



## Coronavirus Halts the Bull Market April 2020

My Dear Client:

First and foremost, I hope that you and your family are healthy and well.

Last quarter, as the market surged and continued to push higher thru February, I asked, “Welcome to the Roaring Twenties? Or the End of a Great Ride?” I wondered whether the market could continue unabatedly higher like a balloon defying gravity or (my opinion) we were in fact on the cusp of the end.

The state of the economy changed drastically since last quarter's end. The rapid spread of COVID-19 is the type of large, unpredictable, exogenous, global shock, referred to as a "black swan" event, capable of sending the world into recession. Which it surely has – and abruptly ended the longest bull market in U.S. history, too.



This quarter we experienced all time U.S. market highs in February only to see markets plunge during the following 30 calendar days more than 30%. Including the biggest one-day point drop in Dow 30 Index history: -2997 on March 16. The Federal Reserve responded quickly to liquidity concerns and economic fears by lowering interest rates 1.5% to a target range of 0.0% to 0.25%. Additionally, the Fed enacted emergency lending programs to keep credit flowing in nearly every part of the economy.

Investors braced for an impending recession by selling equities and cyclical commodities in favor of safer government bonds and gold. Within equities, Growth protected more than Value, Large-Cap outperformed Small-Cap companies and U.S. fell less than International equities. Fixed income market investors, sought higher quality, longer-dated bonds. The 10-Year Treasury yield ended the quarter at 0.7%. WTI Crude Oil slumped -66.5% as Russia and Saudi Arabia increased production even as demand fell. Consensus among economists is that a recession is imminent with a potential double-digit GDP contraction in Q2 2020.

Jobless claims surged 10 million over the last two weeks in the quarter and by 12 million more in the first half of April. The March jobs report showed a net loss of 701,000 jobs with unemployment rising to 4.4% from 3.5% at the start of the year.

Policymakers have acted swiftly. Never outside of war has the simultaneous quarantine of so many billions of people occurred. Whether mandated by the government, compelled by health professionals or undertaken voluntarily, the global stoppage of daily human activity has reduced economic activity to a subsistence crawl. The bipartisan \$2.3 trillion U.S. government relief bill (CARES Act) is expected to provide funding payments to individuals, broader unemployment benefits, loans to small businesses, airlines and critical defense businesses. Additional support for small business, hospitals, virus testing and likely state governments is on the way.

History will decide if this unprecedented aid – much of it tax-free – can keep citizens, business, and the country as a whole, solvent to re-emerge and restart “normal” economic activity.

## Domestic Equity Market



In a terrible first quarter, as a style Growth outperformed Value more than 12%: The Russell 3000 Growth dived (-14.9%) while the Russell 3000 Value Index slumped (-27.0%). Investors favored Large-Cap (-20.2%) over riskier Small-Cap (-30.6%). The worst-performing style was Small-Cap Value, which fell (-35.7%) while Large-Cap Growth protected the most during the downturn, with a return of -14.1%.

The traditional defensive out-performed cyclicals among the 11 S&P sectors. The economy-sensitive sectors (cyclicals) of Financials (-31.9%), Industrials (-27.0%), Real Estate (-26.1%) and Materials (-19.2%) fell sharply while Energy super-cratered (-50%). Communication Services (-17%) and Consumer Discretionary (-19.2%) were down as expected.

Energy companies faced the double whammy of significant pressure given Saudi Arabia's and Russia's decision to rapidly increase oil production while global demand fell off a cliff. The Information Tech (-11.9%), HealthCare (-12.7%), Consumer Staples (-12.7%) and Utilities (-13.5%) protected on the downside, dropping less than the S&P 500 as demand for these products and services continued even during social distancing.

In general, the grocer and consumer packaging companies, along with technology companies that provided in home entertainment, delivery, or communication services, saw sales surge.

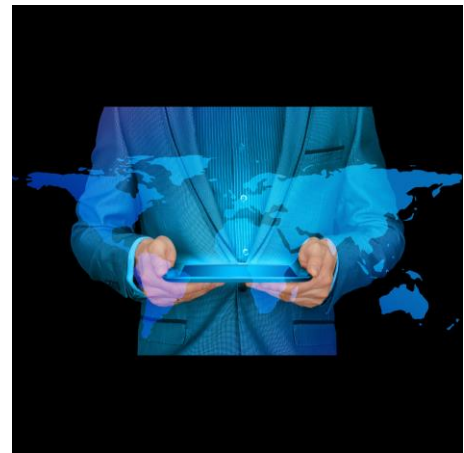
## International Markets

Fears of the COVID-19 and its rapid spread worldwide sent international equity markets lower, nullifying the optimism created by last quarter's subsiding of the U.S.-China trade war. The ravages of the disease showed no bounds and respected no borders, infecting even heads of state like Prince Edward, Prince Charles, and British prime minister Boris Johnson.

More volatile emerging-market equities (as measured by the MSCI Emerging Markets Index) fell (-23.6%) and developed international equities as measured by the MSCI EAFE Index (net of taxes) fell (-22.8%). Like in the U.S., Growth stocks held up better than Value across international markets.

Within developed markets, Switzerland (-11.5%) and Japan (-16.8%) fared better than commodity-oriented Australia (-33.3%) and countries heavily affected by the virus like Spain (-30%) and Italy (-29%). Within EM, the worst-performing countries not surprisingly were also commodity exporters: Brazil (-50.3%), South Africa (-40.4%) and Russia (-36.4%). In contrast, China was the best-performing country, falling only -10.2% during the quarter despite its central role in the global crisis.

The Chinese, via their proactive testing, tracing and aggressive quarantine policies, were highly effective (at least according to numbers the Chinese government has released) in mitigating the spread of coronavirus and began opening their economy in March. My skepticism stems from our never being able to fully accept initial economic data out of Beijing; the same is likely true regarding COVID-19 data.



## Bond Markets



The U.S. bond market, as measured broadly by the Bloomberg Barclays Aggregate Index, delivered a 3.2% return in Q1. Fears related to the coronavirus and recession caused widespread panic, leading to a dash for liquidity and the security of U.S. debt.

During the quarter, cross-asset correlations spiked, credit spreads widened and liquidity evaporated from the market. The Fed was compelled to take immediate action to preserve market stability in a growing panic, enacting several programs last seen during the Financial Crisis of 2007-2009: lowering the federal funds rate back to 0%-0.25%, providing “unlimited” quantitative easing and offering several credit facilities designed to enhance broad liquidity.

The Fed’s action served as a gravitational force, pulling yields across the U.S. Treasury curve down to record levels that were once unimaginable. The bellwether 10-Year Treasury yield dropped from a paltry 1.9% at the beginning of the year to 0.7% at the end of Q1.

Investors seeking the safety of U.S. Treasuries benefited in Q1 with a return of 8.2%, while those invested in U.S. corporate credit faced downside pressure of potential defaults. Corporate issuers experienced a material repricing during the quarter, with concerns rising about their ability to service a large debt burden in the coming quarters with customer activity (and thus revenues) reaching a standstill. Investment grade corporate debt returned -3.6% while high-yield issuers delivered a fear-based -13.1%. Monetary and fiscal actions could provide the needed support for liquidity constrained corporate issuers during these uncertain times – we hope.

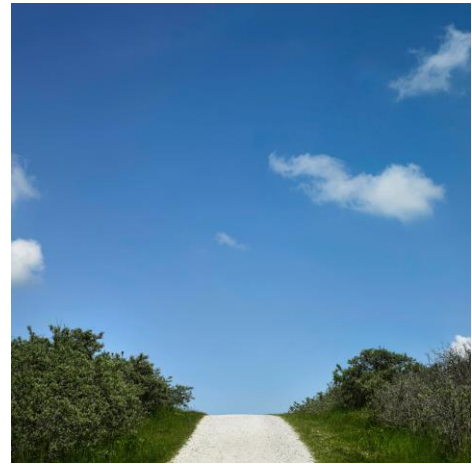
Similarly, I note municipal bonds returned -0.6% in Q1, lagging taxable peers by a wide margin. Munis experienced significant outflows this quarter. High-yield municipal bonds were the worst performing sector, down 6.9% while the high-quality pre-refunded municipal bonds cushioned downside price action and delivered 0.02%. Municipal bonds, which are typically tax-free and collateralized either by assets or the state that issued them, are signaling that the market is concerned about solvency within many U.S. jurisdictions.

The next few quarters will lay bare all of the mispriced risk in the corporate and municipal debt markets fueled by a decade of low interest rates, abundant Fed stimulus dollars, the craving of higher yields at any cost, and lenient loan terms (aka covenant-lite debt terms).

## A Look Ahead

At this moment we know what we know, we know what we don't know, and what we don't know has quite a range of outcomes. Tragically we may not yet have seen the worst of the human impact from the spread of coronavirus. I expect the number of confirmed cases and deaths to grow in magnitude and in geographic dispersion. Additionally:

- The longer the global economy remains in shelter-at-home (lockdown), the negative impact to growth will increase at a faster rate. The spillover effects into more areas of the economy and capital markets, such as furloughed workers longer at home leading to the bankruptcy of more retailers.
- The oil meltdown has recently caught headlines because of negative oil prices, but throughout 2020 the price has steadily trended down and is now caught between oversupply and diminished demand. While the impact on the US, it's longer implications for commodities and Emerging Markets economies dependent on oil will be negative.
- U.S. growth is likely to take a hit of historic proportions in 1H20 followed by a second half of the year that depends entirely on unknowns of the peaking of new infections, the timing of lockdowns beginning to unwind, and how much higher unemployment restricts consumption in a service-based economy.
- Globally before the COVID-19 epidemic numerous major economies were on the brink of recession, but this global lock-down will push every country impacted into a recession. This will have a significant impact on which traits investors will prefer.
- Bond interest rates will be historically low for a while which will have an outsized impact on expected yields, diminished returns from diversified portfolios, and mute the impact of high debt for countries.



The powerful stock market rally in the U.S. that began in late March and continued into April with talks of a V or U-shaped recovery all seem a bit premature and overly optimistic – especially remembering the last time there was a fear-based economic slowdown.

University of California, Berkeley economists Emmanuel Saez and Gabriel Zucman, renowned for their work on economic inequality, reminds us that the closest thing to a [comparative] metric we may have is the resumption of air travel after 9/11 — until now, the most abrupt shutdown of U.S. commercial activity in modern memory. Civilian domestic flights were grounded for only two days, Sept. 11 and 12, 2001, but the slowdown in business persisted much longer: U.S. air passenger counts fell from an all-time peak of 65.4 million in August 2001 to only 35.8 million that September.

Despite the resumption of flights, passengers remained wary of flying; stricter security arrangements including confiscation of possibly dangerous implements and a slow ramp-up of air marshal coverage contributed to the falloff in flying. Passenger traffic didn't return to pre-9/11 levels until July 2004, *nearly three years after the attacks*.

Today, airline activity including passenger traffic and flight routes is currently at 5% of its normal levels  
...

In the last few quarters, I spoke of the U.S. bull market being closer to its end; thus, we have been reducing our equity exposure, raising cash and looking at conservative fixed income or opportunistic private/alternative investment opportunities. My portfolio considerations remain consistent with those recommendations of the past few quarters. **Maintain a focus on a risk-balanced, multi-asset class approach, and evaluate opportunities when larger short-term declines occur.**

Consider the following:

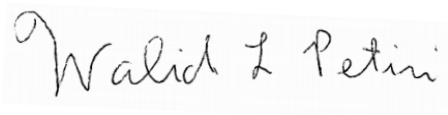
- Maintain overall U.S. equity allocation to portfolio targets and below maximum range;
- Prepare to use cash that was raised from Large-Cap and other U.S. equity sales for new investments;
- Direct fixed-income portfolio allocations to high-quality bonds and proven opportunistic credit strategies;
- Seek niche and opportunistic illiquid private investments;
- Review prior asset allocation adjustments in public equity assets preparing for further corrections;

At this moment there are too many unknowns to warrant hyper-enthusiasm or increased exposure to equity market risks in lieu of disciplined, pragmatic caution. There will be ample moments during this and subsequent quarters to strategically deploy our capital.

Despite shelter-in-place, our firm is fully operational and effective in watching over your assets. I have and will continue to discuss any concerns or changes of plan to assure that your current strategy is on target to achieve your objectives.

As always, it is a pleasure to serve you, and I look forward to continuing our work together.

Appreciatively,

A handwritten signature in black ink that reads "Walid L. Petiri". The signature is written in a cursive, flowing style.

*Walid L. Petiri*

Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, JP Morgan, *LA Times*.