First Quarter 2020

Quarterly Letter to Clients

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This letter has been one of the most difficult to write in a succinct manner. The world as we knew it dramatically changed in the First Quarter of 2020, by an upper respiratory virus that early in January was thought to just be a severe flu, but turned out to be something much, much more. By the end of the quarter, the whole world was in a state of anxiety and fear. The Novell Corona Virus, or Covid-19 has put the world in a state of suspended animation — in a self-induced coma — as governments around the world pondered the steps needed to contain the contagion. The improbable has morphed into the unimaginable, resulting in the unprecedented.

The virus is more contagious than originally thought, which quickly allowed it to gain pandemic status. In addition, the initial range of the rate of mortality was high enough to get world leaders' attention. War has been declared against the invisible enemy, which admittedly sounds like something out of a 1950's Sci-Fi movie, and has ramped up to a full, all-out battle. The enemy could be compared to a natural disaster on a global scale, combined with an economic shock that is similar to almost every company in the world experiencing a labor strike – with every worker heading home to wait for the call to come back to work. The negative economic impact has upended almost every major industry in the economy, with cancellations, supply chain shifts, and cash receipts all stretching the ingenuity of leaders to find a way to survive the impacts of Covid-19.

Governments, in a grand attempt to contain and mitigate the contagion, resorted to restricting citizen movements through social distancing and outright quarantine in the hot spots, with the hope that these actions would reduce the health crisis to a more manageable event. As the humanitarian issues grew, so did the economic impact of the government's actions. The prioritization of prevention over production resulted in the sudden stop in economic activity, which has threatened more than just the initial impacts of a temporary work stoppage. The loss of demand for goods and services is so widespread that, as it cascades throughout the economy, the ability to accurately estimate the final impact may be nearly impossible.

If COVID-19 wasn't enough, the second punch to the gut of the economy came with the mid-March announcement that Saudi Arabia and Russia could not agree on production levels at their most recent OPEC meeting. As a result, Saudi Arabia unilaterally announced an increase in production, which sent world oil prices plummeting to below $25 per barrel. The combination of increased supply and reduced consumer demand put energy related bonds and stocks in a tailspin, which caused added pressure to the already stressed capital markets. Normally reduced oil prices act like a tax cut for consumers, providing them with more disposable income. However, in this instance, consumers are sheltering in place, significantly reducing the demand for gasoline.

In an attempt to try to mitigate the financial impact of a temporary situation and not let it cause a permanent problem, governments responded with an unprecedented level of fiscal and monetary stimulus. The amounts are staggering. Just the top five G20 countries initiated the following fiscal measures during March, 2020[1]:

1. U.S.: $2.3 trillion (11% of GDP)
2. Germany: $189.3 billion (4.9% of GDP)
3. China: $169.7 billion (1.2% of GDP)
4. Canada: $145.4 billion (8.4% of GDP)
5. Australia: $133.5 billion (9.7% of GDP)

The Global Central Banks have also taken extraordinary measures. Here in the U.S., the Federal Reserve has reduced the Fed Funds Rate by 1.5%, while making numerous interventions into the credit markets in areas where markets became downright dysfunctional. The Fed has committed to increasing liquidity through Quantitative Easing as much as is necessary to stabilize the markets, which has already been reflected in the $2 Trillion increase in the Fed's balance sheet. They have also introduced a number of new lending facilities to support the flow of credit to consumers, small businesses, and large corporates, which was partially funded from $454 billion allocated to the Treasury in the CARES Act recently passed by Congress.

Prior to the Fed's intervention, corporate spreads widened significantly, with High-Yield bonds and marginal investment grade credits leading the pack with spreads of 1000 basis points or greater. Prices of higher quality bonds were put on sale, dropping 15 to 30%, with many bonds trading at $0.85 to the dollar. It's estimated that somewhere between $300 and $350 billion in marginal investment grade bonds could be downgraded to junk status.

[1] @howmuch_net @IMFNews https://t.co/WRaN7201dl

While both fiscal and monetary actions can provide a temporary stop gap to the personal pain of the economic crisis, the financial solution is intertwined with the timing of a resolution to the health crisis, which appears to be a moving target. People will not be able to return to some semblance of normal until they can be reasonably assured that they will either not contract the virus, or that suitable therapeutic drugs will be available to avoid the most serious consequences of catching the disease. Since the time it will take to fulfill either of these conditions is currently not known, the range of possible outcomes is quite high.

At present, the estimates of the impact to U.S. Gross Domestic Product (GDP) range from down -25% to -40% in the Second Quarter. This on the heels of the down draft in March, which most likely will put the First Quarter of 2020 near negative territory. A contraction of this magnitude is without precedent, and only adds to the uncertainty in trying to handicap the timing of a reversal.

The paralysis of the lockdown has come at a heavy cost. Almost two thirds of the 8.7 million jobs created since the great recession have been lost. In the first 3 weeks of the nationwide shut down, it is estimated that 17 million people could join the ranks of the unemployed. Tens of millions are expected to lose their jobs in the upcoming weeks.

Many companies are facing the real possibility that their inability to generate cash now may hamper their ability to service their fixed obligations in the future. This lack of liquidity could rapidly turn into a credit event. Just a few short months ago, the leverage created by issuing bonds to buy back stock and boost reported earnings per share was considered a main ingredient to the magic elixir served up by many Chief Financial Officers (CFOs). The rationale was that share buybacks were a tax-efficient way to return capital to shareholders, financed with the combination of excess cash flow and low-cost debt. However, the current economic shock has removed not only excess cash flow, but in many cases, cash reserves that bond holders and rating agencies take into account in determining the company's ability to meet their debt obligations. The major ratings agencies, looking towards the future, are less sanguine about the improvements that have been made in many industries over the past decade. In a short 90 days, companies may either be destroyed or have to totally reinvent themselves to avoid becoming a bankruptcy statistic. The grim nightmare is changing the lives of individuals and companies. Records are being broken at a breakneck pace, as the contagion rages around the globe. The road ahead will be long, difficult, and full of hard choices.

Bond and Stock Markets

The capital markets experienced violent reactions to the unfolding events related to the coronavirus. The "cash is trash" mantra quickly turned to a "dash for cash" as all capital market participants began to weigh the uncertainty and magnitude of the economic impact of the health crisis. Global capital retreated from riskier investments, in favor of higher quality U.S. Treasury Securities, forcing prices up and yields down. The flight to quality and the demand for dollars caused massive disruptions in credit markets, spurring the Fed to intervene with rate cuts and numerous programs to provide liquidity to those markets in dysfunction.

Yields across the maturity spectrum decreased on average 1.3%, with 1-month Treasuries falling to near 0%. Spreads on poor quality credits widened considerably, with sellers in the below investment grade category (aka junk bonds) increasingly not finding a willing buyer for bonds they wished to sell. In many cases, investment grade bonds saw similar market action until the Fed announced that it would intervene and "backstop" those markets that were not functioning properly. As a result of the Fed's intercession and the market's gyrations, interest rates fell precipitously during the quarter. The U.S. Treasury 10-year dropped 122 basis points from its December 31, 2019 level of 1.92% to end the first quarter at 0.70%. As the table below shows, higher quality fixed income securities were in the spotlight. In general, higher quality credits outperformed their lower quality counterparts, with bonds outperforming stocks during the quarter.

Time-Weighted Rate of Return Summary *As of 3/31/2020*

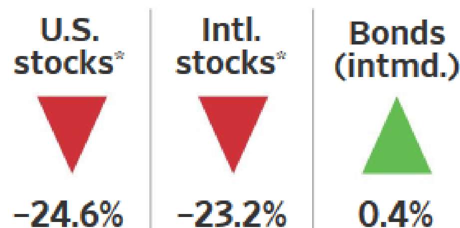
Bond Indexes	Quarter	1-Year	3-Year	5-Year
US Treasury Bills	0.6	2.4	2.0	1.3
Barclays US Gov 1-3 Year	3.0	5.9	2.9	2.0
Barclays Intermed Gov Bond	5.2	8.9	4.1	2.8
Barclays Intermed Gov/Corp	2.4	6.9	3.8	2.8
Barclays Muni Bond 5 Year	(1.0)	2.2	2.4	2.1

Stock Market Indexes	Quarter	1-Year	3-Year	5-Year
DJ Industrial Average	(22.7)	(13.4)	4.3	6.7
Dow Jones TTL Stock Mkt US	(21.3)	(11.0)	2.0	3.7
NASDAQ Composite	(13.9)	0.5	9.6	9.8
S&P 500	(19.6)	(7.0)	5.1	6.7
MSCI EAFE (NET DIV)	(22.8)	(14.4)	(1.8)	(0.6)

As the sheltering in place mandates spread across the country in tandem with reported cases of the virus, demand for goods and services dropped precipitously. By the end of the quarter, the S&P 500 recorded its 8th largest quarterly decline in earnings estimates, reflecting the impact of social distancing

policies that forced reduced hours of operation or outright business closures. The stock market experienced tremendous volatility and declined 34% in just 33 days, marking it the swiftest end of a bull market since the 1930s. This compares to the 10 months that in took to record a 20% decline in stocks during the 2008 financial crisis.

During the past quarter, the S&P 500 decreased -19.6%, while the Dow Jones Industrial Average (DJIA) plunged -22.7%, and the tech-heavy NASDAQ fell -13.9%. Investors lost their desire for riskier stocks, as smaller capitalization stocks underperformed larger and mega cap equities. As the Scoreboard graphic below shows, the average diversified U.S. stock fund was down -24.6%. [2] International stock funds only fared slightly better, marking a -23.2% decline during the quarter.



At this juncture, it is nearly impossible to try to predict both the health and financial impact of the coronavirus pandemic. We're in a truly unique situation that no one has ever experienced before. It is an historic time that most likely will be characterized by the tragic human toll seen around the world and the cost in lost economic growth required to slow the contagion. The government response is aggressive and forceful to try to bridge the gap created by the sudden stop of economic activity. Whether the actions taken will be enough to avert a deep recession is really dependent on the length of time it takes for the world to return to full employment.

From an investment perspective, it has never been more challenging to put capital to work. The speed of change in markets and the level of uncertainty

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[2] https://www.wsj.com/articles/u-s-stock-funds-first-quarter-damage-24-6-11586139120?mod=searchresults&page=1&pos=11

related to whether companies will be temporarily or permanently impaired by the virus is difficult to estimate.   In addition, the government interventions have, for all intents and purposes, nationalized the government and corporate bond markets. The impression that the Fed will backstop financial markets and keep rates at extraordinarily low levels, continues to skew valuations further away from the reality that business fundamentals validate.

Nevertheless, our strategy for client accounts remains focused on customizing portfolios to achieve the goals required to meet the purpose of the funds invested. We will continue to structure the fixed income portion of your portfolio with an emphasis on capital preservation and stable cash flow, while providing a reserve for near-term cash needs. The equity portion of your account is constructed to provide a combination of capital appreciation and dividend income to meet your long-term growth objectives and provide for future spending needs. It is never more important to maintain a disciplined approach to investing as it is during a time like we are currently experiencing. As such, we will continue our search for stocks that can be bought at prices that meet our investment standards, while selling those stocks that no longer meet our criteria.