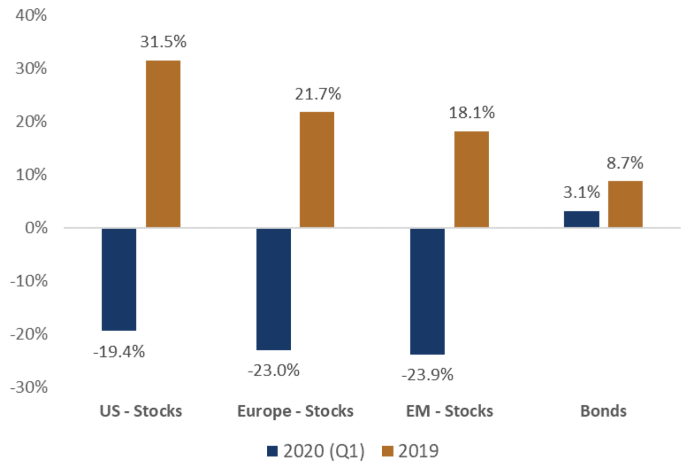
COVID 19 – Reflection and Response

"The whole problem with the world is that fools and fanatics are always so certain of themselves, and wiser people so full of doubt." ***– Bertrand Russell***



We spent many hours at the end of 2019 looking at all the potential risks in the economy and markets and nowhere did we find a global pandemic caused by a bat in China. This quarter was the worst performing 1st quarter in history with the S&P 500 down 35% on March 23rd, before rallying to close the quarter down 20%. It only took 18 trading days to go from the greatest market in history to a bear market. There was no discrimination in the decline as nearly all companies suffered significant declines, regardless of their health and growth prospects. Unless we are going into a depression, we believe that much of the bad news has now been priced into stocks. However, a market bottom is typically a process and not an event. The coming months will tell us more about this recovery as the duration will dictate its shape: V, U or L.

Where Are We Now?

We believe we are in the beginning stages of an event driven recession. Remember, we won't know that we are in a recession until after the fact, as a recession is defined as two consecutive quarters of negative GDP growth. In an event driven bear market recession, declines are typically 29%, while the average recession has produced declines in the 35% range. Based on history, we should have seen the lows, but this virus is anything but normal and the global economy is shutdown in a way that is difficult to compare to past events.

Large market declines typically have an "ABC" pattern. The "A" phase is a very large waterfall decline that ends with massive selling and panic. That phase ended on March 23rd (down 35%) and we entered the "B" phase, which is typically a very large rally (currently 25%) that eventually falters. The C phase is usually the last leg down and the testing (or penetration) of the bottom and then we eventually recover. So, when does this happen and how long will it take? That is the magic question, and no one knows the answer. It is 100% dependent on the virus and policy makers response.

Where Do We Go from Here?

Optimistic Outcome – There are a number of positive variables that may allow for a quick recovery. We bullet point those below:

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- The Federal Reserve (Monetary Stimulus) – The Fed's response to the Coronavirus has been quick, targeted and appears to be unlimited. If we can compare the Fed's moves to the financial crisis, the stimulus has been larger and faster. The Fed Funds rate is now at zero and they are injecting trillions of dollars into the system.

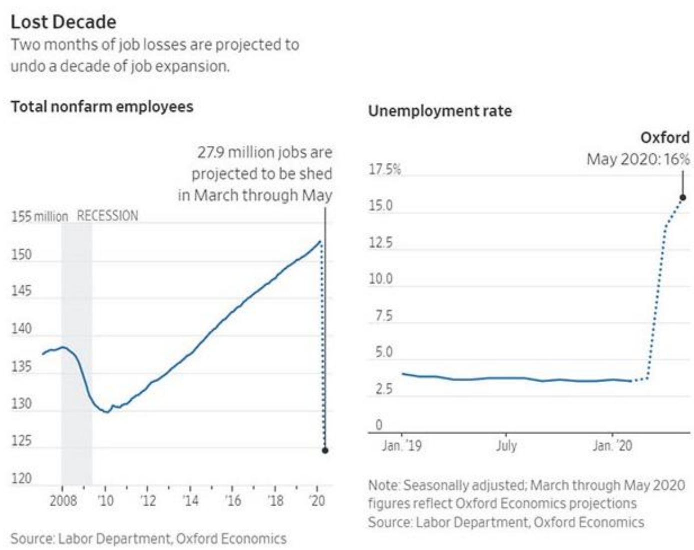
- The Government (Fiscal Stimulus) – Although the weeks feel like months for most of us, the CARES Act was actually put together in a relatively short amount of time and will provide $2.3 trillion of rescue and support. The stimulus is targeted to all facets of our economy, including individuals, public companies and small businesses. The goal of the CARES Act is to provide cash to individuals and incentives to companies to keep their workforces in place. Additionally, congress has already indicated the willingness to provide more stimulus should it be needed.

- The curve "flattens" – Most forecasts assume the virus will be brought under control within three months, which would cause the curve to flatten and turn downward. This outcome would mean that the quarantines and business closures worked. There is the potential for a large snap back due to pent up demand, which could result in a "V-shaped" recovery. As a reminder, the market is forward looking, therefore regardless of the speed of the recovery, most forecasts have the market back to where we started 2020 by year end.

Negative Outcome – In bad times, the negatives seem to always outweigh the positives and today's news and social media are adding fuel to the fire.

- The Virus Gets Worse or Comes Back – The US now has the most cases in the world, and we appear to be behind the curve when compared to countries that were successful in slowing the spread. Tests are still in short supply and results can take over a week. This means that the news will continue to worsen in the short term. Longer term, if the virus emerges again later in the year, some fear that there may be no sports in the fall and college classes might not resume until 2021.

- Recession – We already mentioned that we are in a recession. We are going to see some of the most mind-blowing negative numbers in the history of our economy. Some have forecasted GDP growth to decline by as much as 38% in the 2nd quarter with 27.9 million people expected to lose their jobs *(Oxford Economics)*, increasing the unemployment rate to 16%.



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- Corporate Earnings – We have discussed the importance of earnings growth many times and that has been one of the biggest drivers of the last 10 years. Now, for 2020, earnings are expected to decline by 1/3, according to Goldman Sachs. Some companies will have reduced revenues, others will have no revenue. Although some expenses can be reduced, many are fixed and thus can't be reduced at the same level as revenues will decline. We will get a better handle on the earnings deterioration later this month as the first major wave of releases start to come in.

- Leverage – The low rates of the past 10 years created a lot of leverage in the system. Many companies borrowed cheap money and bought back their own stock, which artificially boosted earnings. The end result is that some companies will default on their loan obligations, hurting banks (& other lenders) and potentially causing some to go bankrupt or seek rescue from the government.

- Dividends & Buybacks – The dividends paid by S&P 500 companies are projected to decline by 25% in 2020 (Goldman Sachs). Boeing, Delta, Ford, Macy's and many others have completely suspended their dividends. In addition, share buybacks are projected to decline 50%. Over the last 10 years, the largest source of buyers for the market has been companies buying back their own stock. Losing their biggest buyer may be challenging for stocks in the short term.

- Oil – As if COVID 19 wasn't enough, we have entered a perfect storm for oil. As a result of the virus, the demand for oil is at the lowest level in recent memory. On top of that, supply is also at an all time high as Saudi Arabia & Russia have decided to go into a price war by increasing production at a very inopportune time, causing oil prices to plummet by over 65%. The purpose of this war is to put the US Shale companies, who have become major global players, out of business. We don't believe this price war will last long. Both Saudi Arabia's and Russia's economies depend on oil and they need to have prices above $84/Barrell & $40/Barrell respectively to make money. In our view, Saudi Arabia has the weakest hand in this stand off and should reduce their level of production soon. There is no other sector of our economy that is more leveraged than energy and this will be disastrous for many of its participants.

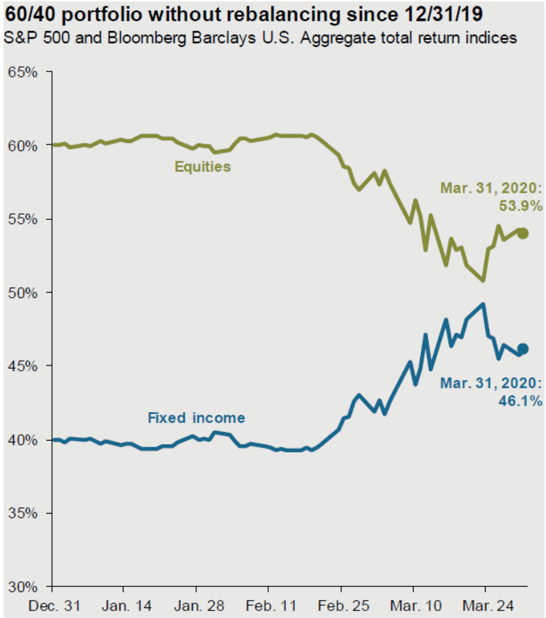
What do Investors Do Now?

It's easy to get tripped up and compound an already bad situation. Jason Zweig, the long-time columnist for the Wall Street Journal wrote a great article a few weeks ago entitled "We Can't Prevent Market Panics, We Can Control How We React" (Source: WSJ). In it, he offers great advice to all investors on what to do now:

> *"After all, it isn't investments that make or lose money; it is investors, with our own excesses of greed and fear. And that means market panics aren't a time for reaction; they are a time for introspection."*

We are using this decline as an opportunity to better position our client's portfolios for the future. Some say the best thing to do is nothing, we don't necessarily agree with that approach. Below are a number of strategies and ideas to get us through this downturn in a better place than we entered it:

- Rebalancing – Keeping your original allocations at the proper weightings is perhaps the easiest strategy of all. It forces us to buy low and sell high, which is the objective of any investor. As you can see from the chart to the right, a basic 60/40 portfolio, went to almost 50/50 over the course of the 1st quarter. A simple rebalance increased equity exposure at the recent lows by selling outperforming bonds.



- Dollar Cost Averaging – Another basic strategy is dollar cost averaging. When investment values go down and we are buying monthly, we purchase more shares. We have seen a number of investors eliminate their monthly investments over the past 2 months as they are gripped by fear. The reality is these are the best months we have had to dollar cost average for the long term in 5 years. On the flipside, it's been nice to see a number of clients who have been sitting on cash realize that this is the opportunity to invest.

- Tax Loss Harvesting – We always say it is what we keep that matters. In taxable accounts, we have taken the opportunity to harvest losses where possible with one caveat. When we replace a stock, or any holding, we want to replace it with a position that should recover at the same rate and ideally at a higher velocity than the position sold. We can use an unlimited amount of losses to offset gains and if we run out of gains, they will offset $3,000 of ordinary income annually.

- Pruning and planting – For some of us, a good COVID activity is starting our gardens. With any healthy garden, the first step is to weed, taking out all of the unwanted plants (holdings). Then we

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need to add new, healthy plants (buying when great companies are at low prices) and prune (selling during large market rallies). Like the Farmer's Almanac, prognosticators on TV are constantly telling us when the right time is to do all of this. The reality is that no one knows. We have put together a very structured program for adding and reducing exposures at various targets. Cleaning the garden, adding new plants, and trimming around the edges can be very accretive to a long-term strategy.

Conclusion:

First and foremost, we hope that everyone is staying safe and remaining healthy. These are challenging times, but we will get through them. We wish we had all the answers as they relate to the Coronavirus and its impact on our lives and investments, but no one does. All we can do is work hard and remain flexible to take advantage of the opportunities as they present themselves. We have sent out several communications regarding tax law changes and the CARES package as it relates to small business owners. If we can answer any questions related to your investments, taxes or general planning, please don't hesitate to call.

As always, please let us know if you have any questions or if there have been any changes to your overall plan or risk tolerance.

Sincerely,

Canal Capital Management