Economic & Market Commentary

Choose an adjective, the past six weeks have been unrelenting, anxiety-provoking and downright scary. The spread of the coronavirus, combined with disarray in the energy markets, abruptly brought the decade-long bull market to an end on March 12th, when the S&P 500 index fell 20% below its February 19th all-time high. But that was only the beginning. From February 19th to March 23rd, the U.S. stock market saw the fastest meltdown in its history, producing a loss of 33.9% for the S&P 500. That was followed by a three-day rebound, which produced a 17.5% gain- the best 3 day stretch since the 1930s. In the 21 trading days from February 27th to March 27th, the S&P 500 moved more than 2% on 18 days (eleven down days and seven up days). These price moves included the largest percentage gain since 1933 and the second largest percentage loss since 1940 (exceeded only by Black Monday in 1987).[1] The S&P 500 ended the quarter down close to 20%. Similar to other financial panics, risk assets became highly correlated and few global assets were spared the carnage.

The Wall Street Journal tracks 73 equity global markets – all of which were down in both local currencies and dollars during the first quarter, with China the best (-10% in dollars) and Brazil the worst (-50% in dollars). Commodities were also hit, with gold (+4%), orange juice (+24%) and wheat (+2%) the only positive returners, while oil, thanks to a combination of the Russian and Saudi production dispute and fears of demand destruction, down 66%. Stocks were crushed across all categories, with large capitalization and growth stocks doing slightly better than small capitalization and value stocks. The so-called FAANGS (Facebook, Apple, Amazon, Netflix, Google) and Microsoft all performed better than the S&P 500 index, with two (Netflix and Amazon) actually in the plus column. The only positive-returning asset class was U.S. Treasuries, which benefited from a flight to safety and the liquidity-enhancing actions by the Federal Reserve Bank, that pushed short-term interest rates close to zero.

Within the stock market, all sectors of the S&P 500 were negative, with those that are thought of as being defensive (Consumer Staples, Healthcare, and Utilities) somewhat less impacted. In addition, Information Technology and Communication Services, largely a result of the FAANGs, produced a less negative result. Industrials and Financials, considered more sensitive to economic activity, suffered as recessionary fears increased. Finally, energy, following the steep decline in oil prices, was the worst performing sector, down 50%.

Unlike the 2007-2009 financial crisis, when problems in the financial system caused an economic meltdown, the spread of the COVID-19 disease has caused a health crisis that has evolved into an economic crisis that has caught almost all businesses unprepared. We have no special insight into the medical ramifications of the pandemic and will leave the prognostications and means of mitigation to the epidemiologists, the Centers for Disease Control, and other experts to give us guidance. There are, however, certain assumptions that can be made, and we have incorporated them in our investment thinking.

1. We believe the pandemic is still ascending. Although the rate of new infections is beginning to "flatten", mitigation is still in process and suppression is not yet on the horizon. Valiant efforts are being made to develop therapeutics and vaccines, but they need further testing for efficacy and safety before they can be widely employed. Therefore, it should be assumed that the virus will be long lasting.

2. We believe the virus will not be easily eradicated, "flattening the curve" may be a good mitigation policy, but will not prevent a potential reappearance this fall, adding to its longevity.

3. The economic consequences of the pandemic could be severe and long-lasting as well, in spite of the massive $2 trillion CARES Act recently passed and signed into law in our opinion.

The National Bureau of Economic Research Cycle Dating Committee is the official designator of recessions. A recession is usually defined as two successive quarters of negative real Gross Domestic Product (GDP). That Committee has not yet spoken, however, we think it's fair to say we are in a recession at this time. Most economists agree. Charles Schwab recently published a table of the second quarter GDP estimates from 18 firms. They were all negative (from -9% to -40%), an extremely wide range of expectations, highlighting the confusion surrounding the current environment. We can look at history to gain some insight on the path of the economy. The average post-World War II recession has lasted 10-12 months, with the longest ones lasting 16 months (1973-1975) and 1981-82). There is much debate as to the depth and duration of the current contraction. In our view, the case for a strong rebound (the so-called V shaped recovery) has diminished. The damage done to the economy is enormous, but very challenging to measure at this stage. The consumer, representing close to 70% of the U.S. economy, is now facing unemployment (10 million individuals filed for unemployment insurance over the past 2 weeks), diminished wages and income, and fear. These factors are difficult to overcome quickly and could become a long time drag on what was assumed to be the cornerstone of the continued U.S. economic expansion prior to the epidemic. Even if this episode lasts an average length of time (10-12 months), it is unlikely to produce a rapid rebound in economic activity. The +2% real GDP growth that we were expecting prior to February will need to be dampened and is more likely be a +1% normalized level. As an anecdotal model, we might observe what is happening in China, as it begins to show signs of recovery. The Wall Street Journal has published articles about the Chinese situation, and it indicates that China is beginning to grow again. Most of their growth is coming from the industrial and property sectors. Their consumer sector (which is a smaller percentage than the U.S.) is less encouraging, as they are more reluctant to spend as fears of what they have lost, and what lies ahead.

In terms of business economics, the COVID-19 situation will likely cause some heavy rethinking on the part of company managements, in our opinion. Supply chain issues have become very

apparent in the last month. To conclude that business will attempt to shorten supply chain would not be farfetched. This will bring more production back to our shores, which could be a costly proposition. With profit margins at record highs, it would be our assumption they will decline.

As usual, when we write our quarter-end outlook we are on the cusp of earnings reporting season. We anticipate that managements will be particularly aggressive bringing down expectations. We expect to see many "kitchen sink" reports, as disruptions take their toll and managements clear the decks. Near-term financial guidance will be all but useless, as no one knows what's in store. So, earnings will carry little weight, and the focus will be on liquidity and solvency of companies' balance sheets.

As to what this portends for stocks, again we can look at history. In the post-World War II era, the average bear market has gone on for 15-16 months, with 1973 –1975 and 1980 – 1982 bears lasting close to 20 months. The steepest declines were close to 50% peak to trough. The S&P 500 ended the quarter down 20%, with peak to trough down close to 35%. The stock market could have a retest of the lows or there could be some surprisingly good news (flattening of the infection curve, discovery of a therapeutic or vaccine, etc.) and more record up days. We have little clue as to which way the market will go on a daily basis. As we have always said, we are keen observers of the fundamental economic events and try to apply our observations to evaluate companies that we think have understandable business models, staying power, and are selling below what we think is sound value. We then try to model how those fundamentals will impact the businesses our clients own and the equity market as a whole. As we go through this exercise – making judgements about corporate earnings over the next few years, and into the near-term future we can develop some conclusions. At this stage, we think the stock market is valued to provide total returns in the mid-single digits per year over the next decade. So, while the market is less expensive than it was on February 19th, it is not in "buy it blind" territory. Interestingly, Professor Robert Shiller of Yale published an April 2, 2020 article in the New York Times and concluded:

> "on balance, I'd emphasize that the stock market is not as expensive as it was just a month ago. Based on history, we would expect to see it be a reasonable long-term investment, attractive at a time when interest rates are low

While stocks may not be cheap, we believe they will produce better returns than bonds and cash over time. As a result, we are more likely to be net buyers than sellers of stocks, and we will continue to do so in a disciplined manner. We are using this period to re-examine clients' holdings and, as best we can, judging that they have the liquidity to make it through this tough period, reviewing to ensure our original purchase thesis is intact, and looking for opportunities to upgrade any current weak holdings into potentially stronger candidates.

Fixed Income

Investor fears regarding efforts to slow the spread of the coronavirus in the U.S. causing the economy to experience a sudden stop, negatively impacted the fixed income markets in March, as well as the stock market. The bond market deteriorated so quickly that liquidity and credit became an issue, not unlike during the Financial Crisis. There were massive redemptions in fixed income mutual funds and Exchange Traded Funds (ETFs) in the first quarter.[2] The selling and liquidations started with debt linked to companies that were directly impacted by the deteriorating economic environment. Bonds issued by energy companies, airlines, the cruise industry and lodging were the first to see massive declines in market values. The selling was more dramatic for lower rated securities, such as high yield and companies that were on the cusp of high yield,[3] such as auto manufacturers and retailers. Eventually investment grade rated debt began to sell off too. Mortgage backed bonds, commercial loans, municipal bonds and asset backed debt all followed suit. The sell-off affected short maturity bonds, as well as long maturity bonds.

Investors dumped stocks and bonds and bought the safest fixed income securities in the world, US Treasuries, in a "flight to quality". Fixed income spreads, the yield differential between Treasuries and other types of debt, widened substantially as investors tried to gauge the economic damage that was being done to combat the spread of the coronavirus. The combination of selling pressure with widening credit spreads increased the speed in which asset prices lost value.

The Federal Reserve Bank (the Fed) reacted to the crisis by cutting the Federal Funds rate to near 0% and implemented several lending facilities to improve liquidity and prevent the credit market from seizing up. These programs include the establishment of the Primary Market Corporate Credit Facility, the Secondary Market Corporate Credit Facility, and the Commercial Paper Funding Facility, all with the intent to provide credit to large employers.

In support of credit to small businesses and the consumer, the Fed created the Term Asset Backed Securities Loan Facility and the Main Street Business Lending Program. Lastly, it set up the Money Market Mutual Fund Liquidity Facility to assist money market funds in meeting redemption demands by investors. These programs allow the Fed to purchase corporate bonds, asset backed securities, including student/auto/ credit card loans, commercial paper and municipal bonds to name a few asset classes.

During 2008, the Fed was widely criticized for reacting too slowly in addressing the financial crisis. This time, the Fed has been pro-active in deploying unprecedented amounts of liquidity to the financial system by buying assets (also known as "Quantitative Easing") on an open-ended basis.

In our opinion, these measures will provide the necessary liquidity to ensure the normal functioning of the fixed income markets. We see that conditions are already improving, and asset prices are recovering from the lows set in March. Corporations have been issuing large amounts of bonds and the panic selling has subsided, as indicated by new money flowing into bond mutual funds and ETFs these last two weeks.

At the end of the first quarter, the 10-year Treasury yield fell to 0.66% and the 2-year Treasury yield was at 0.25%, providing a 41 basis points positive slope to the yield curve.

Treasuries and agencies had positive returns for the quarter, benefitting from the "flight to quality". The Bloomberg Barclays U.S. Aggregate Index returned 3.15% for the quarter. Treasuries and agencies account for 2/3 of the holdings in the Aggregate Index.

Investment grade corporate bonds returned -3.63% for the quarter, while municipal bonds generated -0.63% and US High Yield -13.12% for the quarter. Lower credit rated bonds lost greater value than higher rated bonds. All of these index returns are for all maturities in each class. Shorter maturities had higher returns than longer maturities.

For the remainder of this year, we expect rates to remain low and the Federal Reserve to do everything in its power to provide liquidity. Once the pandemic has subsided, the economic toll of this event can be better assessed. Massive monetary and fiscal stimulus, in our opinion will help to cushion the severity of a recession.

During this period of heightened volatility, we believe our disciplined approach to managing fixed income portfolios should continue to offer attractive risk-adjusted returns. We continue to favor high-rated corporate bonds, agencies and Treasuries. For our taxable clients, municipal bonds continue to offer a high-quality tax-free income stream with attractive risk/reward characteristics.

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[1] Howard Marks, Oaktree Capital – March 31, 2020
[2] Bloomberg
[3] High yield bonds are rated below BBB by S&P or below Baa3 by Moody's

Past performance is not indicative of future results. *All references to market performance are sourced from Bloomberg.*