Quarterly Investment Perspective

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Key Points:

- *Stocks suffered through their worst quarter since the depths of the 2008-09 Global Financial Crisis, while high-quality bonds held their own amid severe market volatility. No one knows for sure where the stock markets are headed, particularly in the short-term. However, history shows that stocks typically rally strongly well before recessions end.*
- *Needed lockdown measures to slow the spread of the coronavirus have stalled economies. However, governments have rolled out fiscal stimulus packages to limit permanent economic damage, and central banks have implemented monetary stimulus to keep credit markets working. All of this policy support should ultimately prove successful.*
- *Diversification and balance helped portfolios weather the worst of the storm. Our disciplined approach to portfolio management has helped to manage risk and better position portfolios for a market recovery. There will likely be a choppier path forward for markets and the economy, but given the current focus on the health crisis, we have faith that there are better days ahead.*

Market Review & Outlook

Stocks entered into bear market amid investor panic

Stocks suffered through their worst quarter since the depths of the 2008-09 Global Financial Crisis (GFC). The global stock market fell nearly 35%[1] from its peak on February 20th, and volatility spiked to levels not seen since the GFC. In mid-February, investor sentiment quickly changed from calm to panic amid concerns over the growing human and economic costs of the coronavirus pandemic. In early March, an oil price war between Saudi Arabia and Russia started a collapse in oil prices and exacerbated the stock market downturn, which bottomed on March 23rd. Since then, stocks have recovered nearly half of their losses amid signs that the spread of the virus is slowing, and unprecedented amounts of government and central bank stimulus.

High-quality bonds played their defensive role

Investment-grade bonds, those issued by governments and corporations with low-default risk, held their own amid severe stock market volatility. (See **Figure 1.**) Outside of a few trading days when temporary liquidity issues surfaced across the entire marketplace, high-grade bonds provided much-needed stability and liquidity for investors. As of this writing, bond returns have increased further, amid central bank commitments to purchase them in an effort keep interest rates low.

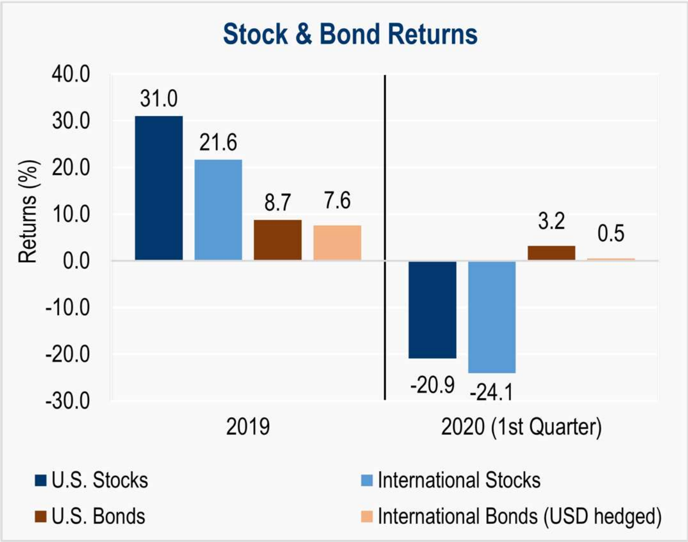

Figure 1. Stock markets suffered a stunning blow at the start of the year that few investors could have anticipated following 2019, a year in which stock markets around the world soared. Investors scrambled to sell stocks betting the global economy was headed for a sharp downturn. Investment-grade bonds in aggregate posted positive returns amid falling interest rates and strong investor demand for safe assets.

U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Barclays Aggregate Bond Index. International bond returns are represented by the Barclays Global Aggregate Ex USA Hedged Index. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Source: Morningstar, Russell, MSCI, Barclays. Data as of 03/31/2020.

Have we seen the worst, or is there more to come?

No one knows for sure where the stock markets are headed, particularly in the short-term, as there are a lot of unknowns about the virus and the healthcare response. Some believe that stock markets reached a bottom (on March 23rd) after the fastest (30%+) drop in history[2] as markets priced in a sharp decline in economic activity and corporate earnings. Given what we know at this point, our best guess is that markets will not likely retest the March bottom given the tremendous amount of fiscal and monetary relief that has just started to infuse into economies and lending markets, along with the high likelihood of more to come. On the other hand, markets can decline again on worse-than-expected economic and earning data as well as unexpected setbacks to virus containment or medical treatment timelines.

Stocks typically rally strongly before recessions end

Stock markets may see a return of volatility in the short-term, as many businesses start reporting bad quarterly performance and earnings over the next few weeks. However, the long-term picture has brightened for stocks for a couple of key reasons. The first is higher expectations for future long-term returns, as the March bear market has improved global stock market valuations from much higher levels going into the pandemic. This occurred in 2009 when the global economy was in a deep recession, and stock prices went on sale. The second reason is that history shows that on average, stock markets typically reach a bottom and begin to recover months before the economy does. (See **Figure 2**) Stocks almost always rally powerfully before a recession ends, regardless of whether the recovery is powerful or weak.

Stock Market Returns Around Economic Cycle Troughs

Date of Stock Market Low (Month End Close)	Date of Economic Cycle Trough	Number of Months between Stock Market Low and Economic Cycle Trough	Stock Market return between Stock Market Low and Economic Cycle Trough
Jun-1949	Oct-1949	4	**14.5%**
Sep-1953	May-1954	8	**24.8%**
Dec-1957	Apr-1958	4	**6.9%**
Oct-1960	Feb-1961	4	**18.5%**
Jun-1970	Nov-1970	5	**17.5%**
Dec-1974	Mar-1975	3	**19.5%**
Mar-1980	Jul-1980	4	**15.6%**
Jul-1982	Nov-1982	4	**28.7%**
Oct-1990	Mar-1991	5	**22.1%**
Sep-2002	Nov-2001	-10	**-29.8%**
Feb-2009	Jun-2009	4	**23.8%**
Average:		**+3.2**	**14.7%**
Average: (excluding 2001 recession)		**+4.5**	**19.2%**

Figure 2. On average, stock markets typically reach a bottom and begin to recover months before the economy does.

Sources: Source: National Bureau of Economic Research, Bloomberg, and Lord Abbett.
Past performance is not a reliable indicator or guarantee of future results.
Stock Market data is represented by the S&P 500 Index Price Return.

Economic Review & Outlook

Needed lockdown measures have stalled economies

To say that a lot has changed since the start of the year would be a huge understatement. Just months ago, investors were optimistic that the global economy would stage a modest rebound. The U.S. and China had appeared to make progress on a trade agreement, and central banks around the world looked poised to keep interest rates steady for the foreseeable future. Today, the global economy is likely entering into recession due to countries around the world willingly turning off significant parts of their economies to save lives. Because the suppression in economic activity is unprecedented in speed and scale, and also driven by government decision-making, governments have played a crucial role in making sure their economies come out on the other side of COVID-19 intact.

Fiscal stimulus limits permanent economic damage

Many countries have rolled out very sizable fiscal stimulus packages to combat the economic aftershocks of the coronavirus pandemic, the largest of which has come from Washington, D.C. On March 27th, the U.S. government passed a $2.3 trillion Coronavirus Aid, Relief, and Economic Security ("CARES") Act, which has provided immediate relief with direct aid to businesses, households, state and local governments, and the healthcare system. This is the largest economic relief bill in U.S. history and contains discretionary spending and loans that total to about 10% of U.S. gross domestic product (GDP).[3]

The CARES Act is an aggressive stimulus bill that was designed to help mitigate job losses and business failures, and provide temporary support to individuals and households in troubled financial situations. Although the stimulus will not likely prevent the economy from falling into a recession in the second quarter or prevent the unemployment rate from soaring in the weeks and months ahead, it should help to temporarily support the economy until the need for social distancing fades substantially, hopefully by the summer.

Monetary stimulus keeps credit markets working

In coordination with government fiscal stimulus, central banks around the world have stepped in to prevent any unwanted tightening of financial conditions. The U.S. Federal Reserve (the Fed) led the way by quickly and forcefully lowering short-term interest rates to near-zero and stepping in with several facilities to ensure that financial lending markets and banking systems continue to function properly. Additionally, the Fed has launched unlimited "quantitative easing" programs not only to keep long-term government bond interest rates low, but also to ensure that local governments, businesses, and households in need have access to low-interest-rate credit. Although not to the same degree as the Fed, central banks in Europe and Asia have also provided significant new stimulus to support their economies.

Policy support should ultimately prove successful

The various stimulus measures that have been put in place so far have been able to stem the stock-market selloff and improve sentiment despite the significant rise in virus numbers. However, a more extended period of social distancing and lockdown will likely require additional stimulus. In the meantime, however, the size, scope, and swiftness of all these stimulus measures will play a crucial role in limiting the economic damage and minimizing the risk of a worst-case (sustained downturn) scenario. The much-needed stimulus should leave households and businesses in a better position to weather the economic downturn and ultimately allow the economies to restart more smoothly in the long term.

Near term economic shock expected to be deep

Nonetheless, we are at the doorstep of an economic downturn, caused by a virus that is still surrounded by a lot of uncertainty and fear despite signs that the spread of the virus is slowing. The dual shocks of coronavirus and the collapse oil prices are likely to push the global economy into recession over the next one-to-two quarters, ending an 11-year business cycle. Most economists are forecasting record-sized contraction over one or two quarters. According to the International Monetary Fund's (IMF) most recent forecast, the global economy is projected to contract by -3% for the full year 2020, much worse than during the 2008–09 GFC.[4]

Economic recovery expected to start more quickly

Despite its dire near-term forecast, the IMF's baseline scenario of the global economy is projected to grow by +5.8% in 2021 as economic activity normalizes, helped by policy support. While the initial economic shock of the current crisis is likely to be much greater than that of the GFC, the cumulative negative economic impact after the coronavirus crisis passes is likely to be significantly less. (See **Figure 3.**) According to a recent analysis by the BlackRock Investment Institute, the GFC propagated through debt deleveraging, which served as a longer-term (~50%) drag on pre-trend potential economic growth. The current crisis is front-loaded, however, and if containment measures are lifted and stimulus is effective, there can be a quicker recovery with limited permanent damage (median estimate of ~15% drag) on the pre-shock growth trend, a fraction of that caused by the GFC.

Hypothetical hit to U.S. trend GDP in coming years compared with the Global Financial Crisis

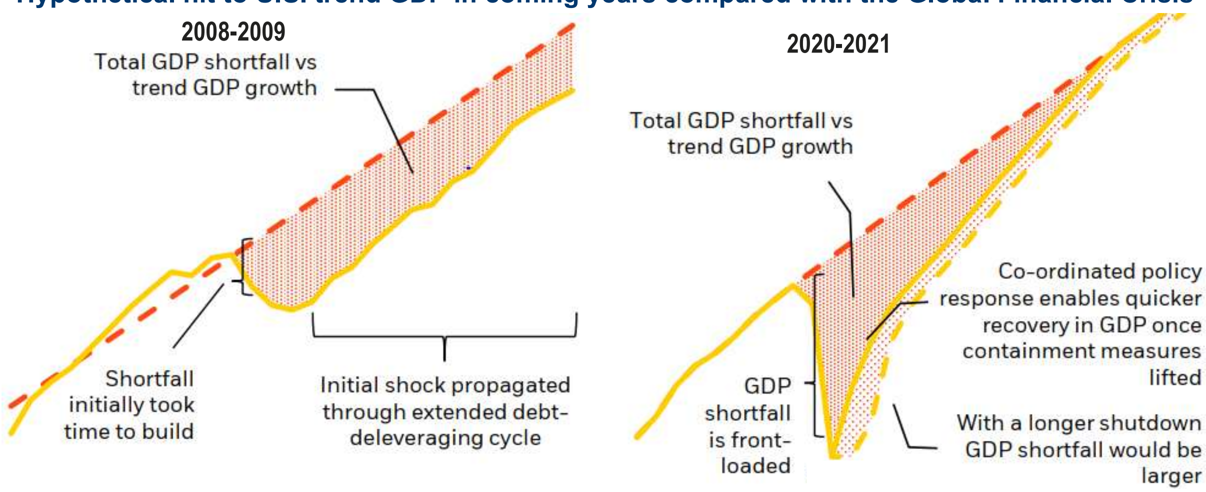

Figure 3. The chart on the left shows how the GFC shock had a longer-term drag on pre-trend potential GDP growth. The chart on the right shows that the GDP shortfall from this shock is front-loaded, with a likely more limited and shorter-term drag.

Sources: BlackRock Investment Institute[5], with data from Haver Analytics, April 2020.

On the Minds of Investors

Should I invest differently now for after the crisis?

The current crisis is different in many ways from past downturns. Past crises have typically resulted in cyclical economic downturns that indirectly—and gradually—impacted consumer, business, and investment activity, whereas the current shock is coming directly from a shutdown in activity that is very visible, large, and sudden. Activity being deliberately frozen and halted has forced consumers, businesses, and investors to change the way they live and operate for a considerable period. This leads to the question of whether consumer, corporate, and investor behavior will change permanently.

From an investment perspective, this leads to many more questions like the following: Will owning retail, restaurant, and leisure stocks make sense if consumers shop in stores (or eat at restaurants) much less than they did before? Will owning airline stocks make sense if people do not fly nearly as much? Will owning real estate stocks make sense if certain companies lease less office space in commercial buildings with the ability of people to work from home? Will owning oil companies make sense if there will be less investment in energy infrastructure given the crash in oil prices? In other words, should one invest differently now for what could happen after the crisis?

Trying to answer these questions in the heat-of-the-moment may lead investors to make rash decisions about how they invest their portfolios. These decisions could include abandoning investment in certain sectors, industries, or companies that are currently struggling and concentrating their portfolios in areas that are doing really well at the moment. These decisions could also include tactically or permanently reducing stock investments entirely.

We caution against making these types of decisions amid all the noise and speculation in the news today. We do think the current crisis could lead to permanent changes in consumer and corporate behavior that would imply changes to the investment and market landscape. However, we believe these changes are not anything new or different from what typically happens to the investment and market landscape over time. Perhaps the current crisis may accelerate some of these changes. More importantly, we also think these changes do not have to destroy aggregate economic activity. Rather, similar to the impact of technological innovation, they will create winners and losers over time. Investors who take a diversified and balanced approach to their investment plan need not invest differently, as they will be relatively insulated from the losers and will benefit from the eventual winners.

Portfolio Management

Our portfolios are built for times like this

Few areas of the capital markets have been spared so far this year, as the longest-running bull market finally ended due to the tragic realities of the coronavirus pandemic. While Capstone portfolios haven't escaped unscathed, clients have benefited from our long-term investment philosophy and disciplined approach.

Our investment philosophy around diversification and balance helped portfolios weather the worst of the storm and avoid unwanted surprises. Our commitment to broad diversification helped mitigate the impact of the worst-performing stock sectors and industries (like airlines, restaurants, hotels, leisure, and energy) that have unfortunately been devastated by the coronavirus and the collapse in oil prices. Similarly, our commitment to portfolio balance—by structuring bond allocations to have a focus on government securities—helped to offset some of the stock market volatility. Our high-quality bond allocations acted as much-needed portfolio stabilizers to balance portfolios against stock market declines.

Our disciplined approach to portfolio management has helped to manage risk and better position portfolios for a market recovery. One area of focus has been on rebalancing, by trimming from significantly overweight bond positions and incrementally adding to stocks that are significantly discounted. The goal has been to gradually bring portfolios back to their target (neutral) mix based on client-specific objectives. Another area of focus has been on taking advantage of opportunities to harvest losses in stock positions to offset future portfolio gains and lower client tax bills. We have been doing this while keeping portfolios invested so that they do not miss out on days and weeks with sharp rallies (like we've experienced since March 23rd), and certainly, so portfolios don't miss out on what will eventually be a sustained recovery.

Our Portfolio Trade team continues to monitor portfolios closely and systematically tax-loss-harvest and rebalance portfolios when it makes sense to do so. As always, our team will be methodical when implementing these processes, and mindful of tax consequences, cash flows, and other client-specific needs. We are as confident as ever that a disciplined approach to rebalancing will add value over time.

Why we have increased allocations to U.S. stocks

In our previous market communication, we talked about Capstone's Investment Committee's decision to increase U.S. stock allocations. Our Portfolio Trading team successfully completed this transition in March across client portfolios. Last month was a good opportunity to do this because U.S. stocks were significantly discounted. We believe that given the relative strength of U.S. corporations, they could be more insulated should global stock markets continue to fall amid this ongoing crisis.

Looking ahead over the next year or two, we believe that the U.S. economy will be much better positioned for recovery compared to many other major economies abroad. This is due to what was a relatively stronger U.S. economy going into the crisis, and the unprecedented amount of economic stimulus injected by the U.S. government. The overall U.S. policy response to the coronavirus shock has been decisive and comprehensive, exceeding the scale of policy action in other major developed economies. We expect there is more stimulus to come.

In our view, the U.S. stock market also has a relatively high concentration of quality companies with the capacity to weather the storm. This is particularly true with larger-cap companies, which is why we also increased large-cap stock allocations within the U.S. We believe sturdier large companies will likely be better able to withstand the imminent economic slowdown, particularly if it lasts longer than expected.

Near-term future is uncertain, but we are optimistic

There will likely be a choppier path forward for global stocks as some countries begin easing lockdowns and partially reopening their economies, potentially leading to a second wave of infections. The months ahead will be trying times for all of us: as consumers, as investors, and as people contending with the virus. But given the current worldwide focus on the health crisis—including containment measures, and the brightest medical science minds working tirelessly to produce and distribute effective treatments (and eventually a vaccine)—we have faith that there are better days ahead.

Sources & Notes

[1] Source: MSCI, Morningstar Direct. Global stocks as measured by the MSCI ACWI IMI Net-Return Index, cumulative return from 02/20/2020 to 03/23/2020.

[2] Source: Bank of America Securities, CNBC. https://www.cnbc.com/2020/03/23/this-was-the-fastest-30percent-stock-market-decline-ever.html

[3] Source: Bureau of Economic Analysis. Nominal GDP: $21.73T (Q4 2019) seasonally adjusted annual rate

[4] Source: International Monetary Fund. https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020

[5] Source: BlackRock Investment Institute. https://www.blackrock.com/corporate/insights/blackrock-investment-institute/publications/global-macro-outlook

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