First Quarter Market Review and Comment
April 2020

Updated Market Performance

Returns	1st Quarter 2020	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**-19.60%**	**-6.98%**	**5.10%**	**6.73%**	**10.53%**
DJIA	**-22.73%**	**-13.38%**	**4.42%**	**6.86%**	**10.00%**

Performance: January was flat and looking back was the calm before the storm posting a flat return of -0.04%. February started off strong (up ~4.98% from the beginning of February) as we hit a new high on the S&P 500 (SP500) on February 19th of 3,386.15 (Close) and then the bottom fell out as we dropped -12.76% to end the month in correction territory. February ended down -8.23%. March continued February's decent as we entered into a bear market posting a -12.35% decrease. However, March would have ended a lot worse if we did not rally from the low of 2,237.40 on March 23rd. From the low we rallied an astounding 15.52% to end the month. The rally has continued into April. Through April 17th we have regained another 11.12% from the beginning of March, which should help relieve a little of the shock from opening your statement.

After a strong 4th quarter 2019 with the SP500 up 9.07% the 1st quarter of 2020 not only brought unprecedented times but along with it came a bear (Not the Tiger King). After a roller coaster of a quarter that made your stomach drop again and again, there is a temporary sigh of relief that the quarter is over. The 1st quarter ended down 19.60%. The damage was limited as we received massive fiscal & monetary stimulus (The Fed also said they would do whatever it takes). The Dow Jones Industrial Average (DJIA) trailed the SP500, posting -22.73% over the same period. For the previous twelve months the SP500 has returned -6.98%, handily outpacing the DJIA which returned 13.38% over the same period. The annualized three-year returns are better than the near-term returns, but not impressive, with the SP500 posting 5.10%, while the DJIA is running at 4.42%. Over the last five years the annualized returns are running below historical norms (around 10%), with the SP500 returning 6.73% and the DJIA posting 6.86%. The ten-year annualized numbers are still running above long-term averages (around 10.00%); the S&P500 posted 10.53% vs the DJIA which turned in 10.00%.

Breaking down the returns for the Q1 2020, we note that there were seven outperforming sectors and four underperformers. **The best sectors were Technology (-12.22%), Healthcare (-13.07%) and Consumer Staples (-13.39%)**. **The losers during the quarter were Energy (-51.06%), Financials (-32.34%) and Industrials (-27.41%).** The clear winners the last twelve months were Technology (8.87%), Healthcare (2.78%) and Consumer Staples (-3.41%). Bringing up the rear were Energy (-54.36%), Industrials (-21.07%) and Financials (-19.00%).

Economy: The coronavirus outbreak is driving changes to the US economy so quickly it makes forecasting more challenging than usual. Economic growth for the 1st quarter and 2nd quarter 2020 are expected to remain below average and potentially very negative due to the drastic measures implemented to slow the spread of the virus. This has virtually shut down economy and most non-essential businesses. Growth is expected to bounce back once the economy is fully operational and the threats from the virus have subsided either due to a successful treatment, increased immunity, or a vaccine. After the economy bounces back it will return to the below average growth trajectory we were experiencing before the

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pandemic. The economic recovery is going to be path dependent on how long the economy is shut down and how bad the spike in cases are once restrictions are lifted. The longer the economy remains dormant the more economic damage we will experience extending the length of the recovery.

The third estimate of 4th quarter Gross Domestic Product (GDP) is 2.1% according to the report released at the end of March by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 4th quarter was unchanged from 3rd quarter 2019. GDP for 2019 came in at 2.3% compared to 2.9% in 2018 and 2.2% in 2017. The long slow recovery which has been in place since mid-2009 will soon end abruptly. Currently the New York Fed Staff Nowcast (Forecast of U.S. GDP Growth) has forecasted 2020 Q1 GDP growth at -0.40% and 2020 Q2 GDP growth at -7.9%. By comparison, China says their GDP contracted at -6.8% in the 1st quarter of 2020. China's 2019 GDP was 6.1%, 6.6% in 2018 and 6.8% in 2017. The first quarter GDP contraction is the first since records began in 1992, reflecting the severe damage caused by the COVID-19 outbreak after the authorities enforced a near two-month-long shutdown of all non-essential business activity. Growth rates for the European Union (EU) and the Euro Area were 1.2% and 1.0% respectively in the 4th quarter 2019. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2017. GDP Growth forecasts for the end of the 1st QTR 2020 are -9.2% for the EU and -9.0% for the Euro Area.

Unemployment could get depression era high, but we did shutdown the economy. Once the economy is restarted unemployment should drop. According to the Bureau of Labor Statistics, March unemployment rose to 4.4% an increase of 0.9% from February's 3.5%. March's 0.9% increase is the largest month over month increase since January 1975, when the increase was also 0.9%. Unemployment is expected to be as high as 15% by the end of the Q2 2020. Unemployment for 2019 came in at 3.67%. The number of unemployed rose from 1.4 million to 7.1 million in March. The sharp increase reflects the effects of the coronavirus and the corresponding efforts to contain it. The labor force participation rate was 62.7% for March a decrease of -0.7% from February.

Inflation is still below historical averages. After averaging ~2.07% in the 4th quarter 2019, inflation as measured by the Consumer Price Index (CPI) increased slightly to an average of 2.10% in the 1st quarter 2020. The average rate of inflation for 2019 was 1.82% and continues to be subdued by historical standards (~2.50% over last 30 years). March came in at 1.50%, a decrease of 0.8% from February's reading.

Consumption is an important driver of the economy as it represented 68% of 4th quarter 2019 nominal GDP. Due to recent events surrounding COVID-19, many businesses are operating on a limited capacity or have ceased operations completely. The U.S. Census Bureau announced in April that retail sales for March 2020 were down -8.7% compared to February and were down 6.2% below March 2019. Food and beverage stores were up 28.0% percent from March 2019, while clothing and clothing accessories stores were down 50.7% from last year.

Manufacturing economy contracted in March. Economic activity in the **manufacturing sector** contracted for the month of March after expanding marginally in January and February, with the Purchasing Managers Index (PMI®) registering 49.1, a decrease of 1.0 from February reading of 50.1. Three of the big six industries expanded, with Food, Beverage & Tobacco Products expanding strongly. The **overall economy** grew for the 131st consecutive month, according to the nation's supply executives in the latest **Manufacturing ISM®** *Report on Business®*. Based on historical relationships between PMI and GDP, a PMI of 49.1 corresponds to a 1.8% increase in real gross domestic profit (GDP) on an annualized basis.

It is important to bear in mind that the COVID-19 pandemic did not begin to take hold in the U.S. until late February, and thus whatever impact it will have on housing prices is not reflected yet. According to the S&P Case-Shiller Home Price Indices home prices rose in January with the S&P CoreLogic Case-Shiller National Home Price Index rising 3.9% over the last 12 months. Phoenix, Seattle, and Tampa had the largest year over year increases with 6.9% for Phoenix and 5.1% for both Seattle and Tampa. According to the National Association of Realtors, the year over year change in existing home sales was 17.2% in February for Single

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family homes above $250,000 and housing supply continued to remain tight in February with 3.2 months of supply.

Markets: Last quarter I kept hearing the acronym NABAF (Not as bad as feared). Basically, all the bad news was shrugged off because it was not as bad as feared and the market would continue to rise. The market even tried to dismiss the virus/pandemic in early February before it became worse than feared. The S&P 500 then began its decent. In only 22 trading days the S&P 500 fell 30% from its high reached on Feb. 19. This was the fastest drop of this magnitude in history. The second, third and fourth quickest 30% drops all occurred during the Great Depression era in 1934, 1931 and 1929, respectively.

- **Covid-19 Virus: The market reacted fast and furious as it priced in a worst-case scenario. We have since bounced off the lows as the market is starting to see some light at the end of the tunnel. The market was helped with the enormous amounts of fiscal and monetary stimulus.** The immediate impact was felt with the closing of most of the global economy. The question now is how we safely open the economy back up. The longer everything is disrupted the more economic damage we will endure. As restrictions begin to be removed do not be alarmed if we have setbacks. This is something that we have never done before. Once we get on the other side of the virus and the economy returns to normal capacity equity markets should benefit from ultra-low interest rates and the tail wind of all the economic stimulus we have and will receive. The old acronym TINA (There is no alternative) will come back to fashion.
- **Earnings growth for the SP500 is expected to decline -14.5% for the 1st quarter 2020. If the actual decline for the quarter is -14.5%, it will mark the largest year-over-year decline in earnings reported by the index since Q3 2009 when the decline was -15.7%.** According to FACTSET, of the SP500 companies that have reported earnings as of 17 April (Approximately 45), 66% reported earnings above the mean estimate and 70% have reported sales above the mean estimate. **Most companies are pulling previous guidance and not giving forward guidance at this time.** Looking at future quarters, analysts predict a decline in earnings for the second quarter of -26.6%, third quarter -13.3%, and fourth quarter -4.8% for 2020.
- **After the market decline stocks are cheaper but not cheap. *It does not look like we will receive any meaningful earnings growth until early 2021.*** The current 12-month forward Price Earnings (PE) multiple on stocks is 15.4. The long term (20 Year Average) PE for stocks is 15.5, so we do not see a lot of room for valuations to move higher without growth. As earnings continue to come in lower, the E in the P/E ratio will get smaller and in turn lower our PE levels a little more (This is as long as prices don't increase at the same time offsetting any decrease in PE). Lower interest rates allow for higher multiples.
- **Interest Rates are near Zero again and the Fed is ready to do whatever it takes.** The Federal Reserve made an emergency interest rate cut on March 3rd dropping the rate down 50bps (basis points) or .50% to 1.00%-1.25%. On March 15th they made another emergency rate cut slashing rates down to 0%-.25%. At the same time, they launched a Quantitative Easing (QE) program (They are basically buying bonds to increase the money supply, as well as encourage lending and investment). They were originally going to buy Treasury's and mortgage backed securities like they did during the financial crisis, but then they added corporate bonds (First for the Fed). They are also doing some other easing with credit facilities to provide liquidity to other parts of the market especially money market funds. They originally had an amount of 700 billion, but on March 23rd they came out and said that there was no ceiling and QE purchases would be unlimited. They also said they would do whatever it takes.
- **2 Trillion plus fiscal stimulus.** The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress and signed into law by President Trump on March 27th, 2020. This over $2 trillion economic relief package will help to protect the American people from the public health and economic impacts of COVID-19. There will be at least one more round of fiscal stimulus if not more.

- **Oil prices crash.** Who would have thought that you would have demand drop because economies are basically shutdown and at the same time have Russia and Saudi Arabia decide to increase supply? January WTI crude prices were around $60 per barrel. Now they are around $12.87 per barrel. Right now, there is too much supply with very little demand. OPEC + decided to make supply cuts starting in May, but without adequate demand it will not be enough to get oil prices to stabilize and rise.
- **Election Year (Remember).** Election years bring policy uncertainty, which usually translates into higher market volatility. Currently the Pandemic is overshadowing most policy uncertainty. The last 23 election years since 1928 the S&P 500 was only negative 4 times. Historically if the S&P 500 rises between July 31st and October 31st in an election year, the incumbent candidate (current holder of office) wins 80% of the time. On the other hand, if stocks fall, the incumbent loses 88% of the time.

Forecast:

We think the biggest threat to the stock market is the uncertainty presented by the Covid-19 virus and the uncertainty of how and when the economy will return to business as usual. This uncertainty will persist until the economy is back up and running and the virus is no longer a threat. We originally thought we would test the lows (SP500 2,237.40) set back on March 23rd. After all the Fiscal and Monetary stimulus so far and signals that there is more to come if needed, I do not think we will test the old lows again. We do think there will be continued volatility and the market will go down when we have setbacks. We think the SP500 will end the 2nd quarter between 2,600 and 2,700. At this juncture, we venture a guess that stocks will end up somewhere between -8% and -10% for the year.

For the next six to nine months, the Federal Funds rate should remain at its current range of 0%-0.25%. **The 10-year Treasury which is currently priced at ~.62% should remain in a range between .50%-.75% through the end of the 2nd quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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