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Economic and Market Environment

Second Quarter 2020

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The Economy

- The U.S. economy entered the year in good shape but has been devastated by the coronavirus disease (COVID-19) in March.
- Our economy is now contracting and is in the early stages of a severe recession, one that encompasses the globe.
- Rough estimates suggest that Gross Domestic Product (GDP) may decline as much as 8% in the second quarter or some 30% on an annualized basis.
- Monetary and fiscal policy turned aggressive quickly, responding to severe interruptions in business.
- The recession should be brief by historical standards. Much of the decline in demand is deferred spending, not canceled, but it will take time to return to full strength.
- Inflation concerns are off the table as coronavirus effects are deflationary.
- After the recession, we believe the U.S. economy should achieve above-trend growth temporarily, only to return after a few quarters to its longer-term growth of around 2%.

Stocks and Bonds

- With the coronavirus came a bout of extreme volatility in both markets.
- Stocks suffered major declines. From their peak, the popular averages declined by approximately 35%. This is the swiftest decline of such magnitude on record.
- Both short-term and long-term interest rates have collapsed, ranging now from near 0% on the short term to just over 1% on longest-maturity U.S. treasury issues.
- At this point, for longer-term investors, stocks look cheap and bonds look expensive.
- We believe that over the longer term, high-quality stocks can return to trend-line growth of high-single to low-double-digit total investment return.
- While bond yields may rise marginally from depressed levels, we expect them to remain very low relative to history.
- Geopolitical surprises, such as the coronavirus, are always a potential threat to economic and market stability. The best hedge against these threats are high-quality, liquid investments.

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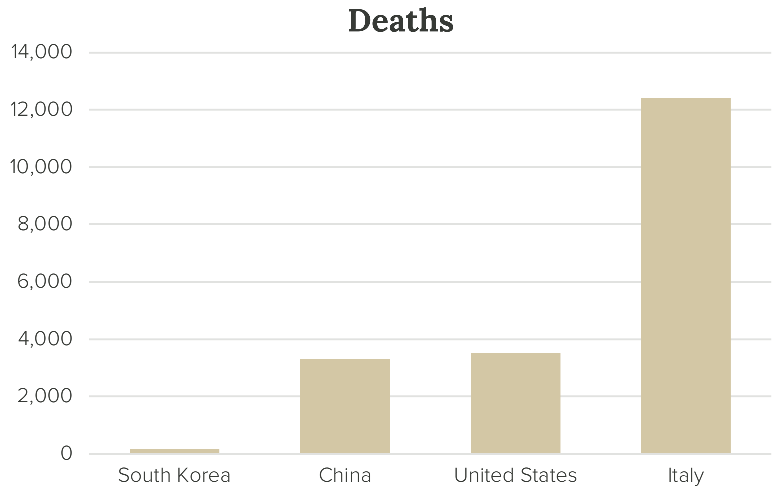
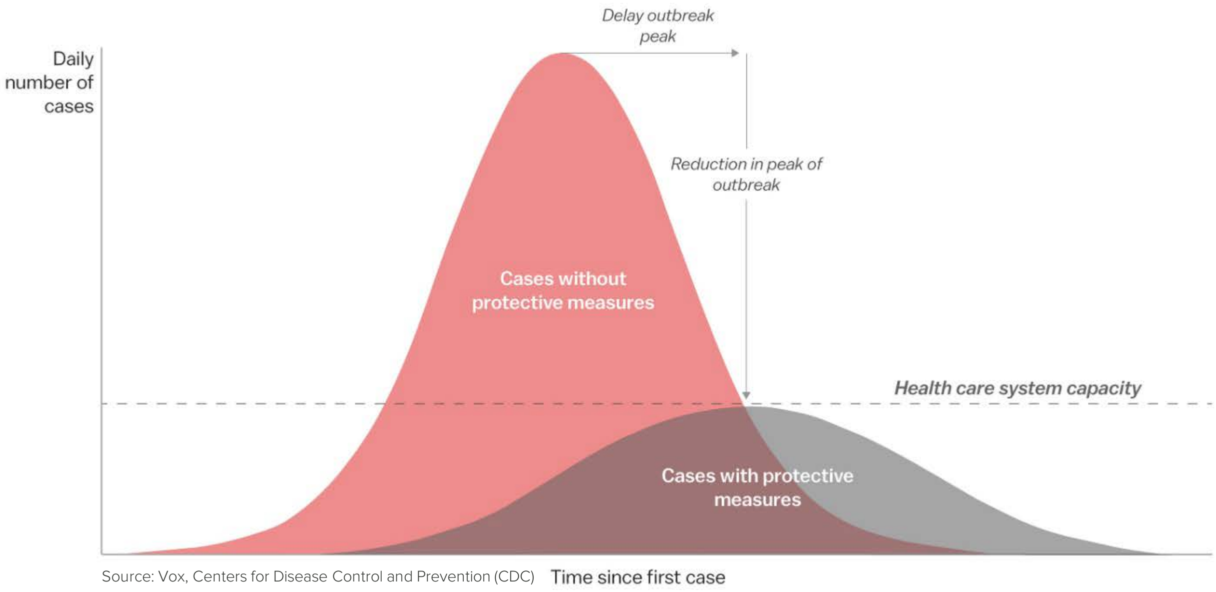


Source: Center for Systems Science and Engineering (CSSE) at Johns Hopkins University
Data as of April 1, 2020 @ 9:42 am EST

- The first confirmed case of coronavirus in the U.S. occurred on January 21st. As of this writing, we have 189,753 confirmed cases, and the trend is exploding geometrically.
- China seems to be in control of the virus, while the U.S. appears to be following the trend of Italy.
- Conventional wisdom assumes the U.S. is still in the early stages of the outbreak.
- Extreme mitigation efforts are underway. It should be clear in the next few weeks if these efforts are being successful.
- It is difficult to overstate the economic impact of the pandemic, both domestically and globally.

Flattening the Curve



Source: Vox, Centers for Disease Control and Prevention (CDC)

- In the absence of a vaccine, social distancing is the most effective means of mitigating the virus.
- The capacity of the healthcare system to care for infected and compromised patients is being challenged, but flattening the curve of infections can spread out treatment and make the crisis more manageable.
- Health-wise, this is an extremely high-risk situation, requiring stringent social distancing and widespread suspension of personal contact.

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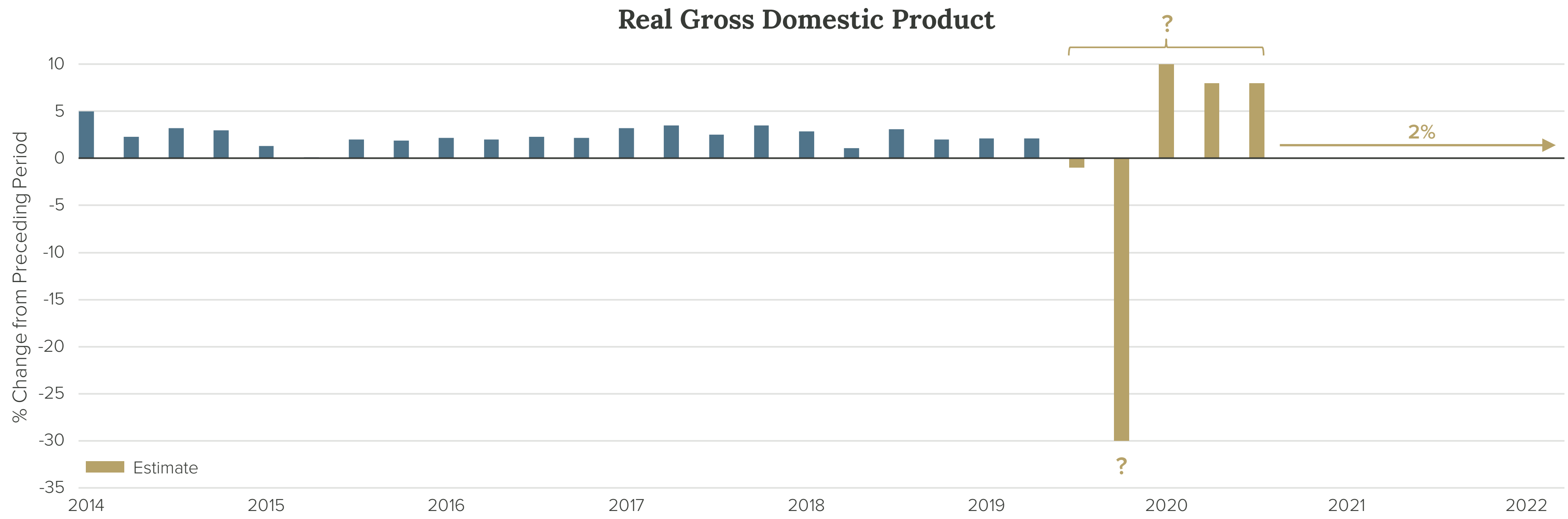
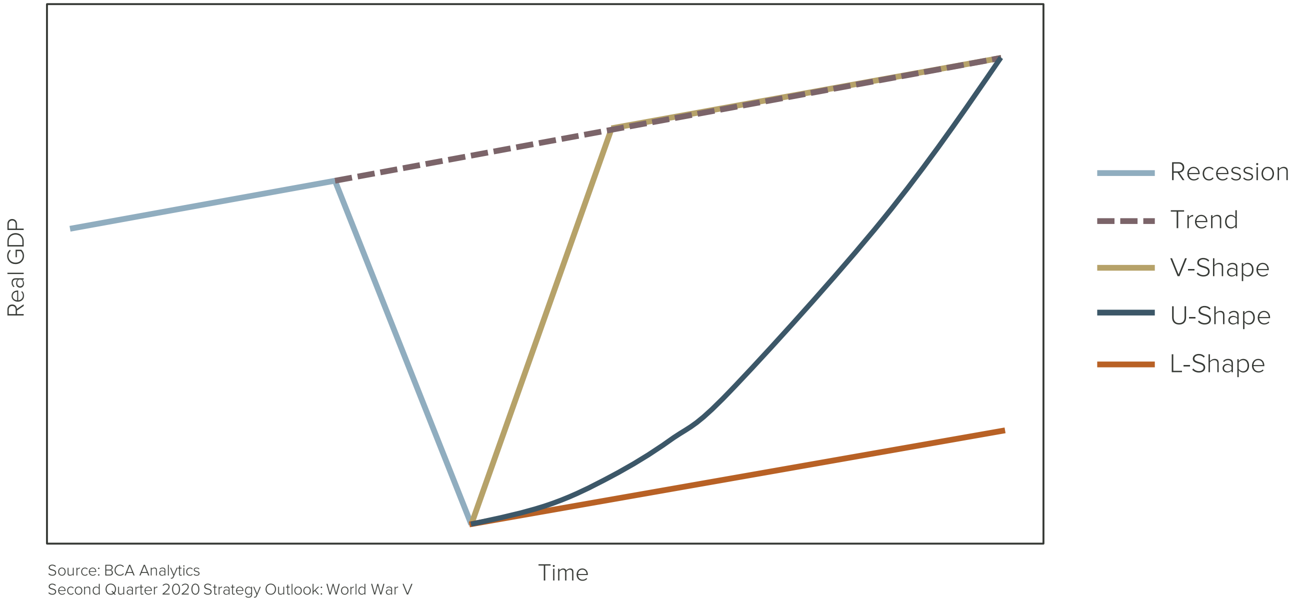


Source: Federal Reserve Bank of St. Louis
Real Gross Domestic Product, Percent Change from Preceding Period, Quarterly, Seasonally Adjusted Annual Rate (Data Through: Q4 2019)

- The U.S. and global economies are now contracting sharply and are in the early stages of a severe recession.
- The recession should be brief. Its duration will be closely tied to the duration of the coronavirus outbreak in this country and how quickly somewhat normal activity can resume.
- First quarter GDP was probably slightly negative, but the second quarter will likely provide an economic contraction of record proportion.
- Recovery later in the year should be robust, leading to a new recovery/expansion that will provide trend-line GDP growth of approximately 2% over time.

THE SHAPE OF THE RECOVERY: V, U, OR L?



Source: BCA Analytics
Second Quarter 2020 Strategy Outlook: World War V

- We assume with confidence that the U.S. economy will recover. The shape of the recovery can come in one of three forms.
    - V: immediate bounce back, as social distancing and other mitigation measures are lifted quickly
    - U: a slower, more gradual recovery because some containment measures are left in place longer than expected
    - L: a very slow recovery, as longer-term effects of the pandemic permanently depress output relative to its long-term trend
- We believe a U-shaped recovery is the more realistic scenario as containment measures are gradually lifted. Recovery can begin relatively soon, but the slope of recovery is more gradual than in a V scenario.

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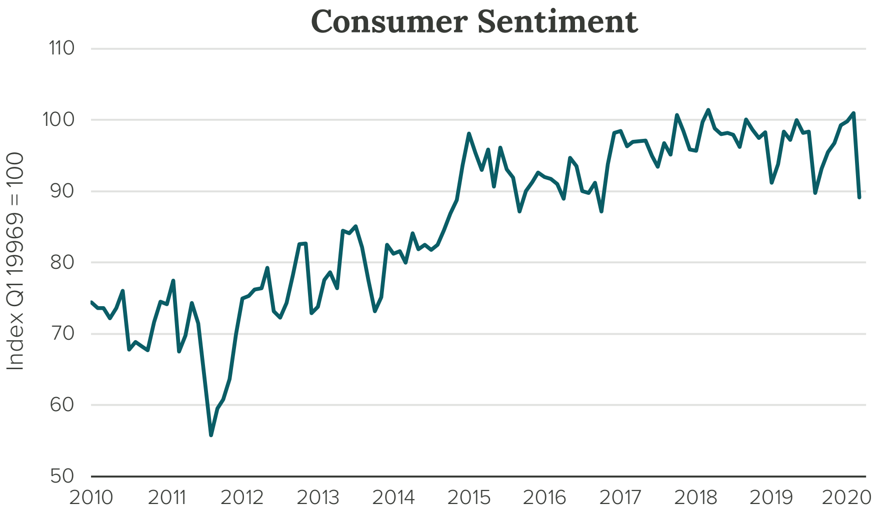
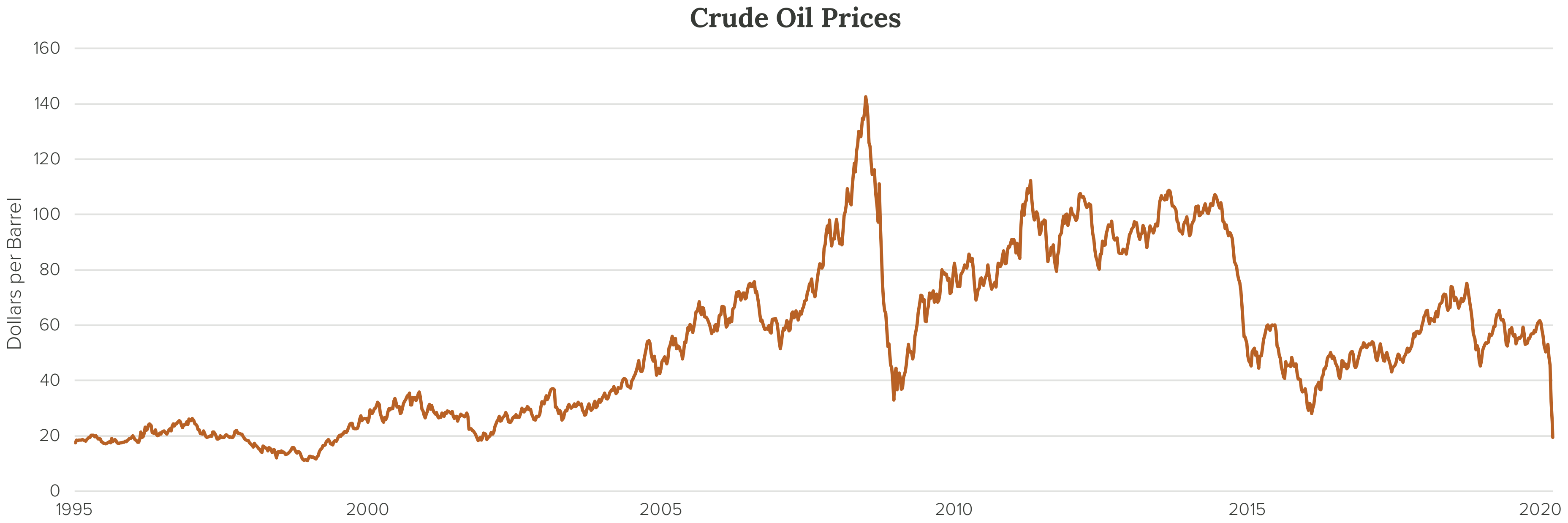


Source: Federal Reserve Bank of St. Louis
University of Michigan: Consumer Sentiment, Index 1966:Q1=100, Monthly, Not Seasonally Adjusted
(Data Through: March 2020)

Source: Federal Reserve Bank of St. Louis
Initial Claims, Number, Monthly, Seasonally Adjusted
(Data Through: March 2020)

- Confidence by consumers and business leaders is one of the more important business indicators, since it influences consumer and business spending.
- The coronavirus and its expected effect has already had a major impact on confidence.
- Since underlying confidence was strong in the pre-coronavirus era and the economy was healthy going into the crisis, confidence should return when some of the uncertainty is removed.
- First-time unemployment claims have skyrocketed. These claims presume sharply rising unemployment figures, perhaps of historic proportion.



Source: Federal Reserve Bank of St. Louis
Crude Oil Prices: West Texas Intermediate (WTI) - Cushing, Oklahoma, Dollars per Barrel, Weekly, Not Seasonally Adjusted (Data Through: March 23, 2020)

- There has been a total collapse in the price of oil this year, going from as high as $60 to as low as $20 per barrel, compounding the economic damage of the coronavirus.
- Oil is now buffeted by two huge forces: a Saudi price war and less demand due to the coronavirus impact.
- A number of bankruptcies are likely to occur in the oil patch. Overall capital spending will also suffer as energy spending is a significant portion of overall investment.
- The price of oil should be self-correcting at some point. Over time, price should gravitate toward cost (approximately $50 per barrel), implying that oil prices may rise somewhat over the next year. Context: oil dynamics have shifted dramatically, implying a secular trend toward lower oil prices.
- The good news is that low oil prices represent a huge cash bonus for individuals and businesses.

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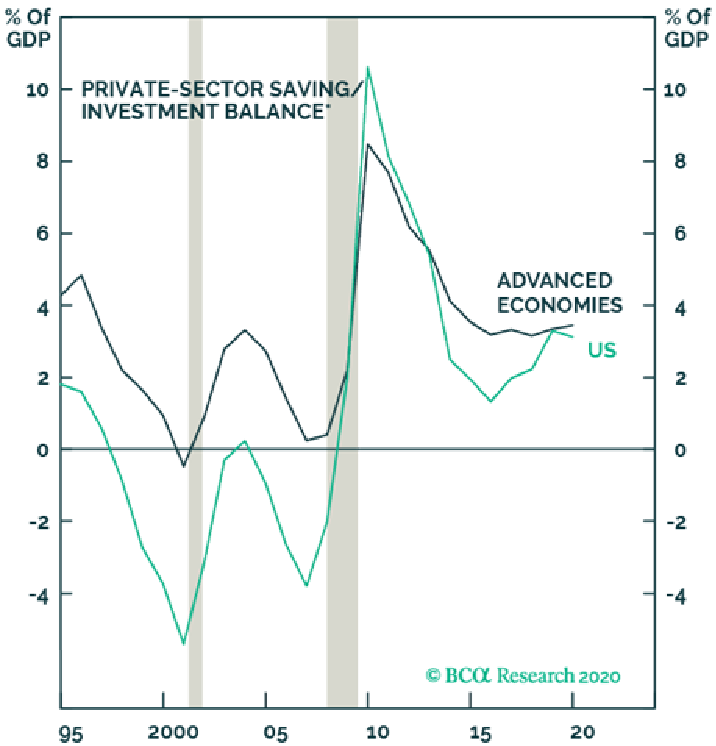

* CALCULATED AS THE CURRENT ACCOUNT MINUS GENERAL GOVERNMENT NET LENDING / BORROWING.
SOURCE: IMF.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Source: BCA Analytics
Weekly Report – February 21, 2020; Markets Too Complacent About The Coronavirus

- The private-sector financial balance is the difference between what the private sector earns and spends.
- Entering the recession, this balance was around 3.5% of GDP, in contrast to the two previous recessions when it was negative.
- This basic condition indicates structural strength in the U.S. economy, a fact that should enable fairly rapid recovery after the recession.

The Dog That Did Not Bark!

	2000	2020
Debt-to-GDP Ratio (Projected 10-Year)	6%	105%
Interest Rates on 10-Year Government Bonds	4.3%	0.8%

Source: Foreign Affairs

Remember when fears of deficits were prevalent? Deficit hawks are now nowhere to be found. Fiscal stimulus can be used with less regard to deficit concerns because…

- When interest rates are lower than trend GDP, deficit spending can be utilized without enlarging the Debt-to-GDP ratio. Even so, the enormity of the recently enacted fiscal package will temporarily widen Debt-to-GDP ratios.
- The U.S. authorities have acted aggressively with fiscal policy. This is good.
- Unlike tax cuts which are permanent, the current fiscal stimulus package is more of a one-time event; therefore, its ongoing deficit impact is lessened.

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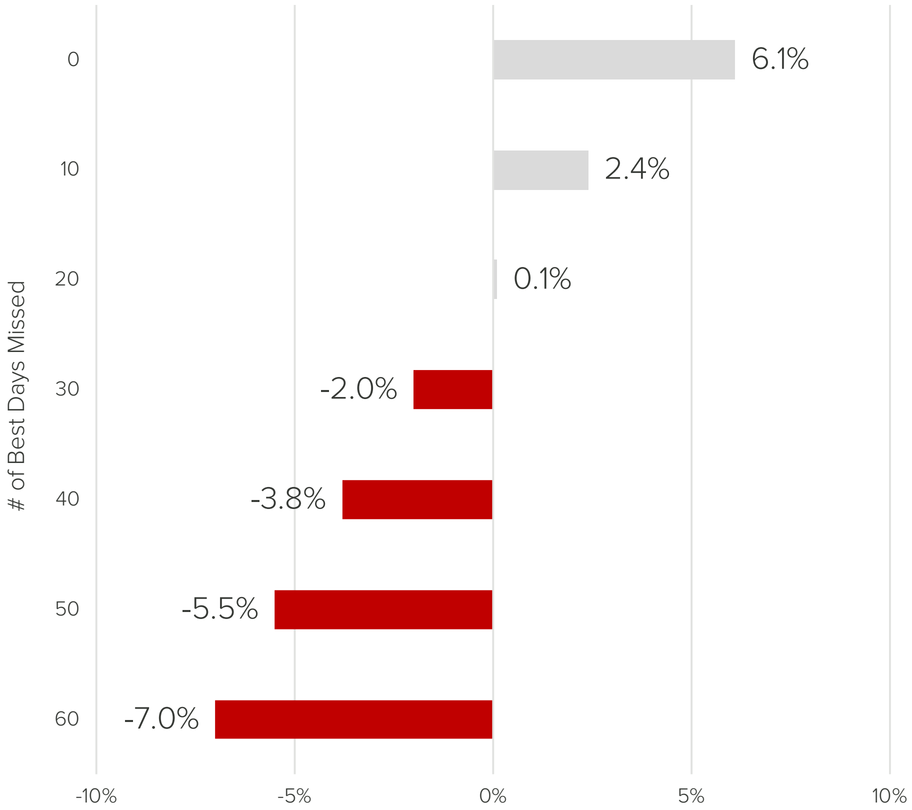
Source: Federal Reserve Bank of St. Louis, S&P Dow Jones Indices LLC
S&P 500, Index, Daily, Not Seasonally Adjusted (Data Through: March 23, 2020)

- From peak to trough, stocks declined by 35% in less than one month. This is the most rapid retreat in history.
- There has been no place to hide in this decline with little discrimination among individual stocks or sectors.
- Stocks are now discounting a dire future characterized by very low to no growth in corporate earnings. This is likely an overreaction.
- At some point, value becomes evident in high-quality stocks that are built to endure. We believe we are close to that point.
- Over the last 50 years, there have been four or five historic buying opportunities. We may be experiencing another one at this time.

- In extreme markets the urge to sell out can be overwhelming.
- Long-term investors should resist the urge to try and time the markets.
- The accompanying chart validates the practice of staying invested.
- Being out of the market and missing out on the best days has been costly. Missing out on all of them over the last 20 years resulted in a compound return of -7% compared to a return of 6.1% when missing none of them.

S&P 500: Best Days Missed



Source: The Wall Street Journal, JPMorgan Asset Management
Best Days Missed – S&P 500's best days from 2000 – 2019, Annualized Return

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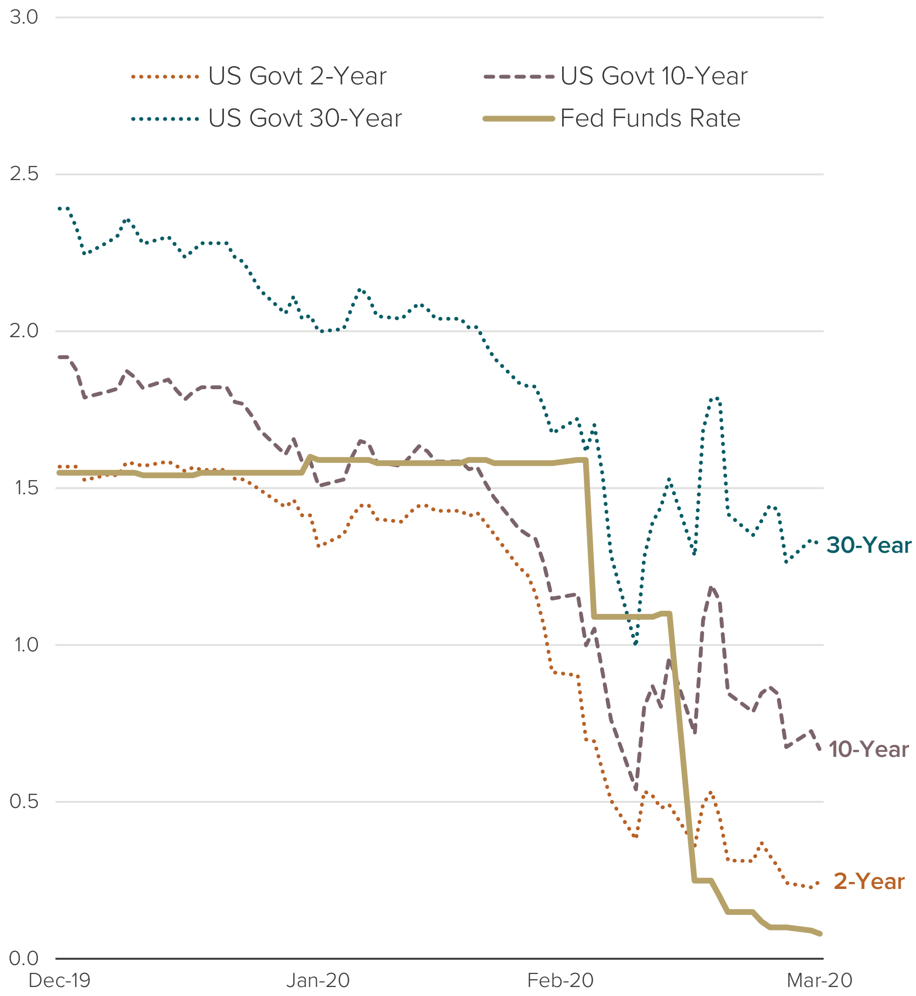
- Bond yields have fallen off the cliff this year, reaching historic lows.
- Bond yields have typically been good discounters of future economic trends.
- Currently, bonds are not only discounting a severe recession but also suggest an extended period of low growth for the U.S. economy. Like stocks, bonds may be overreacting to expected conditions.
- Bond yields are also forecasting an extended period of very low inflation.
- Federal Reserve policy is expressed in the rate of federal funds. At 0% to 0.25%, policy is very accommodative and is not expected to change in the foreseeable future. Bond yields will stay low for a long time.



Source: Bloomberg
(Data Through: March 31, 2020)

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