

TRAPHAGEN

CPAs & WEALTH ADVISORS

Q1 2020 Market Synopsis

Economic & Market Update/Comments:

As all of you know, our nation and the entire world are going through one of the most difficult periods in recent memory. The COVID19 pandemic has impacted essentially every person in the world. Some have been touched directly by the virus itself, some have lost their jobs in a recent layoff, others have shuttered their small businesses, while many have significantly altered their educational, social, and work schedules in accordance with social distancing measures. For our clients dealing with any of these issues, the impact the virus has had on the financial markets has probably faded into the background.

Family, friends, health, and your personal wellbeing are what most should be focused on during this time, but it is our job to solely focus on your investment portfolios and making sure your financial/retirement plans remain on track. We, as always, continue to be laser focused on these points, regardless of circumstance.

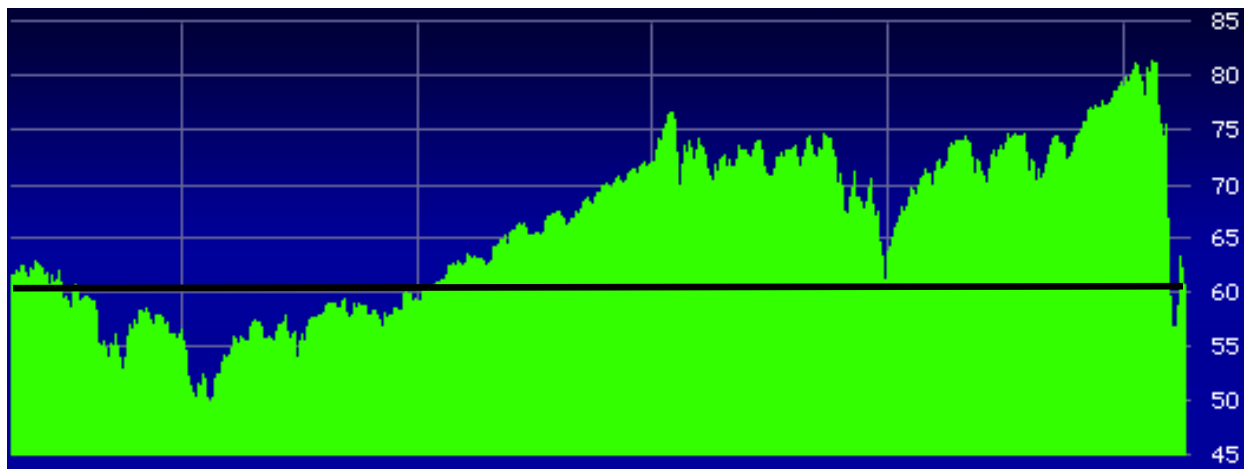
2020 YTD Asset Class Returns (3/31/2020)	
US Mid/Long Treasury Bonds	+ 10.2%
Private Real Estate (TIPWX)	+ 1.3%
Insurance Linked Securities (XILSX/SRRIX)	+ 1.2%
Alternative Lending (LENDX)	+ 0.7%
Municipal (Tax Free) Bonds	- 0.4%
Investment Grade Bonds	- 3.1%
Private Farmland/Infrastructure/Timber (VCRRX)	- 5.8%
High Yield Bonds	- 11.7%
US Large Cap Stocks	- 19.6%
Foreign Developed Stock Market	- 23.5%
Emerging Stock Market	- 24.5%
US Public Real Estate	- 25.2%
US Small Cap Stocks	- 32.7%
Nat Gas/Oil Pipeline Companies	- 40.6%

The COVID19 pandemic is historic in many ways, and its impacts did not spare the financial markets from the record books. The SP500 had its worst Q1 in history with a return of just under - 20%. In addition to this, we also observed the quickest ever move down from all-time highs to an official bear market and then to the -30% mark in mid-March. The SP500 ranged from an all-time high of 3391 on February 10th to a recent low of 2191 just a little over a month later on March 23rd. At these lows the SP500 was down 35% from mid-February with volatility levels only observed in the financial crisis.

All other risk assets participated in the downdraft as well, with high yield bonds the best performer down ‘only’ 11.7% while natural gas/oil infrastructure companies the worst, down 40%.

Bonds had a mixed quarter despite a historic drop in interest rates and the lowest interest rate levels observed in our nation’s history. The 10-year Treasury yield dropped from 1.9% on January 1st to its current level of 0.6%. This caused Treasuries to be the best performing financial asset with a return of just over + 10% within the quarter. Other bonds (corporate and municipals) were down between 1% and 12%.

Below: *Chart of the Global Stock Market (ACWI) since April 2015. Over 5 years of price gains were eliminated in 4 weeks, which represents the quickest decline of this magnitude in history.*



COVID19 Related Factors Which Impacted Markets in Q1 2020:

- **Oil Price Decline:** With the combination of significant demand destruction caused by global shutdowns and an ill-timed oil price war between Saudi Arabia and Russia, oil collapsed from near \$60 per barrel in early February to its current level of \$24 per barrel. Oil has not been this cheap since 1999! Recently the globe consumed about 98M barrels per day, with new supply roughly balanced at the same level. With the global shutdown, demand

could decrease to around 70M barrels per day with increasing supply from Saudi Arabia. This price decline, although a positive for most consumers with lower prices at the pump, is obviously a significant negative for energy, industrial, logistics, and many financial companies and their employees. There is some hope that a new deal can be reached within the coming days that would significantly cut supply and stabilize prices. In addition, many US companies are voluntarily cutting production and future capital spending.

- **Government Mandated Business Shutdowns:** Across large portions of the US and the entire world, government mandated shutdowns of ‘non-essential’ businesses and shelter in place orders have caused an interruption of business activity not seen since the great depression. This has had an unprecedented impact on all aspects of the economy from the smallest businesses to the largest; restaurants, travel/tour companies, cruise lines, airlines, malls, and physical entertainment venues have been particularly hard hit.
- **Stress Within the Bond Market:** Usually bonds are among the most stable financial assets, with lower risk and predictable cash flows. However, starting in mid-March we saw a combination of two factors which caused bonds to fall in price to a degree only matched by the financial crisis. The market simply stopped working correctly because of forced selling and a liquidity crunch causing significant ‘dislocations’ in pricing of up to 15% from actual value. We were able to take advantage of this for almost all clients. In addition, the difference between rates on corporate/municipal bonds and Treasury bonds widened by up to 6%. This caused a swift downward price adjustment across these sectors. Over the past couple weeks, we have seen a stabilization on both these fronts.
- **Unprecedented FED Policy:** Because of extreme market and economic conditions the FED reduced short term rates from 1.25% to near 0% over the span of a few weeks. In addition to this, they have made the historic decision to support credit markets by purchasing unlimited amounts of Treasury bonds along with unspecified amounts of municipal, mortgage, and investment grade corporate bonds. Although this is by no means a cure, it was critical to stabilize markets that are needed for the economy to function properly. The FED (along with other central banks) is prepared to do ‘whatever it takes for as long as it takes’ to continue to support markets.

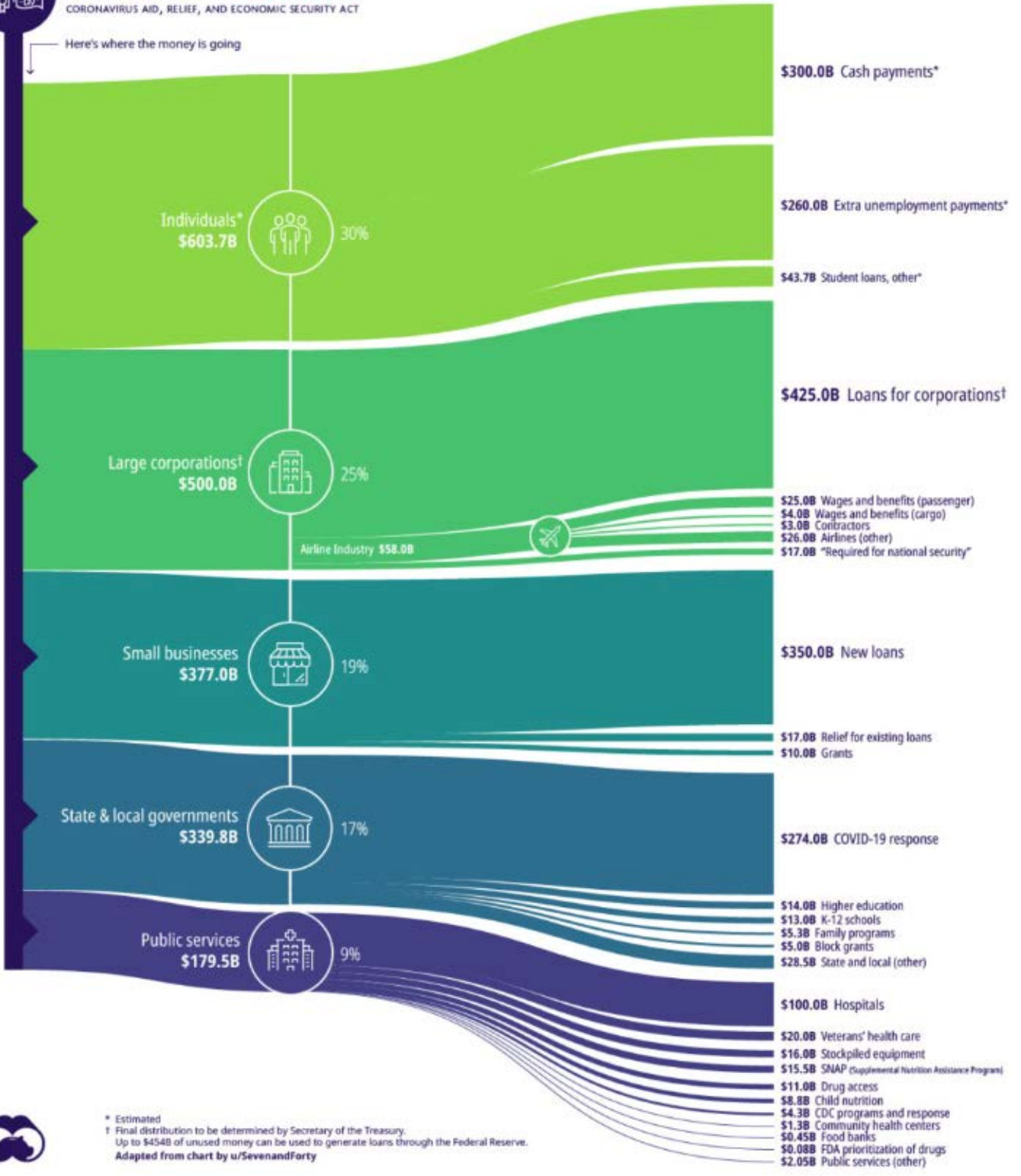
- **Unprecedented Fiscal Policy:** Although the government usually moves extremely slowly (especially when republicans and democrats have to work together) the immense \$2 trillion ‘CARE Act’ passed with impressive speed. This is the largest such bill implemented in history. One can spend days going through the details of the program, on the following page is a helpful graphical overview of how the money within the bill will be utilized.



CARES Act \$2 trillion

CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT

Here's where the money is going



* Estimated
 † Final distribution to be determined by Secretary of the Treasury.
 Up to \$454B of unused money can be used to generate loans through the Federal Reserve.
 Adapted from chart by u/SevenandForty

Traphagen 2020 Portfolio Changes & Performance Update

Below you will find a summary of major changes we made to portfolios in January/early February (*[before the Pandemic](#)*):

- **Decrease in High Yield & Investment Grade Debt:** We saw record low credit spreads for corporate credit vs. Treasuries coming into the year, which means corporate credit was very expensive. We sold a significant amount of our credit exposure at profit and transferred the proceeds into Treasuries.
- **Increase in Treasury Bonds:** The increase in allocation to Treasuries proved extremely beneficial as the pandemic grew in severity. These securities were the best performing in the entire portfolio to this point as interest rates came down to record levels with returns in the + 5% to + 10% range.
- **Decrease in US Large Cap Equity:** With somewhat elevated valuations in the US Stock market and our own Traphagen Recession Index (TRI) indicating an elevated chance of a recession throughout most of last year we decided to trim between 2% and 4% out of US large stocks. Of course, we did not know about the pandemic, but between elevated valuations and some yellow flags on the economy this trim in allocation also proved beneficial.
- **Increase in US Mid Cap Equity:** US middle sized companies looked significantly cheaper to us than their large cap counterparts, so we did move about 2% of portfolios into the mid cap space. Largely due to the COVID19 crisis and liquidity issues with smaller companies, this sector has underperformed this year.

Major changes we made to portfolios in March (*[opportunistic investments/trades made during the Pandemic](#)*):

- **Increase in allocation to large cap technology companies:** After dropping roughly 25% from their recent highs and wiping out about 2 years-worth of gains, we added to our large cap technology exposure for almost all clients. These companies offer some of the best organic growth and healthiest balance sheets in the entire stock market.
- **Increase in allocation to pipeline/storage companies:** This group of companies have limited cash flow exposure to the price of oil and natural gas; but in times of panic can be dragged down with the rest of the energy sector. After dropping around 35%, the dividend yield increased to around 8% on this group with cash flows that should be resilient during 2020. In fact, several insiders/executives

within this sector have been purchasing very large amounts of their own stock on the open market throughout March.

- **Allocation to Public Real Estate:** For the first time in years publicly traded real estate is attractive in terms of valuations and yield. Our clients have been invested in private real estate which is up more than 1% this year and has proved to be immensely important in the preservation of capital. Our new allocation to public real estate is well diversified and has the largest allocation to data centers, cell phone towers, distribution/warehouse (ecommerce related), and multi-family residential. There is some retail/commercial, but this is more limited.
- **Allocation to Utility Companies:** These are traditionally very defensive companies that because of forced selling in March and possibly some near-term headwinds, dropped by about 30%. After this drop, we purchased a well-diversified fund of utility companies across the country with a dividend yield of around 4%.
- **Trim of longer-term Treasury Bonds/TIPS:** After the surge in prices and sharp drop in rates to around 0.5% on the 10 Year Treasury, we see little long term opportunity in holding these bonds. Of course, for some conservative investors we will continue to hold some Treasuries for safety, but for others we either eliminated exposure entirely or trimmed by 50%.
- **Increase in allocation to High Yield Corporate/Muni Bonds:** With the dislocation in the bond markets we took advantage of this very rare opportunity caused by the difference between market price and actual value and purchased these bonds below true value. Since purchase, the dislocation has largely closed with increases in prices of 5% to 10% for our clients.

2020 Market and Economic Outlook Update:

For the first time since May 2009, we are almost certainly entering a US (and global) recession. We do feel this will be one the deepest recessions we have seen over the past 50 years, with some very tough economic and earnings numbers coming out over the next 2-4 months. As we compose this, the unemployment rate just increased to 4.4%, which is the highest level seen since mid-2017, and it is poised to move significantly higher over the coming month or two. Traphagen does think unemployment will spike into the 15%+ range. This will surpass the levels seen in 2008/2009, but we also think the spike will be relatively short lived. Once shutdowns are lifted we expect a quicker return to more normal levels versus other recent slowdowns.

Below: Unemployment rates since 2007 in the USA



It should be no surprise to investors that over the next 3-6 months earnings revisions for 2020 will be significantly reduced, but that is to be expected, and the stock market (probably sooner rather than later) will look past depressed 2020 earnings and begin focusing on more normalized earnings levels in 2021.

There is no question April and May will be very difficult months in many aspects, but it is our continued belief once into the summer months things will begin to improve significantly on both the health and economic fronts. No one knows the exact time major league baseball will open or you can enjoy a dinner with friends and family at your favorite Italian restaurant, but it will happen. And once we get to that point, the stock market and economy will be well on its way to recovery and the warm summer sun will shine on our country yet again.

As communicated earlier, we encourage all our clients to take care of themselves, their health, family, friends, and neighbors during this stressful time. The markets, economy, and life will come back as it always does. All the while we will remain focused on taking advantage of unique opportunities generated by this downturn while preserving your hard earned capital.

Best regards,

Your Traphagen Investment Team