Market Commentary

First Quarter 2020

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We must start this commentary by saying to each and every one of you that we sincerely hope this missive finds you and your loved ones both safe and healthy. Undoubtedly, this must be what is first and foremost in our minds. Everything else is a far distant second. To say we are in unchartered waters seems woefully inadequate. While we will discuss economic and financial market issues, this market commentary will differ a bit from our usual format due to rapidly changing events and the complete disruption of business (and life) as usual.

Just three months ago we discussed equity markets that had risen over 30% in 2019. We looked forward to a continued economic expansion along with modest interest rates during 2020. Stocks traded in a narrow range from the start of the year through mid-February before the economic implications of the global pandemic from COVID-19 began to affect financial markets. While we will discuss market returns and some basic economic data in this commentary, we are clearly facing "unknown unknowns" – a phrase attributed to former Defense Secretary Donald Rumsfeld, but originally described in 1955 by two psychologists, Joseph Luft and Harrington Ingham. They defined unknown unknowns as "*risks that come from situations that are so unexpected that they would not be considered.*" Some people refer to situations like these as Black Swan events. No matter how you refer to the current situation, the past few weeks have been among the most volatile in financial market history.

The disruption in financial markets was both sudden and severe. After peaking at an all-time high on February 19th, the S&P 500 began a dizzying descent that saw the benchmark index decline 26.75% in just 16 trading sessions to enter bear market territory. This marked the most rapid decline of 25% or more from a market peak in history. Stocks continued to decline further, reaching their nadir on March 23rd with a decline of 33.9% from the February 19th peak. US equities staged a strong – and to some, surprising – rebound in the last week of March, rising by 15.5% in the final six trading sessions. This brought returns on the S&P 500 for the full quarter to a decrease of 19.6% on a total return basis. This was the worst quarter for US equities since the fourth quarter of 2008 during the financial crisis.

Fixed income yields also swung violently, reaching all-time intra-day lows of 0.40% on the benchmark 10-year US Treasury note in mid-March, before rebounding slightly to end March at 0.70%, significantly below the 1.92% yield at the end of 2019. The Federal Reserve lowered the Fed Funds rate twice during the quarter for a total reduction of 150 basis points in an effort to combat the global slowdown caused by the COVID-19 pandemic. Fed Funds currently are in a target range of 0.00-0.25%. The significant decline in interest rates did not lead to gains across fixed income holdings except for US Treasuries due to a sharp rise in credit spreads. Bonds that had previously been considered "ultra-safe" such as short-term municipal bonds and agency securities saw their prices decline despite the fall in interest rates as investors demanded a larger premium versus Treasury notes and bonds.

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Economic and Market Outlook

We have recapped where we are now. The question on everybody's mind is, "Where do markets go from here?" The short answer is, we do not know with any degree of certainty. We have lived through many market panics and financial declines, but this one is truly quite different. It is very emotional and psychologically based. Economic data released during March showed a US economy growing at or above a 2% trend rate. Housing starts, pending home sales and new job creations all exceeded expectations in January and February. Clearly, this growth has already come to a screeching halt in the past few weeks. While we can wait for data to be released over the next few months for confirmation, we can state with near certainty that the US economy – along with most of the globe – is in a recession. Perhaps not as classically defined in economics, which requires a decline in real GDP for two consecutive quarters, but we are in a sharp decline in economic activity, nonetheless. Importantly, this recession is far different than nearly every other recession we have faced because it was not brought about by imbalances or excesses in the economy. As we stated earlier, the US economy was in very good shape as recently as late February. What we are facing now is more akin to a natural disaster, rather than a recession caused by high interest rates or a bubble in commodity prices.

Oil prices collapsed during the quarter, reaching levels not seen in over 18 years. The combined forces of a price war between Saudi Arabia and Russia and a sharp reduction in demand tied to a decline in economic activity, pushed oil prices down by more than 65% during the quarter using West Texas Intermediate as the benchmark. Oil ended the quarter at $20.48 a barrel as compared to $61.06 at year-end 2019. Our fair price range of $50-70 per barrel was based on supply/demand prior to the COVID-19 outbreak. With a precipitous decline in global demand caused by significantly less travel and the near shutdown of many airlines around the globe, it will be some time before oil price volatility subsides and a new price range is established. We believe oil will trade meaningfully below $50 a barrel until the US and other economies resume something close to normal activity. The small bright spot that lower oil prices provides is the benefit to consumers from lower fuel prices.

As we have written to you many times over the past years, corporate earnings ultimately drive equity prices. The challenge we have today is the huge range of possibilities for corporate earnings in 2020 and 2021. With little foresight into how the pandemic will play out, we cannot estimate earnings with any degree of confidence. We need to look out to a more "normal" economic environment and estimate when that will occur. With large parts of the economy essentially shut down currently, it will take months after the social distancing has ended for businesses to resume full operations. The question becomes, when do earnings begin to "normalize"? It will be some time in 2021 at best, but we may need to look out to 2022 for a better overall picture. Based on this, there are significant shortcomings to traditional valuation methodologies. We know with a great degree of certainty the US economy will contract sharply in the second quarter of 2020. The magnitude of the decline will be stunning but should not come as a surprise with so much of the economy shut down. Current estimates vary in a wide range from an annualized decline of 15% to 34% in GDP. An economic contraction of this magnitude has never been experienced in this country. Unemployment will rise sharply and could easily surpass 10% in the next month or two. Depending on how prolonged the social distancing guidelines persist, unemployment could rise significantly above 10% as we move into the summer months. Without dismissing these statistics, they are so distorted that we cannot read much into them. The sharper the decline, the more pronounced the eventual rebound will likely be.

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Portfolio Positioning

Client portfolios saw minimal position changes during the quarter as declines were seen in all asset classes and the speed and volatility of the declines made trading imprudent. We continue to believe growth stocks will outperform value stocks although some areas of value (financials, particularly) have sold off significantly and may be poised for a snapback when conditions improve. The disruption from the pandemic has reinforced our conviction in our focus on companies with strong balance sheets, and diversified customer bases or differentiated product lines. These companies sold off significantly in the market downdraft as well but should be better positioned to rebound when economic growth resumes.

Conclusion

As we look through the balance of 2020, we see many challenges, along with opportunities for the US economy. The one certainty will be elevated volatility in financial markets for some time. Until there is a resolution to quarantining situations and businesses can reopen, it is a fool's game to try to estimate the financial impact to corporate America. We have seen numerous companies withdraw their 2020 earnings forecasts recently. This trend will continue when first quarter earnings are released beginning in the next few days. Because of this lack of guidance – understandable in the current environment – we cannot formulate any definitive forecast for the economy or for corporate earnings. This deprives us of traditional valuation metrics. We do know the US economy was still growing close to 2% through February. Interest rates are extremely low and are expected to remain very low for a significant period of time. Inflation is sparse and aside from a few highly demanded items relating to COVID-19, pricing pressures are difficult to find. The combination of these factors helps form our mosaic that the decline in financial markets was based partly on psychological panic and partly on a sharp contraction in economic activity. We believe the "peak" in COVID-19 should come in the next few weeks. If new cases, along with fatalities from COVID-19 begin to decline meaningfully from those levels, we could see a resumption of economic growth during the summer months. That would lead to improved confidence among investors, and hopefully reduced volatility along with higher equity prices.

It would be foolish to try to conjure a fair value for equities under these circumstances. We can only look back to previous challenges the country has faced and look at what the economy and stock prices did at the end of those periods. We firmly believe it is always better to say "I don't know" than to make up a forecast. Looking back at the last sharp decline in US GDP growth of this magnitude, we need to go back almost 75 years. Following the end of World War II, GDP declined by 11.6% for the full year 1946 as the war effort came to a rapid halt. We do not see full year GDP declining by anything close to 11.6% as the third and fourth quarters should show sharp recoveries from the second quarter decline. Despite the sharp GDP decline in 1946, stocks fell by a bit over 12% during that year before starting a five-year run of rising prices. The situations are not identical, but they provide a reference point for analysis.

Individual investors tend to trade on emotion, enjoying rising stock prices, but getting panicked when stock prices decline, especially when there is a sharp and rapid decline. The old Wall Street saying, "stocks take the staircase up and the elevator down", has been shown a few times in the past couple of years. Having been in this business for several decades, we counsel that the best thing you can do in volatile times is nothing. This is not always easy, but it removes emotion from the equation. It is seen time and again that investors reach the point of maximum pain very close to market bottoms. If they sell their equities at that point, they have significant difficulty deciding when to get back in, thinking they will get

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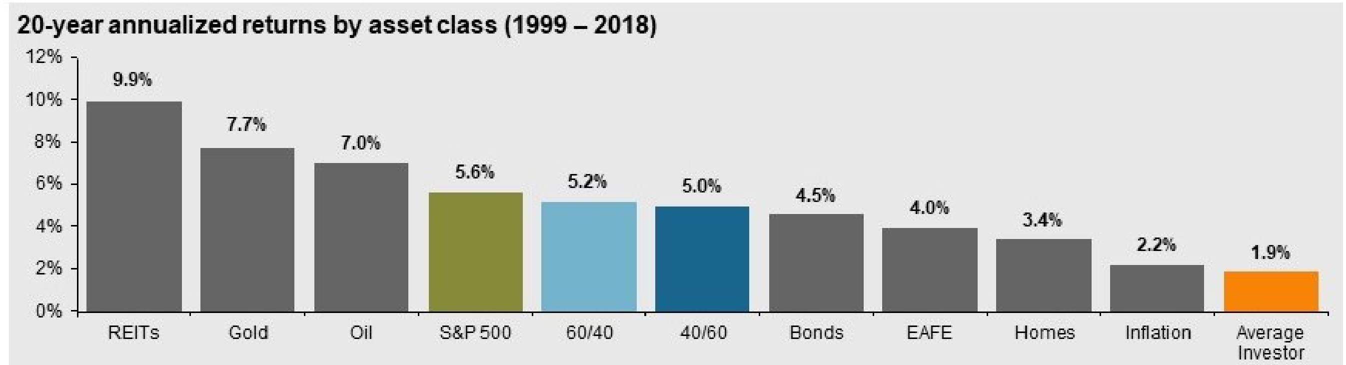
another chance to buy stock cheaply. Unfortunately, this results many times in investors watching stocks rise 10 or 20% from where they sold before they capitulate and buy back into the markets. This is why individual investors tend to lag not only professional investment managers, but also almost every asset class. This is best shown in the chart below. Even though investors may select the correct asset classes, they tend to trade at exactly the wrong time, to the detriment of their overall portfolio returns.



Source: JP Morgan

Stay safe and healthy.

March 31, 2020

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