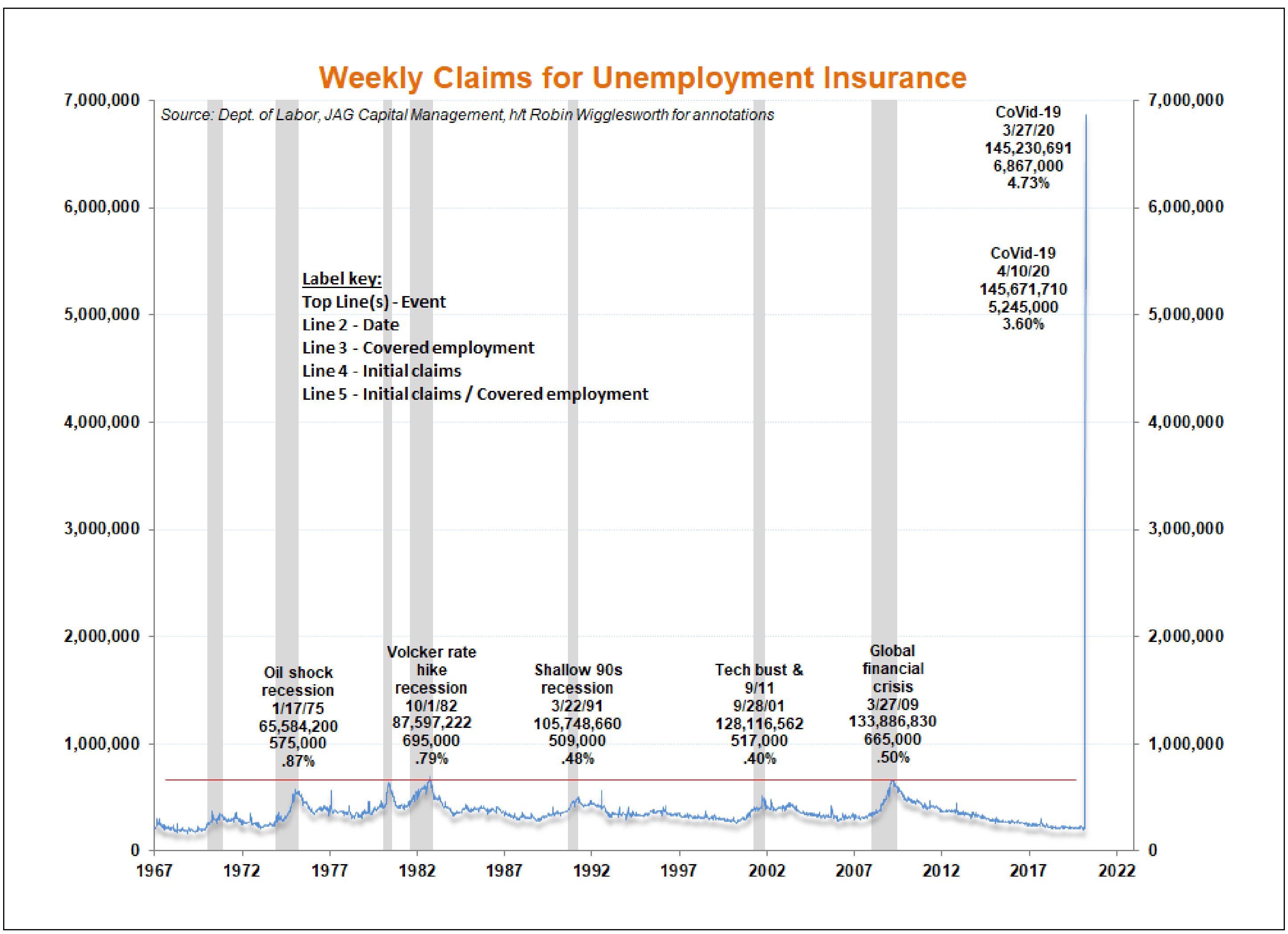
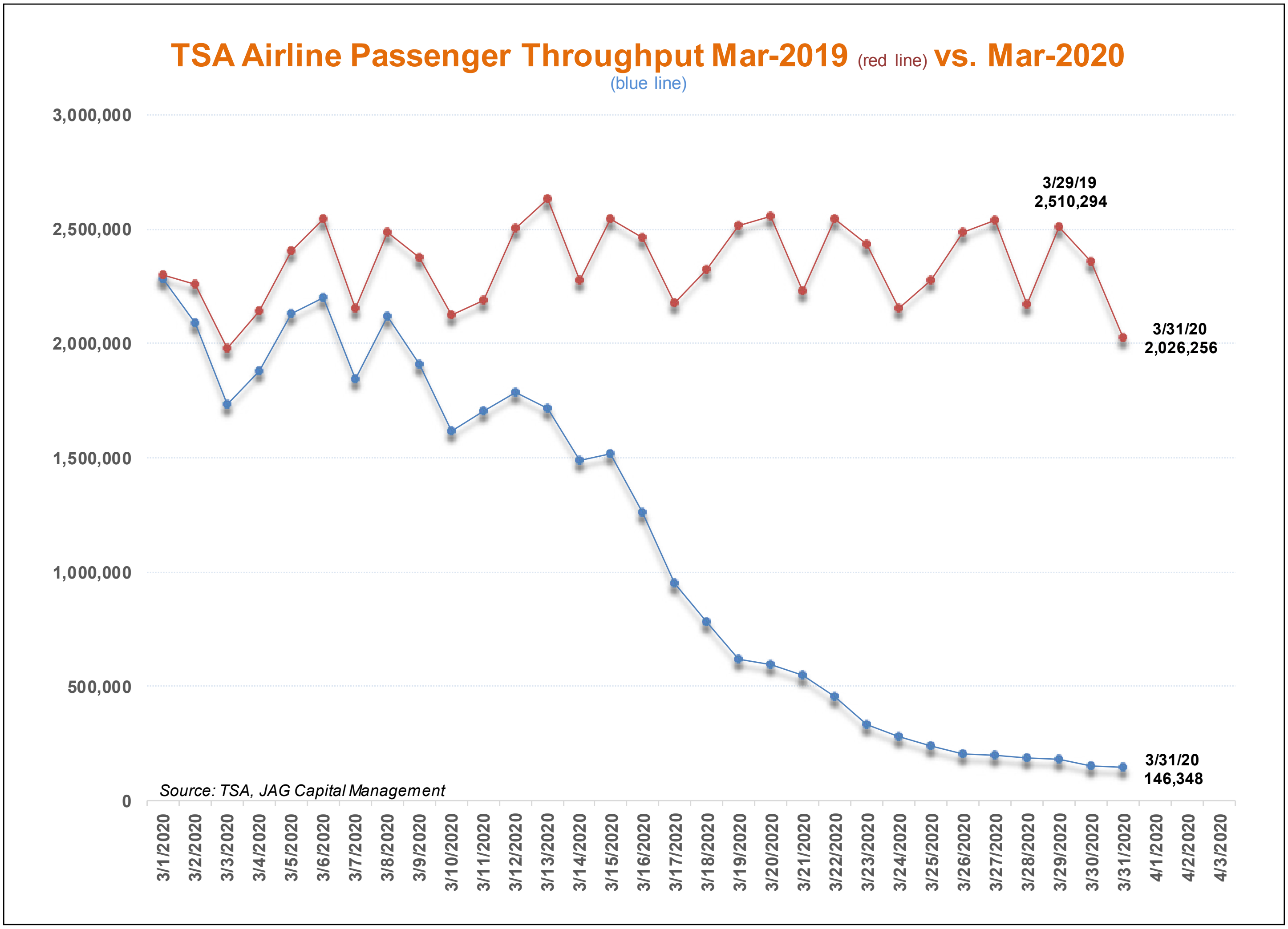
Quarterly Comments

NOTES FROM QUARANTINE

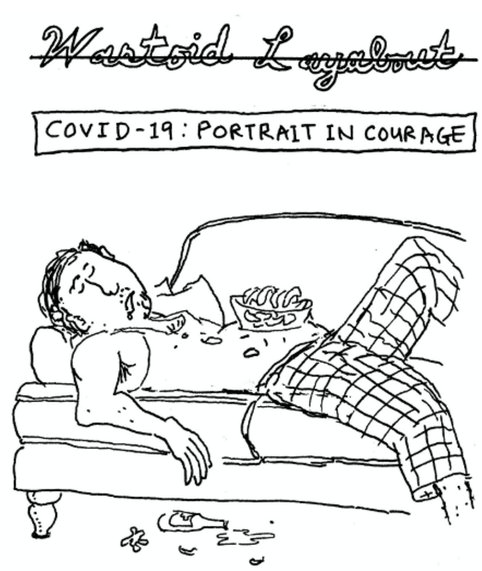
The first quarter of 2020 will be remembered in decades to come as a time of significant and extremely compressed changes to the global economy, society, and the capital markets. Over the span of less than 30 days beginning in mid-February, mitigation of the COVID-19 pandemic emerged as the sole focus of policymakers, business owners, employees and investors across the developed world. Fearing the direst projections from early epidemiological models – some of which projected millions of deaths from the virus – governments mandated an unprecedented economic lockdown and urged everyone but essential workers to stay home and "shelter in place."

In the United States, jobless claims spiked horrendously, from 3.3 million in the week ended 3/21/2020, to a revised 6.9 million as of 3/27/2020. Millions more job losses have continued into April. At the time of this writing, nearly



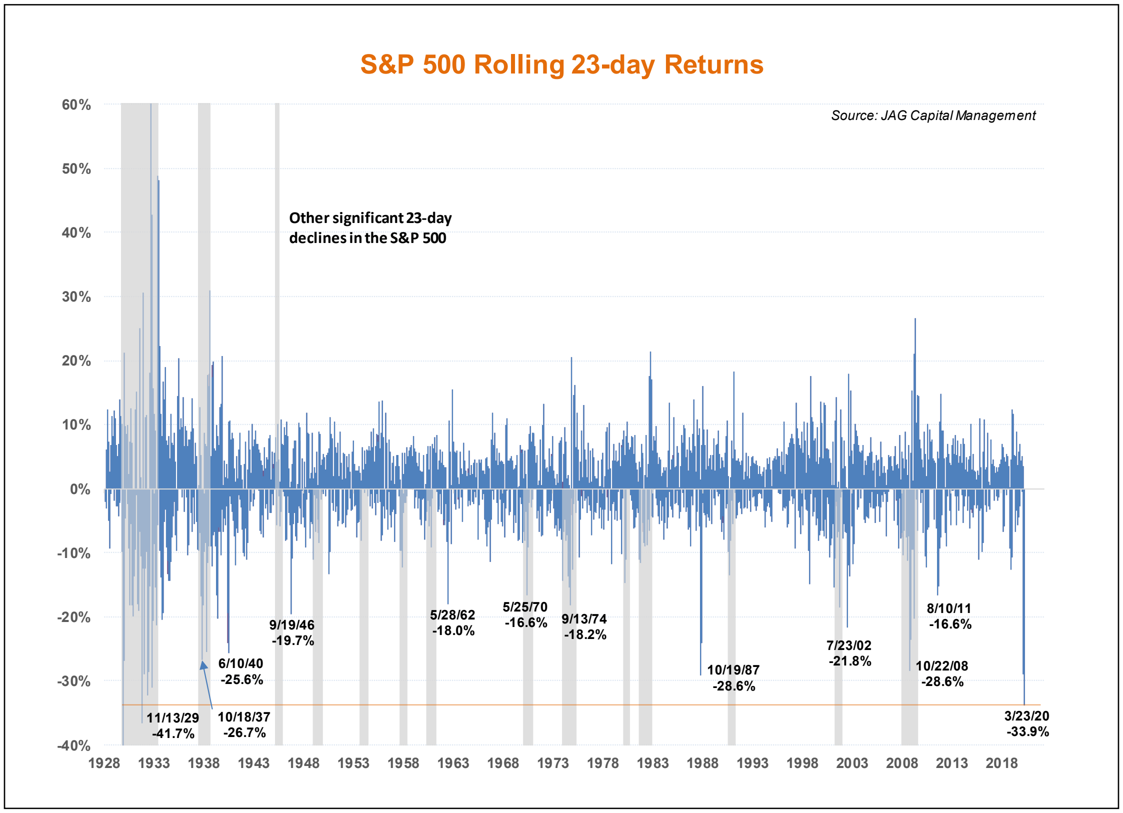


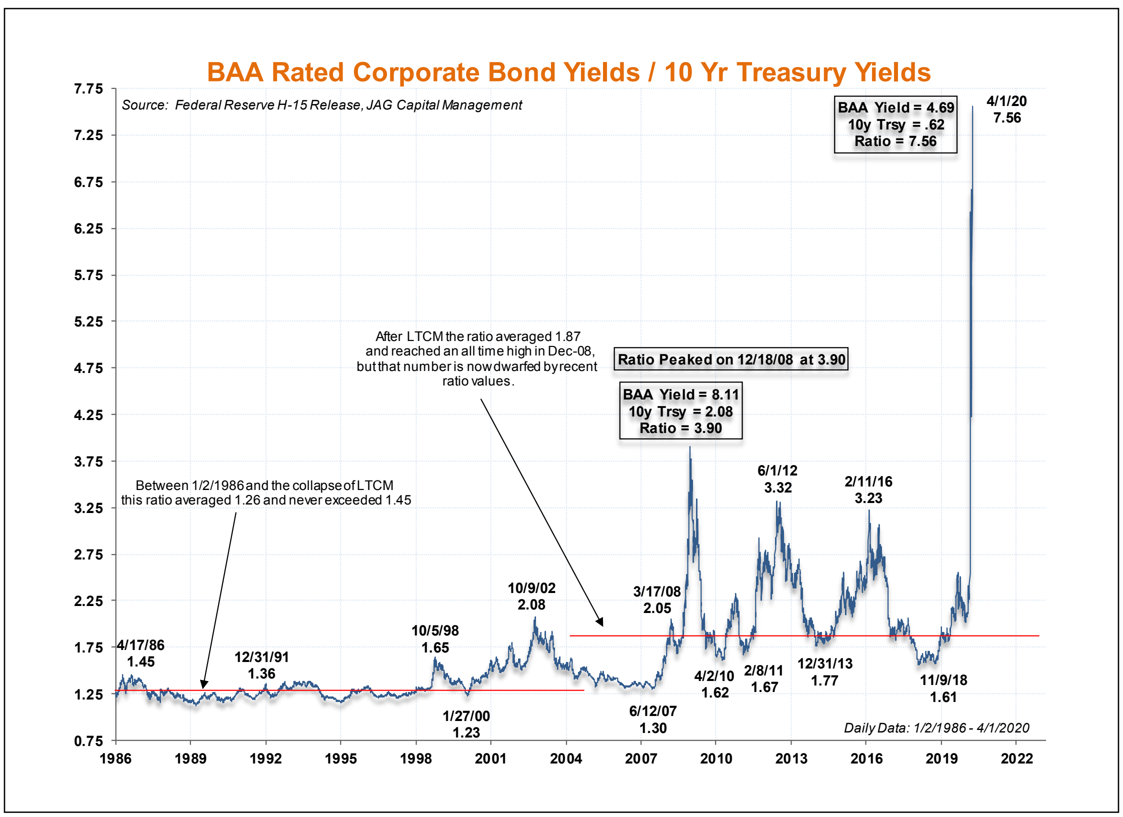
17 million employees have lost their jobs over the past several weeks. Commercial air traffic fell by more than 90% year-over-year during March, and industries from bars and restaurants, to movie cinemas, to hotels, theme parks and casinos have ground to a standstill. Economists project a GDP contraction of 30-40% for the 2nd quarter, although most admit that forecasts are difficult to make without greater clarity on when lockdowns are going to be phased out.



Capital markets experienced epochal volatility during the 1st quarter. The S&P 500 fell by 33.9% over the 23 trading days ending 3/23/2020, representing a 7.47 sigma event that was the sharpest and deepest such correction since 1929. Meanwhile, Treasury yields collapsed amidst a mad dash for dollars, and credit spreads for municipal, investment-grade corporate, and high-yield corporate bonds ballooned to levels not seen since 2008. As of 4/1/2020, the ratio of BAA-rated corporate bond yields to 10-year Treasury yields reached 7.56x, dwarfing the previous record of 3.9x that was set in December 2008. There were also widespread dislocations within the mortgage-backed securities market, and even bid/offer spreads for cash Treasuries widened out to highly abnormal levels during the latter half of March.

The final week of the quarter was highlighted by the announcement of a number of massive multi-barreled "bazookas" of stimulus, all of which are designed to mitigate some of the damage of the government-imposed shutdown in the battle against COVID-19. So far, they appear to be having the desired effect. Despite the roiling sea of deteriorating news in the job market and economy, the S&P 500 declined less than 20% during the first quarter, thanks to a 17% rally during the week ending 3/30/2020. Credit markets also improved notably into quarter-end, as Fed and Treasury actions helped calm panic.



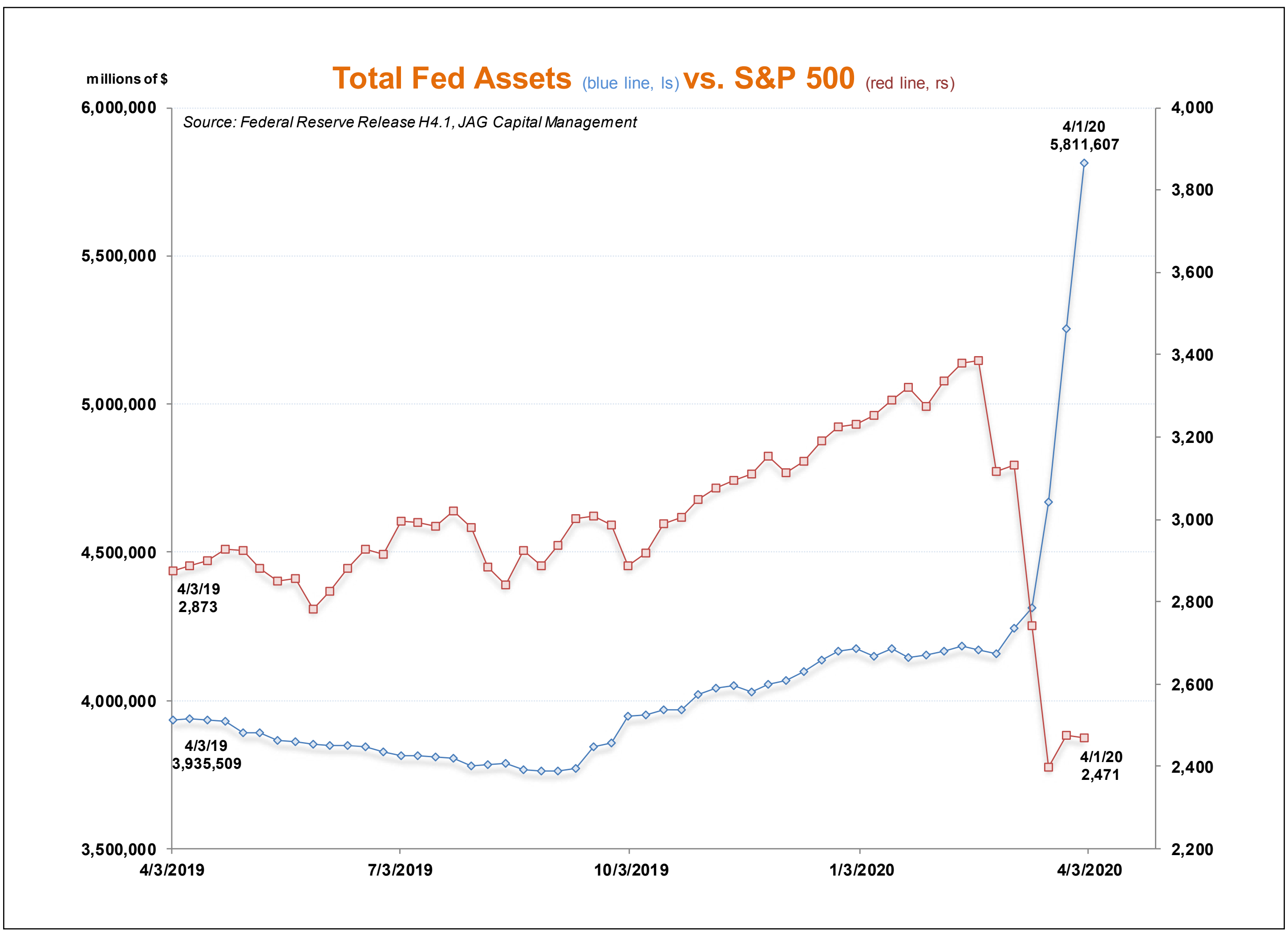


MARKET OUTLOOK

One of the many eternal frustrations for investors is the all-too frequent disconnect between asset price movements and economic headlines. The current COVID-19 crisis environment is a jarring example of this dissonance. As we detailed earlier, the news flow on the economy is epically somber. And yet, at the time of this writing, the S&P 500 index has rallied roughly 25% since March 23. Although the market is still more than 18% off the February highs, the fact is that – technically speaking – stocks are now back in a bull market (defined by a 20% or greater rise from the lows) cycle. For most of us, it is difficult to reconcile the relative resilience of the equity markets with the fact that GDP will almost certainly contract dramatically over the next several months.

However, unlike conditions that prevailed prior to previous recessions, the economy was relatively healthy before COVID-19 barged onto the scene. Less than 45 days ago, the U.S. job market was at or near full employment, GDP growth was bumping along steadily between 2-3%, the personal savings rate was 8.2% and rising, and consumer balance sheets were quite healthy. This stands in stark contrast to the conditions that prevailed prior to the 2001-2002 and 2008-2009 recessions, which were characterized by imprudent consumer spending, excessive investor speculation, and parabolic gains in asset prices. The fact that we entered this contraction with generally strong economic and market fundamentals may help us achieve quicker recovery once the biological crisis abates.

Another exception to historical precedent is the extreme haste and massive force with which policy makers have acted to counter COVID-19 related deterioration in the economy and capital markets. In effect, they have compressed a decade's worth of political and policy debate into just a few weeks. Chastened by their arguably slow-footed response to the 2008 financial crisis, the Federal Reserve, Treasury, and Congress have injected roughly $10 trillion of monetary and fiscal stimulus since mid-March. It is difficult to overstate the monumental scale of these actions, which include unlimited and open-ended Quantitative Easing to include corporate and municipal bonds, trillions in dollars of repurchase agreements, $500 billion of direct stimulus checks to taxpayers, at least $350 billion of forgivable SBA loans for small businesses, and $2.3 trillion to bolster local governments and mid-sized businesses. Altogether, the aggregate stimulus measures amount to roughly 50% of GDP, and there is more to come. Similar plans are being implemented in Asia and Europe, as leaders



everywhere are competing to architect lavish spending policies to catalyze stability and recovery.

The timing and cadence of the path of economic normalization will be closely linked to the developments on the battle against COVID-19. Thankfully, the curve of new infections is flattening in most areas of the U.S. and Europe, and hospitalizations and deaths from the virus appear to have peaked. The smartest scientists in the world are working to develop treatments and a vaccine for this disease, and there is reason to believe that one or more therapeutics may be approved as early as May. Viable candidates include Remdesivir, an anti-viral drug from Gilead Sciences (GILD) that has shown early promise. Successful development of a prophylactic vaccine against COVID-19 infection is farther off, with the testing and approval process likely to stretch into at least the 4th quarter of 2020. Until a vaccine is approved and available, it is likely some physical distancing practices will need to remain in place, which could slow the path to economic normalization even after work-from-home policies are eased for most businesses.

Self-Isolation Insight

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Always remember that capital markets are discounting mechanisms. As such, they continuously (and often counter-intuitively) adjust to incorporate future potential outcomes for all manner of macro- and micro-economic conditions. Therefore, the short-term path of asset prices tends to be extraordinarily volatile, especially during periods of high uncertainty, as market participants vote on the probability of future conditions. Given the current global state of play, we do not expect this volatility to abate soon. Investors simply do not yet know enough about the shape or speed of the path toward economic normalization. That said, we are working hard to concentrate our investments in companies we believe can survive and thrive for the long term.

From an investment perspective, markets are likely to recover before we can declare victory against COVID-19. Similarly, stocks typically bottom months before economic contractions end. Time will tell, but it is possible that the worst market conditions are already behind us, given the strong rally in stocks since late March and the marked improvement in credit market conditions.

During periods of disruption in the capital markets, it is vital to manage both opportunities and risks. Within our equity strategies, we are concentrating our research efforts on identifying companies with strong balance sheets, robust cash flows, "sticky" goods and services (including subscription-based services with high switching costs), and leading competitive positions that will have staying power throughout this period of turmoil and beyond. We think many physical retailers and restaurant businesses, especially those who rely on shopping malls, could suffer from more lasting changes in consumer behavior. Although many of these companies are undeniably inexpensive, we would argue that they are unlikely to recapture their former valuations anytime soon. As has been the case since the fall of 2014, we continue to urge investors to take a cautious view of the Energy sector. Valuations are indeed rock-bottom for the stocks of energy-producing companies, but they are heavily dependent upon the price of crude oil to generate revenues and profits. Given collapsing demand and ample supply, oil prices are likely to remain under pressure for quite some time, resulting in an unappetizing reward-to-risk proposition for common shareholders.

It is difficult for us to see how the waterfall of so-called "helicopter money" being dropped into our economy and markets will not exert upward pressure on consumer prices and interest rates. Looking forward, we think bond investors will be forced to navigate the twin risks of higher inflation and rising rates. Remember that all else being equal, higher rates cause bond prices to fall, which tends to be disconcerting to conservative investors in commingled vehicles like mutual funds or ETFs. Higher inflation is the long-time enemy of bond investors, as it eats away purchasing power. However, we believe the recent turmoil in the fixed income markets has created opportunities to earn attractive total returns in short- to intermediate-term corporate bonds. In the latter half of March, a global stampede out of risk assets and into "risk-free" assets like Treasuries caused corporate bond prices to fall and credit spreads to gap out to the widest levels since 2008. But the Fed's recent announcement that they will be purchasing investment-grade and below investment-grade bonds is likely to result in tighter credit spreads in the coming 6-12 months. Such a tightening in spreads, if it comes to pass, could result in double-digit returns for carefully selected bond issues over the intermediate term. From our perspective, the risk-reward for credit-sensitive bond portfolios compares quite favorably to the meager yields offered by cash and Treasuries.

The investing landscape is challenging and chaotic right now, but this too shall pass. In the meantime, our team is working full-bore to help our valued clients steward their assets into the future.

Norm Conley
CEO & CIO

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