



March 27, 2020

Dear Clients and Friends,

We are now 4 weeks into this crisis, at least as measured by the stock market. The S&P 500 peaked on February 19th and fell 33%. The bottom (so far) was on March 23rd (last Monday). From Tuesday to Thursday, we had 3 up days, which was an emotional reprieve from the relentless losses, but today (Friday) looks like it will be a down day. Nevertheless, it appears we will have an up week for the first time in a month.

So, it's natural to ask: Are we there yet? Was that the bottom?

Nobody knows for sure. However, we can look at previous market declines for clues. In each case, you will see there were fundamental reasons for the declines and the subsequent rebounds. Fed and government reactions were also important.

Black Monday 1987



In 1987, the stock market fell 25% over a couple of days. Black Monday was the largest drop since the Great Depression. What happened? In the five years prior to October 1987, the market had tripled in value. It was considered overvalued at the time. The G-5 nations had been managing the US dollar in

international currency markets since the Plaza Accord of 1985 – first depreciating the dollar, and then in 1987 the Fed began raising interest rates in order to strengthen it. This started the market decline, and then in October, what was then called program trading took over and accelerated the decline. This is when the exchanges implemented circuit breaker rules, which we have seen used recently. After the crash, the Fed created liquidity and there was no recession. The market recovered within a little more than a year.

Tech Bubble & Bust 2000 - 2003



During the 1980s and 1990s stocks averaged 18% annual returns, which led to significant overvaluation by 1999. Technology was growing exponentially in the 1990s as a result of Intel's chips, Microsoft's Windows, Apple, the PC and the growing use of the internet. Between 1995 and 2000, the tech heavy Nasdaq Composite rose 400%. It reached a Price/Earnings ratio of 200. The S&P, which is more diversified, reached an all-time high P/E ratio of 30x... more than double its long-term average. When the tech bubble burst, it was primarily due to simple overvaluation. The Fed had been raising rates for six years from a low of 3% to 6.5%. There was a recession in 2001, but what exacerbated the Bear Market was the bombing of the World Trade Center 9/11/01. That led to the Iraq War that officially began in 2003 but was preceded by a yearlong buildup of forces. So that Bear Market began with rising interest rates, an overvalued market, a recession, and a war. The bottom of the Bear coincided almost exactly with the attack on Iraq in March 2003.

The Great Financial Crisis (GFC) and Bear Market of 2008 – 2009 was the result of overleverage that stemmed from the real estate sector but permeated the whole financial sector. Because banks are the heart of our financial system, it was like a heart attack. As before, the Fed and interest rates played a role. Rates had risen from 1% in 2004 to 5% in 2007 as the Fed tried to cool the economy down. The market was not overvalued in 2007, but a significant recession ensued. Unemployment rose to 10%, and the entire financial system was at risk. The Euro, which was a relatively new creation, was near failure. Some European countries had much worse unemployment and financial problems than the US. In this case, while the Fed helped create the crisis, it undoubtedly helped save the day with massive programs to create liquidity and lowering of interest rates. Congress also stepped forward with several stimulus measures. The first was in 2008, a \$152 billion bill consisting of \$600 tax rebates. In 2009 there was an \$800 billion stimulus package. Additionally, the Treasury Department undertook a program of capitalizing

and regulating the largest banks, in order that the public regain trust in the banking system at large.



Correction of 4th Quarter 2018

Next, in what may seem like a mild Bear Market in comparison, the market fell 25% in the fourth quarter of 2018. In this case, it was really caused by the market’s concern about the Fed raising interest rates. The market was at a high valuation of 19.4x earnings, but that is nowhere near the overvalued levels of 2000. The markets were simply concerned the Fed would raise rates too far and the economic growth period would end. The Fed signaled they would change course, which they did in 2019 and the market made a rapid recovery.



Coronavirus Crisis 2020

That brings us to today. The current drop looks more like 1987 than any of the previous falls, but the fundamentals are unlike any previous period. The Fed had not been raising interest rates. The economy was strong. As we have reported before, in early February valuation was high, but not



extremely so... the P/E was 20.6 based on trailing earnings versus a 30-year average of 18.6. There is no war like in 2002 – 2003. Trade wars seem pretty insignificant now. The heart of the matter is the recession. How bad will it be?



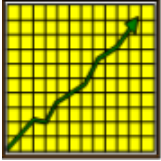
Again, nobody knows for sure. I have mentioned to some that I think this is a risk of time, not of price. I believe the economy will rebound strongly once the virus has passed through. Earnings will follow. The government has learned from previous crisis and reacted swiftly. The Fed is throwing the kitchen sink and all the bathroom sinks at providing liquidity. Interest rates have been lowered to zero. It is beginning to work. We saw bond prices swing wildly but they have now recovered. In last week's letter I explained the problems a lack of liquidity causes. There are still some problems in municipal and corporate bonds, but the liquidity issue will subside. Solvency will be what matters going forward.

Returning to the original question, "Are we there yet? Was that the bottom?" Maybe. During the next few weeks the virus is going to get worse, and the economy is going to get worse; but we know that. The question is whether it gets worse than we think it will be. There were 3 million people that filed for unemployment last week. The market went up the day that was announced. Medically, I have the same information you have, and have no expertise to add. I am worried about the response on the medical side of this crisis, and the pressure building to get everyone back to normal. It seems to me that massive testing would be the best way to get people back to work, but we are nowhere near that goal. And, if the virus lingers, or goes and comes back, the economic problems last longer.

But, based on the Fed's actions, and the fiscal stimulus, and the national effort to slow the virus, and the bounce in the stock market, and the recovery in the bond market; we think it is time to make the first tip toe steps back into re-balancing. We're going to be working next week on it. Nothing aggressive. We will also be looking to upgrade holdings. Funds that have not done their jobs will be replaced or reduced. Sectors like high yield bonds are being studied. Spreads have widened to levels that have historically been attractive, but that may not be the best place to take risk. Some low volatility strategies have not been as low vol as intended.

We will proceed slowly and cautiously. Our timing will not be perfect. But we will keep working to make better portfolios for when we get to the other side of this.

Take care,



Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer
And Your Entire Colorado Financial Mgmt. Team

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