MONTHLY NEWSLETTER

Market Report – Titan Investment Management LLC

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Executive Summary:

- Polls indicate more and more people are aligning with the Republican party headed into the election year. This has especially been the case for Independents leaning Republican as they outnumber Independents leaning Democratic for the first time since 2014.

- Rather than polls, democrats can hang their hat on record voter turnout for Super Tuesday. While polls indicate the democratic base has shrank, the base that remains more than came out to vote and support their candidate.

- President Trump v. Biden seems to be the base case scenario following Tuesday. However, the inaccuracy of poll data emitting from just the Democratic primary indicates a 2020 election that is largely in the air.

- COVID-19 caused the market to enter a correction phase, falling 12.75% in a matter of 7 trading days. Historic time periods that include virus outbreaks have resulted in a positive return for the year despite significant corrections.

- The infectious nature of COVID-19 is estimated to be less than SARS, but more than Influenza. Data is still being gathered, but the virus's ability to wrap itself around the globe has clearly caught the world and the US on its heels.

- China and S. Korea seem to be through the worst of it as the number of new cases is declining. However, the global infection rate has found new legs in the US, Europe, and Middle East. If China is any sort of proxy, COVID-19 runs for ~45 days before it peaks and begins to run off.

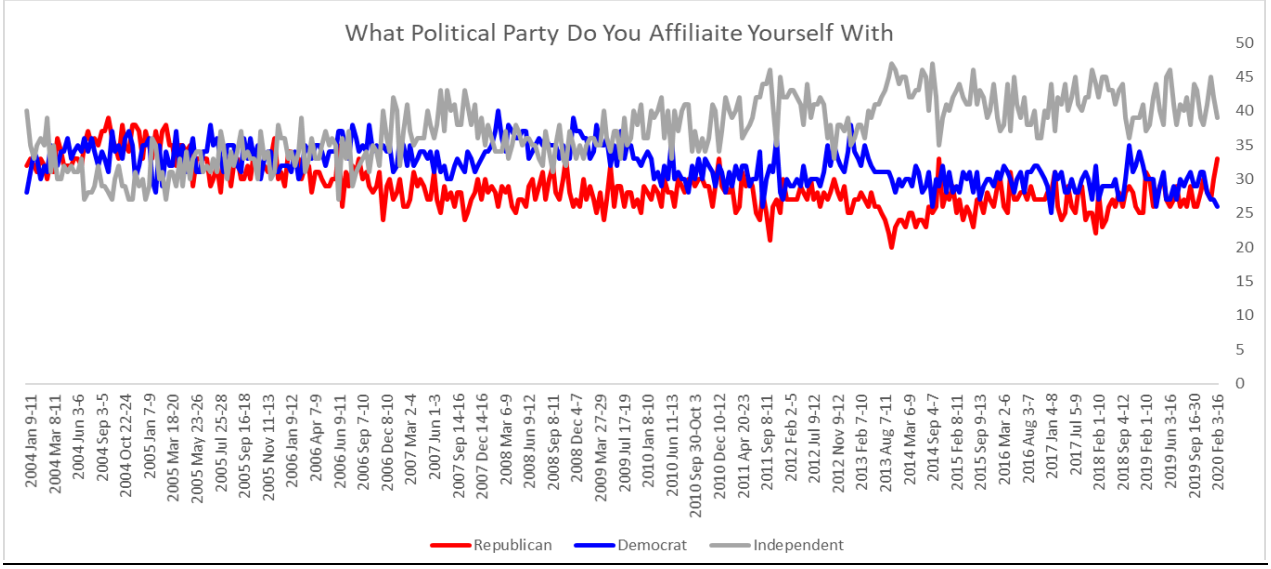
- Equity markets are down 9% YTD on the back of COVID-19. However, multiples are trading inline with historic averages while corporate and economic fundamentals remain robust. Non-Farm Payrolls just posted 273K despite dealing with the fallout of the virus.

- The FOMC cut overnight target rates by 50bp as the US Treasury curve is inverted out to 10 years and interest rates are at historic lows. This interest rate environment serves as an environment for both consumers and firms to refinance and free up cashflow.

- Stocks are pricing at an 8-year low when comparing to bonds. This discount comes with the selloff from COVID-19, a strong US consumer, and historic periods of robust returns for the year. There is no such thing as a guarantee, but more arrows are pointing towards an opportunity than not.

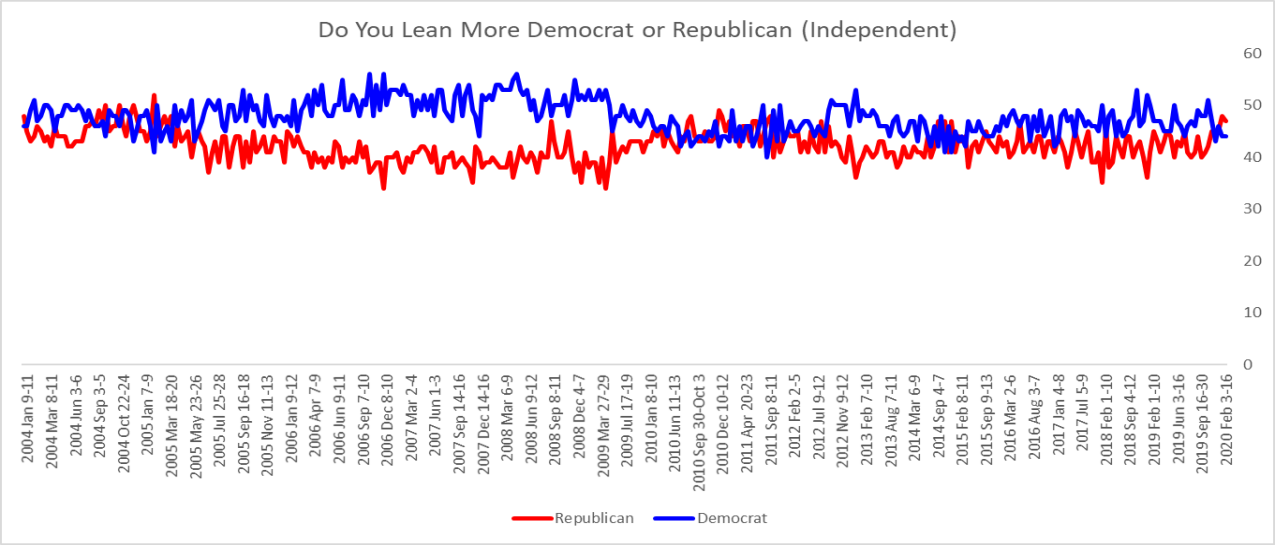
Presidential Election 2020:

The Presidential election is roughly 7 months away with many polls indicating that President Trump will be unseated by either Joe Biden or Bernie Sanders. Polling tends to get closer and closer as one approaches election day, but some early signs are emerging that present positive and negative aspects for each party.



The Moderate (Independent) vote is increasingly becoming important for both parties to harvest as it has encompassed most of the US population since 2014. The trend for Republicans has taken a positive turn with poll numbers highlighting the highest affiliation with the Republican party since June 2006. However, the trend for Democrats has taken a less than positive turn as party affiliation is near a 20 year low. Overall, it seems the general trend to take away from this is that over the past 20 years people who once affiliated themselves with the Democratic Party have shifted towards being an Independent.

The follow up question to this graph is asking that growing constituency of Independents what direction they tend to lean.



This direction seems to be fairly split as neither party has ever been able to consistently rally the moderate base. However, the Republican Party has recently overtaken the Democratic Party since the Democratic

Primaries have heated up. Coupled together, these graphs and polls tend to favor a Republican nominee for President as we speak.

Super Tuesday was a big benefit for the Democratic party in aggregate. Super Tuesday just took place and voter turnout hit a record turnout and highlighted the enthusiasm among the Democratic base. Virginia and North Carolina saw turnout increases of 70% and 17% while Colorado, Maine, and Minnesota are claiming high turnout. The caveat with the latter three is that the states switched from a caucus to primaries this cycle making any historic comparison difficult. Lastly, the states of California and Texas are still counting, but all signs point to a higher turnout. This turnout is especially significant as exit polls are indicating a higher turnout from moderates. Texas alone saw a 10% increase from moderate voters over 2016. Obviously, a moderate is not forced to vote for Biden or Sanders come election time, but this increase in overall enthusiasm gives the Democratic Party something to hang their hat on.

The democratic race is down to Biden vs. Sanders. Super Tuesday was a massive comeback for the former Vice President as Iowa, New Hampshire, and Nevada were an unmitigated disaster. Averaging the latest polls leading up to Super Tuesday and reality provide compelling evidence that polls do a poor job of predicting a winner.

State	Poll Average	Actual Result	**Differential**
California	Sanders +12.0	Sanders +8.7	**3.3**
Texas	Sanders +1.5	Biden +4.5	**6.0**
North Carolina	Biden +13.4	Biden +18.9	**5.5**
Virginia	Biden +17.5	Biden +30.1	**12.6**
Maine	Sanders +14.0	Biden +1.2	**15.2**
Alabama	Biden +25.0	Biden +46.6	**21.6**
Arkansas	Biden +13	Biden +18.1	**5.1**
Colorado	Sanders +11	Sanders +12.5	**1.5**
Massachusetts	Warren +2	Biden +6.9	**8.9**
Minnesota	Sanders +5.0	Biden +8.7	**13.7**
Oklahoma	Biden +7.0	Biden 13.3	**6.3**
Tennessee	Biden +7.0	Biden +16.7	**9.7**
Utah	Sanders +6	Sanders +17.2	**11.2**
Vermont	Sanders +41	Sanders +28.8	**12.2**

The differential between the polling average and actual result average 9.5, in other words polls showed a margin of error of nearly 10%. In addition, the majority of President Polls of Trump v. Biden or Trump v. Sanders show an estimated margin of error of only ~3.5%. Overall, the accuracy of polls needs to be taken with a grain of salt and recent results indicate another method of measurement maybe warranted if the US population wants to glean any applicable information.

Focusing on reality, Sanders won 4 states while Biden took the other 10. The result becomes even more depressing for Sanders if early votes towards Buttigieg and Klobuchar are added to Biden and Warren is added to Sanders. At this point Sanders needs to mount a significant comeback as his showing against Biden on Super Tuesday was worse than his performance against in Clinton in 2016.

Whether President Trump or Biden/Sanders wins the 2020 election is entirely too early to tell. Polls would favor Biden or Sanders as both have consistently been shown to beat President Trump. However, as the most recent poll data versus reality from Super Tuesday would indicate this could almost be considered worthless given how wrong the polls have been.

The marketplace seems to be indicating that President Trump of Biden is an acceptable President given the 4.10% rally the day after Super Tuesday. As stated, it's early, but neither President Trump or Biden have provided a detailed plan of the economy. With that being said the underlying assumption is neither individual would seek to "rock the boat," as both have been against Medicare For All, free education, paying off all student debt, and a general wealth tax.

Assuming Biden wins the Democratic nomination, the main political issues will most likely come down to ObamaCare 2.0 and the handling of COVID-19. The economy and Ukraine will most likely be avoided as the economy has exhibited strength over the past four years and Biden would have a hard time throwing President Trump under the Ukrainian bus without getting caught in the wheels.

Coronavirus:

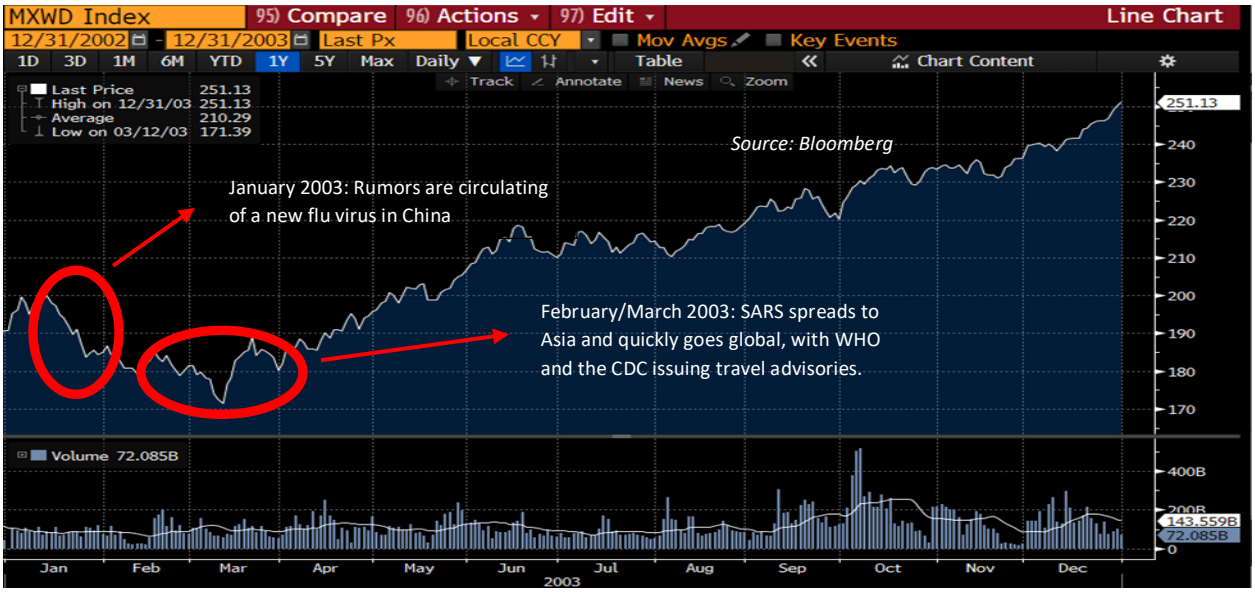
The coronavirus has caused mild to moderate upper-respiratory tract illness, like the common cold. Most people get infected by a coronavirus at some point in their life with symptoms including: runny nose, headache, cough, sore throat, fever, and a general feeling of being unwell. In addition, a coronavirus can sometimes cause more serious sickness such as pneumonia and bronchitis.

The recent coronavirus (COVID-19) started to show signs of emerging in early January. Patient zero or the exact start of the virus has not been disclosed, but the resulting spread of the virus has caused the S&P 500 to fall 12.75% in a matter of 7 trading days. Given the robust return in 2019, it seems the market was looking for a reason to pullback and the virus has been the catalyst. Before giving into the fear of panic a similar incident most might remember is that of SARS.

Ironically, SARS has a lot more in common with COVID-19 than most might realize:

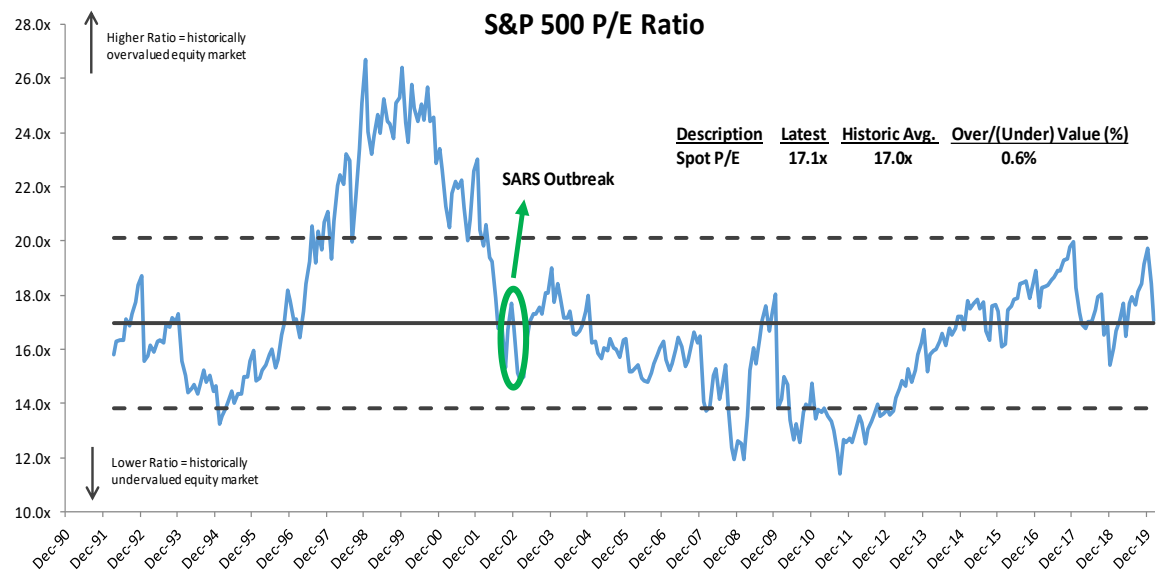
1. Both are believed to be passed on from bats from southeast inland China.
2. Both begin as an upper respiratory tract illness.
3. Both can lead to more complicated medical conditions that result in death.
4. Both had/have an unknown incubation period.
5. Both were detected by WHO (World Health Organization) early in the calendar year.

Unlike COVID-19, China was hesitant to notify WHO and despite the earliest cases of SARS appearing in November 2002, WHO was not notified of any outbreak until February 10, 2003.



The graph above highlights the global equity market and the resulting decline that happened over the initial fears that roiled the market from SARS. However, as can be seen the rest of the year was euphoric and for those who panicked, they missed out on a global rally.

Another ironic similarity is the overall value of the market prior to SARS compared to the current situation.



The main points to take away from the global equity market during SARS are the following:

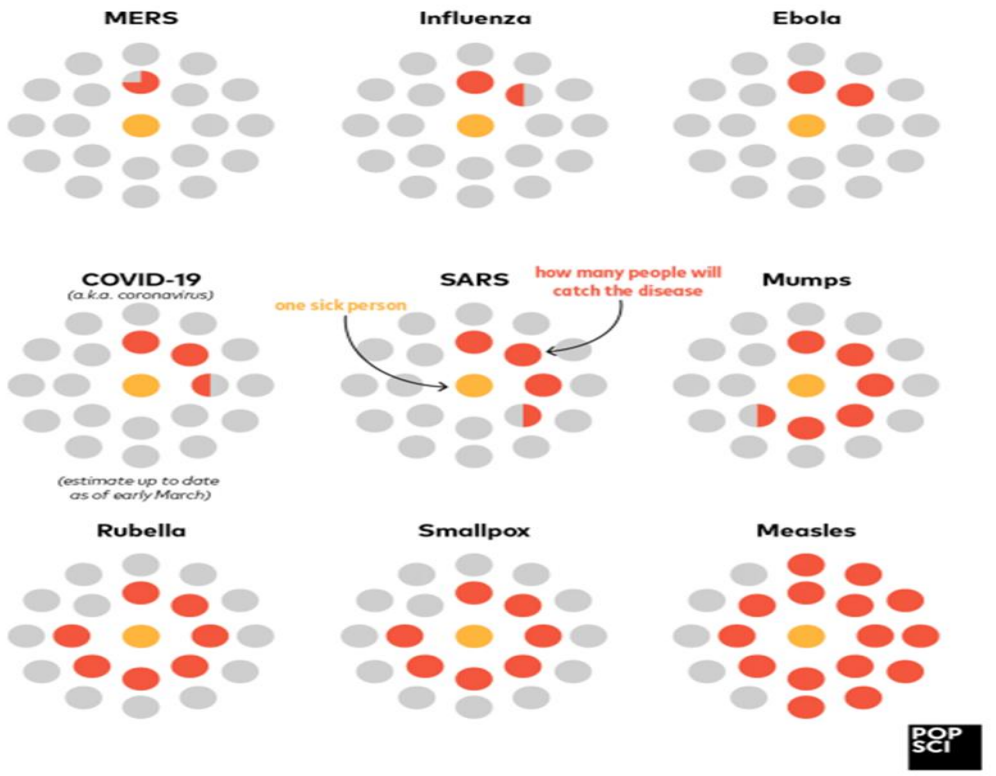
- Prior to the SARS, multiples were trending lower as the dot.com bust, Enron bankruptcy, and the war on terror weighed on sentiment.
- The multiple itself fell roughly 2pts that resulted in global equity markets falling roughly 13.8% peak to trough. Time elapsed was from Mid-January to Mid-March.
- SARS was largely under control and travel restrictions were lifted by May 2003.

As of March 5, 2020 COVID-19 has resulted in the following breakout:

Cases	Deaths	Recovered
98,051	3,356	54,125

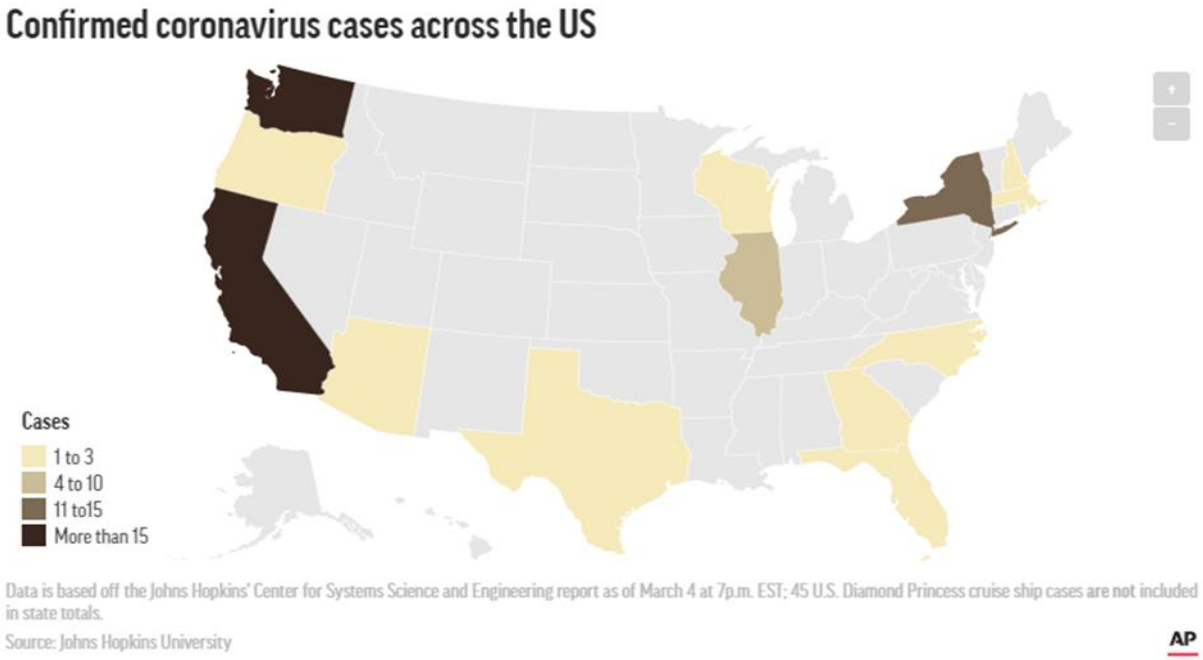
The fatality rate of 3.4% is not meant to be taken likely, but compared to historic epidemics is one of the lower fatality rates. However, this low fatality rate is one of the reasons COVID-19 is more infectious. Many of the infected have reported little in terms of symptoms and thus exposed themselves to others. Epidemiologists tend to use the basic reproduction number (R0 – how many people an infected person will infect) to measure a virus's ability to infect others. An R0 of less than one implies an infected person infects less than one other person on average and the virus will largely die off on its own. However, a R0 greater than one grants a virus the ability to spread and proliferate if left untreated. In other words, if an R0 is 1.2, for every 5 people infected, the disease will spread to 6 new people on average. Extracting this trend forward points to an exponential effect on the population, especially when condensed.

The graph below highlights that the current estimate for COVID-19 's R0 is 2.5 while SARS carries a 3.5 and general Influenza is 1.5. However, in both SARS and Influenza's case symptoms were visible and the infected new it was something more than the common cold.



Coronavirus is on par with SARS in terms of infectiousness. *Infographic by Sara Chodosh*

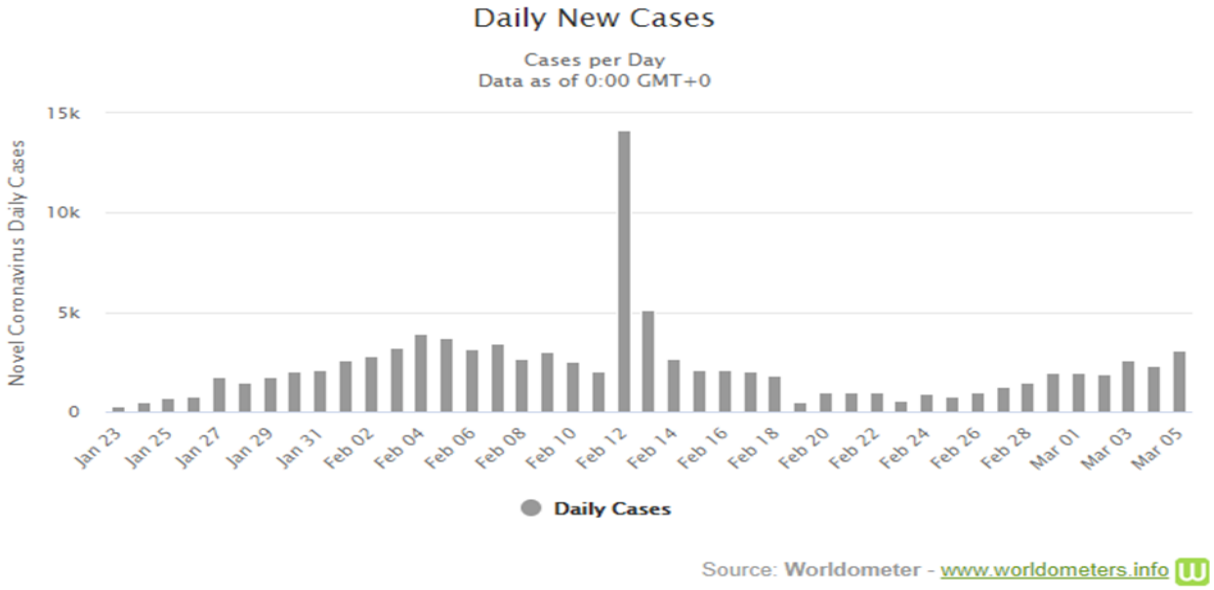
Taking all the data we currently have at our disposal, the last question to attempt to answer or least provide some context on is how long will this play out.



The US has confirmed 239 cases, with 14 fatalities. A majority of these deaths have originated from a nursing home in Seattle, WA where many of the residents already had a compromised immune system. However, the bigger issue for the US seems to be that of adequate testing and precautions.

Vice President Mike Pence has already declared the US will fall short of delivering its stated goal of 1 million test kits by the end of this week. In addition, the CDC has acknowledged the initial batch of test kits were faulty and not accurately capturing the virus. Lastly, the majority of states were slow to even adopt any testing facilities.

Whether one looks at the number of test kits, the quality of test kits, or availability of test kits. The US has largely fallen short compared to other developed nations. This is especially the case in comparison to China and S. Korea. Both of those countries built temporary hospitals in a matter of days, quarantined both the infected and perceived infected, and created drive through testing facilities. All these factors are pointing to a lower and lower infection rate emitting out of China and S. Korea while the trend is rising in the US.

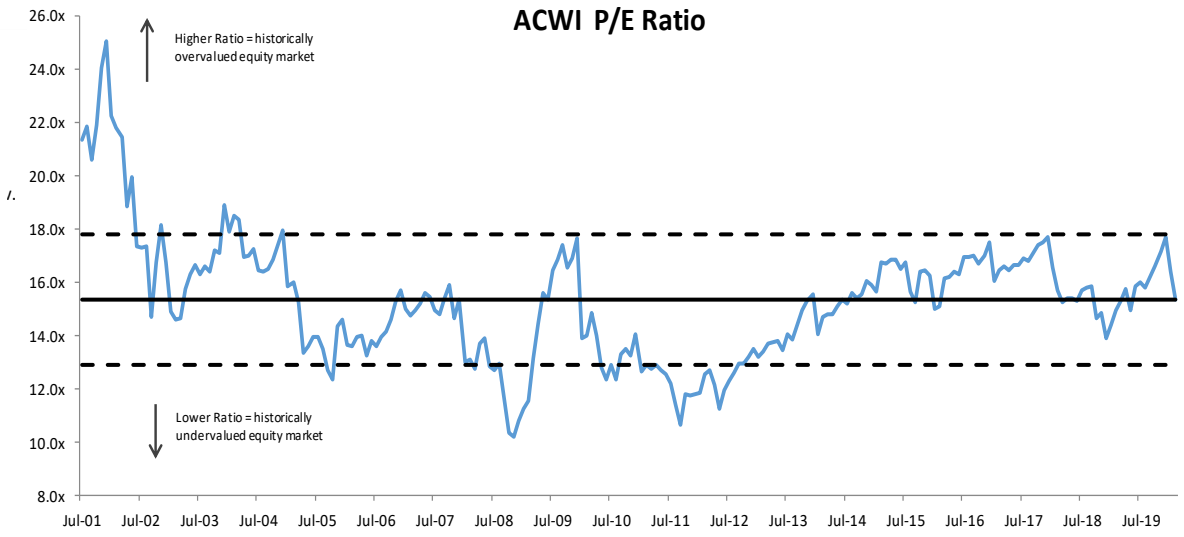


The overall number of new cases is beginning to grow as the number of new cases is falling in China and S. Korea, but are finding legs in the US, Europe, and Middle East. Given the timeline for China to recover from the disease has taken ~45 days, the US and Europe may not be out of the woods until late April. This leads to the scenario where Spring cannot get here soon enough. Historically, corona viruses shelf life is dramatically less on inorganic surfaces the warmer the weather gets.

Bringing all this information together implies an environment in the US where the infection rate is going to get worse before it gets better, but has largely been priced into the market from a historic perspective.

Equity & Fixed Income Valuation:

SPX Index	P/E RATIO	P/CF RATIO	P/B Ratio	Div. Yield	Earn. Yield
+1 Std. Dev	20.13	14.24	3.60	2.67	6.29
Average	16.98	11.10	2.88	2.09	5.29
-1 Std. Dev	13.84	7.96	2.15	1.50	4.28
Z Value	0.03	0.49	0.52	-0.08	-0.12
Percentile	18.94%	8.08%	15.39%	67.72%	73.89%



The global equity market is done over 9% through the end of this week. In addition, the market has corrected over 12% since the peak of the market back on February 12th. Historically, these viruses have bottomed out in the market in March and appreciated materially from that point. In addition, the current P/E stands at 15.4x and is directly in line with the historic average. Focusing more on the fundamentals of the actual firms that make up the US market provides a decent outlook:

- Profit margins are at 10.6%, historically high, and much higher compared to previous periods of virus outbreaks.
- An intrayear decline of less than 15% has resulted in a positive return over the entire year in 26 out of the past 30 years.
- Unemployment remains at historically low levels with Non-Farm Payrolls posting the strongest January and February since 2012.
- Purchasing Managers Index has turned from negative to positive over the past 2 months despite the outbreak of the virus.
- Inflation remains stable hovering around 1.5%.
- Household leverage remains steady and well below the level that resulted in the Great Recession.

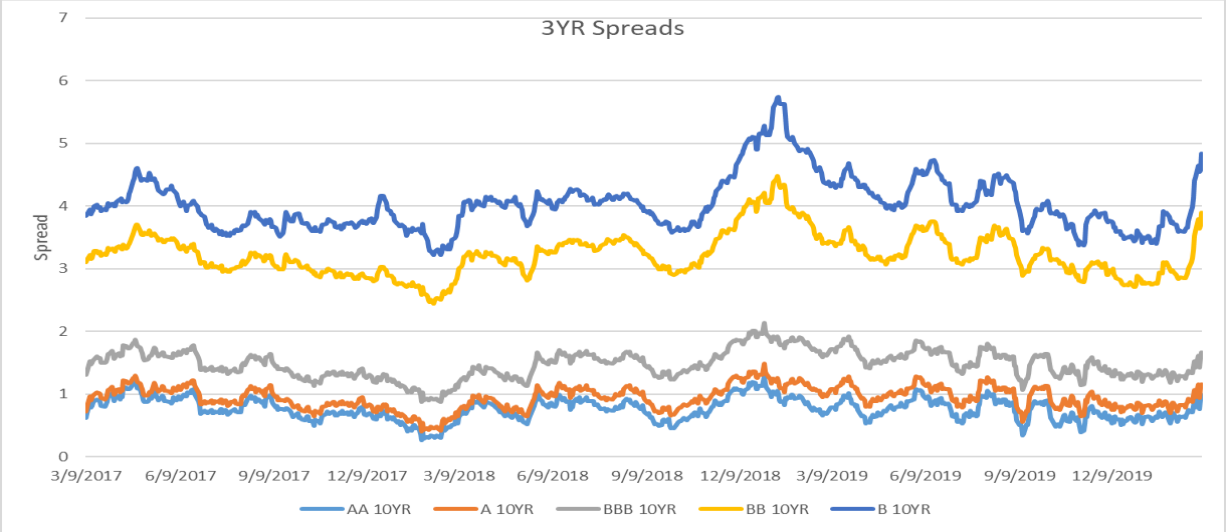
The one blemish on corporate America is that of corporate debt. Corporate debt as a percentage of GDP is at all time highs and highlights that while the US consumer has a healthy amount of leverage corporations do not. However, leverage does not take into account the level of interest rates. The coverage ratio of EBITDA divided by the annual interest payment continues to drop. Thus, corporations would argue that while leverage is high it is not indicative of the overall health of their financials.

Given the inline multiple coupled with strong underlying fundamentals of the economy paints a picture of resiliency in the market. This resiliency if effectively selling at a discount and even more so when considering the alternative-fixed income.

The FOMC made an emergency 50bp cut in the overnight target rate to 1.125%. This cut in conjunction with an inverted yield curve out to 10 years and a 30 year bond only offering 1.30% highlights the bond market's premium. Factoring in inflation and solely focusing on US Treasuries would create a negative yield factoring

in inflation. Thus, the only way for bonds to show any material appreciation would be for interest rates to fall even closer to 0%.

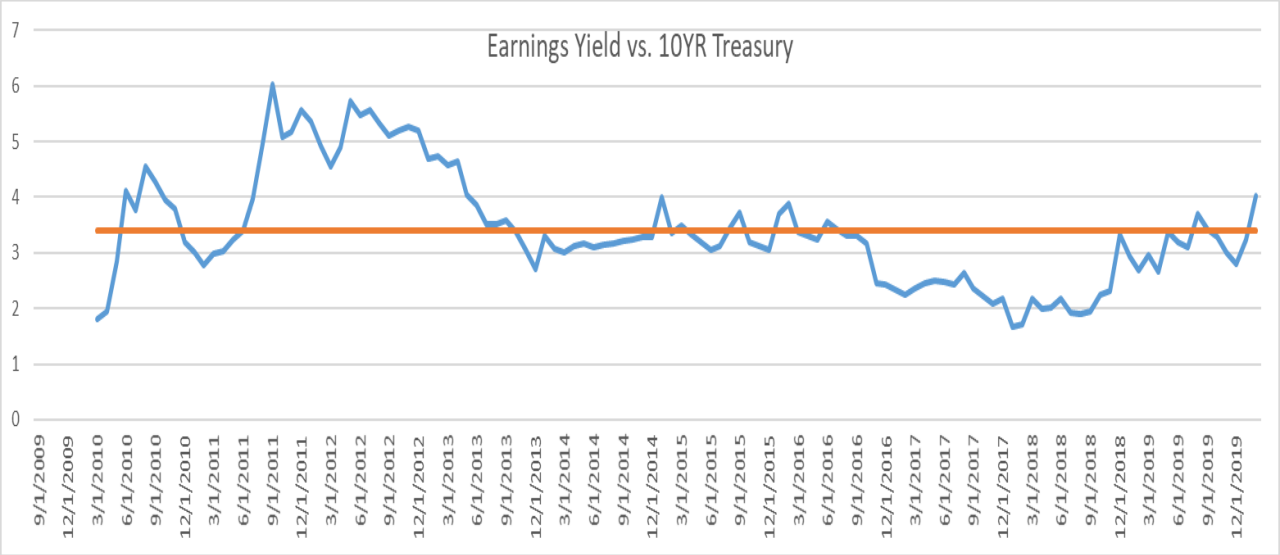
This expectation of lower rates is hard to reconcile when interest rates are already at a historic low. This low rate environment has caused many investors to "reach for yield." This reach has taken on the character of overweighting high yield bonds.



Some investors have increasingly piled into these high yield bonds and unfortunately saw the drawback of chasing yield over the past 20 days. Spreads have widened nearly 100bp and not have not appreciated in the same fashion as US Treasury bonds. This widening largely resulted in high yield bonds falling 4% despite interest rates falling. This goes to serve that while high yield bonds have a place in a portfolio they are not an adequate hedge of risk in times of duress.

One of the biggest tailwinds pointing to equities is the relative value of equities versus bonds. Equities relative to bonds are the cheapest they have been in 8 years. The spread of earnings versus the US Treausry

yield highlights the profitability exhibited by firms and the ultra low interest rate environment. This spread not only indicates the value of equities relative to bonds, but also paints a robust lending environment for corporations and consumers.



Falling interest rates will provide consumers and firms the ability to refinance their mortgage and other obligations. This lower rate will free up cashflow for both consumers and firms to pursue incremental purchases and/or new ventures. The only industry it will most likely weigh on is banks as the spread between interest income and interest expense continues to be squeezed.

Conclusion:

If SARS or any other virus outbreak is any indication, any setback in equities is an opportunity to take advantage of a correction in the market. This perceived advantage is backed by strong corporate fundamentals and a relative value of equities over bonds that has not been witnessed in some time.

The panic that ensues from unknown variables such as COVID-19 are incredibly difficult to analyze given their infrequency and lack of fundamental thought. However, using SARS or your standard US influenza as a proxy indicates a virus that is not nearly as deadly as its peers, but much more infectious. Overall, this virus will most likely take months to play out, but history indicates a rally that ensues from the initial panic.

If you have any questions, please do not hesitate to ask.

Respectfully

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