QUARTERLY REPORT

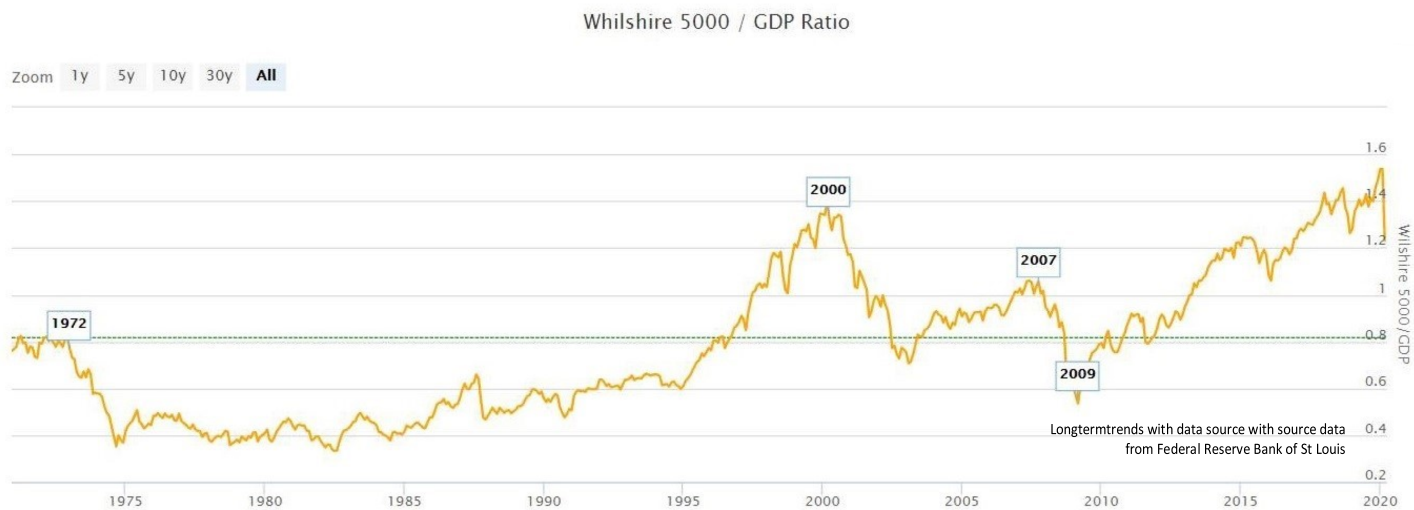
Vaughan Nelson Investment Perspective

March 31, 2020

For several quarters, we have discussed the ongoing dollar liquidity shortage and resulting "liquidity recession" that began in the first quarter 2018 and created a rolling repricing of global assets. During the first quarter of 2020, the CV-19 Pandemic accelerated the liquidity recession to its conclusion and added a global economic contraction that is comparable to the Great Depression. Despite fiscal and monetary policy commitments equal to 40% of GDP, equity markets experienced the largest quarterly decline on record with the S&P 500 and Russell 2000 Value falling approximately -20% and -36%, respectively.

Equity markets entered 2020 with elevated valuations hopeful for an acceleration in earnings growth that would offset stretched valuation measures. On one measure, Total Market Cap to GDP (Chart 1), equity markets reached a peak of approximately 160% and remain elevated at 120%, despite the steep market sell off. It should be noted that the 120% valuation doesn't account for an expected decline in GDP that could reach double digits.

Chart 1
Market Cap to GDP



Counteracting the unprecedented interruption in economic activity, Congress has committed $1.6 trillion in fiscal stimulus and the Federal Reserve has committed to expanding its balance sheet by $6 trillion. While these figures are enormous, representing approximately 40% of U.S. GDP, they are merely a down payment designed to offset the anticipated contraction in liquidity and economic activity over the next two months.

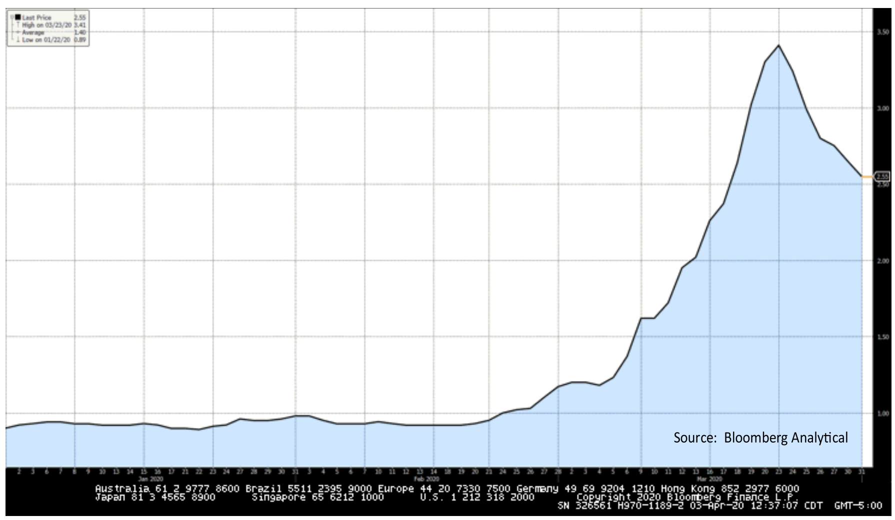
The center piece of the fiscal spending is $3,400 payments to households of four with average income. These direct payments are supplemented by $350 billion in the Paycheck Protection Program "PPP" to incentivize businesses with under 500 employees to retain their current payrolls. Based on the design of the PPP, we think it will be much less effective than originally intended. We also expect many businesses in struggling industries (e.g. retail, travel, hospitality) to take advantage of the expanded unemployment benefits and dramatically reduce employee count, shutter locations, and renegotiate leases and other contracts.

We entered this economic contraction with material excesses built up in credit markets. Monetary policy is centered on dampening interest rate volatility and supporting investment grade bond markets. Currently left out of policy support are high yield markets, leveraged loans, CLO's, and nonagency mortgages and CMBS. Essentially the Fed is providing policy support that allows markets to function without influencing the "price discovery" process. Unless, the Fed expands policy support to these other areas we would anticipate a further decline in equity valuations and further dislocations in highly financialized portions of the economy (e.g. residential and commercial real estate).

Absent a durable treatment for CV-19, we are not expecting a V-shaped economic recovery. The economic contraction will quickly spill over into local and state government budgets severely impacting local government finances. We are expecting many more fiscal and monetary programs at the federal level to provide offsets to these pressures. As these issues are truly global there will be long lasting impacts to supply chains, asset markets, currency exchange rates, and geopolitics.

While the US Treasury market was the beneficiary of a massive flight to safety and the Federal Reserve's support, the reduction of federal funds rates to zero and Quantitative Easing (QE), all other sectors of the bond market performed poorly. Prior to the Feds adoption of several liquidity support programs in March, Investment Grade (IG) credit spreads widened from +115 to +345 basis points over Treasuries (Chart 2). The rapid increase in risk premiums was a combination of COVID-19 induced recession concerns and a total lack of liquidity within "risk" sectors of the fixed income markets. Once the various support programs were announced in late March by the Fed and optimism of massive fiscal support from Washington, liquidity was rapidly restored within the high grade sectors. Investment grade credit spreads narrowed to +255 basis points, removing most of the illiquidity premium, although the spread widening due to recession concerns remains.

Chart 2
Investment Grade Credit Spreads



In the first quarter, the Bloomberg Barclays Aggregate Index returned 3.15%. The indexes 40.9% allocation to US Treasuries, which were up 8.2% were offset by the 24.1% allocation to Corporate bonds which were down 3.6%. While volatility will remain high until a clear indication on the reopening of the US and Global economy appears, we remain positive on the higher credit quality areas of the corporate bond market, especially in the short to intermediate maturity buckets. We will continue to manage client portfolios with a shorter average duration compared to the benchmark and maintain an overweight allocation to corporate bonds with solid balance sheets and better liquidity.

The Municipal market did not escape the overall market liquidity crisis. Concerns about state and local revenue reductions and the massive exit from mutual funds/ETFs drove municipal returns to lag US Treasury returns with the Intermediate A-AAA rated Municipal Index returning -0.3% in the quarter.

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