COVID-19 MARKET THOUGHTS AND PORTFOLIO STRATEGY

March 17th, 2020

On Saturday, March 7th the markets were simultaneously impacted by two separate black swans style events. First, the Covid-19 virus, also commonly known as the corona virus, quickly began spreading in small towns in Northern Italy resulting in the Province of Lombardy to issue a lockdown order. This is when it became clear that the virus had moved outside of Asia and was likely to become a global pandemic, which is what ultimately happened. Secondly, Saudi Arabia and Russia kicked off an oil price war that caused oil prices and related securities to fall by 50%.

These events represented real shocks to the economy, markets, and what many of us considered normal everyday activities. In the following sections we will discuss (1) how these events impacted the Dynamic Income Allocation Portfolio or DIAP, (2) the actions we took in response to these events, (3) how we are thinking about the markets and portfolio going forward, and (4) the fallout from the oil price war.

But before we begin, we believe it is important to acknowledge the reality of our present situation and that this event will represent a material negative short-term shock to the economy and markets. However, we must not lose sight of the fact that the Covid-19 Pandemic will subside and the economy and country will rebound and move forward. Medical experts and our government leaders have the tools to alleviate this virus, but it will take some tough medicine in the short-term. There are better times ahead.

Impact to DIAP:

The primary objective of the DIAP is to produce less volatile returns than the market. We achieve this by realizing a greater portion of market returns during positive return periods, and a lesser percentage of the downside during negative periods of returns. Up until these recent events the DIAP had achieved this objective.

Unfortunately, the portfolio did not provide the downside protection we would have expected given the recent negative shock to the market. The primary culprit was our large position in Master Limited Partnerships (MLP's) that was materially impacted by the one-two punch of the Corona Virus and oil price shock. MLP's fell two times faster than the market and overwhelmed the benefits of the remainder of the DIAP portfolio.

Between the beginning of February to March 9th, the DIAP fell 15.7% and the S&P 500 declined 14.6%. This is the first downside period in the history of the portfolio that we matched the negative market return. Approximately 9.8% of the decline in the DIAP was due to our position in MLP's that quickly collapsed 41% in the last two days of this period as both black swans materialized. The remainder of the portfolio declined just 7.8%, in line with how we would expect the portfolio to respond to the 15% drop in the stock market.

Changes we made to the DIAP:

It became clear to us over the weekend of March 7th that markets would likely face material downside at he opens on Monday and that MLP's would fall significantly further. We made the decision to rebalance the portfolio on Monday, March 9th to reflect this reality.

We made the decision that negative markets would most likely persist and that we were possibly facing a new bear market. Thus we took the portfolio to what we call "Max Protect". This means lowering our equity exposure to only 30%, which is the lowest allowable allocation to equities per the DIAP's mandate requiring a diversified portfolio. We also sought safer assets including Mortgage Backed-Securities and Long-Duration Corporate Bonds. Below is a table showing the new allocation of the DIAP as of March 8th.

Ticker	Asset Class	Allocation	Yield
VYM	US Dividend ETF	10%	3.3%
EFAV	Int'l Low Volatility	10%	6.1%
VPU	Utilities	10%	3.1%
PFF	Prefered Stock	20%	6.4%
MBB	Mortgage Bonds	10%	2.6%
VCIT	Intemediate Corp	15%	2.9%
VCLT	Long Corp Bonds	20%	3.7%
HYG	High Yield Corporate	5%	6.1%
		100%	4.3%

As you can see, the yield is 4.3% as of today, March 17th. This still represents a substantial premium to US treasuries which are currently yielding 0.80%.

The sharp unexpected hit to MLP's also exposed an error in our portfolio construction process that we have now corrected to ensure the DIAP doesn't produce similar unacceptable results moving forward. We have made the following two changes to portfolio construction rules.

First, no subsector of an asset class will be allowed to have an allocation above 10%. Examples of subsectors include: Utilities, REITs, MLP's, Mortgage Bonds, High-Yield Bonds, and Emerging Market Securities. If this rule had been in place, MLP's would have been constrained to a 10% portfolio weight instead of 25%. If this had been the case in February, then the portfolio would have declined just 10% during the February 1 through March 8 time period.

Second, larger asset classes that encompass a variety of sub-sectors in their respective category will not be allowed to exceed a 20% allocation. For example, larger asset classes include US equities, International Equities, Preferred Shares, and Investment-Grade Corporate Bonds of various durations. These assets are less vulnerable to idiosyncratic risk than the subsector asset classes mentioned above.

We are confident these changes will ensure we don't experience a similar downside capture in the future.

<u>What we expect from Markets over the next several months:</u>

Before we get to our market views, we believe we need to address the economic situation and the uncertainty of the current environment.

The Covid-19 Virus is still not well understood. We do not know if it spreads through airborne methods or the exact length of time to become symptomatic. There is also confusion over death rates, and too little understanding of the importance of hospitalization rates.

What we do know is that it is extremely contagious, almost doubling the number of confirmed cases each day. We also know that if left unchecked it will overwhelm the hospital system. But most importantly it appears the spread can be contained through strong quarantine and social distancing measures.

Unfortunately, the remedy to Covid-19 will take a very heavy economic toll in the short-term. As I write this Europe and the United States have likely begun a new recession. Closing large portions of the economy is unavoidable. In the past few weeks, we have seen places like China, Korea, Japan, Singapore, and even some of the first towns quarantined in Italy arrest the spread of the virus through aggressive quarantines and social distancing. Hopefully, quarantines will work elsewhere and to date appears to be the best response to halting the pandemic. In the past day, it appears that Europe and the US has reached this conclusion and is in the process of initiating quarantines as well.

The economic cost to quarantines is extraordinary. We agree with those economists calling Q2 US GDP growth to decline between -5% to -12%. The good news is that this decline should be short-lived, and we should expect a sharp rebound in the second half of the year due to the massive stimulus effort that will be necessary to quickly re-ignite the economy before a prolonged recession causes other unintended side-affects that are currently unmeasurable. Politicians are already debating a wide variety of stimulus measures including bailouts for the hard-hit travel industry, SBA loans for small companies, paid sick leave, and even direct payments to every US household. These would all be appropriate as the impact we will take from quarantines will require a stiff dose of stimulus.

Forecasting short-term market moves is a fool's errand. However, we think it is entirely reasonable to break up the current market reaction to Covid-19 into a series of phases with some probable guidepost along the way. In our view we believe this is the best way to understand what may happen, and how investors and portfolio managers should consider acting as these phases unfold.

These three phases are Panic, Acceptance, and Recovery.

<u>The Panic Phase</u>

We are currently in the Panic phase, although as we write this analysis, we may be already transitioning to the next phase.

In the Panic phase, equities fall significantly with large spikes in the VIX index, which is sometimes called the fear gauge as it measures investors future expected stock-price volatility. The VIX hit an all-time high of 82.7 yesterday (it is normally 15-20 by comparison). During the Panic phase, all assets even safe havens fall in concert. Safe-haven assets such as US Treasuries rates spike and gold falls as investors desperate for cash sell even the most liquid assets.

Below are charts of the10-Year Treasury Yield and Gold for the year to date. As you can see, from mid-February until March 8th as investors fled into safe-haven investments like Gold and US treasuries (remember, declining yields means bond prices are going up). As the market realized it was being hit by 2 black swans the morning of 3/8, both gold and Treasuries reversed course as investors were forced to sell these assets to raise cash. We generally only see this during the sharp drop offs during the panic phase of a new bear market. We saw similar market reactions in 2008 and 1987.

<u>Spot Gold Price</u>

10-Year Yield

<u>The Acceptance Phase</u>

We call the second phase the acceptance phase. All panics eventually come to an end as the initial uncertainty and realization that investors are miss-positioned comes to an end. However, it is important to stress that the stock market can continue to decline during this phase. In fact, there is usually one final negative stock price move as the markets finally bottom. Backward looking economic data released during this phase is generally very negative. This is not an "all-clear" to buy stocks. However, it is a good place to start increasing exposure to equities if investors have extra cash and a longer time horizon.

The hallmarks of this phase is a bottoming or improvement in haven assets like gold and Treasuries. The federal reserve has begun acting aggressively. Equity volatility starts falling from its highs and we no longer see large record down S&P days.   In particular, we will see gold prices rise substantially in anticipation of large government stimulus and lower interest rates. (see last chart of 2008 crisis below)

Specific to our current situation with the Covid-19 virus, we think this phase will be initiated by the realization that we need to shut down the economy through quarantine to stop the virus. In particular, I am looking for large US cities to initiate self-quarantines. Yesterday, San Francisco did just that. Also, at this point every school and sporting event has been shut down for the next several weeks. The uncertainty of "how will we respond" diminishes as citizens and governments take action. We believe the markets are entering the Acceptance phase now.

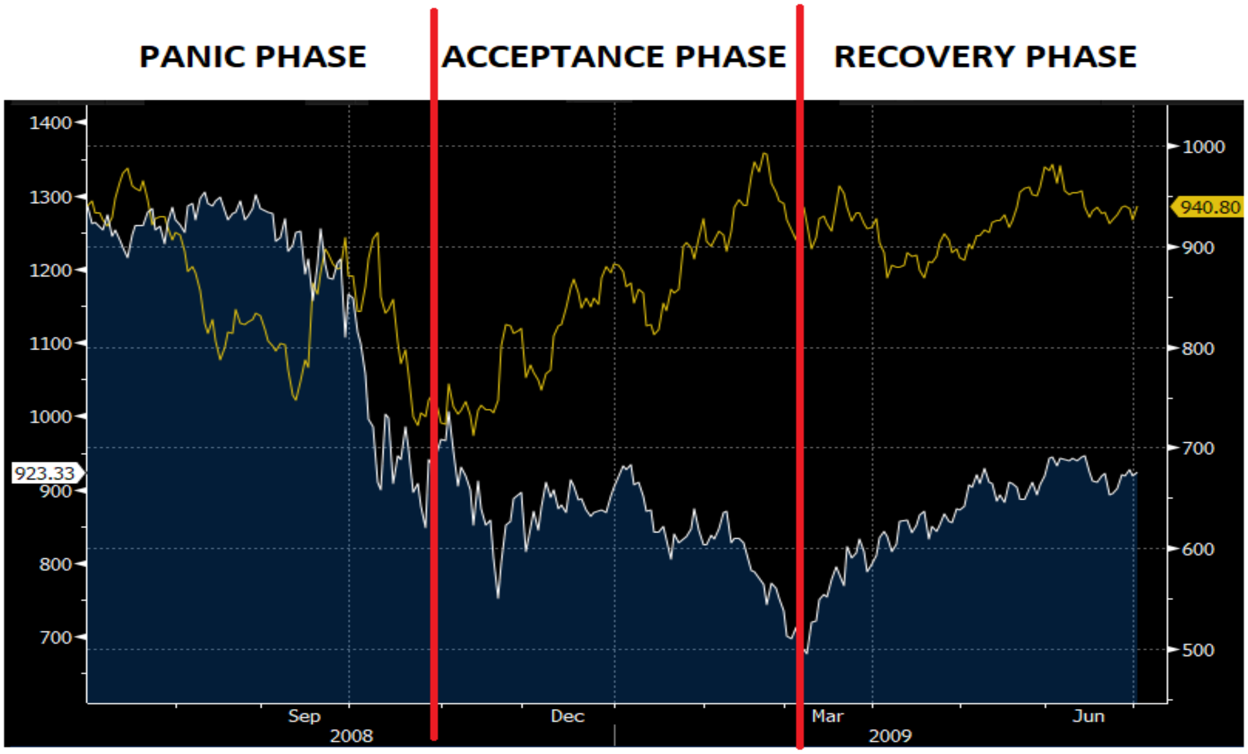
The Recovery Phase

The final phase is Recovery. This is the phase where markets finally bottom and investors should tilt aggressively towards stocks and high-yield bonds, while selling haven assets and trimming investment grade bonds. Assets have typically been largely oversold at this point and represent compelling long-term opportunities, particularly in light of lower interested rates needed to spur an economic rebound.

This Recovery phase begins as Investors start anticipating better times ahead and much of the uncertainty surrounding the cause of the panic has been diminished. Economist will start talking of green shoots, and forward looking economic data will inflect positively. Equities will start outperforming other safe-haven assets.

As it relates to the Corona Virus, we expect the trigger of the recovery will be driven by the lifting of quarantines in the US and Europe. New Covid-19 cases will begin slowing markedly. Airline travel will be allowed on a limited basis, and sports league will announce the resumption of activities. China for example, has moved into this phase and their stock markets have actually turned higher.

It might be helpful to overlay these three phases on the 2008 Financial Crises so we can better understand the market action associated with each phase. In the chart below the white line is the S&P 500 (left axis) and the yellow line is the gold price (right axis). The Panic phase began on September 1st and ran until November 1st (2 Months). You can see both gold prices and stock prices fell sharply in this phase. The Acceptance phase than ran until early March (5 Months). Gold prices started to perform well and the pace of decline in stocks moderated. Finally, the Recovery phase began and stocks bottomed and performed very strongly moving forward as a new bull market begins.



Oil market fundamentals have materially changed:

As we have discussed in the past, oil market fundamentals were steadily improving prior to the demand hit from decreasing global travel due to the Corona Virus. Our initial view was that the virus would be constrained to Asia and that their hit to oil demand would be short-lived and mostly offset by declining Libyan production and a halt to Chinese imports of Iranian crude on the black market.

OPEC was also planning on cutting production further to deal with the Corona virus hit to oil demand. Unfortunately, Russia refused to corporate and the Saudis responded by flooding the market with crude oil and lowering the official Aramco price by an extra $8 per barrel to all of Russia's oil customers. In hindsight, expecting an autocratic dictator and reckless prince to make rational decisions was a mistake.

The result is an oil market that could be oversupplied by anywhere from 8 to 20 million barrels per day. This is an astounding number that will quickly result in inventories piling up to their limits. The Trump Administration has offered buying oil for the Strategic Petroleum Reserve (SPR), but the spare capacity is just 72 million barrels. If there were no limits to how quickly we could physically fill the SPR (there is) it would theoretically just absorb a few days of oversupply at best. US inventories will likely hit their max of between 500-550 million barrels by May. It isn't inconceivable that we could run out of places to put all this oil.

It will take years to unwind this elevated inventory level and oil prices will remain under pressure during that time period. When the Saudis pulled a similar stunt in 2014 and oil inventories went to 500 million barrels, the oil price didn't bottom for another year and a half. If there is an abundance of oil in storage, supply and demand don't matter.

The wishful thinking would be that the Saudis and Russians will come to their senses and stop this foolish price war. However, this is unlikely to happen as it has quickly become abundantly clear that the US shale patch doesn't make money at $50 and at $20-$30 they will go bankrupt. Now the Saudis and Russians smell blood and they have shifted their focus to destroying the US shale industry. Do not be surprised if half of the US shale industry goes bankrupt. Wall Street is in no mood to invest more money in energy and bail this industry out.

US production will ultimately decline as the industry doesn't have the cash to keep drilling. It will take a boatload of money and significantly higher prices to reverse this decline. I suspect it could be 2-3 years away. In the mean-time Energy and MLP's are un-investable.

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We hope you find our views helpful. Please reach out to us if you have any questions.

Warm regards,

Tyler Hardt, CFA

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