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Investment Management and Financial Counsel

March 20, 2020

Dear Clients and Friends,

To begin with, we are still available to assist with your investment and financial planning needs. We are supporting the effort to lessen the risks to our employees and our community by allowing and encouraging our employees to work from home. But, we have been busily communicating with clients and each other via email, telephone, and web conferencing. We have served our clients and communities for over 30 years and we are here for you if you need anything.

To say "it has been quite a week" would be an understatement. Here is a summary of recent events:

- Monday – Thursday the S&P 500 was down 10.7%. As I began writing this Friday morning it was up 2-3%, and now near the close it is down 3%.
- The yield on 10 year US Treasury bonds rose from 0.94% to 1.12%. The low closing yield was 0.54% on March 9th.
- Oil prices fell to around $20 and have now settled at about $24.
- Market volatility has spiked to historic levels. During times like this, markets do not function properly. Do not get overly worked up by the volatility. Temporarily, prices are not representative of value, but are determined by supply and demand; and when investors step aside there are much wider swings. This was true even in bonds recently, which is why the Fed has stepped in to buy bonds.
- There were no new coronavirus cases in China for the last two days, offering some hope that this will eventually get behind us.

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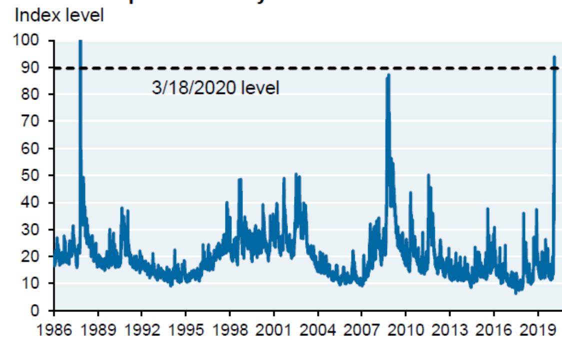

- Total deaths, however, have exceeded 10,000 and there have been more deaths in Italy than in China.
- California is on a statewide lockdown.
- Social distancing has shut down normal life in the US. News of a surge in layoffs and a collapse in spending, has been both historic in size and speed. These developments argue for a sharper drop in GDP in Q1 and Q2 than previously estimated.
- Goldman Sachs current estimates for US economic growth :
  - Q1 -6%
  - Q2 -24%
  - Q3 +12%
  - Q4 +10%
  - Full year -3.8%
- Goldman Sachs also now estimates unemployment will reach 9%. 2 million or more unemployed claims are expected to be filed next week.
- For what it's worth, the NY Fed and the Atlanta Fed have GDP forecasting tools and both still point to positive GDP growth for the current (1st) quarter, but those don't reflect the near total shutdown of activity currently underway.
- By anyone's definition, this is/will be a recession… probably to be named the Coronavirus Recession. The US and other governments' responses will mitigate the depth and duration. Here are the actions taken and considered:
  - The Fed lowered rates to 0% - 0.25%
  - The Fed added $1.5 Tln in liquidity to the repo market to aid in the functioning of the US Treasury and money markets
  - The Fed has begun quantitative easing (QE4). Asset purchases of $500 Bln of US Treasuries and $200 Bln of Mortgage Backed Securities
  - The Fed just announced they would include short term municipal bonds in their purchases
  - On March 14th, Congress passed a healthcare related bill that includes: free testing for the coronavirus, emergency paid sick days, paid leave for those unable to work due to the virus, expanded unemployment insurance and food assistance.
  - Tax filing and payment day has moved to July 15
  - Congress is working on a $1 Tln stimulus package that reportedly will include cash payments to individuals making less than $70,000 per year, loans to business of all

sizes, and probably other pet issues that various congress men and women have wanted. The implications may be long lasting and are unknowable, but the depth of the problem means any stimulus measures are ok in the short run.

- There are news reports the US Treasury may issue 50 year bonds to finance the stimulus, but it is not clear if the market will buy them.
- There have also been stimulus measures taken or planned in the UK, China, Australia, Europe, and Japan.

A few moments ago, as I was writing this memo from my home office, and CNBC was on silently in the background my son came in and asked, "Why is the market up today"? He is 15 and taking a class in high school called Personal Finance, so he's not completely unaware; but like most people the daily swings of the market are a mystery to him. The simple answer I gave was "maybe it's gone down enough", but that was followed with an explanation that the market is a discounting mechanism. It efficiently discounts all the known information, and then it adjusts as we get new information. When I wrote to you last, I gave you Goldman Sachs' economic growth estimates, which were much more benign than those shown above. The information has changed, and the market has gone down to reflect that information. Will it stabilize here? It depends on the information. One important thing to remember is that the market moves on what I call the second derivative. It's the change in the rate of change. That will be the case here too.

Source: Robert J. Shiller, S&P Dow Jones Indicies. Q4 2019.

Like the economy, the impact on corporate earnings is unknown. For some perspective, I looked back at prior periods. Shown on this chart are earnings going back more than 100 years. At the risk of boring you with details, I have to make a quick comment on operating vs. reported earnings. Corporations regularly write down earnings for accounting purposes. Earnings after write-offs are called 'reported' earnings. Operating earnings attempts to tell investors what the normalized operating company is doing. Yes, there is accounting manipulation; but we subscribe to the notion that if you want to understand the normalized profit of a company you should use operating earnings.

Back to prior periods… before the financial crisis began, the S&P 500 was on its way to earning $100 in 2007. Earnings were $24 in the 2nd Qtr 2007. By 4th Qtr 2008 they were $0. For the 12 months ending 3rd Qtr 2009, earnings were $40, a drop of 60%. Importantly, the market bottomed 6 months earlier. They

finally crossed the $100 level in 3rd Qtr 2013. By then the market had already risen 135%. During the tech bubble/bust earnings didn't fall as much. They fell from $57 for the twelve months ending 6/30/2000 to $39 for the twelve months ending 3/31/02 – a fall of 31%. In that case the market didn't bottom until early 2003, but that was because of the over-valued level we started from and sentiment issues related to 9/11 and the Iraq war.

Today, earnings were running at about $40 per quarter before the recession, or about $160 on an annualized basis. Let's assume $0 earnings for 2nd Qtr and 3rd Qtr. I'm just guessing, but it might be worse in one and better in the other. Then we will get a strong rebound in the quarters that follow. The real point of this exercise is this… I hear from clients and friends that the market is all about fear and greed. It's gambling… that value doesn't have anything to do with it. It went up, so it has to come down. THAT IS NOT TRUE! The market will recover because earnings will recover. The value of an investment is the future cash flows discounted into present value. Investors are changing their estimates of future cash flows, and the discount rate changes due to changes in interest rates and perceptions about risk. That is what I will try and explain to my son (and to you).

Finally, our analyst Zach Cole did a research project on the three biggest stock market drops since World War II. The research underscores the value of a balanced portfolio. The most common portfolio allocations for our clients are 50% or 60% equities. The average decline of those portfolios was 20% - 25% from peak to trough. We are pretty close to that level now. The average recovery time to reach the prior peak was 2.3 to 3.0 years. On average, stocks fell 46% and took 4.7 years to recover. Remember, it is extremely hard to time the market. Over the last 20 years the market was up 222%. If you missed only the best 10 days your return would have been cut in half.

Disclosures

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Any investment program may be volatile and can involve the loss of principal. Global investing can involve additional risks, such as the risk of currency fluctuations. No assurances can be made regarding the accuracy of any future prediction. Past performance is no guarantee of future returns. Not all past predictions were as accurate as those represented in the content of this newsletter.

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