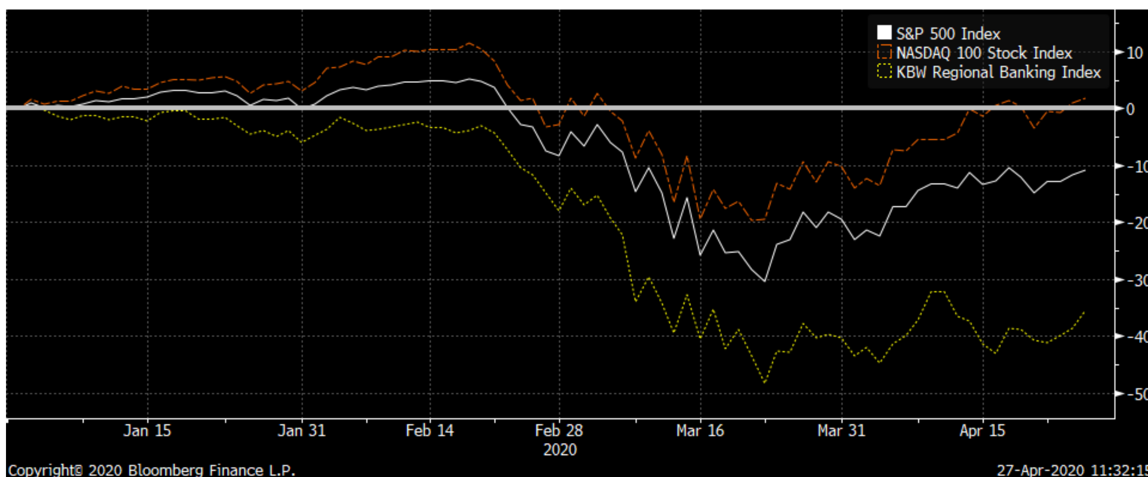
FROM THE DESK OF ERIK OROS

MAY, 2020

Global markets mounted an extraordinary recovery in the month of April, across asset classes and risk types, as central bank and federal dollars were injected into the system with historical speed and magnitude. Uncertainty remains robust as earnings season kicks off in earnest. We have only just begun to see the magnitude of the economic fallout due to the pandemic. The extent to which valuations price this uncertainty remains an open question. As clarity and transparency around potential outcomes remains elusive, our view is that investors would be prudent to reduce risk at the current juncture. At Gideon, maintaining a balanced, independent outlook for our clients, weighing risks in order to tailor portfolios and solutions that meet our clients' needs and objectives, across market cycles, has been our consistent focus. As such, in this letter we present a balanced outlook that outlines performance, valuations, and risks across asset classes.

Before we begin our review of April's performance figures, it is important to frame our discussion with the trends and prevailing market outlook "pre-COVID." While 2019 was an exceptional year for equities, it was far less so for earnings growth, with S&P earnings growing under 1% for the year. This dispersion equated to a 31.5% price return in the S&P 500, with just about 100% of those returns equitable to multiple expansion. The narrative supporting these expanding valuations centered around two pillars. First, investors expected a V shaped earnings recovery in 2020 as the effects of the trade war with China in 2019 subsiding and the Fed beginning its easing program in the summer of 2019 (more on recovery letters and symbols to come.) Next, with yields expected to remain low, "TINA – There is no alternative," remained a powerful force driving equity allocations institutionally where the hunt for yield remained robust, with the yield on nearly 60% of S&P 500 shares exceeding that of the 10-year treasury in February. Multiple expansion led us to worry about the dangerous combination of declining estimates and shrinking multiples, a recipe for the swift declines we experienced in March. As we wrote in February "While indicators remain sanguine about the possibility of a recession in 2020, we are concerned that revisions from the lofty growth estimates for 2020 earnings could have a dramatic impact on the multiple expansion that has drove markets higher in 2020."

Fast forward to April when a walk down Broadway through Times Square certainly would remind us that the pandemic still holds a looming effect, a look at certain asset prices and valuations might suggest that we've already recovered. As shown in the charts below, significant price dispersion has occurred over the month between asset classes, sectors, and security types.



While shares of banks, travel and leisure, and other obvious trouble areas of the market remain pressured, the tech-heavy Nasdaq-100 has gone positive on the year after falling nearly in lockstep with the broader averages.

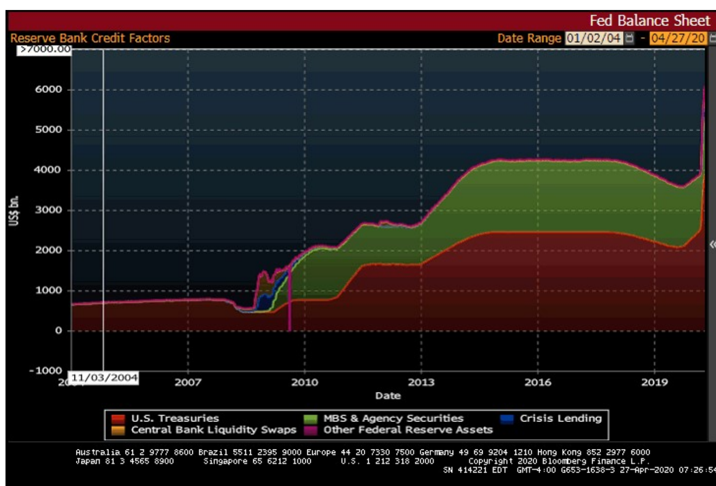
Similarly in fixed income, shares of the investment-grade ETF, LQD, fell even more precariously in the first few weeks of the crisis than those of high-yield corporates, bank loans, and high-yield municipals, as investors worried about a wave of

downgrades; yet while these stressed areas have staged only modest recoveries, LQD like the Nasdaq, has clawed back losses to go green once again YTD.

Furthermore, while the final weeks of February and the first three weeks of March were characterized by the dangerous combination of declining estimates and multiple contraction, multiples have begun their expansion again, remarkably reaching *new highs* for the year as we close out April.

Along with optimism around reopening plans, what is giving investors conviction is likely the scope and scale of the programs instituted by the Federal Reserve, the Treasury, and their respective counterparts globally. The market hit its low for the year on March 23, just a day following the announcement of "unlimited" QE by the Federal Reserve. Along with a whole host of new and old acronyms for crisis-era lending programs, these stimulative measures amounted to an unprecedented increase in monetary and fiscal support (see below).

The effect of this stimulus has had a direct result on liquidity conditions. Companies used this month and the respite afforded by these support measures to issue record amounts of securities to sure up balance sheets. Even companies with large net cash positions have raised large swaths of debt to prepare for the worst.



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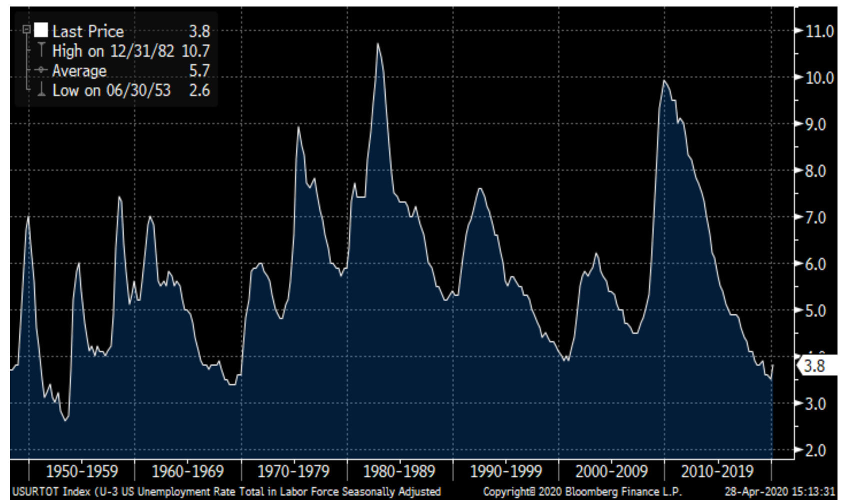
	Monetary Policy	Fiscal Policy
U.S.	Rates cut to 0-0.25%. Unlimited asset purchases.	$2.9 trillion stimulus (15% of GDP).
Japan	Rates at -0.1% already testing effective lower bound. REIT and ETF purchases doubled.	Y108 trillion yen stimulus (20% of GDP). Package includes existing measures.
Germany	ECB deposit rate at -0.5% already testing effective lower bound.	€156 billion stimulus (4.5% of GDP).
France	Asset purchases expanded by €120 billion by year end.	€45 billion stimulus (1.8% of GDP).
Italy	Pandemic Emergency Purchase Program to buy €750 billion of bonds.	€20 billion stimulus (1.2% of GDP).
U.K.	Rates cut to 0.1%. Purchase of £200 billion in bonds.	£65 billion stimulus (3% of GDP).
Canada	Rates cut to 0.25%. Program to buy C$5 billion a week of government bonds.	C$260 billion stimulus (11% of GDP).

Note: Green = adequate policy response
Orange = partial policy response
Red = so far policy response insufficient
Colors based on Bloomberg Economics' judgement, noting limited space for conventional monetary response.

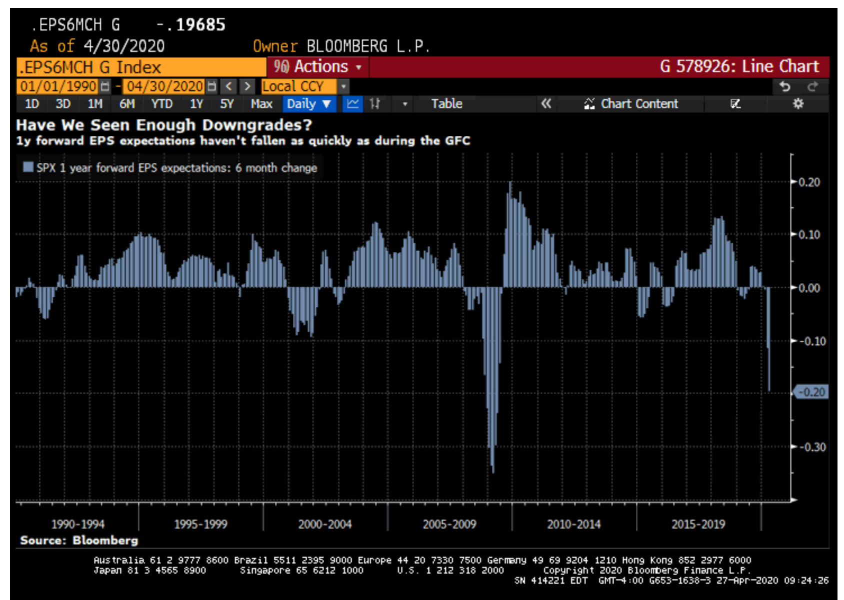
In his "Streetwise" column for the WSJ, James Mackintosh wrote "investors are all amateur epidemiologists now." The most pressing question facing investors remains the cadence and scale of reopening and recovery. It is clear that the speed of the eventual reopening of the economy will directly influence the magnitude of the economic recovery. Perhaps however, as investors we can better assess the financial damage already inflicted rather than puzzle at rate-of-transition models or access potential vaccines and treatments. The economic fallout experienced to date is immense. In the five weeks leading up to 4/24/20, 30.3 million Americans filled for unemployment, representing 18.4% of the 164.7m American labor force. This compares to an all-time high rate of unemployment since 1948 with the previous high being 10.7% in 1982.

The scale of the decline in economic activity forecasted for the second quarter is staggering with consensus forecasting a seasonally adjusted decline in GDP of 26%. The US consumer who represents just short of 70% of US GDP is likely to be especially hard hit by the crisis. This is demonstrated by a wide range of headline grabbing statistics that are likely to continue. 3.4 million homeowners, 6.4% of all mortgages, are now in COVID-19 related forbearance plans. Q1 Personal Consumption dropped 7.6%, nearly double the estimated 3.6% fall.

As earnings season kicks off, we will have a improved, but far from complete, sense of the damage that COVID and the mandated shutdowns have inflected upon US corporations. Earnings estimates for 2020 of S&P companies have fallen nearly 20% since the onset of the crisis. The question around reopening and ultimately how long this crisis will last will profoundly impact these estimates going forward. It is important to note however that much of the damage that has occured over the past two months is likely to result in liquidity shortfalls and damage to many businesses that ultimately will never be recovered.



There is a common perception that investors went point to point from 2009 to 2019, sailing smoothly to new highs across asset classes. In reality, equity markets have trembled every instance monetary stimulus has been even remotely threatened. We saw this extreme trepidation at the end of QE1 in 2011 which spilled into a eurozone debt crisis, the 2013 "taper tantrum," in 2016 when the prospect of Fed Lift Off resulted in a EM currency crisis, and in the fourth quarter of 2018 when the Fed declared its tightening program was on "autopilot." Fed fund futures currently price in zero rate hikes until 2023 and there is active discussion of negative rates. If relentless monetary stimulus is in our future what are the implications? The Fed was supposed to take away the proverbial punch bowl before the party really got going and yet markets are shaken to crisis anytime it is taken away.



This leads us to our discussion around inflation expectations. Along with the extensive fiscal stimulus enacted by Congress, questions around deficits and inflation potential have become top of mind for our clients. First it must be mentioned that these fiscal and monetary measures are designed to combat *deflation*. While cheap airline tickets, rents, and certainly oil evidence the instant deflationary effect of the crisis thus far, we must closely monitor supply chains where disruptions such as those we have seen in beef prices can have an inflationary impact. Endless monetary and fiscal easing has not resulted in inflation in the aging economy of Japan; however, as the size of the Fed's balance sheet and national debt continue to grow, this is clearly a risk that bears monitoring, especially for fixed income investments.

In our conversations with clients over the past few weeks we have focused our attention on taking the opportunity afforded by the bounce back to "high grade" portfolios. While there certainly will be ample opportunity amongst distressed issuers and in the hardest hit sectors, without any clarity on the duration or severity of this crisis it is likely premature to assess risk in these

assets with any degree of conviction. In particular, high grade municipal and corporate bonds, emerging markets, and financial stocks are areas where we have particular concern around risk.

Despite improving liquidity and prices across asset classes, markets are likely poised to remain much less efficient and increasingly detached from fundamentals. While storage costs and ill-designed exchange traded products can help explain a negative price in the oil futures market, you would be hard pressed to find an economics textbook designed to account negative prices for such a widely used input cost. It is during such inefficiencies and spells of illiquidity when there will likely be great opportunity for investors to enter positions with high levels of margin of safety and asymmetric risk/return profiles.

In the nadir of Mid-March liquidity became extremely stressed across asset classes, spilling its way into even the most traditionally risk-off assets such as treasury and precious metals. This liquidity crunch resulted in such dislocations and market inefficiencies, particularly in the shares of Closed End Funds and registered investment companies. Discounts to net-asset-value (NAV), even in the case of those funds whose holdings are entirely liquid, widened to levels in many securities that reflected more panic and forced selling than fundamentals. The opportunity to purchase these shares at exceedingly wide discounts in the shares of those companies/funds whose underlying investments and managers we have confidence, presented investors with a margin of safety that can protect our downside and present additional upside over the medium term. While these discounts have become fewer in the month of April, it is in such situations of inefficiency and mispricing where we are finding the greatest opportunity, and we expect to get another bite at the apple.

Finally, we would like to remind investors that while COVID dominates the headlines, it is still an election year. In a world without the virus this would likely be the focus of headlines and investor letters. How the balance of power shifts in Washington is likely to have a profound impact, especially as investors look toward 2021 and beyond. With rapidly rising deficits, the prospect of higher taxes is likely to be a focus of intense partisan debate. At Gideon, our focus will likely be dominated by an assessment of the fallout and the response and reopening related to the virus but we must also remain vigilant to other risks such as the election, fissures in the eurozone, geopolitical tensions, and global trade policy that are likely to intensify as a result of the pandemic.

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