Dillon Capital Management
Economic & Capital Markets Strategy 1Q-2020

Highlights

- Stocks suffered worst quarter since depression
- Bonds helped preserve capital
- A recession lurks, yet opportunity grows

Economy

The US economy is on the brink of recession! The label won't officially be applied until we book two successive quarters of negative gross domestic product (GDP) change. It's possible that 1Q-2020 may still turn out positive while 2Q and 3Q seem doomed due to government's response to shutdown vast portions of the economy. However, if the shut-down leads to an earlier peak in new cases and we get a medical solution to the illness, 3Q could log a snap-back to economic growth. That's a speculative bet along the lines of a pre-season over wager on the Phillies to win 81 games – it's becoming mathematically impossible the longer the virus remains in charge.

No bell rings at the beginning or end of a recession, rather it's a change in trend from relative prosperity to relative decline. Change to a negative trend has historically been preceded by excesses (dot-com bubble, real estate lending); this was different. Although excessive levels of corporate debt exist, this excess only contributed to the scope of the decline in markets; the virus was the catalyst.

The fed cut interest rates in March to get ahead of disaster, dropping the fed funds rate to 0.0%, then added liquidity by purchasing corporate bonds and mortgages in the open market. The treasury engaged with the CARES Act, printing and distributing cash to shuttered businesses and unemployed workers affected by shutdowns.

The move to a zero-rate appeared superficial and hurt the bond market while the other support measures appear quite appropriate. Even so, at this point, estimates are for negative economic growth of 10-20% for the full year.

Capital Markets

For global financial markets 1Q can be split in half: the S&P 500 was up 4.9% to an all-time high on February 19, then dropped 34% by March 23rd before rebounding in response to Congressional passage of a $2 trillion economic rescue package and aggressive steps to further ease monetary policy by the Federal Reserve. Results for the quarter: -23.7% from the high; -19.6% for the quarter.

Major Indexes	1Q-2020	1-year
Short-Term Treas. (1-3 Yr.)	2.8%	5.4%
Barclay's Aggregate Bond	3.2%	8.9%
S&P 500 Index	-19.6%	-7.0%
Russell 2000 (Small Cap)	-30.6%	-24.0%
MSCI EAFE (International)	-22.8%	-14.4%
MSCI Emerging Mkts.	-23.6%	-17.4%
S&P/GS Commodity	-23.3%	-22.3%

There are two main problems affecting the capital markets at this point: 1) businesses are shutdown, 2) the bond market has become dysfunctional.

For stocks, companies are faced with lower revenues and earnings that are unpredictable right now as we journey toward the bottom of this economic cycle.

Estimates for where the S&P 500 (2,585 on March 31) is headed range from 1,200 to 3,000 – the bearish level is for the short-term low, while the bullish level assumes a mid-year recovery.

Taking a more quantitative approach to predicting a level for the S&P using full year estimated earnings, might consider a decline in earnings for constituents in the index of 20%, to $140.76. applying a normal p/e ratio of 15x leads to a prediction of 2,111 for the S&P. We don't make index predictions, but this number might be a useful watermark: A more severe virus impact (more cases and deaths, longer shutdowns and unemployment) could result in

809 N. Bethlehem Pike, Ste. F1
Ambler, PA 19002
215-367-5365

further selling, but a look-thru to a return to growth in 2021 could provide investors the information they need to push the index higher in late 2020.

So far for the bond market, the fed's move to zero had a negative impact. It was great for treasury bonds as investors sought a safe-haven, bidding up prices, but the rest of the bond market sold off, reaching historically high yield spreads (the difference in yield to maturity between a treasury and another bond) in less than two weeks. The fear, of course is that borrowers might not be able to repay loans and investors want a higher yield for this change in the level of risk.

The low interest rate policy of the last 10-years encouraged unprecedented issuance of corporate debt, often used to for stock buy-backs. Credit rating agencies were already downgrading credit when the year began. The economic contraction will speed up the re-ratings, making it more expensive to refinance maturing loans. In the largest category, bonds rated BBB, the lowest level of "investment grade," a rerating to "junk" status will push spreads out another 200-300 basis points. The yield on a corporate bond issued by a well-known company could rise from 2.50% today to 5-6% if downgraded. The high-yield bond index has spiked to an average 9.8% YTM.

International markets contracted more than the US. The level of disdain among European union members has escalated with the UK's Brexit, the virus's impact on Italy and the likelihood that a recession is already underway. It's important that the EU recognizes the need for central funding and can reach a compromise among member nations.

Real estate is complicated. Homeowner debt levels are not a big concern, but turnover of existing homes remains low and prices, so far, stable. Yet residential mortgage securities took a hit similar to corporate bonds, suffering from very little liquidity into the quarter-end as yield spreads spiked over repayment risk.

The commercial property market rode the economic recovery the last 10-years to solid occupancy levels and prices gains. This can change quickly in an economic slowdown. Retail space was already acting poorly due to the trend toward internet shopping, and with the shutdown, there is no revenue to pay the rent. Other types of real estate have been cast into the pool: hotels, office space, and even apartments. With interest rates moving higher, cap rates will expand and bids to purchase will decline. Potential losers are leveraged real estate owners and mortgage lenders that will experience higher defaults.

Investment Strategy

Our investment strategy contemplates a recession for 2020. Stocks usually decline in advance of a recession, stabilize at lower levels during the period of contraction, then begin to recover by the time a recession is officially recorded (think mid-4th quarter). In 5-10 years, the low we reach won't matter, we'll be higher. The current vacancy of investors creates a buying opportunity. For stocks, we still like large caps with sustainable, organic growth and good balance sheets.

Balanced portfolios (stocks/bonds) are now underweight their equity allocation target. It's the time to begin rebalancing, reducing the overall bond allocation in favor of stocks. Within the bond allocation, we like adding to corporate bonds at the high-end of the credit spectrum.

G. Foley – April 2020

Please call or email with questions or comments!

809 N. Bethlehem Pike, Ste. F1
Ambler, PA 19002
215-367-5365

Dillon Capital Management
www.Dillonone.com