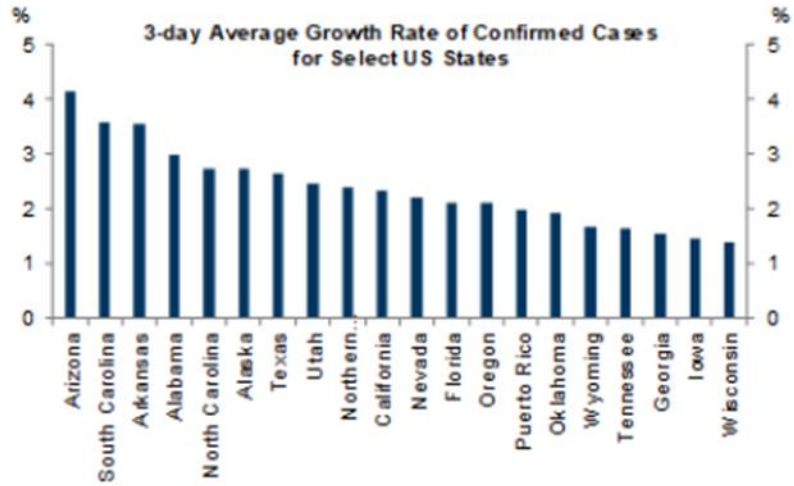
June 12, 2020

	Worldwide		United States		
	# of Cases	# of Deaths	# of Cases	# of Deaths	# of Tests
4/10	1.6 M	97 k	466 k	17 k	
4/17	2.2 M	147 k	662 k	29 k	3.4 M
4/24	2.7 M	192 k	869 k	50 k	4.6 M
5/1	3.3 M	234 k	1.1 M	63 k	6.2 M
5/15	4.4 M	304 k	1.4 M	86 k	10.3 M
5/29	5.9 M	364 k	1.7 M	100 k	15.1 M
6/12	7.6 M	422 k	2.0 M	114 k	21.9 M

Dear Clients and Friends,



Yesterday the stock market had a spasm and fell 5%. One of the reasons cited was reports that there was a second wave of Covid-19 cases underway. Over 2 million Americans have now been infected, another milestone, and the number of new cases has increased in Texas, Florida, and California. The sub-headline in Bloomberg News read, “Experts say that surges can’t be linked directly to reopenings”. Give me a break. Of course it’s related to reopening. There is still a lot we don’t know about this virus, but we know it passes from person to person. The more people interact, the more cases there will be. But what does that mean to the economy? The stock market? Governmental response? Not that much in my opinion.

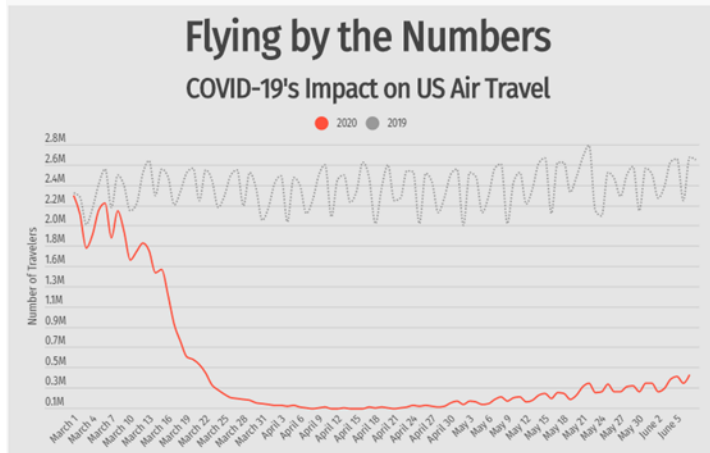
First of all, there is no way the Federal Government is going to shut down the economy again. It is an election year and the President did not want to shut down the economy in the first place. States are also going to be reluctant to shut down. It is going to be left to cities and towns most affected, and my guess is it will be driven primarily by whether hospitals are able to handle the new cases. In Colorado, the Convention Center in Denver and the Ranch Events Complex in Loveland were outfitted for overflow Covid19 patients and have not been needed. They remain available in case there is a surge in cases this fall. Perhaps other states have not been as proactive, but a wholesale shutdown is extremely unlikely in my view.

What does that mean for the economy?

We think the economy will slowly recover, as depicted in the chart below. The worst was in April when everything was shut down. It will get better month by month, but it will be sometime next year before we are close to the same level of economic activity as we saw in 2019. Following air travel will be an

Exhibit 7: GS Economics forecasts economy returns to pre-virus level by year-end 2021

Source: Goldman Sachs Global Investment Research



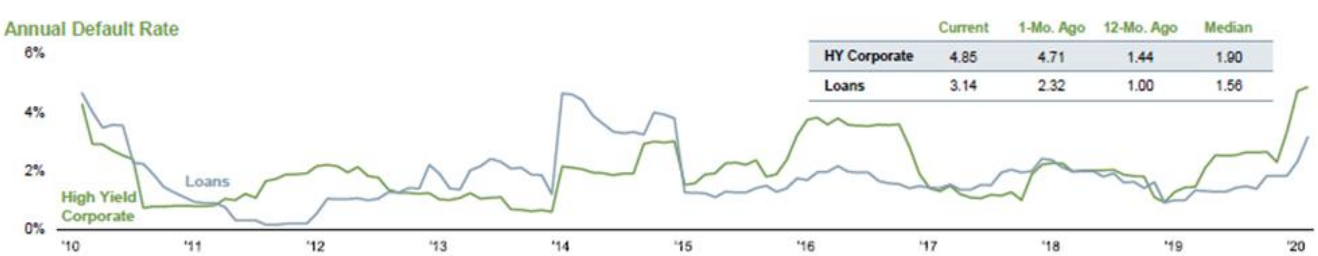
interesting way to monitor economic re-opening. There is still a long way to go.

Employment is not going to bounce right back, and there will be a number of bankruptcies, both big and small. Remember that in our system, bankruptcy does not always end with the end of a company. In fact, more often than not companies come out of bankruptcy in better financial shape than when they entered. Hertz has filed for bankruptcy, but you can still go rent a car. Most airlines have filed for bankruptcy before, some more than once. General Motors filed for bankruptcy in 2009. They're still selling cars.

How about the banks? It seems that every financial crisis over the last 30 years was either caused by, or resulted in some kind of banking crisis. There was Penn Square Bank in the 1980s that led to the fall of Continental Illinois – then the fourth largest bank in the US. There was the Third World Debt Crisis, the Savings and Loan Crisis, and the Great Financial Crisis (GFC). A few of our Clients have asked whether there is another risk lurking out there in the banks, and one pointed to an article in *The Atlantic* that details dire risks. I like *The Atlantic* so I was surprised to read such an alarmist article. The author is a law professor at UC Berkeley who has some experience with the derivatives implosion during the GFC, so his views cannot be dismissed out of hand; however, I disagree with him. He argues that the banks are loaded with bad loans packaged into Collateralized Loan Obligations that could fall like dominoes, similar to what happened in 2009 with real estate mortgages. I think he has exaggerated the risks.

What are the risks and how is it different today? The GFC was caused by a real estate bubble, and a bunch of bad debt. When the bubble popped, the loans collapsed. The collateral wasn't any good, and the banks were over-leveraged. In response, the Fed and Treasury department forced the banks to increase their capital, and real estate loans are much more tightly regulated as are banks in general. A new type of market has developed since the GFC called 'Leveraged Loans'. These are corporate loans that go directly into the public markets, similar to high yield bonds. Banks may have some of these loans in their portfolio, along with other bonds such as US Treasuries and municipal bonds. Other buyers of these loans include mutual funds, insurance companies, and other large investors. We recently held a mutual fund that invested in them, called American Beacon Sound Point Floating Rate Income.

Here is a chart showing the default rate on loans and High Yield corporate bonds:



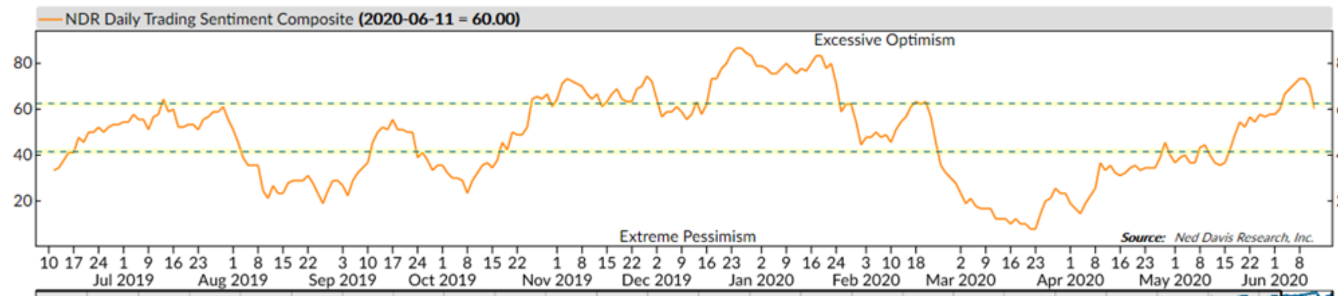
You can see that there has been an uptick in defaults from a low of 1% to a current level of 3%. HY corporate bonds have also seen an increase in defaults from 1.4% to 4.9%. These rates will probably go higher (and that's why we sold the Sound Point fund); but they are unlikely to reach a level that risks the entire banking system. Probably the biggest reason for confidence is the Federal Reserve has given an explicit guarantee to the markets; they will do whatever it takes to provide liquidity to the banks, and even to corporations.

Another risk on some Clients' minds is whether all the money printing by the Fed will lead to inflation. My answer is maybe… someday in the future… but not anytime soon.

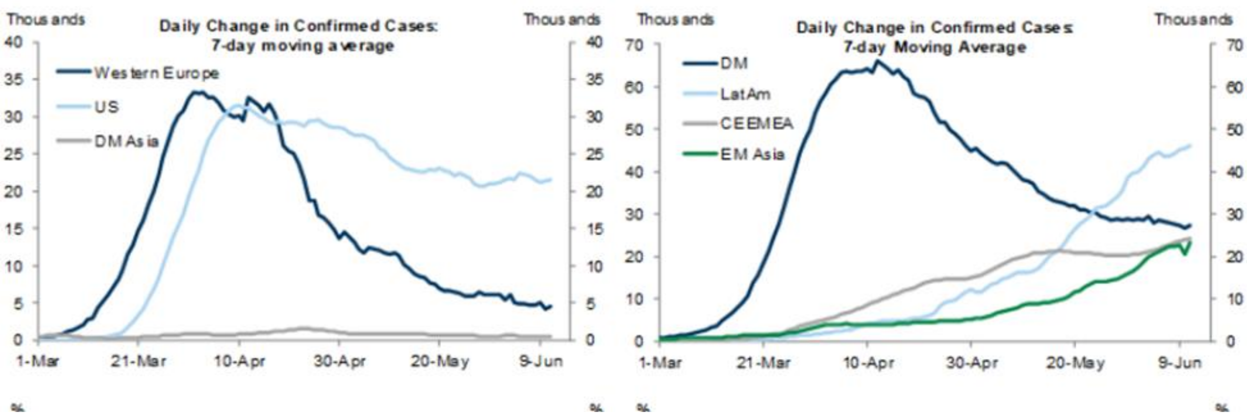
This chart shows the market's expectations for inflation going forward. A recession such as we're in, has massive deflationary pressures. Think about all the people out of work now. There will be no wage pressure. Gasoline prices are down. Clothes prices. Name it and it is hard to imagine anyone raising prices. You can see inflation expectations fell from 1.6% to 0.6%. They have since rebounded to 1.3%. Very low by historical standards, and below the Fed's target of 2%.

Finally, let's address yesterday's correction. Here's the chart I've been showing you for several weeks.

From March 23rd (the bottom) through June 8th, the market rose 45%. It broke out of the trading range on May 13th and barely had a down day until this week. The P/E ratio was exceeding 20x on 2021 earnings! That's absurd. Sentiment had reached into the Excessive Optimism level, and there were reports of Millennials speculating on beaten down stocks. It's just a correction. It was needed. The only thing different is that everything seems to happen faster these days. I think it's because of computer trading. We just have to get used to bigger and faster moves. I don't cheer for market declines, but I am glad when value is restored, and we can look for stocks at attractive prices. It's better today than it was last week.



On a final note, the CoronaCrisis is getting worse in emerging markets countries as shown here:



As we reported before, we have reduced our allocation to international investments. That is due partly to the relative performance, but also to our concerns about the financial and economic risks to countries that have fewer resources to fight the pandemic. This bears watching.

The weather is beautiful lately in Colorado, and things are opening up. Have a great weekend. Stay safe and healthy.

Until next time,

Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

And Your Entire Colorado Financial Mgmt. Team

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