Economic Update

A Review of First Quarter 2020

It has been an eventful quarter, to say the least. After just completing an entire decade without a single recession in the United States, we started the year feeling relatively optimistic about future economic growth for both the U.S. and the world as a whole. The 2019 stock market gains had been spectacular, expected GDP growth looked solid and unemployment remained at historic lows. When Chinese authorities first reported the COVID-19 outbreak to the World Health Organization on Dec. 31, markets barely noticed, clearly anticipating that the outbreak could be contained locally much like SARS had been contained during the early 2000s.

It wasn't until late February when the hopes of containment disappeared that market sentiment began to quickly shift. On March 11, the WHO declared the rapidly spreading disease a pandemic, although that had become obvious to markets weeks before. As of this writing, the virus has spread to nearly every country on the globe save a number of small remote islands that remain fairly isolated from the rest of the world.

The net result was the fastest 20% drop in Dow Jones Industrial Average history. It took just 20 trading days for the Dow to enter bear market territory. Prior to that, we were enjoying the longest bull market of all time. Since the initial sudden drop, the market has stabilized somewhat. Unfortunately, the damage to our economy is only just beginning.

U.S. Economy

Employment is the most immediate economic casualty. Unemployment claims have been skyrocketing over the past few weeks. There were 6.6 million new claims filed during the week ended March 28 alone. This follows 3.3 million claims filed during the week prior to that. These are unprecedented numbers. For comparison, the worst single week during the 2008-09 Great Recession was just 665,000 new claims.

The totals would have been even higher except for the fact that many people have not even been able to apply. The crush of layoffs are said to have overwhelmed the limited staff at most state unemployment agencies, leading to countless stories of error messages, frozen screens, disconnected calls and busy signals. Hopefully this will be resolved soon as Congress has earmarked $1 billion of the total stimulus funds specifically to help handle the unprecedented workload at the individual state level.

The official unemployment rate reading for March just came in at 4.4%, but that figure lags reality. Per former Federal Reserve Chair Janet Yellen, the true number is probably now closer to 12% or 13%. It will likely keep growing during the upcoming weeks. Economists are generally predicting a peak unemployment rate ranging from 20% to 30% before all is said and done.

Jobs that rely directly on face-to-face customer interaction are the ones most at risk. This includes industries such as restaurants and bars, hotels and tourism, retail excluding food and beverage, entertainment and transportation. Per the Bureau of Labor Statistics, these industries comprise a total of 30.8 million U.S. jobs, which amounts to approximately 20% of our total labor force.

On a GDP basis, this same group amounts to roughly 19% of consumer spending, so we expect GDP to also take a hit during the first quarter and then completely crater in the neighborhood of -20% to -30% annualized during the second quarter given that the shutdown is now more fully in effect. This will almost certainly put us into a recession, which is defined as two consecutive quarters of negative GDP growth.

On the other hand, the aforementioned group only comprises 7% of S&P 500 operating earnings, which might help explain why the stock market has held up relatively well since its initial drop. Large publicly traded companies will likely fare better than many small businesses during the ongoing shutdown.

Overshadowed by the virus and jobs news is the ongoing oil price war going on between Saudi Arabia and Russia. Both continue to flood the market with oil. Rarely have we seen both a demand and supply shock occur at the same time. At one point, West Texas Crude (WTI) dipped down below $20 per barrel. While this is good for essential workers who still need to drive, it is bad for oil producers and the U.S. market as a whole, since we are now a net oil exporter. A portion of the recent market decline can be attributed to oil prices.

Government Response

Government response has been dramatic, which has contributed to the recent market stabilization. Significant monetary and fiscal stimulus have come from the Fed and Congress respectively.

Monetary stimulus comes in the form of loans from the Fed. They have been doing everything that they can to support the market. They have already cut rates to 0-25 bps, announced a restart of Quantitative Easing and injected over $2 trillion total in short-term funding for market liquidity. We are now expected to stay at 0-25 bps for at least the next 12 months.

Fiscal stimulus comes in the form of grants from Congress. They have been very active as well, passing the largest economic stimulus package in U.S. history. The $2.2 trillion package includes direct $1,200 cash payments to many American citizens, $150 billion for the healthcare industry, $500 billion for state and local governments and $350 billion for small businesses. As of this writing, they are now considering at least one more round, given that even more relief is needed.

Even with just the amounts already promised, we are now looking at a budget deficit totaling somewhere between $4 trillion and $5 trillion, dwarfing anything that we have ever seen previously.

International Economy

Forecasts for the Eurozone are similar to the U.S., meaning economists are predicting a meaningful drop in first quarter GDP followed by an additional 20-30% annualized drop during the second quarter. Much like the Fed in the U.S., the European Central Bank has announced multiple stimulus programs. The most recent one as of this writing was for 750 billion euros with a promise that there are “no limits to our commitment to the euro” per ECB chief Christine Lagard.

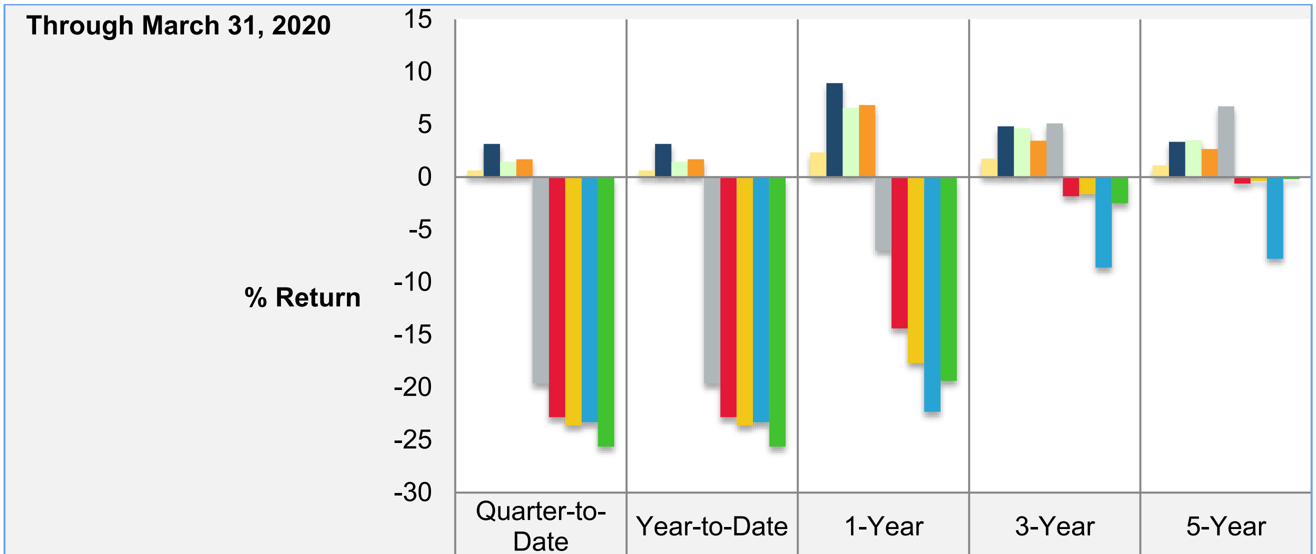
Ironically, China may finish 2020 as one of the few countries with slight positive GDP growth for year, given that they are now thought to have passed the peak growth of new virus cases and have started to get back to work. Factories are re-opening and offices are starting to fill. Of course, their economic recovery will be limited as their developed market customers must now go through the same pain that they did in order to get the virus under control.

Markets

The first quarter of 2020 saw a swift reversal for equity markets throughout the world. U.S. large-cap equities, as represented by the S&P 500 Index, lost 19.6% for the quarter after finishing 2019 up 31.49%. For comparison, developed international equity markets, as represented by the MSCI EAFE Index, finished the quarter down 22.83%.

Emerging markets performed slightly worse. The MSCI Emerging Markets Index finished the quarter down 23.6%. Alternatives such as commodities and real estate also offered no protection. The Dow Jones UBS Commodity Index lost 23.29% for the quarter and the Wilshire REIT Index was down 25.63% during the same period.

Bond indexes fared better. The Barclays U.S. Aggregate Bond Index gained 3.15% for the quarter. The Barclays U.S. Inflation-Linked Bond gained 1.69% for the quarter. The Barclays Global Aggregate Bond Index gained 1.45% during the period. Unfortunately, it appears that most individual fund managers were unable to keep up with these benchmarks as they were generally positioned more aggressively with regards to credit risk as compared to the underlying indexes.



	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	0.64	0.64	2.34	1.75	1.12
Barclays US Agg Bond Index	3.15	3.15	8.93	4.82	3.36
Barclays Global Agg Bond Index	1.45	1.45	6.59	4.65	3.49
Barclays US Infl Linked Bond Index	1.69	1.69	6.85	3.46	2.67
S&P 500 Index	-19.60	-19.60	-6.98	5.10	6.73
MSCI EAFE Index	-22.83	-22.83	-14.38	-1.82	-0.62
MSCI Emerging Markets Index	-23.60	-23.60	-17.69	-1.62	-0.37
DJ UBS Commodity Index	-23.29	-23.29	-22.31	-8.61	-7.76
Wilshire REIT Index	-25.63	-25.63	-19.38	-2.49	-0.19

Source: Morningstar. Past performance does not guarantee future results. An investment cannot be made directly in an index.

(Refer to the end for index definitions.)

Outlook

A typical bear market goes through four distinct phases: recognition, panic, stabilization and recovery. It feels like we are now in the third phase of that cycle. The recognition and panic phases happened very quickly in this case, attributable to the sudden realization that COVID-19 would be a pandemic and not just a localized outbreak.

If we are, in fact, now in a stabilization phase, that doesn't mean that the market has definitely hit its bottom. While we don't expect the same kind of volatility that we saw during the panic phase, future market direction will primarily depend on news of virus containment and/or governmental response. Incremental bad news on either of those fronts will cause markets to drift down. Incremental positive news will cause markets to drift up. Horrible GDP or job numbers will probably not have as much of an impact, since those are already universally expected at this point.

Without having any unique insight as to the near-term direction of the market, our advice remains the same. For investors with a long enough time horizon, historically it has always been best to stay the course. Ultimately, that will likely be true in this case as well.

Barclays US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Barclays Capital flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Barclays Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Barclays Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

DJ UBS Commodity Index: Dow Jones-UBS Commodity Index℠ and Dow Jones-UBS Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the DJ-UBSCI℠, which is calculated on an excess-return basis, and the DJ-UBSCITR℠, a total return index based on the DJ-UBSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate

Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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