



First Quarter 2020 Investment Commentary

We are all now living through a period in history none of us will ever forget. The impact on our families, communities, and country has been profound. There remains great uncertainty, worry, and fear about the coronavirus and its impact: how widely it will spread, how fatal it may be, how long it will last. When will we see signs of stabilization in its spread and a decline in daily new cases? When will we “flatten the curve”?

While many had reason for cautious optimism that the virus might be largely contained to China, it is now obvious that is not the case. The United States and world are now facing a health crisis and an economic crisis. Both need to be fought with massive government policy responses and individual behavioral changes.

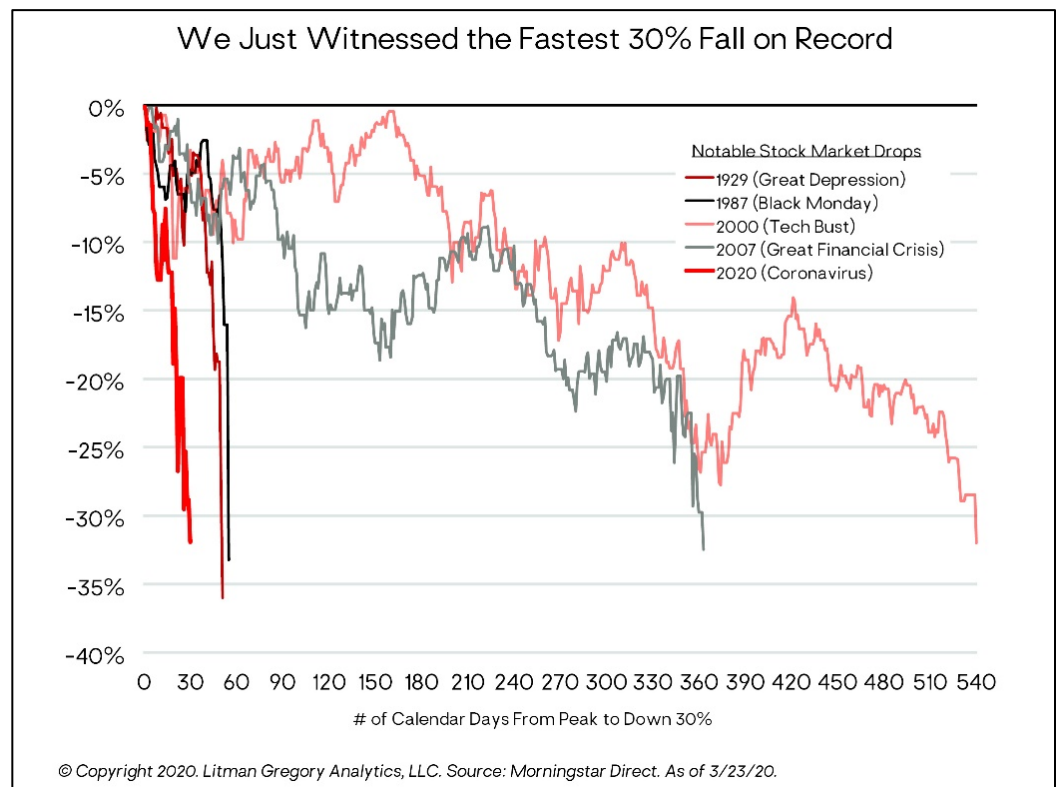
We’ve frequently said that recessions and bear markets are inevitable phases within recurring economic and financial market cycles and that investors need to be prepared for them to happen. However, we’ve also mentioned that their precise timing is consistently unpredictable and that there is *always* the risk of an unexpected “external shock” to the markets and economy (i.e. a geopolitical conflict or natural disaster).

It’s one thing to say it and another to actually live it. It’s still another when the precipitating event or catalyst for the recessionary bear market is something none of us have experienced before: a global pandemic, which has instigated an extreme societal response—including the indefinite closure of schools and non-essential businesses, shelter-at-home orders, quarantines, lockdowns, and social distancing—and has potentially overwhelmed medical facilities, personnel, and supplies.

We will get through this crisis period. Things will eventually improve and recover.

In the meantime, events are moving very rapidly, policy responses are in flux, and markets are extremely volatile. This commentary reflects the facts, circumstances, and our thinking as of March 24, 2020.

We sincerely hope you and yours are able to remain healthy and manage well through this challenging period.

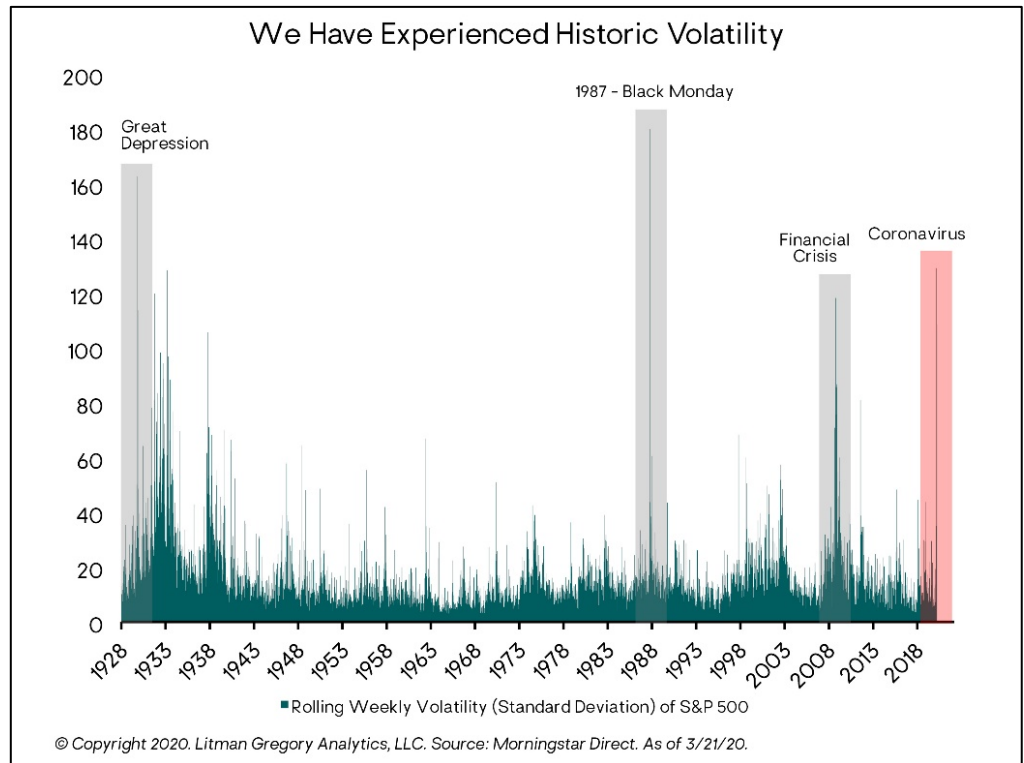




First Quarter Market Update

The first quarter of 2020 has been an unprecedented period in U.S. financial market history across numerous dimensions:

- The U.S. stock market fell into a 20% bear market in the shortest time ever—just 22 days—and continued further, dropping 30% in a record 30 days. The typical historical bear market peak-to-trough decline has taken around 12 to 18 months.



- Short-term expectations of stock market volatility, as measured by the VIX index—often referred to as the market’s “fear index”—closed at an all-time high in its 30-year history on March 16. And the market’s actual realized volatility has only been higher in October 1987 (Black Monday) and the late 1920s.
- The 10-year and 30-year Treasury bond yields fell to all-time lows of 0.54% and 0.99%, respectively, on March 9.
- Oil prices had their biggest one-day drop since the 1991 Gulf War, plunging 25% on March 9, triggered by a price war between Saudi Arabia and Russia.

Note, all returns in this commentary are as of the market close on March 23.

Year to date, larger-cap U.S. stocks have fallen 30%. Growth stocks have continued to roundly outperform value stocks: the Russell 1000 Growth Index has fallen 25%, while the Russell 1000 Value Index has fallen 35%. Smaller-cap U.S. stocks have done even worse, falling 38%.

Developed international stocks have fallen 34%, and emerging-market stocks have dropped 31%. Much of the differential between U.S. and foreign stock market returns has been due to the appreciation of the U.S. dollar, which has risen roughly 4.5% year to date.

In the fixed-income markets, core bonds have gained 1.1%. As noted above, Treasury bond yields have fallen sharply. They have been extremely volatile as well—shooting up on some days when stocks were also sharply selling off. The 10-year yield is currently at 0.76%, down from 1.92% at year-end.



Turning to the credit markets, floating-rate loans and high-yield bonds have taken it on the chin, with both dropping around 19%. Investment-grade corporate bonds have been far from immune, having lost 10%.

First Quarter Macro Outlook

Financial markets in 2019 were a positive surprise for many investors; however, the start of 2020 has been the exact opposite. Just three months ago, most investors were astonished to see stocks jump 20% to 30% during the eleventh year of a historic bull market. Even core bonds clocked in a 9% return last year. However, things have changed dramatically since year-end. Though one thing is constant: Just as no market pundits expected U.S. stocks to gain 30% last year, none of them expected a 30% drop in the first three months of 2020 and the real possibility of a severe economic recession.

Coming into the year, we saw the potential for a moderate rebound in the global economy (especially outside the United States) on the back of reduced U.S.-China trade tensions and extensive global central bank monetary accommodation. In January and early February, there were signs the manufacturing sector had bottomed and a nascent global recovery was indeed underway. Stock markets rallied to all-time highs.

However, the arc of the coronavirus and the increasingly aggressive U.S. and global response to try to slow its spread has drastically changed everything. Our base case now is that the U.S. economy is headed into recession in the second quarter. It is likely to be a severe one, with a sharp contraction in GDP and an unprecedented rise in unemployment and jobless claims.

The consensus also appears to believe the recession will be short in duration, with a rebound beginning around the third quarter. However, this is by no means a sure thing. To the extent equity markets are not fully discounting a more severe outcome, downside risk remains.

The depth and duration of the recession—and the strength and timing of the ensuing recovery—depend on two key variables:

- 1) The progression and spread of the virus: how effective our medical response and social-policy efforts are in flattening the curve
- 2) The fiscal, monetary, and regulatory policy response: how quick and effective new policies will be in supporting households, businesses, and financial markets—mitigating the short-term recessionary damage and preventing a downward spiral into something much worse than a short but severe recession

The effectiveness of the medical response and economic policies (and their impact on human behavior at the societal level), will help answer the fundamental economic question of how severe and how long the economic downturn and recession will be. The answer to the economic question will help answer the investment question of how severe and how long the equity bear market will be.

The financial markets and the economy are interconnected—each drives the other and can reinforce or magnify a trend in one direction. A rebounding stock market supports the real economy and vice versa



through positive wealth effects, increased incomes, profits and spending, risk-taking, and optimism. However, they can also feed off one another on the downside, in a self-reinforcing negative spiral that can ultimately lead to an economic recession if the spiral is not broken.

On the Coronavirus

We are not medical experts, virologists, or epidemiologists. Thus, we have little to say on the medical side of things that others haven't already said, or that all of us aren't hearing and reading every day in the news. What we will say is that, as we write this, the data show the virus is continuing to spread at an increasing rate in many countries, including the United States and across Europe. There is still little clarity or certainty as to when this trend will flatten and decline.

We expect financial markets to react positively at the first signs of a flattening in the number or rate of new daily cases reported, as we saw happen in China in February, and as also happened during the SARS epidemic in 2003.

Italy *may* be a leading indicator of the progression of the virus in other developed countries. Many experts have said the U.S. virus situation is roughly two weeks behind Italy's. However, there are also important differences between the two countries (i.e. medical infrastructure, demographics, policy response) that make for an imperfect comparison.

On the Economy

The near-term economic damage from the United States' and other countries' response to the virus now looks almost certain to be severe (barring some unexpected major medical breakthrough in the near future).

On Sunday, March 15, the Federal Reserve held an emergency meeting where they cut the federal funds rate by one percentage point to near zero. The Fed also announced it was restarting quantitative easing (QE) with *at least* \$700 billion in planned purchases of Treasury bonds and mortgage-backed securities.

At his press conference following the meeting, Fed chair Jerome Powell said GDP growth was likely to be negative in the second quarter, and beyond that the economic outlook was highly uncertain, as it depends on how widely the virus spreads: "I would say in fact, unknowable."

Over the following week, economist after economist slashed their second quarter GDP forecasts deeper and deeper into contractionary territory. They may have changed again by the time this is published, but to give a sense of the magnitude, going into the last week of March, Goldman Sachs was forecasting a 24% annualized decline, Morgan Stanley a 30% decline, JPMorgan a 14% decline, and both Bank of America and Citigroup a 12% decline, to name a few. For comparison, the worst quarter during the 2008 financial crisis was an 8.4% annualized GDP contraction, in the fourth quarter of 2008.



On Sunday March 22, Federal Reserve Bank of St. Louis president James Bullard topped them all. He was quoted by *Bloomberg News* citing the potential for a 50% quarterly drop in GDP and a 30% unemployment rate in the second quarter, in the absence of massive fiscal and monetary policy support.

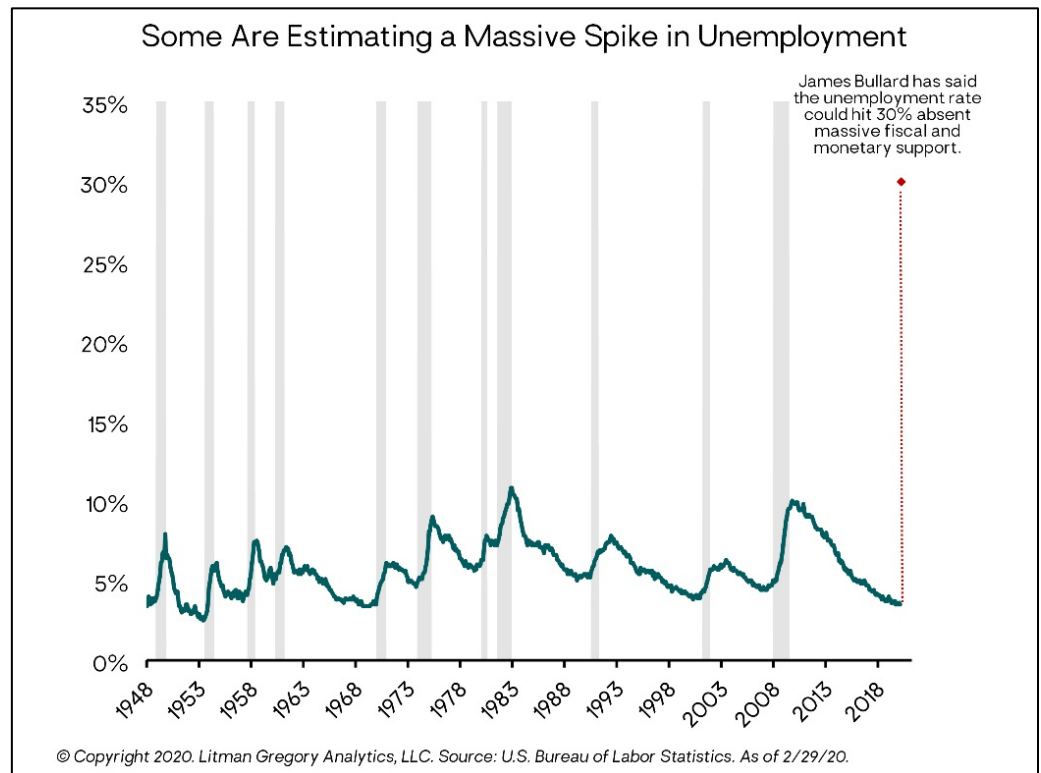
Bullard also said that with an aggressive government response, economic activity should begin to bounce back in the third quarter. He stated the fourth quarter of 2020 and the first quarter of

2021 could be “quite robust” as Americans make up for lost spending. “Those quarters might be boom quarters,” he said. As another example, Goldman Sachs forecasts a 12% growth rate in the third quarter and a 10% increase in the fourth quarter, following their expected 24% second quarter plunge (forecast as of 3/20/20).

As mentioned earlier, an economic slowdown—particularly an extremely sharp one due to strong virus containment efforts—can quickly morph into a self-reinforcing negative spiral. Consumers cut back spending, businesses lay off workers, unemployment rises, incomes drop further, spending drops further, corporate profits drop, companies and households default on loans, companies go out of business, investment and employment drop further, etc., causing an even deeper and longer recession (if not depression) and bear market.

In this case of a severe external shock, the government’s economic policy responses are critical. There are two main levers: monetary policy (central banks) and fiscal policy (government spending, tax cuts, unemployment insurance, loans, debt forgiveness, etc.).

One lesson learned from the 2008 financial crisis is: When it comes to the policy response, go big and go fast. Time is of the essence (just as it is with the virus response). Governments need to make a credible commitment to “do whatever it takes” to support the economy and prevent the negative spiral from taking hold.

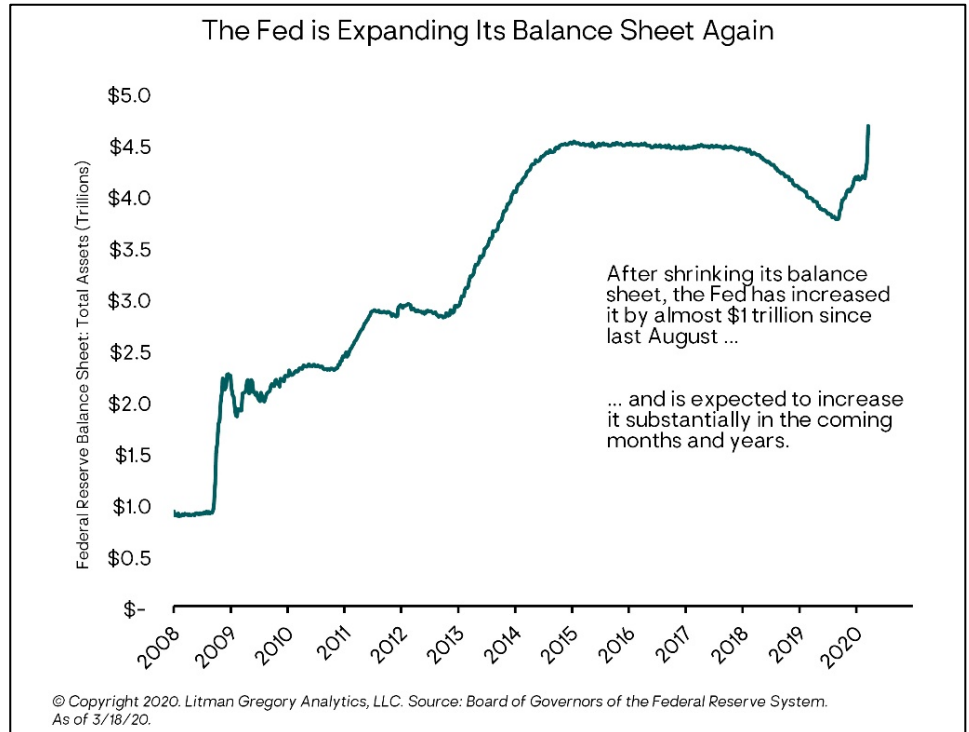




Monetary Policy

The Fed and other major central banks seem to be all-in to support the fluid functioning of credit, lending, and financial markets, and their critical role as the “plumbing” of the real economy.

As noted above, at an emergency meeting on Sunday March 15, the Fed cut the federal funds rate to near zero and restarted QE. A week later, it increased the QE program from “at least \$700 billion” to essentially an unlimited amount in order to keep interest rates and borrowing costs low. The Fed also initiated a number of programs—going beyond the tools it enacted during the 2008 financial crisis—to try to ensure enough credit, loans, and liquidity are flowing to banks, businesses, households, and the overall global financial system. It is likely the Fed will do still more (i.e. increasing their asset purchases to support the huge fiscal stimulus that is coming or even effectively monetizing the debt or “helicopter money”). Other major central banks are also starting to pull out all the stops, and more will likely come until the crisis period ends (and maybe beyond).



Fiscal Policy

While extremely accommodative monetary policy is necessary, it is not sufficient to mitigate this economic crisis. Only fiscal policy can have a large enough, and direct enough, impact necessary to support and sustain individuals and businesses until the storm has passed and the virus containment measures show signs of working.

After extensive legislative haggling in Washington, D.C. over the components of a \$2 trillion fiscal stimulus package—nearly 10% of U.S. annual GDP—the Senate passed the bill which moves to the House for a vote. It appears congressional Republicans, Democrats, and the Trump administration all seem to be in agreement that something massive needs to be done and done quickly.

Public and business support is also undoubtedly strong. Thus, the political obstacles to getting something done should be relatively low, especially considering how polarized the current political environment



otherwise is. There really is no alternative. Furthermore, like the monetary policy response, the fiscal stimulus is also be global in scale, with even austerity hawks like Germany now acceding to its necessity.

The fact that most everyone across the political, ideological, and economic policy spectrums agrees that the aggressive measures necessary to slow or contain the virus could tip the U.S. and world economies into a severe recession (or depression) is *good* news. It greatly improves the odds countries will act quickly and forcefully to enact fiscal, monetary, and regulatory policies to *prevent* that dire outcome from happening.

Current Portfolio Positioning and Potential Additional Changes

In this period of heightened uncertainty and market volatility, we want to give an update on our portfolio positioning. We'll also discuss how our allocations might change should markets decline further. As always, we remain focused on meeting our clients' longer-term financial goals and objectives, while managing and balancing nearer-term risks.

Entering this year, we remained underweight equities due to our concern about valuations for the overall market (particularly large cap growth stocks) and political uncertainty. Though our mix of U.S. and international stocks were reasonably valued and offered sound dividends, we believed it prudent to protect somewhat against the potential for a selloff and/or recession. After the oil price collapse and our belief that the spread of the coronavirus would not be contained, it was clear to us that we were headed toward a recession. Thus, during the second week of March we began to sell a large majority of our high yield energy bonds as well as more cyclical U.S. and international stocks thereby reducing our equity exposure to approximately 40% in our balanced Global Income strategy. Though remaining underweight equities, we have begun to purchase issues which we believe will provide more stable dividends and potential for growth under a difficult recovery.

As things currently stand—and our assessment is certainly subject to change—we intend to continue to add to higher quality stocks from a tactical and opportunistic standpoint – particularly if equities fall further. Of course, we don't expect to call the bottom of this market cycle. If and when we buy, we should all be prepared for stocks to fall further, given the uncertainties and risks described earlier regarding the coronavirus's spread and the depth and duration of the economic impact.

The good news is that stock markets now do appear to be discounting a recession, but a relatively short one, not a severe or long-lasting one. Though there are not many data points, severe global recessions have been associated with an average decline of approximately 45% in global equities. As a reminder: The S&P 500 ultimately dropped 59%, 49%, and 48% in the 2007–09, 2000–02, and 1973–74 bear markets.

If the virus news gets worse in the United States (before it gets better), investor sentiment could take additional hits with further market declines. Such declines—driven by fear, uncertainty, and human herd behavior—can feed on themselves resulting in a major overshoot on the downside compared to the market's "fair value" on a longer-term fundamental basis (i.e. based on companies' long-term profitability and dividends).



Closing Thoughts: This Crisis Will End.

As investors, it is so important to maintain our focus on our long-term financial goals and objectives. As hard as it may be, from an investment perspective we need to try to look through the current environment of fear and concern—emotions which, given the circumstances, are totally justified and felt by all of us—to the almost certain outcome of the virus crisis receding and economic recovery occurring.

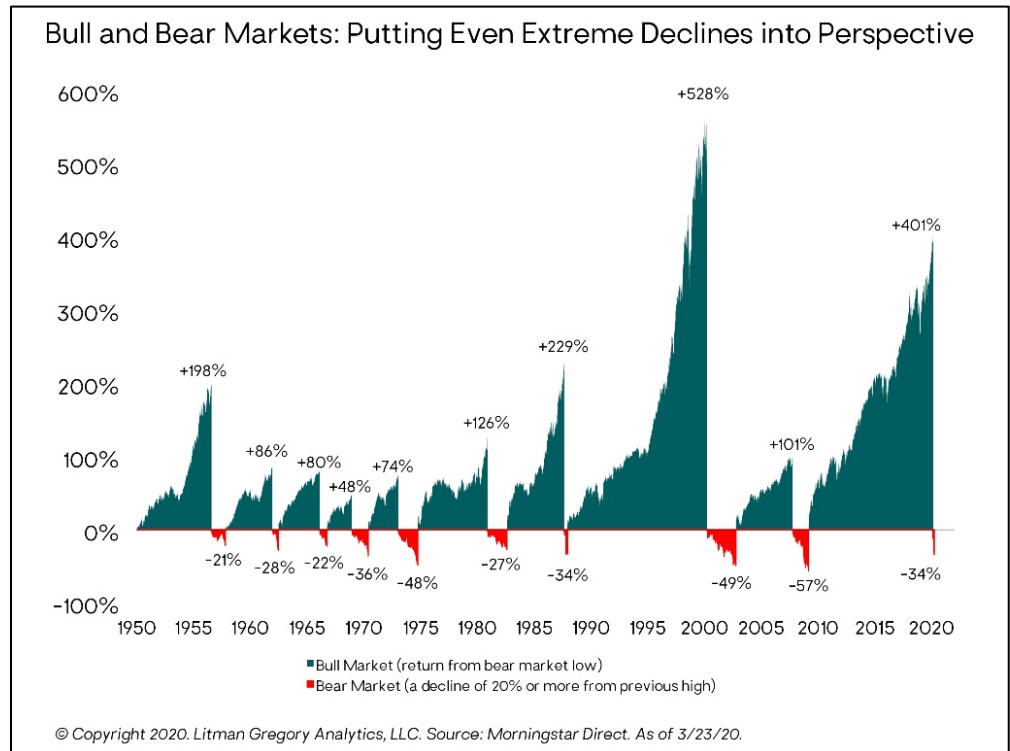
Throughout history, the world has faced numerous severe challenges and economic downturns and has always come out the other side. While not minimizing the unique risks and unknowns from the current crisis, we will bet on that being the case again. There is a good chance the economic recovery may start happening before the end of the year and the stock market may rally looking ahead as green shoots begin to appear.

As a long-term investor, trying to time market tops and bottoms is a fool's

errand. The evidence is overwhelming that most investors diminish their long-term returns trying to do so. They are more likely to chase the market up and down, and get whipsawed, buying high and selling low. However, incrementally adjusting portfolio allocations in a patient and disciplined fashion in response to changing asset class expected returns and risks makes a lot of sense for long-term investors.

The time to be adding to stocks and other *long-term growth* assets is when prices are low and markets—and most of us personally—are gripped by fear and uncertainty rather than complacency, optimism, or greed. Investing at such times will *feel* very uncomfortable. It may seem like the market could just keep dropping with no bottom in sight. However, that is exactly where research, analysis, patience, experience, and having a disciplined investment process come most into play.

Otherwise, if we invest based on our feelings and emotions, we are very likely to cash out of the market *after* it has already dropped a lot, locking in those losses. Then, waiting to reinvest after our discomfort and worry are gone, the market will *already* be much higher. That is not a recipe for long-term investment success, yet it plays out in each market cycle.





Facing the current medical and economic crisis, the situation is probably likely to get worse before it gets better. (We would love to be wrong about that.) However, with some necessary and shared sacrifices from all of us—and clearly those on the medical front lines much more than most—it *will* get better.

As always, we appreciate your trust and confidence in Altrius Capital. Please don't hesitate to contact us with any questions regarding our economic outlook, investment strategy or your personal financial planning matters.



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