Investment Newsletter

First Quarter 2020

U.S. and international stock markets collapsed during the quarter, with the S&P 500 down -19.6%, the MSCI All-Country World ex-U.S. Index down -23.3%, and the MSCI Emerging Markets Index down -23.6%. Investors reacted negatively to the novel coronavirus (COVID-19) pandemic and the implications for global economic activity. In addition, oil prices collapsed 50% in the quarter, tied to lower demand from COVID-19, as well as to the inability of OPEC and Russia to agree on production cuts. Expectations for global economic growth and corporate earnings have been significantly reduced over the past 45 days.

Given that the U.S. economy was strong going into this pandemic, this is not a typical economic downturn. On a global basis, governments are aggressively providing liquidity, access to credit, and fiscal relief to offset the negative economic impact of COVID-19 containment guidelines. In the U.S., the Federal Reserve has reduced its interest rate to zero, and the federal government has enacted a fiscal spending package in excess of $2 trillion, which equates to approximately 10% of annual GDP.

Fixed income markets performed much better than equity markets during this difficult quarter. The Bloomberg-Barclays U.S. Intermediate Government/Credit Index increased +2.4% and the Bloomberg-Barclays Municipal Bond Blend 1-5 Year Index declined -0.5%.

During periods of sharp volatility in the equity market, the bond market typically is an oasis of safety and functions relatively well. The past couple of weeks, however, have been a notable outlier. With the exception of U.S. Treasuries, volatility and illiquidity hit most sectors of the U.S. bond market particularly hard - most notably Corporates, Municipals and Mortgage-Backed Securities. As a whole, these sectors have now posted negative total returns year to date.

This divergence in performance primarily reflects a massive flight to quality and safety to U.S. Treasuries – which posted higher returns - and massive fund outflows from all other sectors. The unwinding of leveraged strategies and the rebalancing of portfolios out of bonds and into equities were also factors.

The abnormally high amount of fund outflows within a very compressed period caused some markets to freeze and price discovery to disappear as sellers outnumbered buyers. For several days, many ETFs and mutual funds were selling at steep discounts to their net asset values, highlighting liquidity concerns.

This past week saw a sharp reversal of this dislocation, particularly in the municipal bond market, in response to the Federal Reserve's monetary support and Congress' fiscal stimulus. While we do not expect prices and yields to return to levels seen earlier this year, we do expect improvement as the effects of monetary and fiscal stimulus flow through.

The extreme dislocation over the past few weeks has reinforced our strategy of investing in high-quality, intermediate maturity, individual bonds in client portfolios. During periods of volatility, we believe higher quality bonds will hold up better, and individual bonds will still mature at par, thus ensuring capital preservation – our primary investment objective.

For global financial markets to sustain a recovery, the world – and the U.S. in particular – must get past the peak of the COVID-19 infection curve. When that will happen is unknowable and will take time, but there are currently several encouraging COVID-19 developments: total daily case growth in key geographies is decelerating, daily growth in total U.S. hospitalizations is decelerating, U.S. testing growth is accelerating, and vaccine and drug therapy development are both progressing with urgency.

Total COVID-19 case daily growth has decelerated in China, Italy and the U.S. (Johns Hopkins). China has seen no new cases in Wuhan - the outbreak epicenter - since March 17, and it will lift all travel restrictions to the city on April 8. Moreover, China said its domestic coronavirus transmission has "basically stopped," and that there were fewer than 3,000 confirmed active cases in the country.

In Italy, total daily cases grew just +4.0-4.5% each of the last four days, down from +15% two weeks ago.

In the U.S., while the country is clearly still in the acceleration phase of the infection curve overall, total daily case growth has decelerated to +14-15% each of the last five days, down from +51% two weeks ago. 'Social distancing' coupled with the current 'stay-at-home' and/or 'shelter-in-place' orders from 36 states affecting 90% of the U.S. population appear to be 'flattening the curve' of the outbreak thus far.

Daily growth in total U.S. hospitalizations from COVID-19, potentially a better metric than new daily case growth because it reflects the growth of the virus without any distortion from the acceleration of new testing, has also seen a trend of decelerating growth on a percentage basis to the high-teens from the mid-30s previously (The COVID Tracking Project).

Despite a very late start, testing in the U.S. has accelerated dramatically. From March 4 to April 2, the number of tests taken has increased from 969 to 1,267,658 (The COVID Tracking Project). Eighteen companies have received FDA authorization for their COVID-19 tests so far, and three of them - Abbott, Roche and Thermo-Fisher - will soon be making a total of 29 million tests per month for the U.S. market.

At least 30 companies are working expeditiously on a vaccine for COVID-19. One company, Johnson & Johnson, is preparing to supply more than 1 billion doses on a not-for-profit basis upon approval. Like Severe Acute Respiratory Syndrome (SARS), vaccine research scientists have discovered that the spike proteins on the novel coronavirus trigger the body's immune response, fueling hope for a successful vaccine. FDA approval for any vaccine is projected to be 12-18 months away.

For drug therapies, the FDA just created a special emergency program called the Coronavirus Treatment Acceleration Program (CTAP). It uses every available method to get new treatments to patients as quickly as possible. Currently there are 10 therapeutic agents in the pipeline, and 15 in planning stages. One agent, Remdesivir from Gilead Sciences, will release data from two clinical trials this month.

While there is a lot of stress, fear and uncertainty in the world right now, we are optimistic we will get through this crisis. One key current challenge is to determine what the world will look like when the crisis has ended and what significant changes to the global economy will have occurred based on shifting government, corporate and individual behavior and finances, and how those changes will impact the holdings in our portfolio. We believe new and interesting investment opportunities will develop for our clients as a result of these changes and we intend to be prudent and disciplined in our pursuit of them.