



ACADEMY
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1st Quarter, 2020

Coronavirus-19 Pandemic

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“Listening to and understanding our client’s financial goals allows us to provide the highest level of investment planning advice and service.”

Overview

January into February continued the bull run of 2019 with the S&P 500 up 5.08% on February 19th and ended the quarter down -19.6%. The 10-year Treasury yield started the year at 1.88% and ended the quarter at 0.70%¹. WTI Crude oil began the year at \$61 a barrel and ended the quarter just under \$20.50², a nearly 60% drop. These are just three unprecedented market reactions to the Coronavirus pandemic. The largest of the three stimulus packages will bring \$2.2 Trillion into the economy. We can expect additional unprecedented negative news going forward. Expectations are that unemployment will be above 10%³ throughout the next quarter and GDP may decline 20-30%⁴. There will be bankruptcy’s in various industries that have been heaviest hit by stay in place policies promoted and enforced by state and federal government.

<u>% Return as of 03/31/2020</u>			
<u>Equity Indexes</u>	<u>1st Q</u>	<u>1 Yr</u>	<u>3 Yr</u>
S&P 500	-19.6	-7.0	5.1
Russell 2500	-29.7	-22.5	-3.1
MSCI EAFE	-22.8	-14.4	-1.8
Emerging Market	-23.6	-17.7	-1.6
Wilshire REIT	-25.6	-19.4	-2.5
<u>Bond Indexes</u>			
TIPS	1.7	6.8	3.5
Aggregate	3.1	8.9	4.8
Government	8.1	13.1	5.8
Mortgages	2.8	7.0	4.0
Investment Corporate	-3.6	5.0	4.2
Long Corporate	-4.5	9.6	6.7
Corporate High-Yield	-12.7	-6.9	0.8
Municipals	-0.6	3.8	4.0
<u>Cash Equivalents</u>			
3-Month T-Bill	0.7	2.4	1.9
<u>Consumer Price Index</u>			
	0.5	2.3	2.0

The other unnerving aspect of the pandemic is the uncertainty that goes with it. We aren’t sure how deadly it may be, or how long the spread will prevent the U.S. and the world from getting back to work and providing goods and services. The good news is that many factories in China and other parts of Asia are ramping back up. Growth in death rates in Italy and parts of Asia are starting to drop, “flattening the curve”. As deep and devastating as the pandemic has been to the economy, there is hope that the economy will recover and possibly do so quickly. We look to Q3 and Q4 to potentially see a rebound in growth and a rebound in employment. It really does depend on the virus and our reaction to it. The quicker that

industries and services can redeploy, the sooner the economy can get, if not back to normal, back to what a new normal looks like.

An instructive way to compare Bear Markets is to categorize them into three types: Cyclical, Structural, Event Driven. Unless this pandemic extends into the fall, we believe this Bear Market is Event Driven. That compares optimistically to past Event Driven Bear Markets that have lasted 9 months with an average drawdown of 29%. So far this is much shorter and a bit deeper on the down side.

1	Cyclical Bear Market Average length: 27 months Average drawdown: -31%	<ul style="list-style-type: none">• Definition: Typically a function of rising rates, impending recession, and falling profits• Status: Inflation remains contained and the Fed has accommodative posture
2	Structural Bear Market Average length: 42 months Average drawdown: -57%	<ul style="list-style-type: none">• Definition: Triggered by structural imbalances and financial bubbles• Status: Financial risk remains contained
3	Event-driven Bear Market Average length: 9 months Average drawdown: -29%	<ul style="list-style-type: none">• Definition: Triggered by a one-off shock that does not lead to a domestic recession• Status: Vulnerable to trade and geopolitical events

Source: Goldman Sachs Global Investment Research and GSAM. As of March 9, 2020.

Volatility and Risk

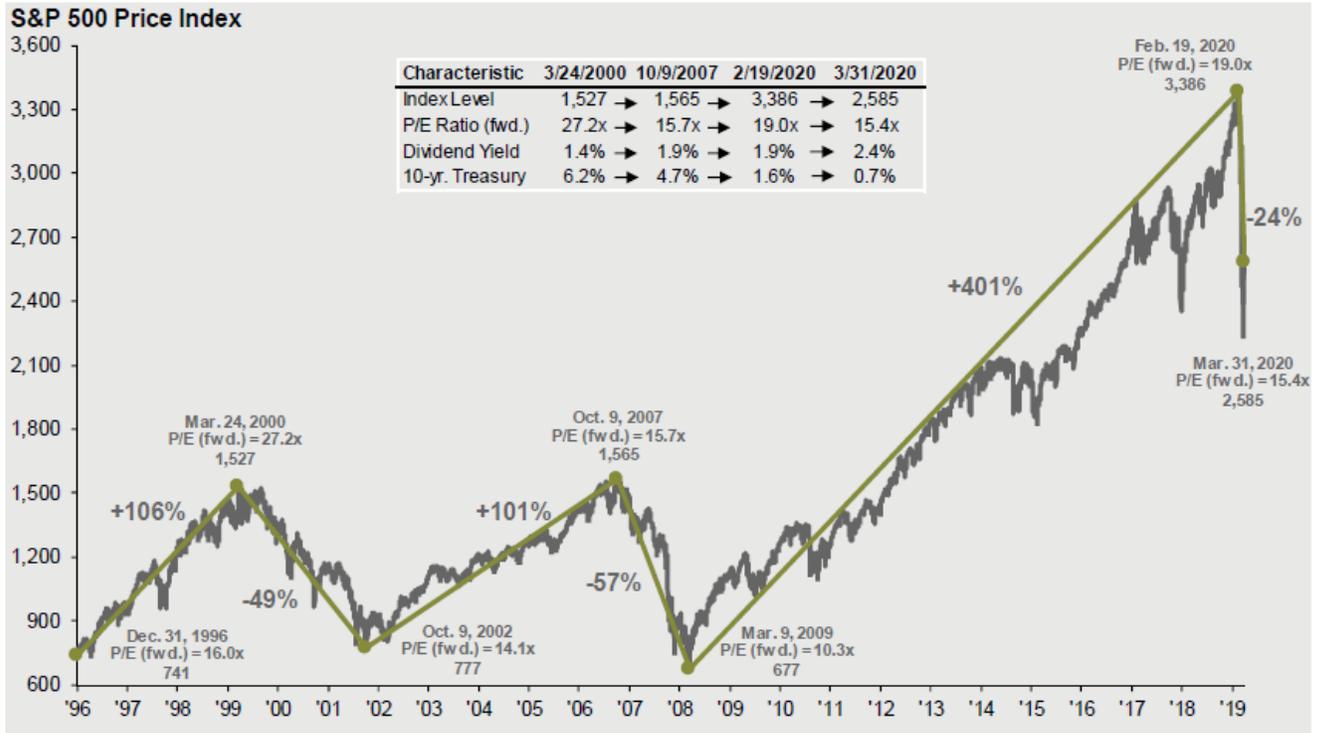
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Equity Markets

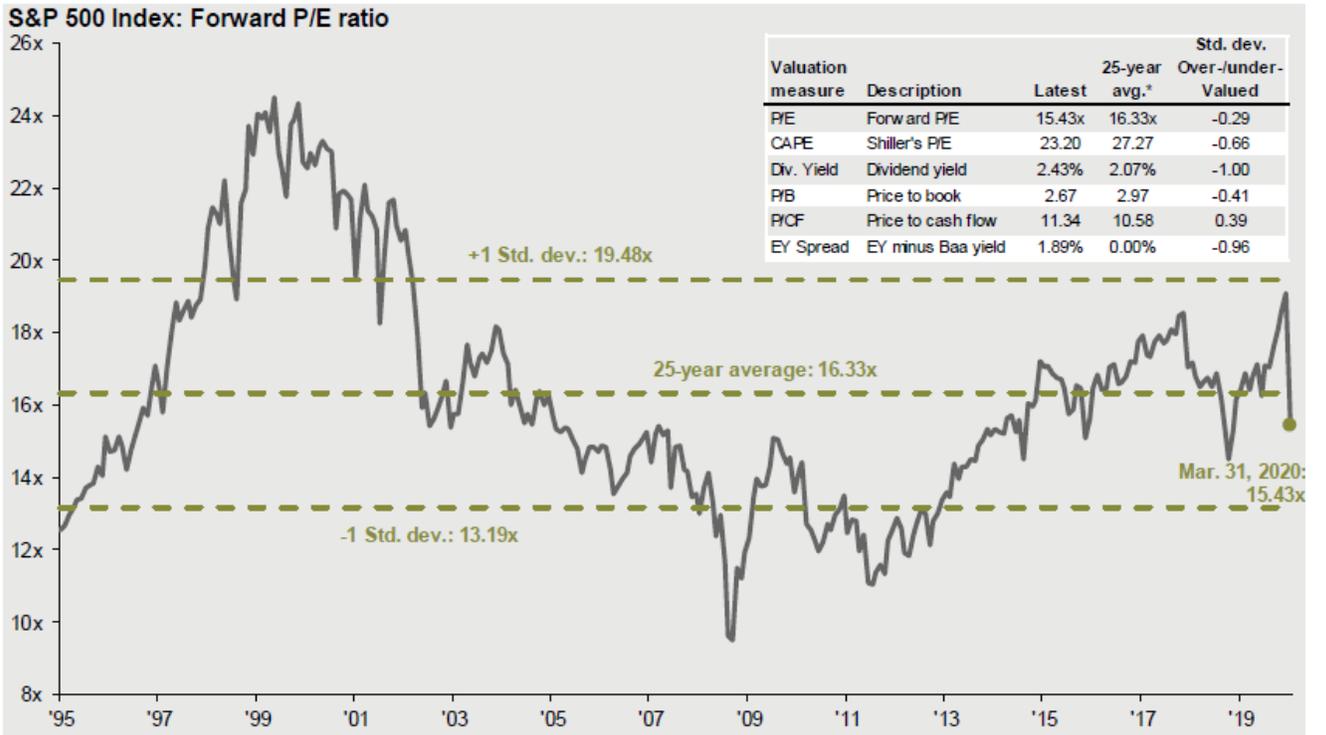
The speed and size of the market drop is clearly shown (see below) in the S&P Price Index chart where within a few weeks we erased all of 2019 gains and fell below the 2018 lows on March 23. A quick partial rebound closed out the quarter. One of the reasons for the drop and the continuing volatility is the uncertainty of earnings and dividends going forward. At the peak in early 1st quarter, the future P/E ratio was just above 19 and at quarter end is 15.4. Dividend yields grew to 2.4% as the market value denominator dropped significantly.

We understand that the earnings themselves will likely fall as the dramatic fall in economic activity from the pandemic flows through to company income statements. The harshest hit industries have a higher probability of reducing their dividend. Airlines, restaurants, hotels, casinos, retail, energy are all areas that need to conserve cash until the economy returns to reasonably normal activity. Many of the companies related to these industries will be taking government infusions which may come with limitations on what they can distribute as a dividend. While the current dividend is higher than average (see chart), the short-term uncertainty of the dividend yield in future quarters is very high.^{5,6}

Equities



Equities



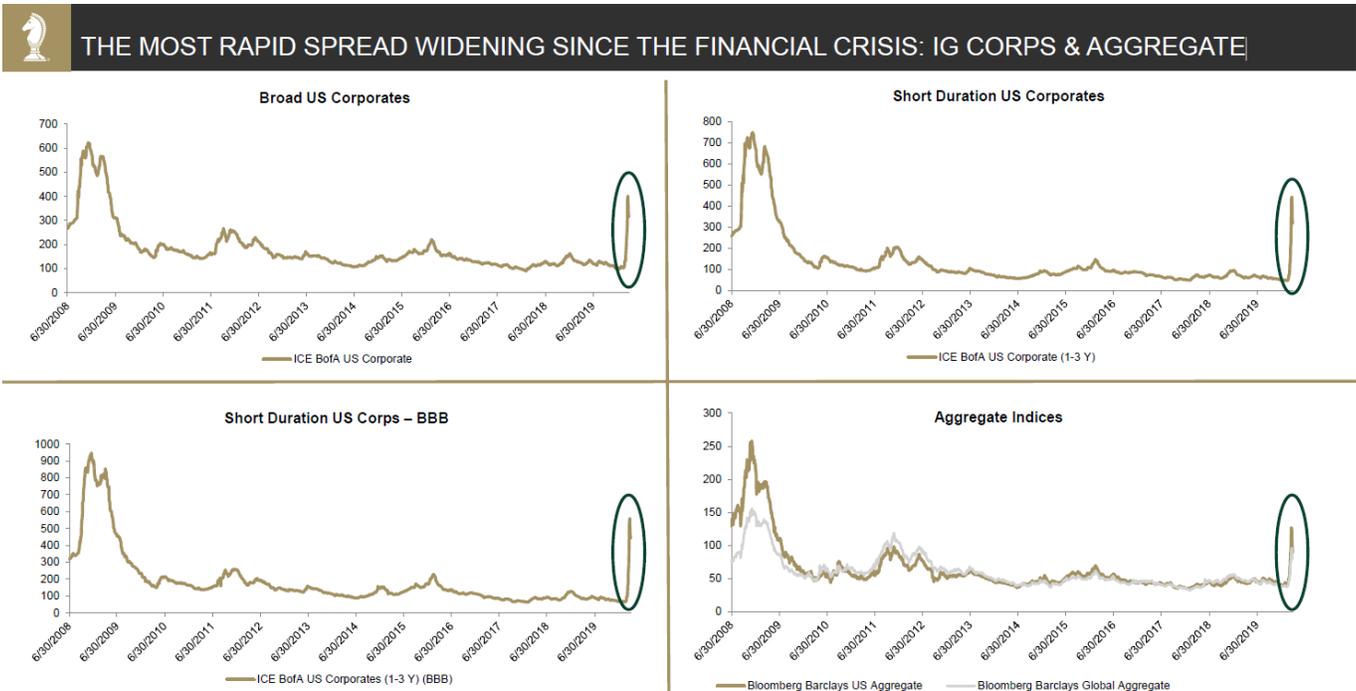
https://am.jpmorgan.com/blob-gim/1383407651970/83456/MI-GTM_2020-Final.pdf

The uncertainty of future earnings and dividends is also higher than normal. The speed of the economic slowdown may also result in a faster recovery. For now, we see the structural fundamentals of the economy as sound. Banking is well capitalized⁷. The government stimulus will support individuals and small businesses in need for the short term. We'll need to keep an eye on the magnitude of the government debt and the long-term impact on

interest rates and inflation. For now, the short-term benefit, pushing the cost to the out years, seems to be worth it. As fundamental long-term investors, we see a diversified portfolio as the best way to mitigate risk and take advantage of long-term economic growth.

Fixed Income Markets

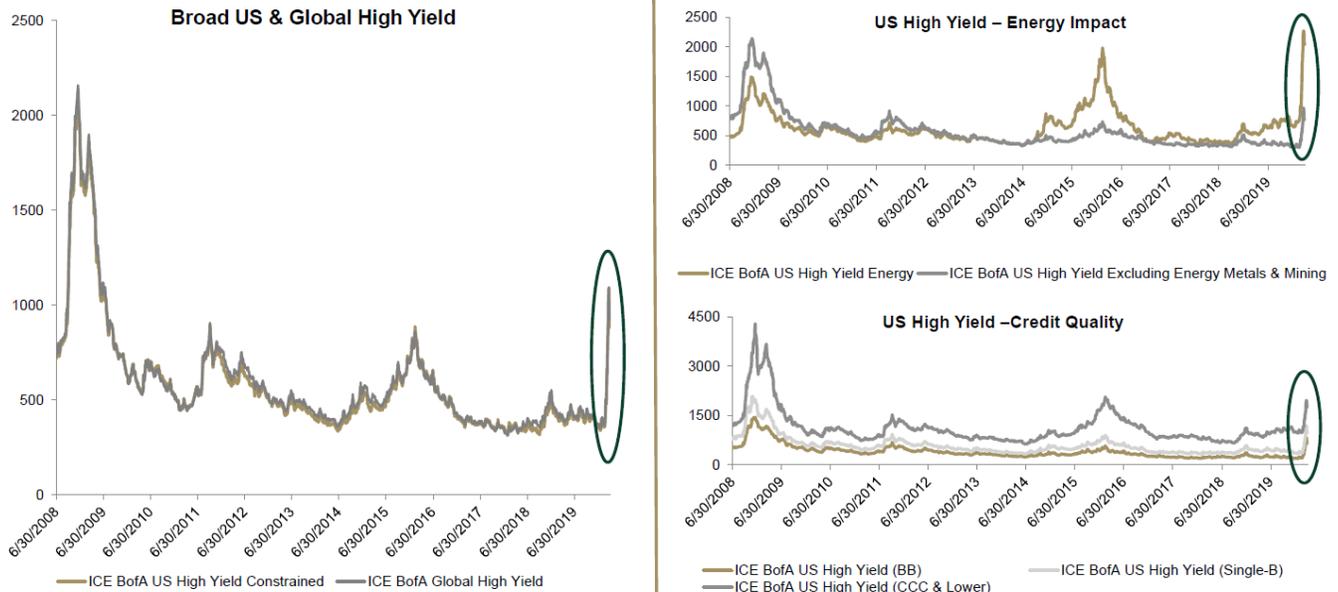
The fixed income market has responded with two unexpected surprises and two predictable moves. The two predictable responses to the economic slowdown from the pandemic was a flight to quality into Treasuries and widening of credit spreads. High yield spreads moved incredibly from 450 bps to over 950 bps. Treasury yields fell to 0.25% on the 2 year and 0.53% on the 10-year. The fed responded to the pandemic by reducing the fed funds rate from 1.75% to the lows we saw in 2008-09 at 0-0.25%⁸. What came as a surprise was how poorly the short term corporate and muni markets performed. One method to reduce risk in fixed income is to move the duration of the bonds from long term to short term. During this flight to quality, virtually all durations of corporate and municipalities were sold, resulting in drop in values of short and long-term bonds. The worse the credit rating the lower the value.



Data as of 3/30/2020.
 Source: Bloomberg Barclays and ICE Data Indices, LLC. Yield spreads represented by the Bloomberg Barclays and ICE BofA indices indicated above. Past performance is not a reliable indicator or guarantee of future results. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. The vertical axis of each chart is measured in basis points (bps).



THE MOST RAPID SPREAD WIDENING SINCE THE FINANCIAL CRISIS: HIGH YIELD



Data as of 3/30/2020.

Source: ICE Data Indices, LLC. Yield spreads represented by the ICE BofA indices indicated above. Past performance is not a reliable indicator or guarantee of future results. It is important to note that the high-yield market may not perform in a similar manner under similar conditions in the future. The historical data shown in the chart above are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. The vertical axis of each chart is measured in basis points (bps).

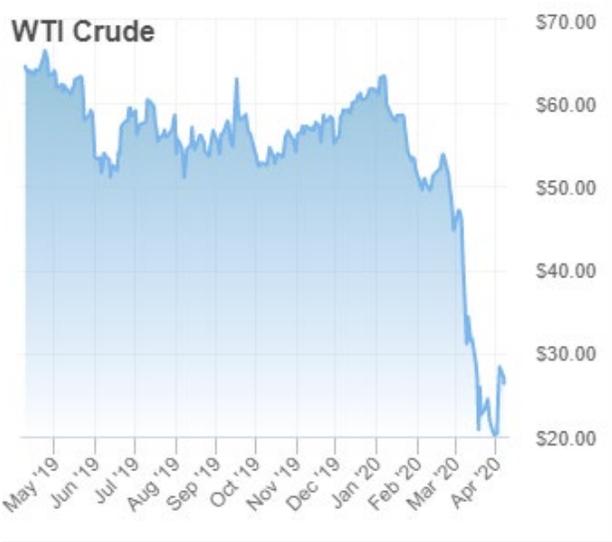
[Lord Abbett High Yield & Bond Debenture Fund PDF](#)

Real Estate, Oil, and Gold

Real estate was the highest performing sector in 2019 and continued that trend in the first half of the first quarter. That all changed as retailers and other commercial real estate rent payers were some of the hardest hit. 1st quarter, Real estate is down over 28%⁹.

WTI Crude was hit double with a sharp fall in demand as well as a shock increase in supply. The lack of flights, driving and overall economic activity devastated oil prices in the quarter. Not unrelated, Saudi Arabia and Russia both violated a production agreement and increased supply. The result was a fall from the highs of \$62 / barrel at the beginning of the year to the lows of \$20 a barrel at the end of the quarter. Gold showed volatility with an initial sell off followed by a quick rebound¹⁰.

An interesting graph shows the 1 oz gold / 1 brl WTI oil ratio which normally runs between 10 and 20. With gold at \$1600/oz and Oil at \$25/brl, the ratio is at 64. We interpret that as a sign of unrest and slowdown in economic activity. Should that trend reverse, we would expect the ratio to fall¹¹.



OilPrice.com





<https://seekingalpha.com/article/4174010-gold-oil-ratio-slips-below-20-tominus-1>

The Year 2020

Markets over the next three quarters are going to be driven by a few key components. How long and how bad will the coronavirus pandemic be. How long will the U.S. and the world basically close large parts of the economy. And finally, how long will it take for the economy to recover from the negative impacts of this massive slowdown. Any and all economists acknowledge the wide range of uncertainty in any of the forecasting metrics. GDP, unemployment, earnings, and dividends simply don't have the clear guidance today that we had prior to the pandemic. Uncertainty doesn't necessarily mean negative, but it does mean that it is easy to be wrong. Uncertainty also tends to lead us to protect against the downside risk, even with strong probabilities of upside potential.

Corrections test our investment planning. The past decade of 2009-2019 seemed to give us consistent positive returns with some risk and volatility. The recent drop reminds us that equity and other higher risk sectors have high downside risk that we must respect. It's why risk assessment and investment expectations are so crucial to the investment process. Aligning your risk profile to match expectations, even during the worst of market declines allows you to stay true to your plan.

Your financial planner at Academy Financial is always available to walk you through your specific situation and develop custom solutions. We've been here before; let our experience and knowledge work for you. As always, we are here to help guide you through these turbulent times.

- 1 <https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2020>
- 2 <https://markets.businessinsider.com/commodities/oil-price?type=wti>
- 3 <https://www.nytimes.com/2020/04/03/upshot/coronavirus-jobless-rate-great-depression.html>
- 4 <https://fortune.com/2020/03/23/morgan-stanley-goldman-sachs-estimate-coronavirus-economic-pain/>
- 5 <https://www.barrons.com/articles/coronavirus-could-stoke-dividend-cuts-in-sectors-such-as-energy-and-airlines-51583962623>
- 6 <https://www.investors.com/etfs-and-funds/sectors/sp500-are-your-dividend-stocks-safe-coronavirus/>
- 7 <https://www.nytimes.com/reuters/2020/04/05/business/05reuters-usa-banks-stress-tests.html>
- 8 <https://tradingeconomics.com/united-states/interest-rate>
- 9 ycharts.com FSRNX
- 10 <https://oilprice.com/oil-price-charts>
- 11 <https://goldprice.org/>

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