MARKETS IN FOCUS

FIRST QUARTER 2020 APRIL 15, 2020

Quarter-in-review – These are trying times for everyone, and we sincerely hope everyone is well. The following note is in no way meant to minimize the turmoil many are going through. For some, the world of investments is the last thing on their mind. But for others who are interested, we want to recap some of the major events of the last few months and share how we see things evolving going forward. We don't claim to have any great insights on COVID-19. However, we will try to offer up a balanced take on the global economy and the state of the financial markets. But remember, the situation is changing rapidly, and some of this could be stale tomorrow!

Market Benchmarks

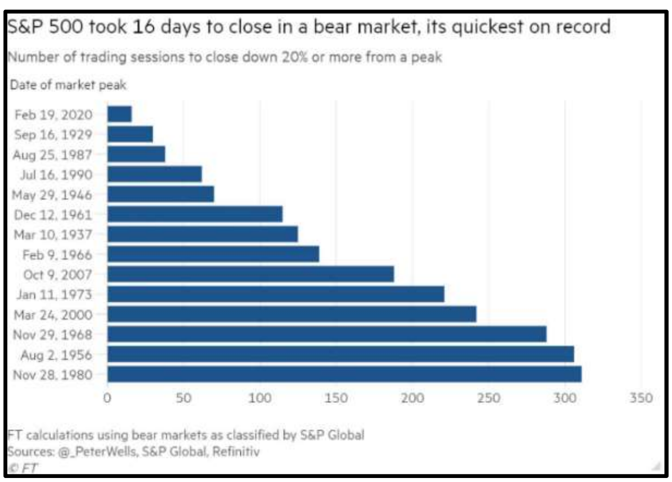
Market Indices	YTD	3-Yr An	5-Yr An
S&P 500 Index	-19.4%	+5.1%	+6.7%
Russell 2000	-30.7%	-4.7%	-0.3%
Global Equities	-22.2%	+1.1%	+2.8%
Int'l Index (EAFE)	-23.0%	-2.1%	-0.7%
Emerging Mkts	-23.9%	-2.4%	-1.0%
Other Indicators	**3/31/20**		**12/31/19**
Fed Funds Rate	0%-0.25%		1.5%-1.75%
2-Year Treasury	0.24%		1.57%
10-Year Treasury	0.66%		1.92%
S&P 500 P/E Ratio*	15.4		18.2
Crude Oil	$20.07		$61.16
Core Inflation	1.8%		1.6%

**Forward 12-month operating earnings per S&P*

The last few months have set a number of records when it comes to the markets, but what stands out the most is the sheer speed of the moves. The S&P 500 peaked on February 19th and 16 days later was in a bear market, defined as a loss of -20% or more. This is the fastest bear on record, as you can see below. The index ultimately lost -35.4% through March 23rd based on intra-day prices. We then experienced the fastest bull market in history as the market rallied +20% in just 3 days!!

There were few places to hide during the first quarter, especially in the equity market. Small-cap stocks were down more than large, and natural resource stocks were down over -40% as oil prices plunged -67.2%. Typical so-called safe havens such as REITS and utility stocks suffered as well with losses of -24.1% and -13.5% respectively. Even precious metals were a minefield. Gold did gain +3.6%, but silver was off –21.8% and precious metals stocks dipped -21.3%.

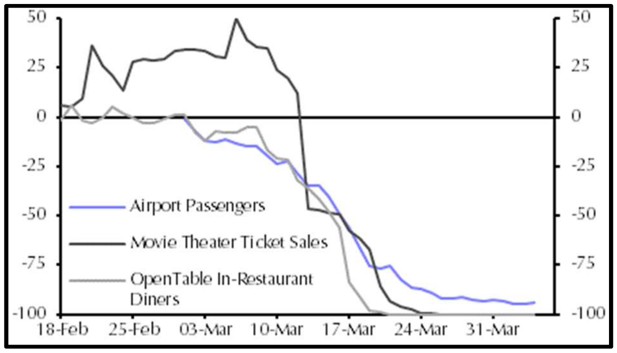
Furthermore, only a relatively narrow slice of the bond market did well. High-quality corporate bonds lost -3.0% while high-yield and bank loans were hard hit with losses of -11.8% and -9.3% respectively. Only high-quality Treasury bonds gained ground because yields fell dramatically. The 10-year yield fell -1.26% during the quarter and intermediate-term Treasury bonds gained +3.1%.



An Economic Sudden Stop – Undoubtedly, we have all read far more about COVID-19 than we would care for. But we have to admit up front that we really can't pretend to know how this virus will evolve other than possibly looking at other countries for clues. Everyone is in the same boat. As renowned investor Howard Marks recently noted, *"These days everyone has the same data regarding the present and the same ignorance regarding the future."*

For the moment, let's stick with what we know for sure. The world economy is experiencing a sudden stop that is without precedent in peacetime. This time truly is different - there is no good playbook for the global recession that is currently unfolding. Recessions are usually caused by the interplay between severe imbalances building up during the expansion and tightening monetary policy. This time is very different because the underlying cause of the downturn is a truly exogenous shock that originated from outside the economic and financial sphere: a highly contagious new coronavirus that has been spreading fast in a globalized world. Parts of China were first to close down, followed by Northern Italy, then much of the rest of Europe and the U.S.

Most governments have responded by aggressively curtailing economic and social activity in order to suppress the further spreading of the virus as quickly as possible. This has already led to a sharp drop in aggregate output and demand in the second half of March which is likely to continue during the second quarter as suppression efforts remain in place. In a sense we are seeing the firstever recession by government decree – a necessary, temporary, partial shutdown of the economy aimed at preventing an even larger humanitarian crisis.



What does this mean in terms of the economic fallout?

- Nearly 90% of the U.S. population is under some form of lockdown.
- Over the last three weeks almost 17 million people have filed unemployment claims, roughly 10% of the labor force.
- Airport passengers, movie ticket sales, and restaurant bookings have all but disappeared, as you can see above.

We are on track for the largest economic contraction in the post-war period. Second quarter growth could contract anywhere from -25% to -40%. Full year growth could fall -7%, far surpassing what we saw during the financial crisis (see the chart at the bottom of the page).

<u>"Everything and the Kitchen Sink"</u> – What's also proving to be different this time, at least during peacetime, is the unprecedented scale of the fiscal and monetary response to the crisis. Policymakers are pulling out all the stops in an attempt to keep the unfolding recession from turning into a lasting depression with widespread bankruptcies and mass long-term unemployment. They are also doing it with a haste rarely seen before. In the U.S., for example, Congress has enacted three phases of its fiscal response so far. While the first two phases were relatively modest in size and narrowly focused, the third phase (CARES Act) is enormous (roughly $2.2tn or 10% of GDP) and broad based. Highlights include:

- $350bn in support for small businesses in the form of forgivable loans.
- $300bn of direct payments to middle- and lower-income Americans ($1200 per adult and $500 per child).
- $260bn for expanded unemployment benefits.
- $340bn in support for states and localities.
- $425bn to fund a joint program between the Treasury and the Fed to lend to businesses and state and local governments. This could be leveraged to $4tn.

While some call this a stimulus bill, disaster relief might be a better term. The general theme is one of transfers and grants to allow small businesses and households to survive in "suspension mode" for the next 3-4 months. In particular, the Act's small business loan provision is effectively a grant for businesses to cover their essential expenses and payroll for the next eight weeks. The Treasury is already seeking to upsize this program by $250bn (to $600bn).

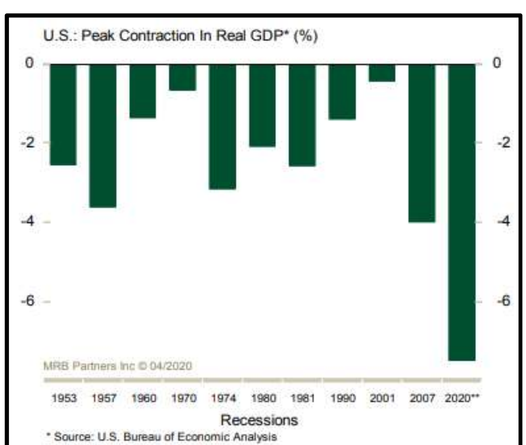
For those who have lost their employment income, the new Act supplements states' existing unemployment insurance (UI) payments by US$600 per week through July 31. This will be on top of the standard state UI which averages $380/week. Taken together this works out to roughly $52K at an annual rate. The Act has also extended the duration of all state UI programs to 39 weeks and partially expanded coverage for individuals previously ineligible for UI, like contractual/self-employed/ freelance workers. It is quite possible unemployed workers will see 100% or more of their lost incomes replaced for a period of time.

There is also likely to be a Phase 4 plan. Components of the next package are rumored to include more aid for the unemployed as well as direct payments to states and local authorities. Another round of payments to individuals cannot be ruled out. Congress should not be blamed for being tight with the purse strings.

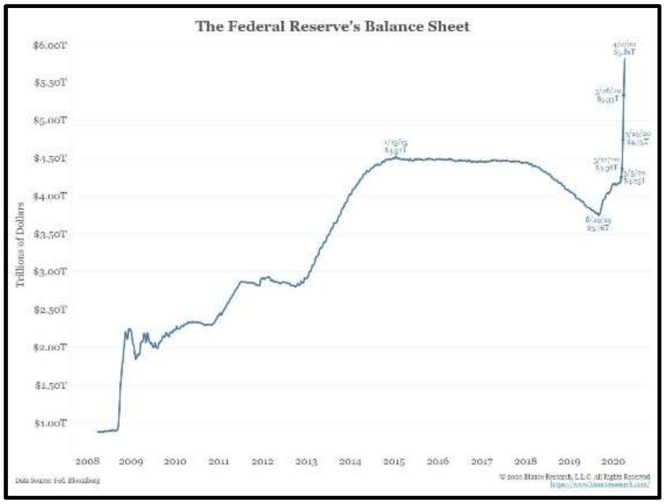
<u>To Infinity and Beyond</u> – The other unprecedented policy response comes from global central bankers. Almost without exception they were quick to cut interest rates and flood the system with liquidity to prevent the financial system from seizing up. Central banks have stepped up as lenders of last resort not only for banks but increasingly for businesses in general through a range of lending and asset purchase programs. If we focus on the U.S again, the Fed has moved like never before. Specifically:

- Predictably they cut rates to zero.
- They announced an open-ended program to buy Treasury and mortgage securities – QE infinity!!
- The Fed created vehicles to provide loans directly to corporations, buy existing corporate debt in the secondary markets (including ETFs), and make loans against asset-backed securities.
- They launched programs to help the commercial paper market, money market funds, and the municipal market.

As a result, the size of the Fed's balance sheet has soared to over $5tn (chart at the top of the next page) and it's not a stretch to think the balance sheet hits $10tn at some point late in the second quarter or early in the third quarter. This was unthinkable only three months ago.



What Does the Future Hold? – Now we must transition from what has happened to what we think may happen in the coming months. We would argue that investor and market psychology seems to have gone through three stages so far this year:



1) Stage one was the shock of an out-of-control virus spreading around the globe. This naturally was the trigger for the bear market and flight to safety.
2) Stage two was the massive policy response. This was the proximate cause of the bounce in equity prices.
3) We now seem to be moving into digesting the economic fallout. How bad will the slump be and, critically, what will the exit from the economic "sudden stop" look like?

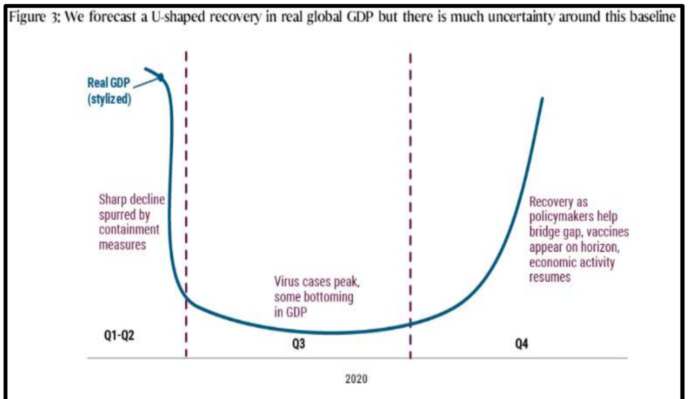
To many the last point may sound awfully premature. But from a market perspective, if you are discounting future scenarios you have to consider that 'this too shall pass.'

In our mind the two most likely scenarios over the coming months are as follows.

The U-Shape Recovery - Recent data out of Europe and even parts of the U.S. gives us some hope that the growth rate of infections is flattening. This raises the possibility that parts of the world will slowly start to ease the restrictions on social distancing, etc., probably in stages (maybe by type of business or an individual's age). We are already seeing such moves in China, Austria, Norway, and Denmark. Under this scenario the global economy will transition from intense near-term pain during the virus-suppression phase to gradual healing over the next six-to-twelve months.

However, restrictions on economic activity will likely be lifted only gradually and at different speeds for different sectors and regions, thus the rebound will be muted. The chart below shows a stylized example. The initial sharp contraction in the economy is followed by a bottoming process that could last a few months as the virus comes under control but before output and demand ramp up. The subsequent recovery picks up pace slowly as workers filter back to their old jobs but individuals and corporations prove reluctant to resume old spending habits. How long this whole process takes is tough to guess, but it is almost certainly going to be measured in months and not weeks.

Figure 3: We forecast a U-shaped recovery in real global GDP but there is much uncertainty around this baseline



Source: PIMCO. **For illustrative purposes.**

The W Scenario – The other, less optimistic scenario is an initial recovery interrupted by a relapse as infections start to grow again. The ultimate recovery could very well hinge on the development of a vaccine in 2021. This more bearish scenario would play out if the current suppression strategy turns out to be insufficient to significantly slow the spread of the virus, so that stay-at-home measures have to be kept in place for longer than currently anticipated. With activity depressed for longer in this scenario, many of the more highly leveraged firms in the cyclical parts of the economy would likely default, feeding back negatively into jobs and demand.

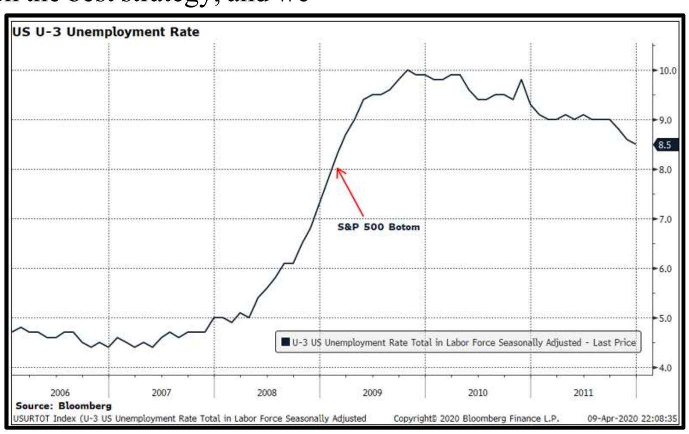
Under either scenario we could see the equity markets hit new lows in the months to come. It actually isn't unusual for markets to rally off an initial low (the so-called bear market rally) before rolling over again and testing those lows a few months after the fact. We saw this in 2008/2009 as well as the 1973/1974 bear market (see the chart at the top of the next page). However, under the second scenario, we could see meaningfully lower lows.

How people view the two scenarios probably says more about a person's inherent optimism or pessimism rather than the facts themselves. You can find well-regarded experts on both sides of the debate. Remember Howard Marks' quote earlier – *"These days everyone has the same data regarding the present and the same ignorance regarding the future."* For what it is worth our investment committee leans towards the former scenario, although even under this situation we think there's a decent chance we test the March lows. But that being said, we don't think anyone can make a really high conviction bet at this point.

Markets Generally Turn Before the Data – During every bear market over the last thirty years we hear a common refrain – *"I'm just going to sit in cash until the news gets better."* And frankly, we have wrestled with the same instinct ourselves. When every day is one bad headline after another the natural inclination is to sit this one out. But this just replaces one problem with another. What's the trigger to re-invest?

One thing we do have confidence in when speculating about what the future holds is that the markets will turn before the data. We see this at the bottom of every bear market. Stocks stop going down on bad news and start to rally on news that is less bad than the day before. For example, at the bottom of 2008/2009 bear market stocks hit a low even though layoffs persisted for many months. The chart at the bottom of the page shows this. The equity market bottomed in early 2009 but unemployment continued to soar from roughly 8% to 10% over the coming months. If you waited for the peak in unemployment you would have missed a +55.3% gain in the S&P 500. It was the same story during the Great Depression. Stocks bottomed 12 months before bank failures came to an end. Similarly, in 1973/1974 stocks bottomed far before unemployment and inflation peaked.

Now don't get us wrong. We are not arguing that the low was put in on March 23rd because we've been rallying in the face of continued bad news the last few days. It is certainly a low, but we will only know if it is the low with the benefit of hindsight. But we are sure that trying to time your market exposure based on the headlines of the day is a recipe for frustration and disappointment. The only rational approach in our mind is to hold a diversified portfolio. You don't have the safety of cash during a downturn but you participate to some degree during the upturn. Over time this has proven the best strategy, and we continue to think this is the wisest approach today when no one can predict the future with any confidence.



Looking Ahead – In this business, like any business, there's rarely such a thing as "knowing the future." But usually the future will be mostly like the past. Our brains are wired to look for patterns and exploit them. This trait, plus the ability to communicate these patterns to our progeny, probably helped us avoid becoming saber tooth tiger appetizers in the dark reaches of our history.

Of course, the future is always uncertain, but we aren't going out on much of a limb to say that today the uncertainty is much greater than usual. To put it in economic terms: the probability distribution governing future events is much wider and the tails much fatter. In fact, there are potential negatives (and perhaps positives) that few living people have faced before. The downturn could be much worse than what we have seen in the last 50 years. But can you rule out a possible economic boom under a positive scenario (a vaccine early next year?) given all the money we are throwing at today's problem?

We do believe the dramatic action on the part of policy makers has bought the global economy some time for infection growth rates to slow. While lockdowns clearly have an extremely negative initial effect on economic activity, the good news is that there appears to be an inverse relationship between their severity and duration. Hopefully by July we are talking about at least parts of the global economy returning to work. We won't speculate here on what the longer-term consequences of the crisis will be, but topics such as government deficits, inflation, globalization/outsourcing, and growing income inequality are all going to be big issues. Will airplanes have a middle seat again? What happens with November's election? The list goes on and on. But we think that 'this too shall pass.' Finally, we want to wish everyone well and remind you to utilize your financial advisor to talk about your concerns and, if need be, customize your asset allocation based on your specific needs.

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