FIRST QUARTER 2020

Market Update

We hope everyone is staying healthy and safe during this unprecedented crisis. What a difference a day, quarter, or decade makes! The euphoric investment environment and fantastic returns from 2019 have come to a halt. The year 2020 opened the new decade with a far bigger bang than anyone could have anticipated. This immense and unprecedented shock is transforming markets at a rapid pace, as the spread of COVID-19, massive unemployment claims, weaker economic data, and new government support evolves. Huge levels of uncertainty were exhibited with the stock market's worst quarter since 1987. Additionally, within a few weeks in March 2020, eight of the ten most volatile days occurred in the last 10 years. Just recently, in the first full business week of April, there was a huge rebound. The stock market had its best week since 1974. In fixed income, the entire U.S. yield curve temporarily dropped below 1%, something never before seen. As if one Black Swan event was not enough, the price of oil hit an 18-year low, down over 66% in the first quarter. These double black swan events generated sharp equity declines, dramatic bond spread widening, and volatility that hadn't been witnessed since the Great Financial Crisis (GFC).

Historical asset class total returns

	Total Returns			
	2020 First Quarter	**2 Year** (2018 & 2019)	**2010-2019** 10-Year	**2000-2009** 10-Year
U.S. Large Cap Equities	-18.2%	12.1%	13.5%	-0.9%
U.S. NASDAQ	-12.8%	15.2%	16.1%	-4.9%
U.S. Small Cap Equities	-32.7%	5.6%	11.8%	3.5%
International Equities	-22.7%	3.2%	6.1%	1.7%
Emerging Markets Equities	-23.6%	0.8%	4.1%	10.0%
High Yield Bonds	-12.7%	5.8%	7.6%	6.5%
Investment Grade Corporate Bonds	-3.6%	5.7%	5.5%	6.6%
Emerging Markets Corporate Bonds*	-14.9%	5.3%	6.4%	8.2%
Barclays U.S. Treasurys & Gov Index	8.2%	3.8%	3.1%	6.1%

Source: Bloomberg as of March 31, 2020

Note: U.S. Large Cap Equities – S&P 500, U.S. Small Cap Equities – Russell 2000, International Equities – MSCI EAFE Index, Emerging Markets Equities, MSCI EM Index, High Yield Bonds – Barclays High Yield Index, Investment Grade Bonds – Barclays Investment Grade Corporate Index, Emerging Markets Corporate Bonds – Credit Suisse Emerging Market Corporate Bond Industrial Index, U.S. Treasurys – Barclays Government and Treasury Index.

* Inception date is Sept. 28, 2001 for 2000-2009 returns.

Don't fight the Fed? Actions to combat COVID-19

Questions on the top of everyone's mind are how long will the lockdown last and what will be the effect on the economy. While much of this is evolving in real time, we do know the U.S. government announced the largest ever $2.2 trillion stimulus package (CARES Act) on March 27 to try and combat the negative impact of social isolation. To put this amount in perspective, the size of the U.S. economy is about $21 trillion, or a little over $5 trillion on a quarterly basis. This means the package amounts to approximately 40% of second quarter GDP. Whether or not this package is large enough, brings us back to our original question, regarding how long the shutdown will last. If the shutdown is short and the economic impact is largely limited to the second quarter, then this should have a substantial effect. However, it is also important to note that a large portion (nearly 40% or about $850 billion) of this package is in the form of loans versus money that does not have to be paid back. The $350 billion in small business loans can be forgiven. This is dependent on if companies keep workers employed, which isn't a given in this environment. Additionally, the government likely isn't done yet. Phase 4, could follow the $2.2 trillion stimulus package, which is already being discussed. It will likely include many of the components seen in the first CARES Act, with additional measures. It is also key that programs are put in place quickly, so businesses and individuals can pay their bills. During the 2008 financial crisis, it took three months to get individual stimulus payments out.

YTD government bond yield changes

	Dec. 31, 2018	Dec. 31, 2019	Mar. 31, 2020	Change
2-Year U.S. Treasury Yield	2.49%	1.57%	0.25%	-1.32%
5-Year U.S. Treasury Yield	2.51%	1.69%	0.38%	-1.31%
10-Year U.S. Treasury Yield	2.68%	1.92%	0.67%	-1.25%
30-Year U.S. Treasury Yield	3.01%	2.39%	1.32%	-1.07%
Japan 10-Year Government Bond Yield	0.00%	-0.03%	0.03%	0.06%
Germany 10-Year Government Bond Yield	0.24%	-0.19%	-0.47%	-0.28%
U.K. 10-Year Government Bond Yield	1.28%	0.81%	0.35%	-0.46%

Source: Bloomberg as of March 31, 2020.

The Fed is also taking countless actions to support the economy and provide liquidity to markets. Within just 12 days in March, the Fed cut the Fed Funds Target Rate (FFTR) 1.5%, to a range of 0-0.25%. Even before the emergence of COVID-19, a persistent macroeconomic theme has been low economic growth, low inflation, and low interest rates. These extreme low interest rates are a significant positive for stocks and for industries like housing and autos, which are sensitive to borrowing rate levels and consumer affordability. The 10-year U.S. Treasury bond yield ended 2018 at 2.68%. In 2019 the yield ended the year at 1.92% and it hit an all-time low of 0.32% in March. In the last three significant economic downturns, the Fed cut the FFTR approximately 500 basis points.

The very low level of interest rates today is limiting the Fed's ability to stimulate the economy and the financial markets. This was likely a contributing factor that spurred further action via quantitative easing and other programs (such as TALF – Term Asset-Backed Loan facility and lending to small and medium businesses). On April 9, the Fed announced a combination of new and an expansion of existing programs, summing $2.3 trillion. These very aggressive programs are comprised of loans to small and medium sized businesses, households, as well as U.S. cities and states. The lending program will allow companies that until recently were investment grade to receive loans. The Fed also announced it will backstop some riskier corporate debt. One example is allowing purchases of high yield bond ETF's. Never before has the Fed announced unlimited quantitative easing (QE). In the course of a few weeks, the Fed has already purchased around $1.3 trillion (year to date) in assets, increasing the Fed's balance sheet to over $6 trillion, or approximately 28% of GDP. During the 2008 financial crisis, the entire amount of QE over about a year and a half period totaled about $1.7 trillion.

Unlimited QE but no further ability to cut rates

Fed interest rate cuts		QE in $ billions	
1989	6.75%	Nov 2008 - Mar 2010	1,725
2001	5.50%	Nov 2010 - Jun 2011	600
2007	5.00%	Sep 2010 - Oct 2014	1,613
2020	1.50%	Mar 2020 - Dec 2020 *(Est)	3,300

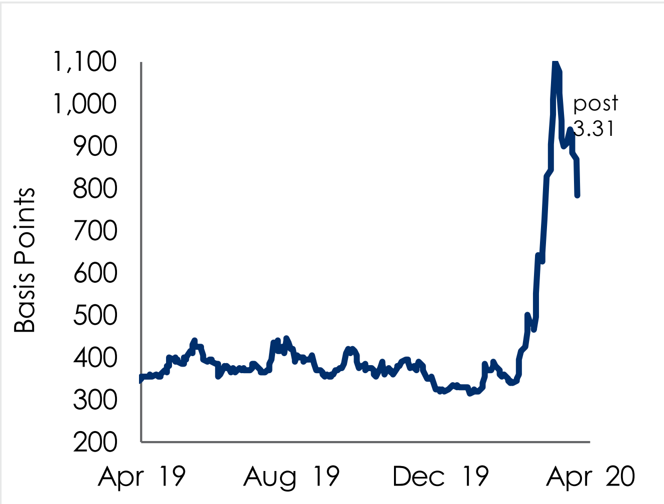
Source: Bloomberg as of 4/2/2020

March madness: Volatility, leverage, and speed

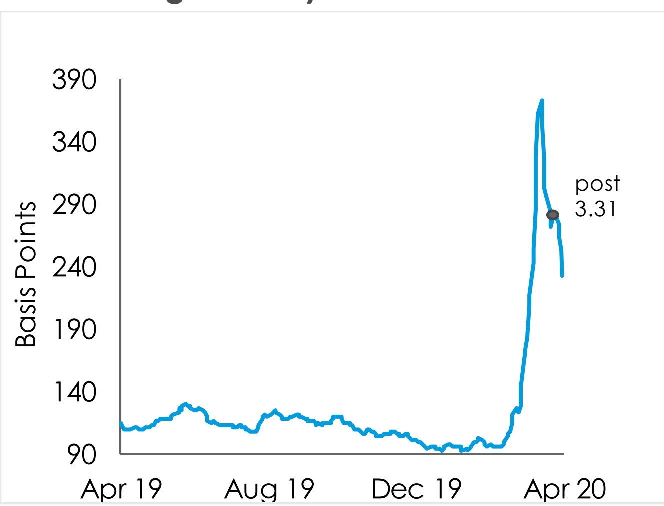
For all the basketball fans out there, unfortunately March Madness didn't take place in its traditional sense. However, anyone paying attention to financial markets could surely attest that March was indeed somewhat mad. Corporate bond investment grade spreads initially tripled in three weeks. The speed of bond widening outpaced the 2008 financial crisis. Spreads have subsequently tightened with the equity market rally and are currently well below financial crisis levels. The same dramatic move can be seen from the price of corporate debt ETFs. These fairly new financial products continue to exhibit very high levels of volatility.

Even though the current crisis evolved at a rapid pace, there are several positive factors relative to past recessions. This recession was spurred by COVID-19, whereas most recessions are caused by an underlying financial problem. In the case of 2008, the mortgage market and an overwhelming amount of risky asset backed securities spurred the economy's downturn. Fast forward to today, the U.S. housing market is far healthier and U.S. banks are much better capitalized. One of the chief surprises that came from the pullback in markets is the unhealthy amount of leverage that still exists in the system. While many were surprised by the sharp pullback in equities, the leverage and volatility in the fixed income markets was most surprising from our perspective. Once the markets began to decline, leveraged positions in both equities and fixed income breached market value covenants and a cycle of forced selling began.

U.S. corporate bond HY spread Bloomberg Barclays Index



U.S. corporate bond IG spread Bloomberg Barclays Index



Source: Barclays as of April 10, 2020

Another question on everyone's minds is, have we already hit the low in equities and the high in spreads within fixed income. This is a difficult question to answer because it depends on the length of the shutdown, the speed of economic recovery, and the effectiveness of existing and new government stimulus programs. As the spread of COVID-19 slows, less of the uncertainty lies in the length of the shutdown, but rather the speed of economic recovery. The answer to these questions is a chain of interdependent connections, which we have never experienced to this degree before.

The good news is the spread of the virus is showing signs of slowing, with new cases in New York starting to plateau as well as in Spain and Italy. However, even if the virus peaks in the U.S. within the next two weeks to a month, it doesn't mean we will go back to the same economy prior to the shutdown. Even with economies such as Japan, South Korea, and China open for business, many people still have not returned to their normal way of life. Small business closures and large retailers shutting down stores that won't reopen, will likely impact the unemployment rate and economic growth beyond the second quarter. We will also begin to see first quarter earnings soon. Investors will be more focused on company outlooks and projections than results just reported.

Economic pain to moderate recovery

In just the last few weeks, the US economy has lost almost 17 million jobs and second quarter GDP is expected to contract around 25%. These figures are incomparable to anything we have seen in the last 50 years. This data does not yet reflect the magnitude of job loss that will come from April figures, which will get reported in May. The unemployment rate could reach as high as 30%. The other concern is that until a vaccine is released, the economy may only return to 80-90% capacity, prolonging economic recovery.

When the economy does eventually recover, consumer confidence and consumer spending will be key to how the economy recovers. Consumer behavior and thinking will likely be altered by this pandemic. An increase in the household savings rate is likely. Amid the endless flows of quickly changing information we would like you to come away with the following themes.

- Investors need to reanalyze return expectations. With such low rates and economic challenges, we believe mid to high single digit annual returns will become the new norm.
- The downturn will also likely accelerate weaknesses that were already present in the U.S. and abroad, even during a strong economy.
- We have never experienced anything like the economic impact from COVID-19. The

government has taken unprecedented actions to close down the economy and also stimulate it. When our economy restarts, things will likely be different. Unfortunately, the longer term impacts are still largely unknown. Continue to focus on asset allocation and long term investing. Here are a few themes that could emerge from this crisis.

More people will be working from home in the future.

De-globalization could become a more prominent theme.

We could see a higher household savings rate weigh on the economy.

We could see social unrest if COVID-19 death rates and financial challenges are as high as predicted

Significant change can develop from this crisis. The economic uncertainty is substantial, but will be somewhat offset by very low interest rates, the Fed's aggressive lending and QE programs, as well as the governments hefty stimulus packages. We wish everyone good health and strength during this difficult time. It is our hope that in our next newsletter we will be through the worst of it and be able to share signs of stabilization and recovery. Until then, take time to enjoy the little things and stay positive.

Cliff Noreen and Ariana Lucera

Disclosures

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Description
The **Barclays Capital Long U.S. Treasury Index** includes all publicly issued, U.S. Treasury securities that have a remaining maturity of 10 or more years, are rated investment grade, and have $250 million or more of outstanding face value.
The **Barclays Capital Investment Grade Corporate Index** measures the performance of investment grade corporate bonds.
The **Barclays Capital High Yield index** measures the performance of corporate bonds rated below investment grade.
The **Standard & Poor's 500 Index** is based on the market capitalizations of 500 large U.S. companies having common stock listed on the NYSE or NASDAQ
The **NASDAQ Index** is a market capitalization-weighted index of over 3,300 common equities listed on the Nasdaq stock exchange
The **Russell 2000 Index** measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index.
The **MSCI EAFE Index** is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.
The **MSCI World ex US Index** captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries excluding the United States. With 1,010 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country
The **Credit Suisse Emerging market Corporate Bond Index** is a market-capitalization weighted index that tracks the liquid, tradable portion of the Emerging Markets USD corporate bond market
The **MSCI Emerging Markets Index** captures large and mid-cap representation across 24 Emerging Markets (EM) countries

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