



It's been like going from day to night! The sun shown on the 4th quarter of 2019 as the USMCA moved toward Congressional approval and Phase I of the trade deal with China produced a truce in the trade war. Economic activity appeared headed for reacceleration. Yet by the middle of January, day turned to night, and sunrise never came.

At the beginning of the year, investors were most concerned about the uncertainty surrounding the presidential election in the fall, but for now, that uncertainty has been set aside. As everyone knows, the radical flip from day to night occurred with the emergence of COVID-19, and the unprecedented decision of governments around the world to shutdown economic activity has taken front and center stage in all discussions. All investors were caught unaware, and the market reacted with panic: selling of stocks and buying of Treasury bonds.

Therefore, we find ourselves in the midst of a recession. Nothing that is occurring today can be called a “normal” recession triggered typically by monetary tightening by the Federal Reserve Board, dramatic increases in financial leverage or excesses in consumption, production, and inventories. Instead the recession can be said to have started by surprise—the difficult, but ultimately correct decision to protect human life by sacrificing short-term economic stability. It's a surprise because the world at first did not appreciate the virus' high death rate, which appears to be 10 times or more that of a typical flu. This justified in everyone's mind that a shutdown of the economy to flatten the mortality curve was, and is, the right response. The unintended consequence of this government action is to magnify the impact of the virus into a drop in real GDP of perhaps 10% or more in the second quarter.

At the same time, these economic consequences added further to the plight and panic in financial markets. Yet, both the virus and the economic and financial market responses are transitory events. The virus will ultimately be contained and economic activity will recover. In the meantime, the first quarter of 2020 saw the worst quarterly decline in the U.S. stock market since 1987. The S&P 500 and the Russell 1000 Value plunged in the 1st quarter about -19% and -26%, respectively.

As is reflected in the above return difference, “growth” stocks also outperformed “value” stocks, and the historically high discount for value stocks relative to growth widened even further. This is not hard to understand because if you are stuck at home as most people are what do you do? Watch Netflix, connect up with your friends on Facebook and Google, call or text on your iPhone, and order products on Amazon. As part of the famous FANG stocks that dominate the market capitalization of the S&P 500 and growth indexes, these stocks performed admirably as follows: +16%, -18%, -14%, -13%, and +7%, respectively. To the extent their valuations were unattractive before the start of this crisis, we believe they are all the more so today.

In contrast, sectors with real economic sensitivity were hurt the most: materials, energy, financials and industrials. Among value stocks, healthcare, staples and utilities held up the best. Consumer staples, an area of minimal consumption growth in recent years, has seen extraordinary demand as the panic in stocks was met with an equal amount of panic in purchases of toilet paper, paper towels, cleaning supplies, and canned goods like soup. The hoarding behavior currently on display should result in relatively good earnings reports from consumer staples companies for the first quarter of 2020, but hoarding just steals demand from the future and investors will soon recognize the temporary nature of many earnings improvements.

We believe there will nevertheless be permanent consequences for the economy from this corona crisis. Supply chains will be reworked to become more responsive to healthcare needs, where possible, employees will become fully equipped to work remotely, corporate balance sheets will be retooled to contain less debt leverage, and working capital will be raised, particularly in the stocking

of higher inventories rather than the “just in time” approach currently in place. We think these are just a few of the potential changes.

While supporting businesses and workers during the “shelter in place” period certainly makes sense, the government response leaves much to be desired. We agree that targeted responses to replace lost revenues of businesses and incomes of workers during the shutdown make sense, but we do not think \$2 trillion that includes “helicopter money” does. It balloons the deficit and federal debt massively while only providing a moderate amount of relief to individuals.

Furthermore, Federal Reserve Board Chairman Powell’s makeover would fit nicely into the era of “Born to Be Wild”* as he slashed the Fed Funds rate to zero and launched another \$2 trillion program of quantitative easing. We agree that adding liquidity to bond markets has some value, but the real problem stems from the freezing of the corporate bond market, not Treasuries. One of the unintended consequences of such a wild spree of buying of Treasuries and mortgage-backed securities (MBS) is the fear that as the Fed monetizes federal debt, higher inflation can’t be that far behind. From the start of 2020, 30-year Treasury bond yields fell from 2.29% to 0.92% at their low in March, only to see the yield rebound to 1.89% before settling in at 1.31% at quarter end. Such induced volatility helps no one, and quantitative easing has a checkered record of stimulating the economy.

The parts of these programs that helps businesses meet their debt service obligations between March and July and supports household payments for rent, food and health care are important to prevent a contagion that leads to a longer lasting downward spiral in the economy. With constrained production, by the time COVID-19 has run its course, inventories will have been depleted, the labor force will want to go back to work, a surge in spending should begin, and economic growth should be rekindled even if the path of full recovery takes many months. From our viewpoint, the panic appears to be close to an end, and the investing landscape hasn’t looked this good in years, at least for stocks. Treasury bond return outlook is poor. Yet, there is reason to have optimism about the outlook after the virus peaks, and the potential for double-digit returns from today’s levels has led us to stay our course of investing in companies with attractive long-term valuations and fundamentals.

*“Born to Be Wild,” *Steppenwolf, 1968*

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