Global Economic Shock

A look back and look ahead as the world unfurls and rebuilds

The first quarter of 2020 will go down in history books for many reasons. Not only did the longest bull market in history come to an end but the Coronavirus pandemic surprisingly crippled the global healthcare system and financial markets. It contributed to the quickest move into bear market territory for equities in history, drove Treasury yields to frightening low levels, led to a collapse in commodity prices, created liquidity challenges in bonds not see since the Great Recession and forced global economic activity to standstill.

As we try to navigate through this exogenous shock to the world and advise our clients in these highly uncertain times there are a few key things to take into consideration. First, the U.S. economy entered this self-inflicted economic lockdown on solid footing with banks well capitalized and corporate and household balance sheets robust. Second, unfortunately, because data is released on a lag, be prepared for headlines to get worse before they get better. Third, as we wait for a return to normalcy, we cannot ignore the unprecedented and swift actions taken by the Federal Government and Federal Reserve to bridge the gap until we can safely return to normal life. Fourth, the biological response to this virus may go down in history books as one of the largest globally coordinated humanitarian efforts in history. The amount of money, resources and human intelligence that is being spent around the world to accelerate treatments and a vaccine is going to help us put this crisis in the rear-view mirror quicker than some fear. Lastly, regardless of the speed and the magnitude of which the economy reopens, it will reopen! The American spirit is strong and resilient and eager to get back to work and rebuild the economy.

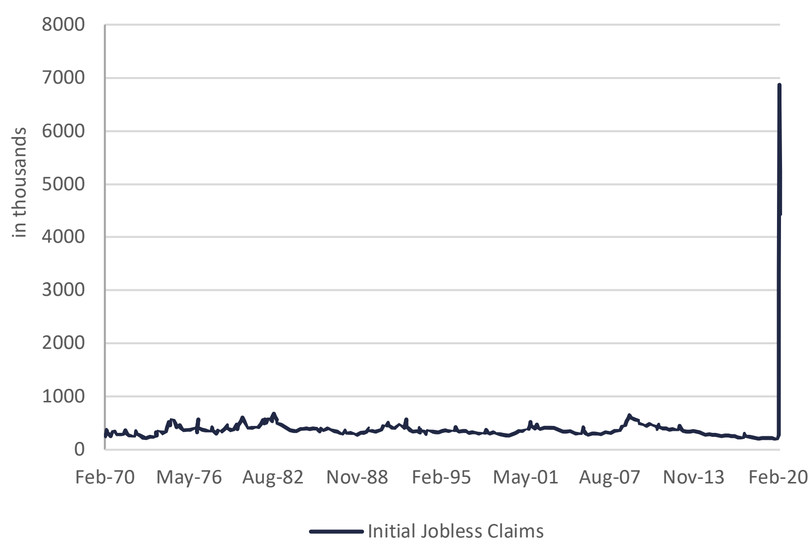
We empathize with how difficult the recent few weeks/months have been for all our clients, their families and their businesses. These are truly unchartered times and below we want to offer our perspective on the U.S. economy and the asset classes. It is important to remember that often in the depths of fear, attractive opportunities arise, especially when looking at long-term asset allocation.

U.S. Economy – From Strong to Forced Economic Shutdown

To understand how quickly the economic outlook has changed it is important to remember what the economy looked like just before COVID-19. Americans were enjoying the best labor market since the late 1960s, cheering the positive progress made on a more than two-year trade war between the U.S. and China, small businesses were seeing record high confidence and global manufacturing was finally rising into expansion territory. In an instant, the Coronavirus turned the global economy upside down. The U.S. labor market has collapsed and in just five short weeks the U.S. has lost all the job creation (and then some) that we have enjoyed over the past decade **(chart 1),** manufacturing has halted, housing activity has ceased, and consumer spending has resorted to necessities only. When you take a booming economy and force it to shut down, it is not surprising that the data will break some of even the worst economic data seen in economic history.

Chart 1: The U.S. Economy Has Lost a Decade Worth of Jobs

Footnotes: Data as of April 18, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



It is also important to put the current crisis in perspective. Below we highlight the extraordinary and swift measures taken by the Government, we will discuss the response to the virus and note the better than expected health data that may be getting lost in the face of fear. We will also look internationally to try to offer a timeline for our recovery. Lastly, we highlight the rapid improvement from the biological, political and health aspect of the pandemic that will dictate the speed and magnitude at which the economy can reopen

- **Federal Government and Federal Reserve expedited unprecedented support:** The speed at which the Federal government has approved more than $2.5 trillion to aid the U.S. economy (and more likely to come) is unprecedented. It took Congress more than 550 days to approve nearly $2 trillion of stimulus in the 2007-2009 Great Recession. It took this Congress only 75 days to agree on more than $2 trillion in support as a response to the Coronavirus. **(Chart 2).** Remember most of the 2007-2009 aid was to shore up bank balance sheets, the current aid is direct (in cash in some instances) to the public and small businesses. In addition, the Federal Reserve has reduced interest rates near zero and expanded their balance sheet to over $6 trillion by purchasing assets that were unthinkable in the last credit crisis (e.g. municipals, high yield bonds). **(Chart 3).** These coordinated actions have offered much needed monetary support to American families and small businesses but also thwarted the risk of an economic crisis turning into a banking crisis.

Chart 2: Speed and Magnitude of Fiscal Stimulus Unprecedented

Footnotes: Data is as of April 16, 2020. Onset of Financial Crisis begins in August 2007, onset of COVID-19 crisis begins with first Chinese death January 11, 2020.
Source: Cornerstone Research Partners, Verdence Capital Advisors.

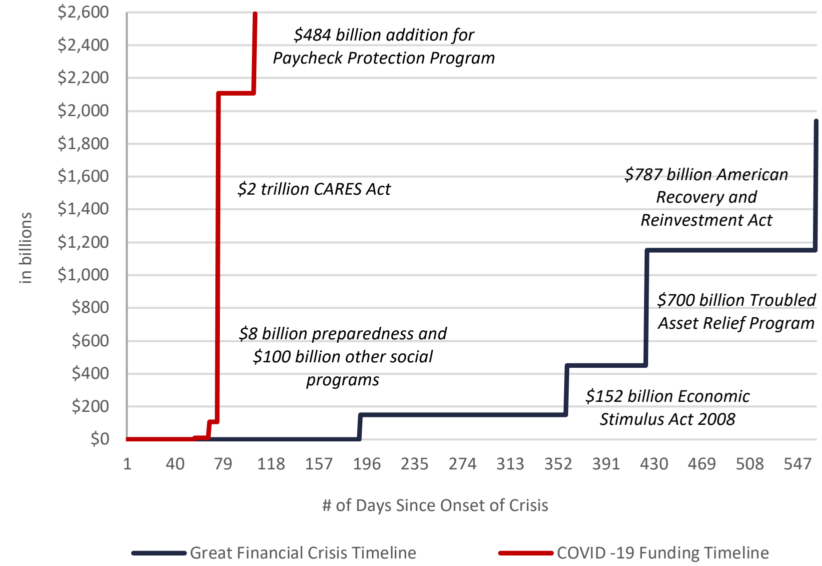
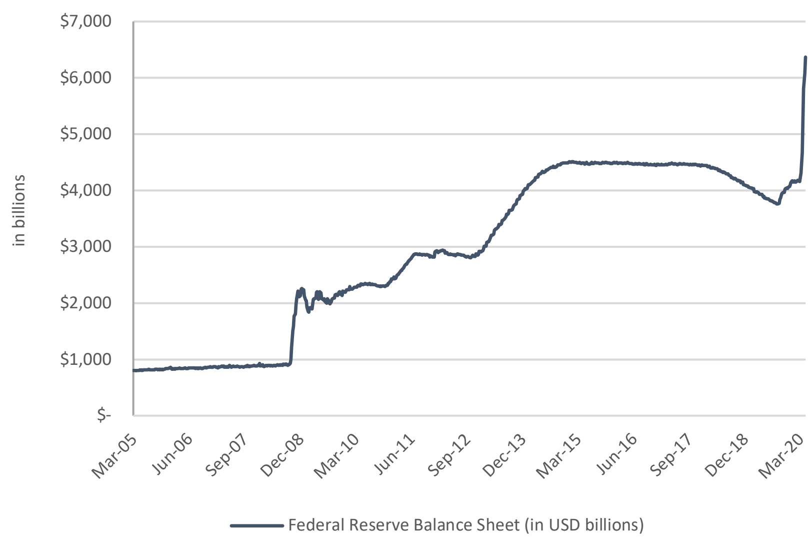


Chart 3: Federal Reserve Support Unprecedented

Footnotes: Data as of April 20, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Positive gets lost in the face of fear:** It is hard to ignore how quickly the positive biological and medical developments are emerging. Not only have American manufacturing companies turned automotive plants into medical supply plants basically overnight, but the death rate is a fraction of what was projected as recently as late March, ICU bed usage is declining and lower than thought, and the number of hospitalizations is coming down. Testing has surpassed over 4 million tests and only ~20% of those tested are positive. There are public-private partnerships to accelerate therapeutics and the WHO has more than 70 candidates working on a vaccine. We acknowledge the importance of widespread testing and the U.S. is using the Defense Production Act to accelerate materials to prepare states to be able to satisfy phase one of the criteria to reopen.

- **Looking internationally for a timeline for recovery:** If there is a silver lining in the Coronavirus pandemic it is that we were not the first country hit by the virus so we have many international allies that we can look to for guidance and trends. For example, the trend in New York has followed very tight to the trend in Italy. **(Chart 4).** Italy saw its deaths peak March 27. So far, the U.S. has seen their deaths peak April 15th, so if the pattern persists, we are ~three weeks behind Italy. Italy has recently begun to loosen restrictions by region. We can also look to China and what we have seen is that after a massive drop in manufacturing at the depths of the virus (February) we have seen a "v-shaped" recovery in manufacturing as it has moved back into expansion territory. **(Chart 5).**

Chart 4: Looking Internationally for Cues on Timeline Recovery

Footnotes: Data as of April 16, 2020.

Source: Worldometer, nyc.gov, Verdence Capital Advisors.

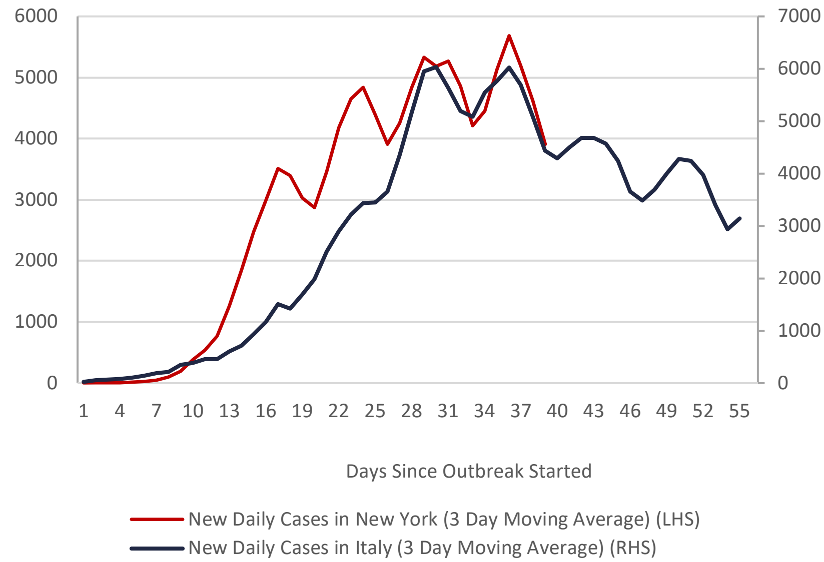
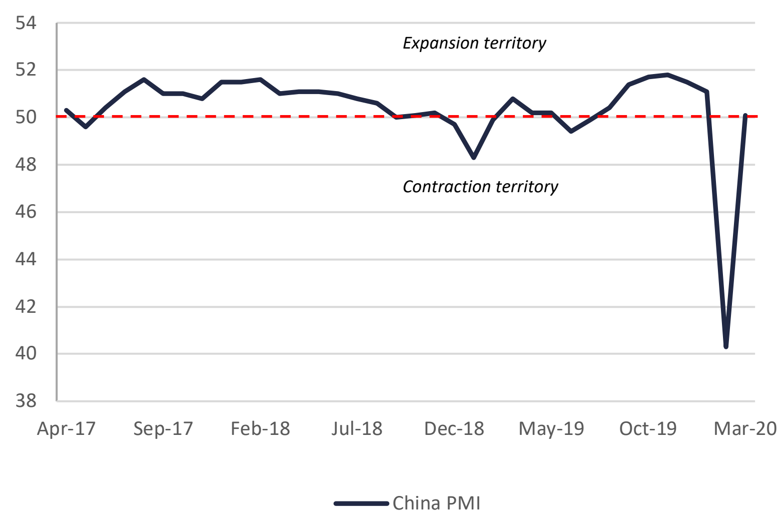


Chart 5: Can we Follow China's "V-Shaped" Recovery?

Footnotes: Data as of March, 2020.

Source: Bloomberg Finance LP, Verdence Capital Advisors.



Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

Past performance is not indicative of future returns

Discover true independence.

- **The economy needs to open. Speed dependent on rate of change in other factors:** The U.S. economy and American workers are not structured to withstand being forced from working. You can see that by the growing number of protests from Americans wanting to get back to work. Small businesses make up 40% of all U.S. economic activity and account for ~50% of the jobs in this country. This portion of the economy needs to get back to work before the actual virus becomes more dangerous than reopening the economy. At this point, testing and the continuation of a reduction in cases is crucial for states to start opening gradually.

Unfortunately, the chance of a sharp economic recovery ("V-Shaped" recovery) is less likely at this time and social distancing and capacity limitations for the coming months will make the economic recovery more gradual. Part of the gradual return to normal will also be dependent on the human emotion. The elderly and those with preexisting conditions may be slower to return. However, if therapeutic developments and/or a vaccine accelerate quicker, this base case scenario may prove to be too pessimistic.

Fixed Income: Where to Find Value in the Fed's Bond Market?

The fear of widespread defaults in the bond market increased every day that the economy remained closed and as the Federal government negotiated a stimulus package in 1Q20. There was indiscriminate selling across nearly all fixed income sectors which caused disorder and liquidity challenges. As a result, the extra yield investors demanded to own corporate debt, specifically high yield, widened to levels not seen since the Great Recession. **(Chart 6).** It took a massive quantitative easing (QE) program from the Fed, in which they committed to buying a wide variety of fixed income products, to restore order to the fixed income markets.

With interest rates in the Treasury market near record lows we believe there is more interest rate risk in holding traditional Treasuries because they will likely move higher as the economy reopens. In addition, history can offer guidance as to where your fixed income portfolio should be positioned after the Fed starts increasing its balance sheet to normalize credit conditions. As seen in **chart 7**, in the prior Fed quantitative easing programs during the Great Recession, Treasuries lagged the other fixed income sectors. At this time, we recommend short to intermediate maturing bonds given the historically low level of interest rates. However, with the recent dislocation in the market, select credit sectors are offering attractive risk/reward potential. We would prefer leveraged loans and investment grade corporate bonds at this time. While high yield is offering investors more attractive return potential than has been seen in prior months, there is still a significant amount of default risk from energy companies in the high yield sector and we see more credit downgrades are likely until the economy reopens. Therefore, volatility is likely to persist and could present additional buying opportunities.

Chart 6: Extra Yield Investors Demand for Credit Risk Surges

Footnotes: Data as of April 20, 2020.
Source: Federal Reserve, Verdence Capital Advisors.

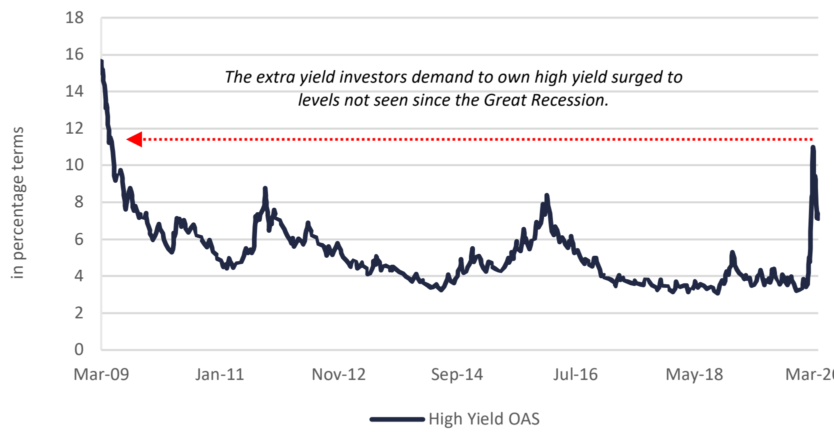
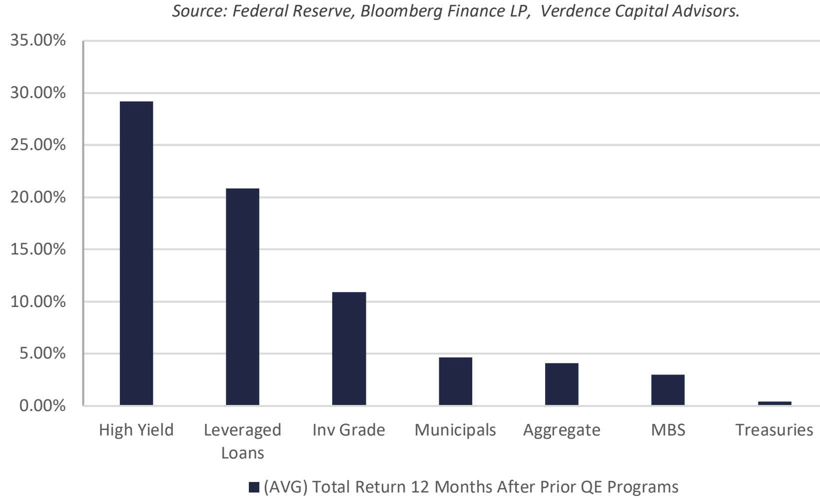


Chart 7: Return of Fixed Income Assets After "QE"

Footnotes: All QE programs and return 12 months later are average returns.
Programs ran from 2008 – 2013.
Source: Federal Reserve, Bloomberg Finance LP, Verdence Capital Advisors.



Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

Past performance is not indicative of future returns

Discover true independence.

Global Equities: Fall from Grace – How to Find Value in Self Inflicted Bear Market

Global equity investors had plenty to celebrate at the beginning of 1Q20. The trade war uncertainty was clearing, interest rates were lower, Brexit was behind us and global manufacturing was finally back in expansion territory. In fact, the S&P 500 made 13 fresh record highs by mid-February, earnings for 2020 were expected to jump ~10% and bullish sentiment on equities was at the highest level since October 2018. As the Coronavirus quickly spread throughout the world, that euphoria was replaced by shock and awe as the S&P 500 experienced its fastest move into bear market territory in U.S. history **(Chart 8).** It took the S&P 500 only 22 trading days to drop more than 20%. The second quickest drop was seen in the Great Depression. In addition, equity volatility surged to a record high **(Chart 9)** and resulted in the triggering of stock market exchange circuit breakers (i.e. a temporary halt in trading).

As seen in history, equity prices tend to overshoot and even undershoot depending on the circumstances, so it is not surprising that equities fell from their record high as quickly as they did. Especially when fundamentals changed in an instant and earnings became anyone's guess. However, what we also saw was when news of stimulus grew louder, the S&P 500 posted its second best 10-day rally on record. In the near term, while we try to gauge the length of the economic lockdown and its ultimate impact on growth and earnings, it is clear we may not be out of the woods yet. In fact, after such rapid turnarounds history proves that the near-term rallies are less consistent. However, if you gradually add exposure on weakness, this proves beneficial to investors' long term (12 months) **(Table 1).** Some other reasons we favor global equities for investors with a 12-18-month time horizon include:

Chart 8: Fastest Fall from Grace in U.S. History

Footnotes: Chart shows the number of days that it takes the S&P 500 to drop into bear market territory. Source: Bloomberg Finance LP, Verdence Capital Advisors.

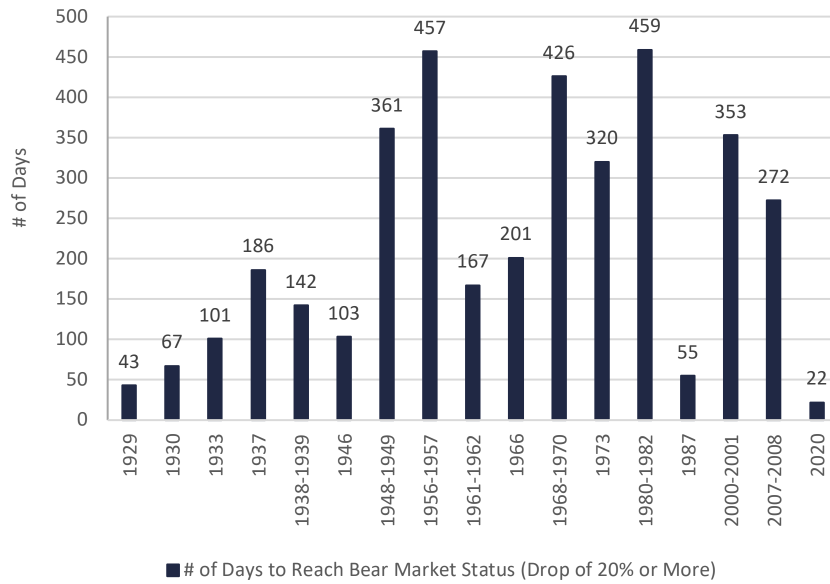
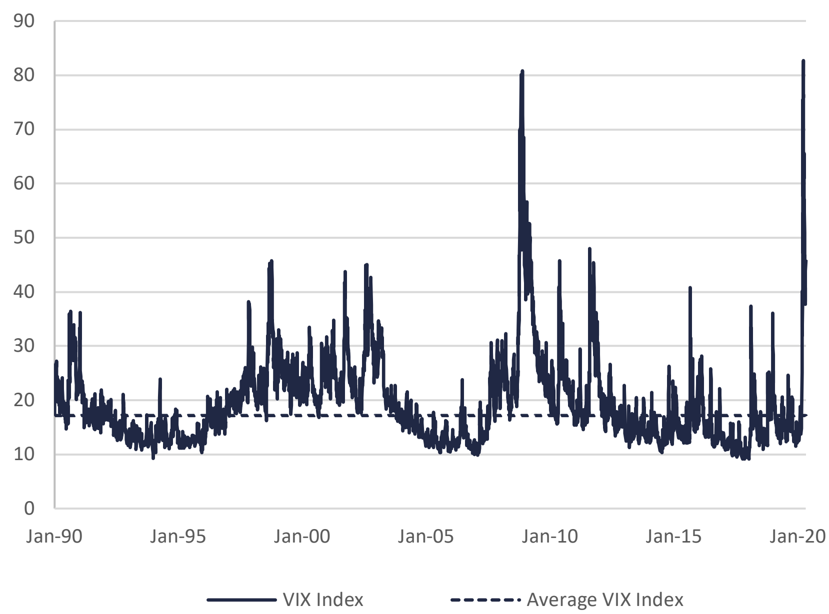


Chart 9: Volatility Hits a Record High

Footnotes: Data as of April 20, 2020
Source: Bloomberg Finance LP, Verdence Capital Advisors.



Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com

Past performance is not indicative of future returns

Discover true independence.

- **Central bank supportive:** Through cutting interest rates to basically zero and expanding their balance sheet to a record high, the Fed is encouraging investors to take on risk. Historically, expansion in the balance sheet has been correlated with a rise in price to earnings multiples for stocks. In addition, on a relative basis 80% of the S&P 500 companies are paying a better dividend yield than the five-year Treasury. This is a global phenomenon with 100% of the Eurostoxx 600 and Nikkei 225 paying a higher dividend yield than their five year sovereign bond yield**.**

- **Event versus recession driven bear market:** There have been many pullbacks and bear markets in the history of equity investing. They can be classified as a decline in asset prices because of an impending economic recession or a decline due to an exogenous event. We isolated the worst pullbacks in the S&P 500 that were not driven by an impending recession but because of an event. What history suggests is that the returns from the trough in these scenarios prove to be attractive over the next one-year time frame **(Table 2)**.

- **Cash on the sidelines:** The equity bear market in 1Q20 saw indiscriminate selling across all the equity sectors and nearly all asset classes. As a result, there is over $4.5 trillion of money sitting in money market mutual funds, the highest amount on record. As a percentage of the equity market (Wilshire 5000) it reached the highest level since December 2012. Using history as a guide the last time it reached these high levels as a percentage of the equity market, equities rallied over 30% one year later.

Table 1: Fast Recoveries Can be Choppy to Start

Footnotes: Data is best 10-day S&P 500 rallies since 1950.
Source: Strategas Research Partners, Bloomberg Finance LP, Verdence Capital Advisors.

	10D % Change	+1 Mo	+ 3 Mo	+6 Mo	+12 Mo
3/23/2009	21.6%	3.3%	9.5%	29.8%	40.9%
12/5/2008	16.4%	6.7%	-14.3%	7.2%	25.6%
10/18/1974	15.9%	-0.5%	-0.7%	19.4%	23.5%
8/26/1982	15.7%	4.0%	13.2%	23.8%	38.6%
10/23/2002	15.4%	2.0%	-4.2%	1.7%	16.7%
8/19/2002	13.9%	-8.1%	-5.7%	-10.5%	4.2%
11/2/1987	13.7%	-9.3%	-1.4%	2.3%	8.4%
4/19/2001	13.6%	2.8%	-5.0%	-13.1%	-12.2%
10/18/1982	12.5%	0.2%	6.2%	16.1%	24.1%
10/22/1998	12.4%	6.9%	15.3%	25.8%	19.6%
Average	**15.1%**	**0.8%**	**1.3%**	**10.3%**	**18.9%**

Table 2: Event Driven Bear Markets Typically are Good Buying Opportunities

Footnotes: Top 15 S&P 500 declines outside of a recession since 1950.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

Cause	Year	S&P 500 Decline	S&P 500 Return 12 Mos Later
Policy Error, Computerized Trading	1987	-33.5%	22.8%
Flash Crash 1962	1961-1962	-28.0%	32.7%
Policy Error	1966	-22.2%	33.2%
Policy Error	2018	-19.8%	37.1%
Policy Error	1976-1978	-19.4%	12.6%
European Debt Crisis, U.S. Debt Downgrade	2011	-19.4%	32.0%
Fall of Long Term Capital Management	1998	-19.2%	39.2%
Global Growth Fears	2010	-16.0%	30.8%
Valuation Correction	1983-1984	-14.4%	29.6%
Korean War	1950	-14.0%	31.4%
	Average	**-20.6%**	**30.1%**

Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com
Past performance is not indicative of future returns

Discover true independence.

Where to position in global equities: The declines year to date in global equities has been relatively similar in magnitude. However, the U.S. has been able to modestly outperform its global international counterparts. As a result, valuations still favor international equities over U.S. equities. Within the U.S., value looks historically cheap compared to growth as the bulk of the event shock has impacted both the energy and financial sectors. However, growth has also weakened during the slowdown and with exposure in sectors such as healthcare, pharmaceuticals, technology and biotechnology we have gradually been adding exposure to growth stocks as they stand to benefit from the fight against the virus.

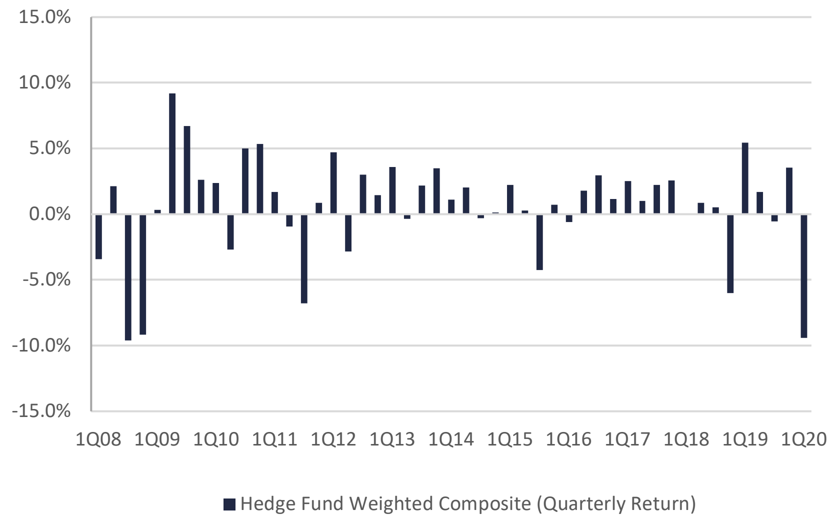
Alternatives: When Everything is Correlated, Even Alternatives Do Not Catch a Break

When all asset classes become correlated (or move in the same direction) in an event driven shock like what we saw in 1Q20, there tends to be little place to protect your portfolio except in cash. Even uncorrelated assets like hedge funds and commodities disappointed investors. Hedge funds struggled as they were positioned for an improvement in fundamentals and they were not positioned for such a rapid shift in fundamentals (i.e. worldwide pandemic). Hedge funds saw their worst quarterly decline since the Great Recession **(Chart 10)** and commodities experienced their worst quarterly decline since 4Q08. Not only did demand drop off for commodities as the world went into lockdown but they were also dragged lower by the deterioration in oil prices after a nasty price war between OPEC and Russia. Despite disappointing performance in 1Q, alternatives deserve a spot in portfolios to gain income, diversify and still offer good long-term risk/adjusted returns. We recommend the following in alternatives:

Chart 10: Hedge Fund Post Worst Performance Since Great Recession

Footnotes: Data as of 1Q20.

Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Hedge funds to recover:** Hedge funds rarely see back to back quarterly declines, especially after such a significant drop like what was seen in 1Q20 (-9.4%). Going back to 1990, if the Hedge Fund Weighted Composite declined more than 5% in a single quarter there has only been one scenario where the Index drops another 5% in the next quarter. That was the Great Recession. Excluding the Great Recession, hedge funds tend to rally, on average, 4.7% in the quarter after the Index experiences a drop of more than 5%.
- **Commodities deserve a bounce but oil lower for longer:** As soon as the global economy begins to reopen, commodities in general should be offered some relief. However, crude oil may remain lower for longer as the supply glut has deepened. Therefore, we would recommend an underweight exposure to commodities.
- **Private equity potential strengthens:** We continue to favor private equity in these highly volatile times. Not only are investors in private equity not burdened with the daily volatility in the public market but the dislocations across many sectors has created opportunities for private equity. The private equity market came into this crisis with a significant amount of dry powder waiting for attractive opportunities. The dislocations in credit have offered attractive opportunities for private credit managers. In addition, the low level of interest rates favors private real estate.

The Bottom Line:

We realize this is a challenging and concerning period in our history for all our clients. The human element to this crisis is unnerving and a crisis like this can define a decade. As we navigate through this unchartered territory, it is important to remain flexible and disciplined and not let emotion and/or fear cloud your long-term investing goals. While the term "bear market" can be discerning, it is important to remember that regardless of the catalyst, at least one bear market should be expected in the span of a long-term investment cycle. In fact, the most recent bull market that investors had become accustomed to was an anomaly by lasting more than 10 years. What is successful in an overall investment cycle is that you do not try to time market bottoms, look for value and make adjustments that fit with your long-term risk objectives. We will continue to be disciplined and look for value in areas of the market that offer good long-term risk/reward potential. When you look back in history some of the best investments came during bear markets. It takes courage and the appropriate due diligence to find these areas.

Leo J. Kelly III
Chief Executive Officer, Partner
lkelly@verdence.com

Megan Horneman
Director of Portfolio Strategy
mhorneman@verdence.com