**First Quarter 2020**
**Courtesy of Miles Capital**

## Economic Commentary: COVID-19 is a Black Swan Event

A Black Swan in economic terms is an unpredictable or unforeseen event, typically one with extreme consequences. During the first quarter we experienced what will likely become a "Black Swan" event. The economy started the year strong with the consumer (roughly 70 percent of the economy) continuing to drive markets and equity markets reaching all time new highs. Then the COVID -19 global pandemic crisis caused a dramatic shock to the human race and the economy.

There was an unprecedented hard stop to the global economy stemming from human health issues and challenges to quality of life. This virus first affected the global supply chain which then rolled into affecting the global demand chain as well. Layoffs and unemployment increased by three-fold at the end of the first quarter. The economy is now expected to enter a recession (negative GDP growth for at least the first and second quarters of 2020).

Equity markets dropped more than 35 percent from the record high in February and closed the quarter down just better than 20 percent for the quarter, the worse quarter since 4th quarter 2008. The Federal Reserve (Fed) dusted off the 2008 playbook and cut the Fed Funds rate to the 0.00-0.25 basis points (bp) range and announced quantitative easing (QE) to the tune of almost $4T in purchases and loans. The federal government passed the largest-ever stimulus package ($2T) in an effort to keep businesses and workers afloat.

The impact to the economy is largely expected to be temporary. However, the duration of that "temporary" depends upon the effectiveness of eliminating the COVID-19 threat here in the U.S. Unemployment due to the COVID crisis is expected to peak over 20 percent, likely the biggest jump in unemployment on record. How long it takes for people to be able to go back to work significantly impacts how long it takes for businesses to resume full activity.

The economic impact of COVID-19 is likely to be longer and more intense than previously thought, and we have lowered our macro forecasts. We now see global GDP falling 2.4% this year, with the U.S. and eurozone contracting 5.2% and 7.3%, respectively. We expect global growth to rebound to 5.9% in 2021. We forecast a decline in real annualized GDP of 7.6% in the first three months of the year and 35% (annualized) in the second quarter, translating to a decline of 11.7% peak to trough.

## Fixed Income Commentary: Some Sectors Get Sick

Fixed income has, for the most part, enjoyed a 30-year rally. Generally, fixed income sectors' returns are inversely related to U.S. Treasury rates. As Treasury rates decline, fixed income returns will rise if all factors are equal. This was true for 2019, but not necessarily true for the first quarter of 2020.

The 10-year Treasury was about 9 percent back in 1990 and is now about 0.67 percent as a result of the recent COVID-19-based economic downturn. This led to a “flight to quality” where investors sought the safety of cash and Treasury securities. However, not all fixed income rallied. Sectors such as corporate bonds were negatively affected due to expectations for decreasing corporate earnings. For the quarter, the Bloomberg Barclays U.S. Aggregate Index increased 3.15 percent (primarily driven by U.S. Treasury performance) while the Intermediate Corporate Bond Index declined by 3.15 percent (primarily driven by concerns over corporate earnings).

The COVID-19 global pandemic prompted the Federal Reserve (Fed) to make dramatic changes to interest rates. They had indicated that, pending changes in inflation, they would leave rates unchanged in 2020.

However, due to the crisis, they have now lowered rates to effectively zero. As a result, interest rates dropped across the Treasury yield curve for the quarter with rates dropping over 100 basis points over the entire 1-month maturity to the 30-year maturity range with some yields dropping to long-term lows. The 1-month Treasury Bill (the ultra-short part of the Treasury yield curve) actually had negative rates for part of the quarter due to the very strong demand for cash-like instruments. The decreased global outlook pushed longer interest rates lower with the 10-year Treasury dropping 125 basis points to 0.67 and the 30-year dropped 107 basis points to 1.32.

As Treasury securities rallied in price, other securities tied to the decrease in the economy such as corporate bonds dropped in price. Corporate earnings, GDP, and housing estimates are all being reevaluated for expected effects on credit sectors and mortgage-based product.
Looking ahead, we believe that the timing and outcome of the COVID-19 pandemic is still in play, but we are hopeful for a positive resolution affecting fixed income.

## Equity Commentary: The Bull Market Falls Ill

There were two distinct phases to the quarter. U.S. equities hit all-time highs in mid-February, then had their worst quarter since the days of the financial crisis as the longest bull market in history came to an abrupt end. The S&P 500 (-19.60 percent) fell nearly 35 percent with the emergence of coronavirus as a global pandemic before rebounding over 15 percent during the last week of the quarter. Small Cap stocks (-30.61 percent) had their worst quarter in over 25 years, while international equities also lost ground as the MSCI EAFE returned -22.83 percent for the quarter.

Every sector was down for the quarter. Energy lagged as oil prices lost more than 66 percent after the collapse of the OPEC+ output agreement and the demand shock from the expanding COVID-19 (coronavirus) pandemic, financials were hit on sharply lower interest rates, and industrials' underperformance was led by the airlines.

While expectations at the end of 2019 saw earnings positive for the year 2020, now estimates project a year-over-year decline in earnings with Q1 earnings expected to be about -5% and Q2 earnings expected to be about -10%. However, those projections could be optimistic, and earnings will be lower in those sectors harder hit by the restrictions. Millions of businesses announced layoffs or furloughs as cash has become tight with nonessential businesses closing. A record 3.28 million workers applied for unemployment benefits in late March, nearly five times the previous record high. Unemployment is projected to keep climbing until May and may peak over 20 percent.

The 2020 presidential election has moved to the back burner as the focus has shifted to the human, market, and economic implications of the coronavirus pandemic. continue. However, as the markets demonstrated, they are a leading indicator. They deteriorated in the first quarter before economic data was available, and we expect they will lead the way back up as well. While the economy may not recover until 2021, it is likely many sectors of the markets recover sooner.

## Special Update: Falling Oil Prices Reignite Concerns

The most heavily traded U.S. crude-oil futures contract fell 43% on Tuesday, April 21st to $11.57 a barrel, its lowest close in 21 years. Tuesday's drop came a day after one contract for U.S. crude fell below zero for the first time in history, forcing sellers to pay buyers to take barrels off their hands. The plunging oil prices can be summarized as a matter of supply and demand and storage costs.

The tremendous drop in oil demand related to a near stop in the economy has resulted in huge increases in oil stockpiles. While some U.S. shale producers are already being forced to shut wells and OPEC is considering bringing forward the start date for planned production cuts from May 1, the expected supply drops are dwarfed by lost demand. Analysts estimate that oil demand has declined by up to 30 million

barrels per day while the agreed upon cut by OPEC is only about 10 million barrels per day. Quite simply, the world is running out of space to store oil. Royal Vopak NV, the world's largest independent storage company, said almost all of its space is sold.

Following two weeks of recovery in stock prices, the drop in oil price has reignited concerns about the coronavirus' impact on the economy and markets. Declining stock prices on April 20th and 21st were not limited to energy firms. Part of the reason is that analysts expect a big drop in energy industry spending, including layoffs, to magnify the economic fallout from the coronavirus. The Trump Administration is considering several possible options to support the U.S. oil industry. Providing assistance to the oil industry will likely face opposition from congressional Democrats. An alternative is to work through the emergency-loan programs the Treasury Department has launched with the Federal Reserve.

As the far-reaching impacts of COVID-19 are digested by investors, market volatility is expected to remain elevated in the coming months and markets will likely experience periods of sharply declining prices. Weakness in a large and important industry such as energy demonstrates the magnitude of economic strains caused by coronavirus as well as the challenges for governments and companies to react quickly enough to limit market impacts.