First Quarter 2020

A Few Words to Start

We are in the investment management business but on a *human level* we are living through an extraordinary period in history that none of us will ever forget. The impact on our families, communities, and country has been profound. While several weeks ago we had reason for cautious optimism that the coronavirus might be largely contained to China, it is now clear that is not the case. The United States and world are now facing the dual threats of a health crisis and an economic crisis. Both need to be fought with monumental government policy responses and individual behavioral changes.

We've frequently said that recessions and bear markets are inevitable phases within recurring economic and financial market cycles. We've also said there is always the risk of an unexpected "external shock" to the markets and economy (e.g., a geopolitical conflict or natural disaster). Investors need to be prepared for both to happen, but their precise timing is consistently unpredictable.

It's one thing to say it and another to actually live it. Everyone has been impacted by this and we are certainly not any different. Our team (Florida stay-at-home order) continues to work hard helping clients think about any mid-course corrections to their financial plans but, at the same time, avoid panicked reactions that could have even more detrimental effect down the road. We all *want* to remain rational about investment-planning-portfolio decisions although it's important for us to understand that we cannot simply rationalize clients away from all of their emotional beliefs. Logic alone is not necessarily enough to convince clients to stay the course during these times. Our sole focus is on understanding each client's concerns and providing some perspective so the best decisions can be made to minimize any long-term regrets.

We will get through this crisis period. Things will improve and recover. Most importantly, we sincerely hope you and yours are able to remain healthy and manage well through this challenging period.

First Quarter 2020 Market Update

The first quarter of 2020 has proven to be unprecedented for financial markets. U.S. stocks fell into a 20% bear market in the shortest time ever. They continued to drop and declined 30% in a record 30 days! Volatility, as measured by the VIX, reached its all-time high on March 16. Oil's 25% drop on March 9 was its biggest one-day drop since the 1991 Gulf War. Finally, 10-year and 30-year Treasury bond yields fell to all-time lows of 0.54% and 0.99%, respectively!

Larger-cap U.S. stocks fell 20% this quarter, having rebounded a bit from their historic drop. Smaller-cap U.S. stocks did even worse, falling 31%. Foreign stocks also suffered significant drawdowns, as developed international stocks and emerging-market stocks both dropped around 24%.

In the fixed-income markets, core bonds gained just over 3%, once again playing their key role as portfolio ballast against sharp, shorter-term stock market declines. The 10-year Treasury yield is currently at 0.70%, down from 1.92% at year-end. In contrast, higher-risk floating-rate loans and high-yield bonds suffered outsized losses, both dropping around 13%. Investment-grade corporate bonds were far from immune, losing over 4%.

Update on the Macro Outlook

We entered the year with an outlook for a moderate rebound in the global economy (especially outside the United States) on the back of reduced U.S.-China trade tensions and extensive global central bank monetary accommodation. Our base case now is that the U.S. economy is headed into recession in the second quarter. It is likely to be a severe one, with a sharp contraction in GDP and an unprecedented rise in unemployment.

The depth and duration of the recession—and the strength and timing of the ensuing recovery—depend on two key variables:

1) The effectiveness of our medical response and social policy efforts in flattening the curve
2) And the speed and effectiveness of our fiscal, monetary, and regulatory policy response

Now that the coronavisus has made it to the rest of the world, governments and people are overreacting. The word *overreacting* usually has a negative connotation, but not when it comes to a deadly (highly) contagious virus that spreads by geometric progression, you want people to overreact and due it early- the cost of underreacting is simply <u>too</u> high.

One lesson learned from the 2008 global financial crisis is that a policy response needs to be significant and executed quickly. Governments need to make a credible commitment to "do whatever it takes" to support the economy and prevent a negative spiral from taking hold. The Federal Reserve and other major central banks seem to have gone all-in to support the fluid functioning of credit, lending, and financial markets, and their critical role as the "plumbing" of the real economy. At the same time, governments around the globe understand something massive needs to be done quickly on the fiscal policy side. Our response won't be perfect but on March 27, Congress passed, and the president signed into law, a $2 trillion stimulus package. Similar support measures are being debated or implemented around the world. Discussions continue about additional steps to take in support of markets and the economy.

Portfolio Positioning*

When you diversify across asset classes and consider a variety of potential scenarios, there will always be leaders and laggards in your portfolio. Some positions, like U.S. stocks, work well in strong up environments like we experienced last decade, while we have incorporated others that benefit portfolios during tougher times like the start to the 2020s. Put together, they build resiliency and protect a portfolio from betting on a single outcome, which can be a disastrous financial result if the opposite happens.

Our allocations to lower-risk fixed-income and diversified alternative strategies have offset some of the equity losses. Treasuries and trend-following managed futures in particular have been areas of positive returns during the quarter and these allocations should continue to do so if the selloff continues.

However, given the extreme volatility and still-negative trajectory of the virus in the United States, we also recently have further increased the margin of safety in most portfolios. We did this in late March by selling our US Mid-cap holding(s) and raising our cash position i.e. money market holdings. The goal is to participate and *protect* during this time and we don't see this as a "market-timing" action per se but more as a tactical tweak to our buying/rebalancing process.

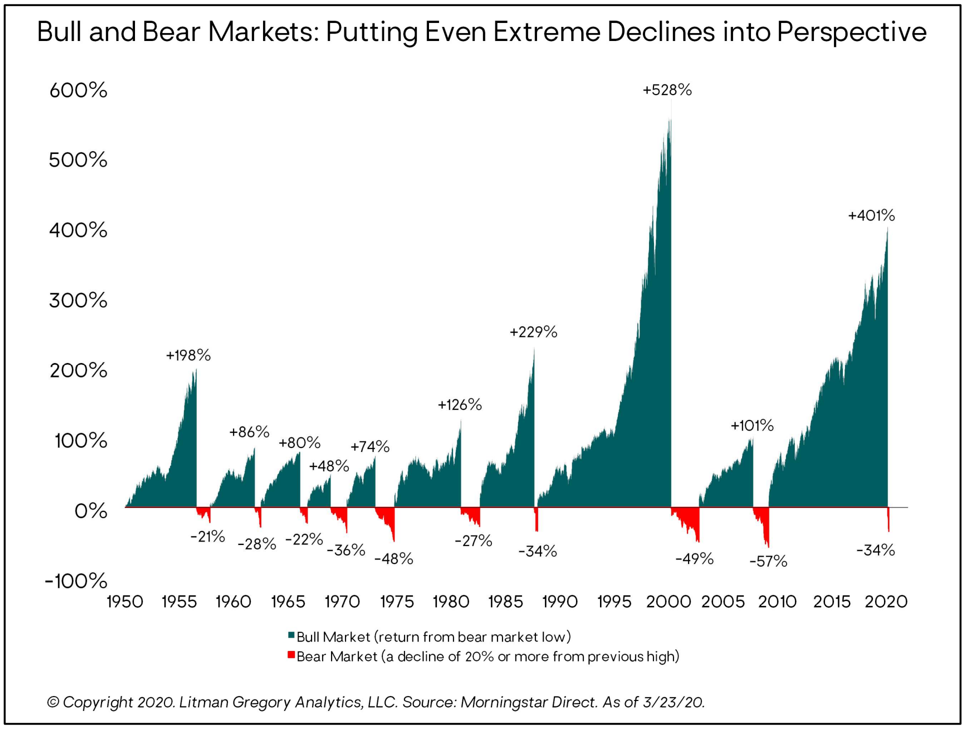
When stock prices—or any asset's prices—*drop*, forward-looking returns *rise*. The outlook for U.S. stock (& Global) returns have actually *improved* with their cheaper valuations and if there are additional market declines and valuations become even more attractive, we plan to increase our equity allocation back to our long-term target allocations. We may add in small increments because the uncertainty induced by the virus may result in greater volatility and thus better "multiple"entry points. We are not looking for the perfect time i.e. "the bottom".

During market meltups and meltdowns, emotions can start to impact your time horizon- that's very human. During a meltup, the time horizon extends to "forever" while during meltdowns it shrinks to months, weeks and then days. With every decision we make, a client's time horizon is deeply embedded into our investment process; we think that is the only way to invest.

Closing Thoughts

During these historic times, it's worth repeating that it's ~~is~~ paramount to stay disciplined and recognize when emotion rears its head in investment decision making. If we invest based on emotion, we are very likely to exit the market *after* it has already dropped meaningfully, locking in losses. By the time the discomfort and worry are gone, the market will *already* be much higher. That is not a recipe for long-term investment success.

Global markets have endured severe challenges and economic downturns in the past and have always weathered the storm. Attempting to time the market's tops and bottoms is a fool's errand; however, incrementally adjusting portfolio allocations in response to changes in asset class valuations, expected returns, and risks can be highly rewarding to long-term investors.



The time to be adding to stocks and other *long-term growth* assets is when prices are low and markets—and most of us personally—are gripped by fear and uncertainty rather than complacency, optimism, or greed. It may seem like the market could just keep dropping with no bottom in sight. But that is exactly where research, analysis, patience, experience, and having a disciplined investment process come most into play.

The precipitating event for the recent volatility is something none of us have experienced before: a global pandemic and an extreme societal response. One in two Americans now live under lockdown (and maybe more by the time you read this). Our medical infrastructure could be overwhelmed. We are probably already in a global recession. Facing this dual medical and economic crisis, the situation is probably likely to get worse before it gets better. We would love to be wrong. But it *will* get better. Remember, bad headlines make for poor investment advice.

The future is *always* uncertain but our investment-planning playbook remains the same: diversify; balance long-term returns with short-term risks; have the courage to remain disciplined. Stay on <u>your</u> course.

Please do not hesitate to reach out to us during this challenging time. We are always "open" to discussing your concerns and deeply appreciate the trust and faith you have bestowed upon us.

*does not apply to all accounts

—Rainey & Randall Investment Management 04/07/20