INVESTMENT COMMENTARY

At a Glance

The unprecedented decision to shut down the global economy to help stop the spread of the COVID-19 virus brought the longest bull market in US history to an abrupt halt. The first quarter of 2020 was the worst quarterly loss for global equities since the fourth quarter of 2008 during the financial crisis. This unforeseen market shock impacted all financial markets, leaving the Global Wealth Strategy portfolio with a net return of -19.69% for the first quarter of 2020. The first quarter returns for the MSCI AC World Index and the Barclays US Aggregate Bond Index were -21.37% and 3.15% respectively.

Although events like this are unpredictable, we can control how we adapt to them. Our disciplined investment process is positioning the portfolio to be prepared if risk levels continue to remain elevated, but still have the ability to participate should markets rally.

Market Recap

In a matter of days, the global equity markets and economy moved from making new highs in a position of growth, to the economy virtually shutting down with stocks falling into a bear market. We also saw a sharp reversal in employment data. According to the US Department of Labor, initial jobless claims soared to a record breaking 6.6 million in the final week of March. We've also noticed a significant uptick in overall market risk due to this increase, and at this time, expect the initial claims to continue to rise given the global nature of this pandemic. Should claims begin to fall, market risk may fall in lock step, one initial indicator that the downturn will be shorter lived.

What made this market selloff different than others was the speed and size of the decline. It took just 16 trading days for the market to drop over 20% and into a technical bear market. To put this in perspective, during the 2008 financial crisis, it took a seemingly forever 188 trading days to accomplish the same feat.

During the month of March, fixed income markets also made history. The 10-year treasury bond yield dropped to a record low of 0.50% as investors sought out lower risk assets. If equity risk continues to escalate, we would expect the demand for treasuries to increase, potentially pushing yields down to another record low. There have even been talks of negative rates in the United States.

Compounding the impact of shutting down the economy, was the failure of OPEC and Russia to agree to cut oil production. This sent oil prices plummeting to levels not seen since March 2002, when the average price for a gallon of gas was $1.24 (source: US Bureau of Labor Statistics). The S&P GSCI Brent Crude Total Return Index finished the quarter down an incredible -60.81%.

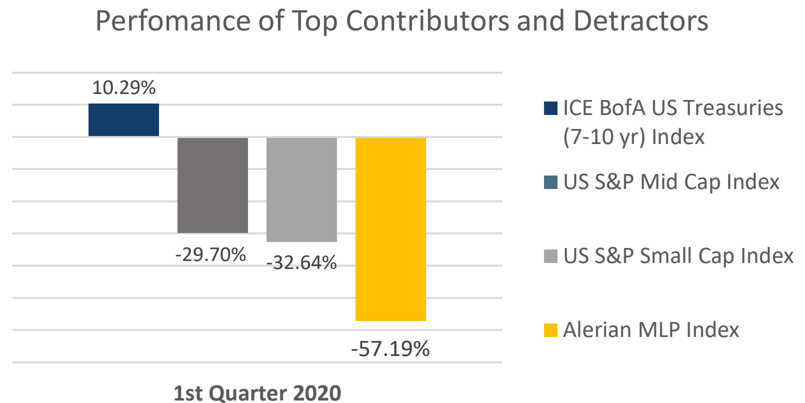
Although the bull market ended in a flash, the MSCI AC World Index and the S&P 500 Index are both still up 198% and 343% respectively from the start of the bull market in March of 2009 through the end of March 2020.

But enough of the bad news, there is also good news that should be highlighted. From the actions we've seen taken by governments around the world, in our view, they are responding with a "whatever it takes" approach to help individuals and businesses, both large and small, get through this crisis. In the US, the Federal Reserve (Fed) has cut interest rates to near zero and lawmakers passed a record multi-trillion-dollar stimulus package. The private sector has also jumped in with both feet to help, with companies like automaker Ford working with 3M on the manufacturing

of respirators and the Army Corp of Engineers doing amazing work by setting up field hospitals across the US. In addition, millions of Americans have chosen to heed the advice of the CDC and practice responsible social distancing in effort to help stem the spread of the virus.

What Helped and What Hurt

The dramatic market selloff in the first quarter didn't discriminate and left US Treasuries as the only asset positively contributing to the portfolio. Treasuries benefited from the Fed's decision to cut interest rates which helped the ICE BofA US Treasury (7-10Y) Index produce a return of 10.29% during the quarter.



As a result of the increased equity risk in February, the March allocation to Fixed Income was increased by 8% which helped to reduce losses for the quarter.

In the US, investors punished small and mid-cap stocks relative to their larger peers, making them two of the major detractors from the portfolio's return for the quarter. The S&P Small Cap and S&P Mid Cap Indexes were down -32.64% and -29.70% respectively, as compared to -19.60% for the S&P 500 Index. The S&P 500 Index was helped by the largest company in the index, Microsoft (MSFT), which through all the market turmoil managed to produce a positive return of 0.28% for the quarter, showing that investors are not painting all stocks with the same brush.

The portfolio's allocation to the defensive sectors in the S&P 500 Index (Consumer Staples, Health Care and Utilities) was a factor in curbing losses, as investors hoped they would be better positioned to weather the crisis. All three sectors ended the quarter down less than the S&P 500 Index.

Given the global footprint of the COVID-19 pandemic, International Equities were also negatively impacted with the MSCI EAFE Index down -22.83% and the MSCI Emerging Market Index down -23.60% during the first quarter. As expected, these areas were more volatile than most US markets, but were some of the first hit by the virus and could be a potential trigger for a recovery.

The Inflation Hedges asset class was the biggest detractor from return in the first quarter. The sharp decline in oil prices combined with the economy shutting down overwhelmed the oil markets and impacted MLPs with the Alerian MLP Index posting a loss of -57.19% for the quarter. Although the portfolio's allocation to MLPs was only 5%, it detracted -2.90% from the portfolio's return. Until oil prices stabilize, we expect the volatility of MLPs to remain high. As a result, the portfolio reduced its allocation to MLPs to 1.6% in April.

Final Thoughts

It was unthinkable that virtually overnight the global economy could be intentionally shut down. It sent shock waves through the markets and produced incredible daily swings in stock prices.

We constructed the Global Wealth Strategy portfolio to adapt to an unexpected market shock like we just experienced. We analyzed high risk market environments as far back as the 1920's, and our research concluded that a quantitative, rules-based investment process can be very effective at navigating through periods when markets are under extreme stress. We also learned that relying on subjective opinions and predictions when making investment decisions can be costly.

As part of our investment process, we allocate capital based on the amount of risk an asset contributes to the portfolio. Two of the data points we use to determine the risk of an asset are its volatility and its correlation to the other assets in the portfolio. During low to moderate risk environments, there will typically be multiple assets in the portfolio that can help mitigate risk. In the case of high risk environments, assets can become highly correlated, which can diminish the benefits derived from diversification. Although this is rare, it can occur when a crisis is global and has the potential to impact all financial markets. Historically, US Treasuries have proven to be an attractive risk outlet during these periods due to their safety and low to negative correlation to equity assets.

When we evaluated the risk of each asset in the portfolio at the end of March, as we expected, risk increased significantly with asset correlations converging. US Treasuries were the lone exception. In order to keep risk balanced in the portfolio, a large allocation to treasuries was required to offset the risk of the other assets in the portfolio. As a result, when the portfolio was rebalanced at the end of March, the allocation to US Treasuries was increased to 64%.

Although this is a meaningful increase to treasuries, it doesn't necessarily mean we are expecting the market to produce large losses in the months ahead. It does indicate that market volatility is likely to remain high and produce daily price movements well above historical averages. To put the markets' recent volatility into context, in the 50-year period ending March 31, 2020, the average daily move (up or down) was 0.72%. The average daily move during March was an incredible 4.95% (source: Factset).

April is earnings season which will give investors their first look into the impact the economic shutdown is having on corporate profits. As of April 9th, Factset is projecting S&P 500 earnings to decline -10.0% in the first quarter. Even though earnings are expected to be down for the quarter, if they come in close to expectations, we believe this will help moderate volatility, potentially creating opportunities to increase our allocation to growth assets. If there are big earnings misses or second quarter guidance is below expectations, we would expect risk to remain elevated and the portfolio would maintain its defensive positioning.

We are hopeful the actions being taken to reduce the spread of the virus are successful and that the stimulus package can keep the economy running until we are all able to get back to business as usual.

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