QUARTERLY MARKET UPDATE

APRIL 2020

CORNONAVIRUS

Name	YTD 2020 Return (%)
Barclays US Aggregate Bond	3.1
Barclays US Credit	-3.1
Barclays US Corporate High Yield	-12.7
S&P 500 TR USD	-19.6
MSCI EAFE	-22.8
MSCI Emerging Markets	-23.6
Russell 2000 TR USD	-30.6

Data Source: Morningstar Direct

There is no question that we have witnessed remarkable events over the past month and a half. Equity markets have declined significantly, and more alarmingly, they have done so in extremely rapid fashion. In fact, the recent market contraction is the quickest on record, with an almost 34% decline in under five weeks.

Obviously, this downturn is a result of the uncertainty surrounding the magnitude and duration of the coronavirus affects. Both the known, and more importantly, the unknown effects of the crisis are the main factors amplifying volatility and putting a fair amount of stress on the liquidity of the markets. We are over a month into this this market downturn as the stock market high was February 19th, as measured by the Standard and Poor's (S&P) 500.

To step back and help provide some perspective on the recent and ongoing events, it may be helpful to categorize the timeline. We could begin with a phase one, which started prior to the February 19th market high. This period could be characterized by strength in certain safe-haven securities such as US Treasury bonds. We saw these types of securities do well, continuing the behavior demonstrated last year, as returns were strong then too. Additionally, we saw the yield curve (which is a graphical illustration of the different yields on varying maturities of government bonds) compress, as many bond investors sought to reduce risk given not only general fears about the state of markets but specifically relating to the developing concerns regarding the impact of the emerging supply chain disruptions. Equity markets at that time, which were still near all-time highs, were less bothered by these developing risks and were still focused on the prospects that corporate earnings and economic growth would continue just as they had been in the past. Phase two, which we are well into now, might be aptly labeled the "uncertainty leading to fear" stage of the crisis. Coronavirus infections are expanding globally, with both containment and mitigation efforts in full effect; this has caused volatility to soar. We have seen the US stock market circuit breakers (which temporarily halt trading) activate multiple times over the past few weeks. The US 10-year Treasury bond yield went below 0.40%, an all-time low. And credit spreads, which measure the difference in yields of bonds which possess credit risk (corporate bonds) and those with no credit risk (government bonds), have widened dramatically.

S&P 500 Sectors	YTD 2020 Return (%)
Information Technology	-11.9
Consumer Staples	-12.7
Health Care	-12.7
Utilities	-13.5
Communication Services	-17.0
Real Estate	-19.2
Consumer Discretionary	-19.3
S&P 500	-19.6
Materials	-26.1
Industrials	-27.0
Financials	-31.9
Energy	-50.5

Data Source: Morningstar Direct

We would anticipate a Phase 3 emerging at some point, though we do not know when that will be. The beginning of this could likely be characterized by a period when the incidences of infections begin to not necessarily decline but increase at a diminishing rate. It could also be when recoveries begin to more significantly accrue and accelerate. Markets sentiment might begin to improve, especially if part of these developments included the prospect for the creation of a vaccination and/or treatment down the line (though likely not complete until much later).

Frankly it need not be any of these developments to usher in a change in psychology. Any sustained progress in the availability and visibility of data, better testing metrics, or anything that provides greater understanding or clarity regarding the magnitude and direction of the health effects, and just as importantly, the economic effects should help diminish the fog of uncertainty hanging over markets.

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Regardless of what the data portends, positive or negative, the market will adjust accordingly and likely do so in a more orderly fashion. The uncertainty is the primary contributor to the massive market gyrations we have witnessed.

Economic Impacts

We entered 2020 in very good shape; January and February demonstrated strength in numerous economic categories. For example, 273,000 new jobs were added in both months, and the growth was broad-based across sectors. Additionally, housing starts for the months of December, January and February recorded both the strongest three-month total and three-month average since 2007. That has all changed, and it has done so quickly.

The Philadelphia Fed Index fell to -12.7 in March from last month's 36.7, indicating a massive drop in manufacturing. Initial unemployment claims for the week ending Friday, March 21st increased by over 3 million to 3,283,000. That is the highest seasonally adjusted number for initial claims recorded. Clearly the current unemployment rate will increase by a magnitude of two or more times from its current 3.5% in short order.

Of course, US Gross Domestic Product (GDP) growth estimates, are being cut. Estimates are all over the map, but it is likely that first quarter GDP (which for the first two-thirds of the quarter indicated approximately 2% growth) could decline by -2%, given what we saw in March. The second quarter decline will likely be a much more significant; accounting for effects on business investment, housing, autos, airlines, and durable goods orders, at least a 20% decline in GDP seems likely.

Corporate earnings estimates have and continue to decrease as well. According to FactSet, analysts had been expecting companies to generate in aggregate 5.0% revenue growth, translating into 7.4% earnings growth for 2020. For the first quarter, current expectations are that the S&P 500 will post a decline in earnings of -5.2% and growth in revenues of 2.0%; for the second quarter, an earnings and revenue decline of -10.0% and -0.4%, respectively. And at this point, estimates for full-year 2020 point to revenue growth of 2.0% and an earnings decline of -1.2%. We will not be surprised to see further downward revisions.

Chart 1 – No Cyclical or Structural Elements

#	Bear Market	
1	**Cyclical Bear Market**	Definition: Typically, a function of rising rates, impending recession, and falling profits
	Average Length: 27 Months	
	Average Drawdown: -31%	Status: Inflation remains contained and the Fed has accommodative posture
2	**Structural Bear Market**	Definition: Triggered by structural imbalances and financial bubbles
	Average Length: 42 Months	
	Average Drawdown: -57%	Status: Financial risk remains contained
3	**Event-Driven Bear Market**	Definition: Triggered by impermanent externalities
	Average Length: 9 Months	
	Average Drawdown: -29%	Status: Vulnerable to trade and geopolitical events

Source: Goldman Sachs Investment Research and GSAM. As of March 9, 2020.

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Event-Driven Contraction

We think it is important to highlight, though, that despite all that has happened, these events are not the result of the normal risks that cause "typical" cyclical or structural bear markets. Things like extreme leverage, an asset bubble, and runaway inflation are not present; standard sources of pressure like excess investment, an aggressive Federal Reserve (Fed), or spiking oil prices (or other input costs) do not currently exist.

What we have here is an event-driven scenario, where governments all over are purposely muting economic activity to balance two elements that are currently somewhat incongruent. On one hand we have the human and health element, where we are trying to minimize health risks, infections, and ultimately death through aggressive mitigation measures (i.e. social distancing). On the other hand, we have an economic element, where we are attempting to sustain economic activity, provide support to individuals and businesses, and working to make a recovery more probable and immediate.

Those are two separate goals that, though not entirely mutually exclusive, are largely at odds with one another at present. For one to be successful, there must be some give from the other. Therefore, global governments are making a calculated assessment, that the long-term results of these two dual goals will be most favorably achieved by dampening economic activity now; absorb a massive contraction in growth in hopes of containing or at least mitigating the spread of the virus, thereby, effectively shortening the duration of the event so we can more quickly resume normal economic and social activity.

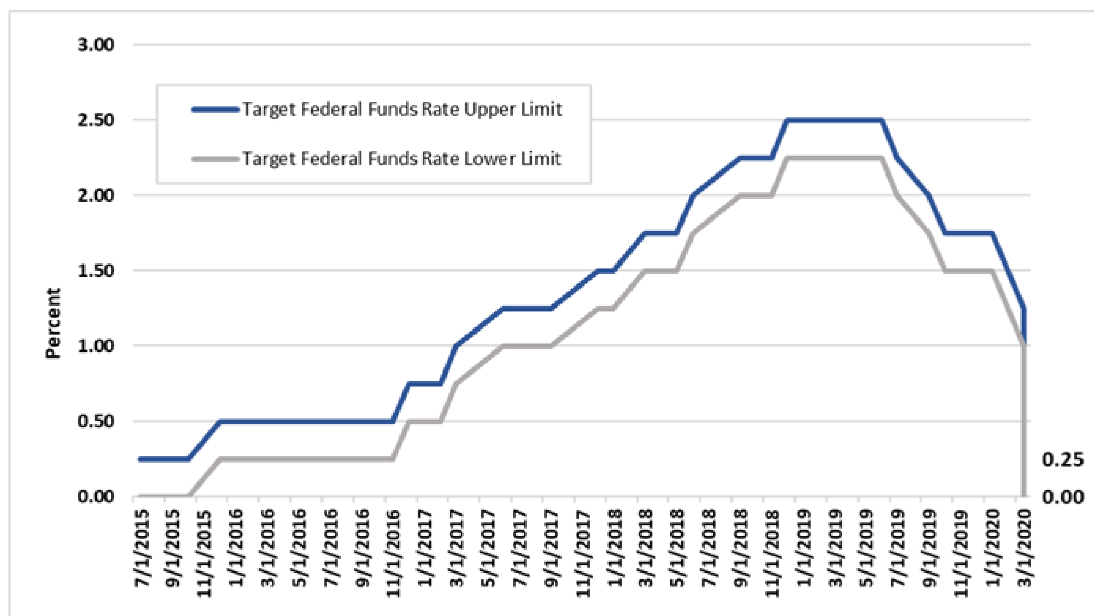
The strategy seems sound on its face. The obvious risk is that the economy's condition, at the point at which the pendulum swings to a more balanced position where economic concerns are not completely subjugated by health fears, will not allow it to adequately respond to resuscitation attempts as anticipated. The longer a purposeful economic hiatus endures, the weaker and more protracted the anticipated recovery.

Monetary and Fiscal Relief

All this written, we do not question an ultimate recovery in economic growth and global capital markets. The primary question revolves around what will happen in the interim and how long it will take. In response to the crisis, various monetary, fiscal, and regulatory levers are being pulled to enhance the likelihood of a quicker recovery.

We have already witnessed a coordinated monetary policy response from G-10 (G-10 represents the top ten industrialized economies) central banks, including the Fed's announcement of a return to zero-bound interest rates (Chart 2) and resumption of quantitative easing - including corporate bonds, both aimed to stabilize market liquidity and confidence in lending facilities. The Fed also reduced bank reserve requirements to zero, which allows banks to make more loans which improves their margins.

Chart 2 – Federal Reserve Fed Funds Target Range



Data Source: Federal Reserve via YCharts

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We are also seeing moves to implement looser fiscal conditions, even if temporary. Congress enacted the Coronavirus Aid, Relief, and Economic Security (CARES) Act, a two trillion-dollar economic rescue and support package providing subsidized lending programs, tax relief, job security, healthcare coverage, etc. The goal of these programs is to create an economic bridge for individuals and businesses alike. Depending on how things develop, there could be additional measures taken down the road.

Process and Opportunity
Periods like these are obviously painful and frightening for investors of all types. Whether you are a novice, professional, individual or institutional in nature, uncertainty elevates anxiety and other normal, emotional human reaction. However, putting the emotion to the side, episodes of significant market disruption do offer the opportunity to take advantage of price dislocations that frankly do not avail themselves too often.

Our Investment Committee process is predicated on a bias towards quality. Our sector and ultimately security selection procedure requires a strict attention to profitability, growth and value metrics. For a security to be considered for inclusion and preservation in any portfolio, all three of these metrics must be satisfied.

During these last few weeks, we have taken the occasion to insert companies that we have wanted to own for some time, but our process did not allow for it. These were companies that had demonstrated leadership (large and expanding market share) in their industries, profitable and efficient execution of their business, favorable and sustainable debt metrics, the ability to generate cash flow, and an articulated growth strategy being executed by capable management. However, they were trading at unfavorable valuation multiples.

As the primary factor in determining the long-term return potential on any investment is the price you pay to own it, we are always sensitive to value. As markets have fallen, and many very high-quality equities have fallen indiscriminately with the broad indexes, we have been able to execute on the purchase or repositioning of many securities that now satisfy our criteria.

As conditions evolve, and as markets fluctuate, our Investment Committee will seek to continue to capitalize on the opportunities we perceive and will continue to adhere to its mandate of executing a consistent process of discovering and owning companies exhibiting a quality bias.

Risk Assessment
There is no doubting the unprecedented nature of current events. The labor market is being disrupted, supply chains are under stress, companies are suspending stock buyback programs and dividends, and coronavirus cases continue to grow. A lack of a playbook makes it impossible to predict much of anything, and that includes the magnitude of, at this point, an almost certain recession.

Where the bottom is for the market and the economy is for anyone to guess. Predictions abound relating to the probabilities of best- and worst-case scenarios, but again, what markets do in response to any hypothetical is unknowable. As such, it is important for investors to use this occasion to assess, or perhaps reassess their risk tolerances.

The exercise of establishing one’s ability to tolerate market volatility in periods of market growth is one thing. It can be another thing entirely when real-world events exert actual pressure on investment balances, as there exists a tendency for some investors to underestimate their tolerance for risk in the hypothetical.

We are encouraging all investors to use this moment to evaluate their comfort level with their investment allocations. As our clients integrate their investment strategies with their financial planning objectives and have planned for enough liquid assets to weather periods of market turbulence, it is nonetheless a good time to confirm both your ability and willingness to maintain current levels of risk.

There is no question it will take some time, months and quarters or even longer, to sort out the economic damage that is being done. Eventually, though, we will no doubt have greater clarity on the duration and severity of the current crisis.

We do know, though, that the outbreak is going to end at some point. They always do. We also know that at some point pent up consumer demand should ignite a rebound in activity, leading to a normalization of flight-to-quality assets, and ultimately more stable markets. In the meantime, understanding that maintaining adherence to your financial and investment plans will afford you the greatest likelihood of successful financial outcomes as we move through current events.

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