SPECIAL MARKET REPORT: MONETARY POLICY IS NOT ENOUGH. HEALTHCARE AND FISCAL POLICY NEEDED TO STABILIZE MARKETS.

March 17, 2020

Disruptions to Daily Life Accelerate

Over the past few weeks, the lives of ordinary Americans have been disrupted by the temporary closure of businesses, colleges and public schools, museums, theme parks, restaurants, bars, gyms, community centers, music venues and festivals, live TV studio audiences, professional sports, public transportation, and other activities that result in gatherings of 10 people or more. The purpose of these changes is to “flatten the curve”, as Dr Anthony Fauci describes it, and preemptively avoid overwhelming the US healthcare system, protect the elderly and immunocompromised, and ultimately minimize the human toll from the coronavirus. Rumors now abound that families in cities across the nation, from San Francisco to New York may be asked to shelter-in-place for 3-weeks, leaving their home only for food, medicine, and exercise.

Policy Response Inconsistencies and Market Volatility

While the US Federal Reserve has been more than willing to address the liquidity risks to the financial system during this time through 2008-era monetary policy actions (0% interest rates, $700 Billion of quantitative easing, 0% reserve requirements for banks), the government has failed to produce sufficient fiscal policy action (government spending and tax cuts/credits) that would help those most directly impacted by lost wages, unemployment, and food and healthcare expenses. Perhaps more importantly, there has been a failure to address the healthcare crisis directly, through nationally coordinated school and business closures, testing, quarantines, and regulation of commerce and transportation, forcing the States and Cities to create their own healthcare policies to address the virus at a local level, and procure their own hospital supplies (ventilators, gowns, masks). As a result, the market has seen unprecedented volatility, as the S&P 500’s last six daily moves are -7.6%, +4.9%, -4.9%, -9.5%, +9.3%, and -12.0%.

US Federal Reserve Timeline	
December 2020	$100B in overnight repos + $20B in two-week repos - preserves economic activity
	Fed continues to purchase $60B in ST Treasury bills a month - preserves economic activity
	Fed increased repo purchases to $150B in overnight repos + $45B in two-week repos -preserves economic activity
March 3, 2020	50bps interest rate cut to 1.0-1.25% - stimulates activity
March 12, 2020	$1.5 Trillion in stimulus ($500B 1-month and $1T 3-month repos) – preserves economic activity, but doesn’t stimulate activity
March 15, 2020	Reduced bank reserve requirement ratios to zero percent effective March 26, 2020 - stimulates activity
March 16, 2020	100bps interest rate cut to 0%-0.25% - stimulates activity
March 16, 2020	$700B Quantitative Easing ($500B+ Treasuries and $200B+ Agency MBS) – stimulates activity

The market's criticism, of course, stems from the fact that at its heart, this is a healthcare crisis, not a financial crisis. And until a solution can address the underlying healthcare issues, Consumer Confidence, and thus Consumer Spending (which accounts for ~70% of US GDP) will suffer. In fact, the most recent data from China suggested that during the peak of the crisis (January-February) retail sales fell by ~24% in China due to coronavirus. Over the coming days, more and more economists will be declaring the US either already in, or about to enter a recession, with similar declines in economic activity.

Business Risk – A Viscous Cycle

As weakness in consumer confidence translates into declines in consumer spending (retail sales), small-medium size businesses will be forced to shutter their operations, and businesses with excess leverage (debt) may begin to default on their credit payments. As businesses shutdown, unemployment will rise, and consumer spending will continue to fall. However, if businesses can institute temporary closures (say 2-3 weeks) and continue to pay their employees during much of that time, profits will decrease, yet the economy can stabilize. The uncertainty is how long businesses will be forced to remain closed and what measures the government will take (fiscal policies) to help businesses and displaced employees during this time (i.e. tax credits to offset sick leave, free medical care for the underinsured, subsidized lending for small-medium size businesses, payroll tax cuts, a check paid directly to all Americans, etc.). The market is very inefficient at pricing this kind of uncertainty.

The silver lining is that it is only a matter of time for the coronavirus to be behind us. Whether it is one quarter or three, the disease will have spread, the vast majority will have recovered, immunity will have been built up amongst the population, and consumer spending will have resumed. <u>As of this weekend, as China continues to emerge from their battle with coronavirus, their stock market (CSI 300 Index) is near its 52-week high, down <5% for the year</u>.

The Next Wave of Responses

Recent presidential press conferences have begun to address both a nationally coordinated healthcare response and a fiscal response. At the moment, the declaration of a national emergency has freed up strategic reserves of medical supplies, and de-regulation has cleared the path to quickly add tests and hospital capacity to the medical system. The House has introduced a $100B bill that addresses free coronavirus testing (even for the uninsured), two weeks of paid sick leave and paid family and medical leave, and strengthened unemployment insurance and food security initiatives like food stamps. It also would increase federal funds for Medicaid to support our local, state, tribal and territorial governments and health systems. The President is urging Senate Republicans to support this bill.

The President and Senate are working on an additional $850 billion stimulus package of their own that is expected to include aid to small businesses and airlines and request a payroll tax holiday through the end of the year.

<u>We expect these types of initiatives to be the catalyst for market stabilization. We believe market recovery will begin when the growth rate of infections begins to decelerate (albeit after national testing becomes more profound).</u>

COVID-19 - USA				
Date	Cases	Daily Case Increase	Deaths	Death Rate
3/8/2020	541		22	4.07%
3/9/2020	704	30.13%	26	3.69%
3/10/2020	994	41.19%	30	3.02%
3/11/2020	1295	30.28%	38	2.93%
3/12/2020	1695	30.89%	42	2.48%
3/13/2020	2247	32.57%	49	2.18%
3/14/2020	2954	31.46%	57	1.93%
3/15/2020	3680	24.58%	68	1.85%
3/16/2020	4661	26.66%	85	1.82%

In the interim, fundamental data, such as Retail Sales, Consumer Confidence, Consumer Spending, and GDP growth are going to look ugly. But the market has dislocated itself from much of this data and has priced in much of this news.

Lessons from 2008

Following the 2008 Financial Crisis Congress passed the Troubled Asset Relief Program (TARP), which allowed the government to purchase toxic assets and equity from financial institutions to strengthen its financial sector and address the subprime mortgage crisis. While $700 billion was allocated to this program, between 2008-2014 only $426 billion was invested in these “troubled assets”, which were later sold for $442 billion generating a small profit. The government claimed that TARP prevented the American auto industry from failing and saved more than 1 million jobs, helped stabilize banks, and restored credit availability for individuals and businesses.

Earlier that year, Congress approved the Economic Stimulus Act of 2008, whereby eligible taxpayers (subject to income limitations) received a check for $300 each.

While we don’t know whether any of these types of programs will be necessary to support the consumer, the travel, leisure, and hospitality industries, or any other industries for that matter, it does seem that there is a precedent for similar actions. Should the government continue to infuse capital into the hands of businesses and consumers, the economy will be in a very strong position to rebound after the healthcare crisis is behind us.

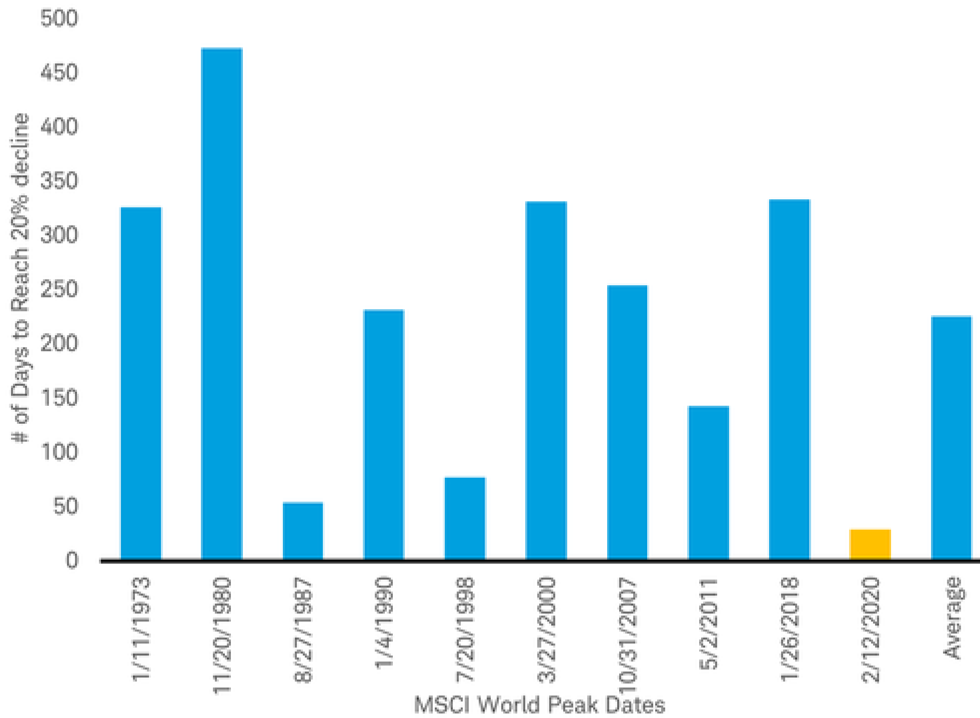
U, V, or L-shaped Recovery

The two most pressing questions facing investors seem to be around how long this current crisis will last, and how long it will take for the market to recover. We believe that, while a recession is increasingly likely, if not already begun, near-term weakness is likely to be followed by a rebound in the second half of this year.

Equity markets tend to recover in one of three ways – V, U and L shaped recoveries. The “V” shaped recovery assumes a classic economic shock, and then a rebound in growth. It is the steepest and quickest recovery, followed by the U, and then L. If the virus were to peak, then abate over the summer, the strong monetary policy actions of the Federal Reserve, and any fiscal policy from the government will set us up for this type of recovery as infections slow and the economy restocks. If there

is some permanent loss of output as a result of this healthcare crisis, we are more likely to see a "U" shaped recovery. The 2002 SARS, 1968 Hong Kong flu, 1958 Asian flu, and 1918 Spanish flu were all "V" shaped recoveries.

We are currently in the fifth largest bear market since 1970. Historically, it takes an average of 8 months to enter a bear market. This one has taken less than 30 days. Following such a rapid decline, and given the immense monetary and anticipated fiscal responses, we believe a V or U-shaped recovery is the most likely outcome.



Source: Charles Schwab, Factset data as of 3/13/2020. MSCI World Index data since 1/1/1970.

Conclusion
We will continue to provide market updates as economic data is released and policy actions are approved. During this time we continue to take advantage of market volatility by tax-loss harvesting portfolios in order to realize losses without changing allocations, and rebalancing accounts back to target equity/fixed income allocation (essentially realizing profits from bonds, and reinvesting those back into stocks at lower prices).

As always, feel free to call if you have any questions, or would like to discuss any of these issues further.

Looking forward to speaking soon,

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