Quarterly Playbook
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Current Financial Planning and Investment Themes

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"What Happens Next"

Within a matter of weeks, our world was shut down. COVID-19 has wreaked havoc on people, economies and markets. Never before have we shut down economies to this extent. Fortunately, however, we came in to this with arguably the strongest economy in history, we have companies all over the world working on a treatment or vaccine, and even though this is an unsettling time, we will get through this -and probably faster than you think.

US Economics

What happens next with our economy is the subject of wide speculation. Are we in a recession? How deep will it hurt? What's the likelihood of a snapback in economic activity? While we are undoubtedly in uncertain times, the resilience of the US economy has been shown time and time again. Just like Olaf the snowman in Disney's Frozen 2 says "water has memory", so does the economy. The infrastructure that was in place to deliver the level of GDP prior to the COVID-19 lockdown, is still in place waiting for when the economy is restarted. While the reversion may not be instant, I believe the liquidity assistance that multiple Government institutions are injecting will allow the majority of company and personal balance sheets to suffer only minimal damage. The economic lockdown began in mid-March, so GDP for the 1st quarter may still come in OK. In fact, the Atlanta Fed's GDP Now forecast still has the 1st quarter at a 1% growth rate as of the time of this writing. The definition of a recession is two consecutive quarters of negative growth. Most assuredly, the second quarter is likely going to come in as a large decline due to the mandated lockdown. The question is, what does the third quarter (July-August – September) look like? A newly released WSJ consensus forecast of economists expect GDP to recede by -25% in Q2, followed by +6% growth in Q3, and +7% in Q4. Our baseline scenario has been that the economy will restart by the end in April, which is looking very possible at this point. This will be the key if there is to be a "V" shaped recovery.

US Equity Markets

After posting the strongest year of performance since 1997 last year, the S&P 500 took only 19 trading days to fall into *BEAR* market territory, which is considered a 20% drop from recent highs. At its low on March 23rd, the S&P 500 declined 34% from its peak on February 19th. Since then it has rallied more than 24% off the lows. It took less than three weeks for the S&P 500 to fall from 52 –week highs to 52 –week lows. The level of volatility has been staggering, but also provides some insight. This type of selling suggests it is purely related to fear. That said, some of the fears will be realized, such as a mandated economic lockdown causing millions to file unemployment. However, most of the time our fears overshoot the reality. It's times like these that markets tend to "shoot first, and ask questions later". The last four virus related sell-offs (SARS '03, MERS '12, Ebola '13-'14, and Zika '15-'16) saw markets fully recovered in just six months. Now this situation is much more intense, but there is a correlation of intensity to recovery as well. Also, consider the fact that the Trump Administration is throwing "everything and the kitchen sink" at the problem with massive stimulus coordinated through multiple channels. While it is difficult to identify the individual stocks that were oversold unjustly vs. the ones that declined for good reason, we do believe that the stock market as a whole is cheap. Our view is that, even though earnings will be much lower for 2020, next year will resume at the prior trend leading to optimism and higher P/E multiples. Although there may be additional periods of volatility, we are looking for the US stock market to finish 2020 approximately where it started the year, which based on the S&P 500 is another 16% up from here…

US Fixed Income

Just as the stock market was rocked by the COVID-19 fall out, so was the bond market. Initially, the broad fixed income market acted as a flight to safety trade providing portfolio ballast. However, not long after the stock market sell-off started, anything that had credit risk saw their spreads to treasuries blow out to extreme levels, meaning yields spiked and prices fell significantly as prospects of economic damage ramped up. Even Muni bonds sold off sharply. The only fixed income asset class that remains positive is US Government bonds, with the 10-year treasury yield hitting an all-time low of 0.31% and the 30-year treasury yield hitting an all-time low of 0.70%, breaching the 1% threshold for the first time in history. In response, the Federal Reserve dropped interest rates to zero and announced an unlimited "Quantitative Easing" program to buy US Treasuries, Mortgage Backed Securities, and Corporate Bonds including High Yield (Junk) bonds. The Fed said it would buy assets "in the amounts needed" to support smooth market functioning and effective transmission of monetary policy, which appears to be working. We believe that the run up in Treasury prices (and corresponding low yields) is likely to subside, but only slightly. Meanwhile, spreads of other fixed income asset classes are likely to come in significantly (meaning prices will rise). Some of the best opportunities we see lay in High Yield bonds, with spreads of over treasuries of 700-900 basis points (7-9% additional yield).

International Markets

International markets have fared much worse than the U.S. during the spread of COVID-19. We believe that the Eurozone is likely to experience a deeper recession than the U.S., but should also experience a bigger economic bounce when the virus subsides. We think the region will be one of the main beneficiaries of the rebound in global trade. We see Eurozone equities as currently very attractively valued, and we believe the European stock market could be one of the best performers in a recovery. Meanwhile, Emerging Market stocks trade at a record 65% discount to U.S, but while valuations at these levels are compelling from a long-term perspective, there is also much uncertainty. However, a headwind internationally is that the synchronized easing by 23 global central banks has taken place since the middle of last year does not leave much additional room for stimulus…..

Real Estate

Since the market peak on 2/19, REITs have underperformed broad equities, weighed down by increasing strains in credit markets and the prospect of a sharp reduction in real estate demand. However, REIT balance sheets are significantly stronger today than in 2008, with leverage near historical lows. In addition, the Federal Reserve has rapidly responded to the unfolding crisis, reducing the fed funds rate to zero, which tends to benefit REITs. That said, with many REITs trading at significant discounts to their intrinsic values, we see potential opportunities to take advantage of market dislocations.

Interest Rates & the Fed

So the Fed went from being boring to playing financial Rambo, firing monetary bazooka's at the economic enemy. In an unscheduled emergency meeting on March 15th, the Fed announced it was cutting the Fed funds rate to zero and launched a $700 billion quantitative easing (bond purchase) program. Then, on March 23rd the Fed announced the bond purchases were now unlimited instead of being limited to $700 billion. The Fed also will extend credit to banks that issue Paycheck Protection Program (PPP) loans, purchase up to $600 billion in loans issued through the Main Street program to medium-sized firms. The moves also involve secondary corporate credit facilities that will allow the Fed to buy corporate bonds from "fallen angels" that have slid into downgrades, and a $500 billion program to buy bonds from state and municipal governments totaling $2.3 trillion. In all, the programs could combine to provide more than $6 trillion of liquidity to the financial and business system. Wow, what a bazooka! With markets bottoming on the exact day of the March 23rd announcement, it's a not so gentle reminder, don't fight the fed! But what about inflation? Good question! In theory, all this money being "printed" and injected into the system should be inflationary right? Well, that has not been the case recently. In the last 10 years since the financial crisis, the Fed alone has pumped more than $3.9 trillion into the economy and when combined with the 3 other most powerful central banks, that number tops $9 trillion. Yet the problem for the last 10 years has been the *lack* of inflation, and in fact worries about deflation. This time it comes in much quicker than in the past, so we shall see. However, recessions have proven to have a decreasing effect on inflation, historically. That said, we expect the Fed to maintain its "easing" policies for at least the next year.

Legislative Affairs

What started as a contentious election year with an attempted impeachment of President Trump by the Democrats somewhat quickly turned to Republicans and Democrats working together to pass the largest economic aid package in American history. The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress with overwhelming, bipartisan support and signed into law by President Trump on March 27th, 2020. This was one of the quickest governmental actions taken in response to an economic distress that we have ever seen. Even though not perfect, the CARES act provides massive relief for individuals and business alike including:

- **Expanded unemployment insurance** (UI) for workers, including a $600 per week increase in benefits for up to four months and federal funding of UI benefits provided to those not usually eligible for UI, such as the self-employed, independent contractors, and those with limited work history.
- **$350 billion allocated for the Paycheck Protection Program**, which is meant to help small businesses (fewer than 500 employees) impacted by the pandemic and economic downturn to make payroll and cover other expenses from February 15 to June 30.
- **Recovery Rebate for individual taxpayers.** The bill would provide a $1,200 refundable tax credit for individuals ($2,400 for joint taxpayers). Additionally, taxpayers with children will receive a flat $500 for each child. The rebate begins to phase out at Adjusted Gross Income of $75,000 of for singles, $112,500 for heads of household, and $150,000 for joint taxpayers at 5 percent per dollar of qualified income, or $50 per $1,000 earned. It phases out entirely at $99,000 for single taxpayers with no children and $198,000 for joint taxpayers with no children.
- **Waives the 10 percent early withdrawal penalty** on retirement account distributions for taxpayers facing virus-related challenges. Withdrawn amounts are taxable over three years, but taxpayers can recontribute the withdrawn funds into their retirement accounts for three years without affecting retirement account caps. The bill also waives required minimum distribution rules for certain retirement plans in calendar year 2020.
- **$454 billion in emergency lending** to businesses, states, and cities through the U.S. Treasury's Exchange Stabilization Fund.
- **$150 billion in a Coronavirus Relief Fund** for state and city government expenditures incurred due to dealing with the coronavirus public health emergency.
- **A variety of business tax provisions** including a 50 percent refundable payroll tax credit on wages paid up to $10,000 during the crisis whose businesses were disrupted and firms experiencing a decrease in gross receipts of 50 percent or more when compared to the same quarter last year; and Employer-side Social Security payroll tax payments may be delayed until January 1, 2021, with 50 percent owed on December 31, 2021 and the other half owed on December 31, 2022. The Social Security Trust Fund will be backfilled by general revenue in the interim period.

Financial Planning Corner

Behavioral Biases: How our minds can work against us and our goals when making investment decisions

Did you know that emotional decisions during volatile markets, like what we're experiencing now, are the primary reason that the average market investor earns far less than the market as a whole? It's called the behavior gap, and it stems from how human psychology is hardwired (which is primarily for life and survival). However, how our behavior is biologically programmed is a bit of a mismatch for making optimal decisions with investing, and this is where the average investor falls prey to their own behavioral biases.

In the spirit of being in a volatile market that tends to draw out the majority of investment mistakes made by the average investor, let's talk about a very common and currently relevant bias of the human mind that contributes to these less than optimal investment decisions, and how it can be avoided:

The Availability Bias

What causes more deaths annually: shark attacks or lightning strikes?

Believe it or not, death by lightning strike is about 37 times more likely than from a shark attack according to data captured from 2001-2012. Most people's gut reaction is that shark attack is much more likely. Why? Because during that same time frame the media generated over 15 times as many news articles about shark attacks as they did for lightning strikes.

This example demonstrates a common behavioral bias called the Availability bias. The Availability bias explains the tendency for people to judge the likelihood or frequency of events based on how easily they can recall examples of these events in their mind. In other words, people assume that what they see and hear about most happens more often than what they do not see or hear about. Another interesting fact is that it's easier for people to recall negative information than it is to recall positive information.

How can the Availability bias work against us when it comes to investing?

It actually hurts us in a number of ways: we can choose investment strategies based on what gets advertised the most or based on what performed the best most recently (note: data shows that investors who chased the returns of what performed best the year prior faired very poorly). <u>But perhaps the most critical way it can work against us is by shaping our behavior and decisions on the most recent events and media coverage</u>. And you better believe that scary market declines are the media's playground!

Here's how it all plays out and causes poor investment decisions:

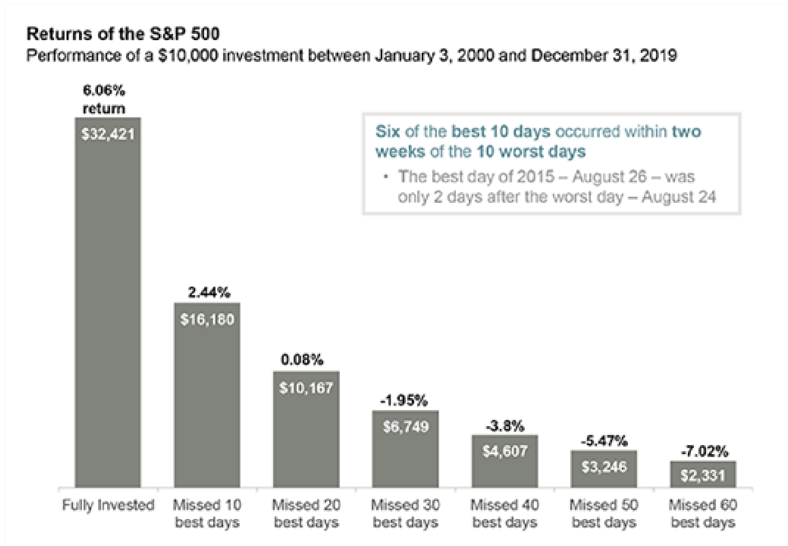
1. A market event happens and causes a decline or bear market

2. The media knows problems attract more viewers than good news does (by a longshot), so they go all in with news coverage about the market tanking and the legitimate possibility of the sky falling.

3. Investors are not reminded by the media that market declines have been normal since the existence of the market (and actually happen about 1 in every 4 years), nor are they reminded that there has yet to be a bear market throughout history that has not fully recovered and more.

4. Investors eventually succumb to what they are being bombarded with in the media and news, they lose sight of the actual risks and expected returns over the long run, and they take emotional action from their behavior being influenced by the Availability bias. Investors will commonly pull out of the market and move into cash and/or bonds, and it's this single act that causes more reduction in long-term returns than any other behavior. That's because the market's greatest return days are often intertwined with the worst decline days, and missing those greatest return days are detrimental to your long-term returns.

Just take a look at the various outcomes from investing $10,000 in the S&P 500 for a 20-year period from 1998 to 2018 and what the Availability bias can do if you were to pull out of the market for some of the greatest return days:



How can we avoid the Availability bias devastating our investment returns?

The Availability bias and the potential for irrational decision making based upon it is clearly in full play right now.

The best ways to avoid it now and going forward?

1. Maintain perspective at all times! Always remember that investing is a long-term game and short-term investment decisions typically yield poorer investment results. We should be hyper-focused on our long-term goals from day 1 onward.

2. If you choose to follow the media during market declines, just be aware of how this can play against you with your biases. Don't allow this to be one of your blind spots.

3. Before making any investment decisions, write down on paper what your 3 most important financial goals are, and how the action you're thinking of taking today would positively or negatively affect those goals.

Remember, during every market decline, the media and news sources are essentially trying to paint the picture that "this time could be different". Avoid the Availability bias and replace that mindset with "this too shall pass" during market turmoil, as we have yet to encounter an event where the latter didn't serve us better than the former.

Let's explore the six other most important biases that come into play during times of volatility.

Recency Bias

When we predict what's going to happen in the future, our minds naturally reach for what happened most recently. In part, that is because our brains have an easier time remembering what just happened versus what occurred further in the past. Although this shortcut usually works out for us in everyday life, it can result in us placing undue importance on recent events when we make investing decisions. For many investors, this means that when their portfolio drops 10% or more, recency bias convinces them that it will continue dropping.

Herding Behavior

When you're choosing which restaurant to order takeout from, you might consider looking at their reviews online. If one restaurant has plenty of rave reviews, while the other has only a few subpar comments, you will choose the restaurant with plenty of rave reviews. With restaurants and many other parts of our lives, it can be a good idea to follow the crowd. During market volatility however, many investors are overreacting, so the crowd's usually going in the wrong direction. And going against the crowd, especially during times of uncertainty, can feel extremely unnatural.

Action Bias

"Well, at least you tried." This common consolation can be comforting and justified in many decisions. Prior research has found that the urge to take dramatic action can trick us in cases where the statistically correct choice is thoughtful inaction. During times of volatility, sometimes resisting the urge to "Sell! Sell! Sell!" could be the right decision. Doing nothing while markets are dropping is extremely hard for us, however, because it goes against our instinct to take action. In our minds, it hurts less to try something and lose, compared with doing nothing and losing the same amount. If investors don't calmly think about the appropriate course of action, and give in to action bias instead, it can make their losses objectively worse, but, to them, it can feel subjectively better.

Overconfidence Bias

Do you believe you are an above-average driver? If you said yes, you have agreed with about 90% of all drivers in a famous study of everyday people who said they were above-average drivers. Even though we know we all can't be above-average drivers, our minds tell us that we must be better than the rest. This is overconfidence bias. We all tend to be unrealistically optimistic about our chances of success. When it comes to making investing decisions, this can result in investors making rash choices and believing that, when push comes to shove, they will be spared the pain others will experience.

Confirmation Bias

Even if we try to engage in proper research before making a decision, our minds will automatically pay more attention to information that supports our current beliefs. Confirmation bias is our tendency to find and interpret information in a way that supports our opinion, and it can derail even the most well-meaning investor who is trying to keep up with the news.

Loss Aversion

One of the most well-known and often-cited behavioral biases, loss aversion, also comes into play with investing. Specifically, a 10% portfolio loss feels a lot worse than a 10% gain for many investors because we are loss-averse: Experiencing a loss generally feels twice as bad as gaining the same amount. As market volatility continues, investors may experience strong emotional reactions that cloud judgment.

Source: Morningstar "A Behavioral Guide to Market Volatility"

We're here to help. If you have questions about these or any other topics, don't hesitate to call us at (855) AFS-4545.