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April 2020

Quarterly Market Insights

The COVID-19, the Economic Impact, and the Policy Response

The year began on firm footing. Economic expansion appeared to be accelerating and job growth was strong. Coupled with low interest rates and forecasts for increasing profits, stocks repeatedly hit new highs.

But that was yesterday's news. The coronavirus epidemic has forced economic activity to a halt in many parts of the country. What we are seeing is far different versus the more typical slowdown or recession, if there is such a "typical" thing.

With this shutdown being implemented, a severe slowdown or more likely a recession will ensue. The severity and the length of the downturn are the real questions.

Contractions have their roots in various causes. Inevitably, consumer and business confidence take a hit and spending declines. Today, however, many are simply unable to spend.

Social distancing and mandatory closures of businesses have placed a roadblock in front of our normal spending patterns. The service sector, with its person-to-person interactions, has been the hardest hit, and massive layoffs have begun.

The shift in the atmosphere has been incredibly abrupt. Aircraft carriers don't turn on a dime, but the $20 trillion U.S. economy has. It's unprecedented.

The enormous amount of economic **uncertainty** is very difficult to model (i.e. to predict the eventual outcome) because we don't have a modern precedent.

Imagine you are driving down the road at 40 mph and someone puts a blindfold on you. In a manner of speaking, that's what has happened to the market.

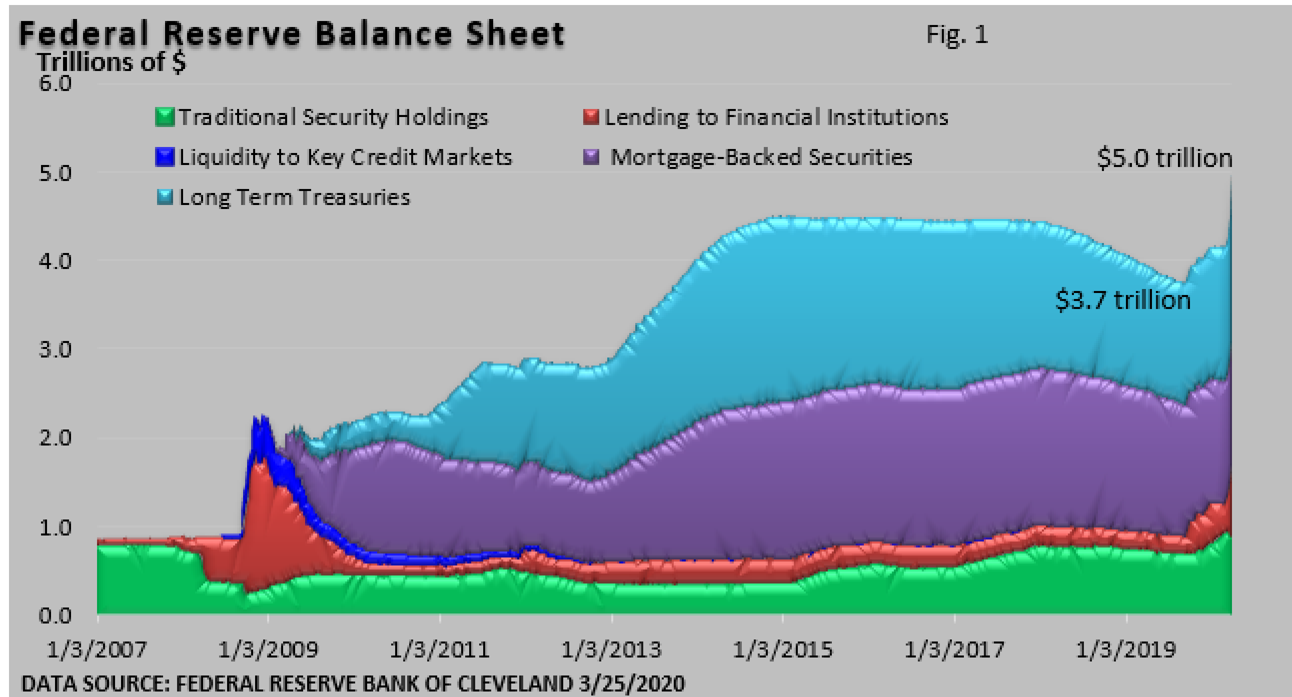
Today's economic environment more closely resembles a natural disaster that affects an entire region. When a disaster happens, businesses typically treat such an event as transitory.

This time, the entire country is feeling the sting. The longer it drags on, the more businesses will fail, and the more temporary layoffs will become permanent.

The Fed and the Government Step In

In order to soften the economic blow, the Federal Reserve (the Fed) has gone well beyond simply cutting interest rates to zero. It has implemented several programs designed to keep credit flowing in the economy and prevent a health crisis from morphing into a new financial crisis.

That said, banks are in much better shape today than in 2008. The Fed has been proactive to prevent, not react to, a major failure. In just three weeks, it has purchased nearly $1 trillion in assets to support various credit markets (Fig. 1). That number will likely go much higher.



Additionally, the Fed has focused on corporate and municipal bond markets, commercial paper markets (short-term unsecured loans by large companies), money market funds, and more.

Yet, its interest isn't simply on Wall Street. It has also reached out to Main Street and is getting deeply involved in loans and grants to small businesses so that firms can maintain payrolls, at least for a while.

This time, the Fed's response has been far more aggressive, and its scope has been much broader than during the 2008 financial crisis. The same can be said of the $2 trillion stimulus package known as the CARES Act signed by the president at the end of March (with a fourth coronavirus relief package likely to come).

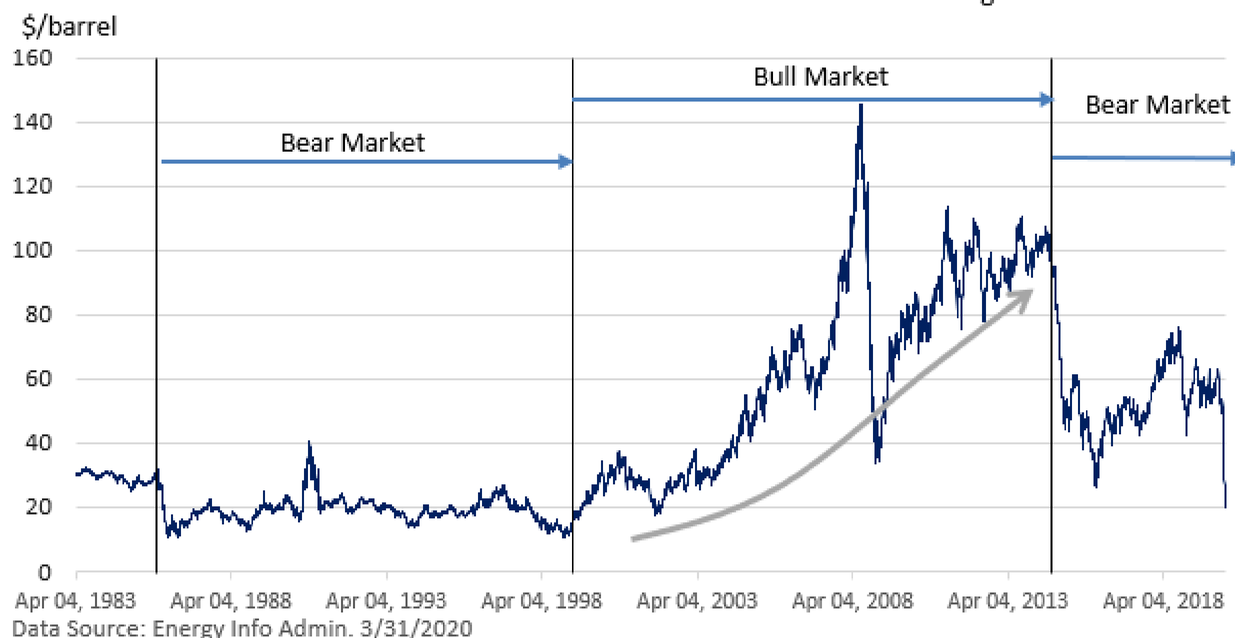
The goal – ease what's likely to be a steep economic downturn in the 2nd quarter and put a foundation in place for an eventual economic recovery. If government mandates require that we stay at home and require that businesses temporarily close, it only seems reasonable for the government to lend a helping hand.

Though volatility is expected to continue, these various programs are an important reason why stocks rallied near the end of March following a 34% selloff in the S&P 500 Index in just over a month.

The average peak-to-trough decline in a bear market (defined as a 20% drop or greater) is 36.2% per LPL Research (back to 1929). But the **speed** of today's decline is unprecedented.

Oil is Pummeled

In addition to the pandemic, cratering demand for oil and a price war launched by Saudi Arabia and Russia last month sent oil prices to their lowest level in almost 20 years. While lower oil prices are usually seen as a positive for the consumer (since they have more money to spend on other things), falling gasoline prices are not having the desired affect since people have little to spend the savings on and layoffs will hit the U.S. energy sector (which has been a growth engine for the U.S. economy and is important for national security reasons).



Looking to History

There is not a modern precedent for our current situation but let us offer two past epidemics as guidance.

The deadly 1918 Spanish flu pandemic caused a 7-month recession in the U.S. (National Bureau of Economic Research/NBER). Going back to the 1850s, it is the shortest recession on record.

In the 1st quarter of 1958, GDP fell 10.0%. While the research available is sparse, the 1957-58 outbreak of the Asian flu appears to be the culprit behind the steep decline. GDP rebounded in the second quarter of 1958, and the length of the recession was pegged at 8 months (NBER).

Still, we recognize the economy today is much different than during these prior pandemics. We are not saying that this situation will mirror the quick snap back in the economy mentioned above, but we are saying that it has happened before and we need to be mindful that we don't take the scary headlines today and extrapolate too far into the future.

Current times remind us of the epic poem "**IF**" by Rudyard Kipling which he wrote for his son. It is a wonderful poem but one of the more important sections today reads ***"If you can keep your head when all about you are losing theirs… you'll be a Man my son!"*** We often need to remember this in both the good and bad times. This too will pass.

Road to Recovery

No one rings a bell on Wall Street sounding the all-clear sign. Collectively, investors attempt to price in future events. The 2007-09 recession ended in June of 2009, but stocks bottomed in early March of 2009 (i.e. three months earlier).

As we search for an improving market and economy, here are some signposts to look for:

1. A massive response by the Federal government and the Federal Reserve. We think we can check the box on this signpost.
2. A peak in U.S. coronavirus cases and subsequent decline in new cases.
3. Effective and timely testing and monitoring.
4. Removal of lockdowns and our increased confidence to go back in public.
5. Effective treatments and/or a vaccine are developed.
6. Economic clarity – how low and how long might the economic downturn be?

Stock Indices	March 2020 Return*	1st Qtr. Return %*
S&P 500 (large)	-12.35%	-19.60%
S&P 400 (midsize)	-20.25%	-29.70%
Russell 2000 (small)	-21.73%	-30.61%
MSCI EAFE (intl.)	-13.35%	-22.83%
Bond Yields	**March 31 Yield & Qtr. Change**	**Dec. 31, 2019 Yield**
3-month T-bill	0.11% (-1.44%)	1.55%
2-year Treasury	0.23% (-1.35%)	1.58%
10-year Treasury	0.70% (-1.22%)	1.92%
30-year Treasury	1.35% (-1.04%)	2.39%
Commodities	**March 31 Price & Qtr. Change**	**Year end 2019**
Oil per barrel	$20.48 (-$40.58)	$61.06
Gold per ounce	$1,596.60 (+$73.50)	$1,523.10

*Stock indices include reinvested dividends and are not annualized

Final Thoughts: Getting to the Other Side

We recognize this is a very troubling time. What is happening is unparalleled in modern history. We are facing a potential economic crisis, and one inspired by a health crisis. Historically,

pandemics peak, and this one will too. Further, underlying U.S. economic fundamentals are strong.

We are confident that we will eventually see an economic recovery, furloughed workers will start going back to work, and we will get to the other side. While it may not be easy, we can and will do this!

This is a great time to revisit your financial plan and all the assumptions that were made. Let us help you with this. And if you have never done a plan, let us know and we would be glad to do one for you.

As many of you know, we have been working remotely for the past few weeks to comply with regulations and to protect our employees and clients. While it is a change, we are proud to say that it has worked very well. Not that we anticipated what has occurred, but we have invested extensively in our capabilities over many years and have the necessary processes, technology, back-up systems and security in place to deliver a seamless and consistent client experience (albeit virtually). We thank you for your understanding and support during this time.

Stay safe, stay healthy, abide by government mandates designed to slow the spread of COVID-19, and remember, **we are always here for you**.

Thank you for your trust and business.

Hopwood Financial Services, Inc.