There is never one convincing indicator or policy that signals a turning point in a market downturn. Rather it is always a confluence of several factors that require a judgment call on whether and where to re-enter cheap markets. For us, these include:

- Recession-like pricing across financial markets (met in mid-to-late March),
- A reversal in investor positioning from optimistic to pessimistic (met in early March); and,
- Extraordinary fiscal and monetary stimulus (met in late March).

The **negative wildcard** remains the COVID-19 daily infection rate, which is slowing. The deceleration/flattening/declining number of cases is critical because it could prompt announcements about the scope and pace of relaxing containment measures, which could check expectations about the duration and depth of the current recession.

What's Next for the Economy?

Efforts to fight the virus' spread have put almost three-quarters of the U.S. population under a stay-at-home order. Every month that large parts of the global economy stay closed, annual global growth might fall by 2 percentage points.

Many economists think the U.S. economy may shrink for two quarters, which is the common definition of a recession. Unlike previous earnings recessions, which are caused be a collapse in demand that lasts for over a year, this recession was triggered by the economy being "switched-off." Interestingly, consensus estimates for next year are holding strongly.

The CARES Act, a $2 trillion rescue package intended to provide short-term financial relief to those most affected financially by efforts to combat the virus, was signed into law near the end of March. The Act offers financial aid in various forms to individuals, small businesses, large corporations, state and local governments, healthcare providers, and educational institutions. To put the Act's size in context, $2 trillion is more than half the estimated 2020 Federal Government revenues of $3.6 trillion. It is also nearly 10% of the value of all goods and services produced in the U.S. in a year.

Congress has already begun work on another multi-trillion-dollar financial package aimed at stimulating future economic growth.

U.S. Treasury Yields

U.S. government bond interest rates hit historic lows in the first quarter. The yield on the 10-year Treasury ended at 0.70% compared to 1.92% at the beginning of the year. Along the way, it temporarily fell below 0.50%. This happened as the Federal Reserve, in coordination with other major central banks, reduced short-term interest rates to near zero and announced the intention to buy back certain longer-maturity bonds.

We find Treasuries **extremely overvalued**. The ratio of long-term Treasury yields (1.2%) to S&P 500 earnings yield (5.2%) has had a mean of 0.8x since 1925. The current ratio is 0.2x. The last time Treasuries were this overpriced was back in the 1950s.

Volatility Creates Opportunity to Reallocate

During March, U.S. stocks fell across the board with smaller company stocks and value-oriented stocks suffering some of the largest losses. Stocks in the financial, energy, travel oriented, airlines and hotel segments, where our clients have limited holdings, were especially hard hit.

Day-to-day volatility was unsettling and the decline very rapid. By mid-March, the S&P 500 had lost more than 20% from its all-time high achieved on February 19, entering a bear market. Stocks hit a low point on March 23, down almost 31% from the start of the year. From that low, stocks surged more than 15% to the end of March. Such volatility is abnormal and can be disturbing. We suspect above-average volatility will continue for some time.

Portfolios may have drifted from their target asset allocations. We see a strategic opportunity emerging to improve future returns by allocating modestly more to equities given the repricing that has occurred. The

unprecedented fiscal and monetary response also supports a more positive view.

Likewise, a severe market drop often improves the attractiveness of stocks or bonds that were recently deemed "pricey". Our tactic is to review holdings that have held up better than the markets and to possibly swap out of some of those into other well-positioned, but overly beaten-up issues.

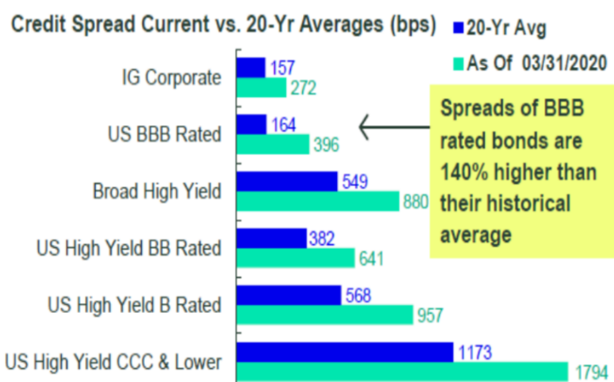
Credit

The case for credit is stronger yet more nuanced. Corporate bond valuations (interest rate spreads versus Treasuries) are clearly cheaper now, creating opportunities for investors.

The virus sell-off saw corporate bond prices fall significantly, with the Merrill Lynch Investment Grade Index down 7% for the month. Lower quality, longer-term corporates have been hit particularly hard. The 10-year triple-B bonds were off about 12% and 20-year single-As down 6% for the month.

Credit risk eased dramatically on April 9, when the Federal Reserve announced that it would expand its bond-buying program to include debt that was investment-grade rated (BBB or higher) as of March 22 but was later downgraded to no lower than BB-, or three levels into high yield.

Strategists see more than $200 billion of investment grade debt falling into high yield territory (such bonds are called "Fallen Angels"). Altogether, the Fed's program will support as much as $850 billion in credit buybacks.



While prices have begun to stabilize, there is still a significant lack of differentiation among issues. This offers potential opportunity to buy bonds that have been "thrown out with the bath water." We are finding attractive investments in the industrials, financial and pipeline/storage areas.

Investing for the Long Term

The fight against the spread of Covid-19, the resulting economic effects, and unprecedented government financial stimulus have disrupted stock and bond prices. Dramatic stock market volatility, likely caused partly by computer-driven trading strategies, has unnerved many investors.

The exact course forward is uncertain, but we remain convinced that Covid-19 will be contained and eventually eradicated.

We are confident that a disciplined, long-term orientation emphasizing the stocks of quality companies will continue to produce superior risk-adjusted returns over most investment horizons.

We continue to stay focused, and our thoughts go out to those impacted directly or indirectly by this disease.

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