1st Quarter 2020

Highlights

- **1Q 2020 was about COVID-19. As the economy shut down, a rush to cash overwhelmed financial markets. Credit markets underperformed taking our portfolios with them.**
- **The lockdown will likely decimate the economy during the second quarter. We believe a strong rebound is likely during the second half of the year.**
- **Fiscal and monetary authorities responded forcefully to the crisis attempting to support the most vulnerable. We believe the aid was timely and necessary to get the economy back on its feet quickly.**

Markets

		Returns (%)			
GIA*	Average Quality	1Q20 Gross	1Q20 Net	12 Months Gross	12 Months Net
Core Plus Composite	**(A+)**	**-3.04**	**-3.12**	**3.63**	**3.26**
Global Credit Plus Composite	**(BBB+)**	**-6.03**	**-6.15**	**1.37**	**0.86**
Emerging Market Corporate Debt Composite	**(BB+)**	**-16.73**	**-16.85**	**-9.25**	**-9.79**
High Yield Composite	**(B+)**	**-20.04**	**-20.15**	**-14.17**	**-14.64**
Benchmark Bonds					
Bloomberg Barclay's U.S. Agg. Index	(AA+)	3.15		8.93	
Treasury	(AAA)	8.20		13.23	
Credit	(A)	-3.14		5.10	
Mortgage	(AAA)	2.82		7.03	
Government/Credit	(AA)	3.37		9.82	
ICE BofAML U.S. Corporate & Yankees	(A-)	-3.36		4.78	
ICE BofAML U.S. Corporate	(A-)	-4.05		4.37	
ICE BofAML U.S. High Yield	(B+)	-13.12		-7.45	
ICE BofAML EM Corporate Plus	(BBB)	-8.21		-1.43	
ICE BofAML Global Gov't ex-US	(AA-)	0.78		3.03	
JPM Emerging Markets EMBI+	(BB+)	-8.67		-3.13	
JPM CEMBI Broad	(BBB-)	-8.04		-1.00	
JPM GBI-EM Global Diversified	(BBB)	-15.21		-6.52	
Benchmark Equities					
S&P 500	NA	-20.00		-8.81	
Nasdaq Composite	NA	-14.18		-0.38	
Russell 2000	NA	-30.89		-25.11	
MSCI EAFE	NA	-23.43		-16.84	
Europe	NA	-24.81		-17.96	
Japan	NA	-17.66		-8.75	
MSCI Emerging Markets Equity	NA	-23.87		-19.80	

* Please refer to the respective factsheets for the long-term composite and benchmark returns for each strategy.

Markets

Unprecedented might be the apt word to describe the world today. With most of the world's population in lockdown, nations are desperately trying to combat COVID-19, and their citizens are adjusting to lives in isolation. Not surprisingly, financial markets were decimated during the quarter, and may have faced total collapse if global monetary and fiscal authorities had not come to the rescue. As the draconian actions needed to combat the virus became evident, financial markets began to crater. A rush for cash ensued with corporations harnessing funds to bridge the slowdown, banks becoming overwhelmed by client draws, margined investors being forced out of trades by the speed and magnitude of the correction and municipalities desperately seeking to assist the sick. Illiquidity became so pervasive, the Federal Reserve jumped in to guarantee funds and become, in effect, the buyer of last resort for most fixed income assets. In record time, the federal government approved a gargantuan $2 trillion spending package and set a challenging example for the rest of the world to follow. The S&P 500 stock index was down nearly 31% for the year on March 23, and ultimately delivered the worst quarter since 2008 at -20%. U.S. treasuries moved higher on a flight-to-quality and returned 8.8% for the quarter, although this normally safe sector also experienced wild volatility as the struggle for cash took place. Credit markets suffered as withdrawals overwhelmed investor demand and illiquidity eroded all forms of price discovery. Adding insult to injury, Saudi Arabia and Russia launched an oil production feud that took the commodity's price down 66% and put an entire industry in jeopardy.

Amongst credit sectors, Investment grade delivered the worst relative performance in March because short to intermediate duration bond funds suffered the largest outflows. Credit spreads widened markedly during the month, even though the Fed prevented a meltdown for the sector by announcing various support facilities. The investment grade corporate bond index, the ICE BofAML U.S. Corporate Index (C0A0), was down -7.47% in March and -4.05% for the quarter. By comparison, the U.S. treasury index returned 3.26% in March and 8.80% for the quarter. Corporate option adjusted spreads (OAS) widened by 203 b.p. to 303 b.p., while the yield to worst of the index rose from 2.88% to 3.66% despite the ten-year U.S. treasury yield declining 1.2%. Issuance for the quarter jumped to $541.3 billion, with an improbable $272.2 billion in March. Both March's and the quarter's issuance shattered prior records as investment grade corporations rushed to raise cash once the Fed reassured the markets. With other sources of financing nearly closed (like commercial paper and new bank loans), companies paid what they had to for funds.

The high yield market also suffered from poor liquidity, outflows, creditworthiness concerns and a pummeling of its largest industry, energy. The ICE BofAML U.S High Yield Index (H0A0) declined -11.76% in March and -13.12% for the quarter. Energy, which constitutes over 14.8% of the index, fell -33.77% in March and -39.70% for the quarter. Spreads to worst widened by 487 b.p. from 370 b.p. to 857 b.p., while the yield to worst increased from 5.30% to 9.06%. High yield retail investors withdrew $13.0 billion in March, the second largest monthly take on record, and a total of $16.7 billion for the quarter. The quarterly withdrawal came close to erasing 2019's inflows. The default rate increased to 3.35% in March (3.54% including distressed exchanges) the highest in three years. The default rate rose by 2.49% from March 2019 due primarily to energy related companies, although the big defaulter for the quarter was expected, Frontier Communications with $16.7 billion in bonds. Given widespread distress in energy, and the virus-induced economic shut-down, the default rate is expected to rise further during the second quarter. The new issue market ground to a halt in March, but still produced a respectable $72.7 billion for the quarter. March's contribution was a paltry $4.2 billion as the sector's illiquidity led investors to focus on the investment grade market.

Emerging markets bonds were negatively affected by the same forces pulling markets down in developed economies. With many countries captive to foreign investor flows, the global rush for cash exacerbated the losses. While the coronavirus was largely controlled in Asia, and only modestly present in other regions, concerns about emerging economies' ability to deal with the outbreaks mounted. The JPM Emerging Markets Bond Index – Global Diversified (EMBIGD), a dollar denominated sovereign index, was down -8.67% in March and -9.93% for the quarter. The JPM Corporate Emerging Markets Broad Diversified Index (CEMBI BD) declined -10.20% in March and -11.52% for the quarter. The JPM Global Bond Index – Emerging Markets Global Diversified (GBI-EM Global Diversified), a local markets index fell -11.07% in March and -15.21% for the quarter as the crisis damaged many EM currencies.

Economy

For the first time, our quarterly economic discussion was held by phone while our team works remotely. We are a tiny reflection of a populace in isolation anxious to defeat a virus that has felled many physically and racked the global economy. The size of the devastation is not yet quantifiable, and will probably take years to repair. Sadly, the pain will likely not be shared evenly as many countries do not have the resources to support millions of unemployed during the four to seven weeks it takes to combat the virus. Furthermore, countries that procrastinated on containment may not find hospitable reactions from other nations as they open gradually and zealously guard against a relapse.

As the COVID-19 shut-downs became evident, economists altered their forecasts for the second quarter and all of 2020. One quarter ago, respondents to the WSJ Economic Survey expected growth rates near 1.8% for each of the first two quarters of the year. The same respondents now expect an economic contraction of -0.2% for the second quarter, although the timing of the survey suggests many replied prior to the harshest closures and have now cut their forecasts further. By quarter-end, many Wall Street economists suggested annualized declines of -20% or more. Most recognize the second quarter is a "lost cause," and are attempting to assess the likelihood and timing of a rebound.

A review of industries surfaces three broad story lines: 1) industries devastated by the coronavirus facing existential threats (travel and leisure, energy, restaurants, and services); 2) industries suffering painful hits, but solvent enough to bridge the quarantine-induced closures; and 3) businesses benefiting from the crisis even though it was never part of their envisioned activity (groceries, mobile telephony, streaming services, and parts of healthcare). The differences between the "haves" and the "have nots" are stark and entirely out of every company's hands. Given the challenges, companies have focused on the health of their employees and their role in helping society overcome the challenge. Earnings for 2020, if there are any, will be secondary to reopening the economy safely.

At this juncture, China has begun to reopen and indicators suggest the economy is recovering albeit at a slow pace. Growth expectations for the rest of the world remain dire and not measurable. It is worth noting, however, that data released for Western Europe and the U.S. for the first two months of the year indicates both regions were improving, as economists had forecast, before COVID-19 exploded.

Scenarios

We propose three scenarios for the U.S. economy over the next 6 months:

1. Our most likely case has the economy collapsing about 20% at an annual rate in 2Q, and then recovering to a positive 8.0% rate in 3Q. By the end of the quarter economists agreed the second quarter will likely be the worst since the Second World War. It is widely expected the U.S. economy will remain in lockdown through the end of April. A gradual reopening may commence in May, but the process needs to be managed carefully to prevent a relapse. Once fully back, the economy should be able to grow at a healthy pace because conditions prior to the virus were supportive, and the government assistance package should provide a helpful bridge. PROBABILITY 60%

2. A second scenario has the economy declining by 30% or more followed by a sluggish recovery. A large 2Q GDP loss is a certainty. The size, speed and timing of the follow-on recovery remains a quandary. A legitimate fear is that the loss is so disruptive it depresses the post-lockdown growth rate. PROBABILITY 20%

3. A third scenario has the economy returning to well above-trend growth rate after the lockdown, having suffered a damaging collapse in 2Q. The government's fiscal and monetary policy support may buoy activity enough to retain consumer confidence and unleash pent-up demand for inaccessible services once the lockdown is lifted. PROBABILITY 20%

Market Outlook

The economic destruction unleashed by the coronavirus pandemic has few parallels in history. Events related to war, weather and even health differed in many ways predominantly regarding the source of demand erosion. The key questions for investment purposes relate to the timing of economic restoration and the quality of the recovery. On timing, contagion data for the U.S. and Europe suggests moderate loosening of restrictions may commence by May. Even with this, however, robust activity will not likely return before July. Considering the state of financial markets, and the government's efforts to support the economy, any evidence of a more favorable trend in the crisis, should improve market sentiment and set the stage for a recovery in asset prices. In fixed income markets, the divergence between government bonds and other sectors can be attributed to both economic deterioration and poor liquidity. Liquidity will likely improve with sentiment. We see significant value in credit markets, especially high yield and emerging markets, although these sectors may be slower to recover. Interest rates may move higher as liquidity and confidence return, but credit spreads are wide enough to offset the negative price effects of such a move.

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Index Definitions

Bloomberg Barclays U.S. Aggregate Index
The Barclays U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Bloomberg Barclays U.S. Treasury Index
This index is the U.S. Treasury component of the U.S. Government index. Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

Bloomberg Barclays U.S .Government/Credit Index
The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries and agencies. The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

Bloomberg Barclays U.S. Credit Index
This index is the U.S. Credit component of the U.S. Government/Credit index. Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

Bloomberg Barclays U.S. Mortgage Backed Securities Index
This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

ICE BofAML U.S. Corporate & Yankees Index
The ICE BofAML U.S. Corporate & Yankees Index tracks the performance of US dollar denominated investment grade debt publicly issued in the US domestic market by US and non-US corporations and non-US quasi-governments.

ICE BofAML U.S. Corporate Index
The ICE BofAML U.S. Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody’s, S&P and Fitch) and an investment grade rated country of risk (based on an average of Moody’s, S&P and Fitch foreign currency long term sovereign debt ratings).

ICE BofAML U.S. High Yield Index
The ICE BofAML U.S. High Yield Index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

ICE BofAML Global Government Excluding the U.S. Index (N0G1)
The ICE BofAML Global Government Excluding the U.S. Index tracks the performance of publicly issued investment grade sovereign debt denominated in the issuer's own domestic currency. N0G1 excludes U.S. government bonds.

JP Morgan Corporate Emerging Markets Bond Index Broad (CEMBI Broad)
The CEMBI tracks total returns of US dollar-denominated debt instruments issued by corporate entities in Emerging Markets countries. Two variations are available: CEMBI Broad and CEMBI. The CEMBI Broad is the most comprehensive corporate benchmark followed by the CEMBI, which consists of an investable universe of corporate bonds. Both indices are also available in Diversified versions.

JP Morgan EMBI+ Index
The EMBI+ tracks total returns for U.S-dollar-denominated debt instruments of the emerging markets: Brady bonds, loans, Eurobonds. The EMBI+ currently covers 104 instruments across 15 countries.

JP Morgan Government Bond Index-Emerging Markets (GBI-EM)
The GBI-EM is the first comprehensive, global local Emerging Markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. Variations of the index are available to allow investors to select the most appropriate benchmark for their objectives.

S&P 500 Index
An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

Nasdaq Composite Index
An index that tracks the change in the total market value of all companies listed on the Nasdaq Stock Market.

Russell 2000 Index
An index measuring the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small cap stocks in the United States.

MSCI EAFE Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe, Australasia and the Far East.

MSCI EAFE- Europe Index
The index is a capitalization weighted index that monitors the performance of stocks from Europe.

MSCI EAFE- Japan Index
The index is a capitalization weighted index that monitors the performance of stocks from Japan.

MSCI Emerging Markets Equity
The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.