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Client Alert:

Bending, Not Breaking

Weathering the Market Storm

March 11, 2020

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Financial markets are reacting to fast-moving external shocks, including an uncertain global health crisis, quarantine-related supply chain and consumer demand disruptions, and the sudden unraveling of the OPEC-Russia alliance triggering a collapse in oil prices.

Read on for our latest thoughts on these interrelated crises and our expectations going forward.

What We're Seeing

Headlines are laser-focused on developments in efforts to contain the spread of the coronavirus, which remains a legitimate threat to global health. Although we're neither doctors nor experts in epidemiology, it's clear we're at a critical juncture and the actions over the next couple of weeks may be particularly decisive. As rational long-term investors, we must try to look through the fog of uncertainty and make educated guesses about how to best measure progress and predict consequences.

The uncertainty about coronavirus flows from its status as a new disease. Doctors don't yet know just how contagious it is, its mortality rate, or whether its spread can truly be contained or effectively slowed enough to prevent overwhelming healthcare systems. We cannot yet dismiss worst-case scenarios which envision 2%+ mortality rates, an extremely contagious nature that's impossible to effectively quarantine, and rapid infection spread that leads to entire populations simultaneously developing symptoms and shutting down most economic activity. Of course, it could still prove to be far less deadly and disruptive.

On this front, we're closely monitoring disease progression on South Korea, Italy, Japan, Hong Kong, and Singapore, which have been fighting COVID-19 infections before it landed in the US (while the virus originated in China, we simply cannot take official Chinese news and statistics at face value). They've resorted to a wide variety of countermeasures, ranging from minimally disruptive disinfecting efforts to full-scale regional quarantines and economic shutdowns. Restrictions on work and personal travel obviously negatively affect transportation and leisure companies. However, the more extreme policies are also triggering cascading supply chain disruptions in imports of some vital intermediate and finished manufactured parts, threatening industries that are reliant on fragile just-in-time inventories.

If any methods prove effective in reducing the virus' spread or treatment outcomes prove it's less severe than feared, we'll have a better idea of the scale and scope of what'll likely need to happen here. If nothing appears to work, markets will begin discounting a longer-term and even deeper impact to economic forecasts.

Meanwhile, American policymakers aren't sitting on their hands, and all levels of government are already acting. Over a thousand domestic cases have already been detected, and a sharp increase in reported cases should be expected at least through the end of April even if public hygiene efforts ultimately bear fruit. This could easily lead to increased fear, dampening sentiment and potentially amplifying the negative effects of school closures, reduced business and leisure travel, and curbs on large-scale events and social activities. Businesses are already taking a hit to earnings and there's more to come – what's still unknown is the magnitude and duration of the remaining disruption, and to what extent the markets will reflect this reality.

This turbulence isn't due to technical factors or obscure monetary policy comments from Federal Reserve officials. The previously positive fundamental backdrop of rising earnings and strong sentiment has faded as an unexpected and serious external threat to economic growth suddenly emerged. Earnings are likely to fall for at least the next quarter and business conditions will be challenged; it's logical that lower profits and reduced confidence are leading to lower equity prices. We're also confronting uncertainty about the wide variety of worse outcomes that are still possible and another unexpected shock in this past weekend's oil price crash. This combination is creating severe volatility as investors process rapidly evolving information. Although painful, all this makes sense given the context.

Our best guess is the progression of new US infections stabilizes by early-mid summer, which subsequently allows economic activity to bottom out and set the stage for a rebound. However, we don't expect the market volatility to subside until there's clear evidence that domestic cases have peaked and start to decline. Until we reach that point, fast-developing news will continue fueling fast-moving markets.

Short-Term Implications

- Increased supply shock disruptions
- Reduced Chinese economic activity
- Financial system stays steady
- Oil industry under pressure
- Potential stimulus incoming
- Other knock-on effects

Short-Term Implications

Here's a short list of what will likely be the most impactful short-term consequences:

- **Increased supply shock disruptions**. As the coronavirus keeps spreading and forcing more restrictive countermeasures, broken links in globalized supply chains will multiply. Businesses with more intricate chains, low parts inventories, and lacking easily available substitutes are most at risk.
- **Reduced Chinese economic activity.** Notwithstanding the reliability of official Chinese data, we expect bona fide progress there and a clear peak of outbreaks within the next 4-6 weeks. Under this scenario factory output will subsequently begin ramping back up and alleviate some international supply bottlenecks. However, the damage to supply channels will require one to two quarters of repair, leading to lower full-year GDP growth.
- **Financial system stays steady.** Unlike 2008, where the fundamental stability of the global financial system was in question, we see very low structural risk at present. Markets have been functioning smoothly (volatility and repricing isn't the same as dislocation and panic). US banks and systemically important financial institutions are highly capitalized, and the Fed is clearly prepared to provide any bridge liquidity that may be needed.

- **Oil industry under pressure.** The same can't be said for the oil industry. The significant drop in prices means many leveraged shale producers are now operating in the red. This has naturally led to declines in oil-related equities and widening in bond credit spreads, which means increased industry-wide financing costs and fewer investments in hardware and jobs. There is a silver lining, as lower energy prices that burden producers are conversely a boon for industrial users, transportation companies, and consumers.
- **Potential stimulus incoming.** The chances of fiscal stimulus are growing, as policymakers seek to lessen the financial impact of anti-virus countermeasures on consumers and furloughed/quarantined workers. Although details are very fuzzy, initial chatter is coalescing around potential bridge financing for small businesses and a payroll tax holiday. If enacted, this would help protect small businesses against temporary cash flow difficulties, increase consumers' spending ability, and hopefully prevent avoidable consumer bankruptcies.
- **Other knock-on effects.** Restaurant traffic, travel & leisure, and airline companies are already suffering and will continue to suffer until the crisis passes. Their troubles have a trickle-down effect, as employees will bear the brunt of the pain from fewer hours and pay cuts, and in turn ratchet down spending to account for their declining disposable incomes. Concentrated short-term layoffs are likely, and we'll be monitoring the pickup in jobless claims closely to gauge the magnitude of the impact.

One beneficial effect of falling interest rates is a likely surge in mortgage refinancing activity, as home-owners take the opportunity to lock in savings. The additional disposable income generated by this trend may help blunt some of the negative impact of job layoffs.

Longer-Term Implications

- 2020 Presidential race becomes competitive
- Peak globalization?

Longer-Term Implications

While it's early to forecast longer-term effects with confidence, we're looking at a couple scenarios that could take center stage sooner rather than later:

- **2020 Presidential race becomes competitive.** Until recently, it seemed most financial professionals were acting under an apolitical assumption Donald Trump was likely to win reelection. Now, President Trump's favorability ratings could shift significantly based on popular perceptions about the federal government's actions to combat the coronavirus. Additionally, countermeasures to contain its spread could stretch into the heart of the general election campaign season, changing candidates' strategies in unpredictable ways.

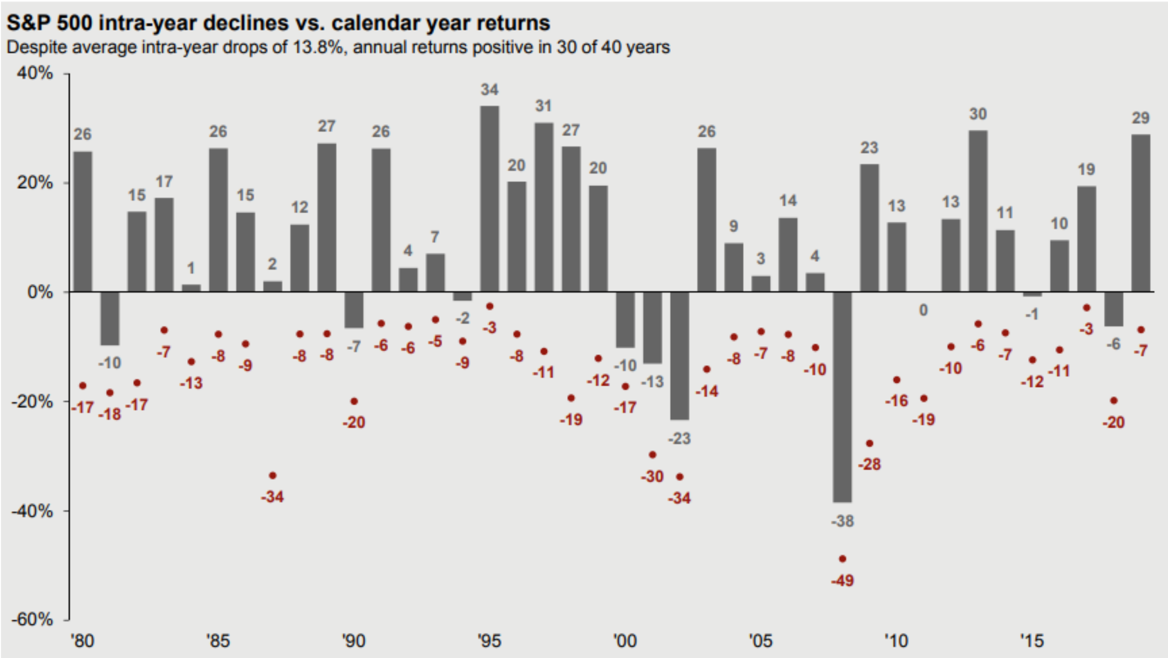
- **Peak globalization?** Globalization had already been under assault from populist political movements over the past few years. The virus-related supply chain disruptions are adding another log to the fire, exposing the fragility of some of its long-touted benefits. The longer such disruptions continue and cascade pain through interconnected firms and industries, the louder the calls for supply chain diversification and safety-first repatriation will grow.

Treasury Partners View

Here's our core thinking; coronavirus is ultimately a transitory event. Unlike 2008, which was a systemic banking crisis that threatened the very survival of the economy's most important underlying financial institutions, this event will pass. There's a chance it could be quite severe, killing a significant number of people and disrupting society's day-to-day functioning for several months. Ultimately, it doesn't threaten the basic underpinnings of our economy; one way or another, cases will peak, subside, and in time life and commerce will return to normal.

However, even a temporary phenomenon can pack a painful punch. Setting aside the potential human toll, the implications of this crisis and its associated countermeasures have already increased the odds of recession. Those odds will continue increasing the longer these disruptions last, and while we can hope (and maybe even assume) everything eventually turns out well, uncertainty reigns for now. The recent market gyrations stem from this uncertainty, as the range of potential outcomes and consequences remains wide and financial assets must logically reprice to incorporate this new information.

We emphasize that this volatility, while incredibly severe, doesn't appear to be destabilizing. Markets are orderly, liquidity is plentiful, and price changes can be explained based on rationally explainable changes to underlying fundamental prospects. This is how markets are supposed to function in response to significant new information.



Source: Q1 2020 JP Morgan Guide to the Markets

While market conditions have quickly deteriorated, remember that they can also quickly improve. Volatility isn't uncommon - over the past 40 years, although the S&P 500 has experienced average intra-year declines of 14%, it's still posted positive returns in 30 out of 40 years. We've experienced relatively low volatility for most of this record-long bull market, and it's understandable that this feels painful after years of smoother gains.

Moreover, there's a fundamental case that improvement is on the horizon. The coronavirus crisis is occurring against what had been a solid economic backdrop – unemployment was low, US manufacturing and service sector activity were both expanding, and global growth was showing signs of a pickup. All that has almost certainly deteriorated since the virus' onset, but the fact we started from a position of relative strength should help cushion the blow and lay the seeds for the eventual recovery.

We remain confident with our client portfolio structures. We carefully design Asset Allocations to withstand potential impacts from economic shocks and volatility, and deploy capital with a long-term view, seeking to find the best opportunities to preserve your wealth throughout the highs and lows of market cycles. For most clients with widely diversified portfolio allocations, their overall portfolios are weathering this storm reasonably well, generating flat to modestly negative YTD returns (as opposed to the double-digit declines in major equity indices). Bonds and Alternatives have been effective stabilizers against the declining equity markets, fulfilling the role we expect them to serve in such times.

Meanwhile, we're staying very busy. We're focused on monitoring existing positions and exposures, reviewing client allocations, and watching fixed income and equity markets for dislocations and any new opportunities that may arise.

Our tireless efforts continue on your behalf. We appreciate the opportunity to oversee your wealth during these challenging times. Please feel free to contact us if you wish to discuss any of these points or how it may impact your portfolio.

For over 37 years, corporations, high-net-worth individuals, family offices, trusts, foundations and endowments have sought our help to construct diversified portfolios positioned to perform throughout market cycles. Among other industry recognitions, Barron's has ranked us in the top tier on its annual listing of "America's Top 100 Financial Advisors" every year since the survey was introduced in 2004.

Speak with Our Barron's Top-Ranked Team Today.

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