% of GDP...



China is now approaching developed country debt levels. The US is around 360% debt to GDP. China may have difficulty stimulating its economy like it did during the last great recession. If that is the case, QE might not be nearly as successful as it was last decade.

LOOKING FORWARD

We try to produce the best risk-adjusted returns available. As risks have increased, we have increased our protection. If risks subside or are priced in, we will gladly reduce our protection. But until the market more fully reflects these risks, we will remain cautious.

Best regards,

Thomas H. Forester
CIO and Portfolio Manager

For more complete information on the Forester Funds, including charges and expenses, obtain a prospectus by calling 1-800-388-0365 or visiting www.ForesterValue.com. The prospectus should be read carefully before investing.