First Quarter 2020 Key Takeaways

The first quarter of 2020 has been an unprecedented period in U.S. financial market history across numerous dimensions. We just witnessed the fastest 30% decline from a recent high on record for the S&P 500 (in only 30 days). We have experienced historic volatility. And U.S. Treasury yields recently dropped to all-time lows.

Larger-cap U.S. stocks fell 20% this quarter, having rebounded a bit from their historic drop. Smaller-cap U.S. stocks have done even worse, falling 31%. Developed international stocks and emerging-market stocks both dropped around 24%. Much of the differential between U.S. and foreign stock market returns has been due to the appreciation of the U.S. dollar, which has risen roughly 2.5% year to date.

In the fixed-income markets, core bonds (Government bonds, plus investment-grade corporate, plus securitized Agency bonds) gained just over 2%, but outside of core bond funds most other bond categories struggled to play their role as portfolio ballast against the sharp short-term stock market decline. Floating-rate loan bonds, high grade corporate bonds, high yield corporate bonds, convertible bonds, emerging market bonds, global bonds, and municipal bonds all took it on the chin, dropping between 1% and 15%. Yields have been extremely volatile as well—shooting up on some days when stocks were also sharply selling off. The 10-year yield ended the quarter at 0.70%, down from 1.92% at year-end.

Our allocations to lower-risk fixed-income and diversified alternative strategies have offset some of the equity losses, but for the quarter largely underperformed my expectations as a stock market hedge. Treasury Inflation Protection Securities ("TIPS") was a bright spot in our portfolios, earning 1.68% for the quarter. Our allocation to PIMCO's multi-sector bond fund, the PIMCO Income fund, faired in line with peer multi-sector bond funds, but disappointed as the hedge I hoped it would be, losing 7.66% for the quarter, due to its holdings in high yield bonds and emerging market bonds. Bottom line, for this past quarter our portfolio diversification wasn't successful in countering a steep and quick equity downturn, but I remain confident in these holdings for the long-term.

The near-term economic damage from the United States' and other countries' response to the coronavirus outbreak now looks almost certain to be severe. GDP is expected to sharply contract, potentially by historic proportions, and unemployment is expected to rise to levels never seen before, with predictions as high as 14%, a level not seen since 1982.

The depth and duration of the recession (and the speed of the recovery) depend on the effectiveness of our medical and policy responses. A medical resolution is a "known unknown." But the Federal Reserve and other major central banks seem to be all-in to support markets. At the same time, governments around the globe understand something massive needs to be done quickly on the fiscal policy side.

On the brighter side…When stock prices—or any asset's prices—*drop*, forward-looking returns *rise*. My outlook for U.S. stock returns improved with their cheaper valuations. So, in the next few weeks I intend to take advantage of this bear market by increasing out allocation to U.S. stocks and away from developed international equities, which are dominated by financial stocks (banks), and banks are likely to struggle to grow earnings in the low interest-rate environment we currently find ourselves in. I will maintain exposure to emerging market equities, as Asian countries have done a good job containing the impact of the virus.

While the news may sound dark and hopeless at times, remember that this too shall pass. The world has faced many challenges and economic downturns and has always come out the other side. We are all facing unique risks and unknowns today, but we will bet on our resilience.

First Quarter 2020 Investment Letter

We are living through an extraordinary period in history that none of us will ever forget. The impact on our families, communities, and country has been profound. While several weeks ago we had reason for cautious optimism that the coronavirus might be largely contained to China, it is now obvious that is not the case. The United States and world are now facing the dual threats of a health crisis and an economic crisis. Both need to be fought with monumental government policy responses and individual behavioral changes.

I've frequently remarked that recessions and bear markets are inevitable phases within recurring economic and financial market cycles. I've also said there is *always* the risk of an unexpected "external shock" to the markets and economy (e.g., a geopolitical conflict or natural disaster). Investors need to be prepared for both to happen, but their precise timing is consistently unpredictable.

We will get through this crisis period. Our collective health, and the economy, will improve and recover. More importantly, I sincerely hope you and yours are able to remain healthy and manage well through this challenging period.

Market Update

The first quarter of 2020 has proven to be unprecedented for financial markets. U.S. stocks fell into a 20% bear market in the shortest time ever. They continued to drop and declined 30% in a record 30 days! Volatility, as measured by the VIX, reached its all-time high on March 16. Oil's 25% drop on March 9 was its biggest one-day drop since the 1991 Gulf War. Finally, 10-year and 30-year Treasury bond yields fell to all-time lows of 0.54% and 0.99%, respectively!

Larger-cap U.S. stocks fell 20% this quarter, having rebounded a bit from their historic drop. Smaller-cap U.S. stocks did even worse, falling 31%. Foreign stocks also suffered significant drawdowns, as developed international stocks and emerging-market stocks both dropped around 24%.

In the fixed-income markets, core bonds gained just over 3%, once again playing their key role as portfolio ballast against sharp, shorter-term stock market declines. The 10-year Treasury yield is currently at 0.70%, down from 1.92% at year-end. In contrast, higher-risk floating-rate loans and high-yield bonds suffered outsized losses, both dropping around 13%. Investment-grade corporate bonds were far from immune, losing over 4%.

Macro Outlook

I entered the year with an outlook for a moderate rebound in the global economy (especially outside the United States) on the back of reduced U.S.-China trade tensions and extensive global central bank monetary accommodation. My base case now is that the U.S. economy is headed into a recession in the second quarter. It is likely to be a severe one, with a sharp contraction in GDP and an unprecedented rise in unemployment.

The near-term economic damage from the United States' and other countries' response to the virus now looks almost certain to be severe (barring some unexpected major medical breakthrough in the near future). While I'm not in the business of forecasting economic data, the current Wall Street GDP forecasts for the first and second quarter are for annualized declines in the range of 9% to 34%.

The depth and duration of the recession—and the strength and timing of the ensuing recovery—depend on two key variables:

1) The effectiveness of our medical response and social policy efforts in flattening the curve
2) And the speed and effectiveness of our fiscal, monetary, and regulatory policy response

One lesson learned from the 2008 global financial crisis is that a policy response needs to be significant and executed quickly. Governments need to make a credible commitment to "do whatever it takes" to support the economy and prevent a negative spiral from taking hold. The goal is to hold the economy in a kind of "suspended animation" until there's a vaccine for the virus that will facilitate a return to our normal lives. The government has two tools it can use to inject money into the economy in its effort to forestall economic collapse: lending and granting money.

Lending (government monetary policy)

The Federal Reserve and other major central banks are the World's lenders of last resort. Their response has been swift. So far, they have:

- Reduced the Fed funds rate to nearly 0%
- Restarted unlimited asset purchase programs ("Quantitative Easing")
- Reduced reserve requirements for banks
- Expanded the asset purchase program to include collateralized mortgage backed securities ("CMBS")
- Restarted Term asset backed securities loan facilities ("TALF")
- Allowed municipal debt to be eligible as collateral in Money Market fund liquidity and Commercial Paper Funding Facility

The Fed seems to have gone all-in to support the fluid functioning of credit, lending, and financial markets, and their critical role as the "plumbing" of the real economy.

At the same time, governments around the globe understand something massive needs to be done quickly on the fiscal policy side. This is where granting money comes into play.

Granting (government fiscal policy)

On March 27, Congress passed, and the president signed into law, a $2.3 trillion stimulus package, the CARES Act, short for the Coronavirus Aid, Relief, and Economic Security Act. To put the scope of this stimulus in perspective, $2.3 trillion is 10% of the U.S. annual GDP! Similar support measures are being debated or implemented around the world. The CARES Act does the following:

- Grants one-time checks amounting to $1,200 per adult and $500 per child to qualifying citizens with income below certain thresholds. ($290 billion)
- Expands and extends unemployment benefits: adds $600 per week to every unemployment check for 4 months, expands the program to cover contractors and self-employed, extends the length of benefits from 26 to 39 weeks. ($260 billion)
- Extends loans to distressed businesses, cities and states, with particular attention given to industries considered important for national security. ($510 billion)
- Extends "forgivable loans" to small businesses to maintain payroll, rent and utilities. ($377 billion)
- Extends direct aid to state and municipal governments. ($150 billion)
- Plans for health-related spending. ($180 billion)
- Plans for other spending and tax breaks. ($516 billion)

Given the scope of the stimulus, one would be hard pressed to argue that the government isn't doing enough. The question is whether the execution of these programs will accomplish their intended goal.

While it appears that workers will be taken care of - through one-time $1,200 grants and expanded unemployment benefits - it's less clear that small businesses will benefit from the stimulus, at least as it's currently designed. Take the Paycheck Protection Program as an example…

Under the Paycheck Protection Program ("PPP"), qualifying small businesses are entitled to receive a forgivable loan of up to 2.5 X the average monthly payroll of the company. The loan is forgivable *provided* the company spends an equivalent amount in the 8 weeks immediately following receipt of the loan, 75% of which must be spent on employee payroll.

So, let's assume that our fictional company, ABC Retailer, receives a loan of $250,000 (2.5 X its average $100,000 monthly payroll). Knowing that the loan is forgivable ONLY IF it spends the money on payroll in the 8 weeks following receipt of the funds, the company continues to pay its employees. But the business is still prohibited from opening to the public, so it's not generating any income that would help to sustain operations beyond the 8 weeks. Once the eight weeks have passed, the loan is forgiven, but assuming the business is still not operational, then ABC Retailer is right back where it started, and without revenue to pay employees, it will have to furlough workers. The workers, in this example, can then apply for unemployment benefits, but ABC will need to close its doors.

Of course, if we assume that ABC Retailer is allowed to open to the public at the end of the 8 weeks, then the program will have succeeded in keeping ABC in business long enough to restart operations. However, if ABC is still not allowed to open its doors to the public at the end of the 8 weeks -- a more likely scenario given the health uncertainties of the virus -- then the net effect of the program will have been to forestall when ABC's employees must apply for unemployment benefits, and the program will have failed at one of its intended goals: keeping ABC in business long enough to survive the virus and resulting economic shutdown.

Absent a second round of forgivable loans at the end of the 8 weeks, some of these small businesses may never reopen, and that will be a tragedy for the business owner, the employees, and for the communities they serve.

Of course, I would miss the point entirely if I didn't draw your attention to the fact that our economy is in a state of constant evolution, and one thing is certain: other businesses, perhaps better and more dynamic businesses, will rise to take the place of those that fail. Just as fire devastates a landscape and clears the way for smaller plants, now out of the shadows, to thrive, so is the case with business failure.

Portfolio Positioning

In a well-balanced portfolio, there will always be winners and losers. Some positions, like U.S. stocks, work well in bull markets like we've experienced this last decade; other positions, like Treasury Inflation Protected Securities, shine during tougher times when stocks are doing poorly, like the first quarter of this year. Put together, they build resiliency into the portfolios of those clients who aren't in a position to simply "ride out" the tough times. Having positions in a portfolio that fair well when stocks do poorly does come at a price. Not to put too fine a point on it, but the long-term performance of balanced portfolios has consistently tracked with the level of stocks in the portfolio: the more stock, the better the long-term performance.

Each time there's a significant disruption in the markets, as we've just experienced, I find myself advocating for clients whom I feel are too conservatively invested to move more of their money into stocks. Where I've been unsuccessful in convincing these clients to follow my advice, I've (eventually) regretted not being more forceful in my advocacy. With this in mind, over the next few weeks I intend to update portfolios to increase exposure to stocks across most models, and I intend to advocate that particular clients take on risk where they have the capacity to do so.

There are, it seems to me, a couple of ways we can respond to the Coronavirus crisis and its impact on stock markets. It should be obvious, if you know my philosophy, that neither involves panicking and selling stocks.

One is to immediately increase exposure to stocks and to do so despite (or because of) how problematic the near-term outlook may be. The other is to wait until the market has clearly bottomed, and to chase it as it rallies. On the whole, I'd rather do the former. That is, increase exposure to stocks when they are so battered (and the investing public terror-stricken) that their long-term value as operating businesses far outweighs the very real risk that their prices will temporarily fall even lower in the near-term. For this strategy to work in practice, though, one must abandon any fantasy of "buying at the bottom."

It will be especially important to look past all the media prattling about "the recession." Of course, there's a recession, and we're already well into it. For some period – this quarter and probably next – it's going to be quite serious. Where does that leave us? More to the point, do you suppose the market doesn't know this, and hasn't already discounted it to some very significant extent?

It seems to me that with the S&P 500 at 2789 as I write this, and with the VIX (volatility index) having closed at a new all-time high of 82.69 on March 16, at least some of the big undiscounted risks are actually to the *upside*. Can you imagine how the market will respond to a successful vaccine, and/or the inevitable decline of the pandemic?

Closing Thoughts

During these historic times, it is paramount to stay disciplined and recognize when emotion rears its head in investment decision making. If we invest based on emotion, we are very likely to exit the market *after* it has already dropped meaningfully, locking in losses. By the time the discomfort and worry are gone, the market will *already* be much higher. Fear and panic are not the ingredients of long-term investment success.

Global markets have endured severe challenges and economic downturns in the past and have always weathered the storm. Attempting to time the market's tops and bottoms is a fool's errand; however, incrementally adjusting portfolio allocations in response to changes in asset class valuations, expected returns, and risks can be highly rewarding to long-term investors.

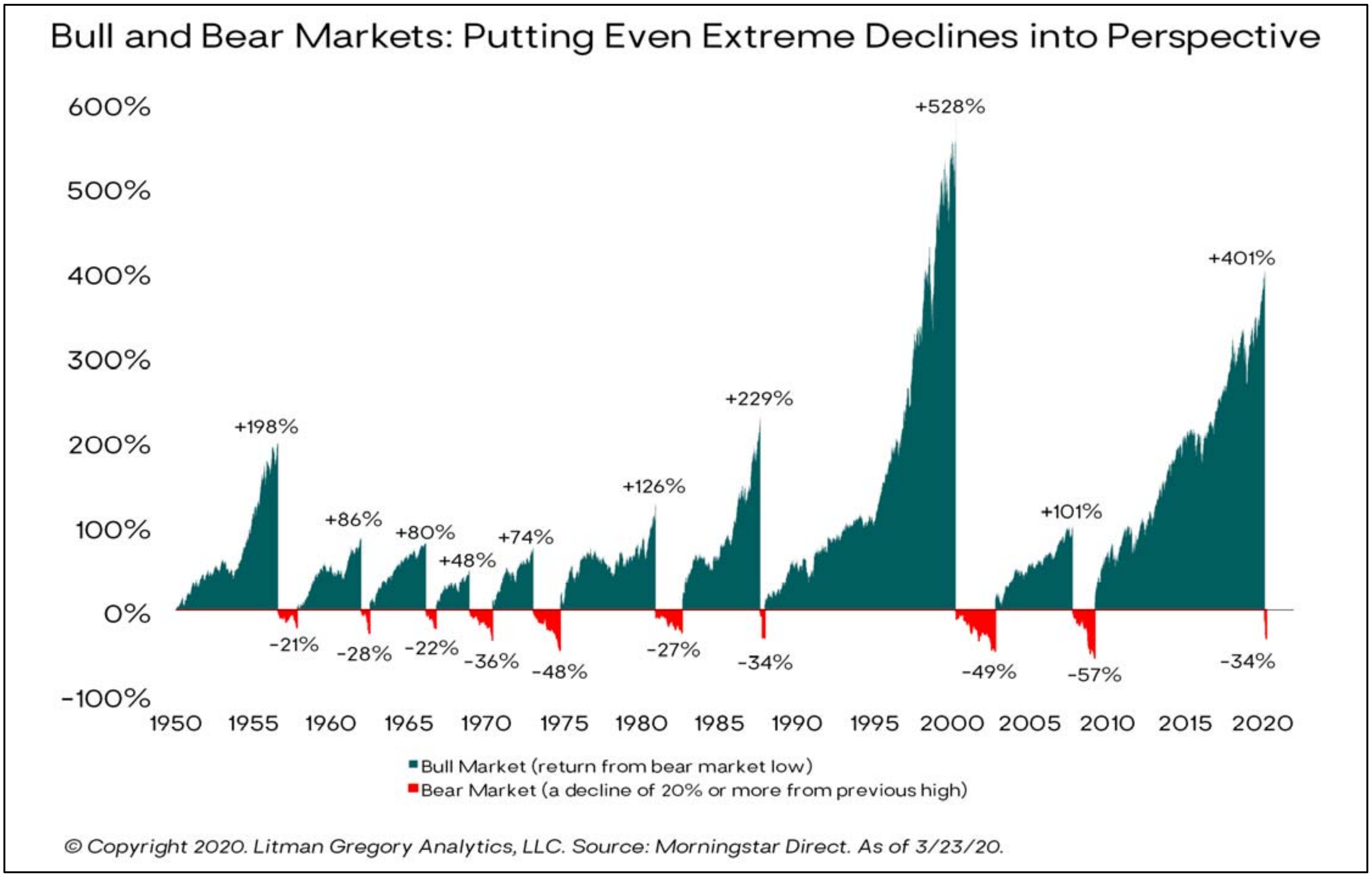
The time to be adding to stocks and other *long-term growth* assets is when prices are low and markets—and most of us personally—are gripped by fear and uncertainty rather than complacency, optimism, or greed. It may seem like the market could just keep dropping with no bottom in sight. But that is exactly where research, analysis, patience, experience, and discipline in one's investment process come most into play.

The precipitating event for the recent volatility is something none of us have experienced before: a global pandemic and an extreme societal response. One in two Americans now live under lockdown (and maybe more by the time you read this). Our medical infrastructure could be overwhelmed. We are almost certainly in the midst of a global recession. Facing this dual medical and economic crisis, the situation is probably likely to get worse before it gets better. I would love to be wrong. But it *will* get better.

The future is uncertain but my investment playbook remains the same: diversify; balance long-term returns with short-term risks; buy low into fear, sell high into greed. Stay the course.

Best,

Kelly D. Kane, ChFC, CFP


Bull and Bear Markets: Putting Even Extreme Declines into Perspective
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+401%
-34%
Bull Market (return from bear market low)
Bear Market (a decline of 20% or more from previous high)
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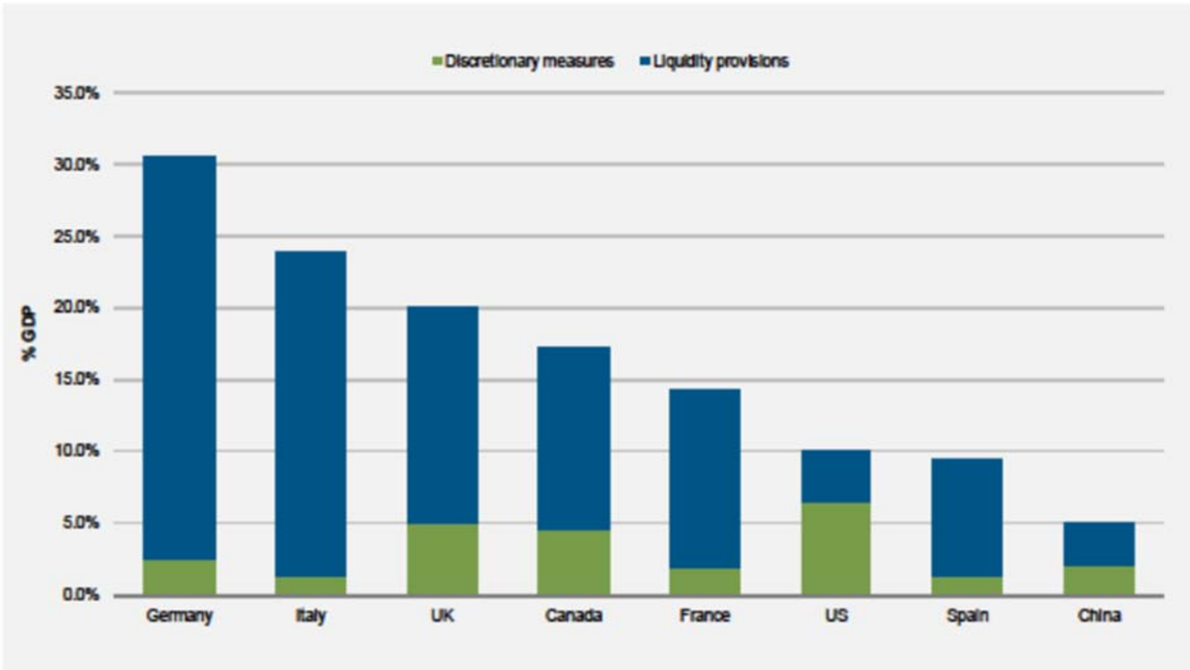
Alongside a large fiscal response, aimed at both liquidity and solvency



As of 21 March 2020
Source: PIMCO, National governments and central banks.
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