2ND QUARTER
2020

SBH NEWSLETTER

Thoughts on the Current Environment

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"Homo proponit, sed Deus disponit"
-Book I, Chapter 19, of The Imitation of Christ,
German cleric Thomas à Kempis, circa 15th cent.

Man Proposes, and the Gods Laugh

As the Latin quotation tells us, "Man proposes, but God disposes." At the turn of the year, it is hard to recall now though only a scant three months ago, the consensus was that global economic activity in 2020 would be weak but nonetheless pointed in the right direction.

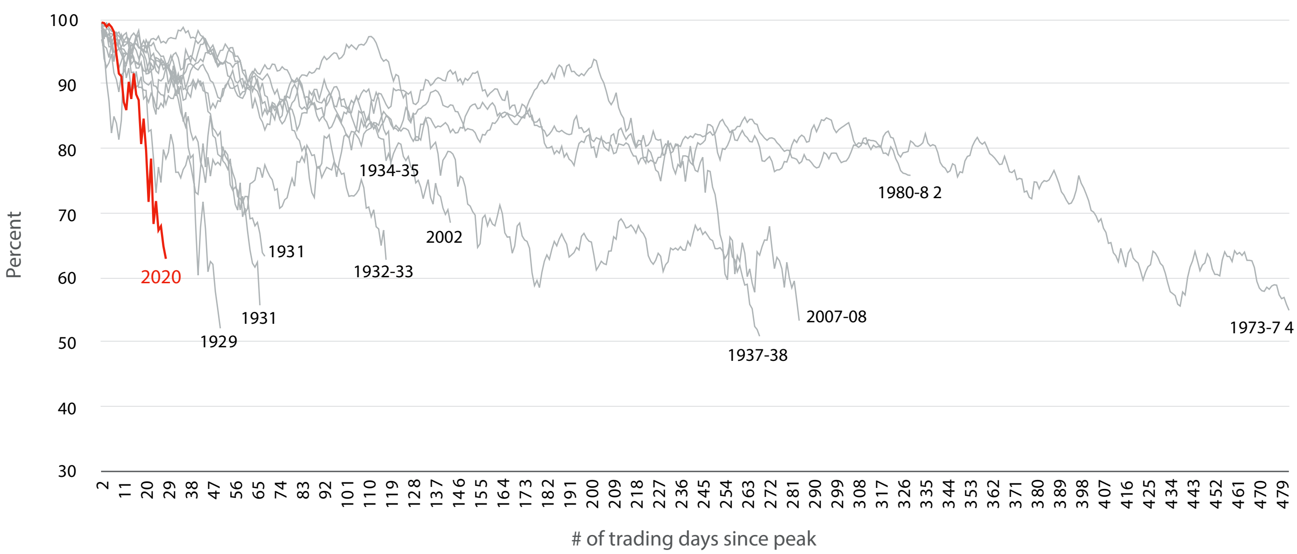
Back then, no one outside of epidemiologists and some worried officials in a mid-sized city (11.8 million people) in Central China called Wuhan, had heard of what we now call COVID-19, let alone "coronaviruses." In record short order, COVID-19 has been accorded pandemic status by the World Health Organization (WHO), a dubious distinction but testimony to the degree of inter-connectedness the world has achieved since the end of World War II. This heightened degree of interconnectedness, which has brought prosperity and better lives to a large part of the global population, also carries with it risks, one of which was probably accorded very low odds by most forecasters: the capacity for a new virus to spread from person to person over vast distances almost as rapidly as information and news does via the internet.

The science, medical risks, methods to address the spread of this virus, and possible treatment are the foremost topics of discussion today. The landscape is changing at a very rapid pace, and what was new yesterday is old hat today. Alongside the medical and social issues are very real economic ones, considering how the virus' presence has altered the rhythms and behaviors of everyday life in the 21st century. While quarantining in place—deliberately inducing social isolation—is for the moment the best tool for blocking the spread of the virus, it is a blunt tool. And because the 21st century economic model is built around a largely service-based economy and shift to experiences over tangible items, social isolation is especially disruptive and comes at huge costs. Unlike a war, which causes shortages of goods and supplies as productive facilities and transportation systems are destroyed or damaged, this pandemic has been most damaging to the service sector—think leisure and hospitality. In the meantime, the production and distribution of essential food and consumer products have continued essentially unabated.

The U.S. stock market has plunged into bear market territory in record time, even reaching the range of bear market lows in the shortest time recorded as the following chart shows. Assuming it is not a flash in the pan, the dramatic recovery in the last week of March could make this the shortest bear market in history!

CURRENT SELL-OFF HAS BEEN ONE OF THE SHARPEST IN HISTORY

Peak-to-trough declines in historical bear markets (declines of 20%+ without a 20% rally) since 1929



Source: FactSet, SBH Quantitative Research Group as of March 2020.

A Disservice to a Service Economy

The markets reacted to an unprecedented economic situation. For the first time, a service-oriented economy is at risk of being unable to function. Unlike the pattern of traditional economic downturns, this was not a problem stemming from the manufacturing or industrial sectors (think automotive or steel) that would bring much of manufacturing to a production halt. Nor was there an issue in the financial system that could lead to a banking crisis (think sub-prime mortgages) or a commodities-based disruption (think oil price shocks in 1973 or 2014).

Instead, there is the risk of the service economy breaking down driven by the quarantining of people, voluntarily or by government order, intended to "flatten the curve" of growth for those contracting the virus. This is being accomplished at the immense cost of causing many companies, large and small, to shut down. Either they are classified as non-essential or their customers have stopped whatever interest they have in the service for the time being (for example, shopping for a new home). Most service businesses are highly dependent on cash flow from operations, and compensation expenses are usually the largest part of their cost structure. If no revenue is coming in, there is only one place to reduce costs. Unemployment claims have skyrocketed, and the unemployment rate is expected to climb sharply for a while. This in turn, will likely lead to an abrupt and possibly steep decline in gross domestic product (GDP) for both the first quarter and especially the second and likely the third.

A New Hope

In an effort to forestall some of the economic carnage, Congress passed a fiscal stimulus bill late in the first quarter, which hopefully will be enough to stem the growing sense of panic that was beginning to pervade the financial markets. Strong enterprises were suddenly being evaluated and priced by the financial markets as if they were about to run out of cash, break financial covenants, and be forced into bankruptcy. At that point, the Federal Reserve (Fed) and other global Central Banks announced new infusions of liquidity into the system, which were then buttressed by the follow-on fiscal actions. The key to whether these financial measures will work—or be sufficient—will be determined by several non-financial factors, none of which can be forecast with confidence at this moment: a yet to be seen rate of infection for this virus (the "Replication Rate") and, more ominously, the mortality rate (what percentage of the population will die from COVID-19?). There are many mathematical models that have been constructed, some of which suggest the mortality rate is as high as the rate of the Spanish Flu pandemic in 1918. Others suggest it could be as low as seasonal influenza.

Another factor is how long it will take before reliably accurate tests with immediate readouts become widely available. At that point, targeted and focused quarantining, which can be much more nuanced than the blunt-edged tactic of sheltering in place, can allow "normal" life, or whatever becomes the "new normal," to resume. Finally, how long will it take to develop a vaccine against the virus? We already know its genetic pattern. The development, production, and distribution of such a vaccine may be the longest running of these tasks to implement, but it would essentially provide an end to the crisis.

While we have no special insights as to how these factors will play out, we can offer some comments about how we are addressing the conditions the current market is presenting us. If it turns out the stimulus bill is enough, it will result from a "favorable" scenario playing out for the virus. If so, then the major question for us to address is which companies will be best positioned in whatever the "new" normal will be and what valuation should be placed on earnings that will be 12 to18 months away from realization. Earnings forecasts for 2020, let alone assessing appropriate multiples on those earnings, may be an unnecessary exercise. If we get a "favorable outcome," investors will stop paying attention to 2020 results anyway. Conversely, if the mortality rate of COVID-19 proves to be like the Spanish Flu, we certainly haven't seen a bottom yet.

Operating in Unusual Times

The Fixed Income team at SBH, much like the rest of the investment community, was faced with unusual circumstances in the markets which were creating significant liquidity stresses during the quarter. This was having adverse effects both in assessing the creditworthiness of companies that had been heretofore seen as having strong balance sheets and in being able to buy and sell within normal bid-ask spreads. However, with dislocations also come opportunities for the various strategies.[1]

In a similar manner, managers of our domestic small cap strategies, all of whom were investing in markets that were down 40 to 50% in the quarter, were beginning to put money back to work. They concluded that the massive dislocations in liquidity had brought prices of individual company shares down to a level that discounted all the risk the managers could imagine, and that the risk-reward trade-off had become attractive. The managers of domestic equity strategies whose benchmark is the S&P 500® or Russell 3000®, which declined much less than the benchmarks for smaller indices, were feeling the same but finding fewer of those opportunities. Our international equity strategy managers, both fundamental and quantitative, had not implemented major alternations yet, all for varying reasons, as is to be expected. As you have heard us say before, these dislocations are often the very times when our disciplined approach to investing in inefficient markets brings the most telling results to our clients.

Needless to say, we are operating in very unusual times, more for the changes that are occurring in the social fabric than for the fluctuations in the financial markets. While volatility in the financial markets is high and prices are moving sharply, such behavior is not unusual in periods of stress. The financial markets are just playing their role as canaries in the coal mine as they signal the significant economic consequences of this pandemic. To be sure, "mere moves in the stock market" can be readily dismissed in comparison to the heightened risks of death, but to the extent that values of financial assets represent the basis for funding retirement plan benefits or endowment and charitable endeavors, they cannot be simply dismissed. We are diligently working from home during this period and our systems and technology have allowed our investment teams to seamlessly make the transition as we watch over portfolios and adjust to the "new normal." We are grateful to report that we are safe, and we wish the same to you and your families and friends.

[1] Just before the end of the quarter, the SBH Fixed Income Group published comments on these unusual circumstances and indicated where they saw opportunities for the various fixed income strategies we offer. If you did not receive this paper, please send me an email at rsegall@sbhic.com, and I will get it to you.

MARKET BAROMETERS
AS OF MARCH 31, 2020

	Apr 1, 2019	2Q19 3Q19 4Q19 1Q20	Mar 31, 2020	Low	High
Dow Jones Industrial Index	26,258.42		21,917.16	18,591.93	29,551.42
S&P 500 Index	2,867.19		2,584.59	2,237.40	3,386.15
Russell 3000 Stock Index	1,690.18		1,489.57	1,288.04	1,984.26
Russell 2000 Stock Index	1,556.06		1,153.10	991.16	1,705.22
Russell Midcap Growth Index	1,106.52		981.09	844.03	1,314.21
Bloomberg Barclays Aggregate Index	2,098.95		2,295.05	2,095.64	2,359.95
Barclays Muni Bond Index	1,214.58		1,263.54	1,174.65	1,318.95
Gold (Price/Oz) London AM Fix	1,291.90		1,604.65	1,270.05	1,687.00
Goldman Commodity Index	2,566.27		1,494.34	1,467.82	2,666.79

Source: Bloomberg.

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