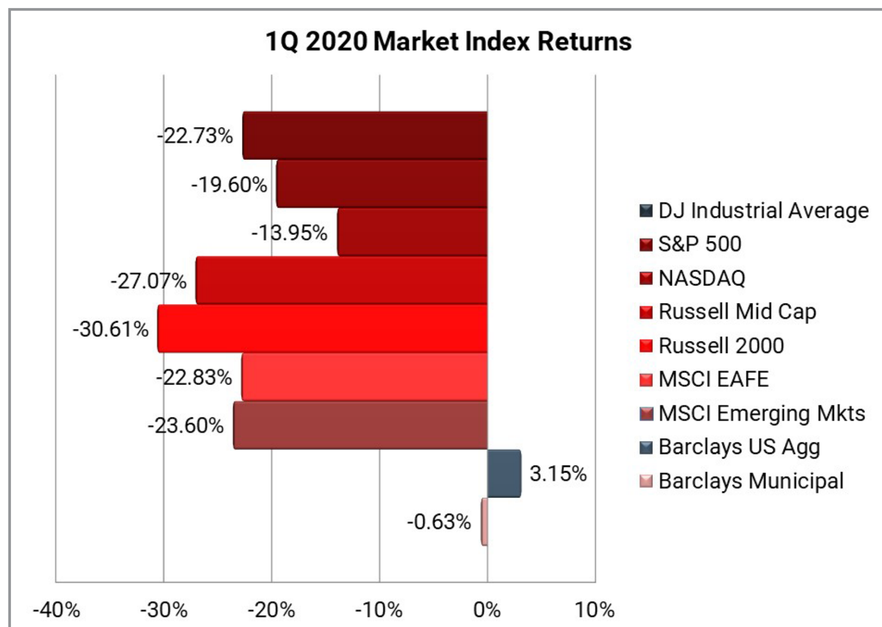
QUARTERLY MARKET COMMENTARY: *First Quarter 2020*

the ECONOMY

If there's one thing bear markets have in common, it's that they all have different causes. As Linscomb & Williams co-founder, George Williams, would say – they all have their own "distinctive personality." The origins have been diverse, such as extreme technology stock valuations, geopolitical turmoil, excessive housing market debt, or, in this case, the outbreak of a novel virus. Yet, despite those varying catalysts, historically a number of conditions are typically present before the onset of major market declines. Usually there are large financial or economic imbalances, often accompanied by monetary tightening from central banks, and frequently spikes in commodity prices. The combination of which generally made the economy more susceptible to recession. But this time really is different. The aforementioned circumstances were mostly nonexistent heading into 2020. Rather, it was world governments' response, however necessary, to the outbreak that has led to this abrupt economic deterioration. It could be considered our first recession by fiat. The policies enacted and actions taken in the wake of the pandemic can and will be debated. But for investors, we feel that it is important to remain focused on the existing steps governments have already taken and what they likely will do going forward, and not on how we wish they would act.

Most of the data collected in the 1st quarter can rightfully be considered "old news" in light of more recent events, but an assessment of where economies were heading into this recession can help inform us on how they may fare during it, and how they come out on the other side. In the U.S., GDP grew 2.3 percent in 2019, and was progressing at a similar pace through February of this year. The jobs market was in



very good shape, with unemployment at a five-decade low alongside a steadily increasing labor force participation rate. Wages were rising between 3 – 4 percent, comfortably ahead of inflation, which had been relatively stable around 2 percent, give or take a few tenths of a percent. As a result, household finances in aggregate were relatively healthy. For example, the household debt-to-GDP ratio is currently 75 percent, and the savings rate is 8.2 percent. Prior to the last recession, these numbers checked in at 100 percent and 3.7 percent, respectively. On the business side, debt levels have certainly increased, but so has cash on the balance sheet and profits, and CEO confidence was at optimistic levels. At near $60 a barrel, oil prices were high enough to incentivize further investment. Of course, given the sudden and unexpected nature of the broad business shutdowns, this data will assuredly weaken in the near-term. There is already evidence of this in the labor market, with initial weekly jobless claims rising into the millions toward quarter end. The official unemployment rate moved up to 4.4 percent, but won't reflect the full extent of job losses until the end of April. March PMI surveys of business sentiment fell to 48.5 for manufacturing and 39.8 for services. Readings below 50 point to a decline in activity. The Federal Government and Federal Reserve have responded quickly though. We'll get into the policy specifics later on, but suffice to say, the programs are incredibly broad in scope, and we believe positive effects are already beginning to materialize.

Europe was in much the same boat as the U.S. at the onset of the virus outbreak. The region's economies were steady if unspectacular, growing at rates similar to the prior year. Unemployment in February hit its lowest level since 2008. We'd expect some deterioration going forward, though the full extent is difficult to gauge. The severity of the virus's spread has differed across the continent. Worse in Italy and seemingly much better in Germany, for example. Some momentum had been building in the U.K., as the country finally, officially, left the European Union (EU) at the end of January, lifting a nearly three-year cloud of uncertainty. But new trade terms still need to be negotiated, and now likely won't be completed until sometime next year. But just like in the U.S., the EU, individual country governments, and the European Central Bank (ECB) have rolled out various plans to combat the virus-induced economic fall-off.

Japan's markets have held up relatively well over the first quarter. We've noted previously that the country's business community has shown an increased focus on efficiency, profitability, and shareholder returns. One of the results is that Japanese corporations generally came into this downturn with more cash on their balance sheets, giving them added flexibility to manage through it. Also, early data suggest a lower virus infection rate, allowing Japan to get by with less stringent economic restrictions. There have been some signs of a renewed pick up in the virus's spread toward the end of the quarter, but it is too soon to draw a firm conclusion.

The center of the virus outbreak, as we're all no doubt well aware by now, was in Wuhan, the capital city of China's Hubei province. The Chinese government, eventually, imposed harsh lockdown measures, and by quarter-end does appear to have meaningfully slowed the growth rate in new cases. To be sure, you can take the reported virus data with a large grain of salt, but a number of high frequency economic indicators do point to a return of activity. Steel demand, traffic congestion, coal consumption, and subway riders are all much higher now compared to mid-February.

Some estimates suggest over 80 percent of manufacturing workers have returned to their jobs. Also, the PMI surveys of business confidence, similar to those in the U.S., rebounded above 50 in March.

Staying in the Asia-Pacific region, Australia's government has responded similarly to its Western peers. Its absolute level of coronavirus cases and deaths though are much lower, especially relative to respective population sizes. There has been some preliminary research linking the ease of spreading the virus to certain climate conditions. So, perhaps the current warmer weather in Australia has had a mitigating effect. Again, the studies are preliminary, but it is something to keep an eye on.

CENTRAL BANKS

Throughout 2019, the Fed engaged in what we would consider a moderate easing cycle. The federal funds rate was progressively lowered from 2.50 percent to between 1.50 – 1.75 percent by the end of last year. Chair Jerome Powell intimated that further cuts were unlikely without pronounced economic weakness. Well, here we are. In February, Powell said that the Fed will "use our tools and act as appropriate to support the economy." Just over a month later, we have a much clearer idea of what that means. The federal funds rate has been reduced back to 0 percent, and an open-ended quantitative easing program has been reinstated. Both of these maneuvers are straight out of the financial crisis playbook. In addition, they established a number of new facilities in order to buoy the economy and promote smoother functioning of financial markets. The "alphabet soup" of programs includes TALF, MMFL, CPFF, PMCFF, SMCFF, and...well...you get the idea. The overarching goal is to support the flow of credit to households and businesses, and ensure appropriate liquidity in several fixed income markets, including corporate and municipal bonds in addition to Treasury and mortgage securities. Also, we'd be remiss not to mention that U.S. banks, in part due to new regulations and oversight from the Fed, are in much better financial shape now compared to the last recession. Because the banking system is well capitalized, the Fed was able to reduce reserve requirements, encouraging additional lending, if and as needed.

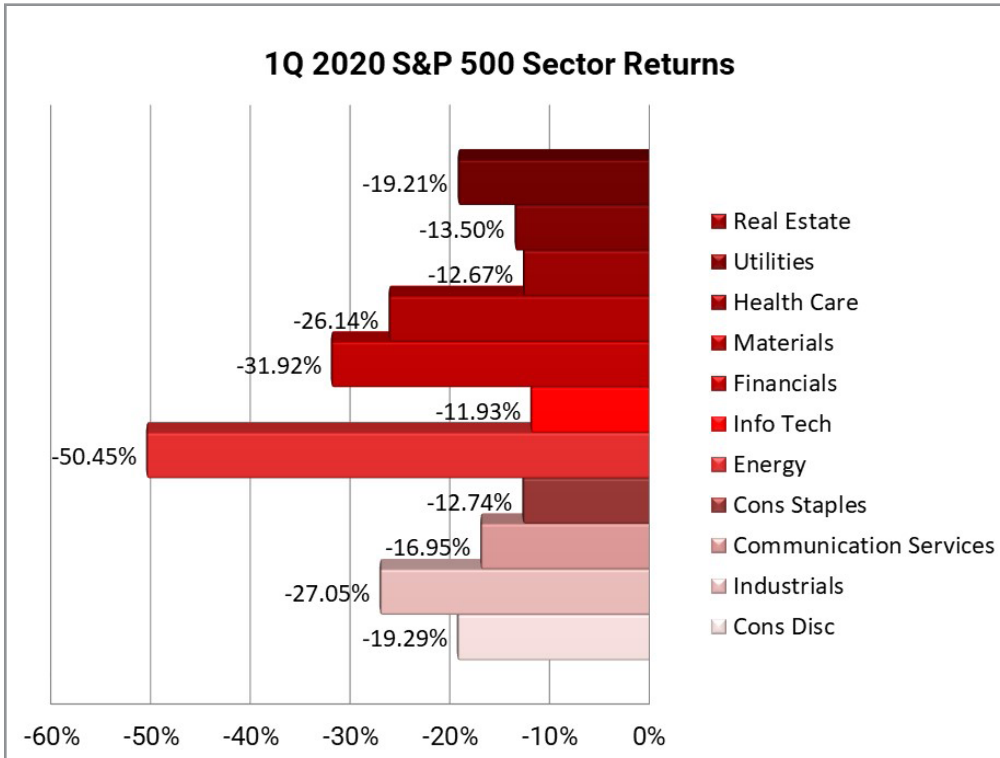
The ECB has enacted similar measures. Interest rates were already about as low as they could go, so no new action was taken there. But President Christine Lagarde announced an expanded asset purchase program, very much like the Fed's own quantitative easing.

The theme is likely to be the same around the world for the time being – central banks easing policy when and where it's possible to do so.

FIXED INCOME

As has been the case historically, government bond rates fell as investors rushed to purchase safer securities amidst a steep stock market sell off. The 10-year U.S. Treasury yield decreased from 1.88 percent at the start of 2020, to 0.70 percent by the end of March. Bond prices rise as interest rates fall, so U.S. Treasury bonds provided a ballast in balanced portfolios during the 1st quarter.

Corporate bonds, on the other hand, experienced more volatility. Yields for both investment grade and high-yield securities rose as investors worried about how an economic recession would affect the cash flows of businesses. This was most acute in the energy sector, as many firms are bound to struggle at current oil and gas prices. As we alluded to earlier, banks are in much better financial health today. We saw evidence of this in the fairly stable performance of bank bonds. This suggests to us that some of the systemic issues present during the last recession are not present today.



Though there were a few hiccups along the way, municipal bonds held up well last quarter, but were not as strong as Treasury securities. A basket of investment grade municipals was down 0.63 percent over the trailing three months. We wouldn't read too much into the disparity in performance between the two sectors though. Municipals are a much smaller and more thinly traded market, so during periods of heightened volatility, we've seen these types of price dislocations before, that aren't necessarily related to the underlying credit-worthiness of the issuer. Historically, these episodes have been short-lived and tend to even out as the trading environment normalizes. The Fed's new facilities are already helping in this regard.

EQUITY

Just like the current economic downturn, the corresponding stock market action and eventual bear market were unprecedented in speed. It took just 19 trading days for the S&P 500 to fall more than 20 percent from its recent high. On average, it is well over 100. For the entire quarter, the decline for large cap stocks was 19.60 percent, but in the interim, the total peak-to-trough loss was near 35 percent. From a sector perspective, consumer staples held up well, which shouldn't be surprising given the rush to stock up on food and household items. Uncharacteristically though, growth-oriented technology stocks fell much less than the overall market as well. Not considered a defensive sector, the unique nature of this bear market in which people are spending much more time at home meant that those companies with internet-related business models haven't seen near as big of a drop off in demand. Given the dramatic decline in commodity prices, it was no surprise that energy and materials stocks tended to underperform.

Overseas returns were negative as well. International and emerging market stocks were down 22.83 percent and 23.60 percent, respectively, in the 1st quarter. We noted earlier that Japanese stocks actually held up better that most other countries, and the same is true for China. The MSCI China was down only 10.22 percent for past three months.

The long-term performance of stocks is dependent on earnings and valuations, but we have noticed an interesting shorter-term trend. The direction of stock markets does seem to have at least a loose correlation with coronavirus growth rates, or lack thereof. We'll keep it on the radar as the situation evolves.

Also, in the midst of down markets, especially ones that have happened so quickly, it is easy to forget why we own equities to begin with. We're reminded of a remark from one of our favorite investors, Peter Lynch of Fidelity Magellan fund fame. To paraphrase – though it may feel like it sometimes, a stock is not a lottery ticket. It's a part ownership of a business.

OUTLOOK

Given the unique nature of this global recession by fiat, it's been speculated that this recession could potentially turn into something like a depression. We take this possibility seriously, but our base case is that a true depression scenario is unlikely. There has been, in our opinion, a stark difference in the policy response. During the Great Depression, monetary policy was tightened, federal government aid was late and arguably misdirected, new trade barriers were erected, and regulatory burdens on the financial system were increased. For our baseball fans, that's going 0 for 4 with a couple of strike outs. And while fiscal and monetary policy are no panacea for what is fundamentally a medical matter, the actions taken by the government and the Fed have been swift and, we believe, far more appropriate. The previously discussed monetary policy actions will be augmented by the CARES Act, a nearly $2.3 trillion stimulus package. It includes over $500 billion in loans to distressed businesses, nearly $600 billion in stimulus checks and expanded unemployment insurance, $375 billion in small business relief, $180 billion in health-related spending, $150 billion direct aid to state and local governments, and a variety of other spending measures and tax breaks. Governments around the world are enacting similarly styled legislation. Given the size, scope, and speed in which these programs are being rolled out, we shouldn't expect assembly line-like efficiency, but feel they are practically implementable.

Though this is not our area of expertise, given the underlying cause of the current economic and market environment, we've spent a lot of time internally discussing the coronavirus and the response from the medical community. And while this is by no means an exhaustive summary, there are a few points worth mentioning that we've found important. First, a note on the various models informing estimates of disease spread and deaths. We are tracking a number of them, but believe we need to be cautious about extrapolating results from one place to another. For example, data from South Korea is a poor fit for Italy. Data from Italy doesn't necessarily create a good model for Japan. Japan is different from New York, which is different from Texas, and so on. Each location seems to be more idiosyncratic, with different factors influencing the spread of the virus. We are being patient and updating our discussions as new information becomes available. We are focused on the trend in daily growth rates, which fortunately have begun to decline in some countries. On potential treatments, there are a number of small trials ongoing and drug development is underway, and some have shown promise, but it is too soon to make any definitive claims about effectiveness. Large medical companies like

Johnson & Johnson and Pfizer are working on vaccine development as well, though that is likely many months away. Rest assured, while the future path of the virus is uncertain, it is encouraging to know that many of the world's best and brightest are working tirelessly to find a solution. We believe that a return of economic activity is dependent on success in two main areas. First is containing the spread of the virus over a reasonable time period, and second are the policy responses which help avoid or mitigate a prolonged financial fallout from the sudden stop in work. We've noted reasons to be optimistic on both fronts. The decline in stock prices has been uncomfortable, to be sure, but based on longer-term earnings expectations, current valuations imply reasonable performance outcomes going forward. In fact, declines of this magnitude have almost always led to above-average returns three years hence.

In a highly uncertain environment, our best advice is to stick to your plan. As always, the Linscomb & Williams team is analyzing portfolios on a daily basis, ready to make changes as needed, and available for any questions you may have. In closing, we'll leave with a quote from Shelby MC Davis, founder of Davis Selected Advisors – "History provides a crucial insight regarding market crises: they are inevitable, painful, and ultimately surmountable." We couldn't agree more.

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