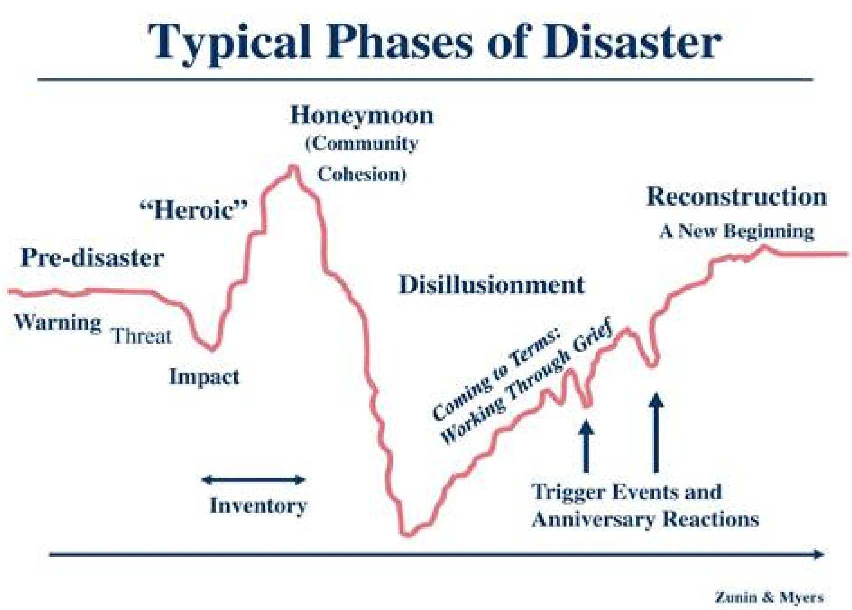
ARE WE HEADED FOR DEPRESSION?

Perspective And Strategies To Consider In Today's Environment

If we look back at past depressions in U.S. history, there are some important facts to remember as we begin to ponder the possibility of another one on the horizon. The depression of 1920-21 was largely caused by troops returning from war entering the job market thus creating a surge of unemployment and wage stagnation. The government did little to assist. During the Great Depression it took the Government 4 years to act and pass its first bill (1933). In addition, the actions of Federal Reserve of that time were much to the contrary of what the Fed is doing today. Back then the Fed actually raised interest rates and declined to act as lender of last resort thus adding to the length and severity of the Depression.

Fast forward to 2020, the Fed has dropped rates to zero and is providing seemingly endless liquidity to the financial system. Congress has passed a $2 trillion stimulus bill in March followed by another $484 billion relief package on April 24 aimed at small businesses, hospitals and healthcare providers and expanded COVID-19 testing. And it appears there is still more to come. Our economy is far more evolved compared to 100 years ago, as is our healthcare system, drug therapies, communications and technology. Put this all together and we are far better prepared to tackle the economic fallout that lies in the wake of this pandemic.

That said, the pandemic we are experiencing now is something we have never seen in modern times and the total human and economic impact remains to be seen. We cannot dismiss the emotional roller coaster that so many people are going through over fear and concern for their jobs, friends and loved ones as well as the isolation and discontent that can develop from the social distancing measures. This roller coaster of emotions is a natural reaction to life altering or threatening events as displayed in the chart below.

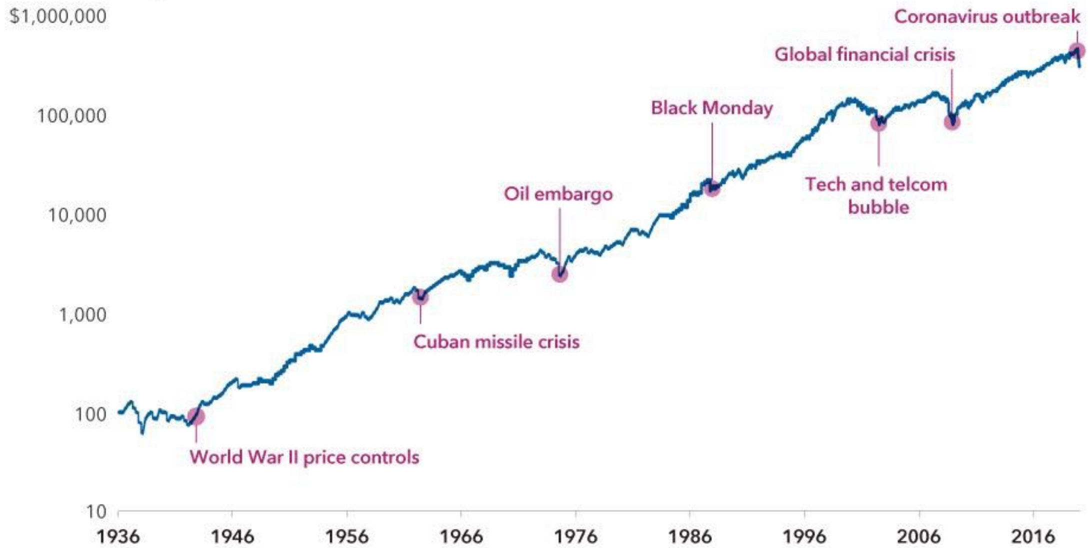


Source: Zunin/Meyers, as cited in Training Manual for Mental Health and Human Service Workers in Major Disasters, U.S. Department of Health and Human Services (2000).

If we were to overlay this chart onto a chart of the S&P 500, I bet it would look very similar. But if we were to zoom out and look back on this period in a timeline of history, it would likely look like a blip on the screen, similar to past recessions.

The stock market has overcome past bear markets and unsettling news

Growth of a hypothetical $100 investment in the S&P 500 Index (with dividends reinvested)



Sources: RIMES, Standard & Poor's. As of 3/23/20. Chart shown on a logarithmic scale. The Standard & Poor's 500 Composite Total Return Index is a market capitalization-weighted index based on the results of approximately 500 widely held common stocks, and assumes the reinvestment of all dividends.

While the surrounding circumstances, duration and severity of every recession varies, we have never seen a recession that we did not recover from. Since 1871, market downturns have recovered as follows:

- 33 percent of market downturns recover within a month;
- 50 percent of market downturns recover within two months;
- 80 percent of market downturns recover within one year; and
- 95 percent of the time those big "once or twice in a lifetime drops" return to even in three to four years.

Collectively, the average time it takes for the market to recover (top to trough to top again) is 7.9 months.

Source: https://rpseawright.wordpress.com/2020/03/31/what-do-market-recoveries-look-like/

So let's look at where we are now. We have entered into another market downturn which started in late February. Since reaching its lows on March 23rd, the S&P 500 has rallied over 600 points although it is still down roughly 12% year-to-date as of this writing. While this rally is welcomed, a return to the level economic activity seen prior to the eruption of the virus is still a long way off. As we move through the 2nd quarter of 2020 and beyond, businesses will gain further clarity on the extent the financial impact and the damage for many will be extensive. Based on this data and technical analysis, we think it is quite possible that we will see a 50% retracement of recent gains that could bring the S&P 500 back down to the 2600 level. While we believe the volatility will continue, history as well as human resolve tells us that we will recover and there are many reasons for optimism.

As we survey the current market landscape and look at what has happened thus far, we find several reasons why maintaining equity exposure is the right thing for investors to do:

- The healthcare industry is pouring resources into understanding and fighting Covid-19. A vaccine could be available in as little as 9 to 15 months
- Annualized inflation rate will be likely be greater than the 0.64%, which is the current rate of the 10 year Treasury
- Interest rates near zero will likely be with us longer than COVID 19. Low interest rates are a positive for stocks.
- The Fed is taking unprecedented steps to provide relief and stability to businesses and local and state governments that have been adversely affected by the shutdown of the economy.
- The fact that the upcoming quarters of corporate earnings (a main driver of stock prices) will inevitably see substantial declines does not mean that the market goes down the same percentage. The market measures multiple years of cash flows into the future. We do not believe that earnings will stagnate at current levels for several years.
- The VIX (an index that represents the market's expectation of 30-day forward-looking volatility) is below 40 after peaking at 85. This is the first time since early March. The VIX topped out in December of 2008 but market did not bottom until March of 2009. The market might make a new low but most stocks might have already hit theirs. We may have entered the next phase of this bear where we begin to separate the winners and the losers.

While everyone needs to consider their own personal financial situation and risk tolerance, here are some strategies we have been employing:

- In taxable accounts, we are harvesting tax losses (selling investments at a loss) and upgrading positions by reinvesting those sales proceeds in higher quality companies or actively managed funds which we believe have better return potential.
- We are tilting portfolios towards healthcare and technology as we feel these are both defensive sectors and will lead us out of the downturn.
- We are using more individual stocks, sector exchange trade funds and active management. Indexing may not be the best strategy as there will be winners and distinctive losers that emerge in the next 12 to 24 months. Selectivity is key.
- We are reducing our European International exposure. Following the 2008-09 Financial Crisis, Europe did not recapitalize their banks like the U.S. did. This will limit their recovery going forward.

Other considerations:

- Minimum distributions from IRAs for people over age 70 ½ will not be required to be taken in 2020. Those that do not need to take distributions to supplement their income should keep this money invested.
- As we see large dips in market valuations, this creates an excellent opportunity to take advantage of Roth conversions. With account values at reduced levels, this results in less income taxes on converted values than would have been paid when shares were worth more.

The definition of a depression is multiple years of economic recession marked by significant declines in income and employment. We are not dismissing a depression but are skeptical as we are in the first months of this horrible crisis and have much time and resources to fight the battle. While the road to recovery will likely be long, there is still reason for optimism.