

Update from the Investment Team

April 3, 2020

Given the extraordinary events of recent weeks, we are departing from our typical quarterly newsletter format of reviewing recent events in financial markets and updating our annual market outlook. As financial and economic uncertainty increased due to the COVID-19 pandemic, we've published regular updates on recent events in financial markets this quarter. These notes are archived on the Resources section of our website if you missed any of them. Our goal in this note is to share some historical context for the current downturn and consider what a recovery might look like.

With regard to the current downturn, we left off in our last missive that "we remain cautious on the short-term outlook. There is no doubt the situation could get worse before it gets better." While this is clearly still the case, we would like to point out three criteria we believe are necessary conditions for stabilization in financial markets and the beginning of a recovery:

1. The scale and urgency of the federal government's response must be consistent with the substantial challenges that confront our economy and financial markets.
2. Financial markets must continue to serve their critical role in the economy of providing a stable infrastructure where financing makes its way to credit-worthy businesses and individuals.
3. There must be some light at the end of the tunnel with regard to the COVID-19 pandemic. This may come in the form of successful treatments or vaccines, broader testing revealing lower mortality, emerging herd-immunity, relative safety for various geographic areas or demographic groups etc.

Since our last communication there has been substantial progress on the first two items on our checklist. The US government has delivered massive fiscal stimulus to aid individuals and businesses disrupted by the pandemic and the Federal Reserve has responded aggressively to restore liquidity to the areas of financial markets in marked distress. It is quite possible that more will have to be done on both fronts, but for the moment we are primarily left waiting for an improvement in the healthcare crisis. As Dr. Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases, recently noted, "you don't make the timeline, the virus makes the timeline."

While we remain at the mercy of the pandemic regarding the timing of a durable bottom for financial markets, progress to date has left us contemplating the potential for recovery. Granted, there is still significant uncertainty on how quickly and effectively the recently announced stimulus can be implemented and how dramatically corporate earnings will be impacted. However, while every crisis is different, it is important to note that the more severe the decline in the stock market historically, the higher the probability and the greater the magnitude of the average rebound over the next 6 and 12 months (see graphic below). The type of rebound that's possible was clearly visible in the closing trading sessions of the first quarter, as the Standard & Poor's 500 surged by more than 20%. Violent rebounds of this kind are inherently unpredictable, but also critical to recouping prior losses – it is the primary reason to remain (carefully!) invested during a downturn with an eye toward longer-term investment opportunities.

Over



To be clear, we believe that the global economy is sliding into recession and that downturns of this scale typically take years rather than months to recover from. While depressed valuations create the potential for sudden, unexpected vaults higher in the stock market, a full recovery will likely take time. In fact, there have been ten prior bear markets in the US since 1948 and the median time before the stock market returned to prior highs was 2.7 years, with significant variance around that median. It is also entirely possible this recovery will take longer than normal as companies may sacrifice some profitability to develop greater resilience given the level of supply chain disruption in recent years.

We continue to maintain less equity exposure than normal and a bias towards higher-quality securities given continued uncertainty about the duration of economic disruption from the COVID-19 outbreak. We also remain relatively fully invested in fixed income investments, which has helped reduce downside participation for the balanced portfolios we manage. Many bonds also look like attractive investments going forward; they provide surprisingly attractive interest rates despite the Fed's efforts to push treasury yields towards zero. We have also begun to add exposure to assets such as gold and treasury inflation-protected securities (TIPS), which may help hedge against unintended consequences of the unprecedented federal deficit and unlimited quantitative easing (money printing) by the Fed. Importantly, however, people and the businesses they build are remarkably adaptable and we are scouring financial markets for investment opportunities that will not only survive but thrive in the months and years ahead.

In many ways, the current crisis seems distinctly different from prior market downturns, but this feeling is a surprisingly consistent reaction over time to abrupt market declines. Another constant over time is that market turmoil is usually a response to new risks that confront investors and ends up creating new opportunities. Our entire team is focused on thoughtful portfolio construction for our clients that addresses both these new risks and new opportunities as they emerge, while keeping client portfolios aligned with longer term goals. As always, please feel free to call us if you have questions – we're here to help as we balance near-term risks against the potential long-term rewards increasingly available in today's markets.

US and Global Stocks: Strong Rebounds after Corrections

[Source MRB Partners, Inc.]

