Second Quarter 2020 Investment Outlook

The Ultimate Catch-22

"Let me make sure you get the … information. A vaccine that you make and start testing in a year is not a vaccine that's deployable. And that is going to be, at the earliest, a year to a year and a half, no matter how fast you go."

– Dr. Anthony Fauci – Head of the National Institute of Allergy and Infectious Diseases

*"*You're going to need a bigger boat"

– Roy Scheider, Actor, Jaws, 1975

Every crisis in U.S. history creates a hero. Most heroes in U.S. history are military related since wars are the biggest threat to a country. George Washington, Andrew Jackson, Ulysses S. Grant, Theodore Roosevelt, and Dwight D. Eisenhower are just a few examples of military heroes that were so idolized by the general public that they were elected President too. During 9/11, the heroes were all first responders risking their own lives to assist their fellow citizens during the terrorist attacks. Today, we have a new enemy with the COVID-19 coronavirus attacking the U.S. and this time the heroes are the healthcare professionals who are literally risking their lives on the front lines caring for COVID-19 patients. 79-year-old Dr. Anthony Fauci, head of the National Institute of Allergy and Infectious Diseases, is a member of the Coronavirus Task Force. Dr. Fauci has been front and center daily, communicating bluntly with the American public about the deadly serious nature of COVID-19. Early on in this crisis, when the President was trying to be optimistic about our nation's ability to fight the spread of this virus, Dr. Fauci was there with more sobering comments, sometimes in direct opposition to what the President was saying. Before COVID-19, Dr. Fauci was involved behind the scenes in other virus outbreaks like Ebola and SARS. He knows the nature of infectious diseases and how pandemics spread. Unfortunately, not many Americans, including mayors and governors of some of the most populous cities and states, took these warnings seriously enough early on. As a result, COVID-19 now represents one of the greatest threat to our nation's stability in its history. Anyone not alive back in the days following Pearl Harbor or during the Great Depression can now understand the fear Americans experienced during those very difficult times.

COVID-19 represents the ultimate Catch-22 scenario. The only way the U.S. gets ahead of curve and controls the spread of the virus is to shut down economic activity and severely limit the freedom of movement. To save lives and win the war with COVID-19, the economy will suffer serious damage. It leads to a plethora of bad outcomes across so many dimensions it is too mind boggling to contemplate. What no one has any clue about today is how the economy comes out of the other side of this event. How quickly will companies bring employees back to work? How quickly will people return to public life? How fast will economic activity return to normal? So many important questions that can't be answered at this time. It is often the fear of bad news that is worse than the bad news itself and this is especially true for financial markets.

Both the Federal Reserve and the Federal government have taken unprecedented actions at unprecedented speed to respond to the economic impact of this event. It took the Fed and Congress about six months to fully respond to the 2008/2009 Global Financial Crisis. It took the Fed about two weeks to respond to the

COVID-19 crisis, cutting interest rates to near 0% and stepping in as a lender of last resort to bring liquidity back to bond markets, which had become dysfunctional in a matter of days. The Fed also increased its balance sheet to over $5 trillion in order to buy bonds from the market, infusing desperately needed liquidity and restoring some financial order. It is conceivable the Fed balance sheet exceeds $7 trillion when this is all said and done. Congress also acted swiftly, passing a massive $2 trillion spending bill in about three weeks to help out small businesses and get money into the hands of most Americans. The debate has already started about the next emergency spending package, which most likely will exceed $1 trillion. It all helps now but the level of debt being created to support the economy today will have to eventually be paid back and inevitably that means higher taxes in the future.

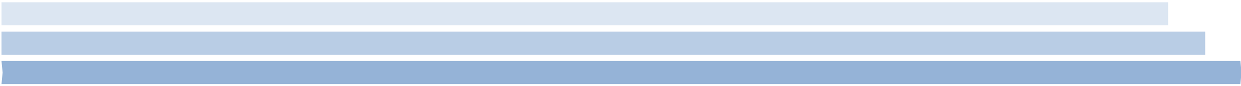
Jaws was one of the first major horror/thriller genre movies and was one of director Stephen Spielberg's career bests. By creating a Great White shark of unfathomable size and ferocity, even though it was fake, people got so freaked out that going into the ocean that summer became an anxiety filled event and people really feared and hated sharks of all kinds for decades afterwards. Jaws had its own Catch-22 scenario. Roy Scheider played police chief Martin Brody of Amity Island (filmed on Martha's Vineyard). Once he saw Jaws for the first time, he instantly knew the public was at grave risk and needed to be warned. The mayor though was more worried about spreading fear and wrecking the summer tourist season and Amity Island's economy. COVID-19 right now represents Jaws and we are going to need a bigger boat of financial support for people and businesses before life can return to some level of normalcy.

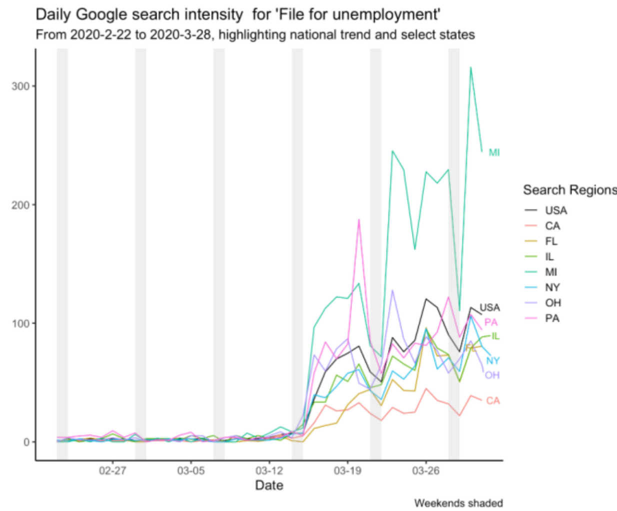
Everyone should brace themselves for some truly horrific economic datapoints in the weeks and months ahead. 20 million or more people could be unemployed by the end of April. U.S. second quarter real GDP could experience a 30% decline. The recently passed CARES Act provided $350 billion to assist small businesses. In the first week of accepting applications, loan requests totaled $1.7 trillion. We will need a much bigger boat as some of the economic damage will be worse than what occurred during the Great Depression and over a substantially shorter period of time.

The COVID-19 situation is fluid from day to day and week to week. Just understand that in order to beat our newest enemy, it means a worse economic impact in the short-term. America may have to experience a short-term mini depression in order to reduce the spread of COVID-19 and save lives. It is the ultimate Catch-22.

Employment

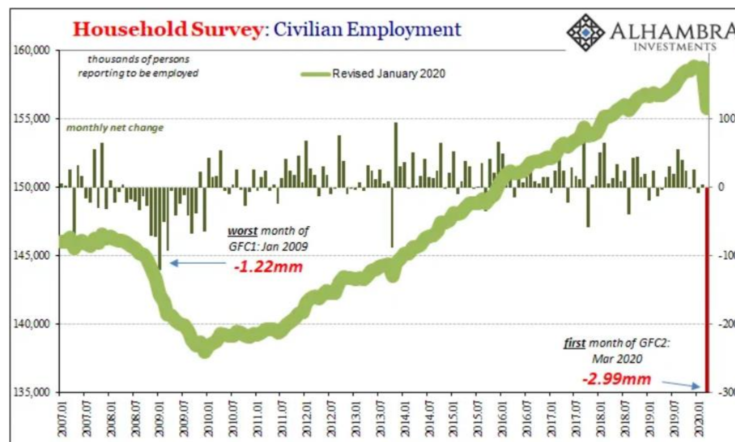
During the 10-year Great Depression from 1929-1939, the unemployment rate hit 25% in 1933. Just four weeks into this COVID-19 crisis, food pantries across the U.S. are already swamped with customers and running out of food supplies. The Greater Community Food Bank in Pittsburgh had a mile long, 800 car line where the wait to get to the handout point was five hours. It's an indication of the large number of people who lost their jobs over a short period of time. Online state unemployment websites and phone centers were so swamped with inquiries that many people couldn't get their unemployment claims processed. Google search trends provides some indication of the magnitude of job losses. The next chart shows Google search intensity trends on File For Unemployment for seven of the most populated states. Until mid-March, the low level of searches on this topic was correlated to the very low unemployment rate of 3.5% up to that point in time. Since mid-March, as businesses started furloughing employees in reaction to the loss of business and forced shutdowns, searches on this topic exploded higher and are beginning to be reflected in the substantial increase in weekly unemployment claims filings. By the first week of April, initial jobless claims surged to 6.6 million and up 10 million over just a two-week period.





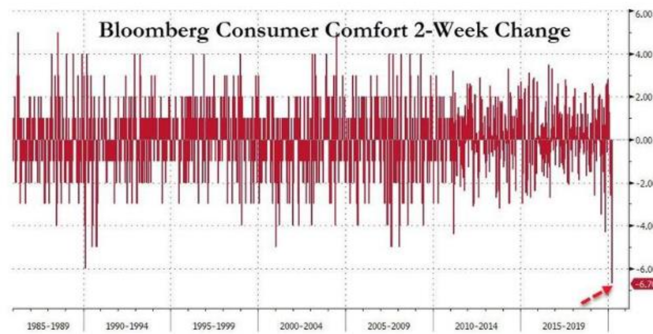
Cornerstone Macro estimates that April Non-Farm payrolls (released May 8th) could decline 20 million and the unemployment rate will increase from 4.4% in March to 17%. If the 25% unemployment level that occurred during 1933 represented a Great Depression, then a 17% unemployment level represents a mini-depression. The unemployment rate could exceed 20% at some point during the COVID-19 crisis. When COVID-19 cases peak and recede will determine when businesses can reopen and rehire workers, but governments are likely to be cautious at first with authorizing larger gatherings and it may take a long time for the unemployment rate to get back towards the very low level it was at in January 2020. Sadly, many businesses won't reopen. The Congressional Budget Office forecasts the unemployment rate will still be 9% at the end of 2021. The ability to control the spread of COVID-19 will determine how long the economy stays in a mini-depression like state.

Below is a chart of a Household Employment survey produced by Alhambra Investments. Note that in January 2009 at the peak of the Global Financial Crisis, the survey level hit -1.22 million when the unemployment rate peaked near 10%. In just the first month at the start of the COVID-19 crisis, the survey hit -2.99 million. The Bureau of Labor Statistics estimated that 16.3 million people were employed in the leisure and hospitality industry in 2018. According to a 2017 industry report from Deloitte, the leisure and hospitality industry generated $800 billion of annual revenues. Just this one industry alone has probably experienced employment and revenue declines of 80+% over the past 30 days.



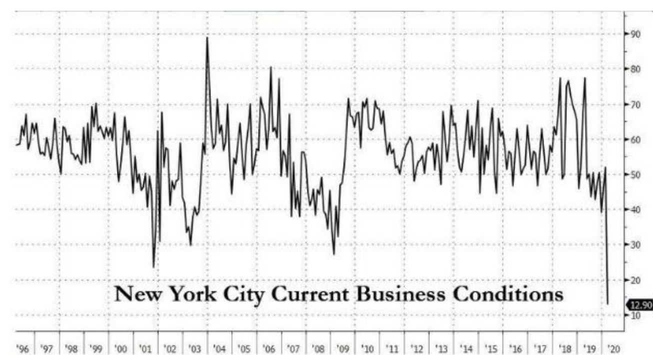
Consumer Confidence

When a natural disaster event like COVID-19 hits in very a short period of time, consumer confidence is going to take a major hit. The next chart shows the Bloomberg survey of Consumer Comfort, which is captured every 2 weeks. It shows a plunge of a magnitude never experienced before in the survey's history going back to 1985. This COVID-19 event is orders of magnitude worse than 9/11, the 2008/2009 Global Financial Crisis, or any recession during the 35-year history of the survey. Since consumer spending represents over 60% of U.S. real GDP, this level of consumer discomfort suggests a very difficult year lies ahead for the U.S. economy. In addition, it may be a decent length of time before consumers feel confident enough to return to their former spending patterns. Typical consumer spending items like eating out, taking trips, and buying cars may take a long time to normalize. For example, annualized car sales in the U.S. may decline from January's 17.5 million to under 9 million in April or over a 50% decline. Depending on how long this lockdown goes on, it could be even worse as China's auto sales declined 90% under its stricter national quarantine rules. How quickly consumer spending returns to prior levels will depend a great deal on how quickly people return to work and unemployment levels reverse lower.



Regional Economic Impacts

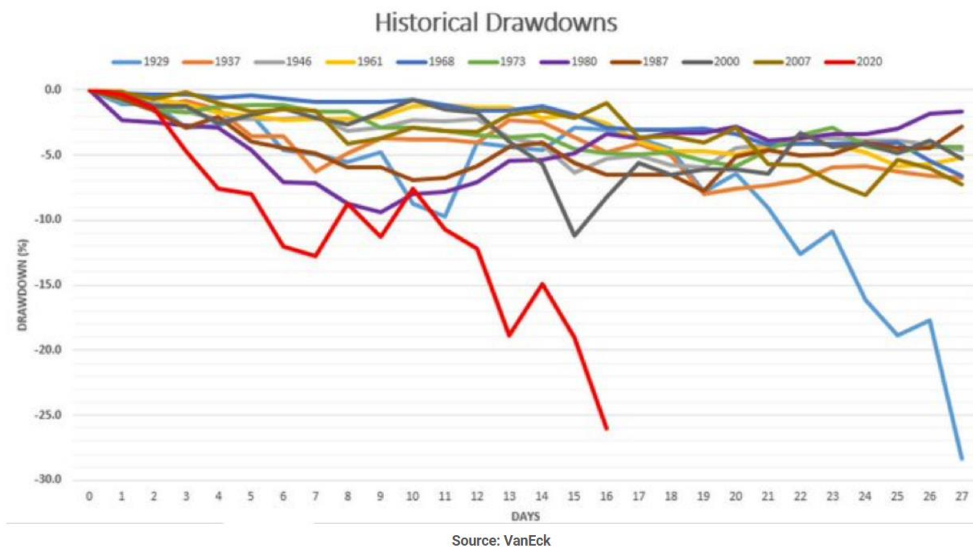
In areas of the U.S. hardest hit by the COVID-19, the economic data is the worst. According to Moody's research, 80% of the most populated counties in the U.S. are on lockdown, representing 96% of U.S economic output. New York City, the largest city in the U.S. and which had the worst outbreak of COVID-19 cases, is approximately 8% of total U.S. real GDP. As shown in the next chart, business conditions there have collapsed. It is worse than 9/11, when the city was most directly impacted by that terrorist event.



New York City may hit peak growth rate of new COVID-19 cases sooner than other parts of the country, but some other major U.S. cities are still experiencing rising growth rates including Detroit, Chicago, Miami, Washington DC/Northern VA, and New Orleans. These cities won't hit peak COVID-19 case growth until several weeks after New York City and hopefully by the end of April. All of these cities were slow to implement restrictions on large gatherings or implement shelter-in-place rules. The nation's bright spots were Washington, Oregon, and California. Seattle had some of the earliest COVID-19 cases but has also implemented some of the best containment policies in the nation and should be one of first areas to recover as a result. While the news headlines will get better for New York City and people will get a sense of relief and optimism that the worse is over, select areas of the country may not experience similar improvements for several more weeks. Tentatively, the White House is targeting May 1 as a soft reopening date for the country as there is immense pressure to allow businesses to reopen in order to minimize the degree of permanent economic damage.

Bear Market Comparisons

A bear market is declared when the stock market declines at least 20% from its most recent peak. The next chart shows the amount of time it took for the stock market to hit a -25% return from the market peak during prior bear markets. The current bear market decline was the fastest on record, hitting a -25% return in just 16 days and beating out 1929 at the start of the Great Depression when it took 27 days to hit -25%.



The next table places all prior bear market periods into categories defined by the severity of the recessions that occurred during those bear market periods and draws an analogy to the current S&P 500 Index level if this current bear market price decline would be similar to the stock market price declines during those past recessionary periods.

Bear Markets: Historical Perspective

Classification	Peak Date	Peak Price	Trough Date	Trough Price	Duration	Max Decline	Analogous Scenario
Mild	8/2/1956	49.64	10/22/1957	38.98	446	-21.47%	2658.87
	2/9/1966	94.06	10/7/1966	73.20	240	-22.18%	2635.08
	11/9/1938	13.09	4/11/1939	10.13	153	-22.63%	2619.82
	11/28/1980	140.52	8/12/1982	102.42	622	-27.11%	2467.93
	2/6/1934	11.19	3/14/1935	8.12	401	-27.48%	2455.67
	12/12/1961	72.64	6/26/1962	52.32	196	-27.97%	2438.82
	7/18/1933	11.37	10/19/1933	8.13	93	-28.54%	2419.71
Moderate	5/29/1946	19.82	6/13/1949	13.54	1111	-31.69%	2312.88
	8/25/1987	336.77	12/4/1987	223.92	101	-33.51%	2251.37
	11/29/1968	108.37	5/26/1970	69.29	543	-36.06%	2164.95
	9/7/1932	8.52	2/27/1933	5.17	173	-39.31%	2054.79
	10/25/1939	12.92	4/28/1942	7.46	916	-42.25%	1955.48
Severe	9/16/1929	30.47	11/13/1929	16.89	58	-44.59%	1876.35
	1/11/1973	120.24	10/3/1974	62.28	630	-48.20%	1753.83
	3/24/2000	1527.46	10/9/2002	776.76	929	-49.15%	1721.88
	3/10/1937	17.52	3/31/1938	8.30	386	-52.65%	1603.42
	10/9/2007	1565.15	3/9/2009	676.53	517	-56.78%	1463.59
Extremely Severe	4/10/1930	24.48	7/8/1932	4.21	820	-82.82%	581.78

Source: Seeking Alpha

The only bear market that fell into the extremely severe category (bottom of table) was the period between 1930 to 1932 (lasting 820 days) at the start of the Great Depression when the stock market declined 83%. It is fair to assume with recent employment and economic growth projections that this downturn is going to be a severe recession even if it ends up being shorter than most. Stock market performance during prior severe recessions is shown in the brown shaded section of the table above. The max decline column shows the total return for the stock market during those severe recessions periods from peak to trough averaged -50%. Applying a similar 50% decline to the S&P 500 Index level peak of 3,383 on 2/19/20 would move the S&P 500 Index level down to 1,916 if the stock market today experienced a similar average decline as in past severe recessions. On 4/9/20, the S&P 500 Index level was at 2,790, which implies another 31% decline is possible under a severe recession scenario. However, the stock market never moves down in a straight line. Ned Davis Research shows that there were six bull market rallies of 20% or more from 1929-1939. Since the recent 3/23/20 market low, the U.S. stock market rallied 27% through 4/9/20. So, large outsized rallies are a normal part of bear markets.

However, there is one major caveat that needs to be taken into consideration in our current situation. During past recessions, the Federal Reserve was never as aggressive as it is today with the level of policy actions taken to help address the rapid decline of the economy. Today, the Fed and other major global central banks are all at zero interest rate policies and are also using Quantitative Easing (basically bond buying) to expand their balance sheets to pump trillions of dollars of liquidity into the financial system to prevent the worse-case economic scenario from happening. In addition, $2.2 trillion of fiscal stimulus programs have already passed with another $1+ trillion spending bill likely coming within a few months and states may implement their own emergency spending bills to contribute to the supporting local economies. Therefore, the degree of monetary and fiscal support for the current COVID-19 situation is unprecedented in our nation’s history and should allow for a meaningful recovery to occur once the coronavirus runs its course and daily life begins to normalize. Therefore, the probability is higher, even under a severe recession scenario, that the downside stock market return outcome could be mitigated to some extent given aggressive central bank and government spending policy responses. The length of a severe recession may also be shortened given the trillions of dollars being spent. The situation today where COVID-19 cases and deaths are still increasing makes it very difficult to predict anything with a high degree of confidence, but it is still useful to go through the What If exercise.

Higher Future Investment Returns

To avoid making this Investment Outlook a total Debbie Downer, let's end on a more optimistic datapoint about the future. The next table shows the median 10-year (2020-2029) annualized real return forecasts for five major asset classes that most investors have in their investment portfolios. Real returns exclude the impact of inflation. These forecasts are made by Research Affiliates Inc. (RAI), one of the investment industry thought leaders in asset class research. In January 2020 RAI produced its last 10-year return forecast update after incorporating the outsized returns experienced during 2019 when U.S. stocks returned 31%. Given the substantial declines in global stocks since its last returns forecast update, RAI went through the same exercise again and updated its return forecasts as of 3/31/20. The table below compares the forecasts from three months ago to the most recent update.

	Forecast @ 12/31/19	Forecast@ 3/31/20	Difference
U.S. Large Cap Equities	0.3%	1.5%	+1.2%
U.S. Small Cap Equities	1.8%	2.4%	+0.6%
Int'l Developed Market Equities	4.9%	7.3%	+2.4%
Emerging Markets Equities	6.8%	9.3%	+2.5%
U.S. Investment Grade Bonds	-0.1%	-1.0%	-0.9%

Source: Research Affiliates, Inc.

Note that before the first quarter 2020 stock market collapse, the forward real return prospects for a 60/40 balanced portfolio invested only in U.S. large cap stocks and U.S. investment grade bonds was extremely poor compared to long-term historical returns. The math worked out to just a 0.14% annualized real return expectation over the next 10 years from investing in just those two asset classes. By incorporating international developed markets and emerging markets equities into a portfolio mix, an investor could increase risk diversification and meaningfully improve prospective return potential.

The latest real returns forecast as of 3/31/20 shows that all asset classes with the exception of investment grade bonds have seen an increase in their prospective 10-year real return forecasts. As stocks declined over 20% during the first quarter, this reset stock valuation levels lower and with lower starting valuations, forward return forecasts increased. The biggest jumps in potential expected real returns were for international developed and emerging markets equities. U.S. large cap has also increased but not to the same extent and small cap return expectations increased the least within stocks. Real return expectations for bonds worsened, with an even larger negative annualized return forecast from three months ago. So, one ray of light from all the negatives we are currently dealing with from COVID-19 is that future real return expectations have increased for the next decade, most especially in non-U.S. stocks compared to U.S. stocks and investment grade bonds. Another important point to make is that most balanced portfolios will be required to underweight bonds in the decade ahead in order to remove a negative headwind to future real returns. Bond yields will need to increase materially from today's historically low levels before future real returns from bonds move back into positive territory. The traditional 60% stock / 40% bond balanced portfolio for now may be obsolete. Investment grade bonds will still offer their traditional risk reduction

benefits to a balanced portfolio but at the cost of extremely low to negative return contribution over the next 10 years.

Summary

The world is dealing with a once in a century event that will change the way we live forever. While the concept of a pandemic is not something completely out of left field, there were no governments or societies on Earth prepared to actually deal with one this deadly. The human toll has been immense, with over 100,000 deaths worldwide and over 100 doctors dying in Italy. There is a tremendous amount of blame to spread around, starting with China and their actions in hiding the severity of this virus for long enough that it could be transmitted around the world. China has a big day of reckoning ahead of it that will change its economic growth outlook forever but that's a major story for another time. Right now, the world is consumed with fighting COVID-19 and it is the ultimate Catch-22 scenario. Here in the U.S., in order to control the spread of the virus, save more lives, and not overwhelm the healthcare system, a majority of economic activity had to be shut down. In doing so, the U.S. economy will be severely damaged in the short-term and millions of businesses will go bankrupt and cease to exist when this is all over. If the spread of COVID-19 peaks within the next few weeks, the economy could recover more quickly. With so many unknowns and so much uncertainty, financial markets will require more time before volatility subsides and a proper assessment of fair value for the stock market can be determined. The phrase "live to fight another day' has never been more apropos in both life and investing.

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