Quarterly Economic Update

June 9, 2020

MACROECONOMIC COMMENTARY

Fiscal/Monetary Policy

By Michael McNair

The speed and magnitude of the government response to the pandemic has been unprecedented. Congress has enacted a cumulative $1.6 trillion of tax cuts and spending that will hit the economy by September 30th. The total fiscal stimulus is equal to 7.9% of Pre-COVID GDP. The litany of provisions within the CARES Act legislation can be overwhelming; however, we can provide a clearer view of the legislation's intentions by categorizing the measures into three groups: emergency health care response, safety net, and economic stimulus.

<u>Emergency Response</u>

Congress earmarked $8.3 billion to combat COVID-19 and increase our health care infrastructure to cope with an influx of patients. The money is being used to increase hospital capacity as well as helping to fund the development of vaccines, therapeutics, and diagnostics.

<u>Safety Net</u>

The CARES Act included a refundable tax credit for two weeks of paid sick leave, 10 weeks of paid family medical leave, emergency grants for unemployment insurance, and nutrition assistance waivers.

<u>Economic Stimulus</u>

Stimulus to individuals included an increase in unemployment benefits and provided $293 billion of direct payments to households, with a maximum of $1,200 per individual ($2,400 for joint filers) and $500 per child under the age of 17.

The CARES Act also provided a number of provisions for businesses including:

The Paycheck Protection Plan provided businesses with less than 500 employees the funds to maintain payroll, rent, and utilities.

$450 billion for company loans and loan guarantees.

Direct aid for negatively impacted industries, including $150 billion for hospitals and $150 billion for state governments.

A fourth stimulus bill included an additional $484 billion of aid for small businesses and hospitals to bolster the previously enacted programs.

Monetary Policy

The unprecedented fiscal policy response enacted by congress was matched by the monetary response by the Fed. The Fed quickly stepped into its role of lender of last resort and stabilized financial markets reeling from COVID induced lockdowns.

On March 16th, the Fed cut rates to 0.25% and instituted an open-ended $700 billion quantitative easing (QE) program. In addition to QE and interest rate cuts, the Fed enacted nine separate domestic credit and loan facilities, some of which break new ground in terms of Fed participation in markets.

To get a better grasp of the programs and their intentions we break the programs into three groups: classic lender of last resort, fiscal partner, and direct investor of last resort.

Classic Lender of Last Resort

Businesses and individuals need to keep a portion of their savings in cash for spending and safety purposes. Un-invested cash does not earn a return but liquidity needs prevent this cash from being invested in anything except the shortest of maturities. However, borrowers typically want to borrow cash to be paid back over long-time periods. The role of the banking system is to rectify the mismatch between the short-term liquidity needs of savers with the long-term, risky funding needs of borrowers.

Through the process of credit intermediation, the banking system transforms risky, long-term loans into seemingly credit-risk free, short-term, money-like instruments that can be withdrawn on demand. However, the stability of the banking system is dependent on its continued access to short-term funding. If savers ever get worried and stop lending their cash into the system, banks can be forced to fire sell assets.

Over the last several decades a shadow banking system has developed which now exceeds the traditional banking system in terms of the volume of credit intermediation. Both the traditional and shadow banking systems consist of borrowers and savers. However, non-bank financial institutions (i.e. shadow banks) replace traditional banks as financial intermediaries in the shadow banking system.

The classic asset-liability mismatch is inherent to both shadow and traditional banks; however, traditional banks have FDIC deposit guarantees and access to the Fed to prevent a bank run. Lack of access to central bank liquidity or public sector guarantees has forced the shadow banking system to rely on securities financing transactions to ensure the safety of saver’s cash with high-quality securities as collateral.

In March the market participants in the shadow banking system began to question the quality of the collateral securing their funds. The stress in the shadow banking system was reminiscent of 2008. However, the Fed was quick to respond – unlike 2008.

Walter Bagehot said, “central banks should lend freely to solvent firms against good collateral at a penalty rate.” On March 17 the Fed stepped into its role as lender of last resort and provided financial market participants in the shadow banking system with short-term funding in return for solid collateral. Though instead of requiring a penalty rate, as suggested by Bagehot, the rate was quite friendly.

The Fed enacted three programs that fall into the classic lender of last resort basket: the Money Market Mutual Fund Liquidity Facility, the Primary Dealer Credit Facility, and the Term Asset-Backed Securities Loan Facility.

Prime dealers and Money Market Mutual Funds are a vital part of the shadow banking system and the facilities allowed these participants to continue to provide short-term funding to businesses, while the Term Asset-Backed Securities Loan Facility allowed the Fed to step into the role of a shadow bank and provide short-term funding directly to institutions in return for collateral.

These three facilities have been highly successful in stabilizing the shadow banking system and money market spreads are no longer stressed.

<u>Fiscal Partner</u>

Within the CARES Act, Congress allocated $454 billion for the Treasury Department that is to be levered 3 to 4 times by the Fed – providing at least $1.5 trillion to be distributed to whatever area of the economy the authorities determine it is needed.

There are three facilities in the fiscal support basket. Two of these facilities make up the Main Street lending program, which will buy $600 billion of loans from banks. Banks can use these facilities to originate new loans to businesses. The issuing banks must retain 5% of the loan on their balance sheet with the Fed purchasing the remaining 95%.

The Paycheck Protection Program Liquidity Facility is designed to facilitate the $349 billion Small Business Administration PPP lending by serving as a backstop buyer of the loans from the originating banks.

<u>Direct Investor of Last Resort</u>

In the programs mentioned above the Fed performed the traditional role of providing funding to financial market participants who are then able to perform their objective of providing funding to households and businesses. In contrast, the programs in this basket allow the Fed to provide funding directly to borrowers without the use of collateral. The Fed is breaking new ground with these policies and in some cases directly side-stepping the Fed charter which explicitly forbids such actions.

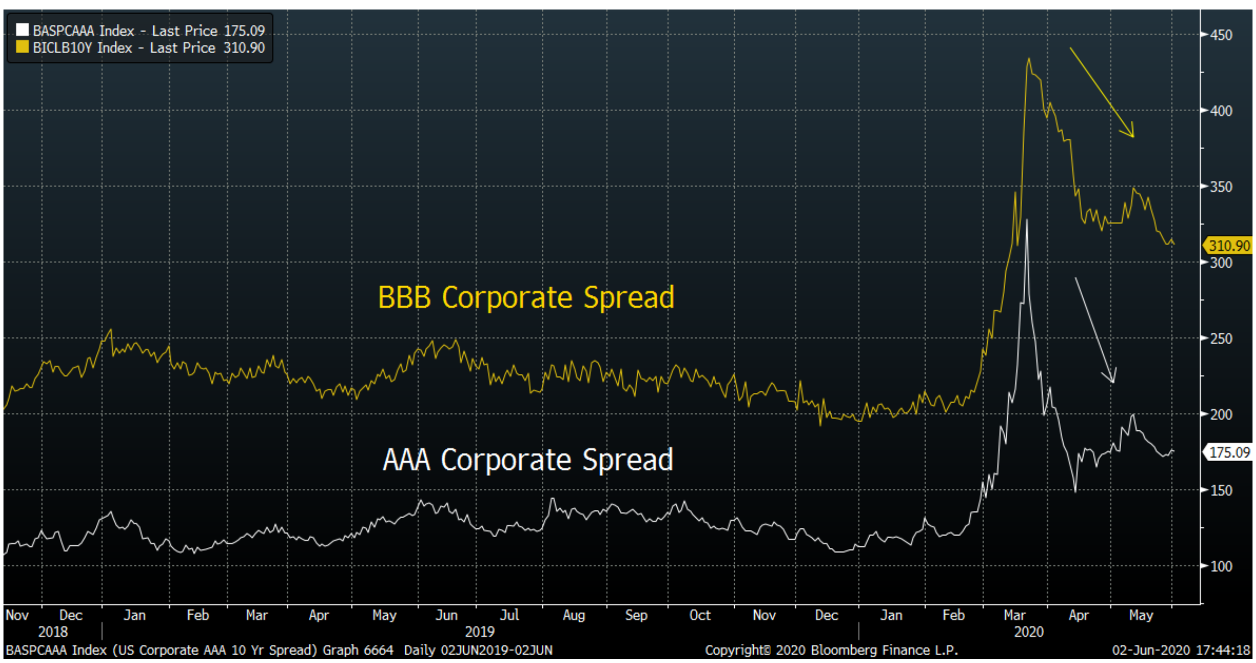
The Fed’s Municipal Liquidity Facility will buy $500 billion in short-term debt issued by large municipalities. The Fed will lend directly to the state and local governments rather than buying municipal debt on the secondary market.

The Fed's Commercial Paper Funding Facility will buy high-quality commercial paper, including asset-backed commercial paper (ABCP). Commercial paper is a short-term, non-collateralized debt instrument used by many companies for their short-term funding needs, or in the case of ABCP, it is used to fund household loans such as credit cards, mortgages, and student loans.

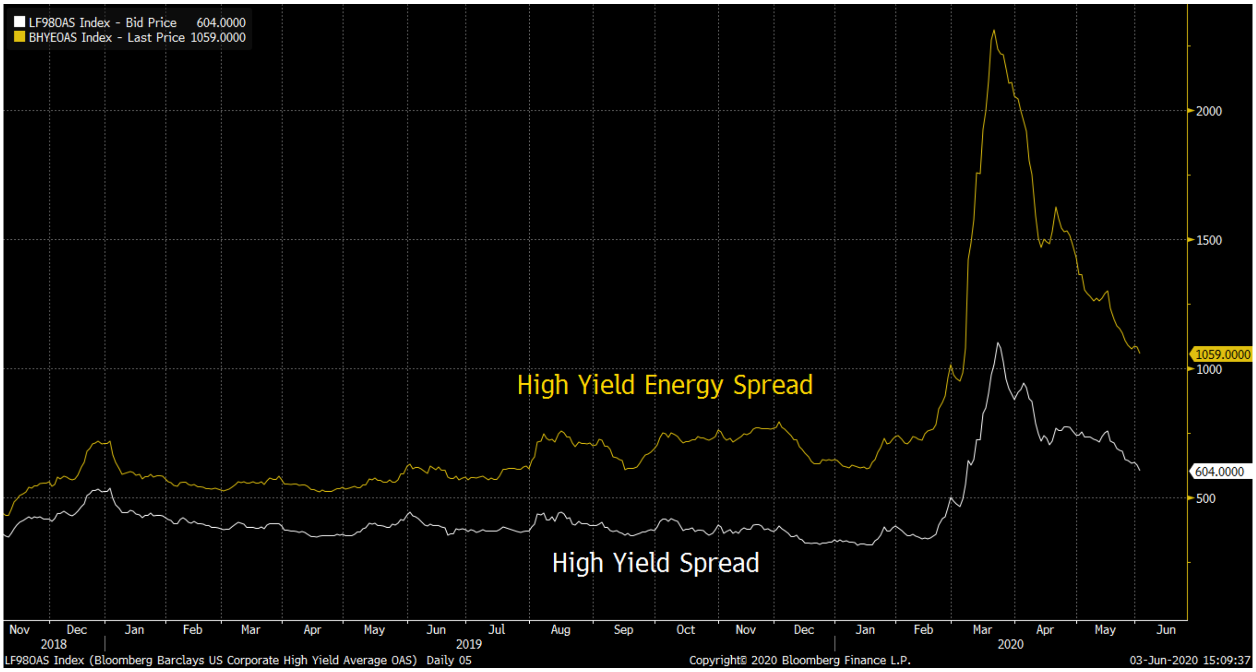
The Fed's Primary Market Corporate Credit Facility will buy debt directly from companies and the Secondary Market Corporate Credit Facility will buy corporate bonds from the secondary market, including the purchase of some high yield exchange-traded funds (ETFs).

While the Commercial Paper Funding Facility provided funding directly to high-quality borrowers, the Secondary Market Corporate Credit Facility includes the purchase of debt from low-quality issuers and without the use of collateral. This is uncharted territory for the Fed to say the least.

The purpose of the Fed's credit and loan programs in not to prevent bankruptcies for insolvent borrowers. The Fed's goal is to ring fence the insolvencies so they do not create a cascade that disrupts the credit markets and increases the cost of borrowing for the parts of the economy that are solvent. The fall in AAA and BBB spreads since the middle of March tell us the Fed's efforts are working.



Importantly, the market is differentiating between credit qualities despite fears that the Fed's actions are distorting credit market pricing. High yield and high yield energy spreads remain stressed, as warranted by fundamentals, at over 600 and 1000 basis points, respectively.



The announcement of these various programs have helped the credit markets recover, but these programs have been slow to start up. The Fed programs add up to over $3 trillion but as of May, the Fed's total credit purchases and loans was only $113 billion.

Treasury Department Impacting Monetary Policy

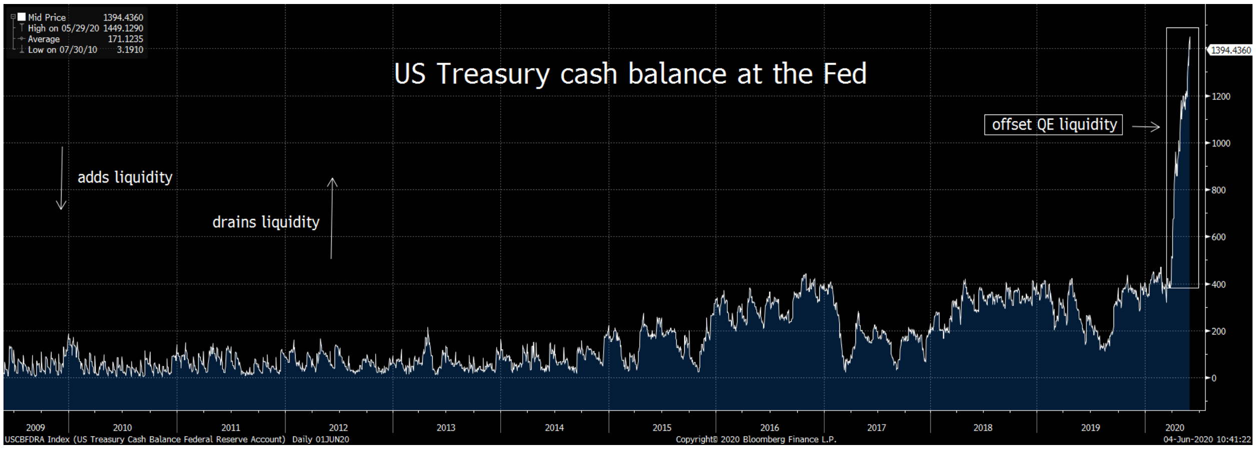
In August of 2015, the Treasury Borrowing Advisory Committee set new guidelines for the Treasury General Account (TGA), held at the New York Federal Reserve. The committee determined that under normal conditions the Treasury department should increase their cash deposits to at least $350 billion to be drawn down under special circumstances.

The unintended consequence of the new guidelines is that changes the in the TGA balance have an outsized effect on financial conditions. When the Treasury is building their cash balance at TGA it drains reserves (i.e. liquidity) out of the financial system. When Treasury is drawing down its TGA balance reserves are added to the system.

The problem is that the Federal Reserve, not Treasury, is supposed to be the sole entity tasked with setting monetary policy. Further, Treasury's TGA balances change for reasons other than monetary policy and can work to cancel out policy actions from the Fed.

Since April, the Treasury has issued a trillion dollars more of debt than they have spent. The commensurate rise in the TGA balance has drained $1 trillion from the commercial banking system, where it could be lent out, and placed on deposit at the Fed, where it effectively gets put under a mattress unable to be accessed by the financial system.

The Fed has been pumping over two trillion dollars into the financial system while the Treasury was taking a trillion out.



The Treasury has been working against the Fed over the last couple of months but that is about to end. The Treasury will draw down its TGA balance by $600 billion by the end of the month. The Treasury's liquidity injection will finally be working in the same direction as the Fed's QE, which will add another $200 billion of liquidity in June and the Fed's credit market funding schemes will also start accelerating this month. In aggregate, the US financial system should receive $1 trillion of liquidity injections in June. To put that number in perspective, consider that the Fed's QE1 program, in 2009, ran at an average of $116 billion a month.

Conclusion

We estimate that the government lockdowns have removed $3 – 4 trillion from the US economy. However, the federal government has responded with both fiscal and monetary policy support. The Treasury's fiscal injection will exceed $3 trillion ($1.6 trillion of CARES Act tax cuts and spending and $1.5 of automatic stabilizers) and further rounds, with state and local government bailouts, along with a potential middle-class tax cut could see the stimulus north of $4 trillion. Meanwhile, the Fed's credit and liquidity backstops will exceed $3 trillion of support. We are in a wartime economy and fiscal and monetary policy are doing 'whatever it takes'.

Economic Outlook

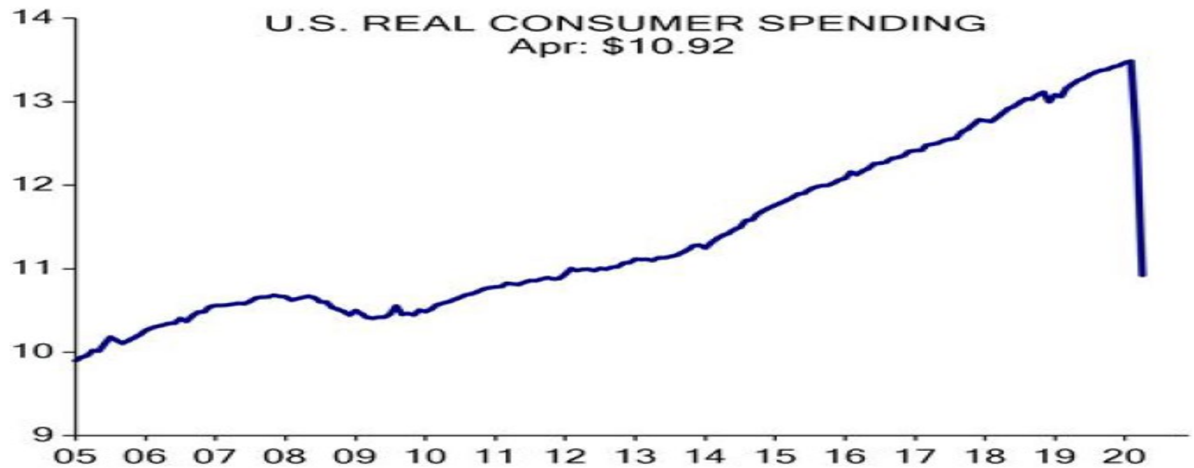
By Bobby Long

Periods of weakness and recession are part of the economic cycle that have persisted throughout history. While each is unique and can be brought on by a variety of economic conditions that may have specific triggers or events, the underlying conditions through the cycle share many similarities that repeat as economic activity expands to a point of peak growth and profits, followed by a period of contraction and then subsequent recovery. Employment typically follows the cycle loosely, rising through the expansionary phase and falling as conditions contract. The length and depth of the contraction can vary, with a recession marked by two or more quarters of negative GDP growth. In the midst of an economic contraction and recession, it is difficult to measure the depth in real time and mark when contraction ends and recovery begins. It's a process that is marked by looking back in time once a sustainable recovery can be quantified by hard economic data. After an 11 year expansion following the prior recession, it is now clear that we are currently experiencing an extremely sharp contraction that most likely will be deemed a recession. While economic conditions were relatively healthy leading into the contraction, the COVID-19 outbreak and subsequent decision to "shut down" the economy has resulted in a uniquely sharp reduction in activity. At this time, we are still evaluating where we are in the process and whether further weakness is yet to come, or whether to look ahead to the recovery. While there is much we still do not know at this point in time, we do know that there are two unique conditions that will mark this period of economic contraction. One is the nature of the trigger and the conscious decisions made to bring the economy to a halt in the effort to preserve public health and the safety of citizens. The second is the degree and quickness of government policy support. Both make it difficult to understand the depth of this contraction and the path to recovery.

The decision to close non-essential businesses and advise citizens to severely limit activities and social interactions has had a drastic effect on the economy. The COVID-19 outbreak alone was enough to dampen economic activity, but the decision to lock things down by government decree led to an outright and immediate collapse. The choice is between taking drastic measures now in an effort to preserve public health and hope to only endure a brief but temporary reduction in economic activity; or risk public health and hope the outbreak would prove less devastating. Choosing the latter not only risks the health and safety of citizens, but carries the risk of a more pronounced longer term impact on economic activity and potentially more permanent effects should it have a major impact on demographics. History will show whether the decision was correct, but it will likely be argued indefinitely. The hope is we will be healthy and wealthy enough to argue the widespread economic lockdown was extreme and unnecessary.

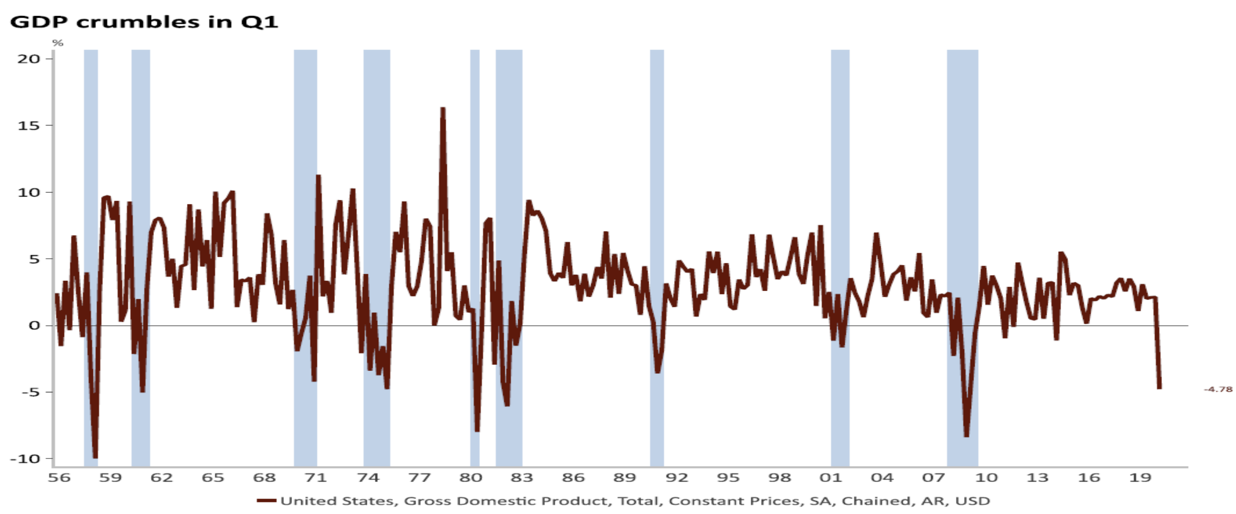
What we do know now is that the COVID-19 outbreak and the decision to "shut down" the economy has resulted in a severe reduction in economic activity and employment. There is a temporary nature to this as activity is sure to rebound as businesses and the economy open back up. However, will it rebound back to prior levels and how quickly will it take to recover are the questions that remain unanswered. If the rebound falls short of prior levels or is slower to take hold, more permanent damage to employment is likely, which could then feed into prolonged weaker conditions.

First, let's look at just how pronounced this drop in activity has been. We could look at a dozen different charts to show this, but they all tell the same story. The consumer spending chart below provides a good example.

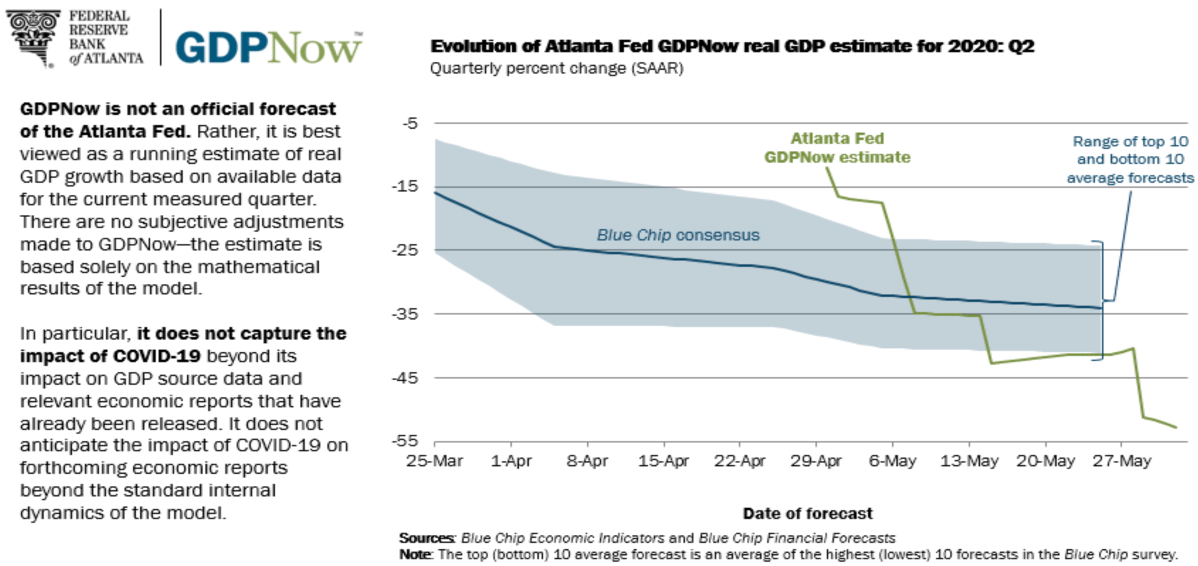


Source: Evercore ISI

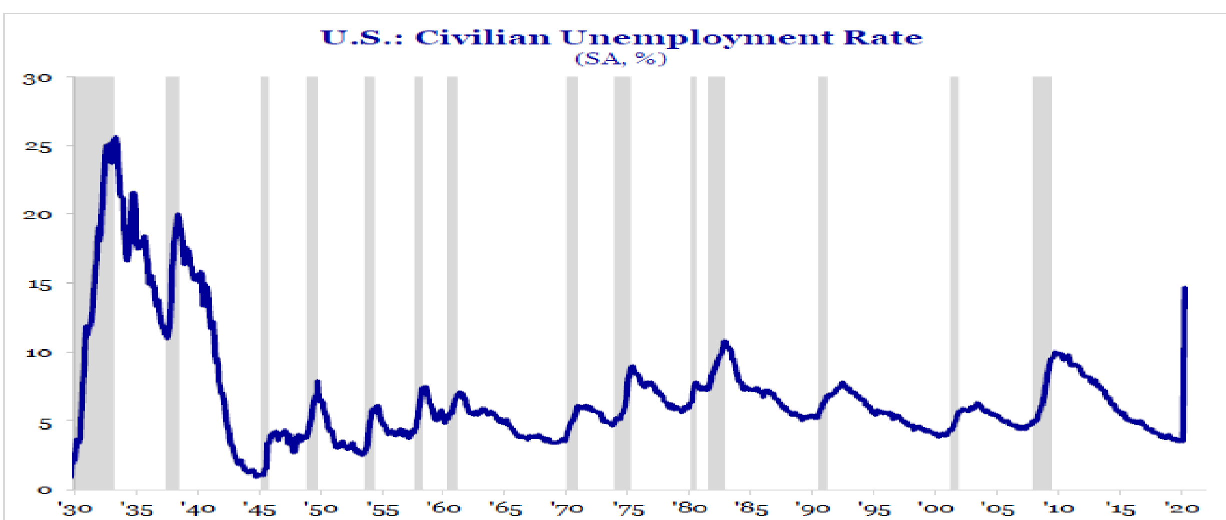
Consumer spending fell 14% in April, after falling roughly 7% in March. The sharp drop in activity can be shown across a variety of measures, but the trademark characteristic of the current contraction versus prior periods is both the degree and quickness of the contraction. In the chart above, note the current drop relative the 2008-2009 contraction. Housing starts fell 18% in March and 30% in April. Retail Sales fell 9% in March and 17% in April. Durable goods orders fell 17% in both March and April. U.S. GDP declined by 5% in the first quarter of 2020. The chart below shows this drop relative to prior recessionary periods over the past 60+ years.



The GDP number is before the widespread lock downs really went into effect. Estimates vary widely, but second quarter GDP could decline by as much as 40%. A plunge of that nature would drop off the bottom of the chart above and well below these prior recessionary periods highlighted by the gray bars. This is an unprecedented abrupt contraction. The Federal Reserve Bank of Atlanta produces a running GDPNow estimate based on current data that is fed from mathematical models without adjustments. This may overstate the estimate, but it has recently dropped below -50%.

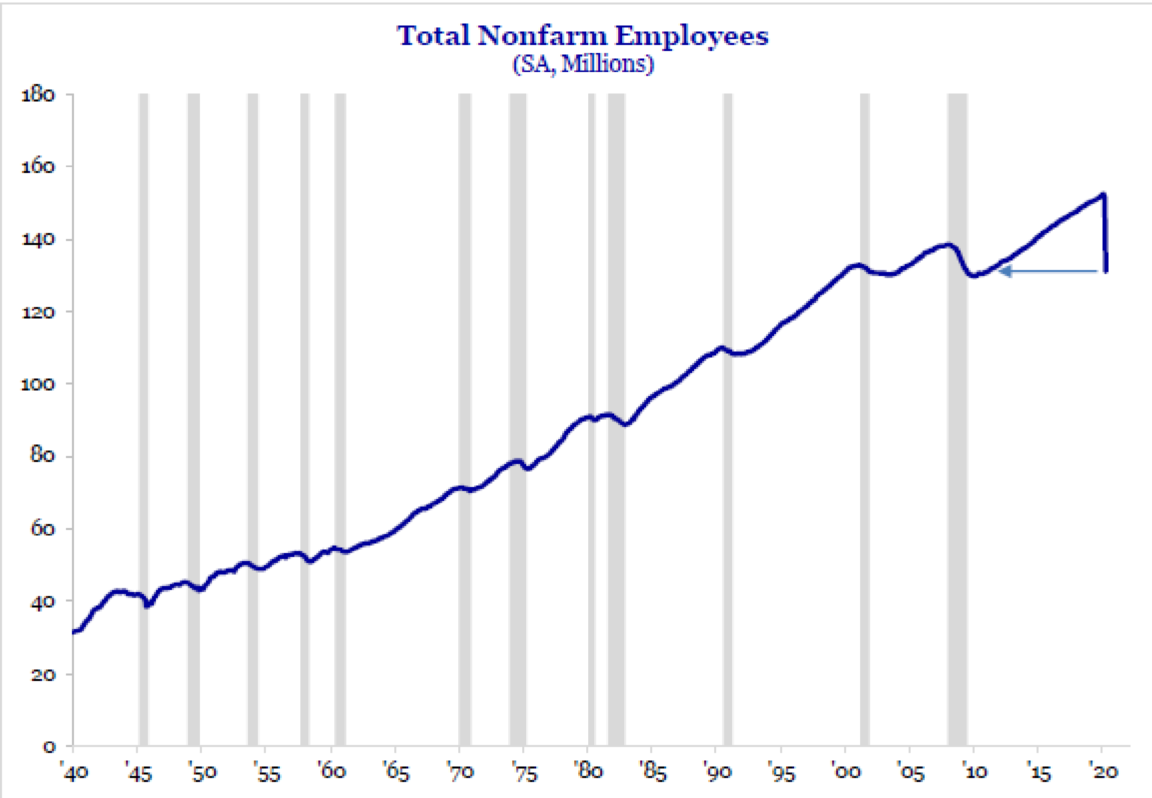


Businesses typically react to weakening conditions by laying off employees as activity and profits shrink, feeding into the cycle of weaker conditions as consumers have less to spend and service obligations. The current cycle is marked by the immediate rise in unemployment. The unemployment rate has increased from 4.4% in March to 14.7% in April. May estimates are for the rate to rise further to 19.5%. The chart below shows how this stacks up historically.



Source: Strategas Securities LLC

At the peak of the cycle in February, there were 152.5 million people on U.S. nonfarm payrolls as measured by the U.S. Bureau of Labor Statistics. This fell by 881,000 in March, then another 20.5 million in the month of April. The chart below shows the decline relative to prior recessions. The current decline wipes out almost all the job gains since the 2009 recession.



Source: Strategas Securities LLC

With the abrupt drops in activity and employment, data collection is challenging and it will be important to see where much of this data stabilizes as the economy opens back up.

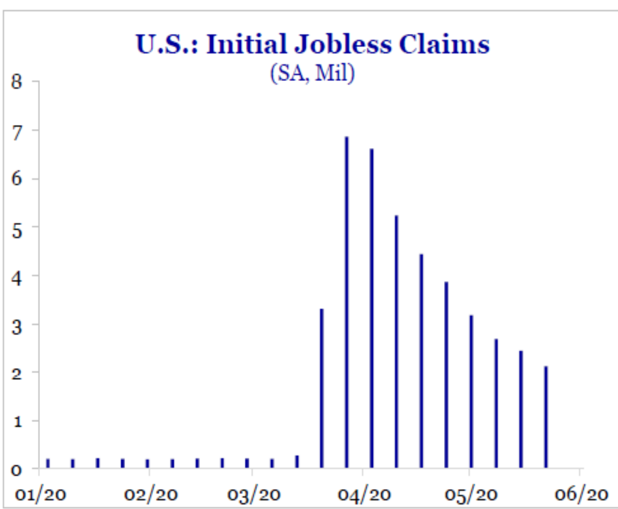
Having discussed the magnitude and sharpness of the current contraction, the government response has been unprecedented as well. The U.S. government has initiated an extraordinary amount of fiscal and monetary stimulus in an effort to both stabilize financial markets and support individuals and businesses affected by the shutdown. While the programs have had their bumps, they have been implemented quickly to help small businesses continue to meet their obligations (payroll, debt service, rent, etc.) and provided a continuing income stream to individuals who have lost employment. Forbearance programs have helped keep individuals in their homes and small businesses out of bankruptcy so far. Monetary stimulus has provided liquidity to ensure financial markets continue to function smoothly. The prior recession was plagued by liquidity issues and the ripple effects of defaults on mortgages and loans that had been securitized and used as collateral to fuel additional lending. Some lessons seem to have been learned and great efforts have been made to provide stability to financial institutions and markets. The efforts also acknowledge that many small businesses and individuals have a very limited ability to navigate more than a few months with a significant loss of revenue or income before they are permanently affected. Keeping businesses afloat until revenues recover and individuals in homes has been a priority.

With the rate of new COVID-19 cases now subsiding in many areas of the country, government restrictions on non-essential businesses and individuals are being lifted and the economy is beginning to open back up. There will certainly be a sharp rebound in activity given the simple function of forcibly halting activity, then restarting it. Economic measures will improve off the lows and data will be less bad. The degree and sustainability of resuming activity will be what is important. This will determine whether furloughed and temporary laid-off employees are brought back. Businesses need employees to operate, so they will be brought back, but at what level? The U.S. has a large service economy and a large portion of job losses have been in the retail, hospitality, leisure, and travel related industries. How quickly these industries recover will be key to employment and the overall direction of economic conditions. Many of those who have lost jobs view this as temporary and assume they will be brought back and rehired as the economy opens back up. As these business open back up, the question remains whether they will open back up with full operations or on a more limited basis. If they cannot resume full operations with a quick return to 100% of prior revenues, some of these temporary job losses will become permanent. Business expenses may also be pushed higher due to costs associated with maintaining stronger sanitary conditions and social distancing measures, which could pressure margins and profits. The government support has provided a lifeline to many small businesses that will give them the opportunity to open back up, but the reality is it could be challenging for many service related industries. All businesses have a business model that requires a certain level of activity to be profitable. The composition of fixed versus variable costs, among other factors, provides a degree of flexibility to navigate different conditions. Airlines need flights filled to a certain capacity. Hotels need a certain level of rooms filled per night. Restaurants need a certain number of tables seated per night. Theaters and entertainment venues need to sell a minimum number of seats. Gyms and fitness centers need to maintain a certain number of memberships. These are just examples and are applicable to both large and small businesses. In turn, many businesses feed off these industries and will struggle if the businesses they serve cannot operate profitably. These businesses will need to quickly ramp back up to a certain level of activity. If consumers are slow to return, it could cause problems.

The concern is some small businesses will not open back up. Some will open back up, but at a lower level of activity with less employees or limited hours. Others may open back up and bring employees back to work, only to be forced to lay them off again after a few months. Business and leisure travel may be slow to return. Employers will slowly send employees back out, but many have grown comfortable without the in-person interaction in the near term and may be happy to keep travel expenses down while they can. Individuals will likely continue to prefer not to travel by air for a while longer as health concerns linger, opting to hit the road instead for any leisure travel. International travel may stay down as well with concerns that travel restrictions could leave individuals stranded. This may impact the recovery of airline and hotel revenues, as well as restaurants and the many other businesses that benefit from business and air travel.

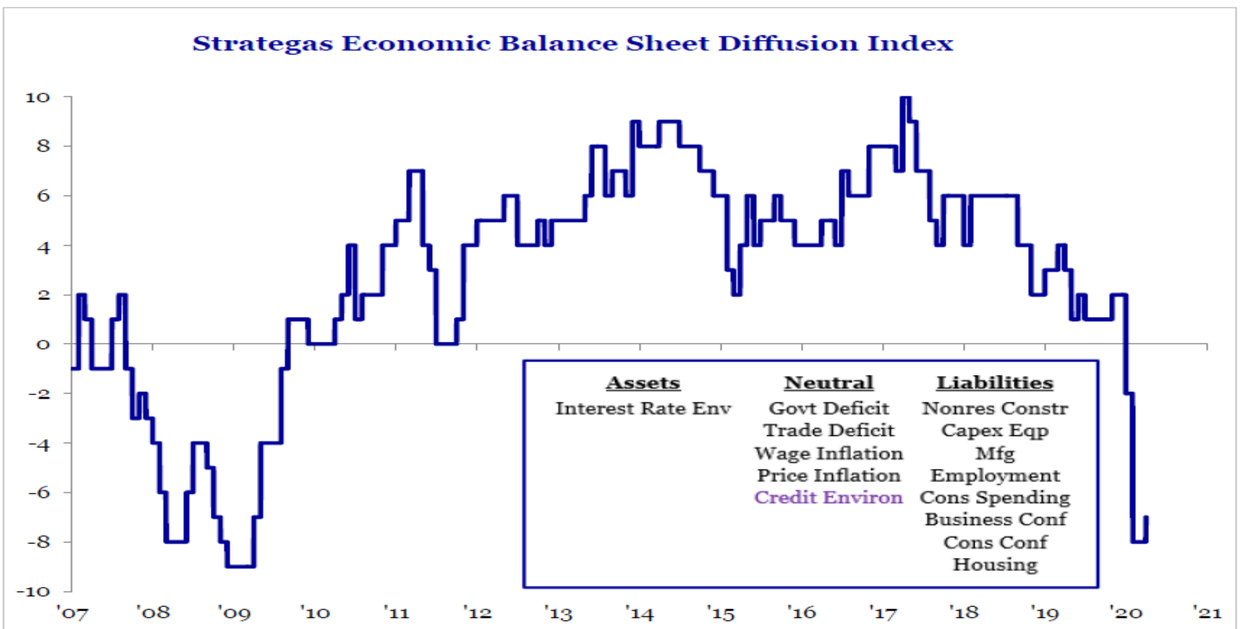
Larger retail businesses have faced challenges for several years now with increasing online sales and consumers spending more on experiences versus goods. They have been shuttering physical stores over the past several years and have already indicated they will not open some stores back up as the economy reopens. Independent retailers often operate with little liquidity and less flexibility to meet fixed costs, leaving them badly in need of a quick recovery. As many businesses and employees have adjusted to work-from-home setups successfully, some employers who occupy large office buildings have indicated they are not in a rush to bring employees back to the office full-time and may have a significant number work remotely on a more permanent basis. If they do, this will negatively affect the surrounding small businesses that serve these central business districts. Markets will eventually adjust rents to stabilize occupancy levels, but those surrounding businesses will have already taken the hit. Businesses that thrive around entertainment venues that host events such as concerts and sporting events will suffer if restrictions around mass gatherings are not lifted soon. Consumers who have dropped memberships to their gyms and fitness centers may not immediately come back now that they have found substitutes in the home fitness surge, leaving many of these businesses already on the path to bankruptcy.

All of these concerns point to why employment is key to a quick recovery, and why it is at risk if activity does not rebound as sharp as it fell. If activity falls short or is slow to resume, it could trigger ripple effects that make this contraction more than a temporary setback. This is why employment levels should be watched closely as the economy opens back up. Employment will tell you whether the activity is resuming. The charts below show recent trends for initial jobless claims and continuing jobless claims. Both are still at high levels, but it is important that these start significantly trending down as restrictions are lifted and businesses open back up.



Source: Strategas Securities LLC

Since we are reopening the economy, conditions will improve as we move into the second half of the year. GDP and many economic measures will likely rebound by double digit percentages in the third quarter based on the math alone. Mobility measures indicate people are beginning to venture back out, restaurant reservations are being made, and TSA checkpoint numbers are picking up some. Government support has helped businesses and individuals affected by the shutdown and so far has largely kept them from experiencing the associated pain. The good news is the economy and consumers were relatively healthy before the outbreak and shutdown. Don Rismiller with Strategas Securities, LLC publishes an Economic Balance Sheet Diffusion Index each month in an attempt to quantify their interpretation of the state of the economy. We have found it to be a good summary and characterization of several broad economic conditions and whether they are currently assets or liabilities to the state of economic conditions. As the chart shows below, the index has weakened significantly over the past couple of months and highlights several liabilities as risks.



We are hopeful of a quick recovery in employment, but view it as a significant risk should it falter. This could be due to a slower than expected recovery, or more concerning a resurgence of new COVID-19 cases. The consumer has been an important component of growth this cycle and a weaker recovery in employment would feed into a negative cycle. The pandemic has also exposed significant supply chains issues that remain a risk to activity. Weak manufacturing activity and trade uncertainties were already hurting business confidence and capex prior to the outbreak, along with political uncertainty that has also increased. Businesses will be reluctant to make investments with these risks on the table. Longer term, supply chain issues and trade disputes could bring more manufacturing activity back to the U.S., supporting private fixed investment. All economic contractions have a trough and subsequent recovery. At this time, it remains difficult to determine where we are in the cycle and we look for signs of stabilization before we can become more constructive on the recovery.

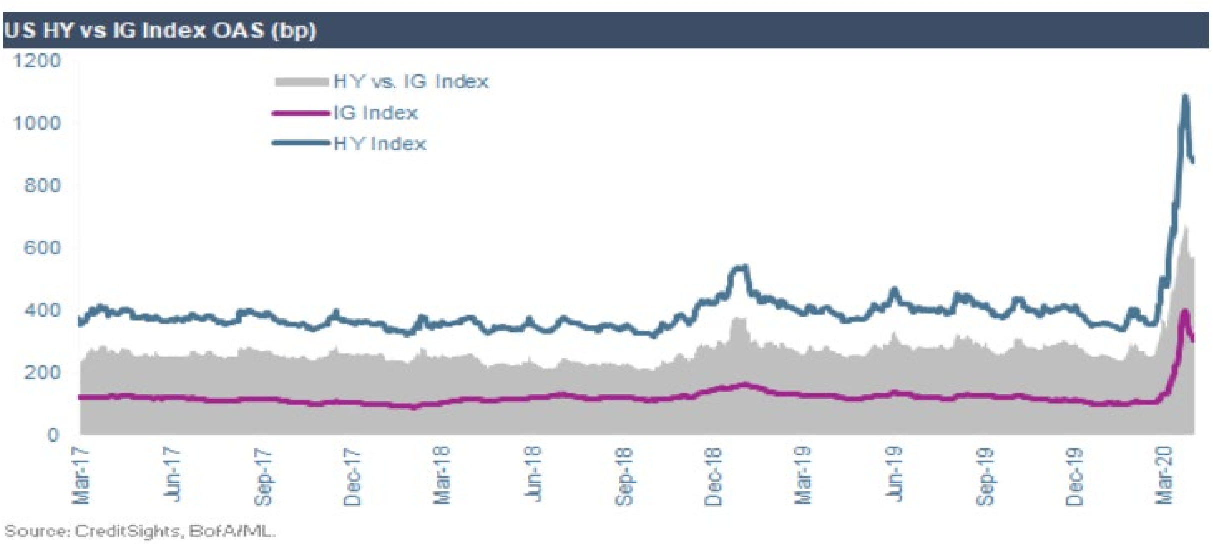
RSA PORTFOLIO STRATEGY

Interest Rates and Fixed Income Strategy

By Nick Prillaman

When we last met on February 25th, the coronavirus was beginning to unleash havoc on the financial markets. The S&P 500 was at 3128, the 2-year Treasury was at 1.22%, and the 10-year Treasury was at 1.35%. By the end of the month, S&P 500 closed down almost 13% from the all-time high on February 19th as investors abandoned risk assets. The 2-year Treasury fell to .91% and the 10-year Treasury dropped 1.14% as the flight-to-quality trade was in full force. Investment grade spreads bounced out 20 bps and high yield spreads gapped 109 bps higher, per Wells Fargo Securities.

The pain trade in risk assets continued for the majority of March as investors gradually realized "COVID-19 would force US and European countries to put large parts of their economies in lockdown," per BofA Securities. The bank went on to say, "In a matter of days the US economy went from record low unemployment to recession and a liquidity crisis developed because everybody needed cash to cover a period of uncertain length with diminished cash flows." The abruptness of the slowdown can be seen in this chart which shows investment grade (IG) and high yield (HY) credit spreads. Bond markets went from being stable and healthy to exhibiting distress very quickly. The IG credit curve even inverted during this time, because according to CreditSights, "as investors were hit with redemptions, short dated bonds seemed to be the ones able to find liquidity, and prices fell quickly." Corporate credit curves are usually upward sloping to reflect the need to compensate investors for their willingness to tie up money for a longer period of time. This was clearly not the case during the panic in March.



Source: CreditSights

The total returns in high grade and high yield were negative 7.46% and negative 11.76 percent. These assets vastly underperformed Treasuries and Agencies which logged gains of 3.26% and .95%. Among high grade borrowers, pipelines and oil and gas were the two worst sectors with eye-popping excess returns of negative 2,128 bps and negative 2,072 bps, according to BofA Securities. Oil-related names were hit particularly hard as crude oil prices went into free fall due to the Saudi Arabia/Russia oil price war. U.S. WTI oil fell 24% on March 9th in the wake of Saudi Arabia slashing its "official crude selling prices for April in a sudden U-turn from previous attempts to support the oil market," per Yun Li at CNBC.com. Oil prices were also affected by demand destruction related to COVID-19.

The mortgage-backed securities market was not immune to what was going on in the global financial markets. As one can see in the chart below of the Bloomberg Barclays U.S. MBS Agency Fixed Rate MBS Average OAS, spreads went from 41 bps in February to 132 bps on March 19th. That was a significant move given that the United States essentially guarantees these assets. In a report dated March 20th, Wells Fargo Securities said, "most of the liquidations for MBS have happened from REITS (deleveraging) and Money Managers (outflows). As we discussed last week, we estimate that REITS might have sold $40-60 billion in MBS recently" The firm also said that the number could have been $20 billion higher. The carnage in the mortgage REIT space was so bad that multiple funds were faced with margin calls they couldn't meet.

Source: Bloomberg

The Treasury market even experienced heightened volatility. Interest rates initially dropped significantly in a flight-to-quality trade. The 10-year Treasury started the month at 1.11% and then fell to an intraday low of 31 bps. The environment then changed as fund liquidations put pressure on rates. Wells Fargo Securities said they saw an outflow of 9% from the AGG and the BND ETFs as of March 20th. From the low of 31 bps, the 10-year Treasury surged almost 100 bps to a high of 1.27%. That was a major oscillation and was very indicative of the extreme nature of the markets at that time.

While all of this mayhem was occurring, the Federal Reserve kicked off its rescue campaign on March 3rd with a 50 bp cut in the Fed Funds rate. Markets clearly needed more as they continued to fall further, so the Fed lopped off 100 bps in the Fed Funds rate to bring the lower bound down to 0 percent on Sunday, March 15th. Beyond cutting rates, the central bank restarted its quantitative easing (QE) program to the tune of buying $500 billion in Treasury securities and $200 billion in mortgage-backed securities. Investors were still not placated by these policy adjustments, so the Federal Reserve brought to bear a full spectrum of tools to combat the widening crisis. In a little over a week, various funding facilities were enacted which included support for commercial paper, primary dealers, money market mutual funds, corporate credit, and asset-back securities. In addition, the limits on MBS and Treasury purchases were removed. The trends in multiple areas of the financial markets began to change. Option-adjusted spreads in the agency mortgage market peaked on March 19th at 132 bps and then promptly fell to 28 bps on March 30th as the Federal Reserve bought $254 billion over that time. Other examples include the VIX topping on March 18th and the S&P 500 bottoming on March 23rd.

With monetary policy makers doing their part in unfreezing the markets, lawmakers ramped up the fiscal policy side to plug the hole in economic activity. On March 27th, President Trump signed the $2 trillion CARES Act. According to the U.S. Treasury, the Act provided up to $1,200 per adult and $500 per child based up upon certain income thresholds. The Paycheck Protection Program provided aid to small businesses while the Coronavirus Relief Fund gave payments to States and Local governments. This law provided much needed relief to the American economy and combined with the Federal Reserve's actions, the financial markets ended with a better tone than the week or two prior.

April was a vastly different month as the upheaval significantly abated from a financial market perspective. BofA Securities said, "Risk assets staged a major rally in April as the US virus case curve flattened, Europe and the US began the process of gradually opening up from the crippling lockdown, a treatment option for COVID-19 was verified (Remdesivir) and Pfizer stated they expect to development a vaccine by Fall on an emergency basis." The S&P 500 returned 12.8% for the month while Treasuries made little progress. The 2-year Treasury yield fell 5 bps while the 10-year Treasury yield dropped 3 bps. Spreads in the Credit Suisse US Agency 3-5 Year Index fell almost 4 bps while option-adjusted spreads in agency mortgages fell 21 bps.

The corporate bond market saw significant outperformance over Treasuries. High grade corporates returned 5.27% and high yield posted a 3.80% gain versus the .41% gain in Treasuries. Even though WTI crude oil traded at an unheard of price of negative $40.32 in mid-April, pipelines and oil and gas were the two leading sectors in high grade bonds with excess returns of 1,088 bps and 718 bps, per BofA Securities.

The risk rally continued for the month of May "as investors took comfort in the reopening of parts of the US, the potential for a fast tracked vaccine, and the Fed's purchases of IG and HY ETFs", according to CreditSights. Strong gains were concentrated in the riskier portions of the market with the S&P 500 popping 4.76%, high yield rising 4.57%, and high grade corporates returning 1.75%. Among high grade sectors, pipelines and oil and gas were the two frontrunners for the second month in a row at 641 bps and 568 bps in excess returns as oil prices recovered. Safer assets posted muted performances with Treasuries losing 31bps in total return and Agencies eking out a .13 bp gain, per BofA Securities. Mortgages were lackluster as well at a .12 bp return, as indicated by Bloomerg.

In the terms of recent activity in RSA's fixed income portfolio, we had a sizable Treasury maturity occur in May and decided it would not be accretive to reinvest the proceeds back into Treasuries. Our weighting declined but our duration increased because of the maturity. We are currently underweight the asset class but long duration. Our view on interest rates is that they are not going anywhere anytime soon. The Federal Reserve is currently supporting the Treasury market and has purchased $1.587 trillion from March 11th to May 27th which gives them $4.110 trillion in total holdings, according to Bloomberg. The chart of the 2-year Treasury shows the effect of the Federal Reserve's purchases as interest rates have been brought to a very low level at 17 bps. Farther out, the interest rate curve is not much more attractive with the 10-year Treasury yielding 68 bps at the time of writing. Rising rates are not something monetary policy makers want right now. According to Bloomberg News, "Federal Reserve Bank of New York President John Williams said policy makers are "thinking very hard" about targeting specific yields on Treasury securities as a way of ensuring borrowing costs stay at rock-bottom levels beyond keeping the benchmark interest rate near zero." Until the economic damage inflicted by COVID-19 is fully repaired, interest rates will be low and range-bound.

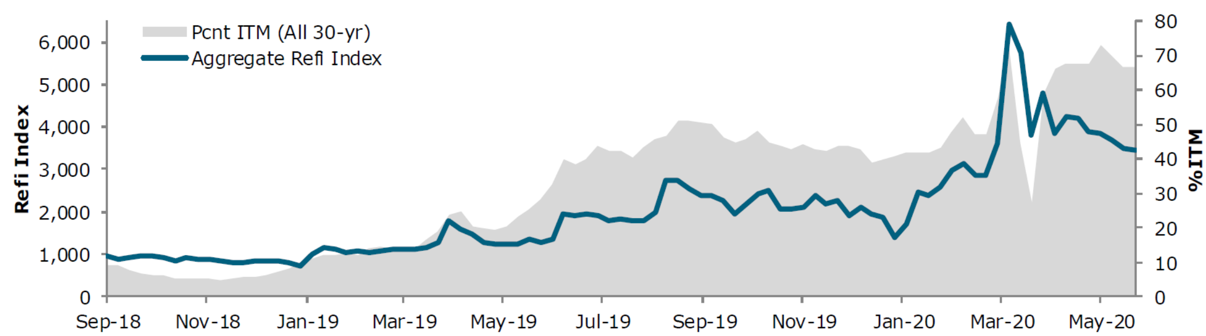
Source: Bloomberg

The Agency portion of the fixed income portfolio had a couple maturities since our last meeting. We purchased a 3-year non-call 6 month security to pick up 77 bps in spread over the 3-year Treasury and to stay duration neutral. Since volatility was high at the time, the spread was exceedingly attractive due to the callability feature embedded within the bond. Now, volatility has come in, so callable bonds are not as attractive, but they do still offer some pickup. After materially tightening since the March peak, spreads in Agencies have been steady and should remain that way. We are roughly equal weight and basically duration neutral. Going forward, we plan on replacing called bonds or maturities with attractive securities and keeping our weighting stable.

Multiple purchases were completed in the mortgage-backed securities sector. We added a 30-year 3.0% coupon Fannie Mae, two 30-year 2.5% coupons comprised of one Fannie Mae and one Freddie Mac, and two 15-year 2.5% coupon Fannie Mae mortgages. The rationale behind the 3.0% pool was to reinvest prepayments, increase our duration, raise the weighting in the coupon and to take advantage of the recent blowout in mortgage spreads. The estimated option-adjusted spread was 73 bps and the option-adjusted duration was 3.69 years. For the 30-year 2.5s, we felt it was prudent to establish a position in the coupon after the Federal Reserve started buying it. The trade brought the portfolio closer to the benchmark. Finally, we reinvested our most recent prepayments into 15-year 2.5s as well as adding new money to the mortgage space after the weighting had declined.

The outlook in mortgages is neutral. Spreads are well off their apex in March and while the value is still better than other government-sectors, mortgages are not as attractive as corporate bonds. The Federal Reserve is continuing to buy mortgages so mortgage spreads should remain in check. According to Bloomberg, the Fed's Agency MBS holdings have increased by around $460 billion from March 18th to May 27th. Refinance risk is an issue at the present moment. According to Freddie Mac, "the 30-year fixed-rate mortgage has again hit the lowest level in our survey's nearly 50-year history." That report dated May 28th showed 30-year average mortgage rates at 3.15% and 15-year rates at 2.62%. The chart below from Wells Fargo Securities shows that over 60% of 30-year mortgages are at least 50 bps in the money which means they have a material incentive to refinance. This is great for American homeowners but not so much for MBS returns. The RSA is underweight the asset class and short duration.

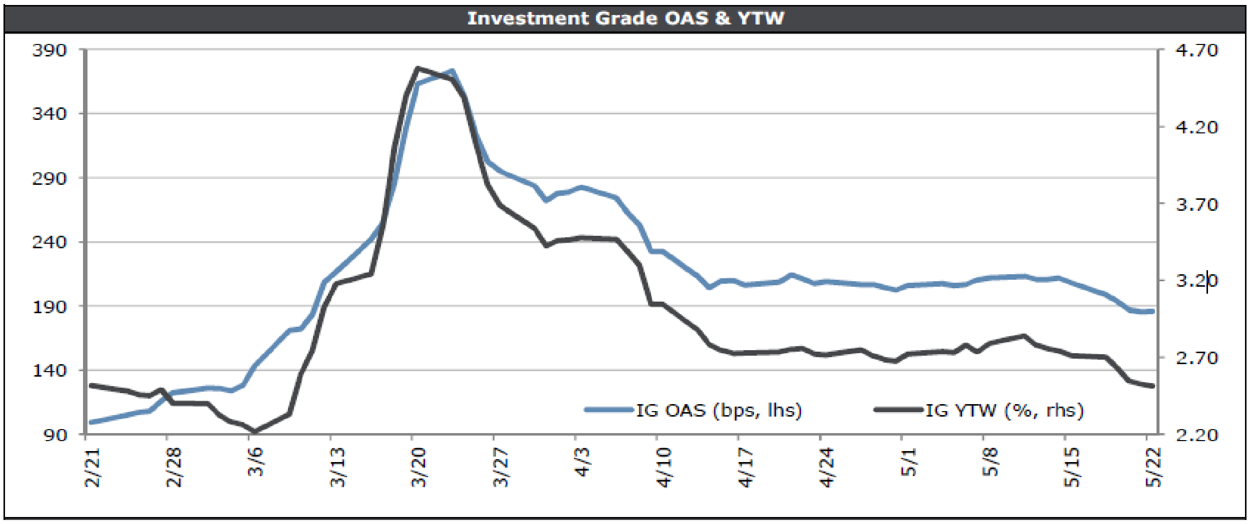
Exhibit 11: Refi Index vs Percent In The Money



Source: Freddie Mac, eMBS, MBA, Bloomberg, Wells Fargo Securities | * Shows percentage of 30-year mortgage universe at least 50 bps in the money.

Source: Wells Fargo Securities

That vast bulk of the activity in RSA's fixed income portfolio came from the corporate bond sector. We purchased 40+ securities in the new issue and the secondary markets to take advantage of the great opportunity that presented itself over the last few months. Some of the bonds we picked up included a 5-year Anglo American security at a spread of 500 bps, a 5-year Lowe's note at a spread of 355 bps, and a 7-year BP bond at 300 bps over. The mid-March through early-April period was particularly good from a buyer's perspective as indicated in the following chart of investment grade spreads.



Source: Wells Fargo Securities

The prospects for harnessing large excess returns have dwindled recently as spreads have come in, but we continue to believe that corporate bonds are the asset to own in fixed income given where spreads are. Our preference is for the investment grade variety as the Federal Reserve stands ready to provide significant support for investment grade corporates with their Primary Market Corporate Credit Facility (PMCCF) and their Secondary Market Corporate Credit Facility (SMCCF). The PMCCF and SMCCF have a combined capacity of up to $750 billion. According to Charles Schwab, the Fed can purchase BBB+/Baa3 rated bonds or higher from March 22, 2020 onward with maximum maturities of 4 years for the PMCCF and 5 years for the SMCCF. If a bond gets downgraded to junk from investment grade during the March 22 time frame, the Fed can still buy it. Corporate bond ETFs can also be purchased with the lion's share being allocated to investment grade funds and the balance going to high yield funds. The Fed's support of the high yield markets appears to be much more limited in scope. This combined with heightened default risk gives us pause on buying large amounts of high yield bonds.

Beyond Fed support, corporations have done an excellent job shoring up their balance sheets. According to Patti Domm at CNBC, "Corporations, borrowing at more than twice last year's pace, have already raised more than $1 trillion in 2020 as they race to restructure older debt, pay down bank lines and raise cash to weather the recession." This is a definite positive for keeping corporate spreads contained and hopefully, they can move tighter as the economy opens back up. The RSA is overweight corporate bonds and short duration.

Domestic Equity Strategy

By Hunter Bronson

It could go unsaid, but we are living through truly unprecedented times. On the day of our last update, the COVID-19 crisis was thought to be largely contained in Asia and Europe, and there had been only 2000 known deaths worldwide. In fact, the virus and its associated disease had only just received their official names. Within a month, virtually the entire world was living under government-mandated lockdown orders, including all 50 U.S. states. To say this would have been hard to predict is an obvious understatement. If there is any silver lining to be found, it is that we have re-learned that the greatest risk in investing and life in general is from the unknown-unknown. It's an indispensable concept in any risky endeavor but one that we tend to forget during long periods of peace and prosperity. We think that it will be with us for quite some time.

Where We've Been

It's important that we review what exactly has happened since our last update to get a sense of where we've been, where we stand, and where we might go. It's hard not to think about Vladimir Lenin's quip that "There are decades where nothing happens, and there are weeks where decades happen." In this case, it might be more like a century. We will do our best to hit the high points. Keep in mind that at the end of the day, through all of the twists and turns of the last quarter, the S&P 500 is up nearly 1%, and the NASDAQ 100 is actually UP 10.5% since our last update!

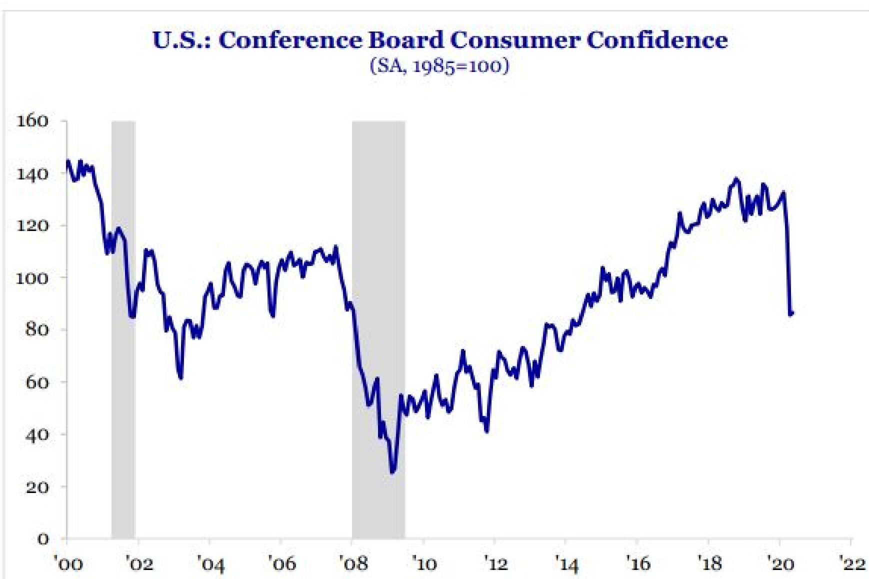


Figure 1: Consumer confidence and economic activity fell off a cliff late in March.

Throughout March, it became increasingly obvious that COVID-19 was potentially deadly for a large swathe of the population, causing severe outcomes in an even larger swathe of the population, and was spreading rapidly across the globe. Consumers began to curtail their behavior ahead of official pronouncements, but the WHO's declaration of an official pandemic and the beginning of "The Great Lockdown" in America ground economic activity to a halt late in the month.

To the Federal Reserve's and Chairman Powell's great credit, we believe that the actions it has taken since late March kept the United States ahead of the curve and mitigated much unnecessary economic and human suffering. On March 15, the Fed first cut rates to 0% and announced an initial $700B in asset purchases – a new QE program. This was just the beginning, as it would go on to set up a myriad of emergency lending facilities and relax operating restrictions on depository institutions over the next weeks.

If you are interested in all of the details of the fiscal and monetary policy response, we would direct you to read Michael McNair's and Nick Prillaman's respective pieces on those issues in this publication. The details and magnitude of the response are overwhelming, as has been its effect on equity markets. The following chart tells the tale.

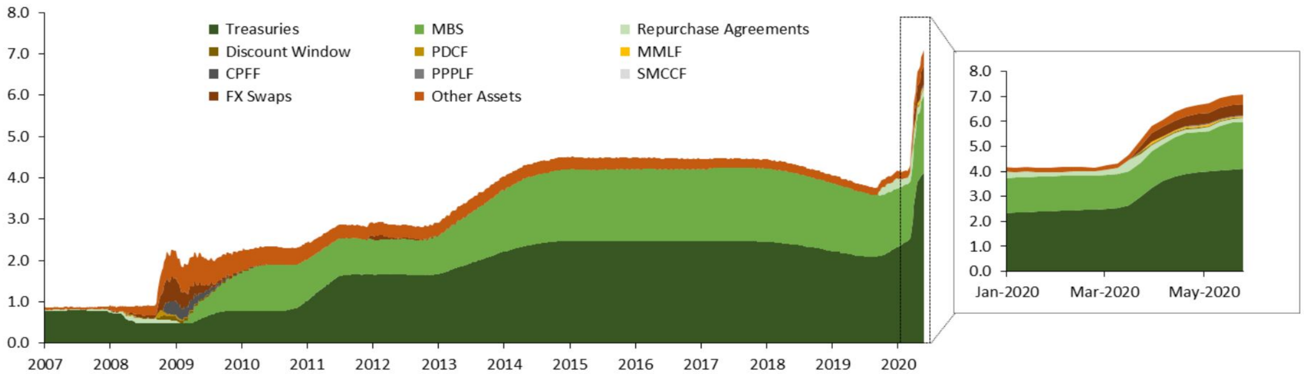


Figure 2: The Fed balance sheet has expanded tremendously since February; Source: Cornerstone Macro

In short, the Fed's balance sheet has expanded a lot – nearly $3T since mid-February - unprecedented on such a short time scale. Coupled with similar global central bank balance sheet efforts, Congress' passing of the HEROES and CARES Acts, and nearly 200 global rate cuts, policy is nothing short of overwhelmingly supportive of asset prices.

The countervailing effects of the virus and physical shutdowns against massive policy response through March and April led to some vicious market swings. The VIX, a broad measure of the S&P 500's volatility, reached and sustained levels that have only been eclipsed by the Financial Crisis.

Figure 3: The VIX spiked and maintained elevated levels.

Within the span of two months, the US unemployment rate flipped from the lowest level in 50 years to the highest in nearly a century. The following chart is staggering - no fewer than 11% of the domestic labor force lost their jobs nearly overnight.

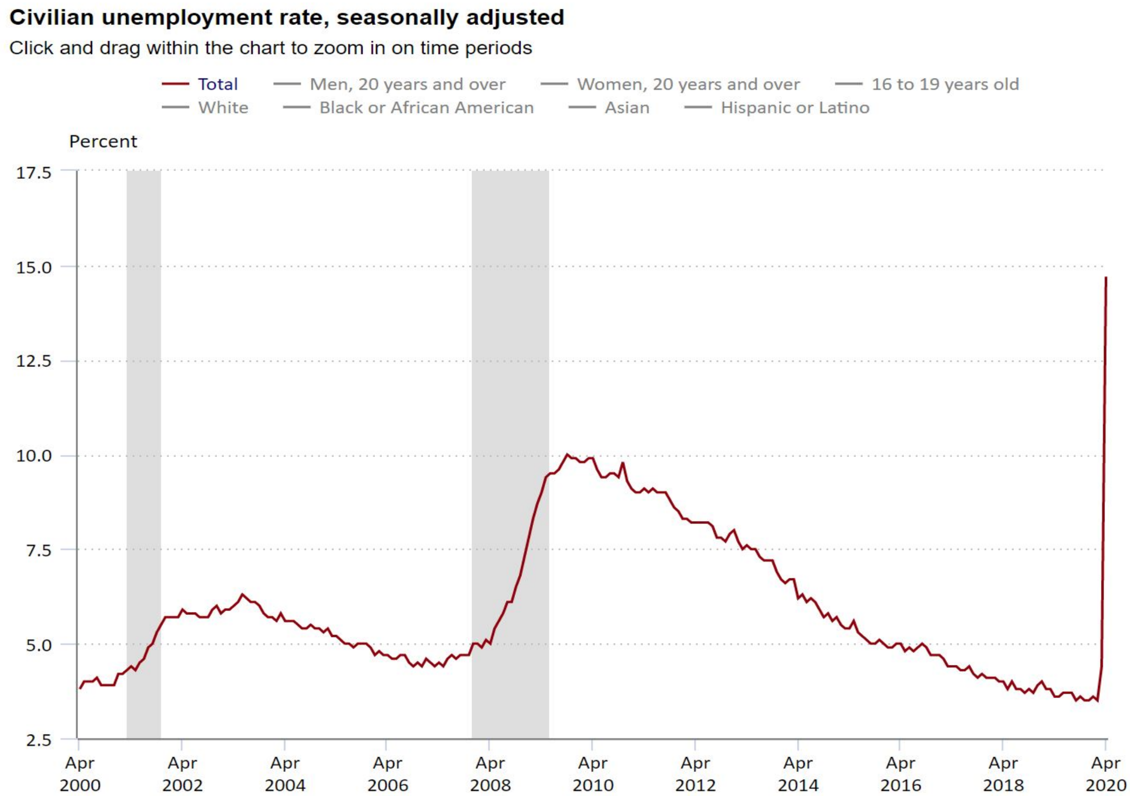


Figure 4: Domestic unemployment's historic April spike; Source: US BLS

Perhaps even more remarkable than the physical damage done to the economy and the resulting policy response in such short order has been the equity market's reaction – the strongest and quickest rally out of a bear market in 88 years. Amazingly, since the trough at the end of March, the S&P 500 has traded back to levels seen as recently as the end of October 2019. Coincidentally, this is exactly the moment preceding SARS-CoV-2's jump to humans – we have truly come full circle.

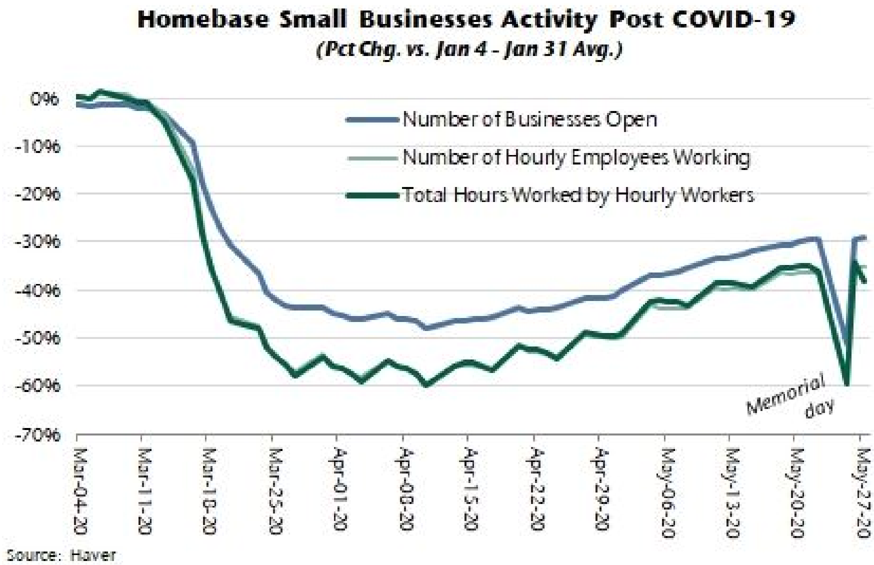
To be sure, the rally has not been uniform across all sectors and styles, and there has been plenty of daily chop between re-opening/cyclicality/value and lockdown/growth/quality through April and May. Tech, healthcare, and communications have outperformed the more discretionary and industrial sectors. Work-from-home oriented companies have outperformed companies whose business involves large gatherings of people. The Yogi Berra-ism "Nobody goes there anymore. It's too crowded," has never been truer. The front-month West Texas Intermediate Crude Oil price settled for -$37.63 a barrel on April 20th, leaving many energy investors wondering how they could fill up their swimming pools. In general, more stable and predictable long-term growth has been rewarded over cyclicality and value, as you can see in the chart below.

Figure 5: NADAQ 100 > S&P 500 > DJIA since mid-February

The more growth, technology, and size exposure your reference index has, the shallower the trough and the greater the recovery. If you believe that the recovery has been driven by massive liquidity injection and bold fiscal policy, then this shouldn't come as much of a surprise. Near-term earnings are murky, at best – particularly for more cyclically-oriented companies. It seems low rates will be with us for quite some time. In this sort of backdrop, a stock's terminal value, or the portion of its value derived from future growth, takes on more importance than near-term earnings and earns a higher multiple. The combined weight of the 5 largest S&P 500 companies has never been higher than it is today.

Figure 6: MAGAF now greater than 20% of SPX; Source: Strategas Research

This brings us to the present. We think the disparity between the equity markets and "the real economy" remains fairly stark. We recognize and appreciate that equity markets are forward looking and green shoots are beginning to emerge. However, we do wonder what the right balance should be between optimism and the still-lingering tail risks. On the negative side, small business activity remains severely depressed, with broad measures of activity down 60-90% at the trough and 30-60% still today. A quarter of all domestic jobs are tied to small business. The American employment picture won't brighten until small business activity picks up.



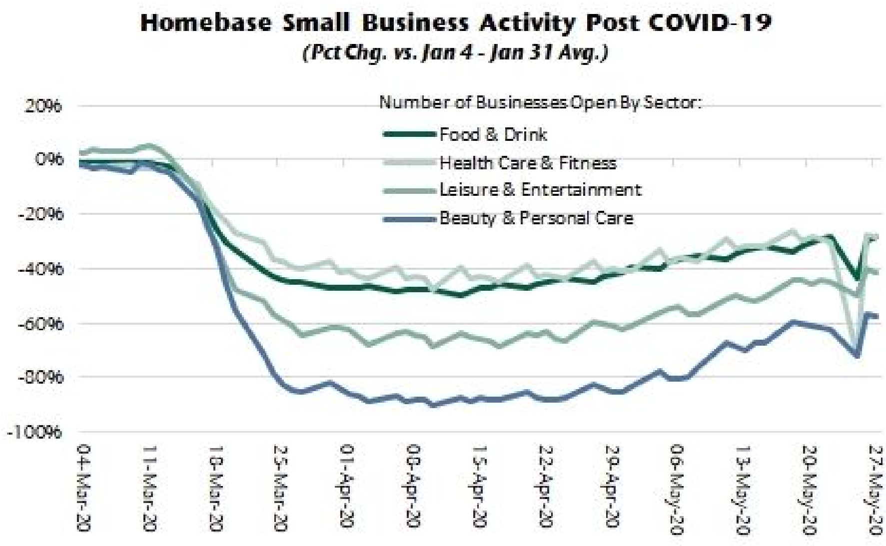


Figure 7: Small business activity is still very impaired; Source: Jefferies

First quarter real GDP was down 5%, and the 2Q number is likely to be down greater than 30%. It will likely take quite a bit of time (years) to re-attain prior levels of earnings and GDP. The massive fiscal and monetary stimulus measures already undertaken have probably only plugged the holes poked in the economy by the virus and "The Great Lockdown." We are skeptical that business investment – and the resulting future productivity and growth – will increase until there is more visibility.

On the positive side, the Fed continues to ease aggressively, and we believe that it will continue to do so as long as inflation isn't a threat. More fiscal stimulus is likely, and we think Congress would prefer to do it well ahead of election season. Recent momentum – especially in cyclical and value factors - has been strong, and we seem to be in an environment where rates are low as far as the eye can see. Apple's mobility data continues to improve and has almost re-attained pre-pandemic levels. If these recent trends continue, we expect the recovery to continue throughout the summer and the equity market to continue to mechanically grind higher.

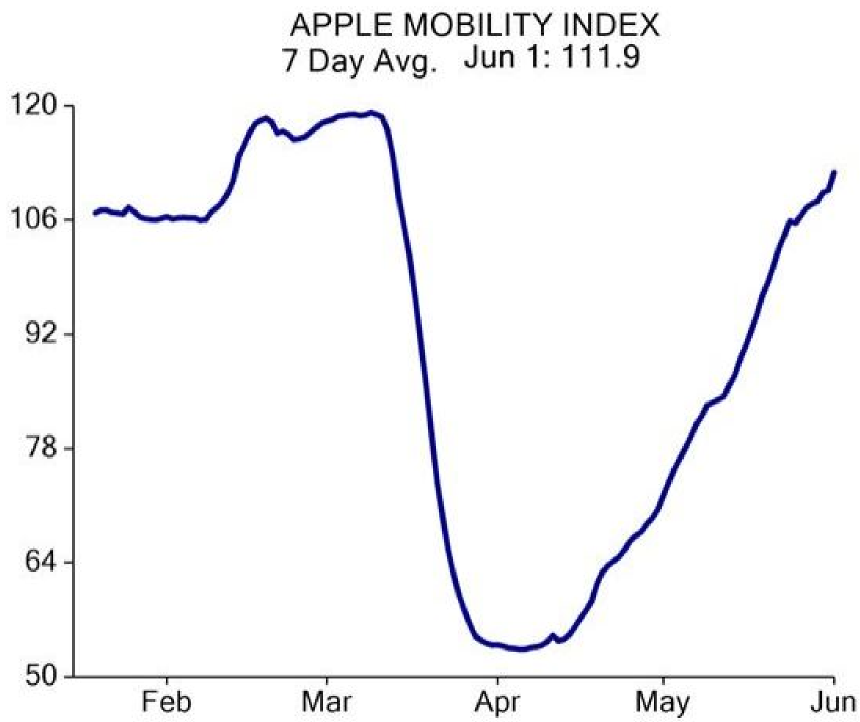


Figure 8: Apple's mobility data has surged through April and May as states re-open; Source: Evercore ISI

Where Are We Going?

Ultimately, this business of equity valuation involves distilling all of the available macroeconomic and microeconomic information into some estimate of forward earnings, looking at current valuations, and asking "Does this make sense?" In normal times, the microeconomic tends to overwhelm the macroeconomic over the short term, as most market participants can agree on the general direction of whole economies within a short time frame. Unfortunately, these are not normal times.

Given all the has happened and the balance of risks going forward, does it make sense for the S&P 500 to trade at 24x estimated forward earnings, more than 2 standard deviations away from the 20-year average?

Figure 9: The S&P 500 trades at 24x the average sell-side estimate of forward earnings as of June 2, 2020.

Said another way, does it make sense that the current equity risk premium on the S&P 500, the premium we are paid to hold equities over risk-free assets, is essentially back to pre-pandemic levels?

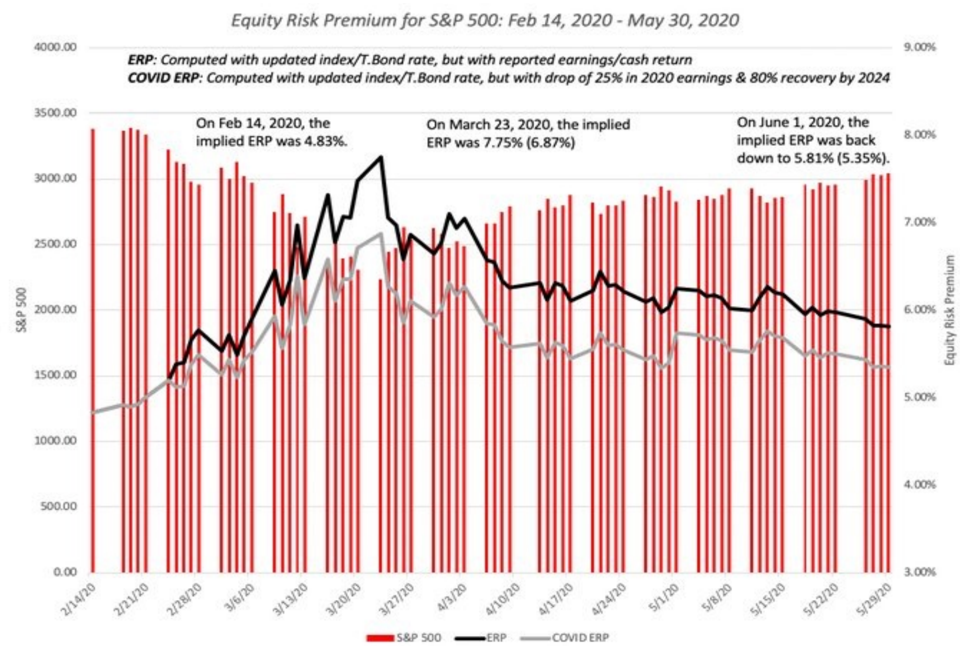


Figure 10: S&P 500 Equity Risk Premium as computed by Aswath Damodaran, NYU Stern School of Business

To answer these questions, we must make an extraordinary number of predictions about a handful of interacting circumstances that are highly exceptional, namely: the COVID-19 pandemic, the economic contraction, geopolitical (and now domestic) tension, and the Fed/fiscal response.

<u>COVID-19</u>

This is the topic that, arguably, has the most unanswerable questions, as viruses don't tend to reveal their plans to us. They include:

- How many individuals currently have the virus, and what is the ongoing likelihood of their spreading it to others? Will there be a second wave?
- To what degree will ongoing social distancing and mask wearing continue, and will it mitigate spread to an acceptable degree?
- Will an effective therapeutic treatment be developed? When? How effective?
- What will the ultimate fatality rate be? Will the virus mutate and begin to effect younger/healthier people?
- Does antibody presence confer immunity? For how long? What is the threshold level for herd immunity?
- Will a vaccine developed? How soon? How effective? Will it confer permanent immunity, or will it be a moving target? Which countries get the vaccine first, and which individuals within those countries?
- Will the virus become endemic, something we need to control forever, or will it be eradicated?

<u>Economic</u>

- To what extent does broad re-opening bring back economic activity? To what extent does ongoing social distancing create inefficiencies in consumer activity that are hard to overcome (e.g. decreased restaurant capacity, etc.)
- Will consumers alter their savings rates permanently, or at least for a long period of time?
- How long do consumers avoid global and domestic travel, both for business and leisure? What is the effect?
- How sticky is unemployment? Have companies decided a permanent reduction in their labor force is more efficient?
- What level of unproductive redundancies need to be or will be built into our healthcare and public transportation systems?

<u>Fed & Governmental Response</u>

- Will the unprecedentedly broad and massive Fed & Treasury combination of grants, forgivable loans, stimulus checks, and asset purchases continue? Will it be enough to offset the economic damage done?

- Will the Fed consider taking rates negative? For how long, and to what degree?
- Will inflation force them to slow down, or will debt loads/deflationary forces force them to speed up?

Geopolitical & Domestic Tensions

- To what extent is our relationship with China impaired? How will that relationship continue to develop?
- Will there be a major push to onshore critical infrastructure? Is globalization over?
- How long does domestic tension last? Does it have a lasting effect on business?

Unfortunately, the answers to these questions interact not only within their own categories, but also across categories. There are hundreds - maybe even thousands of nodes on the decision tree, and we don't get to choose many of the branches. The purpose of this exercise isn't to be doom and gloom or even to demonstrate the futility of forecasting. In normal times, forecasting is certainly possible and helps to inform our investment decisions. We can't put it any better than Howard Marks, one of the greatest credit investors of our time, did in a recent memo.

> " ...if you've never experienced something before, you can't say you know how it is going to turn out…Who can respond to this many questions, come up with valid answers, consider their interaction, and process them for a useful conclusion?
>
> …No one can succeed in predicting things that are heavily influenced by randomness and otherwise inconsistent."

Ultimately, we would argue that this is the most salient point we can make – the near future is extremely uncertain and reasonable forecasting is more difficult than ever. Now, that isn't to argue that we shouldn't make predictions as to what may happen and have those predictions influence our investment decisions. That is our job, and we will continue to do it. However, it is essential we recognize that in such an uncertain time when the error bars are so wide, our forecasts should have a correspondingly smaller effect on our decision-making. The risk of making a catastrophic mistake is too high.

The Dangers Of Market Timing

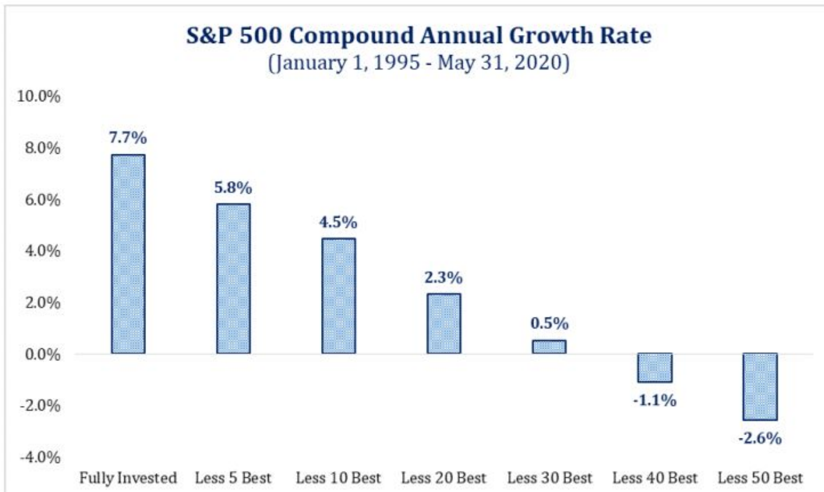


Figure 11: Missing only the 30 best days for equities over 25 years erases ALL returns; Source: Strategas

This is precisely why the Board has, wisely, implemented an Investment Policy Statement for us to rely on. These are exactly the times in which an IPS is most useful in preventing big mistakes. We continue to believe our policy levels are prudent relative to the goals of the organization and the choices available to us. Our perennial overweight in large-cap domestic equity versus our peer group has been and will continue to be seen as a safe haven when compared to international and small cap shares. We think that we would continue to fare better against those alternatives if the volatile period continues. From an active management standpoint, we will continue to stick to our knitting - looking for companies on solid financial footing with good earnings potential and savvy management teams. Finally, we will continue to pick spots to add downside protection when we think it is prudent from an organizational prospective and allocate capital within the bounds of our investment policy statement.

International Equity Strategy

By Steve Lambdin

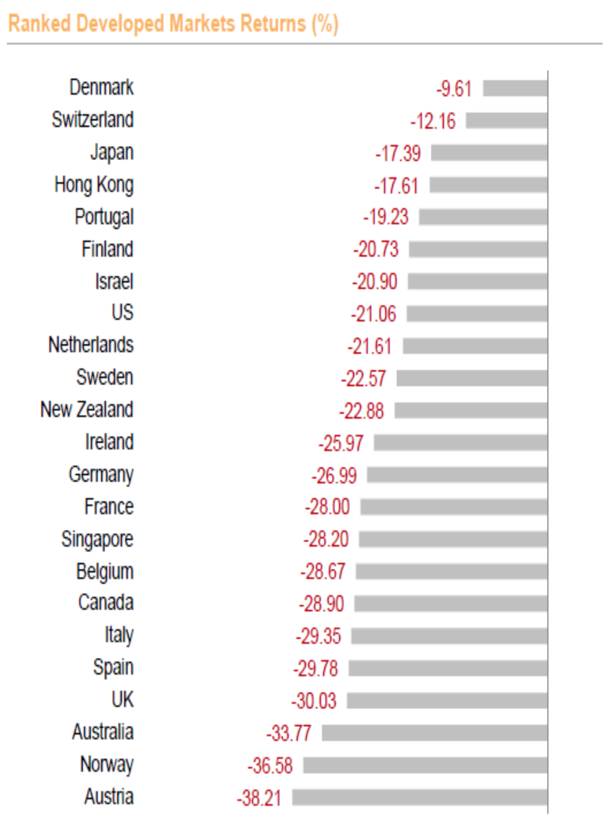
The global equity markets recorded one of the worst quarters in market history in the first quarter of 2020 as concerns over the coronavirus that originated in Wuhan, China spread quicker than a wildfire through most parts of the world. In addition, a Saudi Arabia – Russian oil price war developed sending the price of crude oil down to unprecedented levels. Nothing was spared in equity land as all regions and markets posted negative returns. Only cash, gold, and a few government bonds were able to survive the destruction we all witnessed. What surprised most investors was it only took about four to five weeks to usher in a new global bear market after many markets were at or near record highs in mid-February. This complete “180” in the markets rattled almost everyone with any knowledge of the investing markets. This ushered in an unparalleled level of monetary and fiscal stimulus actions not seen before as these actions attempt to buffer the damage being done as entire economies around the globe have been temporarily shut down in an effort to prevent the spread of this virus. In fact, some countries are even instituting “wartime” measures in an effort to provide critical aid and equipment necessary to combat the effects of coronavirus. Workers not deemed critical at the moment have been sent home in order to slow down the spread of the virus. This has pushed unemployment levels in some regions to levels not seen since the Great Recession of 2008/2009 or even to the Great Depression of the early 1930’s. Businesses have responded by tapping credit lines, instituting deep spending cuts, curtailing dividends to shareholders, and discontinuing share repurchase programs. Some industries have even sought government assistance in order to remain alive until it’s safe to resume operations once again. Obviously, the more economically sensitive businesses have been hurt the worst. Many economic data points are clearly disasters at this point, but investors will be watching these very closely to look for any indications things could be bottoming and perhaps turn up in the next couple of months. Perhaps this provides much needed relief for many of the global equity markets.

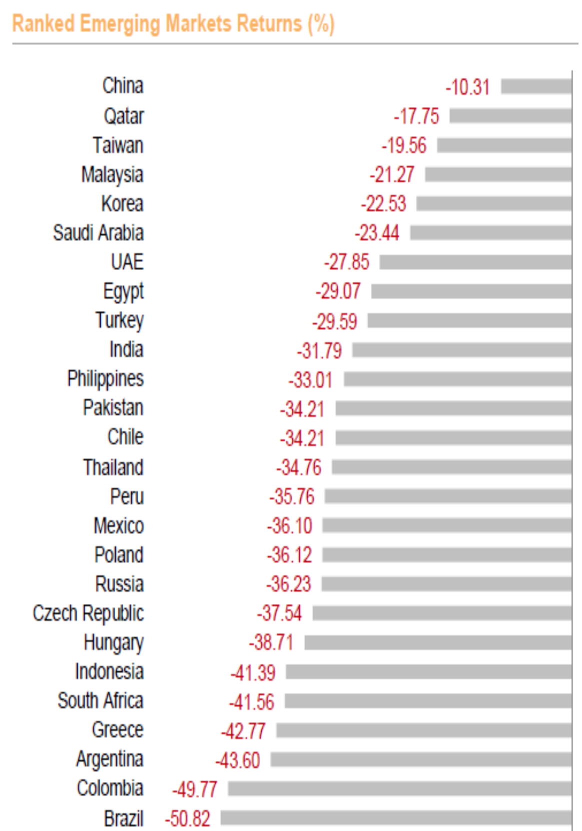
	March 2020		1Q 2020		YTD 2019	
Equity index returns (%)	U.S. dollar	Local currency	U.S. dollar	Local currency	U.S. dollar	Local currency
S&P 500	–12.4	–12.4	–19.6	–19.6	31.5	31.5
MSCI ACWI	–13.5	–12.8	–21.4	–20.0	26.6	26.2
MSCI ACWI ex USA	–14.5	–12.9	–23.4	–20.1	21.5	20.7
MSCI World	–13.2	–12.8	–21.1	–20.1	27.7	27.3
MSCI Emerging Markets IMI	–16.2	–13.7	–24.4	–19.8	17.6	17.3
MSCI EAFE	–13.3	–12.5	–22.8	–20.5	22.0	21.7
MSCI Europe	–14.4	–13.6	–24.3	–21.8	23.8	23.8
MSCI Pacific	–11.4	–10.5	–20.3	–18.4	19.3	18.5

Source: RIMES and Capital Group World Markets Review Q1 2020

The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -22.8% and -23.6% respectively during the first quarter of 2020 vs. -19.6% for the S&P

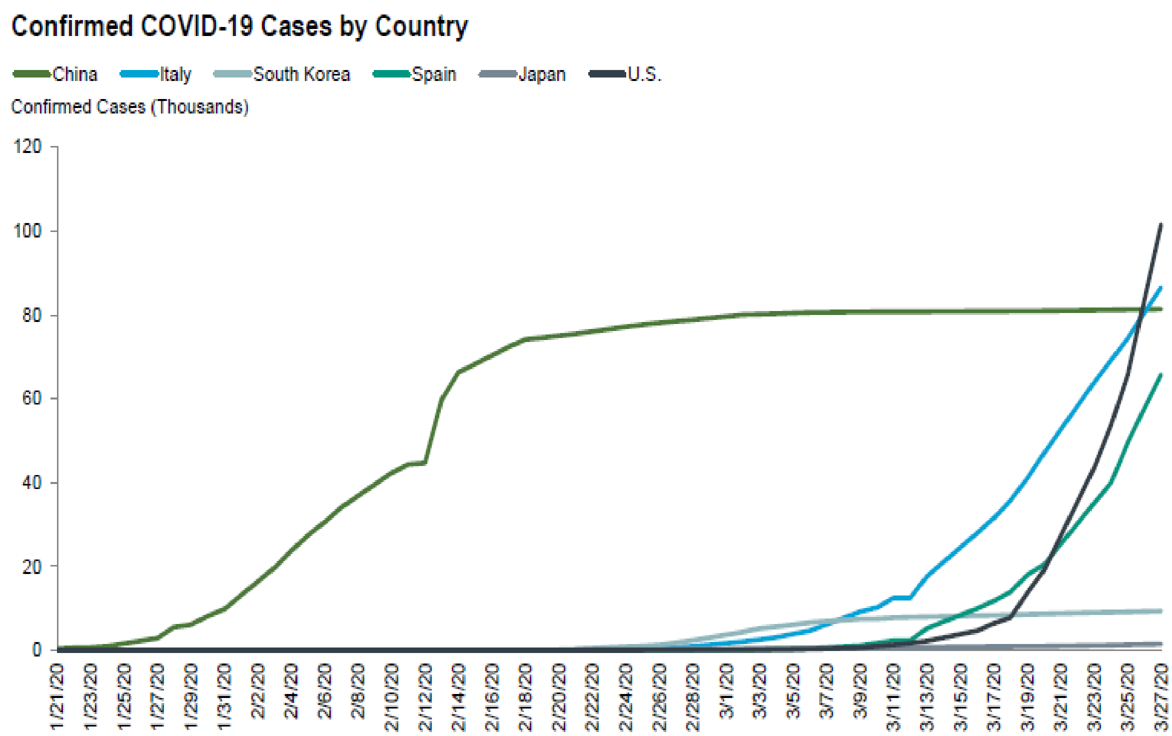
500 Index. No equity markets around the globe provided shelter from the brutality of the sell-off but the S&P 500 Index continued to be the best house to be in a "bad neighborhood". As you would expect, The U.S. dollar was stronger in the quarter as investors flocked to the currency as a safe haven and this hurt returns by about -2.4% for unhedged U.S. investors. The Pacific region was stronger than the European region as the Japanese equity market faired a bit better on the margin vs. many countries in the Eurozone as the virus hit this region harder. Cyclical sectors were very weak vs. the more defensive sectors of the markets as selling pressure was less pronounced. WTI Crude oil fell by -66% in the quarter as the Saudi Arabia – Russian oil price war took center stage as oil markets were way over supplied.





Sources: Resource Consulting Group, MSCI

So far into the second quarter of 2020 thru late May, global equities have reversed course as the barrage of stimulus measures that have been announced or enacted thus far have been well received from investors. These measures are aimed at local governments, taxpayers, and corporations in an effort to provide an economic bridge to the other side of this coronavirus pandemic. How long this bridge needs to be will vary by region, country, and community. But the clear message being sent is that the various governments seem to be willing to do everything that might be necessary to keep things floating at the moment. Perhaps this will lead to a very short recession and even a brief bear market at best. Almost everyone is watching for developments on the coronavirus vaccine front. Positive progress on a vaccine is key for the markets to move higher, as this could be a main driver over the near term. The MSCI EAFE Index and the MSCI Emerging Markets Index are up approximately +12.2% and +9.3% respectively through late May, vs. +17.2% for the S&P 500 Index. Again, the U.S. equity market seems to be the best place to be as this unfolds.

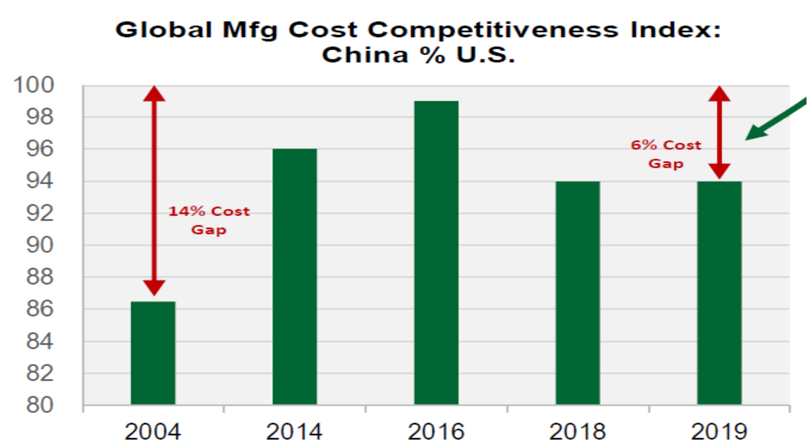


Source: John Hopkins University, Haver Analytics, Fidelity Investments

Asia Update

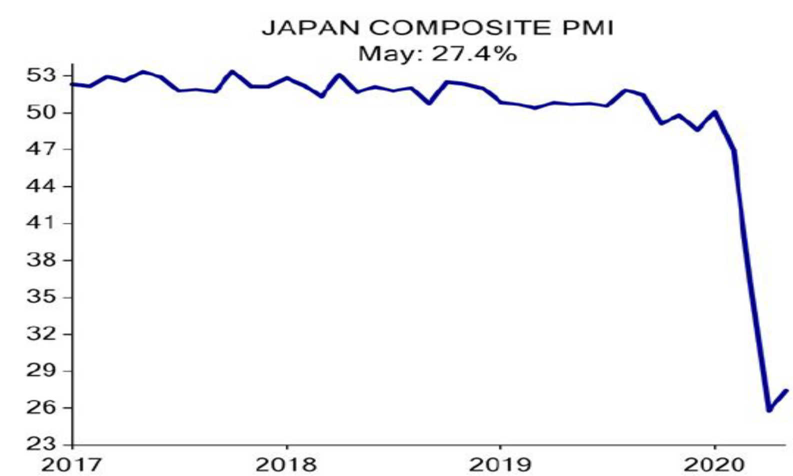
Equities in the Pacific basin struggled mightily in the first quarter just as we saw in every other region of the world. However, on a relative basis, this region did fare a bit better than other regions mainly from the Japanese equity market being in a slightly better position vs. many others around the globe heading into this coronavirus pandemic. Measures already being undertaken to fight the virus in many Asian countries were well ahead of countries in the Eurozone, perhaps giving investors a bit more hope in this region vs. the Eurozone. In addition, stimulus measures were already well underway in Japan in late 2019 in an effort to fight off the effects of the value added tax increase that took effect last October. The MSCI Pacific region fell by -20.3% in the period, as the equity markets in Japan and Hong Kong were more resilient, while the Australian equity market was very weak from fresh concerns with China, which is one of Australia's main trading partners.

The coronavirus pushed China's economy into a historic decline as first quarter GDP fell by -6.8% from a year earlier, which was the first contraction in this economy in decades. Government leaders also withdrew 2020 economic growth forecasts for the first time in years as this virus puts every aspect of this country's economy at risk. However, we do not expect a recession as the economy is expected to resume growth in the second quarter, but at a very slow pace. Leaders have responded by pledging to push more stimulus measures as well as cutting interest rates in an effort to boost demand for products and services. In a glimmer of hope, these measures could be happening just as the economy has passed the low point and production cranks back up. It's just going to be some time before we see pre-coronavirus production levels in this region, especially as other parts of the world are just beginning to emerge from lockdown. The People's Bank of China (PBOC) did reduce rates on the official one year and five year loans by 20 and 10 basis points respectively, which was expected. We expect more actions by the PBOC in the months to come. Industrial production is beginning to perk up as April rose +3.9% from a year earlier vs. March that fell -1.1%. The key automobile manufacturing industry rose significantly as car sales in the region are beginning to recover. Fixed asset growth also came back in April after falling by -16.1% in the first quarter, which was slightly better than forecast. Exports are beginning to rebound as well, as April exports rose +3.5% after falling -6.6% in March. We expect this trend to continue as the world opens back up for business. Retail sales are gradually getting better as well, as April sales were down -7.5% from a year earlier after March fell -15.8%. However, we believe the rate of improvement could stall as consumers may be more cautious in a recovery vs. many business forecasts. April CPI rose +3.3% from a year earlier, which is a slowing rate from the last couple of months as food prices are beginning to fall from the pace of the last several months. Pork prices are falling as more supply comes back from the height of the coronavirus. Over the next couple of months, we are worried about the recent rhetoric between the U.S. and China on trade once again. Relations seem to be breaking down over China's role in containing the spread of the coronavirus. At this point, we do not how far this will push each side, but this could balloon quickly. Investors need to be on guard going forward.



Source: Boston Consulting Group; Cornerstone Macro

The Japanese economy officially entered a recession as first quarter GDP fell -.9% from the previous quarter, or -3.4% from a year earlier. This marks two consecutive quarters of negative growth in this economy. The economy basically remained in quarantine for a large part of the quarter as all parts of the economy contributed to negative growth. It did not help matters the summer Olympics were postponed until next year. We were actually a bit surprised that it was not worse. The lingering effects of the consumption tax hike continued to be felt in the period and this will probably be the case for the second quarter as well. Net exports were weak as expected as other parts of the world are further behind Japan's efforts to fight the coronavirus. Industrial production continued to be weak as March readings fell -3.7% from the previous month, or -5.2% from a year earlier. This is the 6th straight month of decreased year over year industrial production. This is just a signal of how weak this region is at the moment. Perhaps better times are ahead as automobile production begins to increase in the second quarter. Japan's leading economic index fell off a cliff as expected as March's reading of 84.7 was the weakest we have seen in some time. This should begin to improve going forward as the country comes off of lockdown and production comes back on-line. The Bank of Japan (BOJ) kept its short term rate at -.10% and is still targeting a 10-year government bond target yield at 0% at its late May meeting. The BOJ pledged to buy more government bonds and corporate bonds in an effort to push the stimulus accelerator even further. Consumer confidence plunged to the lowest levels since the financial crisis as April fell to 21.6 from 30.9 in March. This is really not much of a surprise as other business confidence readings showed a similar trajectory. The labor market loosened up just slightly as you would expect in the current environment as the jobless rate rose to 2.5% in March from 2.4% in February, while the jobs-to-applicant ratio fell to 1.39 from 1.45. Job losses are becoming more common while the number of job offers are falling. We expect the outlook to pick up a bit from current levels as this economy begins the re-opening process as well. However, were are not sure we will see the magnitude of an economic rebound over the near term in this economy as we could see in other parts of the world.

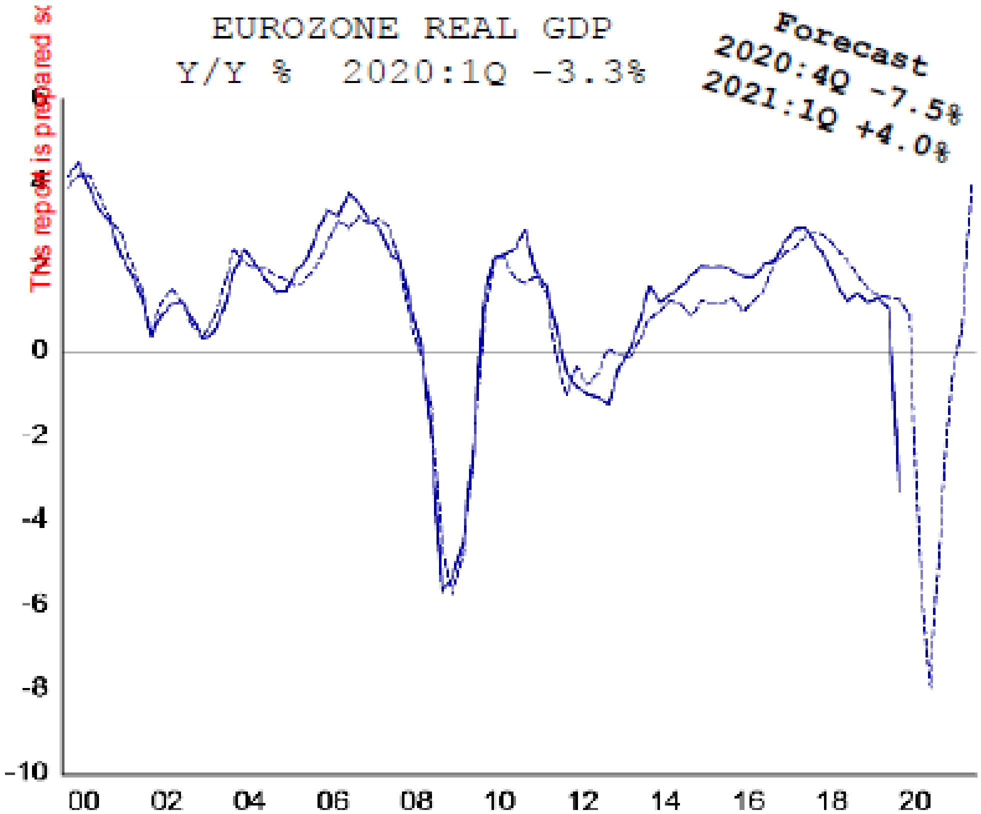


Sources: Evercore ISI

Europe Update

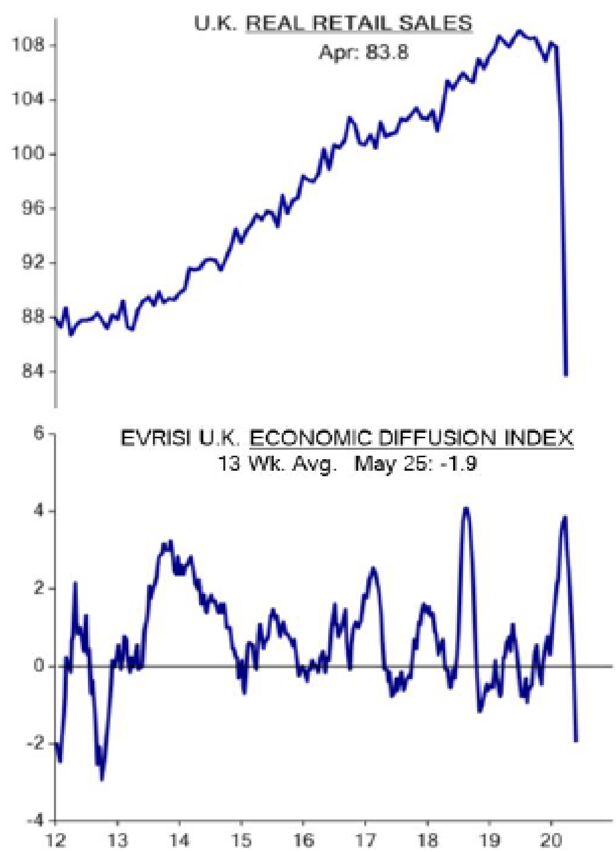
European stocks wound up being the worst performing region among the developed markets as the coronavirus was felt especially hard here. Several countries went into strict quarantine and lockdown measures in an effort to slow the spread of the virus. Unfortunately, this wrecked the economic outlook and pushed equity markets into a swoon not seen since the financial crisis 11 years ago. The European Central Bank (ECB) responded with an aggressive bond buying program with very few strings attached in order to prevent even more financial pain. In addition, several of the larger countries in the Eurozone announced a variety of smaller measures designed to lessen the impact from the virus. Also, on May 27th, the European Union (EU) announced a massive coronavirus-response plan that combines the resources of many of its member countries with commonly issued debt. The structure of this stimulus plan is on a historic level never seen before in the EU. Most investors have been waiting for this moment for some time and should be well received in the marketplace. German yields plunged to historic lows in early March, but managed to move off of the lows by the end of March and have been steady since this time. The carnage from the virus left the MSCI European Index (ex. U.K.) down -22.8% in the quarter.

The European economy fell off a cliff as expected in the first quarter as GDP shrank -3.8% from the previous quarter, or -3.2% from the year earlier period. This was an unprecedented downward move not seen in years. The economies in France, Spain, and Italy were hit especially hard as these countries took the brunt of coronavirus cases in the Eurozone as drastic measures were put in place to isolate people, which resulted in severe economic damage. The northern European countries fared much better in the quarter as the virus has had less of an impact in these economies. After a relatively calm start to the first quarter, Eurozone industrial production fell -11.3% in March from the month earlier, or -12.9% from the year earlier period. This was the first month where the effects of the coronavirus were clearly visible from an economic standpoint. Entire industries were frozen waiting on the virus to take its toll. The economic confidence index fell all the way to a low of 64.9 in April from 103.4 in February. We cannot remember a time on record when we have seen this type change over such a short period of time. However, May readings have rebounded slightly, which we believe is a start in the right direction as we believe better readings lie ahead in the coming months. After a steady rise over the last year, retail sales plunged -9.2% in March from a year earlier, as retailers are facing a crisis they have never experienced. Unfortunately, many will cease to exist post the virus. Core CPI is decelerating as you would expect in the current environment and was reported to be up only +.9% from the year earlier in April. We are now worrying how close to zero the Core CPI will fall. This will not be healthy for this economy if this unfolds. The ECB has reduced the rate paid by banks to borrow money from the monetary authorities in an attempt to let it pass to businesses and households. It has also added some non-targeted stimulus operations designed to help out in the current pandemic. These actions are all helping on the margin. Employment indicators have actually held up better than we would have expected, as the March unemployment rate only rose fractionally to 7.4%. However, we expect this to rise significantly over the next few months as the coronavirus effects begin to be felt. Going forward, we expect the Eurozone to experience a deeper and perhaps longer recession than the U.S. Stimulus measures have finally gotten to decent levels, though not on par with levels in the United States. With its rather large export exposure, the region should benefit as global trade rebounds in the coming months.



Source: Evercore ISI

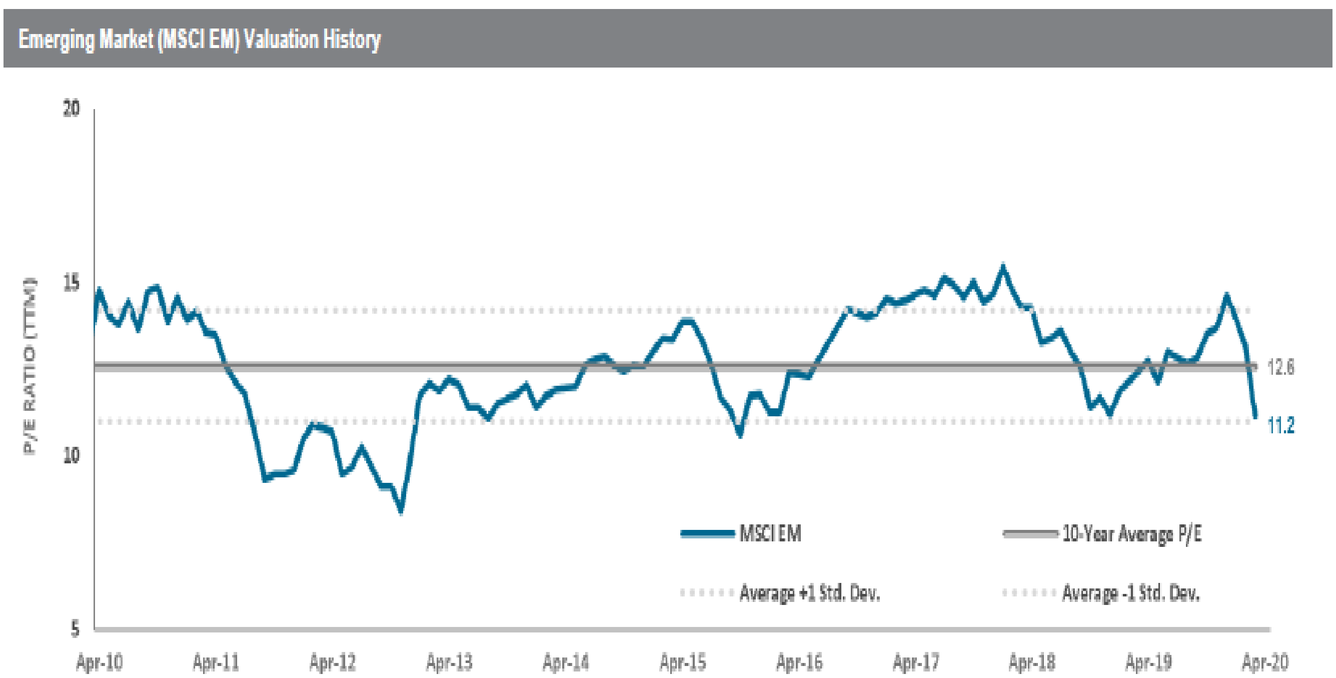
The coronavirus pandemic has taken a deep toll on the economy in the U.K. The government forced a lockdown in early April and subsequently extended it into mid-May. As of late May, the U.K. has seen 270,000 cases of coronavirus, resulting in 38,000 deaths. Only the U.S. has experience more deaths from the coronavirus. Even Prime Minister Boris Johnston contracted the virus. Many here believe the epidemic has peaked and more focus can now be directed to re-opening of the economy. Stimulus measures have been widespread such as job-retention and cheap loans to businesses, more quantitative easing by the Bank of England (BOE), and schemes designed for banks to increase lending. Thus far, the government has announced over 1% of GDP in stimulus actions. We see more needed, but this is a good start. The MSCI U.K. Index posted an astonishing drop of -28.8% in the first quarter of this year. This was one of the worst performing markets in the developed world. With Brexit issues coupled with coronavirus, we can understand this level of performance. As with other regions of the world, first quarter GDP fell -2% from the previous quarter, or -1.6% from a year earlier. However, the news will be much worse in the second quarter as growth could slump to a record going back over a century and push the region into a recession. As expected, industrial production in March fell -4.2% from a month earlier, or -8.2% from a year earlier. Every major component of industrial production fell in the quarter from the coronavirus shutdown of the economy. The full effect of the coronavirus showed up in retail sales as April sales fell -18.1% from the previous month. About the only thing we can say positively is we expect this data point to improve late in the second quarter. Inflation remained no issue in the current environment as Core CPI only rose +1.4% in April from a year earlier. The coronavirus pandemic should keep a lid on this data point for the next several months. At its late March meeting, the Monetary Policy Committee (MPC) voted to cut its main benchmark interest rate by 65 basis points to .10%, in addition to increasing its bond purchase target by 200 billion pounds to 645 billion pounds. These measures are aimed at combating the effects of the coronavirus. Almost all central banks have taken coronavirus measures over the last couple of months. Employment indicators remained surprisingly decent lately as March unemployment rose only to 3.9%, which is only a slight uptick from the previous month. The economy managed to add approximately 200k jobs in first quarter before the onslaught of the coronavirus hit. We look for a complete reversal here in the second quarter as unemployment claims have been running at a robust pace over the last few weeks.



Sources: Evercore ISI

Emerging Markets

Obviously, as the world abruptly changed to a “risk off” environment in late February, emerging market equities were a tough place to be. We saw many countries with commodity exposure such as Brazil, South Africa, and Russia perform quite poorly, as these markets were down anywhere from -36% to -50% in the first quarter. Overall, the MSCI Emerging Markets Index fell -23.6% in the period, which was one of the worst quarterly performances in many years and trailed large cap global stocks as well as stocks in the U.S. As bad as this was, this asset class could also be a good place to be in a global recovery scenario when this begins to take shape. For instance, China was the first country to experience the coronavirus crisis and could actually be moving toward a more normal economic environment over the next few months and with China being the largest constituent of the emerging markets index, this could spell good news for future performance. However, as the case with emerging markets, things can change in the other direction quickly. Nonetheless, post the coronavirus crisis we still see plenty of opportunities for good performance from these equities. The key is to watch for tangible progress on the virus front.



Sources: Baird Q1 2020 Chartbook; MSCI; Factset

International Equity Activity/Strategy

As we look out into the early summer period, we don't know if we have had a bear market rally or if a new bull market formed in late March subsequent the disastrous move downward earlier in the quarter. Regardless, we like what we have witnessed in this rally thus far. We are subject to significant daily swings from news on the virus, a vaccine, further stimulus measures, discord in certain parts of the world, and fresh news on trade relations with China. There are as many issues happening in the world markets at the same time for investors to monitor on a daily basis as we have ever seen. With this in mind, we believe the outlook for equities remains extremely volatile at the moment, but trending in the right direction. Central banks are setting records for the amount of stimulus being injected into their respective economic regions. This is almost always good for equity investors. We look for many global economic measures to bottom in the summer and tick up as many countries begin the gradual re-opening of their respective economies. We see global trade benefitting as this happens. In fact, many Asian countries are already moving in this direction. As businesses re-open, we see this helping employment data points, which are key to better economic outlooks. On the political front, the U.S. election is drawing closer and fresh signs of a very tight race are beginning to catch the attention of many. What once seemed like an easy Trump victory is anything but that at this point. This is worth watching and developments here could easily move markets in a hurry. Recent rhetoric between the U.S. and China has not been good and could be pointing to a re-escalation in the global trade war between these two countries.

We added $200 million to our emerging markets equity portfolio in late March as the price of EEM finished below our put strikes for the month of March. This brings up our underweight of this asset class to nearer a normal allocation to this asset class for a pension fund of our size. This has also allowed us to be more active on the call side of our put/call writing strategy on EEM, as premiums look very attractive for this in the current equity market climate. Emerging market equities still remain an asset class that looks attractive to us going forward over the long-term. Our current allocation to Emerging Market equities is approximately 3.35% of total assets and approximately 10.0% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios. *(Credit is given to the following entities for charts provided: Baird Chartbook, MSCI, Factset, Boston Consulting Group, Cornerstone Macro, John Hopkins University, Refinitiv, Resource Consulting Group, HIS Markit, Evercore ISI, Haver Analytics, Fidelity Investments, RIMES, Capital Group World Markets Review)*