Before beginning our discussion about market conditions in first quarter of 2020, we would like to take a moment to express our deepest condolences to those that have been impacted by the COVID-19 outbreak. The loss of life, health, and income is tremendously disheartening, and we are hopeful that activity will soon return to some semblance of normalcy.

Reflectively, it is difficult to place into context the market action and price volatility experienced in the quarter. The imagery is that of bad dream where you are falling into a perpetual abyss. The market decline seemed to encompass four different phases where 1) The initial fear of COVID-19 in China caused a breakdown in prices, 2) A second leg down driven by the Saudi-initiated oil war, 3) An incremental level of deterioration as the virus began to accelerate in the U.S., and 4) Mass liquidation of risky assets as the economy suddenly stopped and the uncertainty regarding the depth and duration of the impending recession began to influence investment decisions.

The result was one of the worse quarters of investment performance ever recorded as the Russell 2000 Value Index declined almost 36%. Market leadership was decidedly defensive and growth-oriented during the quarter. While no sector produced positive returns, Utilities, Consumer Staples, and Healthcare along with Technology were the best performers. Energy (impacted by the oil price war) and Consumer Discretionary (impacted by a sudden stop in retail and leisure activity) were the worst performers during the quarter. The velocity of the decline along with corresponding spikes in correlations and volatility made stock selection differentiation challenging in the initial phases of the waterfall decline. However, as the bottoming process continues, we would expect correlations to decrease as company fundamentals are more accurately reflected in stock performance.

Ironically, economic activity was beginning to improve in the early part of the quarter. With monetary stimulus from the FED and a cessation of U.S.-China trade tensions, we observed increases in manufacturing activity, regional surveys, economic surprises, and employment formation. We were beginning to see many of the green shoots needed to support equity prices which were already somewhat elevated. Although most of the economic reports for the quarter will be positive, forward looking activity will be abysmal as the impending recession comes to fruition. We expect unemployment to temporarily spike, possibly into the double-digits, and a significant number of small business closures as financial stress increases.

With states representing over 50% of U.S. GDP in some sort of shut down or quarantine and others beginning the same process, the restart of the economy is bound to be disruptive and imbalanced. However, the U.S. Congress and the FED have initiated actions that will infuse over $4T in fiscal and monetary stimulus into the economy. In addition, other global central banks have taken similar monetary policy actions. While these actions won’t prevent additional downside in the market, they serve as a backstop to ensure rational liquid markets that will, hopefully, mitigate what could have been an unquantifiable tail risk.

As we approach the 75th anniversary of V.E. Day, we are reminded that most wars have visible enemies with well-defined goals and objectives. Fighting a virtual war against an invisible enemy, while certainly less ferocious, may prove to be as complicated. Though we believe recent policy actions will help mitigate excess risk, there remains a considerable amount of trepidation among investors. The good news is valuation for small cap equities are tremendously attractive. Should the depth and duration of the oncoming recession end up being shallow and short-lived, small-cap equity prices will rebound significantly. To that end, we are watching for signs that fiscal and monetary policy is driving desired outcomes. In addition, we need to see companies continue to have access to capital at reasonable rates. Moreover, the U.S. needs to institute widespread testing and build adequate medical capacity to properly quarantine those that are sick or at risk while moving others back into the economy to increase our chances of getting back to normal sooner.
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