

INVESTMENT REPORT



LYNCH FINANCIAL GROUP LLC
— Retirement Wealth Management —

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www.LynchFinancialGroup.com

Investment Review and Outlook

First Quarter 2020 Key Takeaways

We are all now living through a period in history none of us will ever forget. The impact on our families, communities, and country has been profound. And it continues. There remains great uncertainty, worry, and fear about the coronavirus and its impact: how widely it will spread, how fatal it may be, how long it will last. When will we see signs of stabilization in its spread and a decline in daily new cases? When will we “flatten the curve”?

While several weeks ago we had reason for cautious optimism that the virus might be largely contained to China, it is now obvious that is not the case. The United States and world are now facing a health crisis and an economic crisis. Both need to be fought with massive government policy responses and individual behavioral changes.

We’ve frequently said that recessions and bear markets are inevitable phases within recurring economic and financial market cycles. And that investors need to be prepared for them to happen, but that their precise timing is consistently unpredictable. We’ve also said there is always the risk of an unexpected “external shock” to the markets and economy (e.g., a geopolitical conflict or natural disaster).

It’s one thing to say it and another to actually live it. And still another when the precipitating event or catalyst for the recessionary bear market is something none of us have experienced before: a global pandemic, which has instigated an extreme societal response—including the indefinite closure of schools and non-essential businesses, shelter-at-home orders, quarantines, lockdowns, and social distancing—and has potentially overwhelmed medical facilities, personnel, and supplies.

We will get through this crisis period. Things will improve and recover. This too shall pass.

In the meantime, events are moving very rapidly, policy responses are in flux, and markets are extremely volatile.

We sincerely hope you and yours are able to remain healthy and manage well through this challenging period.

First Quarter Market Update

The first quarter of 2020 has been an unprecedented period in U.S. financial market history across numerous dimensions:

- The U.S. stock market fell into a 20% bear market in the shortest time ever—just 22 days—and continued further, dropping 30% in a record 30 days. The typical historical bear market peak-to-trough decline has taken around 12 to 18 months.
- Short-term expectations of stock market volatility, as measured by the VIX index—often referred to as the market’s “fear index”—closed at an all-time high in its 30-year history on March 16. And the market’s actual realized volatility has only been

Benchmark Returns (Periods Ended 3/31/2020)

	Quarter	12 Months
Large-Cap Benchmarks		
Vanguard 500 Index	-19.6%	-7.1%
Russell 1000 Growth iShares	-14.1%	0.7%
Russell 1000 Value iShares	-26.7%	-17.3%
Mid-Cap Benchmarks		
Russell Midcap iShares	-27.1%	-18.4%
Russell Midcap Growth iShares	-20.1%	-9.7%
Russell Midcap Value iShares	-31.7%	-24.3%
Small-Cap Benchmarks		
Russell 2000 iShares	-30.6%	-24.0%
Russell 2000 Growth iShares	-25.8%	-18.6%
Russell 2000 Value iShares	-35.7%	-29.8%
Other Benchmarks		
Vanguard Developed Mkts Idx	-24.1%	-15.9%
Vanguard Emerging Markets	-24.6%	-18.6%
Vanguard REIT Index	-24.1%	-16.7%
Vanguard Total Bond Mkt Index	3.3%	9.0%
Credit Suisse High Yield Index	-13.9%	-8.4%

Investment Review and Outlook (Cont.)

higher in October 1987 (Black Monday) and the late 1920s.

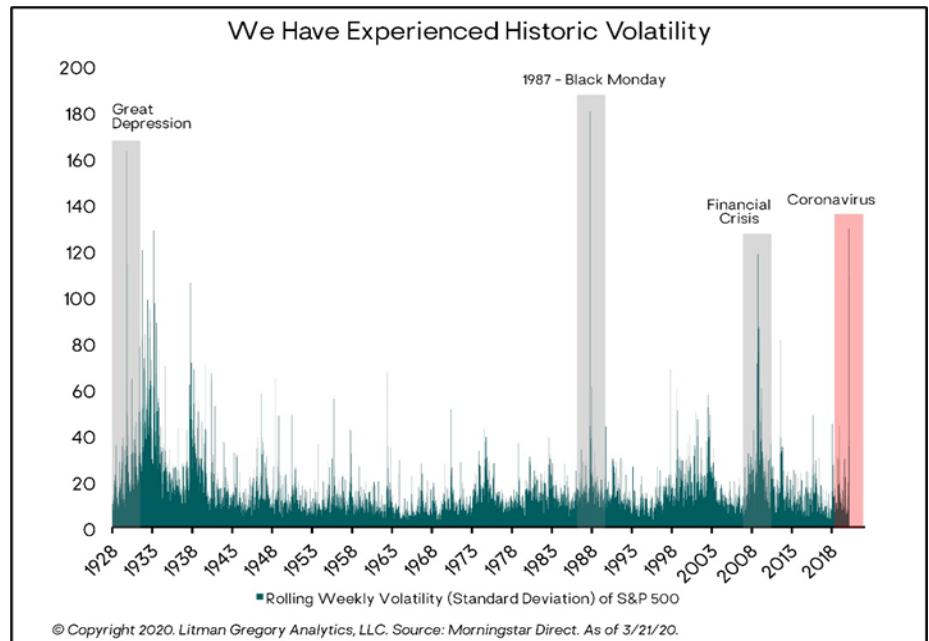
- The 10-year and 30-year Treasury bond yields fell to all-time lows of 0.54% and 0.99%, respectively, on March 9.
- Oil prices had their biggest one-day drop since the 1991 Gulf War, plunging 25% on March 9, triggered by a price war between Saudi Arabia and Russia.

Larger-cap U.S. stocks have fell 20% this quarter. Growth stocks have continued to hugely outperform Value: the Russell 1000 Growth Index fell 14%, while the Russell 1000 Value Index fell 27%. Smaller-cap U.S. stocks did even worse, falling 31%.

Developed international stocks and emerging-market stocks both dropped around 24%. Much of the differential between U.S. and foreign stock market returns has been due to the appreciation of the U.S. dollar, which has risen roughly 2.5% year to date.

In the fixed-income markets, core bonds gained just over 3%, once again playing their key role as portfolio ballast against sharp, shorter-term stock market declines. As noted above, Treasury bond yields have fallen sharply. They have been extremely volatile as well—shooting up on some days when stocks were also sharply selling off. The 10-year yield ended the quarter at 0.70%, down from 1.92% at year-end.

Turning to the credit markets, floating-rate loans and high-yield bonds took it on the chin, with both dropping around 13%. But investment-grade corporate bonds were far from immune, having lost over 4%.



First Quarter Portfolio Performance & Key Performance Drivers

Financial markets in 2019 were a positive surprise for many investors; however, the start of 2020 has been the exact opposite. Just three months ago, most investors were astonished to see stocks jump 20% to 30% during the eleventh year of a historic bull market. Even core bonds clocked in a 9% return last year. But things have changed dramatically since year-end. Though one thing is constant: Just as no market pundits expected U.S. stocks to gain 30% last year, none of them expected a 30% drop in the first three months of 2020 and the real possibility of a severe economic recession.

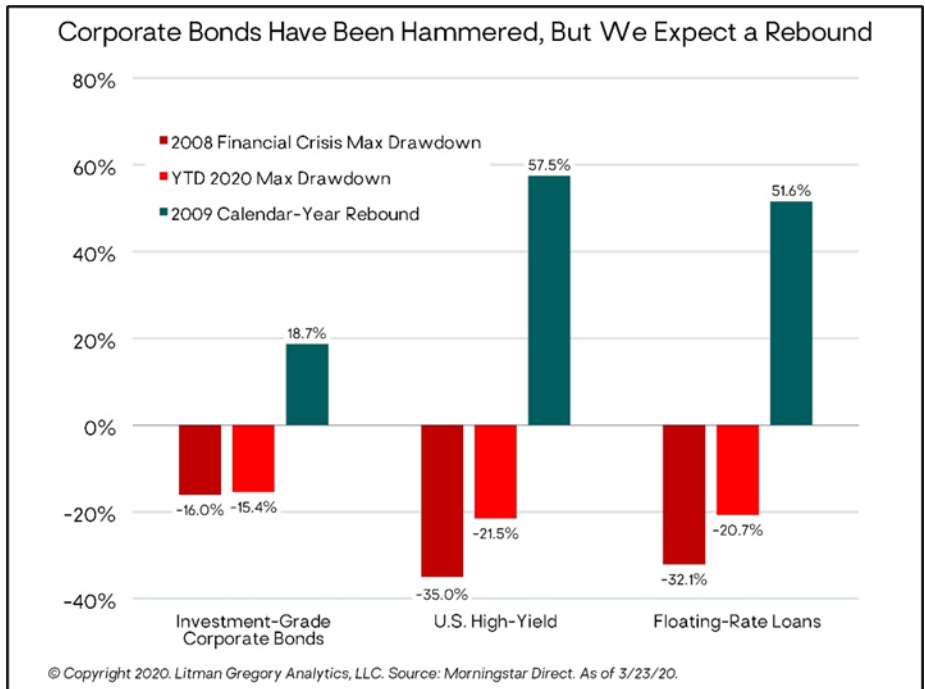
Foreign Stocks

Positions in foreign stocks have been a headwind in this first quarter. European stocks and emerging-market stocks have underperformed U.S. stocks during this swift and severe downdraft. As markets have fallen, there has been a strong “risk-off” demand for U.S. dollars and a resulting appreciation in the U.S. dollar. This has hurt dollar-based investors in foreign stocks. In fact, European markets have performed in line with U.S. markets in their respective local currencies. And emerging-market stocks have outperformed U.S. stocks in local-currency terms—dropping only 19%. We—and many other respected investors we follow—expect the dollar to weaken as the crisis abates and a global recovery resumes. If so, that will be an additional boost to our foreign stock returns going forward.

Non-Core Income Strategies

Tactical positions in non-core fixed-income have been a headwind during the quarter. Flexible bond funds have also suffered relative to U.S. core bonds in this selloff. In general, falling Treasury rates across the curve and widening credit spreads have been a headwind for active bond managers. Floating-rate loans have fallen around 13% this quarter, easily their worst return since falling 23% during the fourth quarter of 2008. At current prices and yields, we expect strong returns for our non-core bond funds over the next one to three years.

The losses so far for high-quality investment-grade corporate bonds are right on par with the financial crisis. And this time the drawdown happened in just 10 days, compared to taking nine months in 2008! This gets to the heart of the Federal Reserve’s massive policy response. They are throwing everything they can at supporting bond markets to prevent them from freezing up and spiraling into an economic crisis.



The good news is that by their nature, bonds have a narrower range of return outcomes than stocks. So we definitely view these as short-term drawdowns and not permanent losses of capital. Our bond funds are run by skilled, experienced managers. Most of them were relatively defensively positioned coming into March,

because yields were low and they weren't getting well compensated for taking on credit risk. Despite that, their fund returns have been hammered this month. But this has created some great buying opportunities for them to put some of their cash to work at much more attractive expected returns. So we are excited about that. And as a reminder, in 2009 as the financial crisis began to ease, there was a huge snapback and very high returns.

Update on the Macro Outlook

Coming into the year, we saw the potential for a moderate rebound in the global economy (especially outside the United States) on the back of reduced U.S.-China trade tensions and extensive global central bank monetary accommodation. And in January and early February, there were signs the manufacturing sector had bottomed and a nascent global recovery was indeed underway. Stock markets rallied to all-time highs.

However, the arc of the coronavirus and the increasingly aggressive U.S. and global response to try to slow its spread has drastically changed everything. Our base case now—and it seems most investors, economists, politicians, and central bankers agree—is that the U.S. economy is headed into recession in the second quarter. It is likely to be a severe one, with a sharp contraction in GDP and an unprecedented rise in unemployment and jobless claims.

The consensus also appears to believe the recession will be short in duration, with a rebound beginning around the third quarter. But this is by no means a sure thing. To the extent equity markets are not fully discounting a more severe outcome, downside risk remains.

The depth and duration of the recession—and the strength and timing of the ensuing recovery—depend on two key variables:

1. The progression and spread of the virus: how effective our medical response and social-policy efforts are in flattening the curve
2. The fiscal, monetary, and regulatory policy response: how quick and effective new policies will be in supporting households, businesses, and financial markets—mitigating the short-term recessionary damage and preventing a downward spiral into something much worse than a short but severe recession

The effectiveness of the medical response and economic policies (and their impact on human behavior at the societal level), will help answer the fundamental economic question of how severe and how long the economic downturn and recession will be. And the answer to the economic question will help answer the investment question of how severe and how long the equity bear market will be.

The financial markets and the real economy are interconnected—each drives the other and can reinforce or magnify a trend in one direction. A rebounding stock market supports the real economy and vice versa through positive wealth effects, increased incomes, profits and spending, risk-taking, and optimism. But they can also feed off one another on the downside, in a self-reinforcing negative spiral that can ultimately lead to an economic depression if the spiral is not broken.

On the Coronavirus

We are not medical experts, virologists, or epidemiologists. So we have little to say on the medical side of things that others haven't already said, or that all of us aren't hearing and reading every day in the news. What we will say is that, as we write this, the data show the virus is continuing to spread at an increasing rate in many countries, including the United States and across Europe. There is still little clarity

or certainty as to when this trend will flatten and decline.

We expect financial markets to react positively at the first signs of a flattening in the number or rate of new daily cases reported, as we saw happen in China in February, and as also happened during the SARS epidemic in 2003.

Italy may be a leading indicator of the progression of the virus in other developed countries. Many experts have said the U.S. virus situation is roughly two weeks behind Italy's. But there are also important differences between the two countries (e.g., medical infrastructure, demographics, policy response) that make for an imperfect comparison.

On the Economy

The near-term economic damage from the United States' and other countries' response to the virus now looks almost certain to be severe (barring some unexpected major medical breakthrough in the near future).

On Sunday, March 15, the Fed held an emergency meeting where they cut the federal funds rate by one percentage point to near zero. The Fed also announced it was restarting quantitative easing (QE) with at least \$700 billion in planned purchases of Treasury bonds and mortgage-backed securities.

At his press conference following the meeting, Fed chair Jerome Powell said GDP growth was likely to be negative in the second quarter, and beyond that the economic outlook was highly uncertain, as it depends on how widely the virus spreads: "I would say in fact, unknowable."

Over the following week, economist after economist slashed their second quarter GDP forecasts deeper and deeper into contractionary territory. They may have changed again by the time this is published, but to give a sense of the magnitude, going into the last week of March, Goldman Sachs was forecasting a 24% annualized decline, Morgan Stanley a 30% decline, JPMorgan a 14% decline, and both Bank of America and Citigroup a 12% decline, to name a few. For comparison, the worst quarter during the 2008 financial crisis was an 8.4% annualized GDP contraction, in the fourth quarter of 2008. (As of quarter-end, Goldman Sachs, for one, has already revised their second quarter GDP forecast to a 34% decline.)

On Sunday March 22, Federal Reserve Bank of St. Louis president James Bullard topped them all. He was quoted by Bloomberg News citing the potential for a 50% quarterly drop in GDP and a 30% unemployment rate in the second quarter, in the absence of massive fiscal and monetary policy support.

Bullard also said that with an aggressive government response, economic activity should begin to bounce back in the third quarter. And the fourth quarter of 2020 and the first quarter of 2021 could be "quite robust" as Americans make up for lost spending. "Those quarters might be boom quarters," he said. As another example, Goldman Sachs forecasts a 19% growth rate in the third quarter, following their expected 34% second quarter plunge (forecast as of 3/31/20).

As mentioned earlier, an economic slowdown—particularly an extremely sharp one due to extreme virus containment efforts—can quickly morph into a self-reinforcing negative spiral. Consumers cut back spending, businesses layoff workers, unemployment rises, incomes drop further, spending drops further, corporate profits drop, companies and households default on loans, companies go out of business, investment and employment drop further, etc., causing an even deeper and longer recession (if not depression) and bear market.

In this case of a severe external shock, the government's economic policy responses are critical. There are two main levers: monetary policy (central banks) and fiscal policy (government spending, tax cuts, unemployment insurance, loans, debt forgiveness, etc.).

One lesson learned from the 2008 financial crisis is: When it comes to the policy response, go big and go fast. Time is of the essence (just as it is with the virus response). Governments need to make a credible commitment to “do whatever it takes” to support the economy and prevent the negative spiral from taking hold.

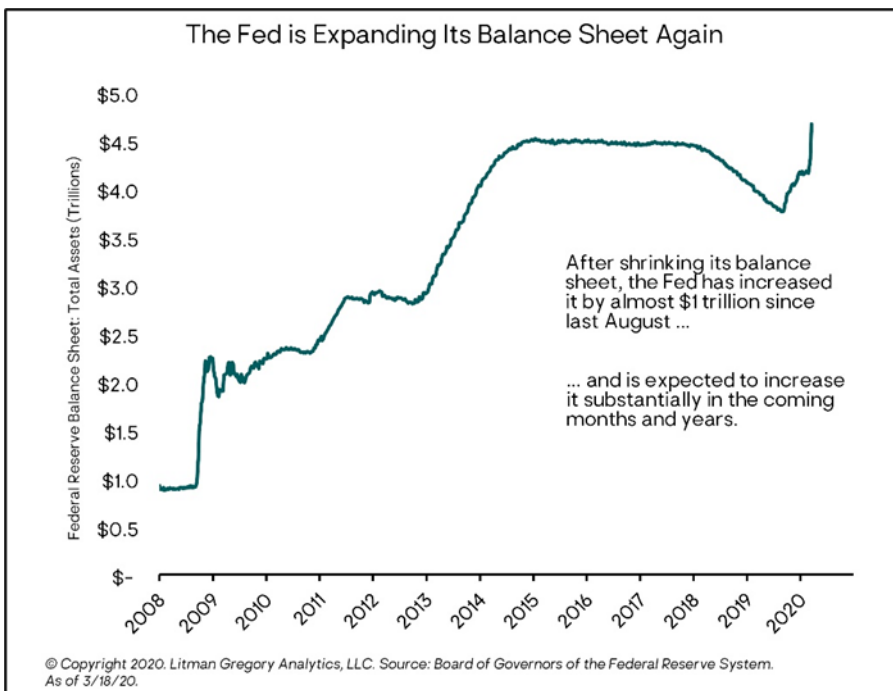
Monetary Policy

The Fed and other major central banks seem to be all-in to support the fluid functioning of credit, lending, and financial markets, and their critical role as the “plumbing” of the real economy.

As noted above, at an emergency meeting on Sunday March 15, the Fed cut the federal funds rate to near zero and restarted QE. A week later, it increased the QE program from “at least \$700 billion” to essentially an unlimited amount in order to keep interest rates and borrowing costs low. The Fed also initiated a number of programs—going beyond the tools it enacted during the 2008 financial crisis—to try to ensure enough cred-

it,

loans, and liquidity are flowing to banks, businesses, households, and the overall global financial system. It is likely the Fed will do still more (e.g., increasing their asset purchases to support the huge fiscal stimulus that is coming or even effectively monetizing the debt or “helicopter money”). Other major central banks are also starting to pull out all the stops, and more will likely come until the crisis period ends (and maybe beyond).



Fiscal Policy

While extremely accommodative monetary policy is necessary, it is not sufficient to mitigate this economic crisis. Only fiscal policy can have a large enough and direct enough impact necessary to support and sustain individuals and businesses until the storm has passed and the virus containment measures show signs of working.

Congressional Republicans, Democrats, and the Trump administration all seem to be in agreement that something massive needs to be done and done quickly. On March 27, Congress passed, and the president signed into law, a \$2 trillion stimulus package. Similar support measures are being debated or implemented around the world. Discussions continue about additional steps to take in support of markets and the economy.

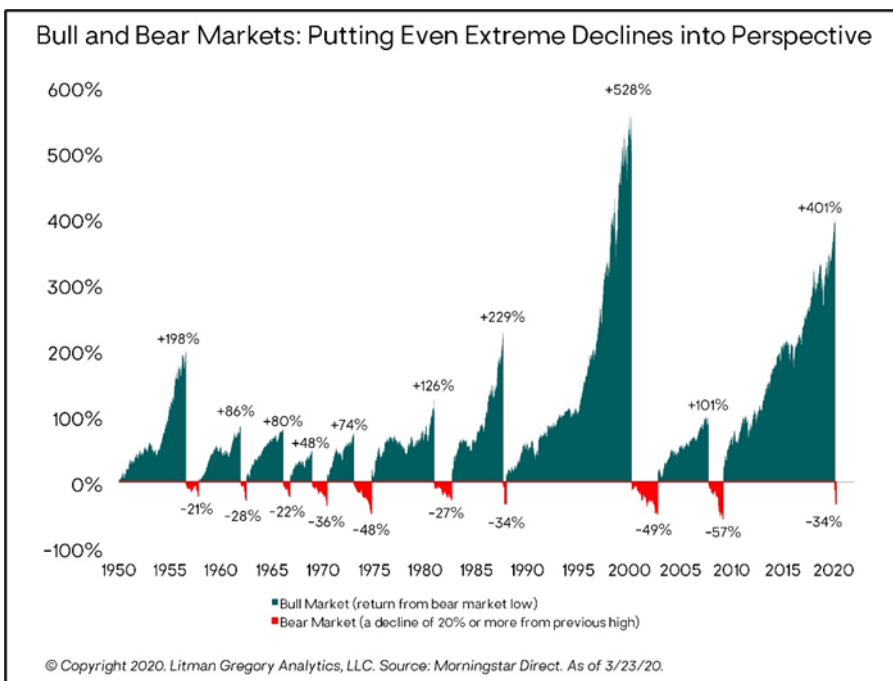
Public and business support is also undoubtedly strong. So the political obstacles to getting something done should be relatively low, especially considering how polarized the current political environment otherwise is. There really is no alternative. And, like the monetary policy response, the fiscal stimulus will also be global in scale, with even austerity hawks like Germany now acceding to its necessity.

Closing Thoughts: This Crisis Will End. This Too Shall Pass.

As investors, it is so important to maintain our focus on our long-term financial goals and objectives. As hard as it may be, from an investment perspective we need to try to look through the current environment of fear and concern—emotions which, given the circumstances, are totally justified and felt by all of us—to the almost certain outcome of the virus crisis receding and economic recovery occurring.

Throughout history, the world has faced numerous severe challenges and economic downturns and has always come out the other side. While not minimizing the unique risks and unknowns from the current crisis, we will bet on that being the case again. There is a good chance the recovery may start happening before the end of the year.

As a long-term investor, trying to time market tops and bottoms is a fool's errand. The evidence is overwhelming that most investors diminish their long-term returns trying to do so. They are more likely to chase the market up and down, and get whipsawed, buying high and selling low. But incrementally adjusting portfolio allocations in a patient and disciplined fashion in response to changing asset class expected returns and risks makes a lot of sense for long-term investors.



The time to be adding to stocks and other long-term growth assets is when prices are low and markets—and most of us personally—are gripped by fear and uncertainty rather than complacency, optimism, or greed. Investing at such times will feel very uncomfortable. It may seem like the market could just keep dropping with no bottom in sight.

But that is exactly where research, analysis, patience, experience, and having a disciplined investment process come most into play.

Otherwise, if we invest based on our feelings and emotions, we are very likely to cash out of the market *after* it has already dropped a lot, locking in those losses. Then, waiting to reinvest after our discomfort and worry are gone, the market will *already* be much higher. That is not a recipe for long-term investment success, yet it plays out in each market cycle.

Facing the current medical and economic crisis, the situation is probably likely to get worse before it gets better. (We would love to be wrong about that.) But, with some necessary and shared sacrifices from all of us—and clearly those on the medical front lines much more than most—it *will* get better.

Stay the course.

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