MARKET COMMENTARY

The Coronavirus Crisis

Q1 2020 - April 9th

- **The coronavirus outbreak is a humanitarian crisis first and a financial crisis second. Our thoughts are with those directly affected by COVID-19 and those involved in the fight against the virus.**
- **For most sectors, the coronavirus brought global economic activity to an unprecedented standstill. The economic crisis was magnified by the fact that the pandemic arrived late in a market cycle that was already characterized by excessive leverage and historically weak balance sheets.**
- **Although governments and central banks have been quick to respond, much more action may be needed as we wait for the discovery of effective treatments and a vaccine.**
- **Despite these issues, we believe there are many attractive opportunities for investors who are prepared to deploy capital thoughtfully, but we believe it is too early to stray too far from those companies and industries that policymakers deem important.**

Overview

The first quarter of 2020—and March in particular—will forever be remembered as the moment when a virus roughly a million times smaller than a pinhead brought the world to a standstill. As the novel coronavirus (SARS-CoV2) and the disease it spreads (COVID-19) moved from China, throughout Europe, and into the U.S., hundreds of millions of people were forced to stay in their homes in an effort to limit the spread. Countless healthcare professionals and other essential service workers who could not isolate or work remotely were forced to battle the deadly virus head on, often with inadequate personal protective equipment. The world united in efforts to learn more about this new virus, which was overwhelming health infrastructure wherever it gained a foothold. The public health mantra of “flatten the curve” was thrust into our vernacular.

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As many major U.S. cities enter their fourth week of containment, we are beginning to get a glimpse into the economic toll that shutting down broad swathes of the economy has taken. In the last three weeks, nearly 17 million Americans applied for first-time unemployment insurance, according to real-time labor market statistics. Many more are expected in the coming weeks. Economists at the St. Louis district of the Federal Reserve have estimated that the unemployment rate could temporarily spike to 32%, the highest in recorded history.

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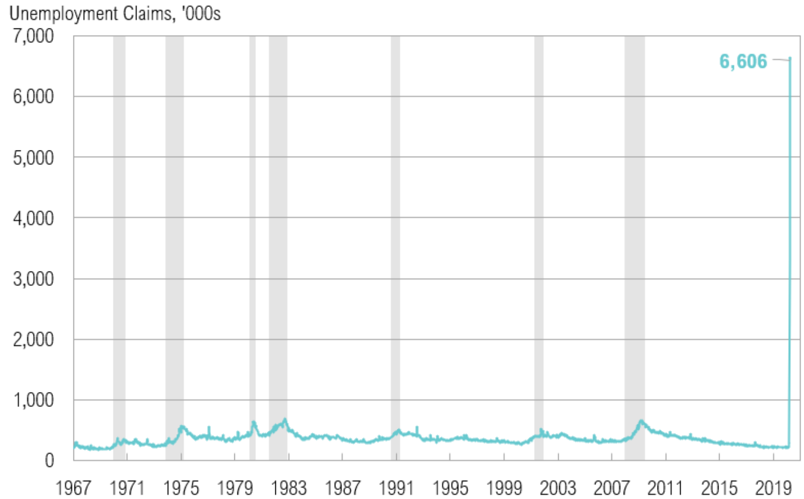
Other non-traditional measures of economic activity also reveal the consequences of the shutdown. On a normal day, roughly two million airline passengers present their boarding passes to TSA agents. During late March, that number fell to just 275,000, down almost 90%. The TomTom Congestion Index, a measure of car traffic, shows a similar situation. Los Angeles traffic is down almost 80% relative to a typical, pre-Coronavirus week. Data released by restaurant reservation website OpenTable showed 100% declines in dine-in reservations for most major cities in the U.S. Mall traffic, concert and sporting event attendance, and all other activities deemed “non-essential” have effectively dropped to zero in much of the world.

Capital markets shifted as dramatically as the economy—on par with some of the most volatile episodes of the past several decades, including the Global Financial Crisis of 2008.

U.S. Initial Unemployment Claims



Source: Bloomberg

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As an example, the yield spread on high-yield bonds over Treasuries rose 700 basis points in the six weeks from mid-February to late March. During the 2008 crisis, a similar move in spreads took fifteen months to occur—from June 2007 to September 2008 (when Lehman Brothers collapsed). A common indicator of investors' anxiety, the VIX Index, which measures market expectations of near-term volatility conveyed by stock index option prices, hit a near-record high of 83 during March, rocketing up from 14 in mid-February.

As if a global pandemic wasn't enough, a spat between Saudi Arabia and Russia also plunged oil markets into an all-out price war during the quarter. On March 7, after Russia refused the production cuts proposed at a so-called "OPEC+" meeting, Saudi Arabia announced that it would flood the market with as much as an extra one million barrels of oil per day and slash costs of all crude grades to all destinations. As a result, crude oil prices declined more than 30% the following Monday—the largest single-day decline since the Gulf War in 1991. U.S. crude oil prices have remained below $30 per barrel since, substantially below the $50 per barrel average breakeven for most U.S. shale producers cited in a recent Dallas Fed Energy Survey. The implications for the shale industry have been catastrophic. According to Baker Hughes, in the past two weeks over 120 oil rigs in the U.S., nearly 20%, have already been idled. While low oil prices are ultimately a positive for consumer spending, a disorderly market in which production shuts down for an extended period will substantially reduce supply and could push prices drastically higher when global economies return to normal.

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The response to the crisis by fiscal and monetary policymakers has been immense. In the U.S., many of the programs used during the financial crisis were re-deployed in mid-March, but at a much larger scale. For instance, in response to that crisis, the Fed implemented quantitative easing—the purchase of U.S. Treasury bonds and mortgage-backed securities with newly created money—to the tune of $60 - $100 billion per month, on average. In comparison, during just the week of March 16, the Fed purchased approximately $375 billion worth of bonds. Instead of rallying on this news, the S&P 500 declined 15% that week. Then, before the market opened on Monday, March 23, the Fed announced it would purchase $125 billion in bonds per day. It also announced an alphabet soup of programs including the Primary Market Corporate Credit Facility (PMCCF) and the Secondary Market Corporate Credit Facility (SMCCF), programs that will allow the Fed to directly purchase investment-grade corporate bonds and the exchange-traded funds that own them. Collectively, these programs represent the Fed's first ever direct involvement in the corporate debt market, an area technically outside of its authority. These programs were complemented with comments that suggested additional and uncapped support was close at hand if necessary, as Fed Chairman Jerome Powell committed to asset purchases "in the

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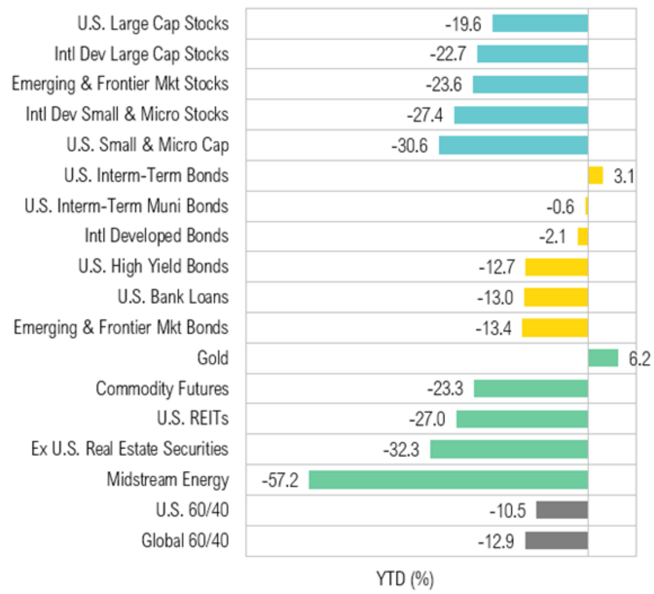
amounts needed" to support markets. Central bankers around the world have followed suit in the hopes of stemming the tide until the world's economies can restart again.

1Q, 2020 Key Market Total Returns



Source: Bloomberg

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The U.S. Congress also became involved, passing the CARES (Coronavirus Aid, Relief, and Economic Security) Act. There was little opposition to providing $2.2 trillion of support—a number more than double the $831 stimulus package passed in 2009. Approximately $350 billion of the CARES Act support is earmarked for small business relief through the Paycheck Protection Program. However, for many, this relief will be neither large or soon enough. Small businesses that lack the necessary liquidity, cash reserves, and access to capital markets will likely—and unfortunately—struggle to weather the storm. According to the NFIB, most small businesses have less than 30 days of operating cash. Thousands are expected to—or already have—shut down. Conversely, larger businesses generally have greater access to capital markets and are expected to fare better. Despite all of March's turmoil, investment-grade companies were able to issue $254 billion of bonds, a 153% year -over-year increase, in the hopes of buying time while the pandemic runs its course.

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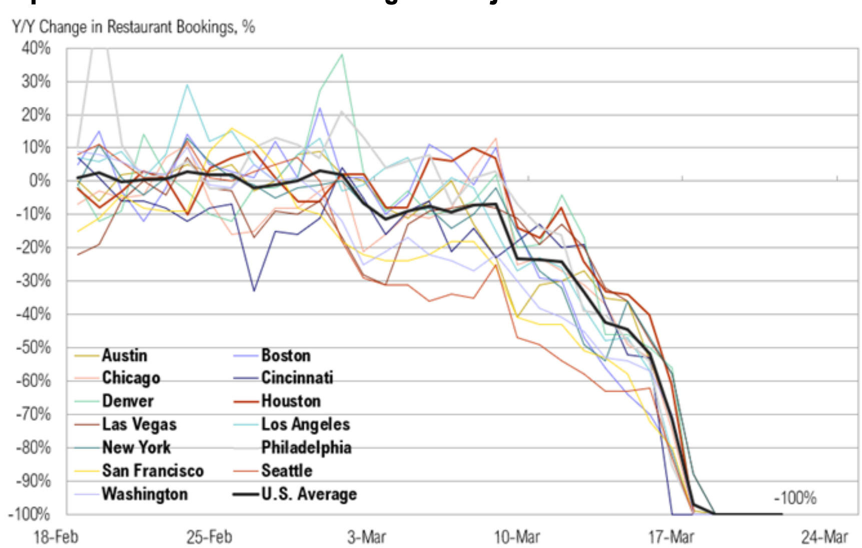
OpenTable Restaurant Bookings in Major U.S. Cities



Source: OpenTable

Looking Ahead

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The longer SARS-CoV2 spreads unchecked, the more lives will be lost. Priority number one, therefore, needs to be fighting the virus. Indeed, the beginning of April brought promising signs that containment efforts have already slowed its spread. The rate of new cases appears to be plateauing. However, all of these containment efforts will leave severe economic disruptions in their wake. Economic activity, as measured by Gross Domestic Product (GDP), will decline substantially in the short term. During the second quarter alone, estimates indicate it could drop by as much as 24% on an annualized, year-over-year basis—which would be the largest single-quarter decline by far on record. Although these numbers are eye-catching, we believe that the pandemic may produce structural shifts within the economy and markets that may ultimately be more important to investors than the magnitude of the downturn.

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In terms of allocating capital, we believe that the worst of the forced liquidation that occurred during the week of March 16 is probably over. That said, we believe that markets will not likely return to normal until a vaccine or effective treatment for the virus is found. There is much we do not know, and some countries that thought they had contained the virus, including China and Singapore, have recently suffered flare-ups that have forced them to reinstitute strict containment efforts. In addition, at no point in the past several weeks did U.S. stocks get especially cheap when viewed relative to the lows of past recessions and bear markets. For instance, the 10-year smoothed price-to-earnings ratio ("Shiller P/E") troughed in March at 24.5, approximately 63% higher than the low of 15 during the financial crisis.

One reason stock prices may not fall significantly further is the Fed's growing involvement in markets, which by some estimates could total $10 trillion or more when the dust has settled. While cheered by many in the short term, this expanded intervention will create winners and losers and undoubtedly broader issues down the road. As we consider allocating capital, we are focusing on sectors and industries deemed systemically important that are expected to receive support from the Fed. The size of the financial crater created by COVID-19 may force the government to become heavily involved in determining which industries and companies succeed. In these areas, debt may be more attractive than equity given the heavy price tag often attached to government support. We expect bailouts of the airlines, for example, who spent 96% of free cash flow over the past decade on stock buybacks, to come at a substantial cost to equity holders.

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In contrast, we remain concerned about the real estate sector, business development companies, and other non-bank lending channels and insurers. These industries appear to be at the epicenter of the global shutdown and will need to deal with the combined impact of lower cash inflows and increased outlays, which will put enormous pressures on their liquidity situation. In addition, they may sit outside of the Fed's umbrella of support. In some of these more stressed areas, there is a growing opportunity for fresh capital unencumbered by legacy positions, to lend capital at attractive rates of return in order to help stabilize viable and established businesses that are desperately in need of the support.

Given the increasing popularity of private investments leading up to the pandemic, we expect that some investors—who were not fully aware of the risks they were taking on with these structures—may soon seek liquidity from these investments, which are inherently illiquid. This could create numerous opportunities to purchase limited partnership interests at attractive discounts on the secondary markets. Early-stage venture investments could also be attractive as younger firms should be able to adjust more rapidly to a new normal.

If there is anything positive that comes from this crisis, we hope it is a resurgence of the ingenuity and perseverance that contributed to building this great country. Indeed, this is already on display in the inspiring stories of healthcare workers risking their lives on a daily basis; in businesses donating meals to those in need or re-purposing their facilities to

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produce masks and ventilators; and in the parents and countless others who are overcoming enormous challenges on a daily basis. We expect to see more of this and are confident that the storm clouds will eventually pass and be replaced with sunshine.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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