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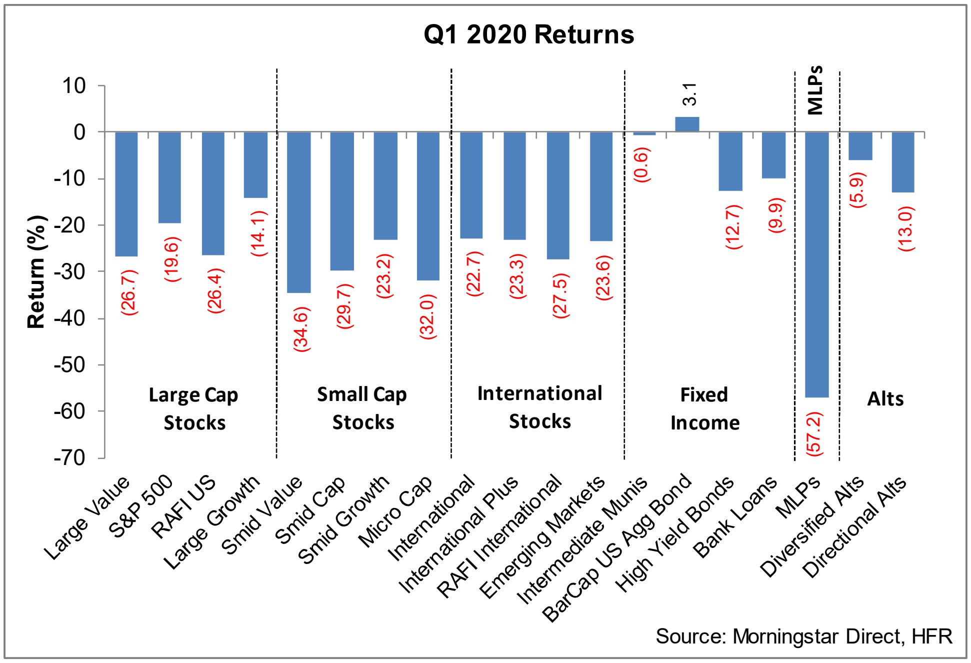
# First Quarter 2020 Investment Review & Outlook




## EXECUTIVE SUMMARY

### Q1 2020 Recap:

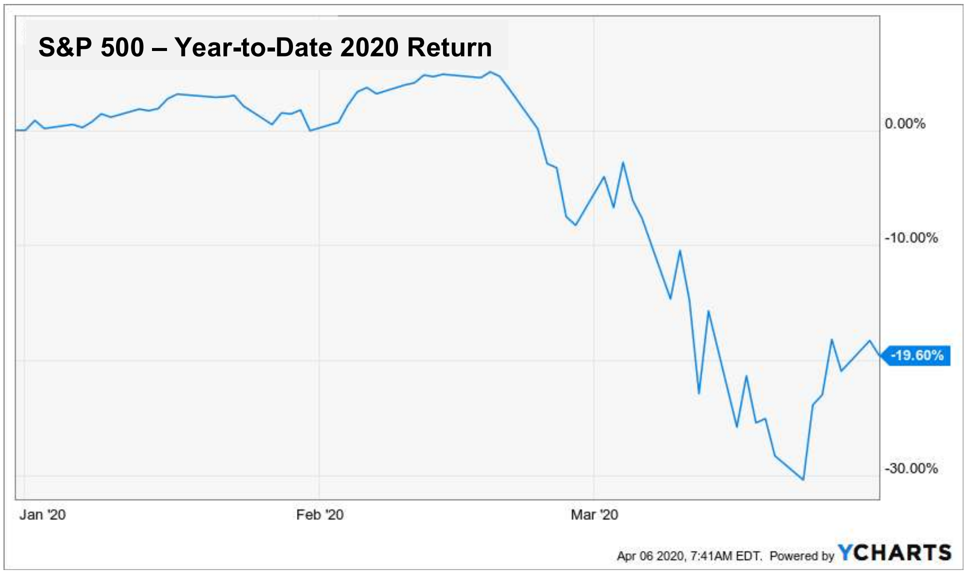
- The coronavirus caused significant declines in virtually all asset classes during the quarter. The S&P 500 entered a bear market after an 11-year bull run and experienced unprecedented levels of volatility during the quarter
- Virtually every fixed income market declined during the quarter except for government securities. Losses for even the highest quality bonds experienced dramatic losses in the quarter before the Federal Reserve stepped in to backstop markets
- Congress passed a $2 trillion stimulus package, totaling nearly 10% of the US economy, to help stem the economic damage unfolding as a result of the national lock down

### NEXT Outlook:

- The market has rallied off government stimulus and the slowing of coronavirus cases, although it remains down materially from its highs. How much longer the economy remains shut down will dictate whether we have a “V-shaped” or “U-shaped” recovery
- We expect volatility will remain very elevated in the months ahead as we navigate stunningly poor data, bankruptcies, and news flow on the virus. A patient, methodical approach to re-deploying capital will be critical as we do not believe this crisis will be quickly resolved

To Our Clients and Friends,

Little preamble is needed from us to update you on the state of the world and financial markets this quarter. Everyone's lives – personal, professional, financial – have been significantly impacted in the last two months by the coronavirus pandemic. The economy is virtually shut, financial markets have plummeted, and uncertainty about our personal health and safety will remain a shadow over our existence for the foreseeable future.



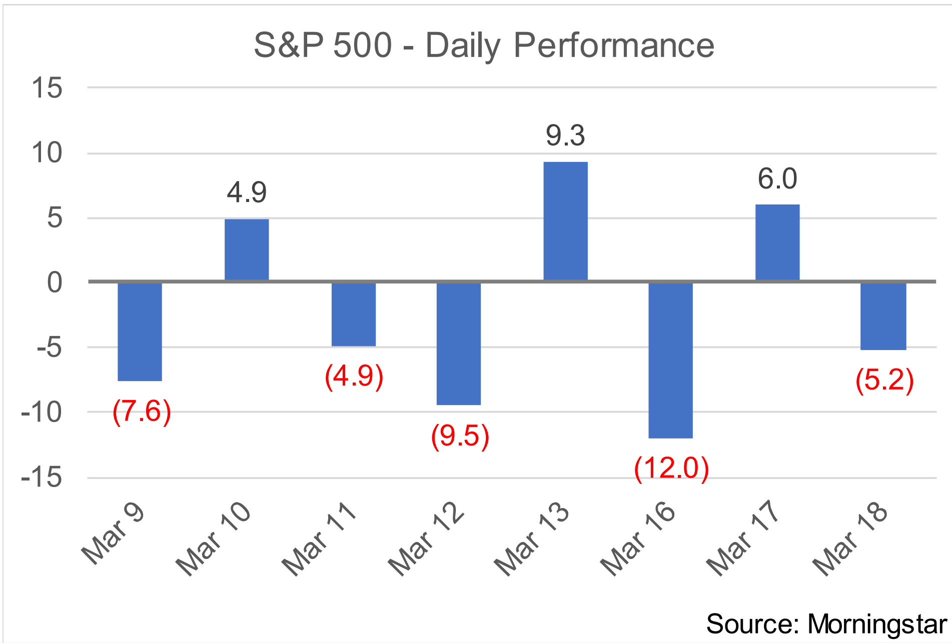

The deterioration of the coronavirus situation was stunning and unprecedented. Stock markets fell into the quickest bear market in recorded history (just 16 trading days) as the nature of the virus and its spread became more understood. What began as just the latest sequel to the SARS, Ebola, or Swine Flu outbreaks from the last two decades – humanitarian tragedies, but not significant economic or market factors – rapidly evolved into something far more dangerous and systemic. We now know that we will almost certainly experience an economic recession; the question remains how deep and for how long that recession will last.

Massive monetary and fiscal stimulus measures in recent weeks by the government will help ease that burden. The government was much quicker to act during this crisis than they were during the global financial crisis. In the span of a week, the Federal Reserve cut short-term interest rates not once, but twice. In subsequent weeks, they provided direct support to financial markets by backstopping money market funds, mortgage-backed securities, asset backed securities, corporates, and even municipal bonds. Congress followed with a $2 trillion stimulus plan designed to support businesses and consumers. The legislative package alone totals nearly 10% of the American economy.

This support has, for now, stemmed the tide of extreme negativity that gripped markets in March. Most risk assets hit a low on or around March 23rd and have since climbed higher, albeit in a volatile fashion. Time will tell whether this is simply a classic "bear market rally" or whether a more enduring recovery is taking hold.

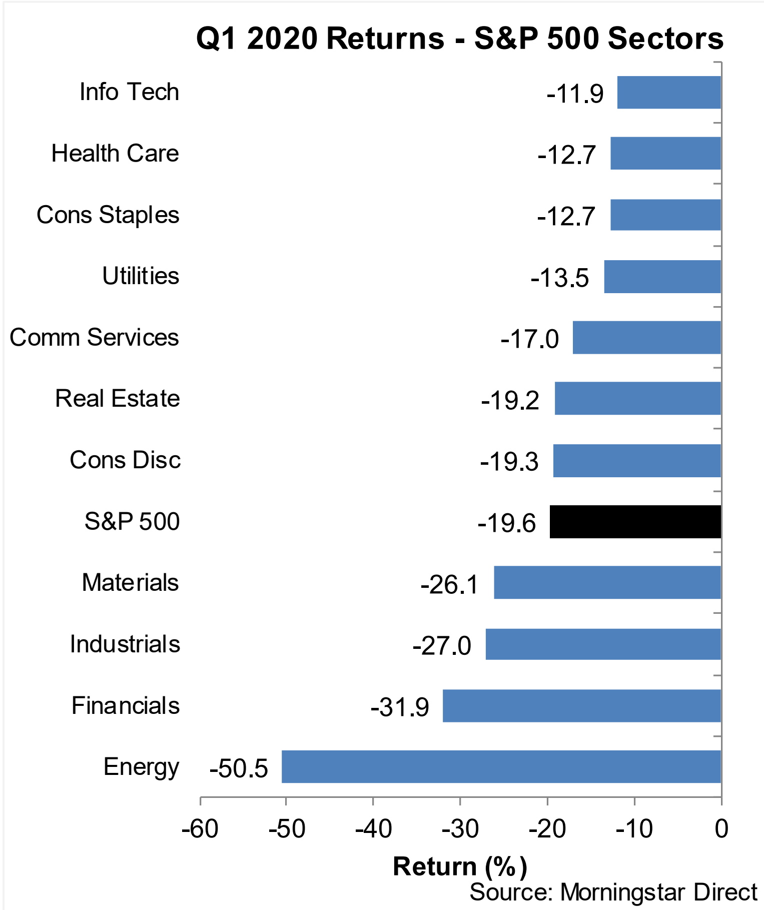
**The Details…**

The S&P 500 Index, which we use as a barometer for the performance of US large cap stocks, declined 19.6% during the quarter. The index had been up roughly 5% on the year in mid-February before succumbing to the effects of the coronavirus. From peak to trough, a period of only 33 days, the index fell approximately 33.8%. This included a stretch of eight trading days in March where daily returns moved up or down by an average of 7.4%! Never in history had we observed this level of volatility.




Somewhat predictably, other areas of the stock market did not fare as well. Small cap US stocks fell 30% in the quarter, while developed international and emerging markets declined 23% and 24%, respectively. To be fair, foreign stocks performed similarly to the US in local currency terms. However, a flight to quality caused the dollar to strengthen and decrease those returns for US investors.

Sector performance continued to be a large driver of market performance, as the technology sector once again outperformed the rest of the market. This performance was partly due to strong performance during the first six weeks of the year, when tech stocks were up more than 10%. Other sectors outperforming included lower risk, less cyclical industries like health care, utilities, and consumer staples. The latter has benefited from the "stocking up" effect, with demand for groceries and other consumer goods surging amid the national lock down.




Lagging performance, of course, was the energy complex. Energy stocks had already struggled coming into the market decline, trailing the rest of the S&P. Then in early March, oil prices fell precipitously following the surprise decision by Saudi Arabia to sharply ramp up oil production and cut prices. This action was in response to Russia refusing to comply with OPEC's efforts to prop up the price of crude oil. At just 3% of the market, energy stocks' direct impact on the index these days is technically limited. However, the sudden plunge in oil prices damaged investor sentiment and caused the market selloff to intensify.

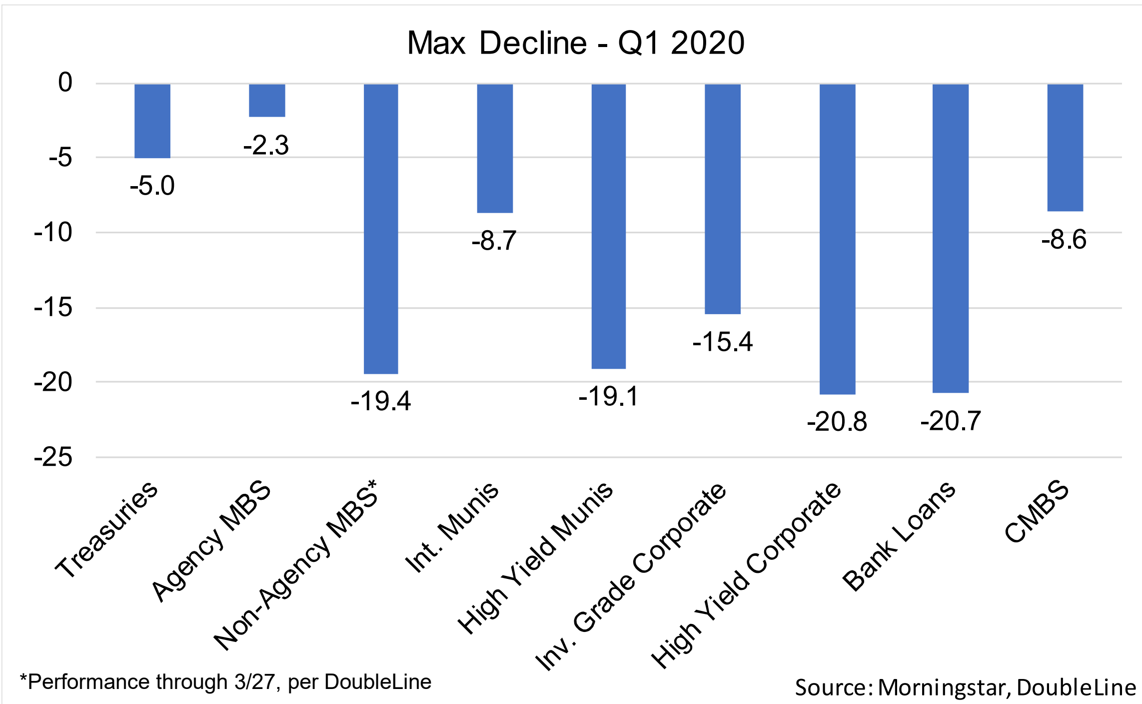
**Special Note on Fixed Income...**

Nowhere was the stress of this quarter more evident than in the bond markets. While most areas of the fixed income market were relatively stable through the first part of the market selloff, in March we witnessed a virtual meltdown across the universe. A liquidity vacuum ensued, causing sharp declines in even the safest of bond sectors. Only once the Fed stepped in to backstop several markets – including markets they've never previously supported – did the initial panic ease.

The broad bond benchmark, the Barclays US Aggregate Bond Index, does little justice in telling this story. The "Agg," as it's known, is predominately comprised of government securities like Treasuries and Agency Mortgages – among only a handful of assets to not decline in value during the quarter. While that index posted modest gains in the quarter, virtually every other fixed income asset declined.

What we would normally consider the highest of quality securities, including munis and investment grade corporates, experienced shocking levels of decline in March. High grade municipal bonds, for example, long considered a form of portfolio safety for high net worth individuals, declined as much as 9% during this stretch. Investment grade corporates, with a miniscule historic default rate, declined more than 15% before the Fed stepped in to directly support that market.

These results were unnerving, to say the least, echoing the liquidity crisis that unfolded in 2008-2009. As a firm, we fully exited many fixed income investments to mitigate these declines. At this point we are seeing stabilization, but the risk of principal loss remains as we are facing potentially historic bankruptcy levels in the months ahead. We will slowly add risk back into this market, but we will be doing so cautiously and prudently.




**Other Asset Classes…**

The initial data on the non-traditional asset classes are mixed. Hedge funds posted widely varying performance, with some positive performers offset by some truly shocking negative returns. The aforementioned disruption in the credit markets, in particular, was a source of severe stress for several managers. As an asset class, the broad hedge fund industry declined by approximately 8% during the quarter – with most of those losses occurring in March.

It is still too early to tell on most private asset classes like real estate and private equity. The key issue for those investments will be the amount of time this economic lock down continues. Fortunately, many private equity funds are flush with cash, which allows them to provide liquidity to their companies in the short-term (compared, for instance, to a standalone private business that has no such lifeline to get them through this).



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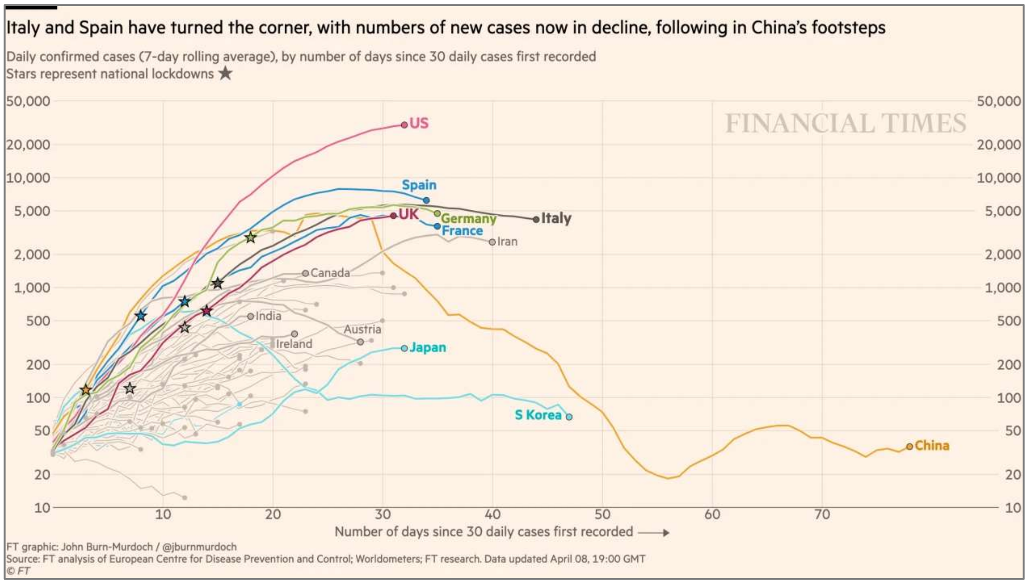
**Our Outlook…**

For the foreseeable future, the only relevant factors for the markets are the coronavirus and our government's response to it. The latest data appears to indicate that the social distancing measures implemented here and around the world are working. The so-called "curve" has flattened, with expectations for peak infections and deaths occurring sometime during the next few weeks in the US.




Between this improvement and government stimulus, stock markets and other risk assets have rallied in the last two weeks from their lows. As we finalize this commentary, the S&P 500 sits just 6.6% below its September 30th value, and 18% below its all-time high in February. Some may wonder whether we are "off to the races." While we would be thrilled, of course, if that was the case, we observe that the bottoming process of bear markets is seldom a clean or easy one. Mini bull-markets of 20% or more are very common amid bear market declines and do not always mark the bear market's end.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Looking forward, there are several critical questions that will dictate whether a return to all-time highs is justified. Among them: How much longer will our society remain locked down? When we re-open, will we experience a second wave of infections? Will business activity rebound immediately or are we facing a long, slow recovery?

As much as we believed early in this process that the virus would simply be a temporary disruption, it is clear that we are facing something much more significant. In the last two weeks more than 10 million American jobs have been lost. Unemployment claims last week of more than 6 million were nearly 10x the previous record amount. Economists are forecasting as much as a 40% annualized drop in second quarter GDP. We won't even fully see the damage to corporate earnings until three months from now when second quarter figures are released.

The markets, of course, know this and are looking through to a recovery. On this matter, there is a considerable variance in expectations. Some expect a "V" shaped recovery, one in which the economy and markets get back on track quickly and make up for lost time. There are others in the "U" shaped camp who believe it will be a long slog as people slowly regain their jobs and consumption. In the latter scenario, corporate earnings will take longer to improve, and it will be difficult to justify a quick rebound to February highs (recall that we experienced zero earnings growth in 2019 and valuations were already expensive heading into this crisis).

Whatever the answer, the initial "shock" of this crisis has passed and the Fed's actions have (probably) eliminated the most disorderly period of this bear market. Investors are likely to be much more discriminating moving forward as the winners and losers of the new world are sorted out. Quality and growth are likely to thrive in this reality, although we surely expect to see episodic rallies in the riskiest parts of the market as investors attempt to bottom fish.

Navigating this environment will be challenging. Although volatility is lower than it was a few weeks ago, it remains extremely high. Therefore, we believe the most appropriate path forward is a patient, methodical one. Markets never move in a straight line, and that will especially be the case as long as the threat of the coronavirus continues to hang over this market. We believe rebalancing portfolios over time, and taking advantage of periodic market declines, will be key to deploying capital in the months ahead.

Lastly, we would note that while the government's actions have very likely headed off this crisis from being much more significant, there will almost certainly be long-term ramifications. Virtually overnight, we are taking our fiscal deficit to levels not seen since World War II. This has profound implications for things like inflation, growth, and interest rates in the future. This is not today's issue, but something we will have to start considering in the years ahead.

As always, if you feel your personal financial situation has changed or you would like to revisit your asset allocation, please do not hesitate to call or visit our offices.

Kindest regards,
Your Investment Team
4/8/2020

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