CAVANAL HILL Funds

MARCH 9, 2020

UPDATE ON COVID-19, ECONOMY, FEDERAL RESERVE & OIL

A RECENT CONVERSATION WITH J. BRIAN HENDERSON, CFA®, PRESIDENT OF CAVANAL HILL INVESTMENT MANAGEMENT AND BILL KING, CEO OF CAVANAL HILL DISTRIBUTORS

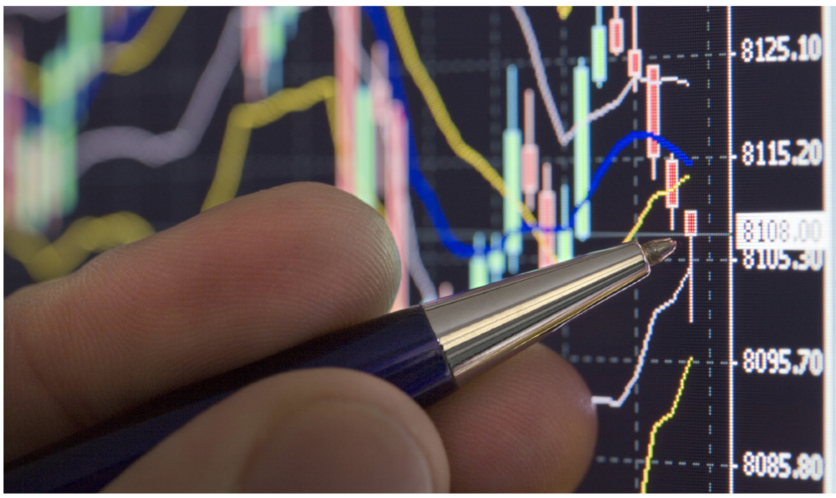
BILL: Stock prices down, and corporate bond yields higher. This seems like a ripe environment for a value-driven firm like Cavanal Hill to take advantage. Let me start out by asking you, is this a buying opportunity?

BRIAN: Not yet! Due to the COVID-19 virus scare, the stock and high yield corporate bond markets are both under tremendous downward pressure while long-term U.S. government bond yields have plunged to record lows. The U.S. large cap S&P 500 equity index is down nearly 20% from its highs reached just a couple of weeks ago, and the international equity indicies haven't fared much better. One of the few safe havens in the financial markets has been U.S. Treasury securities which have soared higher in price with the 30-Year U.S. Treasury bond yield trading below 1%. We have been taking profits from selling some of our long maturity Treasury positions, and cutting our average maturities slightly. Despite the drop in market interest rates, high yield bonds with substantial credit risk have been falling in price particularly with energy bonds where increased bankruptcies are highly likely after Saudi Arabia and Russia started an oil price war sending West Texas Intermediate crude prices down toward $30/barrel.

Historically during previous periods of extreme investor fears and forced-selling, Cavanal Hill has sold out of its most liquid high-quality stock and bond investments to reinvest in new opportunities that have experienced sharp price drops. Not so much this time. We are monitoring our current investments very closely, and are more concerned about protecting capital in our stock and bond funds in a very difficult market. Our Cavanal Hill money market funds are invested in safe U.S. Treasury and government securities, and we are doing everything we can to maintain our current yields in front of expected additional interest rate cuts by the Federal Reserve. For our equity funds, U.S. cyclical stocks in the industrial, energy, and even financial sectors are trading at very attractive multiples; however, at this stage, we would like to see the market start pricing in a recession before jumping in front of an expected continued rise in the virus infections. Broad-based emerging market equity indicies, and high yield corporate ETFs are trading back near late 2018 levels when markets were bracing for a U.S. recession, but they are some of the most volatile parts of the markets and aren't going to hold up well if the S&P 500 starts to price in a recession which is another 15% lower from current levels.

BILL: So what's different about the COVID-19 virus environment?

BRIAN: Managing investment portfolios through a global pandemic is different than dealing with a financial crisis or normal recession. Without a vaccination for 12-18 months, and a slow start on the testing for the virus in the U.S. leads me to believe the negative economic growth impacts from this virus are going to be with us for months, not weeks. We have a real confidence issue in the markets much like what we experienced during the Great Financial Crisis in 2008-2009, and it's going to take significant action by the President and Congress to overcome current concerns. We need real leadership out of Washington, D.C. that so far appears to be down-playing the potential impacts from the virus which isn't supporting confidence for investors to take increased risks or for U.S. consumers. Fortunately, the U.S. economy entered 2020 in great shape, especially within the job market. We are still on the front-end of the virus spread in the U.S. which is likely to get much worse. I am expecting economic data including the employment situation to worsen. While the Federal Reserve has already cut the Federal Funds rates by 50 basis points, and is likely headed to near 0%, lower interest rates do nothing to stem the spread of the virus which is the real issue for the U.S. and global economy. If the Federal Reserve is forced to start another round of quantitative easing, then I suspect that risk assets like stocks and corporate bonds will stabilize in price temporarily as they have done in previous rounds of Fed



balance sheet expansion. A fiscal stimulus package out of Washington, D.C. that includes tax rebates and increased public spending would help brighten the outlook for U.S. economic growth, but getting it passed is likely many months away. In the meantime, as the virus continues to spread it will hang over financial markets, and negatively impact consumers' spending behaviors, and overall U.S. and global economic growth.

BILL: How has the decision by Saudi Arabia to increase oil production during an economic slowdown influenced your outlook for financial markets and the economy?

BRIAN: It's the last thing we needed right now given the fears already from the new coronavirus, but it may eventually lead to a much needed rebalancing in the energy markets. The oil market is currently oversupplied, and the announced Saudi Arabia production increase led to a sharp drop in the price of oil. We need to see a cut in global oil production to have a rebalancing. Many companies were producing just enough to generate the cash flows to make debt service payments with a hope that oil prices would eventually go higher. That's all changing now as the bond and equity markets are no longer willing to provide many energy companies the capital needed to maintain production levels. Many energy related companies aren't viable at $30 per barrel for oil and will be forced to cut production. The most highly-leveraged energy related companies won't survive. For some time, our Cavanal Hill managers have been cutting risk within their traditional energy E&P company allocations while favoring alternative energy related companies and refiners. From a macroeconomic standpoint, lower oil and gasoline prices are good for the U.S. consumer.

BILL: Any final words for our Cavanal Hill shareholders before your next update?

BRIAN: We believe it's times like these that our risk-managed and disciplined approaches for managing money market, fixed income, and equity funds really shine. We have the discipline not to chase returns when times are good in the financial markets, or get too bearish when securities' prices are falling sharply. Being disciplined to be picky when investing our shareholders' capital, and being compensated for the likely risks we are incurring has worked. The only thing we can control is the price we decide to pay for the investments we make.

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