The *Philadelphia* Story

A Quarterly Commentary on the Economy & the Financial Markets — April 2020

From: *Philadelphia* Investment Management Group

OVERVIEW

- ***U.S. Gross Domestic Product Growth Will Slow Measurably in the Quarter Ahead.*** *It is too early to make a call on what the numbers may be; but rest assured, they will be well below the previous quarter's, and it is anyone's guess when GDP will begin to pick up. Our best guess will be in the third or fourth quarter of this year.*

- ***Monetary Policy is at Work to Combat the Negative Economic Consequences Resulting from the Spread of the Coronavirus.*** *The Federal Reserve has lowered interest rates to near zero and is purchasing limitless quantities of Treasuries and other securities, at levels of which we have not seen since the financial crisis of 2008.*

- ***Fiscal Policy is Now the Only Game in Town Left for the Federal Government to Further Address the Unsettled Economic Conditions Resulting from the Virus.*** *Congress, having passed a $2 Trillion support package and directly allocating funds to both families and small businesses, is an unparalleled spending approval.*

- ***The Global Economy is in the Same Predicament as the United States.*** *Governments around the world are loading up on debt, as we are, taking advantage of record low borrowing costs. While these economies were somewhat stagnant even before the coronavirus outbreak, they now find themselves in a rush to liquidity to ward off further economic stalemate over the virus.*

THE ECONOMY

Whatever economic numbers are to be reported for the economy for the fourth quarter of 2019 will offer very little insight into what we can expect in the current quarter and beyond. It is impossible to predict the magnitude of the coronavirus on economic activity, going forward. We are running the risk of a recession, but we hope for just a slowdown in this quarter and next as the Fed, state and local governments go out of their way to counter the negative effects of the virus. If unemployment is any measure of economic activity, the numbers are staggering. First-time claims for unemployment surged more than 1,000% in the week ending the first quarter. Mortgage applications dropped 15%, and restaurant bookings collapsed. Predictions surfaced, in some quarters, of a 24% decline in second quarter GDP.

The Federal Reserve has gone to extraordinary lengths to intervene as businesses feel increased pain. Like the Government's fiscal spending, the Fed's ability to fix the problem and "right the ship" has serious drawbacks. As we will comment in the Fixed Income section below, interest rates are near "0" and massive amounts of buying of Treasuries and other securities, such as mortgage bonds and sub-par debt, is about all the Fed can do unless they get into some other forms of support, such as elimination of penalties for debt defaults and other tactics not used before. Therefore, only fiscal policy is left to help bail us out, and the Government is now doing an aggressive job, with actual handouts to individuals and relaxing the rules on the penalties to small businesses for not meeting their liabilities.

FINANCIAL MARKETS

EQUITIES

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The past quarter saw stocks suffer their worst performance since the depths of the financial crisis, as reflected in the chart below. It wasn't long ago that investors were expecting a modest rebound in the global economy and that trade with China was making headway. Unfortunately, all markets, but particularly equity markets, have a way of over-reacting to events and, therefore, move to extreme levels on both the downside as well as on the upside in valuations. These moves are often accomplished with big volume, somewhat akin to panic volume.

	Equity Returns*			
Index	**Jan**	**Feb**	**Mar**	**1st Qtr**
S&P 500	-0.04%	-8.23%	-12.35%	-19.60%
Dow	-0.89%	-9.75%	-13.62%	-22.73%
NASDAQ	1.99%	-6.38%	-10.12%	-14.18%
Russell 2000	-3.21%	-8.42%	-21.73%	-30.61%

*Total: price change + reinvested dividends

With the exception of the NASDAQ, which has a heavy concentration of technology stocks and was ahead of all four indexes for the first quarter, large capitalization stocks, as measured by the S&P 500, were well ahead of the small capitalization stocks, as measured by the Russell 2000 Index. The 30.61% loss for the Russell 2000 was the largest quarterly loss for the index in its 40+-year history. And small caps bore the brunt of the decline on both a domestic and global level.

At this writing, the equity markets appear to be looking for a bottom from the rapid decline. For sure, a low point will need to be developed and formed through a period of testing before a low can be reached. The high volatility that is with us today will make identifying the bottom challenging, but we hope it may be sooner than later.

Sector	S&P 500 Weight*	Returns* 1st Qtr
• Energy	2.6%	-50.45%
• Materials	2.4%	-26.14%
• Industrials	8.2%	-27.05%
• Cons. Discretionary	9.8%	-19.29%
• Consumer Staples	7.8%	-12.74%
• Health Care	15.4%	-12.67%
• Financials	10.9%	-31.92%
• Info Technology	25.5%	-11.93%
• Communication Svcs	10.7%	-16.95%
• Utilities	3.6%	-13.50%
• Real Estate	3.0%	-19.21%

03/31/20
*Price + income
Source: S&P Dow Jones

No sector or industry group was spared the steep decline caused by the effects of the coronavirus, and all areas of the S&P 500 were in double-digit negative territory. Defensive stocks, such as Consumer Staples, Health Care and Utilities, together with Information Technology, lost less than the other sectors, as shown in the chart, while Energy continued its downward path due to the low price of oil and the collapse of demand with the added burden of the coronavirus.

Markets tend to look forward, as we know, but a better question is what sectors and groups will recover the fastest. Often, groups that have fallen the hardest are the first to come back, but in the present environment, with so much emphasis on health and health improvement technology, these areas should receive a lot of attention as investors move back into the market.

FIXED INCOME

Fixed income volatility continues as uncertainty remains. At the end of the quarter, we reached the end of the shortest bear market ever. It lasted 11 days before snapping back to technically a new bull market. The yield curve has steepened by 20 basis points between the two-year and 30-year Treasuries since the beginning of the year. And now only 39 basis points separate the two-year and 10-year Treasuries. With the intermediate-to-short term yield curve relatively flat, we recommend continued low duration on existing and new money. The corporate BBB/BB to 10-year Treasury spread has fallen recently from 337 basis points to 290 basis points. At the beginning of January, the yield spread was only 124 b.p. In anticipation of possible improvement on the timeframe of business going back to work, spreads have fallen off and there has been some renewed interest in lower-rated corporate and mortgage-backed bonds.

Fixed Income Returns

Index	1st Qtr
Corp/Govt	3.48%
Int. Corp/Govt	2.12%
Long Corp/Govt	7.24%
U.S. Government	8.80%
- Intermediate	5.26%
- Long	21.28%
Corporate	-4.05%
- Intermediate	-3.43%
- Long	-5.29%
- **Quality**	
- AAA	4.49%
- AA	0.69%
- A	-1.18%
- BBB	-7.40%
Municipal	-0.68%
- Intermediate	-0.62%
- Long	-0.72%

Source: BofA Merrill Lynch

It was another rollercoaster ride in the municipal bond market, with a rally sending prices higher and yields lower. Volatility was due mainly to liquidity concerns, not credit concerns. While we expect COVID-19 will present challenges to the public finance sector, we need to remember the municipal sector is strong, with historically low default rates and most credits rated A or higher. Having said, the economic downturn has resulted in a number of downgrades, but downgrades do not mean default. Not all issues will fare equally well, and this impact will be seen across all sectors and issuers, with broad and diverse economic diversification, revenue-raising capabilities, and large cash and reserve balance likely to perform the best. And at present, many municipal sectors will benefit from the additional support going to hospitals, educational institutions, airlines and other businesses. We continue to seek higher-rated issuers in stronger sectors.

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In conclusion, we believe the coronavirus will have a large short-term impact; but long-term, the impact should be minimal. We think several characteristics make this pandemic-generated economic slowdown different from usual recessions. The U.S. housing bust, which we didn't see, caused labor to shift away from construction and real estate into other sectors. Workers unemployed or put on furlough because of the coronavirus are likely to resume their former positions. It seems logical that economic confidence will quickly rebound once the epidemic recedes. In the interim, our recommendation is to remain well diversified in stock portfolios and short-to-intermediate maturities in the fixed income sector of portfolios. One aspect to keep in mind is that prior to the arrival of the pandemic, the economy was doing well, advancing at a modest pace. There is every reason to expect the same once the virus recedes, people get back to work, and business globally begins to pick up.

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