Market Review and 3rd Quarter 2020 Outlook

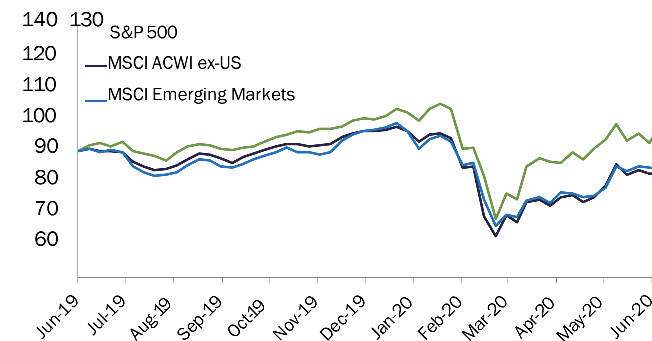
Market Backdrop

Equities markets around the World rebounded strongly from a precipitous decline in the first quarter triggered by the initial spread of COVID-19, but the pandemic's economic damage continued to accumulate. US first-quarter GDP provided a preliminary gauge of the economic toll, contracting 5.0%, down sharply from growth of 2.1% in the previous quarter.

In April and May, authorities in some US states, where infection rates, hospitalizations, and fatalities were highest, issued lockdown and stay-at-home orders to combat the spread of the virus. Economic activity dependent on face-to-face interaction was brought to a virtual standstill, causing employment losses not seen since the Great Depression – more than 40 million claims for unemployment benefits were filed in less than three months. Unsurprisingly, the travel, leisure, entertainment, and hospitality industries, which emphasize physical proximity, were among the hardest hit.

Monetary and fiscal actions sought to contain the economic distress. The Federal Reserve provided unprecedented liquidity across all asset classes and credit intermediaries, alleviating solvency issues and ensuring access to capital. Congress passed the $2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act, the largest single fiscal stimulus legislation in US history, providing direct payments to individual households as well as funds to enable small businesses and service industries to maintain their payrolls, hire back laid-off employees, and cover applicable overhead.

Market Index Performance



As of 6/30/20. Source: Jennison, FactSet, MSCI.

Awash in liquidity, US equity markets began recovering in earnest in late April, just as health care system utilization and fatality rates in the hardest hit regions of the pandemic's first wave hit their peaks. Although economically debilitating, the social-distancing and work-from-home initiatives put in place in March worked as intended, helping to flatten inflection curves and relieving health care systems pushed to the brink of collapse.

Corporations able to do so moved to capitalize on easing financial conditions, issuing record amounts of public debt at very low nominal interest rates. Less well positioned businesses were left to access loans directly from the government on less favorable terms.

Energy markets regained a semblance of order with prices rebounding from acutely depressed levels as the major producers agreed to cut production despite lingering disputes over market share.

In late May, the shocking killing of George Floyd caused an outpouring of grief and widespread demands for social justice, bringing hundreds of thousands of largely peaceful protesters to streets across the United States. These demonstrations were among the country's first large-scale gatherings since social-distancing measures were implemented, and came just as some states were beginning to reopen.

The patchwork of regional experiences and responses to the virus underscored the absence of a coherent national strategy to combat the pandemic, and, even more troubling, reflected partisan divides and an increasing politicization of the crisis. As conditions improved in the original hotspots in the Northeast and Midwest, many states in the South and West, which had few if any restrictions on crowding and no social-distancing or mask-wearing recommendations, saw alarming rates of infection as the quarter drew to a close. The late-June surge in cases in these regions prompted authorities in some areas to rescind moves to reopen.

Style Performance

- In the second quarter, growth stocks continued to lead the market and significantly outperformed value stocks across capitalizations. Small caps, after a dismal first quarter, bounced-back off the bottom and performed best across styles.
- Growth stocks led for the trailing one-, three-, and ten-year time periods as well.
- Large caps continued to dominate market performance over longer time periods.

Style Index Performance

2Q20

	Value	Core	Growth
Large	14.3	21.8	27.8
Mid	19.9	24.6	30.3
Small	18.9	25.4	30.6

Trailing 1-year

	Value	Core	Growth
Large	-8.8	7.5	23.3
Mid	-11.8	-2.2	11.9
Small	-17.5	-6.6	3.5

Trailing 3-Year

	Value	Core	Growth
Large	1.8	10.6	19.0
Mid	-0.5	5.8	14.8
Small	-4.3	2.0	10.6

Trailing 10-Years

	Value	Core	Growth
Large	10.4	14.0	17.2
Mid	10.3	12.3	15.1
Small	7.8	10.5	12.9

As of 6/30/20. Source: Jennison, FactSet, MSCI.

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Sector Performance

- Consumer discretionary was the best performing sector in the second quarter, followed by the information technology and energy.
- In the quarter, defensive sectors such as consumer staples, utilities, and real estate lagged as did cyclical sectors such as financials and industrials.
- Information technology was the best performing sector for the one-, three-, five-, and trailing ten-years, maintaining its leadership during the second quarter rally and first quarter sell-off.
- Despite strength in the second quarter after a sharp sell-off in the first quarter, energy was the weakest sector across longer time periods.

GICS Sector Performance - S&P® 500 Index

	2Q	One Year	Three Years	Five Years	Ten Years
Communication Services	20	11	9	7	11
Consumer Discretionary	33	13	15	13	18
Consumer Staples	8	4	5	7	12
Energy	31	-36	-12	-9	0
Financials	12	-14	0	5	10
Health Care	14	11	10	8	16
Industrials	17	-9	2	7	12
Information Technology	31	36	27	23	20
Materials	26	-1	4	5	10
Real Estate	13	-2	6	8	12
Utilities	3	-2	6	10	11
Total	21	11	11	14	-3

As of 6/30/20. Source: Jennison, FactSet, MSCI.

Sector Weights as of June 30, 2020

	S&P 500	MSCI ACWI ex-US	Russell 1000 Growth	Russell 1000 Value
Communication Services	11	8	11	9
Consumer Discretionary	11	13	15	7
Consumer Staples	7	10	5	8
Energy	3	5	0	5
Financials	10	18	2	19
Health Care	15	11	15	14
Industrials	8	11	5	12
Information Technology	27	11	44	10
Materials	3	8	1	4
Real Estate	3	3	2	5
Utilities	3	4	0	6

As of 6/30/20. Source: Jennison, FactSet, MSCI.

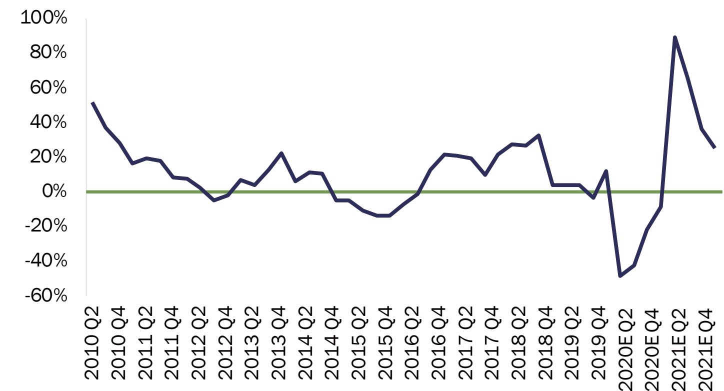
Earnings Results

- Earnings results for the broad market S&P 500 came down since the fourth quarter with 70% of companies beating or meeting expectations versus 77% for fourth quarter 2019 results. It is important to note that because of COVID 19, earnings expectations came down significantly for Q1 2020 and have remained so for the rest of the year.
- Materials, information technology, energy, and health care posted the strongest results with at least 85% of companies exceeding consensus expectations.
- Consumer discretionary had the lowest hit rate at 48% as traditional retailers and hotels, restaurants, and leisure companies were negatively impacted by COVID-19.

Sector Name	% of Companies Beating/Meeting	% of Companies Missing
S&P 500	70%	30%
Materials	89%	11%
Information Technology	86%	14%
Energy	85%	15%
Health Care	85%	15%
Consumer Staples	76%	24%
Industrials	70%	30%
Real Estate	61%	39%
Communication Services	60%	40%
Utilities	57%	43%
Financials	57%	43%
Consumer Discretionary	48%	52%
Energy	61%	39%

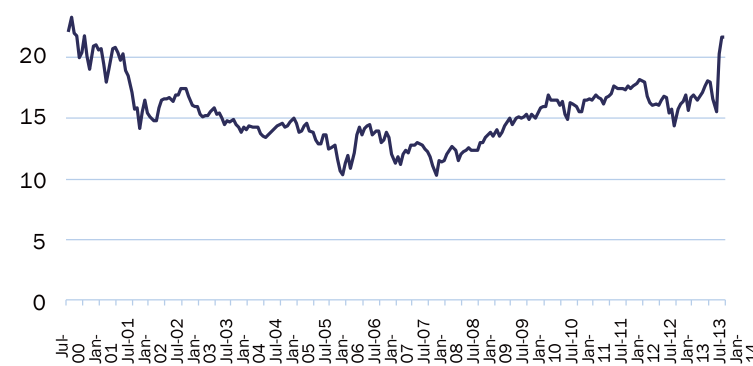
As of 6/30/20. Most recent data available reflecting the end of the second quarter reporting season. Source: Standard & Poor's. A consensus estimate is a figure based on the combined estimates of analysts covering a public company. Percentages refer to companies meeting, beating or missing consensus estimates. Chart was created by Jennison using Standard & Poor's estimates.

S&P 500® Index - YoY EPS Growth



As of 6/30/20. YoY= Year over Year. Source: FactSet.

S&P 500® Index - NTM P/E



As of 6/30/20. Source: Jennison, FactSet, MSCI.

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Earnings: Looking Ahead

- At this point, we are just too early in the crisis to make precise estimates of companies' earnings through the rest of 2020. This level of uncertainty is historic as is the extreme market volatility that comes with it. Recent unexpected spikes in new infections and hospitalizations across several states is a good reminder of the degree of uncertainty around COVID19 and the path for reopening.
- Almost all companies (across sectors and industries) have withdrawn forward estimates and guidance for the remainder of 2020. For most companies, there are too many unknowns around economic activity, confidence, unemployment, rates, defaults and credit losses, drastically lower consumption and business spend, destroyed consumer and business confidence, and the financial hit to both businesses and consumer balance sheets.
- While recent data-points indicate multiple "green shoots" for both domestic and global economic activity, top-down projections for the S&P 500® Index in 2020 continue to coalesce around -20% to -30% earnings growth, dividends projected to decline by 25%, and the suspension of most stock buyback programs. Again, we must recognize that these are early stage guesses at best.
- The timeline around the eventual deceleration of the spread of the virus, along with the depth and length of the impact of "shelter-in-place" globally, is driving this uncertainty and negative market sentiment to record levels. It is clear that we are in a recession — how long it will last and how the rebound will unfold ("V"; "U"; or "V with then a W" shape) is the big unknown.

Outlook from Jennison's Growth Teams

A troubling new surge in viral infection rates in several states has led to second thoughts about moving forward with scheduled, phased-in reopenings. Europe and most of Asia have been more successful in containing the spread, while conditions in much of Africa and South America are acute at best.

Pandemic-related declines in economic activity across the globe during the quarter have led to historic unemployment rates. While strategies for controlling the pandemic's spread are well-documented by science and history, they require will, determination, and a sense of social responsibility, characteristics that have been lacking in portions of the country and globe. Encouraging progress in developing a vaccine has been made, but it will likely be some time before one is approved and widely available for treatment. Ramped-up testing and compliance with social-distancing guidelines seem to be prerequisites for broad economic reopening.

Given the high degree of uncertainty, companies are taking a cautious approach to near-term business planning. Many companies are likewise suspending financial guidance for now with the hope of greater clarity later this year.

Investors and policymakers are wrestling with numerous questions about the days ahead: What are the limits to fiscal stimulus and Fed balance sheet expansion? How quickly can unemployed workers be reabsorbed into a reopening economy? Who will win in the upcoming US elections, and what are the resulting policy implications?

We have lived with the disease for some months now and can better gauge its primary, and in some cases, secondary effects on economic activity and behavior. Consumers have altered their approach to daily life as work from home leads to greater ecommerce engagement, increased demand for food and grocery delivery, rising spending and investment on dwellings, and faster adoption of streaming media, fitness, and entertainment with attendant needs for robust internet infrastructure. The transformation of work is equally notable and starts with the same necessity of robust connectivity. Face-to-face meetings, business travel, and office needs are being re-imagined, giving rise to Zoom, cloud-based telephony, and remote working. The implications are vast, and we are working diligently to understand the opportunities and threats.

The second-quarter recovery in equity prices was as swift and dramatic as their decline from February 19 to March 23. Perhaps even more remarkable was the number of stocks that closed at record highs on June 30. The logic in the market's bifurcation between winners and losers in a COVID/post-COVID environment has lifted advantaged companies and industries to records, while beleaguered companies with bleak prospects for recovery have seen equity values atrophy.

Sector Views

Information Technology

Information technology was among the better-performing sectors in the S&P 500 Index in the second quarter of 2020, advancing 30.5%.

We attribute this favorable relative performance to recent strong technology sector earnings reports and market recognition of the underlying strength of technology company business models. We believe the market should continue to favor companies with asset-light business models and faster organic growth in the current COVID- 19-induced recessionary environment.

During times of crisis, uncertainty, and doubt, businesses and consumers are more willing to adapt their behaviors and to seek innovative, creative products and services that improve productivity and reduce costs, in our view. In tumultuous environments such as the current pandemic, innovative technologies take root and typically gain significant market share. Given this dynamic, we believe technology-related stocks will extend their decade-long market leadership, supported by reasonable relative valuations that continue to be driven by the sector's overall stronger ROEs and free cash flow generation, often as a result of innovative and disruptive product offerings. Specifically, many tech companies have wide competitive moats and other competitive advantages, as well as secular tailwinds, that we believe support durable, high-quality fundamentals, including faster-than-average revenue growth and better-than-average margins.

With accelerating adoption of cloud -computing; digital business-to-business applications; and online retail, health care, education/learning, and business services, technology-related company earnings are driving overall earnings growth globally.

According to our research, strong earnings growth isn't limited to "tech" companies grouped in the index's information technology sector. It extends to other businesses with technologically driven advantages in other sectors, as well, such as social media companies, classified as "communication services," internet retailers and streaming entertainment providers, grouped in "consumer discretionary," and robotic surgery, diagnostic, and biopharmaceutical companies classified as "healthcare."

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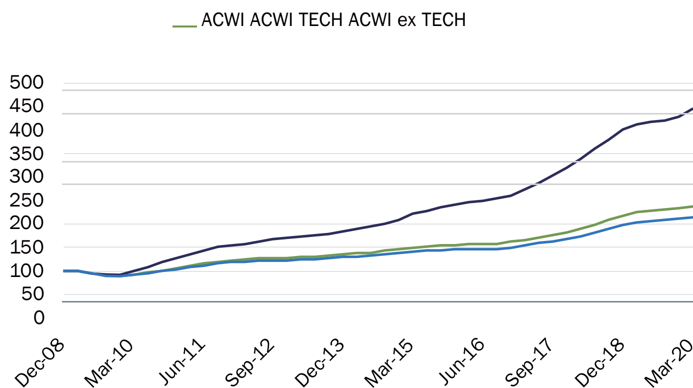
Trailing Quarter-Over-Quarter EPS Growth: MSCI All Country World Index (ACWI) vs. ACWI Technology Sector vs. ACWI ex-Technology Sector. Indexed at 100 from December 31, 2008



As of 6/30/20. Start date was chosen to include the broad market sell off in first quarter 2009 from a global recession. Source Jennison, FactSet and MSCI.

Investment Themes & Areas of Focus

- The use of digital technologies to create new (or alter existing) business processes, cultures, and customer experiences has become a strategic imperative as enterprises seek to meet changing business and market needs. This digital transformation has been driven by digital technologies such as social media, mobile devices, artificial intelligence, and cloud computing.
- Software as a service (SaaS), another of these transformative digital technologies, delivers mission-critical cloud applications and services that are disrupting the software industry. Initially adopted by internet- and cloud-native businesses, and still in the nascent stages of utility, SaaS has begun to penetrate the mother lode of large mainstream enterprise markets. As the strategic necessity of implementing software enhancements as they become available becomes increasingly apparent, businesses are being driven to adopt the SaaS model. With penetration rates remaining relatively low, we believe SaaS expansion opportunities over the coming decade look substantial.
- The COVID-19 pandemic has highlighted the prudence – and in many cases, the government-mandated necessity – of working from home or at other offsite locations. Investors are viewing tech companies with products and services that facilitate seamless offsite work and communication capabilities with renewed appreciation.
- We look for companies positioned to benefit from increased business spending on technology. This includes investing in industries such as 5G, SaaS (Software as a Service), business intelligence (AI), semiconductors, cloud storage and software, and life sciences tools.
- We think the continued ramping-up of data/information/ entertainment usage across a broad range of devices and applications, along with digital payments, are among the areas that offer long-duration opportunities and huge addressable markets for companies with the right technologies.
- Additionally, we are assessing companies that we believe can continue to grow in the current pandemic-induced global recessionary environment regardless of how the economic recovery unfolds.

Health Care

In second-quarter 2020, the Health Care sector of the S&P 500® Index rose 13.6%, underperforming the overall index, which advanced 20.5%.

The relative prospects of health care companies in the midst of the COVID-19 pandemic vary by industry and individual company fundamentals.

Biotechnology. The biotechnology/biopharmaceutical sector had a very strong quarter, continuing the positive trends and relative market outperformance that began in fourth-quarter 2019. The revenues of many companies benefited as patients and wholesalers stocked product in response to the pandemic. With regard to scripts, products used for acute conditions (antibiotics and pain medicines) or that need to be injected by a physician were hurt most. Script trends, which suffered most in late March/early April, have improved steadily since mid-April.
With regard to potential clinical trial delays, we find that:

- The US Food and Drug Administration is being communicative, accommodative, and flexible.
- Companies with fully enrolled trials are the least likely to see delays, as clinical sites will likely prioritize or proceed with fully enrolled trials, especially if they are pivotal.
- Oncology trials and trials related to diseases with high unmet medical needs seem to be taking precedent. For conditions with no current standard of care or where the benefit outweighs the risk, trial enrollments are continuing.
- However, given pandemic-related constraints, some patient enrollments for new clinical trials are being suspended.
- Companies affected by trial-enrollment delays can prepare remotely, which could allow them to be ready to enroll patients more quickly once conditions normalize.
- From a long-term perspective, we are confident that suspensions and delays will be temporary and that they pose no material long-term risk.

Pharmaceuticals. Pharmaceutical companies look to have low exposure to COVID-19. New patient starts could be delayed, and drugs used for acute illnesses (antibiotics, analgesics, anesthetics) or administered by physicians (vaccines, macular degeneration injections) could be disrupted, but most drug sales should be unaffected, including those of self-administered diabetes and respiratory disease treatments.

Medical devices. Cardiology and orthopedic device procedures have been largely suspended in the US and Europe. Our analysis identifies overall sales declines of 40%-60% in the current quarter, but health systems will be motivated to restart procedures as soon as capacity allows. We are focused on high-quality companies that make cardiology, orthopedics, and ophthalmology devices, as well as companies that make diabetes devices, where demand is relatively inelastic.

Managed care. The collapse in health care utilization will be a significant tailwind to insurers. These cost savings will likely far outweigh COVID-19 patient care costs. We prefer companies with low recession exposure (i.e., insurers not hurt by unemployment) such as companies with exposure to government health insurance programs.

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Hospitals. We expect hospital companies will be hurt significantly by delayed or deferred procedures and potentially higher costs for COVID-19-related protective equipment. However, hospitals are receiving US government financials assistance and are generally protected by policy makers.

Life science tools. The life science tools/research group has been resilient, although scientists in work-from-home protocols could reduce demand for instruments and consumables. There could be positive demand tailwinds for the group related to lab testing and research related to food safety and viruses. We are focused on quality names that should be well-positioned after the pandemic subsides, especially companies with bioproduction assets.

Telemedicine. The COVID-19 outbreak has given rise to what we believe is a sea change that could permanently modify health care benefits, treatment, and consumer behavior. In the current environment, employees are now seeking out telemedicine services, and insurance plans are waiving co-pays and co-insurance for those that utilize it. Preliminary data suggest that since the pandemic's outbreak, telemedical visits have increased substantially, with most visits coming from new users.

Investment Themes & Areas of Focus

- We expect that productive research and development activity will yield effective disease treatments that improve the quality of patients' lives. These characteristics historically have been the source of longer-term outperformance in the sector.
- We believe many biotherapeutic companies have compelling fundamentals and innovative products and pipeline drugs.
- The number of drug candidates in biopharma pipelines is at all-time highs. Increased research and development investment by large global pharma companies, as well as advancements in drug screening and discovery, are driving the increase in drug candidates.
- Larger multinational pharmaceutical companies, especially those with patent-expiration pressures, will continue to make acquisitions of smaller cap companies with single products or promising pipeline assets.

Financials

In response to the COVID-19 pandemic and the resulting collapse of the global economy, the S&P 500® Index's financial sector (index) continues to lag the overall market and is one of the worst performing sectors. The drastic fall in interest rates and uncertainty around credit quality has affected both fundamentals and market expectations. The volatility in index performance has been extreme, both during the market sell-off and subsequent rally off the bottom. The index fell 42% from year-end 2019 through the market low on March 23rd, but has rallied over 32% since. Year-to-date the index is -24% versus the S&P 500 at -3%.

At this point, we are still too early in the crisis to make precise earnings estimates for our portfolio companies through the rest of 2020. In fact, almost all companies (across sectors and industries) have withdrawn forward estimates and guidance for the remainder of 2020. For financials, there are just too many unknowns around the impact of rates, credit losses, drastically lower economic output, destroyed consumer and business confidence, and the financial hit to both businesses and consumer balance sheets.

Despite the strong rebound in performance since the market low, many uncertainties remain around when the spread of the virus will slow and what the speed and shape of the economic recovery will be as the world opens up. It is clear that we are in a recession – how long it will last and how the rebound will play out is the big unknown.

Investment Themes & Areas of Focus

- Overall, banks are significantly better positioned today than they were in 2008-2009 across a broad range of balance sheet, capital, and risk management metrics.
- While the draw-down has been extreme, it appears that significant "bad news" is being reflected in current stock prices. For example, our analysis shows several large, industry-leading money center/global investment banks trading at around 1.0X tangible book value (TBV) where, since 2009, they have traded between 1.5-2.0X TBV. Given that we have higher confidence today in reported book value metrics, we consider this evidence that the sector may possibly be oversold.
- Secular growth companies with defensive attributes (low leverage rates, asset light models, sustainable, high margin, and high free cash flow businesses) should continue to fare better in this type of environment. Several digital payment and financial technology companies meet these criteria.
- We believe property & casualty (P&C) insurers should hold in better in this environment, while asset-heavy banks and life insurance companies with more interest rate sensitivity could raise the risk profile of a diversified portfolio.

Midstream Infrastructure

The midstream infrastructure rallied off the bottom in a reversal from last quarter's unprecedented and simultaneous shocks to both oil supply and demand. Amid global government's fiscal and monetary response that helped drive equity market optimism, investors also shrugged off concerns about rising COVID-19 cases several large states across the US, all of which propelled the Alerian Midstream Energy Index up more than 30% over the second quarter. In addition, prior exogenous factors such as the algorithmic trading nature of markets and the forced selling by levered investors – a major headwind only a few months ago – had finally abated over the period and likely contributed to the sector's rally.

After having reduced capex and growth spending over the last 12+ months, which has already, led to improved cash-flow metrics across the board, even the larger, more financially sound midstream companies will likely continue to take decisive measures in order to conserve cash and "right-the-ship" during this global pandemic.

As the US economy begins to open and economic activity begins to slowly ramp, we remain optimistic given the significant transformational corporate reform that has been occurring in the midstream sector over the last two years, which was already having long-term positive benefits. And while it's difficult to predict short-term outcomes, over the longer-term, we believe the large integrated, reformed companies will survive. While the demand for energy hydrocarbons may slow, we do not believe it will not end. These midstream infrastructure companies have physical steel "in the ground," many with asset networks that have high barriers-to-entry and are difficult to replicate, in our view.

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Investment Themes & Areas of Focus

- "Reformed" companies (i.e., companies exhibiting higher capital discipline, and healthier, more conservative balance sheets that can withstand a downturn, along with solid corporate governance).
- Integrated business models – (the "Haves") the larger, more integrated companies with multiple touch-points along the energy value chain, that have higher barriers-to-entry, along with steady cash-flows.
- Firms with exposure to the natural gas liquid (NGL), liquefied natural gas (LNG), and natural gas demand export themes.
- Renewable energy companies to diversify our overall energy holdings, and provide exposure to the renewables investment theme.

Utilities

Because of their defensive attributes, utilities as expected were one of the relative outperformers during the first quarter; however, as economic activity in the US started to ramp up over the second quarter, investors began focusing their attention away from utilities and into more cyclical and growth oriented sectors levered to a recovery.

While market participants continue to focus their attention on the impact to power demand from the COVID-19 pandemic, we do not believe electricity demand is a "needle mover" to company's profitability. By and large, the COVID-19 pandemic's impact to the overall utility sector is likely modest to nil, and is unlikely to impact the longer-term earnings power of the sector, in our view. Furthermore, the utility sector's recent modest performance is at odds with the underlying stability of the group, given the ultra-low bond rate environment, the sector's defensive attributes, along with the continuation of utility companies' ability to execute operationally, delivering on earnings guidance, and de-risking their portfolio's.

During the second quarter, all segments within the S&P 500 Utilities Index advanced over the period, as both multi-utilities and water utilities led the group. Independent power & renewable electricity producers also posted solid returns, and gas utilities – while still positive – were among the biggest laggards relative to the group.

We believe the Utilities sector represents a compelling "defensive growth" proposition for investors for a few main reasons:

- Despite a low growth environment, improving economics in renewables such as wind and solar power, continue to remain a growth driver for the overall sector – companies now have renewables incorporated into their capex strategy plans (versus five years ago when renewables weren't included) – allowing those utilities to earn a regulated rate of return on their renewable investments.
- In our opinion, their "defensive" nature – those with regulated activities and quasi-regulated renewable portfolios, combined with their long-duration cash-flows and predictable rate base earnings – remain not only attractive given their ability to provide stable dividends for investors amidst any macro uncertainty, but also should provide earnings growth above the sector's historical EPS growth, in our view;
- With a lower for longer interest rate environment, utilities should continue to benefit from access to lower cost of capital – savings that eventually flows directly to their bottom-line. It seems intutitive that lower interest rates also make their higher dividend yields more attractive to income seeking investors. Additionally, we believe utility companies, with their more stable and predictable earnings profile versus the broader market, will continue to justify their premium valuation relative to their value index peers.
- The renewables segment within the utility group should continue to benefit from government stimulus packages tailored to a green recovery, along with renewables development tailwinds that should sustain dividend growth.

Investment Themes & Areas of Focus

Industries/sub-industries we currently favor:

- Regulated Utilities - companies operating in favorable regulatory environments and geographies, with above- average projected earnings and/or dividend growth driven by regulatory rate-base investment.
- Renewable Electricity - we see continued momentum across multiple fronts that support on-going investment and usage in renewables, stemming from the "energy transition" – a secular trend toward renewables – that will provide unique investment opportunities over the long-term.
- Water Utilities - state utility commissioners encouraging spending on improving water quality as well as pipeline replacement and maintenance, enables companies to provide transparent 10-year outlooks on their spending and income plans, a positive dynamic for this sub-industry.
- Communications Infrastructure - wired broadband network and datacenter operators are well positioned to capitalize on exponential global data demand growth; and tower operators given their critical infrastructure, multi-year contracts, and strong free cash-flow generation.

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