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"Infection Correction III"

Dear Clients and Friends: April 15, 2020

In financial markets, there is a name for an "event or occurrence that deviates beyond what is normally expected of a situation and would be extremely difficult to predict." It's called a **Black Swan**. COVID-19 is a Black Swan. Just three months ago, we were ringing in a new year with cautious optimism. On the heels of new trade agreements, the U.S. economy was running strong, unemployment was at generational lows, and stocks were at all-time highs. Without some significant event from left field, most economists saw smooth sailing ahead for the global economy.

And then, from left field, it hit. What started as an isolated problem in central China, quickly developed into a global pandemic unlike anything seen in our lifetimes. Market volatility spiked. After hitting historic highs in mid-February, global financial markets plummeted further and faster than at almost any time since the Great Depression. The U.S. equity market fell a stunning -34% through March 23rd, before recovering to close -20% lower for the quarter. Foreign large cap stocks suffered similarly. Still, other investments like small cap stocks and commodities finished more than -30% lower.

The sharp economic downturn and extreme equity moves also triggered a dash for cash, forcing selloffs in some of the highest quality bond markets and clogging the plumbing of the financial system. The flight to safety only seemed to benefit Treasuries as the 10-year yield went from 1.90% to 0.60% during the quarter. However, just about every other bond market suffered as spreads widened significantly across all credit ratings.

What hit us?

In short, we were hit by an unprecedented virus causing unprecedented behavioral changes creating unprecedented economic uncertainties. We believe the resulting drop in stock prices is understandable considering the events. However, the more surprising reaction came from the bond market. The normally placid bond market became extremely volatile as well. So, what happened?

America had mostly dismissed the coronavirus as something contained to Asia. Then, in mid-February, cases started showing up in Italy. Corporate America quickly started raising cash, drawing down lines of credit and other borrowing facilities. As a group, they not only saw the short-term future as uncertain, but were also unwilling to risk losing options later. Ford suddenly asked its banks for $14 billion. GM asked for $16 billion. Boeing asked for $20 billion. Across the country, hundreds of billions of dollars were unexpectedly being requested by countless companies.

While banks and other financial institutions commit to making these funds accessible to companies on demand, they usually don't keep the cash readily available. Instead, they invest in a broad spectrum of fixed income (bonds and bond-like) instruments to generate extra return. When a request is made, the bank sells some of these investments, often to another bank looking to place their own extra deposits. The system usually works smoothly behind the scenes… most of the time.

However, during March, as hundreds of billions of dollars were unexpectedly requested all at once, banks were forced to sell their fixed income investments. But, since all banks were selling at the same time, there was no one left to buy, causing prices for usually very liquid investments (easy to buy and sell without moving the price) to fluctuate dramatically. Very high-quality bonds that had been yielding 2% were suddenly yielding 5%. Lower quality bonds previously yielding 4% were now yielding 10%+. Making matters worse, these artificially distressed prices rippled through the rest of the bond market and beyond.

Whereas the stock market is made up of thousands of stocks, the bond market is comprised of millions of individual bonds of varying issuances, amounts, and maturities. Many bonds trade infrequently but are priced for investors by services that use similar bonds as proxies for prices. When prices started resetting based on the previously mentioned forced trades, even more bonds were "marked to market" at those lower levels.

To top it all off, some investment firms that had borrowed money to build "leveraged" portfolios based on these normally docile bonds found themselves in a bind. As the bond prices started falling, the creditors of these firms required more collateral. Margin calls pushed these vehicles to become forced sellers too, adding fuel to the bond market fire.

So, the simultaneous (and rational) rush to raise cash by so many businesses trying to protect themselves in a time of uncertainty adversely impacted bond investors everywhere. The result has been a temporary but painful pricing problem in much of the bond market. We have seen comparable periods of mispricing in the past which tended to resolve themselves in relatively short order. We expect this episode to play out in a similar fashion. As we talk to our bond managers, they reiterate that they are seeing "price dislocation" and not "credit impairment" in their portfolios. Pricing in most bond sectors has started to improve, encouraging us that this moment in the bond market soon too shall pass.

What is being done?

As citizens during this pandemic, most of us are doing our part by practicing social distancing. We're working from home, having groceries delivered, and becoming expert users of FaceTime and Zoom. Our government, for its part, has unleashed an arsenal of weapons to combat this mandated demand shock. With the goal of putting the economy in "suspended animation," Congress has reacted with remarkable speed and bipartisanship by passing three fiscal aid packages.

The latest is the $2.3 trillion CARES Act. This bill offers direct cash grants and loans to households and businesses to help them through the next few months. Giving credit where due, it appears to be a smart attempt to allow small and medium non-essential businesses to effectively go into a two-month hibernation. The funds help with payroll and rent, hopefully allowing companies to pick up where they left off when this is over. Extended unemployment benefits and cash payments to families should also help most everyone else. This is a massive stimulus program, several times the size Congress passed to support the economy during 2008-2009. More is likely on the way.

The Federal Reserve has also pulled out all the stops. Policy makers cut the Fed Funds rate by a half percent in early March and then all the way to zero on March 15th. They stepped in with unprecedented amounts of money and fiscal support to stabilize markets and specifically target liquidity issues like the ones we outlined earlier. The Fed has resurrected many of the programs created during the Financial Crisis. They have also created a new, unlimited Quantitative Easing program focused on Treasuries, mortgage backed securities, and short-term funding support. They have even dramatically increased the availability of dollars to foreign central banks in efforts to curb the strengthening greenback. For the first time ever, they have started buying corporate debt and commercial paper. During the Financial Crisis, many efforts of support were delayed as the Central Bank tried to figure out its powers and what it could and could not do. Not this time. They are all in.

Expectations

The current situation is much like the proverbial valley of the shadow of death. We know that we must go through it to get to the other side. We know the journey will be grim from a human standpoint and the scale and scope of the economic decline will be serious. But we also know that there is another side, and we will get there. The world's best medical minds are working around the clock to solve this problem. A return to normalcy could occur sooner than expected.

There are already signs of improvement in Asia. Most of China is back to work, in some form. Europe is seeing their cases plateau. Being several weeks behind the rest of the world, America is just now facing the worst of what is expected. However, many of the models are now suggesting that our efforts could very well blunt the worst-case scenarios. Though, these improved outcomes still represent awful human suffering.

The irony of the situation is that as we try so hard to "flatten the curve" and offer financial support for doing so, we risk lengthening the time damage is taking place in the economy. This is likely a driving force behind President Trump's insistence we get America back open for business. However, this is first and foremost a health crisis and all that can be done to ensure the health and safety of our friends and family is paramount.

Stock and bond prices are already reacting to the positive developments, along with the tremendous government response. U.S. stocks have rebounded about 8% since the end of the quarter and erased about half of the total losses experienced. Just as the peak of losses was probably not completely justified, the rebound might not be either. There is still much uncertainty and many difficult times ahead. We will get through this crisis, as we have others. We will likely emerge on the other side in a different place, with altered sets of priorities and behaviors. This will present new opportunities.

With all the heaviness of these times, we'll leave you on a lighter note. An analyst on a recent conference call noted that when this episode is over, many Americans will likely emerge magically cured of their credit card debt. Between their limited ability to spend and government stimulus checks they receive, they won't be able to help but to get into better financial shape. Hopefully, those less indebted consumers will be ready to get out and spend again, jump starting the economy when the time comes!

As always, we thank you for your continued confidence and trust, and we welcome your comments, questions, and referrals. Please don't hesitate to contact us and stay safe and well. We will get through this together!

Summit Asset Management LLC

Note: We have filed our updated ADV Brochure. Please let us know if you would like a copy.