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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

In our last newsletter, we were optimistic that robust and coordinated central bank easing would translate to an acceleration of global economic growth. Coronavirus was not then part of our everyday vocabulary. But, as the stock market appreciated to record levels, word started to spread about a novel virus in China. Since we had experienced several new viruses in recent years, with few significant consequences, there was no reason to suspect this would be any different. **It soon became apparent the novel coronavirus, COVID-19, is much more contagious than its predecessors.** In Wuhan, the reproduction rate of the virus, at the outset, was 3.86, which means each infected person passes the disease to 3.86 more. Through stringent quarantine, China was able to reduce the reproduction rate to .32, effectively containing the virus.

Although slow to react, policy makers finally realized that, unchecked, the rapid pace of infection would soon overwhelm our healthcare system. To contain the virus, a plan called "flattening the curve" was implemented. Governments, correctly, chose to force a temporary shutdown of most non-essential economic activities. The consequence of this policy is the world is now in the midst of a deep recession, the duration of which will be a function of containing the virus. **The downturn was simultaneously caused by both a massive demand and supply shock.** When households are confined to their homes, they can't spend as much, especially in an environment of risk aversion. Businesses also slash spending in an effort to preserve cash. On the supply side, production has been impaired by workers' inability to get to their jobs, resulting in global supply chain disruptions.

Provided that the number of new infections stabilizes in the next two months, growth should begin to recover in the third quarter. From the perspective of sequential quarterly growth rates, a V-shaped recovery is inevitable, simply because the current rate of negative growth would leave the world with no GDP at all. In considering a recovery, it may be better to think in terms of the level of real GDP. From this perspective, it seems more likely that the recovery will be more U-shaped, since the measures necessary to contain the virus may put lingering pressure on the recovery for the next few years. A third, even worse outcome, although unlikely, can't be ruled out. This could be described as an L-shaped recovery, where containment measures will continue to suppress economic recovery indefinitely. We think this scenario is unlikely for the following reasons. Policy makers will learn how to reduce the economic burden without increasing the loss of life. Currently we are overcompensating; once the infection rate subsides we can ease off from economically onerous measures. **Finally, containment will be eased as more people acquire immunity, either through a medical breakthrough or through what is called "herd immunity".** In the absence of social distancing, and other containment measures, it is estimated that the reproduction rate for covid-19 is between 1.5 and 4. This implies between one third and three quarters of the population would need to be infected and immunized for herd immunity to control subsequent infection. Without social isolation, this would take two to three years, even with increased resources to allow hospitals to service a greater number of patients.

The question arises, can we end up in a world where the economy is so devastated, after the virus is contained, that no jobs are available. This outcome would only arise if there is insufficient demand when the economy reopens. **Cutting interest rates is not the only, or most effective, way for central banks to stimulate their economies; especially with interest rates near zero.** Global economies are facing a cash shortage and recent Federal Reserve Bank actions are addressing this issue. The good news is there is no limit to how many dollars the Federal Reserve can create. While central banks will continue to play an important role in mitigating the crisis, most of the burden will fall on fiscal policy. To get a sense of what is optimal, it is useful to consider, a concept one of our consultants describes as "financial time and economic time". People have financial obligations which they match with income earned. A problem occurs when economic time and financial time deviates in unpredictable ways. That is the case now. Economic time has ground to a halt as businesses close and workers are quarantined at home. But, financial time continues, as financial obligations continue to be due. Part of this deviation was addressed by recent legislation, where the government directly transfers money to households and firms, to allow them to service their financial obligations. **While this doesn't boost GDP, since it doesn't contribute to economic output, it does alleviate hardship and create pent up demand for when businesses reopen.** It has been pointed out, if the funding isn't sufficient, that, "If we end up in a depression, don't blame the virus; blame politicians."

Equity investors are risk averse. They tend to over react to what is unknown and COVID-19 is completely unknown. But just as markets over react to uncertainty, they also dramatically discount economic recovery. The number of new infections seems to have peaked in China and South Korea. All eyes are now on Italy. When the number of new infections peak there, it would signal that other western democracies may be able to control the virus and relax containment measures. This combined with monetary and fiscal easing could support stocks in the near term, even with more bad news ahead. **The anticipation of a rebound in growth and a recovery in corporate profits in the year ahead should be preceded by a robust stock market recovery.**

Fixed Income

The monetary policy response by the Federal Reserve was unprecedented in both its speed and scale as the impact from COVID-19 spread through the market and economy. In its role as a lender of last resort, the Fed made swift decisions to provide unlimited support and to do "whatever it takes" in order to help the U.S. economy survive the shock. The Fed's expansion of its open-ended QE, together with new measures to lend directly to firms blurred the lines of monetary and fiscal policy support to not only provide liquidity to the markets, but to also provide targeted support so that businesses and households can get the credit they need to survive through the crisis. Fed Chairman Jerome Powell's comments called for "Aggressive efforts to be taken across public and private sectors to limit the losses to jobs and incomes and to promote a swift recovery once the disruptions abate". **The central bank will buy bonds "in the amounts needed to support smooth market functioning" in a program which goes far beyond its playbook from the 2008 financial crisis.**

The Fed's plan to provide liquidity to the corporate bond market will be implemented through two new programs. One of them, the Primary Market Corporate Credit Facility, will allow the Fed to buy investment grade corporate bonds for the first time in its history. These measures should help to ease financial conditions in the corporate bond market from the liquidity driven, indiscriminate selling of higher rated, higher quality corporate debt that created a technical dislocation in the fixed income market. Fed officials are also taking measures to support smaller businesses, resurrecting a program from the 2008 financial crisis, the Term Asset-Backed Securities Loan Facility or TALF, for lending to small businesses and households. Further, a new program, the Main Street Business Lending Program, will support lending to small and medium size businesses.

The Fed's decisions to (1) Cut rates to near-zero (2) Increase its liquidity injections to keep the market for short-term loans between banks functioning normally and (3) Establish a series of new programs using the Fed's emergency lending powers were enacted at an unprecedented scale. The Fed's overarching goal is to keep the financial shock, which is sure to be steep but which could prove to be short, from turning into a full-blown financial crisis that interrupts the flow of credit to businesses and households that need it. The question is how long the virus will last and how quickly things will bounce back after.

International Market

Mysterious pneumonia cases with an unknown cause began to surface late last year in Wuhan, a city of 11 million in central China. The cause of the pneumonia was later found to be a new virus – severe acute respiratory syndrome coronavirus 2 (COVID-19). The quickly spreading disease forced the Chinese government to lock down Wuhan and the surrounding regions on January 23rd followed by the shutdown of many other cities within the country. These unprecedented steps resulted in severe consequences for the country's economy but unfortunately did not stop the epidemic from spreading to other continents. **As the number of cases of COVID-19 began to surge outside of China, the World Health Organization (WHO) officially declared the outbreak a pandemic on March 11th. Governments around the world proceeded to lockdown cities with the aim to slow the spread of the disease.**

During this urgent time, no one should take this public health emergency lightly as the pandemic has infected hundreds of thousands of people and the infection rate continues to grow. We would like to urge our readers to do your part and adhere to the government's directive to slow the outbreak and "flatten the curve". The draconian measures placed on citizens across the globe have caused economic activity to stop on a scale never seen before. It is reasonable for many to fear that a recession is unavoidable. **However, for investors who feel the urge to sell and exit the equity market, we recommend putting the current economic environment into perspective before making that irrational decision.**

The last global pandemic the world experienced was the H1N1 (swine flu) outbreak in 2009. The U.S. Centers for Disease Control and Prevention's (CDC) official estimate for global deaths associated with this outbreak was 284,000 of which 80% of those who died were younger than 65. Despite the high cost of human life lost, few could now even recall what the economic consequences were at the time of the 2009 outbreak. In terms of market performance, in large measure due to recovery from the Great Recession, it was one of the better years for equity returns. We certainly hope the final toll on life during the current outbreak will be much less and we would never want to diminish the impact of this disease on society. **But as a financial adviser, it is important to highlight there isn't a strong correlation between the health of the global economy and the health threats to global populations.**

"This time is different due to the numbers being reported" many would say. Amid a crisis, it is only natural for the media to continuously report the extreme, surrounding any situation. For the public to make investment decisions based on these reports would be a costly mistake. With the experience from previous epidemics, we believe this to be the case now. Citing a report from The Guardian, a reputable British daily newspaper, on April 28, 2009, "… the sort of global flu pandemic might eventually cost up to 4.8% of world GDP, more than $3 trillion, assuming that 1% of the world's population would die as a result of the pandemic – some 70 million people." **We are seeing similar reports now; in the latest survey conducted by Statista, the monetary global GDP loss as a result of COVID-19 is forecasted to be $3.5 trillion.**

A sharp decline in output across the world has been the immediate impact from COVID-19 to the global economy. However, this could prove to be transitory as the impact over the longer term is less obvious. It is likely that economies may return to the pre-virus path of GDP, albeit with some lost output in the near term; similar to what we've experienced in the pandemics that plagued the world before. The loss of output in some sectors may be permanently lost, i.e. employees won't commute twice a day over the summer to compensate for not commuting to the office now. **Be that as it may, the impact to individual economies in aggregate is expected to be balanced out by the increased output from various other sectors in response to the event.**

We are not epidemiologists. It is neither our job to estimate how widespread this pandemic will be, nor do we have the expertise to provide an estimate. **However, as terrifying as the COVID-19 pandemic may be, efforts to slow the rate of infection have been proven to work.** China, South Korea, Singapore and Taiwan have demonstrated that widespread availability of COVID-19 testing in combination with social distancing measures to isolate community spread clusters can slow the rate of infection. The results from these countries to combat the disease has been encouraging. **To repeat this success in other countries will take extraordinary levels of coordination and resources from the country's leaders alongside extraordinary levels of trust and cooperation from its citizens.**

If history serves as a guide, event-driven slowing of economic activity usually results in a much shorter time period for economies to regain traction. China's plan to lift the lockdown on Wuhan, the virus epicenter, on April 8th has coincided with early signs of recovery. Barring a renewed outbreak of COVID-19, the Chinese economy should start to pick up again in Q2 and is an encouraging sign the slump elsewhere may also be short-lived once the virus is brought under control. **While some industries and companies have borne the brunt of the downturn and others have benefited, it is essential to have an active manager to adopt to the changing dynamics and continue to strengthen the portfolio in order to participate in the next wave of growth.** As Winston Churchill famously said towards the end of World War II, "never let a good crisis go to waste."