MALVERN CAPITAL MANAGEMENT

First Quarter 2020 Review and Market Outlook

April 2020

First Quarter 2020 Review

At the end of the fourth quarter 2019, we were talking about the market "melting up" as nothing stood in the way of the stock market as it proceeded to make new highs. How things can change very quickly. The bear market of 2020 is upon us. The bear has been in hibernation for the past 11 years but with the onslaught of the Coronavirus outbreak and the breakdown of OPEC, all major indices fell in the quarter. Investors were fearful that the virus-related shutdown would lead to a global recession of an unknown magnitude.

At their worst, all major indices fell in the neighborhood of 35% before a late quarter rally erased some of those losses. For the quarter, the S&P 500 Index dropped by 19.60%, the Dow Jones Industrial Average declined by 22.73% and Nasdaq 100 fell by 10.29%. Small-cap stocks as measured by the Russell 2000 Index fell the most for the quarter by dropping 30.61% followed closely by Mid-cap stocks which declined by 27.07% (measured by the Russell Mid-cap Index). There was a striking difference between growth stocks and value stocks for the quarter. Surprisingly growth stocks, which are generally considered to be riskier than value stocks, were actually more defensive than value stocks. The Russell 1000 Growth Index fell by 14.10% in the quarter while the Russell 1000 Value Index declined by 26.73%. Growth stocks ended the quarter out of bear market territory.

Will the late quarter rally be sustained and built upon or will it give way to further selling and a return to the recent lows or go lower? Bear markets are known to have powerful rallies with double digit returns only to give way to further selling. The bear market from 2000 to 2002 saw two significant rallies of 20% or more,

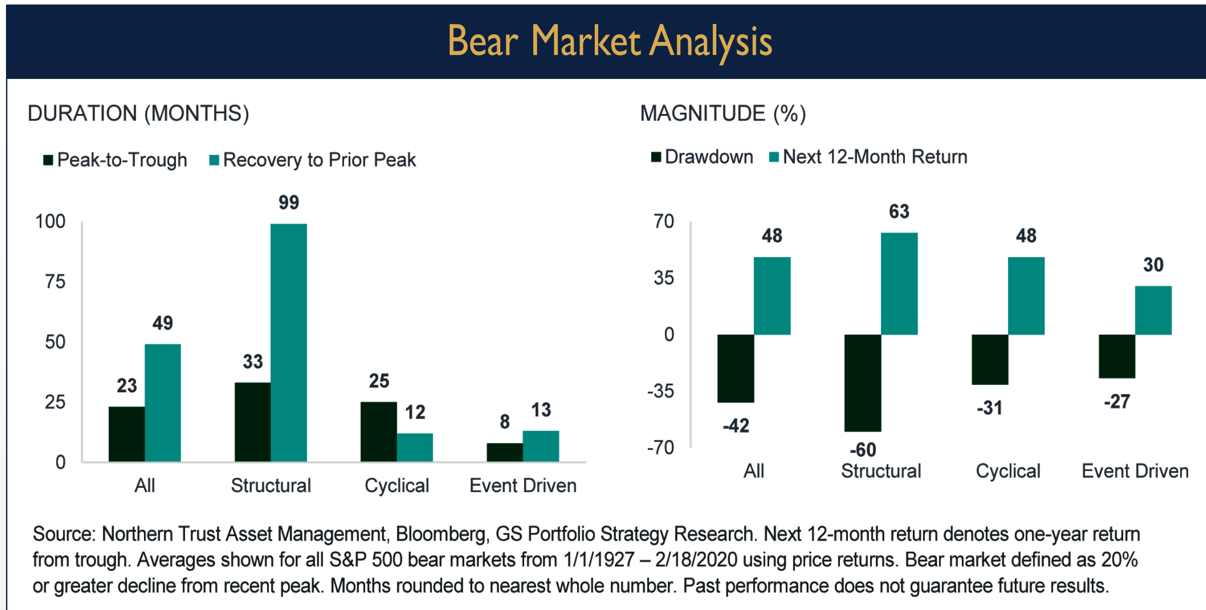
Index Performance

Category	Representative Index	March 2020	1st Qtr 2020	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	-13.62	-22.73	-13.38	4.42	6.86	10.00
Broad US Large Companies	S&P 500 Index	-12.35	-19.60	-6.98	5.10	6.73	10.53
US Small Cap Companies	Russell 2000 Index	-21.73	-30.61	-23.99	-4.64	-0.25	6.90
US Mid Cap Companies	Russell Mid Cap Index	-19.49	-27.07	-18.31	-0.81	1.85	8.77
Largest 100 NASDAQ Companies	NASDAQ 100 Index	-7.57	-10.29	7.03	14.08	13.81	16.17
Developed International	MSCI EAFE Index	-13.35	-22.83	-14.38	-1.82	-0.62	2.72
Emerging Markets	FTSE All Emerging Markets	-16.39	-24.22	-17.56	-1.85	-0.46	0.73
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	-0.59	3.15	8.93	4.82	3.36	3.88
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	-11.46	-12.68	-6.94	0.77	2.78	5.64
Commodities	Bloomberg Commodity	-12.81	-23.29	-22.31	-8.61	-7.76	-6.74
Total US Market (all cap stocks)	Russell 3000 Index	-13.75	-20.90	-9.13	4.00	5.77	10.15
Real Estate Investment Trusts	Wilshire US REIT Index	-19.96	-25.63	-19.38	-2.49	-0.19	7.67
Cash	US T-Bill 90 Day	0.02	0.28	1.74	1.69	1.11	0.59

** 3 year, 5 year and 10 year returns are annualized. All periods ending March 31, 2020.*
All returns include the reinvestment of dividends.

only to see further sell-offs on its way to a 50% overall decline over three years. In the bear market of 2008, we saw a rally of about 28% which eventually led to more selling before a new market low was achieved.

It is important to keep in mind the math of large percentage losses and subsequent recoveries. To recover from a 10% loss, a return of 11% is necessary to break-even. To recover from a 25% loss, a return of 33% is required to break-even. And to recover from a 50% loss, a 100% gain is needed to break-even.



Source: Northern Trust Asset Management, Bloomberg, GS Portfolio Strategy Research. Next 12-month return denotes one-year return from trough. Averages shown for all S&P 500 bear markets from 1/1/1927 – 2/18/2020 using price returns. Bear market defined as 20% or greater decline from recent peak. Months rounded to nearest whole number. Past performance does not guarantee future results.

Turning to the fixed income markets, higher quality bonds were the bright spot for the quarter as the Bloomberg Barclays U.S. Aggregate Bond Index advanced by 3.15% for the first quarter. Lower quality bonds did not do as well. Fears of a recession are not good for lower quality bonds as bankruptcy risks increase. The Bloomberg Barclays U.S. Corporate High Yield Index declined by 12.68%. Interest rates during the quarter were volatile. The 10-year U.S. Treasury Note yield began the year at 1.919% and ended the first quarter at 0.698%.

Where do we go from here? We elaborate with a little more detail on the factors currently affecting the markets such as the virus, the Federal Reserve, a bipartisan government response, the economy, an upcoming presidential election, unpredictable corporate earnings and a cautious market valuation.

Global Shutdown Amid the Pandemic and Oil's Collapse

As we entered 2020 the biggest risk factor facing the markets was the ongoing trade war with China and a potential trade war with Europe. The trade war with China has been all but knocked from the headlines and the discussion of Europe has focused on the severity of the Coronavirus in Italy and elsewhere, not trade. The global pandemic has caused a lot of fear among the people of the world and has led to a shutdown of economic activity. Social distancing has become the new norm as people attempt to prevent themselves from contracting the virus or spreading the virus to others. As a result, commerce has ground to a near halt. Business interaction has stopped, travel and vacations have been cancelled, sporting events have been postponed and schools have closed.

To make matters even worse, the price of oil has collapsed. The Saudis and UAE have entered into a price war with the Russians by increasing the production of oil. Russia wanted to increase the price of oil by cutting production. The Saudis and UAE effectively want to drive the Russians out of business. The Saudis and UAE have a lower cost of production than Russia and can withstand a prolonged cut in the price of oil. This is great for consumers but its collapse has far reaching implications for the domestic producers of oil. The energy sector makes up 2.6% of the S&P 500 Index. This is seemingly a small weighting but still has an impact on the earnings of the whole market, not to mention the bond market as energy companies issue a lot of bonds.

Federal Reserve, Interest Rate Cuts and Quantitative Easing

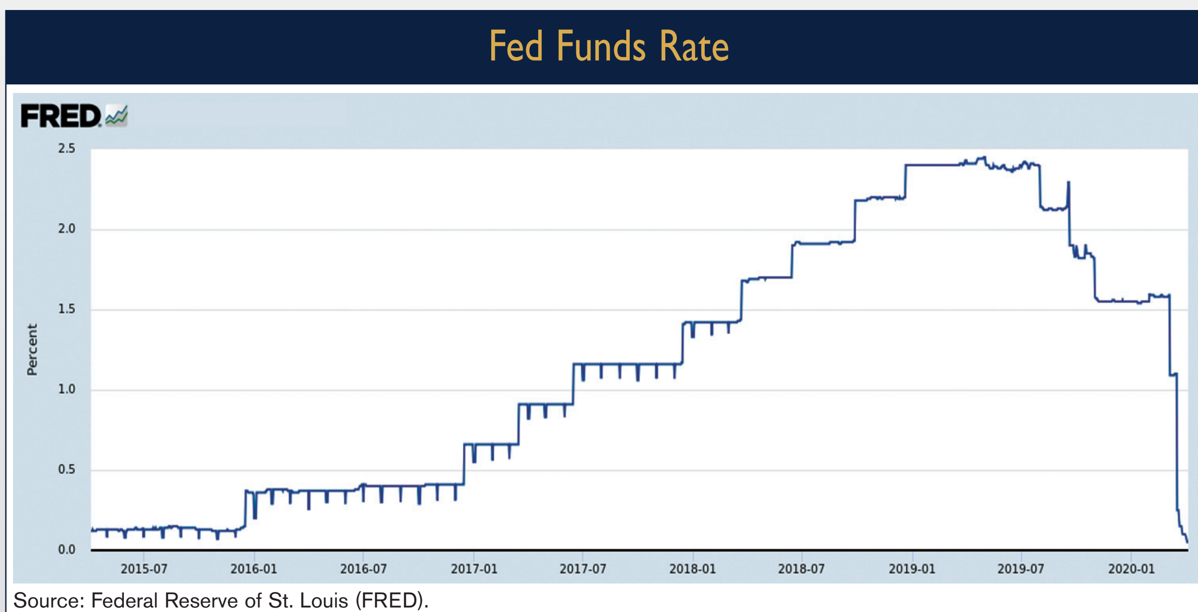
In anticipation of the global slowdown the Federal Reserve has been very active recently. On March 3, 2020 the Fed announced that it would cut the Fed Funds rate by one-half of one percent. Then on Sunday, March 15, 2020 the Fed announced that it was cutting the Fed Funds rate to near zero. The latest cut was done three days prior to its regularly scheduled March meeting so the Fed felt it was necessary to act swiftly and not wait for their meeting when such interest rate moves are usually made. This is the lowest the Fed Funds rate has been since 2015 following a nearly eight years of zero interest rate policy after the financial crisis of 2008.

The Federal Reserve also announced that it would be buying $700 billion of treasury and mortgage backed securities effectively reinstituting Quantitative Easing. Following the financial crisis in 2008 the Federal Reserve had four such distinct Quantitative Easing programs. By buying longer-term treasuries and mortgage backed securities, it is attempting to put downward pressure on longer-term interest rates. When it buys such bonds, the Fed is increasing its balance sheet. In contrast, since 2015 the Fed had been systematically decreasing its balance sheet gradually each month by selling bonds.

The Fed also made an arrangement with five other central banks to reduce interest rates on currency swaps. This is an attempt to allow the markets to continue acting efficiently.

It is pretty evident that the Fed is using all available tools to alleviate any credit related concerns emanating from the Coronavirus pandemic.

Fed Funds Rate



Source: Federal Reserve of St. Louis (FRED).

Fed CARES Act Response

In late March, the U.S. Congress and President Trump reached a deal for a $2.3 trillion spending bill to help Americans and businesses affected by the pandemic. Referred to as the Coronavirus Aid, Relief and Economic Security Act (CARES), the relief plan is intended to pump money into the economy to help offset economic activity that is being lost as a result of the global shutdown.

The U.S. Economy was expected to be around $22.3 trillion in 2020 prior to the shutdown. The question is, will $2.3 trillion added to the economy make any real difference? Some economists have rather gloomy expectations for the economy in the second quarter 2020. If these expectations are true, then the $2.3 trillion injected into the economy should make some difference.

It will also make a big difference to the millions of people who have lost jobs or have been affected adversely by the shutdown. Most Americans are going to receive a check from the government which may go a long way for many of those affected by the shutdown.

Depending on how long the shutdown should continue, there are also discussions about further stimulus bills to help prop up the economy. At this point, the relief act is not being paid for and will add to the deficit for 2020 and the accumulated national debt. We wonder what impact the increase to both the deficit and national debt will have on the future economy. That will have to be addressed another day it seems.

Coronavirus Aid, Relief, and Economic Security Act

Amount ($ bn)	Measure
$290	One-time stimulus checks amounting to $1,200 per adult and $500 per child up to certain income limits
$260	Enhanced, expanded and extended unemployment benefits, adding $600 per week to every unemployment check for 4 months, expanding program to cover contractors and self-employed and extending program to 39 weeks from 26 weeks
$510	Loans to distressed businesses, cities and states. Includes $29 billion for airlines, $17 billion for firms deemed important for national security and $454 billion as backstop for loans to other businesses, cities and states
$377	Small business relief, largely in the form of “forgivable loans” for spending on payroll, rent and utilities
$150	Direct aid to state and municipal governments
$180	Health-related spending
$516	Other spending and tax breaks
$2.283 trillion	**~10.8% of GDP**

Source: CBO, JP Morgan Asset Management.

It is an Election Year After All

Recent events have pushed the presidential election out of the minds of most people. But in less than a year from now, president Trump will either still be president or someone else will occupy the White House.

Trump rallies have been replaced by daily presidential news conferences while no one appears to be talking about the Democrat primaries. It seems like Joe Biden will be the Democratic nominee but there are pundits talking about back-end ways to replace Biden with someone who may be more electable such as Governor Andrew Cuomo. The Democrats would have to change their rules to make that happen but perhaps anything is possible.

The election has implications for tax, trade and foreign policy. All of these issues potentially impact the economy and the financial markets. If president Trump remains as president, he plans on a tax cut specifically for the middle class. He will also continue his trade policy with respect to China and ultimately with Europe.

If a Democrat wins the White House, it is likely that taxes on the wealthy will increase as well as taxes on corporations. Trade policy may also be altered as it is not clear that a Democratic president will continue on the same track as Trump is regarding tariffs.

The markets are not focused on the election right now but they will likely be redirected toward the election once the virus-related concerns subside.

The Economy

We are headed for a recession. Layoffs and furloughs are rampant around the country with some industries such as restaurants hit harder than others. Some forecasts are for the unemployment rate to peak out at 30%, an unemployment rate not seen since the Great Depression. For the first week following the shutdowns of states the initial jobless claims registered 3.3 million people filing new claims for unemployment insurance (the following week there were 6.6 million people filing new claims). The monthly jobs report released by the Department of Labor shows that the jobs market declined by 701,000 for the month of March. This reading certainly has not yet captured the full impact of jobs lost so far as suggested by the new weekly unemployment claims filings. We won't really have a true reading until after the next few months of jobs reports are released.

It takes two consecutive quarters of negative Gross Domestic Product (GDP) growth to proclaim that we are in a recession. A recession is not technically ever established until well after we have already entered into a recession. There are dire predictions for GDP growth. The Congressional Budget office estimates that the economy will contract by 7% in the second quarter of 2020. Over the next few months, economic numbers will be released and it is still too early to speculate how bad things will get.

As bad as things are expected to get, there is also a feeling that we could see a "V" shaped recovery meaning that we will see a rapid rebound once the social distancing restrictions are lifted, people go back to work and the impact of the CARES act is fully felt. The economy could rebound quite quickly giving many hopes that this slowdown is just temporary.

Initial Unemployment Claims

Source: US Employment and Training Administration via FRED. Business Insider

Corporate Earnings

At the end of 2019, the Standard & Poor's Corporation projected full year 2020 earnings at $175.52 for the S&P 500 Index. They have since reduced that estimate for full year 2020 down to $157.90 as of March 31, 2020. Full year 2019 earnings on the S&P 500 Index were reported at $157.12 per share on the S&P 500 Index. It is very difficult to project earnings going forward on the S&P 500 Index until companies start giving some guidance with respect to their earnings as a result of the global shutdown of the economy. Certain industries will undoubtedly be hurt more than others while some others may see some benefits.

The market looks forward and as earnings are reported for the first quarter 2020, analysts will be listening very closely to what companies say about the future based on what companies know and are experiencing with regard to the shutdown. We are in an unusual time and it will be hard to put much credence in the current full year estimate of $157.12 from the Standard & Poor's Corporation. Standard & Poor's Corporation currently projects a modest decline of 1.4% year-over-year for the second quarter 2020. That number is likely going to be taken down further as other analysts have already done. Analysts polled by FactSet project that earnings will decline by 10% year-over-year for the second quarter 2020. We will be monitoring earnings very closely.

Market Valuation

Because earnings are difficult to forecast at this time it is going to be very hard to determine what a fair value for the market actually is. Investors are trying to figure that out right now and that has led to considerable volatility in the markets. We can only speculate and listen to what companies are saying about earnings to help us come up with a fair valuation for the stock market. If we assume that the earnings decline of 10% year-over-year for the second quarter is correct (that analysts polled by FactSet currently project), that suggests we drop from $152.40 per share (Standard & Poor's second quarter year-over-year earnings forecast) to $137.16 per share.

If we apply a trailing price-to-earnings multiple (P/E) of 19 to this earnings number, we would get a fair value of around 2606 on the S&P 500 Index. A 19 trailing P/E multiple is still a little expensive historically but it is lower that the trailing P/E multiple at the end of 2019 (which was around 21). We ended the quarter at 2584.59 so the market seems to be in agreement with our updated fair value estimate. If we can buy into the "V" shaped recovery scenario, we could see a sudden and sharp increase in equity prices as investors look ahead to such a recovery.

We believe it is very difficult to time when to be in or out of the market and urge our clients to stay fully invested at this time.

Conclusion

A recession is looming for the U.S. economy. How deep and prolonged it will be is anyone's guess at this point. We have not had a recession in this country for 11 years. The Federal Reserve has done its part with very accommodative monetary policy to prop up the economy. The Federal government has also done its part with fiscal policy through the CARES act. More help from the Federal government is promised if necessary. The pandemic is all anyone is talking about right now, and rightly so. It has far reaching implications for the economy and the markets. The upcoming presidential election is off the radar at present.

Corporate earnings estimates will fall over the next few months which ultimately means that a fair valuation for the markets will be much lower than we calculated at the end of 2019. However, we are optimistic that a "V" shaped recovery will be in store as there is a lot of pent up demand waiting to be unleashed as soon as the shutdown ends.

As such, we are here to listen, counsel and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer

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