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INVESTMENT ADVISORS

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INVESTMENT REVIEW AND OUTLOOK

A World of Worry

In the span of six weeks, starting in early February, the COVID-19 pandemic swept the globe and by early April there were over 1.5 million cases in 184 countries. As the pandemic spread, restrictions on travel were implemented and these were followed by "stay at home" guidelines in Europe, North America and other regions of the world. COVID-19 represents the ultimate "Black Swan" event: a low-probability occurrence with the potential for significant damage to society and the economy. COVID-19 is easily transmittable, with no approved therapies or vaccines and, without mitigation measures, has the potential to inflict significant mortality.

As the global economy shut down in response to mitigation measures, financial markets entered a free-fall and by March 23rd equity markets had corrected over 35% from their February highs. Concern over the economic fallout combined with a dearth of liquidity also impacted the bond markets, and U.S. investment grade corporate bonds experienced a peak to trough drawdown of over 18%.

In the U.S., weekly jobless claims in early April rose to over 6 million, confirming that the economy was contracting rapidly. The weakness in the U.S. was mirrored in other regions, and consensus expectations now call for a significant year-over-year decline in global GDP during the second quarter followed by a more modest decline in the third quarter. The situation is fluid, and the eventual outcome will depend upon the success of global mitigation efforts as well as the effectiveness of various initiatives put forth by governments and central banks.

Strong Medicine

In the U.S., the response to the economic fallout from the pandemic has been proportional to the threat to the economy, and the initiatives undertaken by the Federal Reserve and Congress are on a scale not seen in modern times. During March and early April, legislation was passed providing over $2 trillion in funding for businesses, consumers, state and local governments and health care providers. The Federal Reserve has taken several steps beyond the scope of conventional monetary policy including a specialized lending facility with the Department of the Treasury as well as direct purchases of fixed income securities by the Fed. The dollar commitment of Fed support is expected to exceed $3 trillion. Outside the U.S., sovereign governments and central banks have also taken similar actions in order to stabilize economies.

The public health response to the COVID-19 crisis has been equally forceful. In the U.S., 45 states have implemented "stay at home" orders and these restrictions are expected to continue until early May. Similar restrictions have been placed in Europe and other developed economies. The surge of COVID-19 cases has the potential to overwhelm health care facilities in some of the regions hardest hit by the pandemic and the mobilization of resources by state and federal governments is encouraging.

The response of the pharmaceutical and life sciences industry to COVID-19 has also been impressive. As of early April, the U.S. Center for Disease Control reports that over a dozen therapeutic candidates are participating in over 400 clinical studies related to COVID-19. At least two potential vaccines have also been identified. Clinical trials began in March and are expected to continue into 2021.

The COVID-19 virus was declared a pandemic by the World Health Organization on March 11th and that date now feels like an eternity ago; it is worth taking stock of the manifold initiatives by both government and the private sector that have been implemented in a relatively short timeframe.

What Do We Know?

An overriding concern in any crisis is the lack of certainty and in the current setting we are facing a multitude of questions about both the Coronavirus and its impact on the economy and financial markets. There is much we do not know. In thinking about this crisis, it may be helpful to focus on what we *do* know. In terms of the virus itself, we have learned much about its transmission and which population groups are most vulnerable. We have also learned from several Asian nations (where the early outbreaks occurred), what mitigation steps are most effective. The protocols adopted by South Korea, Taiwan and, closer to home, Washington state, have demonstrated success in containing the virus and providing a pathway to a resumption of economic activity.

The scientific knowledge about the treatment and prevention (via vaccine) of the virus is proceeding at an accelerated pace. Much of the work on therapeutics is being conducted by public and private laboratories that formulated treatments for HIV, SARS and other complex viruses. While clinical trials are ongoing, there have been encouraging reports about compassionate use of several therapeutic treatments. A vaccine for COVID-19 will likely take 12-18 months, according to the companies involved in its development and success is not assured.

The economic impact of COVID-19 has been pervasive and, despite a strong response from the federal government, there will likely be many businesses that do not survive after the crisis passes. However, the combined actions of the Federal Reserve and Congress are designed to act as an economic "bridge" during the time of greatly reduced economic activity which is expected to last from late March until the end of May. The exact timing of a re-opening of the economy is largely dependent upon the course of the virus.

The 35% stock market correction from late February until mid-March was the fastest on record. While we do not know the exact magnitude of the earnings decline for 2020, the reduction will be large enough to render 2020 earnings meaningless as a guidepost for long-term investors. At its low point on March 23rd, the S&P 500 traded at a P/E ratio of 13x *trailing* 12-months earnings with a dividend yield of 2.8%. Both measures represent an attractive valuation by the standards of recent history.

The Other Side of The Valley

There are no certainties in the current crisis, but we can make some informed judgments about the duration and impact of the virus, the timing of when the economy may begin to re-open and what life may look like on the other side of the economic "valley."

- Given the effectiveness of social distancing and stay-at-home measures, and based on the data from regions of the world that experienced COVID-19 earlier than the U.S., we can expect the rate of infections to peak during mid-to-late April. Experience will vary by region in the U.S.

- After a difficult early adjustment, the U.S. health care system appears prepared to handle the surge of Coronavirus patients needing hospitalization. While it is too soon to know the effectiveness of potential therapies or the timing of a vaccine, there is evidence that rapid progress is being made on both fronts.

- Unemployment rates will continue to rise to levels not seen in over 70 years. However, the federal government stimulus programs, which equate to over 10% of current year GDP, should provide essential support for consumers and businesses in the weeks and months ahead.

- Credit markets, which experienced severe strain in the month of March, have responded favorably to the actions of the Federal Reserve.

- The timing of re-starting of the economy is uncertain but will likely be gradual. Some industries, such as storefront retail, energy and automobile manufacturing, were beset by challenges well before COVID-19 and these sectors will likely experience higher rates of attrition as we come out of the crisis. Similarly, businesses across industries with heavy debt loads and/or disadvantaged competitive positions will experience greater incidences of failure.

- The temporary shutdown of the economy and the policy response have set in motion strong opposing forces: a demand shock (exacerbated by the decline in energy and commodity prices) which is deflationary, and strong monetary and fiscal stimulus which has the potential to be inflationary.

Entering the COVID-19 crisis our portfolios held an "anchor to windward" in the form of cash, short-term U.S. Treasury securities and gold iShares. Since late March we have used a portion of our cash reserves to make selective additions to stocks and bonds at prices which we viewed to be attractive. Our portfolios remain conservatively positioned with an emphasis on quality and organic revenue growth. In light of the significant monetary stimulus by global central banks, we are maintaining an allocation to the gold iShares.

As always, we welcome your comments and questions.