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Review and Outlook

On January 21st, the first Covid-19 case was identified in Snohomish County, Washington State, a person who had recently returned from Wuhan Province in China. On February 19th, the Covid-19 tragedy at the Kirkland nursing home started to unfold. This was also the day the S&P 500 started to fall from its record high. By March 23rd, the S&P 500 had dropped 35% from its February 19th peak.

The drop in March 2020 was the fastest 30% decline in the history of the United States stock market. Small cap stocks fell even more during that time, over 40%. Volatility has been staggering, with record day moves both up and down. While such large moves down in the stock market are unusual, they are not unprecedented. In fact, the S&P 500 has dropped 30% or more seven times since the Great Depression. Each episode has its own story, today dominated by Covid-19, with a global oil price war subplot thrown in. The recent market drop stands out for the speed of its downward movement, moving from the longest bull market in history to a possible waking bear. The dramatic movements have also played out in the fixed income market. We saw all major interest rates (including yields on 10-year and 30-year U.S. Treasuries) fall below one percent for the first time, ever. At first this resulted in gains for bond prices, however bond price fell later as sellers outweighed buyers in a rush to raise cash, in part to pay margin calls by lenders as borrowers' collateral, often stock, dropped in value.

Index Performance Data
Total Return as of 3/31/2020

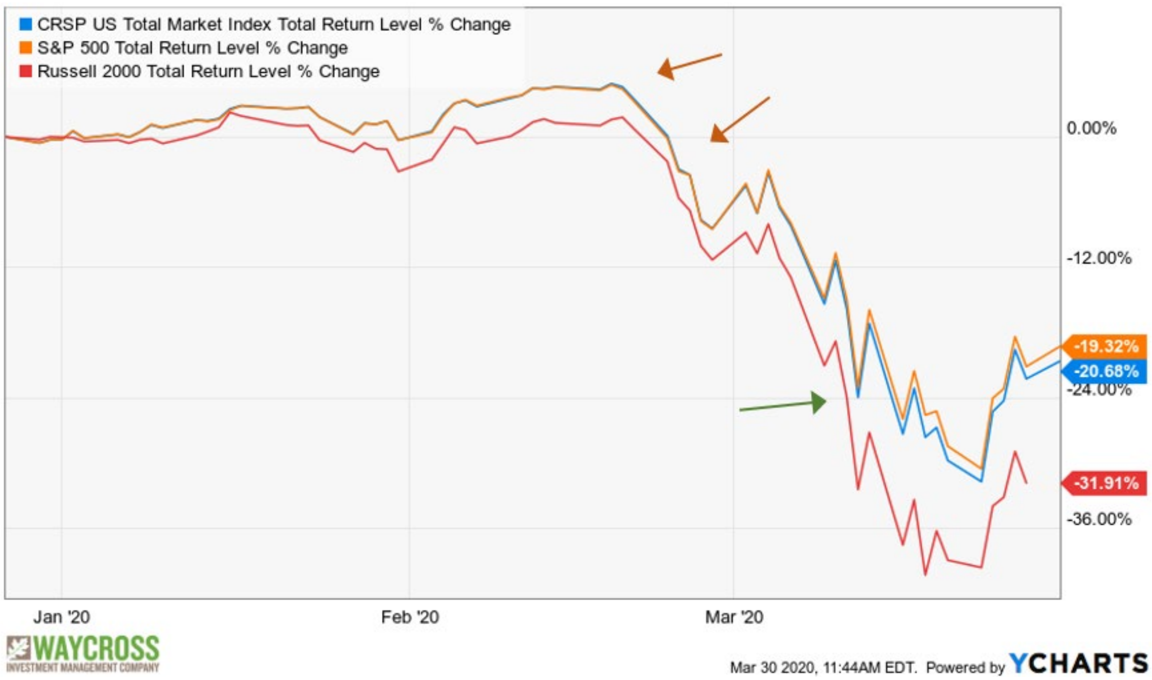
Indices[1]	Q1 2020	Trailing 12 Months
CRSP U.S. Total Stock Market Index	-20.88	-9.24
MSCI Global ex-U.S. Total Stock Market Index	-23.86	-17.91
Bloomberg Barclays U.S. Aggregate Bond Index	3.15	8.93

The Federal Reserve responded to the market drop and economic concerns by adding a dramatic amount of stimulus and support to credit markets. Bond prices recovered significantly after this action. Congress followed by approving unanimously the largest stimulus bill in history. The bill contains support for industries such as airlines, funding for loans to smaller businesses, and checks for many Americans. It's impressive in many ways, but it may not be enough. Many questions remain about how businesses can pay workers something (even if those workers are also collecting unemployment benefits while on stand-by) while also paying rent and other bills. It is not clear how property owners will fare if tenants are allowed to miss several months of rent. Between unintended consequences and whack-a-mole fiscal and monetary problem solving, we are sure to see more government and Federal Reserve actions in the coming days, trying to keep people and businesses as whole as possible.

We know that social distancing stay-at-home orders are necessary to slow the spread of Covid-19 and let hospitals cope with the demand for services. Until we have the ability to test many more people there will remain significant uncertainty about the prevalence of the disease. Increased testing will be a crucial part of re-establishing confidence going forward. We see many positive trends on the testing front, and are optimistic that drive through testing will be available to all of us in the near future. However, in the immediate-term, we fear a number of weeks of distressing nightly news, some of it similar to scenes we have witnessed in Italy. At some point, likely while the health care crisis is still raging, the markets will look past the tragedy and start to rise.

We started to increase our cash positions in late 2019 and early 2020 because of the significant increase in stock prices relative to earnings. We then raised more cash in late February and early March when it was clear that Covid-19 was likely to be more than a repeat of the SARS epidemic, which was more geographically limited and the disruptions more short-lived.

The figure below offers an illustration of the steps we have taken. The orange arrows point to the moments we sold securities and the green arrow points to the day we invested a little in some accounts and positioned all accounts for upcoming reinvestment. Our decision to increase cash positions early in March softened the impact of the market drop on the accounts we manage. In mid-March, we positioned our clients' accounts so we can reinvest the cash in the near future, and even invested a portion of the cash we had in some accounts at that time. Our shifting client portfolios to hold more large cap, and less small cap, stocks has also held up, as can be seen by the underperformance of the small cap Russel 2000 in the chart (red line). We are currently waiting on updated estimates for forward corporate earnings and greater clarity on who benefits from the massive amount of government monetary and fiscal stimulus before investing further.



Again, we are looking to reinvest cash soon; we are not trying to figure out the exact bottom or spending time worrying about how long it will take for the market to get back above its February 2020 peak. We are going to see difficult news about human and economic loss across the United States in the coming weeks. We will reinvest thoughtfully, knowing that, historically, financial markets have tended to improve weeks or months before the economy.

In Focus

The last major global pandemic to significantly affect the United States was the 1918 Spanish Flu. It is not clear whether that flu, which is estimated to have killed over 675,000 Americans, had lasting effects on culture or induced adaptations of new technologies. This flu overlapped with, and was spread in part by, the troop movements of World War I. This was before the time of vaccines. We think that this current Covid-19 pandemic might differ by producing some lasting changes, perhaps starting with better resources put in place to identify and respond to future pandemics.

Two other areas where we could see change are education and business travel, due to a massive acceleration of developing online communication skills. We will likely end up years ahead on this front given stay at home orders across the world. People of all ages are being forced to learn new skills and for many, upgrade or buy new equipment to work from home.

Technology has changed most industries over the last 20 years: music streaming services, ride share companies, movies on demand, electronic medical records, and automation in manufacturing. Still, teachers largely stand before students today much as they did 20 or 30 years ago. In general, education has not been disrupted by technology. Covid-19 may force change as teachers and students, by necessity, develop new skills for remote learning. It is likely many short-term adaptations will become routine, even after the virus passes.

We think business travel will not fully recover. Millions of people who travel for business are currently working from home. Like teachers, they are being forced to learn how to do an old job a new way, and many are starting to wonder why so much travel was required in the first place. Some things are better handled face-to-face, but many things can be done virtually just as well. We think businesses may decide to permanently cut travel requirements once they see how much employees are able to accomplish without it. Why pay for something if it is unnecessary? Airlines and business hotels may have a rough road ahead.

We have also been thinking about the future of restaurants after Covid-19. Will the pandemic result in a future where a much higher frequency of people are eating at home, either cooking for themselves or ordering in? We think the bustle of restaurants will return quickly after the pandemic. Delivery will likely cut into the take-out market, but with time should not reduce the number of sit-down restaurants.

We expect that Covid-19 will add to existing concerns about globalization, the integration of economies through trade. For example, conversations about bringing manufacturing jobs back to the U.S. will have an added sense of urgency and purpose as we talk about shortages of ventilators and personal protective equipment; goods we now see as vital for our health and prosperity. People will say these and other items should be made in the U.S., that we do not want their availability at risk due to supply chain disruptions or the whims of another country. But while the intuition behind this thinking seems clear, the underlying reality is far more complex.

While we may have fewer manufacturing jobs in the U.S. than we had 30 years ago, we produce and export more than ever. We use a lot of machines and incredibly sophisticated automation to both standardize high quality output and reduce labor expenses. So, the loss of manufacturing jobs is not merely a story of trade and offshoring. Similarly, the idea that we can simply bring certain manufacturing jobs back to the U.S. may not be valid. Those jobs may not exist anymore due to automation. We anticipate future discussions about what we might want to produce at home that we no longer produce, and we hope those discussions include a thoughtful review of what we actually acquire through trade and why.

In the more immediate term, we will be trying to figure out how to get back to some semblance of normal as quickly as possible. As we mentioned earlier, a key piece of this will be testing so we know who has the virus and who does not. We should also be able to develop tests to see who has antibodies to the virus, likely making them immune. One of the devastating characteristics of Covid-19 is that a person can be both asymptomatic and infectious, so we are curious to see what future tools are developed for people to be able to communicate to others that they do not have the virus.

Most importantly, we hope that in the wake of Covid-19 more countries will show a renewed investment in pandemic surveillance and response. Some of the solutions are out there already. For example, places like Taiwan, Singapore, South Korea, Hong Kong, and Iceland have already developed a number of tools, including surveillance and management, to navigate pandemics through all phases with the goal of getting back to normal as quickly as possible. Extensive testing, contact tracing, and quarantine with precision is widespread in these countries, and useful cell phone apps have been developed to provide different types of helpful information to the public, such as where personal protective equipment is available and wait times at test centers. In part, this effective response derives from lessons learned during the SARS outbreak from 2002-2004, motivating people and governments to collectively take the Covid-19 threat seriously early on. While the next weeks will be difficult, there is reason to be optimistic. We do know that this will end, and we know that we will be better prepared for the next pandemic, whenever that might occur, by applying the hard-learned lessons from Covid-19.

1. Index price data is downloaded from ICE Data Services. Index performance data is calculated by Axys portfolio accounting software, a product of SS&C Advent.