Equity Market Summary

U.S. Equity Markets	Feb 19-Mar 31	Q1
S&P 500	-23.5%	-19.6%
Russell 1000 Growth	-21.4%	-14.1%
Russell 1000 Value	-27.6%	-26.7%
Russell 2000	-31.7%	-30.6%
Russell 2000 Growth	-29.4%	-25.8%
Russell 2000 Value	-34.3%	-35.7%

Top/Bottom Sectors	Feb 19-Mar 31	Q1
Technology	-21.4%	-11.9%
Health Care	-14.5%	-12.7%
Cons. Staples	-14.9%	-12.7%
Industrials	-29.2%	-26.9%
Financials	-32.7%	-32.0%
Energy	-45.5%	-50.3%

Non-US Equity Markets (in USD)	Feb 19-Mar 31	Q1
MSCI AC World Ex U.S.	-23.4%	-23.9%
MSCI EAFE (Developed)	-22.7%	-23.4%
MSCI Emerging Markets	-23.1%	-23.9%
MSCI China	-12.2%	-10.2%
MSCI Japan	-13.3%	-16.8%
MSCI Italy	-31.6%	-29.2%

Non-US Regions (in USD)	Feb 19-Mar 31	Q1
Developed Americas	-28.8%	-26.5%
Developed Asia	-18.3%	-20.3%
Developed Europe	-24.4%	-24.2%
Emerging Americas	-43.0%	-45.6%
Emerging Asia	-18.3%	-18.1%
Emerging EMEA	-30.9%	-33.5%

Economic and Market Commentary

Summary:

The human costs of COVID-19 continue to mount at a staggering pace and the global healthcare system is being stressed in ways that even the most aggressive of plans would have likely not forecast. A 2020 recession is now a foregone conclusion and the monetary and fiscal response to the crisis has been swift and staggering in its proportion. Because the catalysts for this recession are not like any other, we don't really have historic precedent to model a bottom and recovery. Therefore, predictions that point to a single path with certainty have a high risk of being wrong. Understanding the spectrum of outcomes is more statistically valid, but it only marginally addresses the uncertainty that investors hate. Over the past six weeks investors have endured a 35% peak to trough move in the S&P 500, followed by a sharp 20% rebound. But bottoming is a process and markets may not be done yet. Earnings expectations have been slow to react to what will surely be a strong and synchronized downward trend in earnings. Investing at the bottom of a recession induced bear market is a process requiring a delicate balance between defensive and offensive characteristics. Governments around the globe are acting and acting aggressively to stem the human and economic toll of the crisis. It will be a matter of months not weeks before the global economy begins to stabilize, but financial markets are always forward looking and traditionally markets bottom about four months before the economy. Just when things feel the worst is usually when they are already improving.

Market Review:

Just six weeks ago COVID-19 did not feel like a real threat to the U.S. economy. It was taking place on the other side of the world and creating supply chain issues. It is now very real to everyone in the U.S. and around the world. Not only is it a threat to our collective health, but also to our economy and by extension our livelihood and assets. There is no sugar coating the current situation. But long-term investors would be well advised to readjust their focus back to the long-term. Yes, this too shall pass given time, technology, medical ingenuity, government help, perseverance, etc. A very good question to ask yourself is "will I be glad I own this stock a year or more from now" as opposed to "what is the price of this stock going to do tomorrow".

A 2020 recession is now a foregone conclusion. Not only is most of the world currently operating in some degree of business shutdown, but that followed a lockdown in the Hubei province of China, where many of the parts and products U.S. manufacturers and retailers depend on are produced. The quarter began with what now seems like a trickle of supply chain inconvenience that has turned into a fire hose blast of issues right here in our own backyard. There is debate how long it took for the U.S. administration to take the threat seriously. It probably is not useful for forward looking decisions to spend much time on that. But investors were also slow to react, the U.S. market did not peak until February 19th, well after the threat of spread outside of China. By its March 23rd intra-day nadir, the S&P 500 was 35% lower, in the sharpest selloff in history. It is easy to say in hindsight that we should have seen it coming, just like we should have seen the financial meltdown in 2008 and the dotcom bust in 2000. For investors that were actively thinking about this virus in China it looked similar to the SARS epidemic in 2002 that had a big impact on east Asia but a minor one on the U.S. Policymakers and investors tend to focus on avoiding the troubles of the last economic crisis. But it is all too often that recessions are caused by the 'known unknowns'; those things we know we do not know that are next to impossible to predict. That certainly was the case in this one. There were not many places to hide when the tide went out. Food retail, internet retail, wireless telecom, and internet services were the most resilient sub-industries while anything energy, hospitality, brick and mortar retail, and transport-related companies bore the brunt of investors' wrath. Low beta and large market cap were risk factors that offered the best relative returns but even staples stalwarts like Procter & Gamble, Colgate-Palmolive, and Campbell Soup suffered drawdowns of more than 20% from their highs before they found a bottom. Value factors were some of the most negative for the quarter. Of course, the absolute shutdown of large swaths of the global

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economy means that past sales, earnings or cash flow trends became meaningless almost overnight and the denominator of many valuation metrics became unknowable. It is not a surprise that they were less effective.

The daily count of cases and the economic fallout capture most of the headlines. Some of the hardest hit businesses are in the energy sector due to the double gut punch of plummeting demand plus a price war touched off by Saudi Arabia and Russia. Stock prices of small cap drillers and E&P companies have fallen 75-80% in the quarter. Russia started the price war to attack the U.S. shale business, then the Saudis extended it attempting to bring Russia back into line with OPEC. The resulting drop to ~$20/barrel for the benchmark WTI is -69% below the 12-month high and substantially below production costs for many oil companies. Slowing demand has exacerbated the effect of rising supply to the point where buyers are running out of storage for oil they cannot use. Heavily indebted U.S. shale frackers needing to pump in order to service debt are finding the going rough. The industry is likely to see consolidation of some sort. But a large portion of high yield debt is lent to this industry and if a significant portion were to default it would have ramifications for the banking industry. The energy industry also has generated a substantial portion of recent capital goods investment in the U.S. Highlighting the woes of the oil patch is not intended to diminish the trials of the rest of the economy or to portray a doomsday scenario. The good news is that earnings for energy plus related industrials is only about 7% of S&P 500 aggregate earnings. The potentially not so good news is that energy activity has broader implications in seemingly unrelated sectors. This sector deserves more attention because it just might prove to be the Achilles heel in this recession.

Outlook:

Predicting the containment of COVID-19 and when we can begin the normalization process is difficult at best. Most prognostications that you see on the daily news are opinion based. But each day new data is fed into databases and the data scientists are doing their thing, so some modicum of legitimate conversation is beginning. That modeling is quite sophisticated yet still has plenty of margin of error. One model that has come to our attention predicts daily U.S. deaths will peak in mid-April, but remain in the 1,000s through mid-May, then tail off through June. Remember there is a significant margin of error. Assuming they are close to correct the question becomes at what point can restrictions be loosened and what precautions need to be taken as people begin to interact again. The evolving answers will be integral to answering the question of the timing of a rebound and what shape it will take; a V, U, L, W, etc.

The official Chinese manufacturing PMI collapsed to 35.7 in February, then rebounded to 52 in March (50 is the threshold indicating month-over-month expansion). That is giving some hope for a short sharp U.S. recession. Hope is generally not a sound strategy, but a V shaped recovery certainly is a possibility. But the virus experience in each country is taking a different course seemly driven by containment activities, availability of medical equipment, etc. The equivalent in the U.S. is the ISM manufacturing index which reportedly only dropped in March to 49.1. But the Supplier Delivery sub-index rise to 65, reflecting the recovery of the previous supply chain issues, offset the New Orders drop to 42.2 and Backlog index at 45.9, which are more reflective of the beginning of a recession. However, the U.S. economy is more dependent on the services sector, so watching the ISM non-manufacturing indicator is even more important than usual.

Strategists have begun projecting the depth of the earnings recession despite company analysts' reluctance to revise their earnings estimates until they have better data or guidance. Those top-down numbers are looking at around a 15-25% drop in S&P 500 2020 earnings relative to 2019. Bottom-up analysts' estimates have now begun to fall precipitously, but the aggregation of those estimates only equates to an annual earnings contraction of -2%, at this time. Clearly, there is much more revision to come at the company level. But most of the earnings damage is expected in the first half of the year with varying degrees of recovery in the 3rd and 4th quarters. The healing process for the economy could last well into 2021 so a return to peak earnings will be a mile run instead of a sprint.

Liquidity has been brought into laser sharp focus across all industries as companies struggle with massive shortfalls in revenue. To combat a liquidity crisis the Federal Reserve has gone on a bond buying spree, taking its balance sheet from $4.2 trillion on Feb 26th to over $6 trillion currently. Balance sheets at most financial companies are stronger now than in 2008 and are better positioned to weather this storm. But net interest margins are squeezed in this interest rate environment and trouble loans surely will rise. The sector will not lead us into this recession, but they could be a casualty of other economic issues. While online retailing is further strengthening its competitive position during the crisis, most of the rest of discretionary consumption could be slow to regain momentum in a recovery. This depends on a trade-off between feeling safe both in health and finances with the need to re-engage after weeks in various degrees isolation. But keep in mind that the stock prices for much of this sector already are discounting considerable stress. Department stores, hotels & cruise lines, motorcycles, and casino sub-industries are all down more than -50%. It takes a strong-willed investor to hold onto battered stock but that also means that sometimes the selling pressure exceeds the reality of earnings pressure. Holdings need to be judged on how well current prices reflect the current profit picture and the recovery potential.

Let's not forget that stock prices are a discounting mechanism of future earnings. Yes, this downturn will be very painful for corporate profits. But how much pain is already priced in? It will not be long before investors turn their view to what the post-recession profit picture looks like. That should be a stark contrast to the present. The best question to answer is, "what is a company's earnings profile in the coming economic expansion?" Those that can look past the daily flood of news have a much better chance of recognizing the eventual winners in this cycle.

Have we seen the bottom? The maximum drawdown so far is 35%, which is roughly equivalent to the experience in 1987 and 2002. Are the underlying business fundamentals going to deteriorate beyond those episodes? Is the policy response today going to bring us out of the slump as in the past? While those are difficult ques-

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tions to answer, market bottoms on average are reached four months before the end of the recession. If we are having a short sharp recession, one could postulate, we may have hit the bottom. By definition, a recession ends when economic activity begins to expand again so the sharper the contraction the lower the hurdle is to determine expansion. The average recession runs about 11 months, which would probably mean the bottoming process is not done yet. But this is a mandated recession in response to an unpredictable catalyst. It is difficult to fully understand what that means for its shape and length. But most bear markets end with a process and it is unlikely that process is done yet. Investors should hope for the best but plan for the worst. One thing is for sure, we are apt to see more volatility in the months ahead.

Investing as a significant bear market begins to find its footing to move higher is a tricky exercise. Do you buy the best companies you can find? Or is there a case to be made for buying those that have been sold the most aggressively to catch the recovery. Generally, those are the companies that look the worst right now. They also have the most to gain as the economy recovers. At Smith Group we are applying lessons learned through decades of experience and most specifically from 2008/2009 to continue to invest in businesses that meet our strict investment criteria while minimizing exposure to market risk factors.

Thanks for indulging our economic and market ponderings, and thanks to our clients for the trust you have placed in us in these turbulent times. We are looking forward to the eventual recovery and opportunities for finding growth that surpasses expectations.

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