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Traub Capital Management
Economic and Market Outlook 2020 Q2

THOUGHTS ON THE MARKET AND EVENTS IN Q1

Groundhog Day. Most of you know the movie and if you haven't seen it you likely have heard it brought up in this crazy "lockdown" world we are in currently. Every day is more or less the same. For me, that means since late February I get up and go to the office to work (some things HAVE changed in that time- the last 3 weeks I walk out of my bedroom and into my HOME office). I watch the virus news worsen, I watch the economy crumble further, and I watch stocks and even most bonds swing wildly as never before- but most days down, and for stocks, down big. Rinse and Repeat. Most people are bored with their own personal Groundhog Day. I would love boring at this point (but also want to be clear that I am not complaining, as some are sick or risking their lives- or fighting to save their business or other sick people).

Never have I worked so hard with so little to show for it as in March- the worst month I've lived through in my 33 year investing career (not looking for sympathy- just telling you that March- and thus Q1- was a horrific market). And yes, I lived through very bad investment markets including the market crash of '87 at the start of my career, the dot-com bubble collapse, 9/11, and the financial crisis around 2008. Coming into the year, for the most part, our portfolios were positioned for a good economy with moderate economic growth and roughly all-time lows in the unemployment rate- while still having the benefit of very low interest rates. Yet in a period of about a month the world completely changed. We went from a Goldilocks economy (not too hot to raise interest rates or inflation, and not too cold) to the worst economy since the Great Depression. The market went from peak to trough in just 33 days, losing 34% in that time, experiencing the fastest bear market ever (bear market is defined as a 20% drop from the peak).

And that 34% is misleadingly GOOD! The average stock was down much more than that. The 34% is the S&P 500, which is roughly the 500 largest stocks on a size (market value) basis. This means that the biggest stocks make up a disproportionate amount of the index. Four stocks: Amazon, Alphabet (Google), Apple, and Microsoft are the largest and they currently make up 16% of the S&P 500 index. They "only" fell 25% in that decline. That means the others fell much more than 34%. There is an equal weighted S&P 500 index and that index plunged 39% peak to trough. And that is the largest stocks; the average stock including mid and small-cap stocks has done much worse in this bear market.

To put some numbers behind this and other reasons that March and Q1 were so awful, the S&P 500 fell 20% in Q1. That was the BEST asset class of all the major stock indices we monitor. Large value stocks fell 27%. The average stock in the S&P 500 (meaning equal-weighted) sank over 30%! The small-cap index dropped 31%; the average stock in the S&P small-cap index plunged 44%! All together in the U.S., the average stock, as measured by the S&P 1500, was down 38%! There was similar carnage in international investments. The standard large-cap market weighted index was down over 22%, worse than the S&P 500. The emerging markets index declined 24%. The international small-cap index plunged 28%. We are not aware of any equal weighted indices for these markets but it appears they had the same phenomenon as here in the US: the average stock fared notably worse than the standard market weighted indices.

And what made these investment markets so tough to manage through, was the fact that nearly all bonds that weren't US government bonds (or its agencies), fell during this time, particularly in March when there was little place to hide (and when even some treasury bonds fell). We saw the average investment grade corporate bond and muni bond funds fall double digits during the worst of the decline- with many bond indices having the odd twist of falling more than the Dow or S&P 500. Although there was some recovery by the end of the month, most bond indices/funds had notable falls in March. The municipal bond index declined 4%, the high yield municipal bond index (still mostly investment grade bonds) dropped 7%, the corporate bond index also fell 7%, the high yield bond index and leveraged loan index both sank 13%, and the emerging market bond index (which is over half investment grade government bonds!) plunged 14%. And the hybrid type securities of preferred stock and convertible bonds (hybrid because they typically are considered to have risk between stocks and bonds) both declined as much or more than the S&P 500, down 12% and 14%, respectively. There was little place to hide.

And lastly on asset class returns is a brief discussion on value versus growth stocks. As most of you know now, we tend to favor value stocks and funds. This means we favor companies that trade at lower prices than average relative to their earnings, assets, cash flow, and dividends. Historically, these types of stocks have outperformed growth stocks, the latter of which trade at higher prices relative to the items above due to higher expected growth. But often these growth stocks can't meet the overhyped expectations of future growth and thus lag the market. Although we factor in growth prospects, we pay close to attention to what price we pay for that growth. For about the last decade, and especially the last five years, value has lagged growth and thus the market averages, to our detriment. The current market reminds us of the dot com bubble or the Nifty Fifty (for those who can recall back to the '70s). The stocks perceived as the best growth companies continued to massively outperform in Q1, growing their valuation multiples to the sky. Two examples of this are Amazon and Netflix, trading at P/E ratios of 87 and 92, respectively, while the market P/E is just 20. On the other hand you have many value stocks that trade at p/e's of 3 to 5, such as say Citigroup. These multiples suggest there is a big risk that they go bankrupt, which for most of these companies is not the case. The P/E of the overall value index is just 13. The market (S&P 500) trades at a roughly 50% premium to the value index. The growth index P/E is 24, an

85% premium to the value index. We haven't seen this kind of disparity since the height of the dot com bubble. Following that peak, value stocks massively outperformed both the market and growth stocks and thus we believe we are well positioned going forward.

As for the portfolios and the current downturn, some might ask why we did not do more to protect the portfolios as the trouble surfaced- and of course we do feel we should have done better. We did take steps around month-end after the markets recovered some to take down risk as a 15 to 20% decline in the S&P 500 this year seemed to be too little given the risks. But as we have discussed, we are long-term investors and over the long-run stocks go up and provide much better returns than cash/money market funds. Should we have acted sooner? Yes, in retrospect, but here are some facts to think about as markets moved drastically as the news evolved.

From the Wall Street Journal on April 4th: "The speed of the spread and the depth of the impact caught corporate leaders off guard." And also in same article: "Just never seen anything, remotely, like how fast it turned," said Scott Kirby, the president of United Airlines.

Keep in mind that THE FIRST KNOWN US DEATH FROM COVID 19 CAME ON THE LAST DAY OF FEBRUARY. The market (S&P 500) was already down 13% from its peak at that point. As an FYI, SARS was considered a global epidemic in 2003 emanating in China, killing 800 people and roughly knocking the US market down 13% top to bottom. On 2/28/20 the following statement came from Robert Redfield, director of the Centers for Disease Control and Prevention. "We need to get on with our normal lives." Two days later Mayor DeBlasio of NYC said, "Go on with your lives and get out on the town despite Coronavirus."

As of March 11th stores and restaurants were still open, and no lockdowns were in place. That night, the NBA had its first case and they suspended their season. The COVID19 deaths on each of March 11th and March 12th were 6 in all of the US! On March 12th the market had already moved down 26.7% from its peak in late February, lower than where it stood at month-end or today. So if we put in our order to sell a stock index fund once we heard the NBA suspended their season and the nation's death toll that day was all of 6, we would have had worse returns than standing firm. The first state lockdown came in California on March20th; the market finished the month UP 12% from that day's close!

ECONOMIC AND MARKET OUTLOOK

As you know from our previous emails we have been following the virus quite closely as have the financial markets. While the markets turned down in late February, the ugly economic statistics are just starting to roll in.

The most recently released unemployment data along with the current economic shutdown of the country will guarantee a recession in 2020 with an estimated annual decline of 2.7% in the country's GDP.

This recession, unlike all of those in the last 100 years, is due to a medical issue, not an economic one. However, the loss from the medically necessitated shutdown of the economy will result in major economic impacts.

In our 2019 Q1 outlook last year, we looked at periods of volatility and stock market downturns both when accompanied by and not accompanied by recessions. This market downturn will most certainly be accompanied by a recession. Looking back to 1975, we have seen similar situations of stock market downturns and high volatility when accompanied by recessions a total of seven times. The average decline of the seven periods is 33.4% and the time to recover to the previous high was 3.3 years. It is certainly possible that the average for the past 45 years would also be applicable here. If so, we would have already seen the worst of the downturn, although given a decent recovery already, we could certainly head back to the lows of March 23rd. And we would be looking at a period of 3.3 years to recover again to the all-time high of 3386.

Average, Better Than or Worse Than?

In mid-March, most of the economy in the US that depends on social interaction closed their doors (or had business mostly evaporate) – restaurants , bars, hotels, travel, airlines, schools and conventions to name a few. The damage to these portions of the economy is about as much as can be inflicted. You can see the damage reflected in the various economic data that is current since mid-March – specifically job losses and unemployment, both of which have skyrocketed. These economic indicators will become simplify horrific in the coming weeks as the indicators reflect the full shutdown conditions that exist today. For the airlines, restaurants, hotels, etc., it is not going to get much worse because these portions of the economy are nearly shut down and the damage is done. For these sectors, and for the economy as a whole, the question is how long is it going to last.

If the magic wand could just put it all back together tomorrow, the damage to the US economy would be noticeable, but people would go about their business, a few credit card bills would not be paid, a few more divorces would be processed but the impact would be dissipated fairly quickly.

Unfortunately, the economic shutdown is not going to end tomorrow and when it ends is a medical question, not an economic one. The economic damage will be dependent on the duration of the shutdown. As it continues, more restaurants will not make rent payments, landlords will default on loans, hotel workers will be unable to make their mortgage payments or tax payments, etc. and the longer the outage lasts, the worse it gets.

There are two sources of information about how long the major wave of the infection will last. Data from China and South Korea show that once the needed containment measures are in place, the wave of infections will peak. We have implemented these measures in this country. We have also markedly ramped up testing and are now achieving the 150,000 people tested per day that was discussed in the last update on the virus. However, we are still on the upside of the infection wave. Once we get to the crest, data from China and South Korea indicate it will take 30 days to get the virus down to a manageable level and another 30 days to start to get the economy back to work. Just how long it will take to get the full economy running again is unclear, but it will come back in phases and not all at the same time.

This back-to-work process is happening today in China. The Covid-19 peak there happened at the end of January. Starting thirty days later, around the first of March, the economy began to reopen. Most of the workforce there has now returned to their jobs, but restaurants, retail stores and malls are not yet freely open to the public. The traffic is back on the streets, but discretionary trips and outdoor activities continue to be discouraged. So, it has been 60 days after the peak, for China's economy to restart to a modest degree. The shutdown there is projected to take 5% out of the 2020 GDP in that country and major parts of the service economy are not back yet to full speed.

A similar timetable has happened in South Korea. Remember, however, that the economies in China and in South Korea are different from that in the US. Both are much more manufacturing centered than here where the economy is much more service oriented and services will be harder to resume. The lockdown measures were also stricter in both countries and South Korea, in particular has implemented a stringent contact tracing program that is basically lacking here although late last week, we did see Governor Baker of Massachusetts initiate a contact tracing task force in conjunction with Partners Health which is one of the large hospital networks centered in Boston. The Massachusetts caseworker team will field 1,000 caseworkers. It is a start, but will prove to be a bit insufficient to cover over 10,000 people who have tested positive in the state as of April 1st.

Caseworkers in Massachusetts not withstanding, let us assume that a 60-day timetable after the peak would be reasonable to begin restarting our economy. In this country, we have yet to reach the peak, but the testing program has indeed ramped up considerably. At the beginning of March we were testing 100 people a day. Now, we are testing 150,000 a day – quite a ramp-up in 30 days. The 150,000 per day would seem to be a number that is in the ballpark of what we should be testing, however, our percent positive statistic at 20% indicates roughly four negative tests to one positive one. That ratio in South Korea is thirty to one. Until the negative to positive ratio grows, we are being too restrictive on conditions for making a test. Restrictions on tests will not allow us to catch all of the positive cases. That ratio should be at least ten negative tests to one positive one, not the current 4 to 1. However, we expect the positive to negative test ratio to start to improve as more people get tests. What information we see in the press about people "not being able to get tests" is several days old and we have only ramped up to the 150,000 tests as of April 3rd. The more timely headlines are now complaining about masks, gowns, and other protective equipment.

When Do We Expect The Peak?

Bill Gates has commissioned the University of Washington to build a model of the Covid-19 outbreak. You can find the study here: https://covid19.healthdata.org/projections. This is the best study we have seen. It indicates a peak in the number of deaths to be on April 16th. The April 16th date is earlier than many other projections.

The University of Washington model is continually revised and updated as new data is received. Since its release last week, several revisions have been made. The death toll has been revised downward, the date of the peak has moved earlier by a couple of days and the length of the tail has shortened. Their total death count is now just a bit over 80,000 whereas last week, the mean projection was over 100,000.

We are also very encouraged by the developments that Gilead Sciences has made on its Remdesivir medication. This is a hospital administered, IV process that takes several days. At this point, it has a known mechanism of destruction of the virus and a good track record of its "compassionate use". Gilead has geared up production and now has on hand a sufficient quantity to treat 140,000 patients. Gilead's Phase 3 trial should be complete in a week or two and assuming it is a success, Remdesivir could dramatically reduce the number of deaths.

Back to Work

With a peak in mid-April, we expect the US economy to start coming back together in May, beginning with the country's health-care system. Somewhere around May 1st, the demand on hospital resources for Covid-19 patients will be down to manageable levels. The seasonal demand for hospital resources for regular seasonal flu patients will have also declined markedly. Manufacturers of specialized medical equipment needed for Covid 19 patients will be able to meet not only the current needs but also to begin to build emergency stockpiles and to start supplying the rest of the world.

It will take the health-care system a few weeks to switch from its complete Covid-19 focus back to its normal operations. When the health-care system is operating in a normal manner, the rest of the country can begin to open up. The process will need to be phased in with careful monitoring of the number of Covid-19 infections and the need for hospitalization. If contact tracing systems are in place along with sufficient testing resources, further virus outbreaks can be maintained at levels not overtaxing to the health-care portion of the economy.

Distribution, construction and manufacturing can be brought back as these are all controlled environments for workers. It is interesting to note that through the Covid-19 crisis, single-family residential homebuilding will come back relatively fast- assuming demand remains fairly stable. This is very much in contrast to previous economic recessions when housing usually sees a dramatic decline and a multi-year process to rebuild.

Portions of society that are dependent on large groups of people will be the last to come back. This includes restaurants, bars, sporting events, conventions, etc. It is possible that these sectors of the economy will not be back into full operation before a widespread vaccine is available, which will not be until well into 2021.

Economic Projections

All of the economic data for the next three months will simply be horrific. The unemployment rate will peak no lower than 15% by the summer, the highest level since the Great Depression. The country's GDP will see the largest contraction in modern history with a projected decline of over 5% by the end of June compared to the same period last year. This 5% decline in US GDP will match a similar 5% reduction in growth that China will experience.

It is very probable that we will see price deflation in the second and third quarters in spite of the fiscal stimulus packages put together in Washington. These packages, however, when coupled with an economic restart in June will keep the country from continuing to spiral downwards like happened in 1929. Overall GDP for 2020 will be down a bit over 2.7% from the 2019 levels. By the end of 2020, we expect to be back to a growth mode and successive quarters will be better than the previous ones.

In spite of the improvements in 2021, the overall GDP for 2021 will be higher than for 2020, but less than that achieved in 2019.

We were very pleased to see the prospects for an increase in oil prices. West Texas Intermediate was priced at $63 per barrel in January of this year. That price declined to $20 by the end of March and has since climbed back to $27. It appears there is a good chance for a reduction in supply in an effort to keep the price of oil from further declines. A higher price for oil is important in helping to quell the overall price deflation that we will see this summer for the first time in our lifetimes in spite of all the efforts of the Federal Reserve to promote a small inflation factor. And the higher oil price will help prevent widespread bankruptcies in the oil sector that could then damage banks lending there.

The S&P 500 closed on April 7 at 2659 – an increase of 19% over its low of 2237 on March 23. That represents a substantial run-up from the bottom. Our view of the country's medical health is a bit better than the average, however, we believe it will be a substantial period of time for the market to get back to its February highs. The average period of time for recovery after high volatility coupled with recessions is 3.3 years as noted in the opening section. It could take that long again. Getting the economy back to its full capability will require a vaccine for the coronavirus. A large-scale vaccine will not likely be available this year, so don't expect to be able to do everything that you were used to doing and we will need to be particularly cautious as we head back into the flu season late in the fall as flu patients can put a relatively heavy load on the country's hospital system.

We will also see continued very high levels of volatility from the stock market, particularly over the next two months as the horrific economic statistics for the country are realized. However, we do believe we are about to turn the corner on the path of the coronavirus.

Conclusion

It has been a difficult time with investments as well as with the entire human experience. We did not foresee when we were early in the first quarter, the extent of the damage that will be caused and it will take some time to climb out of the hole that the virus has caused. There will, no doubt, be some negative days as the dire economic news hits the headlines. And we certainly could re-test the March low again in the next few months. But with massive government stimulus around the world we don't see overall declines ahead like we saw in the financial crisis. And we have confidence that looking out a couple of years, the market will be higher at that time than it is now.