PCM
PEAK CAPITAL MANAGEMENT

Should Your Portfolio SHELTER IN PLACE?

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We are living in an unprecedented time in the world. There are three simultaneous crises — public health, economic, and societal — as the coronavirus spreads, causing an economic contraction the world has never experienced. The pandemic is forcing social distancing and, in many cases, a need to shelter in place that is likely to have unknown mental health consequences. Our nation is forced to confront a very uncomfortable dilemma, weighing the risk of loss of life versus decimating the economy and people's livelihoods.

The draconian measures being implemented to slow the spread of COVID-19 is grinding the global economy to a halt in a way never experienced. This has led some to question if the cure is worse than the ailment? In solving one crisis we create several others with unknown consequences, such as the long-term impact of trillions in government stimulus. The Fed bypassed using the "bazooka" in their arsenal and went straight for the MOAB (Mother of all Bombs) where the Fed can buy virtually any fixed income securities, including ETF's.

The impact of shuttering a $21 trillion domestic economy will not be understood for some time. Unemployment could reach as high as 20%, equaling depression-era levels. The contraction in GDP for Q2 is estimated to be -30% (DWS) up to -50% according to St. Louis Fed President Bullard. Economic indicators like the Financial Stress Index and Empire State Manufacturing Index spiked to 2008 levels and, in some cases, exceed readings from the Great Recession. Investors have been confronted with the reality that there is no free lunch, as even highly rated corporate and municipal bonds were taken to the woodshed in the initial sell-off.

The question on every investor's mind is, should I sell and get out or is this a buying opportunity? The answer is yes. I am not trying to be facetious with the answer. I believe the prudent step for investors, depending on your time horizon, is to do a combination of tactical changes and shelter in place with your portfolio. It is during these times that behavioral finance tells us emotional bias is most prevalent and we need to guard against those missteps. This crisis is very different than the dot.com bust in 2000 and the Great Financial Crisis of 2008. Both of those bear markets were the result of structural problems in the economy and markets that needed to be corrected before recovery could occur. Our economy was in most respects healthy and poised for continued growth, then the pandemic hit.

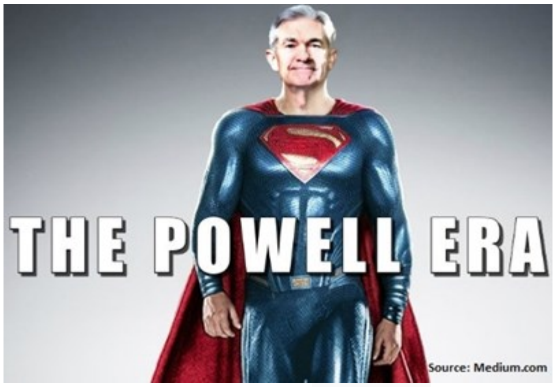
Courage comes from knowing we are not simply guessing what the right action might be, but adhering to a rules-based approach that has stood the test of time.

The difficult question is whether the shut down will cause structural problems or will immediately bounce back when the public health crisis is over? Congress taking quick action on a never considered level of stimulus, $2 trillion just to start, should help offset much of the damage being done and help consumer and business confidence rebound relatively quickly. My largest concern is that corporate debt becomes another black swan event that no amount of fiscal and monetary stimulus can repair. If we navigate this crisis without creating a crisis in corporate debt, I expect a V-shaped recovery in both the economy and financial markets.

So, what should investors be doing today? First, realize that it is going to take courage to take advantage of historically attractive valuations. I remember, vividly, the headlines in March 2009 suggesting the crisis was just beginning and markets had further to fall. It turned out to be the perfect time to buy. If you were a couple of months early you needed a strong stomach to stay the course. Here is where having a disciplined process makes all the difference. Courage comes from knowing we are not simply guessing what the right action might be, but adhering to a rules-based approach that has stood the test of time. Just as we rapidly reduced risk in DRH portfolios when the crisis began, we will need to add risk before the talking heads on TV tell us the coast is clear.

The biggest mistake investors will make following the crisis is to wait for clear skies and sunshine to take on market risk. The S&P gained 25% between March and December of 2009 while many investors were still on the sidelines. It took an additional 3 years to recover the remainder of the losses from that recession. My advice, take an umbrella with you when taking on risk (have hedges). Don't wait for blue skies when risk has subsided as much of the opportunity will have subsided with it. We are here to help guide you through this tumultuous period.

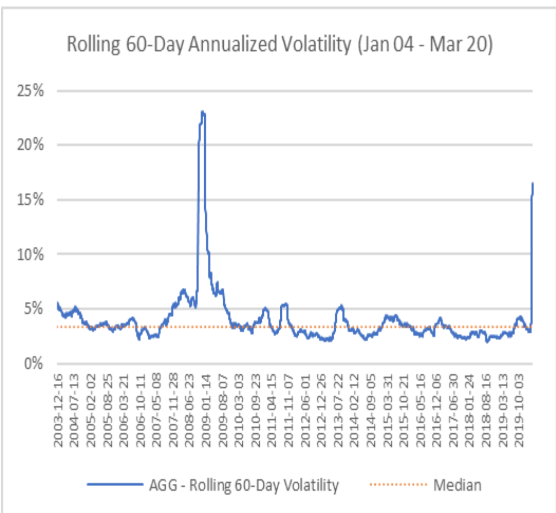
In Search of a Super Hero



The COVID-19 pandemic is a public health crisis, but it quickly turned into an economic and financial crisis as the method to slow the spread of the deadly virus has been to shutter all but the most essential aspects of the economy. We see the effect on major corporations like airlines and restaurant chains, but the real damage is done in the more than 30 million small businesses in the U.S. (SBA data). Chair Powell wasted no time in responding to the crisis in historic fashion. To start, in the span of just 12 days the Fed made 2 emergency rate cuts of .50% each to lower the Fed Funds rate to 0%. Days later Powell announced a $700 billion bond buying package to provide liquidity to markets (QE IV).

- The Main Street Business Lending Program is designed to help previously healthy small and mid-size firms bridge the liquidity gap created by forced closures of businesses. The Fed provides funding and is administered by the SBA.
- A new Term Asset-Backed Securities Loan Facility, similar to what Bernanke created in 2008, has been established to purchase debt that is shunned during a crisis: car loans, education loans and credit card debt.
- The Fed is also supporting the $6 trillion dollar investment-grade corporate debt market by providing liquidity through direct purchases of corporate bonds and bond ETFs in an attempt to stave off a crisis in corporate debt.

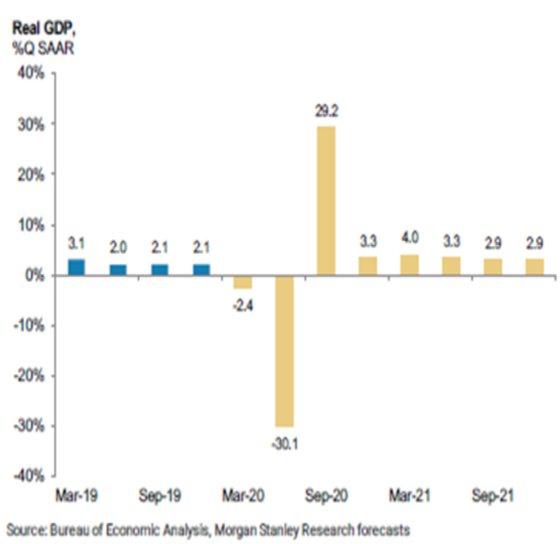
Corporate Bond Dislocations



With the onset of the coronavirus panic, investors have been de-risking their portfolios and moving to cash. While equities receive most of the headlines, the bond market – in particular the corporate and municipal sectors – have come under immense selling pressure as well. Liquidity, or the ability to sell bonds without a significant reduction in price, has dried up in some cases. In the chart to the left, we illustrate the rolling volatility of the Barclay's Aggregate Bond Index (AGG) going back to 2004. For comparison, we also include the median volatility level.

- When liquidity becomes scarce, bond prices tend to fluctuate more than normal. On March 12th alone, the aggregate index dropped -4%, its largest single day move ever. As the chart shows, volatility has spiked to levels not seen since 2008. The current reading of 15% is well above the long-run median volatility of roughly 3%.
- Recent volatility is due in part to COVID-19. In addition, a collapse in oil prices has put the energy sector, which is highly leveraged, under considerable stress. However, the Fed has stepped in to provide a liquidity backstop, which should help markets trade more smoothly.

GDP Estimates

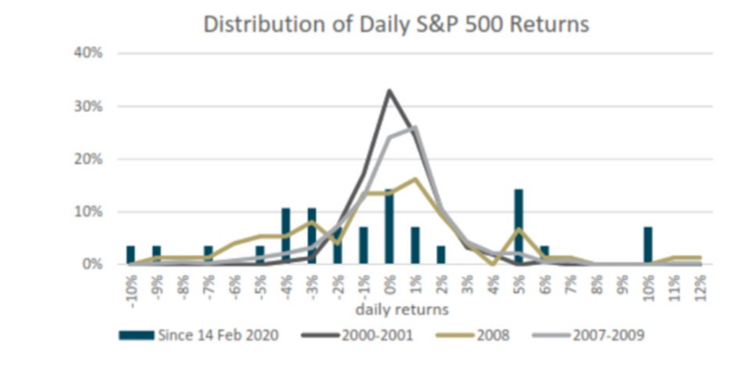


There is a saying among financial industry professionals that differences in opinion are "what makes markets." This means that these differences create buyers and sellers. COVID-19 has created incredible uncertainty around future expectations, particularly in terms of GDP contraction. Q2 GDP estimates vary widely among experts. Perhaps the most dramatic was Morgan Stanley economist Ellen Zentner predicting that Q2 GDP would contract to a GDP of 30.1%. (*Atlanta Federal Reserve Bank GDP)* Now, real time estimates as of March 25, 2020, for Q1 2020 is 3.1%. The bank is clear that current Q1 estimates do not reflect COVID-19 data. A contraction to -30.1% would indicate a sharp decline and deep recession. Much of GDP contraction estimates across economists point to record unemployment claims in March.

- GDP declining estimates result in a sharp decline in consumer discretionary spending.
- Morgan Stanley estimates personal consumption expenditures will contract at a 31% annualized pace (Morgan Stanley)
- Ellen Zentner estimates that Q4 GDP contraction will be (2.3%) (Morgan Stanley).
- Zentner and Morgan Stanley anticipate Q3 GDP to rebound to 29.2%

Macro View – An 11-Day Bear Market

It is human nature to want to attach labels to events. By some definitions, a bear market occurs when the Dow Jones Industrial Average drops by 20% or more over a given period of time. On March 11, 2020, the Dow closed down by 1465 points, down approximately 5.9%, breaching the 20% marker. This brought to a close the longest running bull market in modern history. A 3-day rally in the Dow of 21%, by the same definition, flipped the market in to a bull market. That amounted to an 11 day bear market for the Dow. The BNY Mellon chart below shows that dramatic upswings are not unheard of during bear markets, though. A 5% daily gain had nearly a 15% occurrence with and a 10% gain occurring in approximately 7% of the distribution. It is also worth noting the clustering of negative daily return occurrences on the left side of the normal curve.



SOURCE: BNY Mellon Markets Calculations, Bloomberg; data through March 26, 2020

Taking Stock – Bull Market Radar

Another popular Wall Street maxim is that "there is a bull market, somewhere" . . . even during a global pandemic. Telemedicine has been a focal point as a solution to those avoiding doctor's offices and hospitals while seeking care outside of COVID 19. Teledoc Health is a prime example of a company providing large scale telemedicine, serving as the largest and oldest telemedicine provider in the U.S. Teledoc uses telephone, video conferencing, and mobile apps to provide 24/7, on demand, remote healthcare. The company serves 130 countries with 27 million members. Revenue has grown year over year by around 30%, although the company is not currently profitable (Seeking Alpha). The clearest risk to Teledoc is socialized medicine. Year to date return as of March 26 is over 81%. The return as of March 2nd is over 20% (Google Finance).

Teledoc Health Year to Date Return (as of 03/26/20)

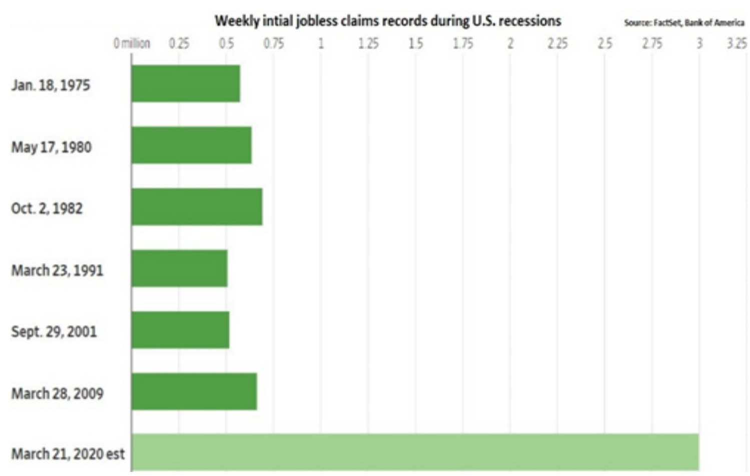
Source: Google Finance

Fixed Income - Blowout of Biblical Proportions

The COVID-19 crisis created a panic in the high yield market that exceeded the market's reaction during the financial crisis of 2008. The spread between the average high yield bond and Treasury prices has consistently remained in the 300-400 basis points range since 2016, with only a short surge during Q4 of 2018. In less than a couple of weeks this spread blew out to over 1,000 basis points, creating a liquidity panic as no one was willing to be a buyer. The shutting down of the global economy is causing many to question how many of these borrowers with questionable credit will end up in default. S&P Global Ratings raised their default estimate to 10% from 3.1% at the end of 2019. The pandemic, combined with a historic crash in oil prices, is another factor, with energy representing 15% of most high yield indexes.

Technical - Charting (Un)Employment

The analysts at FactSet and Bank of America provided estimates for initial jobless claims in advance of the first weekly report, after many in the country were under shelter in place orders and all non-essential businesses were ordered to close. As you can see in the chart, the peak in each of the last six recessions was around 700,000 new claims, making the estimate of 3,000,000 staggering. The analysts, it turns out, were too conservative as the actual number came in at 3,280,000, 10% higher than forecasted. What remains to be seen is the longer-term impact of the newly unemployed, with Congress passing a stimulus bill to backstop worker's wages during the mandatory quarantines. There is no playbook to refer to in this crisis. The Fed, Congress, White House, and businesses are all in uncharted waters.



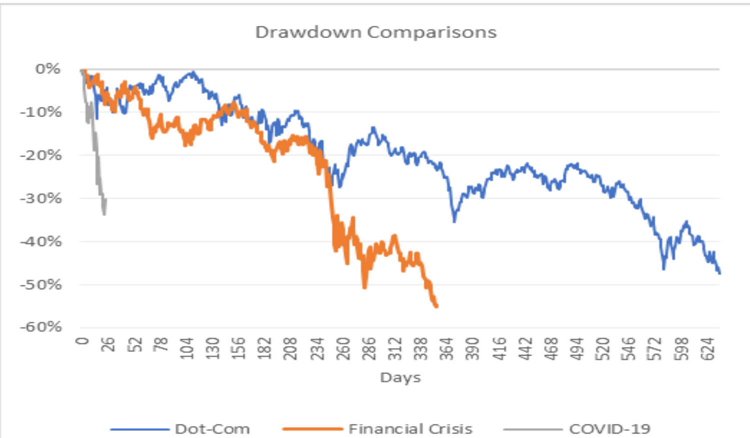
Hedging in Uncertain Times

Clint Pekrul, CFA

March 2020 has delivered exceptional market volatility. We'd have to go back to the 1930s to find a period where markets declined so quickly. The damage inflicted so far by COVID-19 across the global economy is far reaching. Entire swaths of the economy have literally shut down. The virus will eventually pass, but the timeline to recovery is far from certain.

The current environment is similar to past episodes of market turmoil. In the news we've heard numerous references to the October 1987 market crash, when equity markets declined -20% in a single day. Unlike the dot-com crash of 2000 and the financial crisis of 2008-09, which unfolded over several quarters, the current dilemma has transpired rapidly.

In the chart below, we illustrate the market drawdowns over the prior two recessions (peak to trough for S&P 500) and compare them to the current drawdown. As you can see, the pace of the current decline far exceeds what we experienced in the early 2000s and during the financial crisis of 2008-2009:



Source: YCharts

Allocating across global equity markets did little to protect portfolios from downside risk. From the market peak on February 19th through March 24th, all the broad equity market indexes have declined by roughly the same magnitude, based on Table 1 below:

Table 1: ETF Total Returns: 2/19/20 – 3/24/20	
Domestic (SPY)	-27.7%
Developed Markets (EFA)	-26.9%
Emerging Markets (EEM)	-25.6%

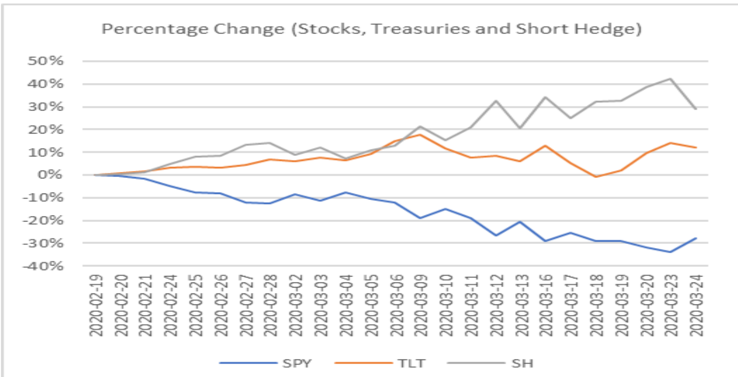
Source: YCharts

Likewise, allocating across various equity factors has proven ineffective downside protection. Based on Table 2, the returns across the primary factors in the U.S. reflect roughly the same degree of loss from the February 19th peak through March 24th, 2020:

Table 2: ETF Total Returns: 2/19/20 – 3/24/20	
Value (FTA)	-37.4%
Size (FYX)	-38.6%
Quality (SPHQ)	-24.4%
Momentum (MTUM)	-27.1%
Low Volatility (SPLV)	-29.5%

Source: YCharts

Despite the downturn across the board in equities, there were measures we could take to offset some of recent market turbulence. In the chart below, we highlight the returns of long-term U.S. Treasuries and a short, or inverse, position to the S&P 500 from the market peak of February 19th through March 24th:



Source: YCharts

As the chart above illustrates, U.S. Treasuries (TLT) have rallied roughly 12% during the steep equity selloff. As expected, an inverse position to the S&P 500 (SH) has rallied nearly 30% over the period.

As we've seen over the last several weeks, market conditions can deteriorate quickly. We have not seen a pullback of such magnitude and quickness since the 1930s. The nature of this drawdown is quite different in terms of duration than what we experienced in the last two recessions. Simply holding various exposures to equities, such as domestic or international or low volatility stocks, hasn't done much in terms of protecting portfolios on the downside.

However, portfolios that incorporated various hedges, such as U.S. Treasuries, inverse positions to broad equity indexes or cash, have likely weathered the current storm relatively well so far, and put clients in a position to recover when COVID-19 passes.

Q: How low can oil go?

Energy markets are notoriously volatile and are made up of near equal parts speculators and hedgers. Oil prices are a function of supply and demand, as nearly any product or service in a free market, but the forces that influence the supply and demand is what really drives prices higher or lower. Let's start with a look at the supply side of the equation. Oil prices plunged 24% in a single day on March 8th, following the failed meeting between OPEC and Russia, and represented the 2nd worse day since trading on the NYMEX in 1983 (only the start of the gulf war in January 1991 was worse). Russia's unwillingness to cut production to support higher prices is an attempt to hurt U.S. shale producers who have dramatically increased market share. The Saudi response to raise supply from 9.5 to 12 million barrels per day is seen as a way to put additional pressure on the Iranian regime. The resulting glut of oil supply drove WTI prices down over 60% in less than a month. The demand side of the equation shows COVID-19 has been just as damaging. IHS Market estimates that reduced demand just in the U.S. takes global oil demand from 100 million barrels a day to 92 million. Once the virus is resolved, demand will return and rig counts indicate supply will shrink but expect low oil prices to remain.

It's impossible to know with any degree of certainty, but I've seen forecasts as low as $10 per barrel. Ultimately, I think this is about Saudi Arabia trying to undermine U.S. shale producers. Even at $50 per barrel, there were signs of stress for domestic production. Now, with WTI trading around $20 per barrel and highly leveraged balance sheets, the future does not look that bright for U.S. shale. Saudi leaders decided to flood the market with supply at a time when global demand was already weak due to COVID-19.

To be sure, Russia has played a roll in all of this as well. The Russians and Saudis formed an alliance years ago as the U.S. ramped up its own oil production. The Saudis were prepared to curtail production at the OPEC meeting earlier this month to stabilize prices, but the Russians pushed to maintain current output. The subsequent fallout resulted in the Saudis reversing course and pushing output to 12.3 million barrels per day by April.

I think OPEC can smell blood in the water with respect to U.S. shale producers. By keeping prices suppressed, coupled with the COVID-19 outbreak, OPEC can put the squeeze on an already stressed U.S. shale market.

Q: What sectors are poised to lead the recovery?

The two most obvious sectors that could lead in the recovery are health care and energy, but for very different reasons. The Health Care Select Sector SPDR dropped approximately 25% in March before recovering as the market rallied. There is going to be a lot of funding in the health care sector that will draw investor attention, and valuation on many blue chip health care stocks is compelling. Energy is more of a speculative answer, but the sector appears to be priced as if oil will remain below $30/barrel forever, which we know is not the case. Many MLPs with reasonable levels of debt have fallen more than 70% since the beginning of 2020, and should recover some of the stock price losses when demand for energy stabilizes. From a historical perspective, consumer cyclicals and financials have been the strongest early cycle performers when emerging from a recession. I think cyclicals will perform well even if they do not lead the market higher, but financials face headwinds on two fronts: low interest rates and potential increase in defaults. While technology may not be the early winner in the recovery, valuations have fallen to very attractive levels early in the anticipated recession, and over the coming years should be in high demand as supply chains gravitate back to the U.S. and raising productivity becomes the next corporate focus.

Well, given how beaten up the market is now, it's easy to just say that the sectors that have suffered the greatest declines are the sectors that will lead us on the upside. But, I'm not sure that's going to be the case. Just sorting through the year-to-date sector returns, the worst performing sectors are energy, real estate, financials, industrials, and materials.

It seems there are some structural issues in the energy sector, with oil prices hovering around $20 per barrel. The market is flooded with supply. Real estate, or particularly REITs, are represented in part by hotel, retail, and casino properties. Vacancies are running high now due to COVID-19 and shops are closed in many cases. But I think REITs could bounce back meaningfully once the economy goes back on line. Banks are flush with liquidity, but face a world of super low interest rates that I don't see changing any time soon. Industrial stocks include the beaten down airlines which may take considerable time to recover, and material stocks might struggle through a potential recession. Honestly, I think the sector that might lead they way through the end of the year could be the sector that's led the market for the past several years, and that's technology.

All weights as of April 1, 2020

Income

Mortgage Backed Bond	18.16%
Investment Grade Credit	13.96%
High Yield Bonds	6.73%
Preferred Stock	7.27%
US Dividend Equities	3.89%
US REITs	4.59%
Cash	45.40%

Balanced Income

US Dividend Equities	13.26%
International Dividend Equities	13.43%
US REITs	13.26%
High Yield Bonds	24.80%
Long Term Treasuries	20.55%
Cash	15.00%
Inverse S&P 500	10.00%

US Growth

Low Volatility Factor	13.06%
High Quality Factor	13.56%
Small Cap Factor	7.37%
Value Factor	11.66%
Momentum Factor	11.91%
Long Term Treasuries	17.44%
Cash	15.00%
Inverse S&P 500	10.00%

Global Growth

Low Volatility Factor	6.51%
High Quality Factor	6.22%
Small Cap Factor	2.29%
Value Factor	5.62%
Momentum Factor	6.03%
Developed Market Equity	15.16%
Emerging Market Equity	15.73%
Long Term Treasuries	17.44%
Cash	15.00%
Inverse S&P 500	10.00%

Weights are approximations only and are subject to change.

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