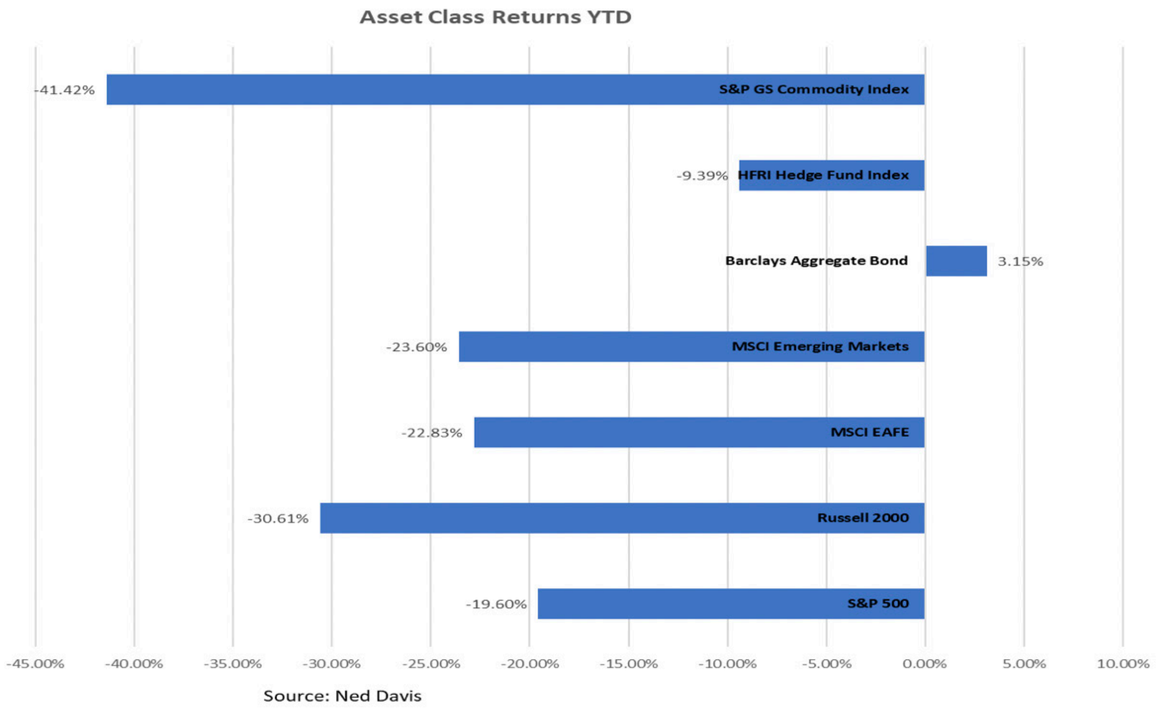
Market & Economic Review Q2 2020

Q1 2020 Review

The S&P 500 index dropped nearly 20% during the quarter, as the Covid-19 virus forced economies to go into shut down mode to slow the spread of the virus. All major asset classes took a significant hit, except for U.S Government Bonds and Gold. The decline in markets was due to the impact of voluntarily shutting down parts of the economy with social distancing and shelter in place.

The beginning of the year started out strong with U.S. equity markets reaching record highs late February. There was some concern with the coronavirus impacting supply chains in China, but no expectation of what was to come in March. February 23rd saw a major lockdown in Italy, and February 29th saw the first U.S. death from the virus, which set off a cascade effect across equity markets then credit markets. Travel and hospitality stocks began to decline in late February, as it became apparent that international travel was about to decline abruptly and significantly. The second week of March is when everything really broke down. On Monday the 9th, the 10-year U.S. Treasury Bond yield reached .38% and by Friday was back up to 1%. Reality set in on March the 11th when the WHO (World Health Organization) declared a pandemic and President Trump issued a ban on travel coming from Europe. The S&P 500 ended the week down 10%, while interest rates on the U.S. 10-year doubled and corporate bond credit spreads began to widen excessively. It became apparent that companies were raising liquidity to ride out the storm, which put pressure on banks to sell off Government bonds to provide that liquidity. The credit markets were seizing up and the Fed was forced to make a rare Sunday(inter-meeting) move, cutting interest rates to zero.

The S&P 500 proceeded to decline, further bottoming out on March 23rd with the announcement by the Federal Reserve that they were going to backstop corporate and municipal bond markets. From the peak on February 19th to March 23rd, the S&P 500 was down 34%. President Trump signed the largest stimulus package in U.S. history, with $2 trillion going to keep businesses afloat and workers able to pay bills until the forced shutdown subsides. By quarter end, the U.S. had approved over 12% of GDP to go towards limiting the coming recession with the ability to increase that to 30% of GDP. This amount of stimulus is multiples of what was utilized during the New Deal and Great Financial Crisis of 2008/2009. The question going forward is "will it be enough?" How will the immediate shut down of the global economy limit the loss of life while allowing for a quick recovery?



Economic Outlook

Typically, recessions aren't known until several months after they began. This time we know there is a recession, because we chose to push the economy into one in order to limit the spread of the virus. Because recessions aren't easily identified in the beginning, stimulus policies get implemented well into the middle of the average recession. In fact, if we look at the Great Depression, the New Deal was approved almost 4 years after the 1929 crash. This time around the stimulus is hitting very early on into the recession. In 2008, it took a while for the stimulus to really filter into the economy and that will likely be the case this time. The Payment Protection Plan (PPP) is designed to provide liquidity to small and mid-size businesses so that they can keep employees on the payroll and cover their rent. For those that qualify, the plan provides enough to cover 2.5 months for payroll. During the beginning of this crisis there was debate about how quickly the economy could open back up. The timeline started to appear longer with stay at home orders and social distancing. The most immediate hit was to travel and hospitality. Planes were no longer flying and restaurants across the country had to shutdown dining room service. It is expected that unemployment in the U.S. will reach nearly 20% sometime in the second quarter with GDP contracting anywhere from 20%-35% on an annualized basis. The first quarter likely saw a loss, with a significant slowdown in March.

Most estimates have GDP bouncing back in the 3rd and 4th quarters. To what magnitude depends on how quickly testing and treating the virus can be ramped up. The shutdown created a supply shock, where even if a consumer wanted to travel or eat out at a restaurant, they can't. As social distancing and shelter in place have become part of everyday life, there is uncertainty on how quickly demand will return to certain parts of the economy. Recent surveys show most Americans will likely not go to a theatre or restaurant even when they open back up. The pace of states opening, combined with different restrictions, could make it difficult for some businesses to operate at full capacity, due to supply chain issues. While there is pent up demand for many services it is likely to be met over the 3rd and 4th quarters rather than mostly in the 3rd as previously predicted. Testing is another big component on how quickly the economy can be opened. Many public companies will not want to face the negative publicity of sending workers back into the office or customer facing situations too soon. For these reasons we are likely to see smaller bounce back in the 3rd quarter and stronger bounce back in the 4th quarter than consensus.

As we wrote in the previous quarter's newsletter, we do not try to make precise predictions on economic statistics. As bad as the track record for forecasters was prior to March, it has gotten worse. We want to understand the consensus and determine if markets are pricing in that consensus. As of quarter end the market was pricing in a quick recovery mostly occurring in the 3rd quarter. We tend to think that the probability of a sharp recovery is lower than what is currently priced into equity markets. Predictions for unemployment in the 3rd quarter range from 15% to over 25% and for GDP to be down 20% to over 35%. The reality is, it doesn't matter where the actual number falls within the range; everyone knows the numbers are going to be bad. What is priced into the market is bad economic statistics in the 2nd quarter and a massive amount of stimulus to help offset it. What is more important is, when will there be enough testing, when will there be a treatment, and when will there be a vaccine? Answers to these questions will determine how quickly supply and demand come back into balance and a return to normal.

The end of June through the end of July will be almost as critical in determining how quickly the economy recovers. This when the PPP incentive to keep employees on the payroll runs out, as well as when the enhanced unemployment benefits expire. The two are diametrically opposed. The business owner is incentivized to keep workers employed, while many workers can make more in the short term from unemployment. If businesses that want to open can't over this period, due to this perverse incentive, then the process of opening will be pushed further out. While there is better support for mid-to-lower level workers and large companies, the resources for small and mid-size business owners is limited. They rely on revenue to generate profit which supports their lifestyle. How long can they hold on and how many businesses will not be able to operate in this environment? If strict social distancing rules are kept in place, how many businesses can operate at 50% of capacity? A lot of things will need to be pulled off perfectly to significantly get things moving to normal by the end of the 2nd quarter.

Equities

The first quarter of 2020, was the worst 1st quarter for the S&P 500 in its long history. It was a very short time between the peak on February 19th and the bottom on March 23rd. In fact, it was the fastest decline from a record high to a bear market on record. U.S. large cap growth stocks continued to lead with a decline of 12.5% versus a decline in U.S. small cap value stocks of 35.6%. We saw stocks that fit within the quality and growth factors hold up the best, while those with higher debt and exposure to value factors perform the worst. Within sectors, technology, healthcare and consumer staples performed the best, while energy, financials, and industrials were hit the hardest. Overseas we saw a big divergence with Asian stocks holding up the best

Large beats mid & small by most on record

Russell Cap-Weighted Total-Return Indices % Gain
12/31/2019 - 03/31/2020

	Value	Blend	Growth
Large	-24.22	-17.70	-12.54
Mid	-31.71	-27.07	-20.04
Small	-35.66	-30.61	-25.76

Source: Russell Data Total-Return

while India and Brazil were hit the hardest. In fact China, where the virus originated, held up just as well as the U.S. and better than Europe.

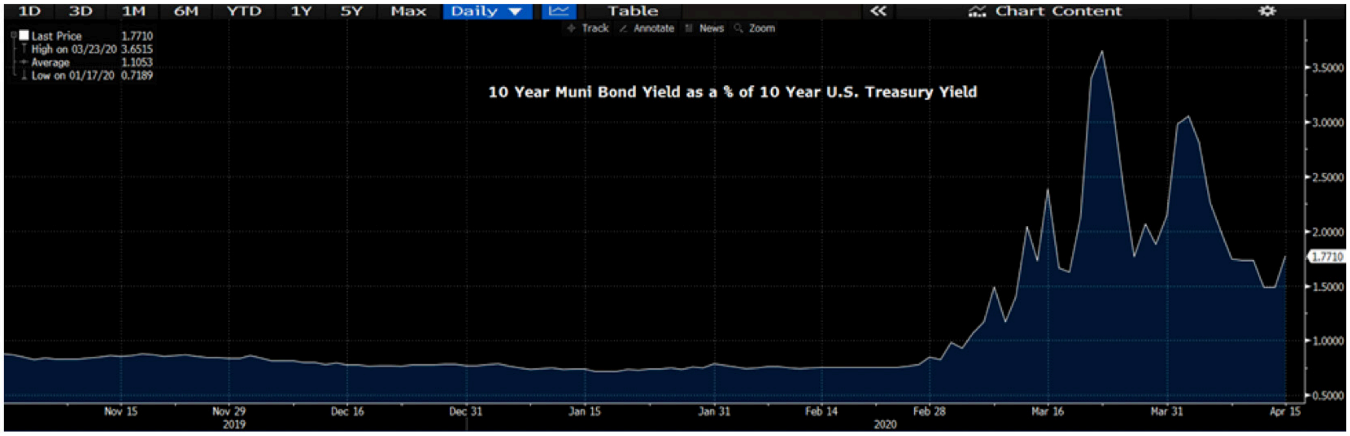
Our movement towards quality and more active mangement within small/mid-cap and international allocations paid off in the quarter. We saw significant outperformance by many of our managers and the ones that lagged were barely behind. While it is likely that growth stocks will continue to outperform value, we have not chased the momentum names. We are in an environment where growth names look expensive and value names still have earnings risk. The managers we own are looking for growth and stable earnings without paying too high of a price. These stocks have held up well, and in many cases valuations have become cheap relative to the long term. While we own value stocks that look historically cheap we are cautious of the current environment of low interest rates and slow growth. There will likely be a time to add to our value exposure, but for now we like the way we are positioned. With small cap stocks underperforming large cap our equity accounts have drifted to a more underweight allocation to small-cap. Instead of re-balancing fully back, we have instead added an allocation to mid-cap growth. Having significant exposure to healthcare and technology, mid-cap growth captures the lesser-known, higher growth potential companies in these sectors. We still see structural issues with small cap companies, primarily the amount of leverage they have taken on. It is likely we will continue to increase our active allocation to small/mid cap managers as well as international.

Fixed Income

The 10-year U.S. Treasury yield hit the lowest level on record March 9th as it briefly touched .38%. With the onset of the coronavirus there was a massive flight to safety. This flight to safety and need for liquidity led to massive dislocations in the credit markets. Corporate bond spreads to U.S. Treasuries widened out to levels not seen since the Great Financial Crisis of 2008/2009. Municipal bonds saw a major dislocation as the yield on a 10 year Municipal bond as a percentage of the yield on a 10 year U.S. Treasury went from 71% to over 350% in less than a month. Intervention by the Fed quickly sent spreads back down quickly.

Outside of U.S. Treasury bonds and Government backed mortgages, bond returns were flat to down for the month of March. While spreads widened out and came back in, they remained wider by month end. Many investors are likely to be surprised that most of their bond allocation did not provide as much protection as expected. With rates at record lows it will be harder to get the same diversification that bonds provided over the past 30 years. Rates are expected to stay low through the crisis, but at current levels they would have to go to or below zero to offset another major decline in equity markets. Longer term we are starting to think through the ramifications of all the debt that the U.S. government is taking on to cushion the recession. We saw a major increase in assets held by the Fed from the last recession, and we have seen a further increase in assets in the quarter. The Fed's balance sheet is now up to $6.5 trillion. At some point the debt will need to be paid off at the cost to future growth or inflated away in real terms.

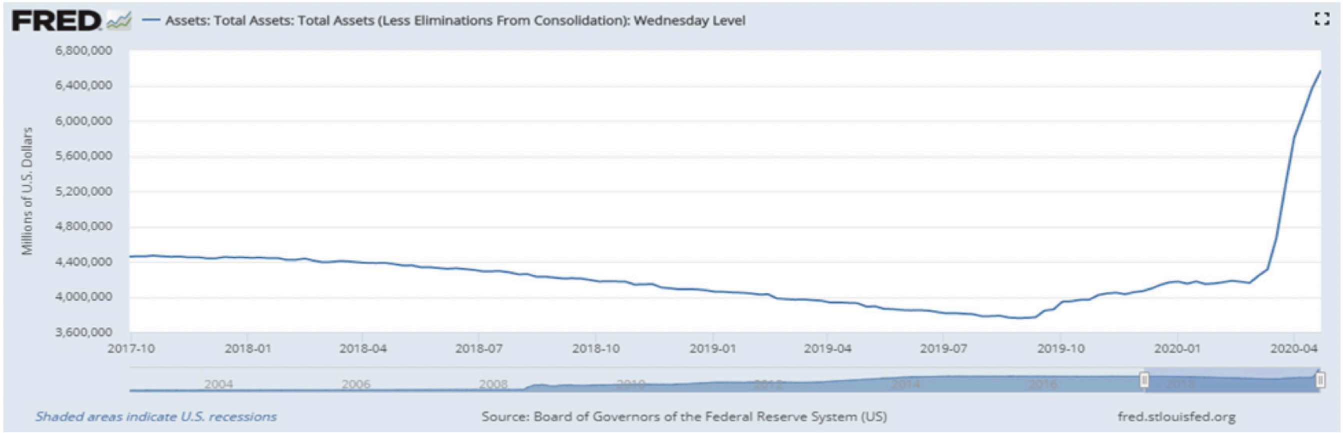
Our approach to fixed income is little changed. We continue to look for quality issuance at fair valuations. During the fixed-income dislocation in March, we were able to put money to work for many of our clients, purchasing bonds at extremely cheap valuations. With the support of the Federal Reserve, investment grade corporate bonds and municipal bonds should hold up well. While high yield bonds were attractive for a brief period, we feel that the risk is not worth the current yield.



Source: Bloomberg

Alternatives

With the selloff in equities, hedge fund strategies performed as expected. The HFR hedge fund index was down 9.39% for the quarter, which was about half of the S&P 500. Some managers were able to preserve capital in the downturn with a few seeing positive returns, which is indicative of our more diversified approach. The private equity space saw a quick halt to the heated action we saw in 2019. Many underlying companies have been marked up as equity valuations moved to record highs. In March, many term sheets got pulled and funds were focusing on their existing investments. Many of the up-close service companies such as travel, restaurants, and fitness studios are likely to see valuations come down over the next quarter or two. On the other hand, many of the technology-oriented companies that help companies work remotely and provide telemedicine will see valuations move higher. We did see a couple of our mangers (and underlying companies) use this as a chance to raise capital from existing investors to take advantage of these opportunities. We are on the tail end of committing capital in our 2018 vintage private equity fund and are in the process of starting our 2020 vintage fund. We will likely see opportunities in private equity secondaries and distressed, which are areas we have had less exposure to. Large institutional investors (such as college endowments) are going to be dealing with liquidity issues. That will provide opportunities in the secondary market, as well as less competition to access the best managers and deals.



Current Positioning

- **Equity:** Favor Large Cap and U.S.
    - Favor Quality and GARP (Growth At a Reasonable Price) managers
    - Adding to active management within our small/mid and international exposure

- **Fixed Income:** Quality bonds with average duration around 5 years
    - Core municipal and investment grade corporate bond allocation

- **Alternatives:** Environment for Hedge Funds is improving we are slowly adding exposure
    - Private Equity exposure is increasing with focus on small-mid buyout funds and co-investments with small to mid-size funds
    - Looking at secondaries and distressed
    - Adding to long/short exposure rebalancing from equities

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Disclosures