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Brightworth Investment Commentary: First Quarter 2020

- The speed with which we gain containment of the coronavirus will determine the timing of the eventual economic recovery
- Deviation in returns amongst bond sectors was the widest in years
- Stocks ended their 11-year bull market in the wake of the pandemic

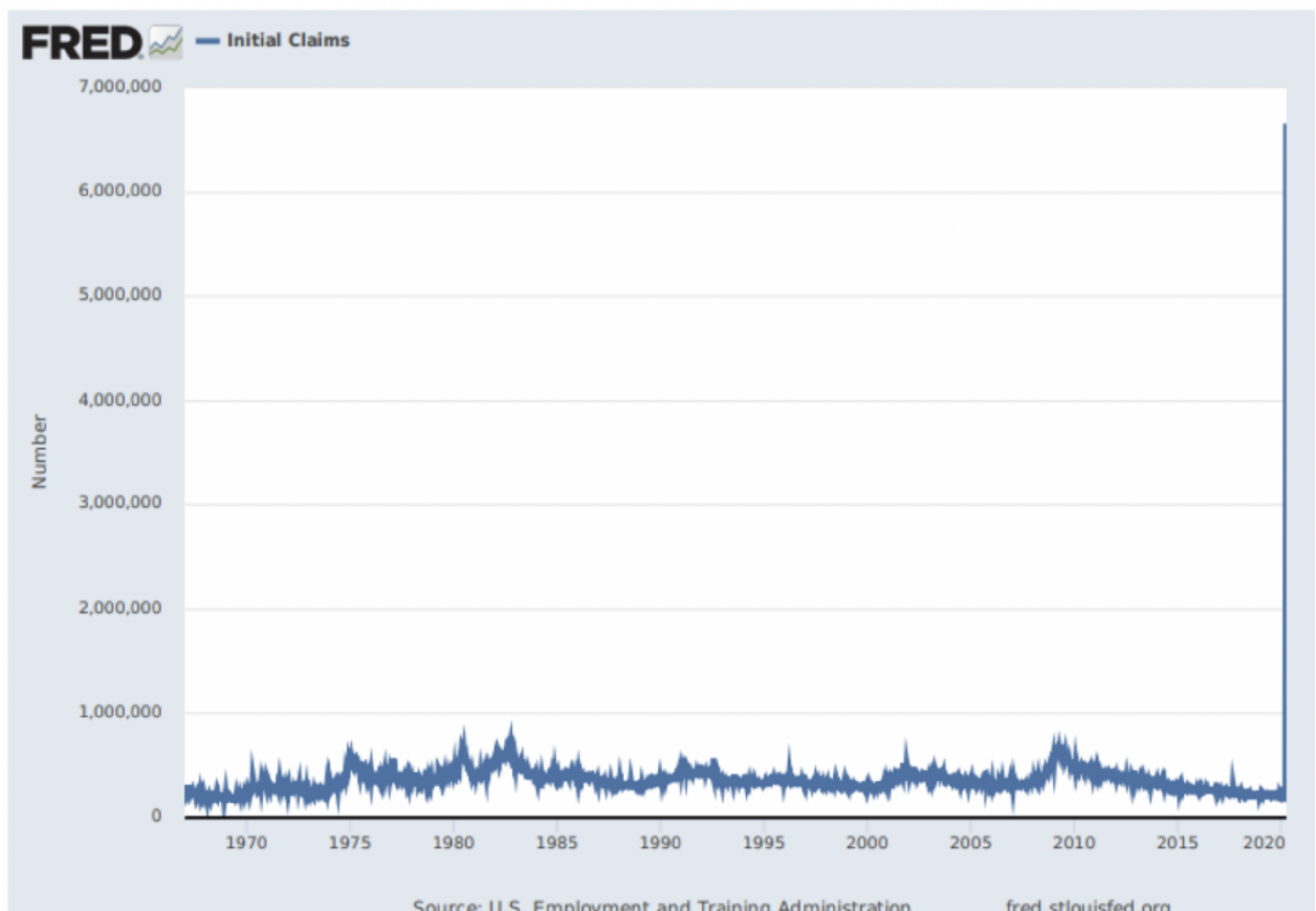
The coronavirus pandemic is unlike anything seen in our lifetimes. The virus has affected everyone and until we can gain control over its spread, life won't return to "normal". While it is difficult to determine when medical science will produce effective treatments and a vaccine, we are confident they will. While this is a very difficult time from many perspectives, there is an endpoint, and the current situation won't last forever. Over the past century, the world has dealt with numerous humanitarian, economic, and political challenges and ultimately prevailed. We see no reason to not remain optimistic that we will overcome this as well.

Economic Review & Outlook
The economy entered uncharted territory to begin 2020 as the coronavirus pandemic spread throughout every corner of the globe. In the coming weeks, economic reports that gauge the health of the U.S. economy will undoubtedly show severe contractions. The U.S. is not alone in this plight. Countries around the world are dealing with the healthcare crisis this virus is causing by shuttering their borders and economies as we attempt to gain a foothold on the contagion. The financial impact of these actions is still very much unknown. As we begin the second quarter of 2020, there is some optimism that containment can occur within 30 to 90

days and the global economy will begin the process of restarting.

Future outcomes are impossible to predict because there are simply too many unknowns. However, what has been encouraging through this entire ordeal is the speed with which our government has responded. The Federal Reserve quickly dropped the federal funds rate to effectively 0%, aiming to lower the borrowing costs for those willing to take out a loan. They have also enacted a host of programs to support lending facilities, money market funds, corporations, and municipalities. The goal of these actions is to ensure the normal flow of credit continues within the household and business sectors until the economy can begin operating on its own. The Federal Reserve was designed for a crisis of this magnitude. They have become the lender of both first, and last resort.

Weekly Jobless Claims



Although Congress was slower to act than the Federal Reserve, they put forth sweeping legislation aimed at directly assisting American workers and small businesses who have been the most severely impacted. The chart of weekly U.S. jobless claims says it all. The spike at the end reflects 3.3 million unemployment claims followed by 6.6 million claims made during the weeks ending March 21stand March 28th. Nothing of this magnitude has ever occurred before.

The short and long term impact to the economy is highly dependent upon how quickly we can gain containment of the virus globally. This could impact consumer spending habits in the immediate aftermath, as well as many years down the road. Some industries and companies will struggle, but many will benefit from new consumer habits. In free markets, the businesses

that are able to innovate and adapt will thrive. The government has done a lot to address the short-term economic ramifications of this virus and may do more. We are now relying on our medical professionals to address the problem. While there are many difficult days ahead, the technological innovations over the decades have prepared us for a crisis of this magnitude better than ever before.

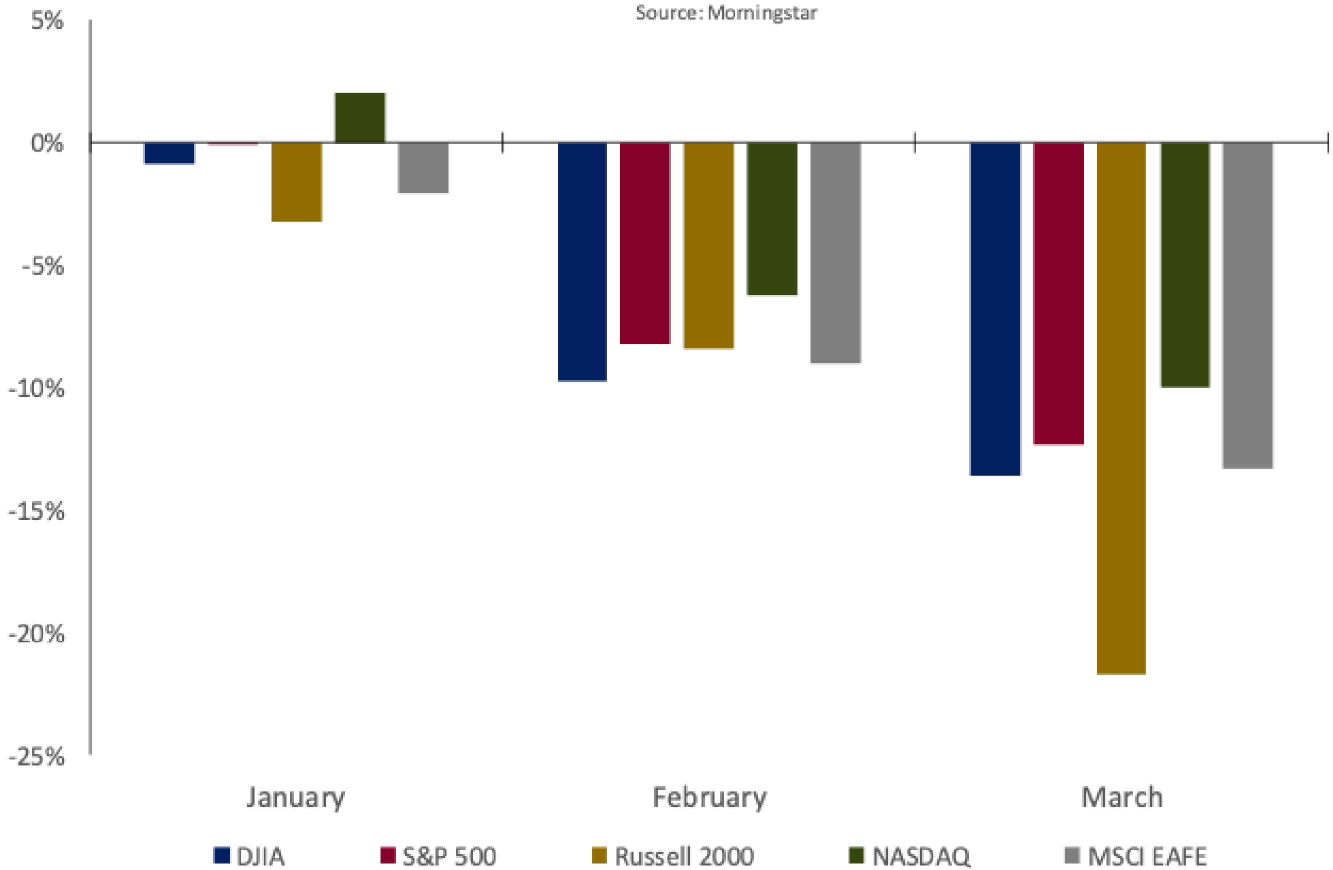
Bond Market Review & Outlook

While the broad bond market held up much better than stocks during the first quarter, volatility was high in the fixed income markets as well. The return differential between Treasury bonds and corporate bonds over the last three months was one of the widest since the 2008/2009 global financial crisis. The Barclays U.S. Government Long Treasury Index delivered a 20.6% return, while the Barclays U.S. Corporate Bond Index lost 3.6%. The below investment grade Bank of America High Yield Index declined 13.1%. Although this level of dispersion is rare, it mirrors how the bond market reacted during the past two economic downturns. The main difference is the unprecedented speed at which this occurred.

The social distancing strategies to slow the spread of the virus have led to an unprecedented slowdown in the economy. This shock to businesses and municipalities brought along the potential for bankruptcies to surge. With the fixed income market being the lifeblood of both corporate and state finances, the government stepped in quickly to help support many areas of this market. Fortunately, the market reaction has been swift as prices have already rebounded since these programs were put in place.

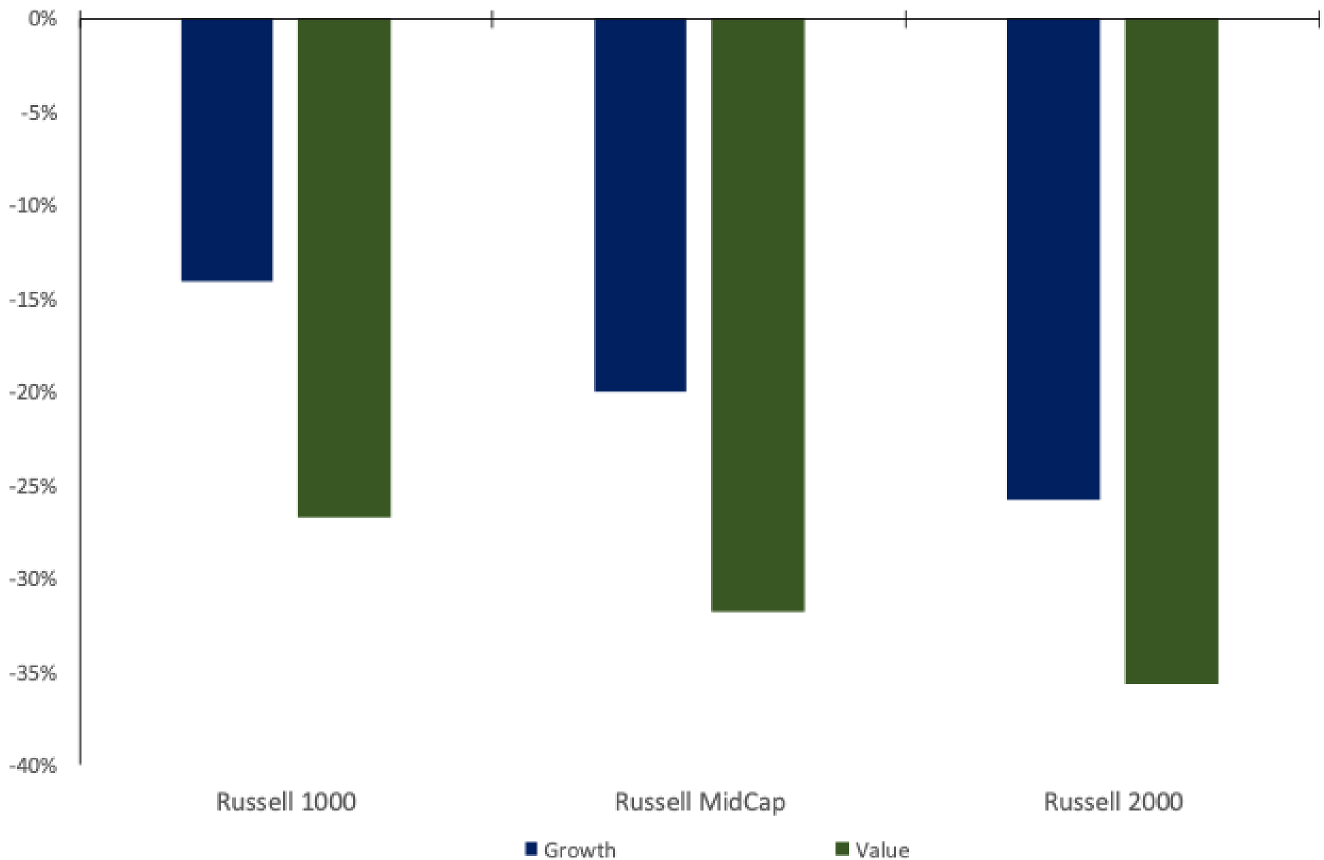
Bond investors now face an interesting question on where to invest their fixed income assets given the wide range of yields now offered in various segments of the market. The flight to safety has sent long term Treasury bond yields down to less than 1% for time periods measured in decades. Investment grade corporate bond yields are in the 4-5% range, while high yield bonds are around 10%. This “spread” is the widest since the 2008/2009 crisis. During the past two economic downturns, maintaining a diversified allocation to bonds served investors well, helping to mitigate some of the downward pressure on portfolios while the economy was contracting, and also benefitting from the recovery. We have every expectation this will be the case again, especially considering there is a higher level of government support for these markets than we had during either of the previous two recessions.

Stock Market Review & Outlook



The Dow Jones Industrial Average and S&P 500 experienced one of their worst quarterly declines in years, declining 22.7% and 19.6% respectively. Small caps had a 30.6% decline. Technology stocks held up better, but still suffered a 11.9% drop. International markets continued to lag most U.S. markets, declining 22.8%. There was nowhere to hide in the stock market to start 2020.

Although stocks were down sharply to start the year, the S&P 500 did rally 18% from its low point to close out the quarter. While it is certainly too early to call that a bottom, it is at least encouraging that the indiscriminate selling by investors looking to sell first and ask questions later subsided as the quarter came to a close. Given the uncertainty ahead, we expect volatility will remain high for some time.



The sharp decline in the first quarter clearly favored growth stocks over value stocks across all market capitalization segments, as shown in the chart. Two of the worst performing sectors in Q1 were energy and financials, both traditional value areas of the market. Lower oil prices and interest rates are putting outsized pressure on these sectors. This will likely continue to support growth stocks, but we caution investors from allocating a disproportionate amount to growth stocks in light of the historically wide gap in valuations between the two. Staying diversified during periods of extreme market volatility has proven in the past to be a good course of action.

Alternative Investments & Hybrids Review & Outlook

As stocks declined sharply in the first quarter, many alternative investments provided meaningful downside protection. The Morningstar Multi-alternative category was down 9.7%, roughly half as much as stocks. Managed futures were a standout as trend following strategies were one of the few areas in the markets to generate positive returns. Market neutral strategies, arbitrage strategies, and private real estate and real assets also held up better than stocks. Other segments, such as public real estate and commodities, declined as much or more than stocks. As always, manager selection is key and we continue to allocate to managers with deep and experienced teams, a disciplined process, and the ability to protect capital and take advantage of the opportunity volatility presents.

Conclusion

The world has changed. Financial markets are in the process of adjusting. Although the uncertainty surrounding this may be uncomfortable, we remain optimistic the steps being taken by individuals, companies, and governments will succeed in ending both the pandemic and economic decline. A well-diversified portfolio with exposure to multiple asset classes is

designed to navigate the financial storms that hit from time to time. Trusting in the plan you had in place before trouble strikes has served our clients well over the past two decades, and we see no reason that will not be the case again this time.

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