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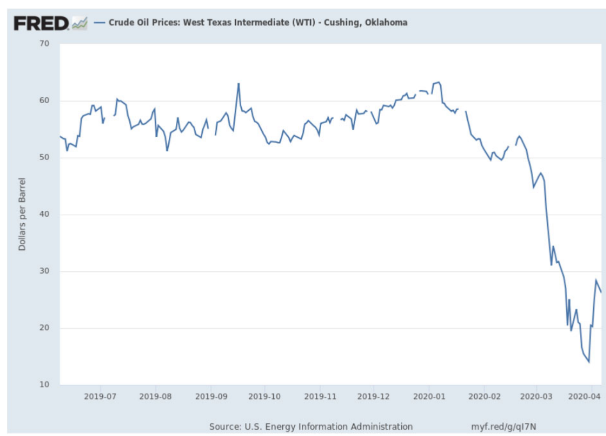
Quarterly Update & Economic Commentary—March 31, 2020

Quarter in Review

The first quarter of 2020 is a quarter that many investors will want to forget. The S&P 500 suffered its worst first quarter going back as far as 1928, and the ninth worst quarterly return since 1928. The S&P 500 Total Return returned -19.60% for the quarter. What made this quarter feel even worse was the quickness of the fall and the fact that it came after hitting all-time highs. The S&P 500 hit all-time highs on February 19, and by March 23 the index was down 34%. All S&P sectors were negative for the quarter but there was significant dispersion between the top performers and the worst performers. The Energy sector suffered the largest decline, falling over 50%, followed by Financials falling almost 32%. The top performing sectors were the Information Technology sector, which fell 11.93%, followed by Health Care, which fell 12.67%, and then Consumer Staples, which lost 12.74%. While the S&P 500 performance was bad, mid-cap and small-cap stocks performed much worse. The S&P MidCap 400 lost 29.80% and the S&P SmallCap 600 lost 32.64%. Across all domestic market capitalizations, growth stocks outperformed value stocks. International stocks lost more than the S&P 500 but not as much as smaller capitalization stocks. The MSCI EAFE NR lost 22.83% and the MSCI EM (emerging markets) NR index lost 23.60%.

A number of factors contributed to a rapid decline of interest rates. The Fed announced two rate cuts during emergency meetings, taking the Fed Funds rate to zero, and investors preferred safer assets over risky assets causing a demand for treasury bonds, pushing prices higher and yields lower. The 10-year Treasury yield fell from 1.90% at the beginning of the year to temporarily below 0.40% and ultimately finishing the quarter at 0.70%. Lower quality bonds, referred to non-investment grade or “junk” bonds, had a terrible quarter, but that is to be expected given the disregard for risk assets, i.e. equities. On the surface, this sounds normal; treasury yields fall and prices rise, while “junk” bonds sell-off during an equity bear market. However, what made this quarter so abnormal for bonds was that commercial paper and other short-term corporate bonds performed very poorly during the last three weeks of the quarter. As panic set in, investors fled assets causing institutional money managers to create liquidity. When faced with a decision of what to sell, managers rationally choose to sell their most liquid and quality investments; short-term corporate bonds. The problem came when there were too many sellers of these short-term bonds and not enough buyers. The imbalance of buyers and sellers caused spreads, the difference in yield between U.S. government bonds and corporate bonds, to widen significantly. This action caused many short-term investment-grade bond managers to post losses during the quarter because their underlying bonds were marked-to-market at a temporary loss. These losses were not driven by solvency fears but of liquidity issues in the market.

Like other areas of the market, the commodity markets were all over the place. The Energy sector was the hardest hit. Crude Oil lost 54% during the month of March and 66% for the quarter. The price of oil was impacted by two factors. The cracks in the oil markets began with a price war between Saudi Arabia and Russia. As global demand decreased, there was an expectation that OPEC would cut production to stabilize prices but Russia, a non-OPEC member, voiced their opposition resulting in no deal for a production cut from producers. Saudi Arabia countered by agreeing to sell oil to China at lower prices which caused steep declines in oil prices. At the same time as the supply glut, coronavirus began to cause a decrease in demand as production in China slowed and global lockdowns resulted in consumers using less gas. When a good has oversupply and decreasing demand, prices fall, and in this case prices have fallen sharply. In more normal environments, lower oil prices is good for the consumer, but in this environment consumers are using less gas to travel which does not add as much of a benefit. The additional negative to the oil plunge is that many U.S. producers cannot produce oil profitably at such low prices, causing job losses and potential defaults from the U.S. oil production industry. A bright side in the commodity market was in Gold. Based on the perceived flight to safety, investors bought gold. For the month of March gold prices increased 1.91% and for the quarter Gold is positive by 4.83%. The majority of other major commodity goods were negative for the quarter, with the exception of Wheat which was positive by 1.79%.

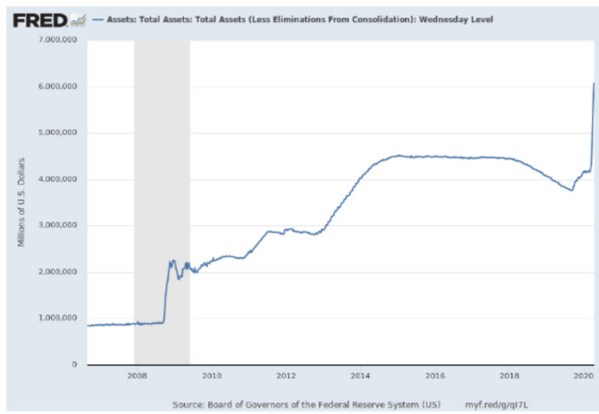


The quarter started off on good footing, ignoring many of the known risks as markets hit all-time highs on February 19. At about this time the potential risks of coronavirus began to take shape and the markets sold off in rapid fashion. As mentioned above, the market fell 34% from all-time highs and did so in just over 30 calendar days. While the worst of coronavirus seemed to be behind China, the virus had spread to other parts of the globe. It hit Italy particularly hard, and began to expand in the United States. Like was done in China, other major countries and cities began lockdowns which halted the global economy. Many economists believe we are already in a recession and growth for the second quarter is being forecasted to slow by between -10 and -30%. While this situation is concerning because of the impact it will have on the health of our friends, family, neighbors and others, the economic impact is expected to be quick, with economic growth expected to resume during the third or fourth quarter. What makes this recession different from other recessions is that it was self-imposed by the lockdowns and many believe or at least hope the economy can be restarted as soon as the lockdowns can be lifted.

When lockdowns are instituted there are many sectors of the economy impacted. The obvious sectors are airlines, hotels, cruise lines and retail. Much of these sectors are non-essential and are the first to be restricted. As the lockdown extends, the impacts begin to hit all sectors, from bartenders to Uber drivers, small businesses and even some local and state government jobs. The job losses are mounting, as was evidenced by the 3.3 million jobs that were announced during the March 23rd initial jobless claim. These numbers are expected to get worse.

While all of this news is horrible, the Federal Reserve and U.S. government stepped in to assist. Essentially, the government is trying to provide a stopgap to help all of those who are financially impacted until the lockdowns can be lifted. If the lockdowns can be lifted in May or early June, the stimulus may provide just enough cover for the economy to recover later this year. The government will send stimulus checks to many Americans. In addition, unemployment insurance has been enhanced to ensure those being laid off or furloughed will receive some income during these difficult times. The CARES Act, which includes the direct stimulus checks and enhanced unemployment insurance, was the congressional act signed into law, mainly to help workers and small businesses stay afloat during the shutdown. The Act also provides other stimulus programs, including loans to small businesses which may not be required to pay back if they do not make any layoffs over a determined time period. While many of these programs sound good on paper, the money needs to flow to business and Americans quickly.

In addition to the fiscal stimulus, the Federal Reserve acted quickly and boldly. The Federal Reserve announced two emergency rate cuts, taking rates to zero. The Fed also announced a number of different programs to help combat the liquidity issues in the cash and bond markets; they also announced programs to assist with the solvency of some corporations. And if that was not enough, they announced a new quantitative easing program originally to purchase treasuries and mortgage-backed securities but later announced they would also buy corporate bonds. They did not stop there either; many Fed Presidents announced they could and would do more, if necessary, which the market interpreted to mean they would consider buying stocks. The Fed is acting as essentially an unlimited purchaser of bonds and maybe stocks. It is difficult to believe their actions would not bring stability. In addition to the actions taken in the United States, central banks and governments around the globe have introduced programs to help individuals and companies maintain their solvency over the next couple of months.



A Look at the Numbers

Name	First Quarter Return (%)	Year-to-Date Return (%)
DJ Industrial Average TR USD	-22.73	-22.73
S&P 500 TR USD	-19.60	-19.60
S&P MidCap 400 TR	-29.70	-29.70
S&P SmallCap 600 TR USD	-32.64	-32.64
NASDAQ Composite TR USD	-13.95	-13.95
MSCI EAFE NR USD	-22.83	-22.83
BBgBarc US Agg Bond TR USD	3.15	3.15
Wilshire US REIT TR USD	-25.63	-25.63
IA SBBI US 30 Day TBill TR USD	0.37	0.37

A Look Ahead

As we look ahead, we are looking at the pain, health-wise and economic, in the near-term. However, we also need to look out beyond the next few months and into the recovery period. The market is a discounting mechanism which means it looks out to the future when valuing current prices. This is why the market began to drop before any negative economic news was reported and why the market may bottom and begin to recover while the economic news is still negative. This is when many retail investors get in trouble: they decide to sell because they believe economic data will only get worse, and therefore the market must get worse. It is often the case that the market recovers before the backward-looking economic news bottoms.

Over the very short-term, the goal for governments is to flatten the virus curve while also keeping as many small businesses and families solvent as possible. We know through April and probably into May, the number of COVID-19 cases will increase, as will the number of deaths. This is a sad and difficult reality to face, but it is the expected reality. In addition to the burden of uncertainty around our health, many Americans are also worried about how they are going to pay their bills. Over the next couple of months, some of the financial burden faced by business and families will be lessened by the large stimulus package that was passed in Congress, referred to as the CARES Act. For 2020, the goal of many business and individuals will be to stay afloat as opposed to earning more than last year. This is where the forecasting gets really complicated: either the infection curve flattens or the health situation gets worse. If these near-national lockdowns are able to stop the spread, therapeutics are developed to treat the infected and there are enough testing kits available to allow some individuals back to work, then the recovery could begin. If the lockdowns extend well into summer and fall, then the stimulus will not be big enough, and it remains to be seen if the government would pass another $2 trillion bill to keep those impacted solvent. If the situation is worse than expected and extends well beyond the second quarter then the market may have much more pain ahead.

As we look past the second quarter and the extreme drop in economic growth, we believe it is possible to see some economic growth starting as early as September, with the economy picking up growth during the fourth quarter. Being that this recession was self-imposed by the issuing of lockdowns and not as a result of economic imbalances, we believe a recovery could take shape this year. Analysts are projecting some ugly numbers during the second quarter. GDP could fall by as much as 30% and the unemployment rate may increase to over 30%, but it is important to remember the market has most likely priced in these forecasts and the government wants individuals to file for unemployment benefits. Part of the stimulus package included enhanced unemployment benefits. It is better for a company to furlough or lay employees off, so the employees can receive unemployment benefits and hopefully the company will not fold or file for bankruptcy. The government wants these businesses to be around when the country gets moving again.

Corporate earnings will take a backseat to daily health updates. According to FactSet, as of March 27, analysts are expecting earnings to decline by 5.2% for the first quarter, 10% for the second quarter and 1.1% for the third quarter, before earnings begin to grow again during the fourth quarter. The current estimate for fourth quarter 2020 earnings is 4.5% and 14.2% for the first quarter of 2021. If Q2 earnings do decline by 10% or more, it will be the first double-digit earnings decline in more than 10 years.

The markets will be taking notice of how other countries across the globe are progressing from an economic and health standpoint. For instance, China was the first country to be hit with the virus and there economy suffered first. Now that they have seemed to have flattened their curve and businesses are opening back up, it would be a great sign if their economy can turnaround without any more flair-ups in cases. There have been other countries like Italy and France who were hit particularly hard by the virus, but since they were hit before the U.S. they should begin recovering before the U.S. Other countries have handled the outbreak relatively well, like South Korea and Malaysia. We should be keeping an eye on these countries to see how they perform economically and if there are any re-lapses as lock down restrictions are lifted.

Most Americans have become focused on dealing with the current global pandemic but it cannot be forgotten that 2020 is also a Presidential election year. It is almost certain that Joe Biden will win the Democratic nomination. This is probably one of the better conclusions for the markets, even if President Trump were to lose the election, markets would not be pricing in a candidate from the Democratic Party's progressive wing. An incumbent President has never won when a recession occurred so close to an election.

impact social distancing guidelines will have on election turnout if they are still in place in November. While this topic will most likely not begin making headline news for another couple months, it may be another risk to the markets come November.

Right now, the markets are solely focused on health updates. Is the curve flattening? Will there be vaccine in the next 12-18 months? Will warmer weather slow the spread? Are there proven therapeutics? The market does not need everything back to normal in a few months, but the market wants to see some indications that some people can get back to work, that supply lines are recovering and kids will go to school in the fall without a major risk of another shutdown or outbreak. Given the American spirit and technological advances over the last several decades, we know we will prevail and we are optimistic that in a few weeks the worst will be behind us and we can begin to move forward. We acknowledge that the move forward may not be fast at first, but we look forward to the recovery. It's also worth questioning what the psychological impact of this event will be, both from a consumer as well as a social distancing standpoint. In the wake of the Great Financial Crisis many consumers took years to return to their robust spending habits as they were nervous to be surprised with a new economic shock. That, combined with the possibility that many Americans may be weary of going in public even after governments have relaxed guidelines, may provide a headwind to the recovery.

As we close this quarterly commentary we would be remiss to not comment on the importance of staying the course and attempting to avoid emotional decisions of selling when there is panic in the markets. It is also a good environment to remind clients to invest based on your needs and objectives and not on sentiment. Heading into January, we were coming off a great year in the markets and hit multiple all-time highs through the first six weeks of the year. In the forecasts and commentary at the start of the year, the risk of the global spread of COVID-19 was not mentioned, which is a regular occurrence that the events that cause market disruptions are typically not in the forecast. If you were chasing returns or being greedy by taking more risk than you should have, given your situation, the rapid decline in market values may have been more impactful and painful than maybe it should have been. These are difficult times for many of people across the globe, but like all hard times they will pass. We will learn from this and better times will be in the future. Stay safe and stay healthy.

If anything has changed with your financial picture that may affect your investment strategy, please let us know so we can make any necessary changes.

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