HIGHTOWER
Westchester

Market Commentary Q1 2020

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. We recognize that many of our clients are concerned, not only about the markets, but also about their daily lives. There remains great uncertainty, worry, and fear about the coronavirus and its impact: how widely it will spread and how long it will last.

While several weeks ago 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 U.S. and the world are now facing a health crisis and an economic crisis. Both 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, but that their precise timing is consistently unpredictable. We've also said there is always the risk of an unexpected shock to the markets and economy or what many have deemed, a "black swan" event.

It's one thing to say it and another to actually live it. And 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, stay-at-home orders, quarantines, lockdowns, and social distancing and has overwhelmed medical facilities, personnel, and supplies.

In the meantime, events are moving very rapidly, policy responses are in flux, and markets are extremely volatile. We sincerely hope you and yours are able to remain healthy and manage well through this challenging period.

Market/Index	2019 Close	As of 03/ 31	March Return	YTD Change
DJIA	28,538.44	21,917.16	-13.74%	-23.20%
NASDAQ	8,972.60	7,700.10	-10.12%	-14.18%
S&P 500	3,230.78	2,584.59	-12.51%	-20.00%
Russell 2000	1,668.47	1,153.10	-21.90%	-30.89%
Global Dow	3,251.24	2,469.53	-14.84%	-24.04%
Fed. Funds	1.50% – 1.75%	0.00-0.25%	-150 bps	-150 bps
10-year Treasuries	1.91%	0.69%	-43 bps	-122 bps

Chart reflects price changes, not total return. Because it does not include dividends or splits, it should not be used to benchmark the performance of specific investments. Source – Morningstar Direct

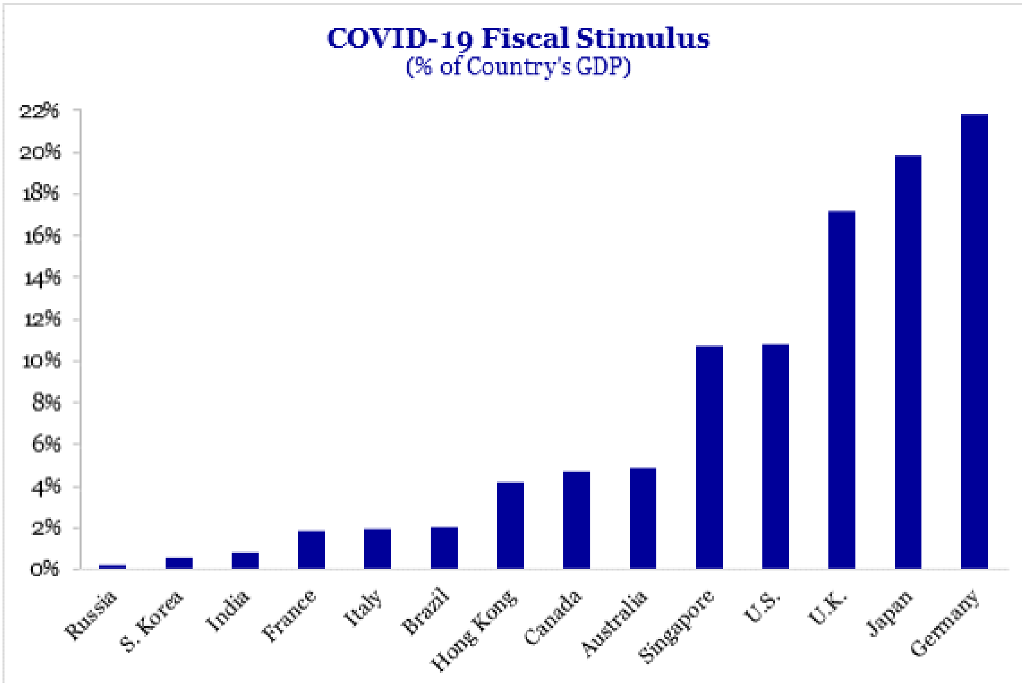
The question that we are asked frequently, particularly of late, is where do we go from here? As you can see in the chart above, there have been very few places to hide. We've seen some of the largest swings in U.S. market history over the past few weeks. This was the S&P 500's most volatile month on record, the Dow's worst 1st quarter in history and the 5th worst quarter of the last 75 years (3Q '74, 4Q '87, 4Q '08, and 2Q '62 only worse).[1] Year to date, larger-cap U.S. stocks have fallen 23%.[1] Growth stocks have continued to hugely outperform value: the Russell 3000 Growth Index has fallen 18%, while the Russell 1000 Value Index has fallen 30%.[1] Smaller-cap U.S. stocks have done even worse, falling 33%.[1]

Source – Morningstar Direct

Historically, future returns, particularly +12 months forward, have been strong following events like this. But it's never an obvious call when you're in the thick of it as the beat of bad news often reinforces investor pessimism even as the market begins the healing process. As they say, they do not ring a bell at the bottom.

It is interesting to put this in context, because the S&P 500 is at a level similar to what it was in January 2017, just three years ago, and it is still almost 3x higher than it was in early 2009 at the trough of the Global Financial Crisis ("GFC").[1]

On Sunday, March 15, the Federal Reserve ("Fed") 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. 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 and rolled out a staggering $2.5 trillion fiscal bazooka. The Fed has initiated several 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 still do more (e.g. increasing their asset purchases to support the already massive fiscal stimulus).



Source – Strategas Securities, LLC

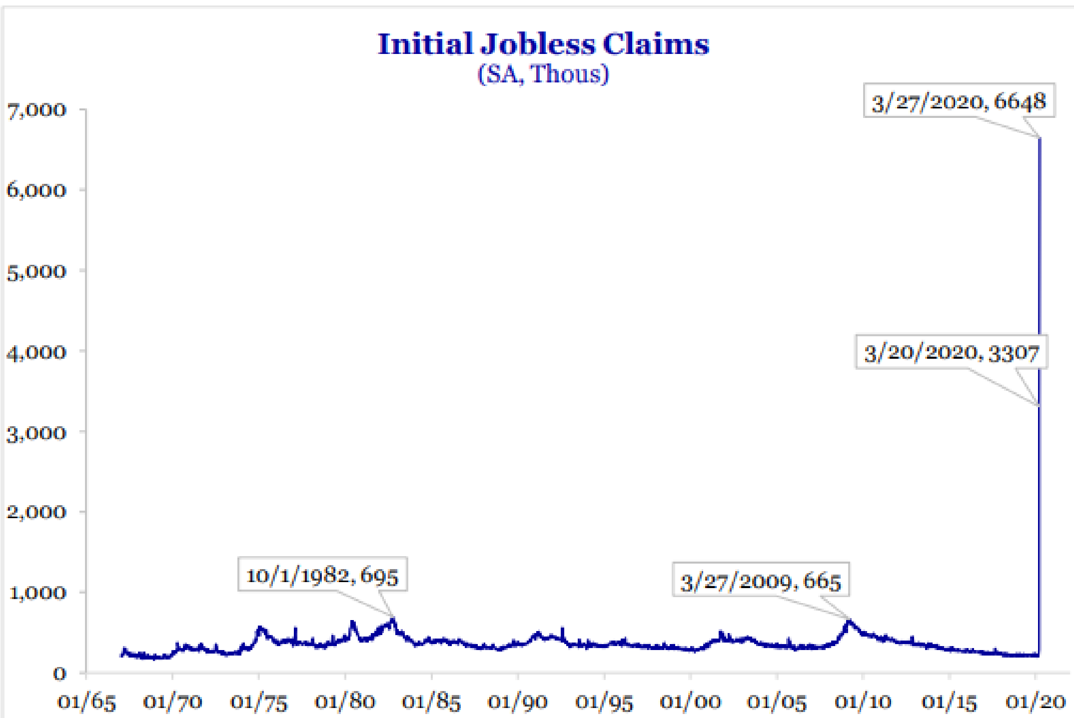
All told, to combat the fear of the fear itself, our D.C. generals delivered $6 trillion in armaments to combat our new hidden enemy. By the close on March 23rd, every asset market was severely, no, historically oversold. Markets were duly impressed and mounted historic rallies. For example, the S&P 500 Index had plunged 36% from its very recent high on February 19th to its recent low in just 23 trading days. On the heels of the $6 trillion monetary and fiscal announcements, the "Fed Put" was back in play. The ensuring rally of 20% over just three trading days was breathtaking, it was in fact the best three trading days since 1931![1] The Dow Jones Industrial Average recorded one of its best single days (+11%) in history.[1] Over the course of the past 27 trading days, the stock market has suffered the quickest -36% bear market in history, as well as the quickest +20% bull market in history![1]

There continues to be calls for a fourth and possibly fifth fiscal stimulus package in the U.S. potentially targeting healthcare, infrastructure, etc. There could also soon be discussions on a middle ground in the health/economic tradeoffs (e.g., workers could return after testing, workers could go to work with masks, etc.).

Unemployment is soaring. Hopefully, once the acute phase of the crisis is over, many people will quickly come back to work. But not everyone will be able to because there will be unevenness in the speed at which different industries come back online, so to speak. Some companies will go under for good. Bars and restaurants may come back faster than hotels, as people may feel more comfortable eating out before they feel comfortable traveling. And there may even be some permanent changes to economic behavior, such as more working from home. This will have long-term implications for which industries and companies thrive and which one's don't. Without a doubt, many people won't be able to go back to their old job or even their old industry.

The novel COVID-19 virus (with no vaccine/effective drugs) has left one option: shutting down economic activity to slow the spread and buy time for doctors. This strategy resulted in 6.6 million U.S. initial jobless claims in the last full week of March, on top of the 3.3 million claims the week before. U.S. nonfarm payrolls fell -701,000 m/m in March and the unemployment rate moved up to 4.4%.[2] Leisure and hospitality accounted for -459,000 jobs m/m.[2] The labor market is collapsing (i.e., workers are not remaining on payrolls despite the stimulus bill).

St. Louis Fed research indicates that the U.S. unemployment rate could touch 32% briefly in the next several months, depending on the extent of the lockdown.



Source – Strategas Securities, LLC

In the fixed-income markets, investment grade core bonds have gained around 1%, once again providing their key role as portfolio ballast against sharp, shorter-term stock market declines.[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 0.73%, down from 1.92% at year-end.[1]

Diving deeper into the credit markets, high yield and emerging market bonds followed the equity markets down, falling 18% and 15% respectively in the quarter.[1] Even investment-grade corporate bonds have been far from immune, having lost over 7%.[1]

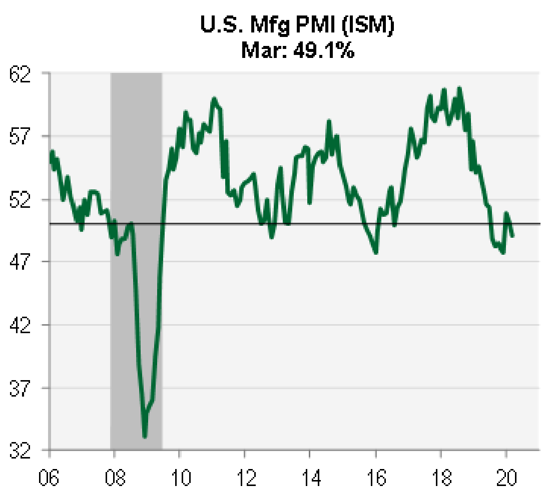
US Yields	4Q'18	1Q'19	2Q'19	3Q'19	4Q'19	1Q'20	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	2.50	2.50	2.50	2.00	1.75	0.25	-150	-225
3-Month T-Bill	2.34	2.31	2.06	1.80	1.50	0.07	-143	-224
2-Year Note	2.50	2.29	1.74	1.62	1.56	0.23	-133	-206
5-Year Note	2.51	2.23	1.76	1.55	1.68	0.38	-131	-186
10-Year Bond	2.69	2.41	2.00	1.68	1.91	0.70	-121	-172
30-Year Bond	3.02	2.82	2.53	2.12	2.38	1.35	-102	-147

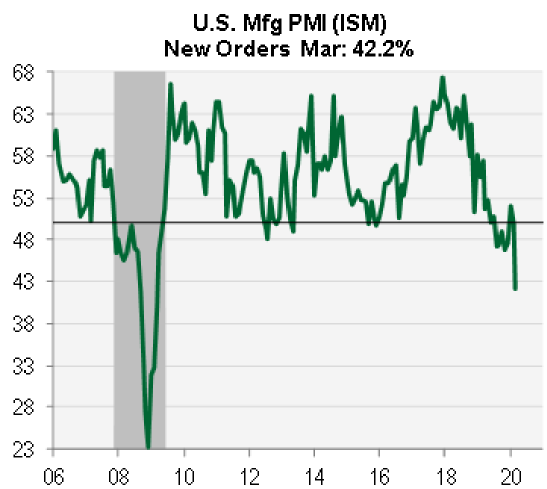
Source – Strategas Securities, LLC

The so-called "independence" of the U.S. energy sector was shattered by just one bad meeting between the Saudis and the Russians, plus the double whammy in the demand shock of idled planes, trains, and automobiles. The oil glut literally worsens by the day in the U.S., in inflation-adjusted terms, prices have collapsed to levels last seen during the 1930's.[1] The race is on to cut back production before storage becomes full.

The ISM Manufacturing PMI declined just 1% to 49.1%, slipping into contractionary territory (consensus called for a 5.6 ppt decline).[3] The index will no doubt fall much more in April. Supplier deliveries was the only component that improved in March, jumping 7.7% to 65.0, buoying the overall index.[3] A reading over 50 means slower deliveries, typically a sign of rising demand in a growing economy. Obviously, this year's slower deliveries are caused by virus outbreak disruptions.

The weakness in new orders, down 7.6% to 42.2% (lowest since 2009), gives a more accurate economic read to the underlying situation.[3]





Source – Cornerstone Macro

After falling in January, existing home sales jumped in February only to fall back off towards the end of the quarter. Both residential and commercial have been affected. Despite the fact that balance sheets for real estate firms are better with lower leverage than in 2008, this part of the market has sold off as well. Rent payments might be delayed or held back. The possibilities of what might happen with the housing market, as well as the economy, run the gamut. Like many other sectors, the answers will be dictated by the virus itself.

This has not just been a problem domestically here in the U.S. but the spread of COVID-19 has sent markets and economies tumbling all over the world. With over 110 countries and territories reporting cases of the virus, major institutions and banks have cut their forecasts for the global economy. Several nations, led by China, have ordered certain areas locked down, restricting movements of millions of people and suspending business operations. China's gross domestic product is expected to plunge to 4.9% this year, slower than earlier forecasts of 5.7% annual growth.[1] Year to date, the STOXX Europe 600 Index fell almost 23%, Germany's DAX slipped over 24%, France's CAC 40 lost 24%, Italy's FTSE MIB Index dropped 26%, the UK's FSTE 100 Index has given back close to 23%, and Japan's NIKKEI 225 is down 21%.[1] Much of the differential between U.S. and foreign stock market returns has been due to the appreciation of the U.S. dollar.

Even though no one seems to be talking about the election later this year, it is still scheduled to happen. The overarching question will be how much does the success (or failure) of the Trump Administration, Congress, and state governors alter the political and electoral landscape during an election year? As in 2008, we are experiencing a major economic event in the middle of a presidential election year and the impact of COVID-19 on the election cannot be ignored. Our sense is that there will be a great deal of uncertainty about the election until we clear through the virus and the U.S. economy begins to re-open.

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. And 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. The 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. But this is by no means a sure thing. The depth and duration of the recession and the strength and timing of the ensuing recovery likely depend on two key variables:

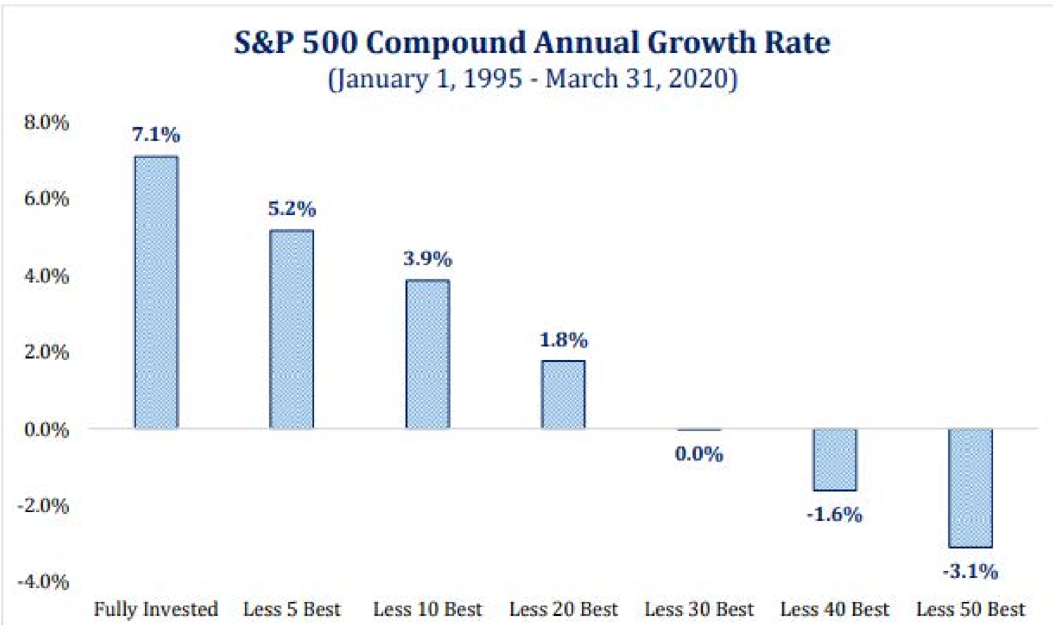
- The progression and spread of the virus. How effective our medical response and social-policy efforts are in flattening the curve.
- The fiscal, monetary, and regulatory policy response: how quick and effective new policies will be in supporting households, businesses, and financial markets, mitigating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

When you diversify across asset classes and consider a variety of potential scenarios, there will always be leaders and laggards in your portfolio. Some positions work well in strong up environments like we experienced last decade, while others benefit portfolios during tougher times, like the start to the 2020s. Put together, they build resiliency and protect a portfolio from betting on a single outcome, which can be a disastrous financial result if the opposite happens.

A typical day in an economy with a double-digit unemployment rate certainly appears depression-like. But the Great Depression lasted for a decade where every day looked like what's being experienced now, with the economy shut down. Given the policies (monetary, fiscal, trade, regulatory) that have been put in place in 2020, a downturn of that length is unlikely. Still, the near-term economic pain is not over yet, and the speed with which workers can be returned to their daily tasks will likely determine the language that will describe this period in the history books.

Our clients are asking us, "what is going to happen to the markets?" Our answer is simply that we do not know; we invest for the long-term, we do not predict stock prices as much as we wish we could. As for the prognosis for your portfolios, our reply is, "what is your timeframe?"

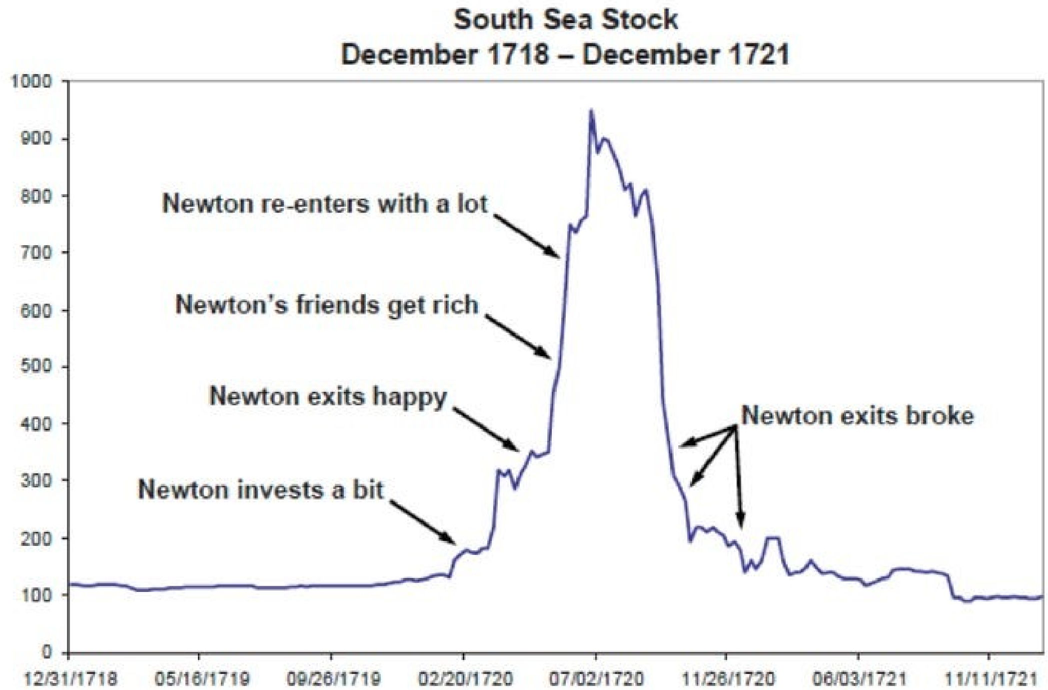
As a long-term investor, trying to time market tops and bottoms is a fool's errand. The evidence is overwhelming that most investors diminish their long-term returns trying to do so. They are more likely to chase the market up and down, and get whipsawed, buying high and selling low. But incrementally 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.



Source – Strategas Securities, LLC

The time to be adding to stocks and other long-term growth assets is when prices are low and markets as well as most of us are personally 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. But that is exactly where research, analysis, patience, experience, and having a disciplined investment process come most into play. Below is an example of one of the world's greatest minds investing mishaps:

Exhibit 4 Isaac Newton's Nightmare
South Sea Stock December 1718 – December 1721



Marc Faber, Editor and Publisher of "The Gloom, Boom & Doom Report."

Source – GloomBoomDoom[4]

"I can calculate the movement of stars, but not the madness of men," Newton apparently said after he lost his fortune.

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. Perhaps during this time of maximum worry, you take a few minutes to consider what happens when we move the time-frame slider from short to long-term. As investors, we think the future looks clearer, and brighter, when we do so.

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

Our advice to clients is something that we take in stride as well, don't let the headlines drive your investment strategy. A solid fundamental strategy is based on your own financial situation, goals, and objectives.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] Morningstar Direct
[2] Strategas Securities, LLC
[3] Cornerstone Marco
[4] https://www.gloomboomdoom.com/