Second Quarter 2020 Outlook and Commentary

It's hard to overstate how dramatically the world has changed since the First Quarter Outlook and Commentary. Three months ago, the novel coronavirus had claimed two lives in Wuhan, China and the first U.S. patient had just arrived in Seattle. Little did any of us know what was about to come.

Academics in the field of strategic leadership have an acronym—VUCA—that fits right now. It stands for volatility, uncertainty, complexity and ambiguity. That aptly describes the challenge facing public health officials, political leaders, CEOs, and we as investors, in responding to COVID-19 and its impact. The course of stock and bond markets in the months ahead will be determined by the complex interaction of various dynamics, each of which is almost impossible to predict and difficult to measure. Chief among these is the timing and manner in which social distancing is relaxed and the economy allowed to thaw. Focusing on just one aspect of this, consider when and how those with COVID-19 immunity are allowed to return to work: Can antibody tests determine immunity with some level of certainty? How quickly can those tests be created, disseminated and administered? What percentage of the population will be determined to have immunity? What impact will their freedom of movement have on both supply and demand in various industries? The extent of the economic and financial fallout could vary dramatically depending on the answers to these and dozens of other questions. And no one has more than a hazy idea of what the answers are and how they will interact.

As corporate earnings season unfolds this month, we may get some limited insight into the impact of COVID-19 on large public companies. But most Americans are employed by small and medium sized businesses. Sadly, a large number of those businesses will not survive. Limiting the casualties will depend on the flow of credit, which is why the recently passed CARES Act (a/k/a the "fiscal stimulus bill") is so important. The legislation devotes $450 billion to support Federal Reserve lending which could amount to over $4 trillion[1]. That lending—even if haphazard and inefficient as it surely will be—should help a wide range of businesses, as well as states and municipalities, to survive the crushing declines in revenue now underway. It's almost impossible though to estimate the impact these efforts will have.

U.S. banks, which were highly leveraged going into the 2008/09 financial crisis, entered 2020 with vastly more reserves. That capital would be more than sufficient to weather the storm in all but the most pessimistic economic scenarios now circulating. But if the lockdown drags on, or if there is a series of false starts, some of the more dire scenarios might become plausible

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[1] The appropriations will cover losses incurred by the Federal Reserve. If the Fed assumes losses of 10% with a small buffer, then $450 billion of appropriations would support $4 trillion of lending. The legislation separately provides for $350 billion in loans specifically targeted to small businesses.

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and capital levels could be tested. To make matters worse, European banks are not nearly as well capitalized as U.S. banks and may need to be bailed out. If bailouts are needed in Europe and that process becomes disorderly, the impact will be felt in financial markets everywhere.

Uncertainty around the reopening of the economy, the extent to which previously healthy businesses can be kept afloat in the meantime, the health and stability of the global financial system, and countless other unknowns make the course of the economy and markets especially difficult to predict.

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As investors began to focus on the impact of having nearly one-third of the U.S. economy suddenly shut down, capital markets responded with record speed. The S&P 500 declined by thirty percent from its February 19th high in 22 trading days. Only twice before had the S&P 500 dropped that far in less than thirty trading days—both during the Great Depression. Smaller company stocks declined even further—43% down from peak to trough on the S&P Small Cap 600 Index for example, as compared to 34% on the S&P 500.

Most sectors of the bond market were ravaged as well. Bond investors engaged in a "flight to safety," dumping almost all bonds other than U.S. Treasuries. The precipitous selling led to large declines in the high yield, investment grade corporate, and municipal sectors. For a brief time in late March these sectors offered outstanding buying opportunities for those brave enough to jump in. Then, just as suddenly as they plunged, stock and bond markets, encouraged by the enactment of the CARES Act on March 27th and a series of programs announced by the Federal Reserve, began a vigorous rally that reversed much of the earlier declines.

At this writing, the S&P 500 is down around thirteen percent for the year. At those levels, large company U.S. stocks seem to be pricing in a mild recession. In the meantime, 22 million people filed for unemployment over the last four weeks. To say there is a disconnect between the stock market rally and the economic data would be an understatement. Often that kind of disconnect is the result of the stock market looking ahead several months and seeing brighter days ahead. In the current situation, we wonder if that's more hope than reality.

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In managing your portfolios, and our own, we are guided by the following:

- For several years now high valuations have suggested long-term U.S. stock market returns going forward will be well below historical averages. That has changed some with the stock market declines. Long-term expected returns from March 31st levels have moved closer to historical norms. Long-term returns on non-U.S. stocks, which have underperformed U.S. stocks for over a decade, should be around, or in some cases above, historical averages.
- Interest rates are at historical lows and are likely to remain low for many years to come. While long-term stock market returns could approach historical averages, bond returns,

which tend to correlate to current yields, are almost certain to be historically low. Low prospective bond returns make stocks relatively more attractive.

- The stock market declines from the February high to the late-March low were significantly less than the average decline in post-World War II bear markets. This suggests that, not only could recent gains be reversed, but there could be substantial further declines before a bottom is reached.
- Volatility, either up or down, will likely provide additional trading opportunities. We plan to take advantage of this when we believe the odds are clearly in your favor. We are counting on the managers of each of your strategies to do the same.
- In taxable portfolios we have also been taking advantage of market declines to harvest tax losses. We will continue to do more of that as opportunities arise.
- In light of VUCA, we are, as always, avoiding dramatic changes to your portfolio, favoring incremental changes and challenging the assumptions behind any portfolio adjustments.
- Finally, in our conversations with each of you, we're reminded that each client's situation is unique. More than ever, in the management of your portfolios, we're tailoring what we do to your specific needs and situation.

We are also keeping in mind, and urge you to do so as well, that at some point in the next 18 to 24 months we should have a COVID-19 vaccine or at least "herd immunity." The world will look a lot different, but life will have returned to something approaching normal. We'll be on the other side, and the economy and the stock market, if not quite back to where they were, will be well on their way.

To close on a cheery note: if you are lucky enough to be fifteen years or more from retirement and not drawing on your portfolio, or if you are ten to fifteen years from retirement and adding to your portfolio, any near-term stock market declines will be of great benefit. By the time you begin drawing on your assets in retirement, most of your investments will consist of purchases made after March 2020, either due to cash additions to your portfolio, reinvestment of dividends within the portfolio, or company share buybacks[2]. New purchases made now are taking place at relatively attractive share prices. That will be even more true if there are significant near-term declines from here. While painful to watch, bear markets can have a very positive effect on long-term returns.

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[2] Company share buybacks have the same effect as reinvested dividends. In both cases existing shareholders end up owning a higher percentage of the company. Buybacks tend to shrink during the worst of a bear market as firms are forced to preserve cash. Nevertheless, a material level of buybacks will persist and, because companies will be buying shares at a lower price, shareholders will benefit just as if they had received the cash directly and immediately reinvested.

Our Pledge to Clients

We will treat your portfolio at Boston Portfolio Advisers as if it were our own.

We will invest for the long-term while always striving to maximize returns and minimize risk.

We will seek to minimize your investment expenses.

We will not accept any payments or anything of value from third parties that might influence our choice of investments for your portfolio.

We will invest our personal assets in parallel with yours.