The Instant Recession

Todd Asset Management Q1 2020 International Market Commentary

	1Q 2020	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
MSCI ACWI ex-US (Net)	-23.4	-15.6	-2.0	-0.6	1.1	2.1
MSCI ACWI (Net)	-21.4	-11.3	1.5	2.9	5.1	5.9
MSCI ACWI ex-US Value (Gross)	-28.5	-23.1	-5.9	-2.9	-0.6	0.8

* *Annualized Total Returns.*

The optimism that investors had entering the new quarter was justified, right up until it wasn't. A trade war between the US and China had been averted, central banks were easing, inverted yield curves had generally been resolved, and the uncertainty surrounding Brexit had eased as well. While that optimism may have been justified at that time, the global coronavirus pandemic erased it and sent markets into a tailspin resulting in roughly 34% declines for both MSCI ACWI ex-US and the S&P 500 indexes from their recent peaks. Economies worldwide suffered from an "Instant Recession" as everyone became familiar with a new term- a Lockdown. As we are seeing the effects of the Coronavirus lockdown related screeching halt of economic activity, we start thinking about the concept of lockdown-omics, i.e. estimating how bad the contraction in activity is going to be. Make no mistake, the economic activity is collapsing. Markets recognized this with their recent decline. They appear to be starting to discount some recovery in activity, despite the fact that we have not seen the full extent of the damage that has been caused. We think the sharpest deceleration of activity on record will probably lead to a sharp recovery later on this year. We may be talking about Recovery-omics before long.

- The first impact of the Coronavirus was the Chinese lockdown. On January 23, 2020, the city of Wuhan was locked down in response to the virus. Travel restrictions ultimately covered the country and eventually went worldwide as other governments adopted them to halt the progress of the disease.

- Global equity markets, interest rates and commodity prices experienced a collapse in response to the COVID-19 outbreak and we have also started what appears to be the fastest, deepest recession to ever hit the global economy. Governments aggressively responded to the health threat by ordering large parts of the economy to shut down causing an "Instant Recession".

- Normally, recessions take years to develop. Consumers and/or businesses usually need to borrow and over-invest in real estate or capital expenditures. There is usually some financial foolishness involved, featuring banks, investment banks and too many loans. Recovery times depend on the extent of bad loans that need to be paid off.

- That is not the situation today. Consumers globally were in better shape going into this instant recession. This recession will hurt their incomes, so some recovery period will be needed. Banks had clean balance sheets, which is important because they finance the upcoming recoveries. The banks are generally in good positions to lend.

- Markets have rallied off the March 23 bottom as Governments and Central Banks started to aggressively respond to the economic pain being caused by the shutdowns. Consumer income relief and business loans being used to backstop world economies.

- We expect a short but likely record breaking decline in economic activity followed by a sharp recovery as the economies of the world re-open after the coronavirus crisis. As China and Europe were impacted before the US was, their recoveries should begin sooner. Expectations are for economic growth to bottom sometime between now and June, followed by the beginning of a recovery over the summer.

Unprecedented relief programs are being put in place to set the stage for reopening the economy. Governments including Japan, Germany, the US and UK have responded with huge relief programs. Central banks have responded in kind, and put together tremendous liquidity packages to keep markets functioning. At this writing, there is talk of re-opening economies worldwide, and governments are trying to do so as quickly as they can get the medical approvals to do so. Given that there are still many painful economic reports yet to come, one can understand their urgency. If China is an example, following the January closing, they began to reopen the economy in stages starting about 7 weeks later. Following the re-opening, consensus is that a record breaking bout of economic weakness and increased unemployment should be followed by a dramatic recovery. Our sense is that while there will be a sharp recovery, it will probably take some time to make up the ground lost by the worldwide economy.

Bear Markets often have similar patterns in terms of how deep they are, and which groups lead recoveries. Given that this decline exceeded all of the bear markets since 1990 except

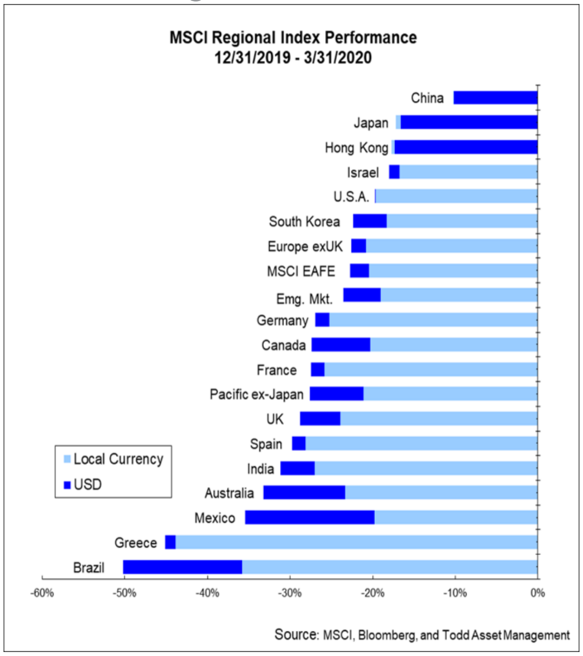
for 2000 and 2009, both of which occurred during the long term secular bear market, we think a lot of bad news was priced in at the bottom. Markets tend not to wait for the full economic recovery to stage a rebound though, as seen in the 20% rebound off the bottom recently. Our belief is overpowering relief programs (soon to be followed by stimulus programs) should give investors some comfort in a forecast for a second half rebound. Looking at bear markets for the index, we find that since 1990, ***1 year returns from the date of the market bottom average almost 37% for the for the ACWI ex-US index.*** The recoveries to be accompanied by:

- Early cycle rotation- towards economically sensitive areas that suffered during the recession relates bear market, but recover afterwards.
- Leadership Changes- Laggards tend to become leaders and vice versa. The worst groups in this decline were Energy, Financial, Real Estate, Material, and Industrial stocks. Most of these will likely be leadership of the recovery phase.
- Regime changes- Rotation in styles usually occurs. We are overdue for a value cycle.

To see a recovery, we need progress on three fronts to occur. First, illiquidity cannot become insolvency. Many good companies have been shuttered for good reason but only temporarily. This is why central banks are saying "Whatever it takes." Central banks have moved aggressively to address this. Second, fiscal policy needs to provide a buffer, with probably $10 Trillion needed globally. Politicians are also saying "Whatever it takes"… The US, Europe, China, Canada, Australia and Japan (among others) have all implemented aggressive measures. Remember though, currently announced programs are generally relief, not stimulus**.** All of the actions to this point are to "weather the storm." Watch for more programs to recover from the storm. Lastly, we need Medical progress. Testing, treatment and prevention. That takes time.

For now, it's a question of patience. Bear Markets sometimes need to retest lows, though we suspect this bear is different as it has not occurred naturally. We saw the first low at -34% from the peak for the MSCI Acwi ex-US, but the worst economic news is still ahead of us. This could cause that retest, because the economic numbers will be really ugly. Comparisons are likely to be drawn to the Great Depression, as unemployment surges temporarily and the economy shrinks. Realize it is not the Great Depression, because this time (unlike during the depression) there is ample liquidity, fiscal stimulus, a social safety

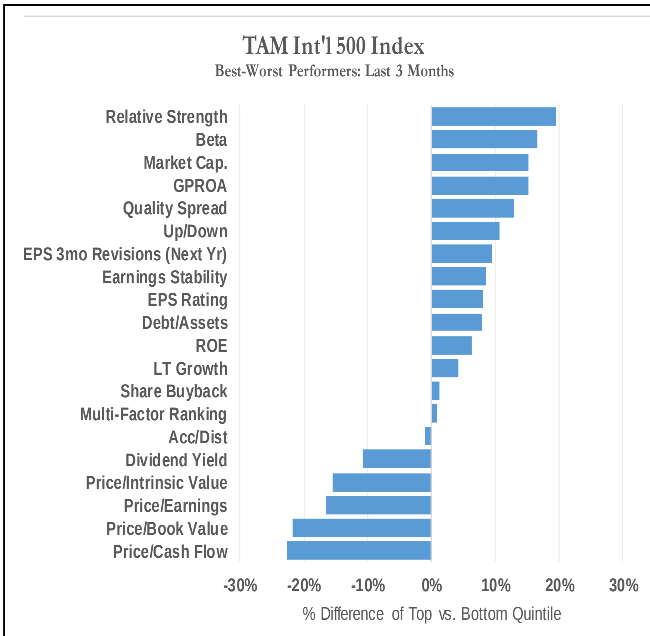
net and relaxing regulations to ensure a recovery from what we think will be a "V" or narrow "U" shaped decline and recovery.

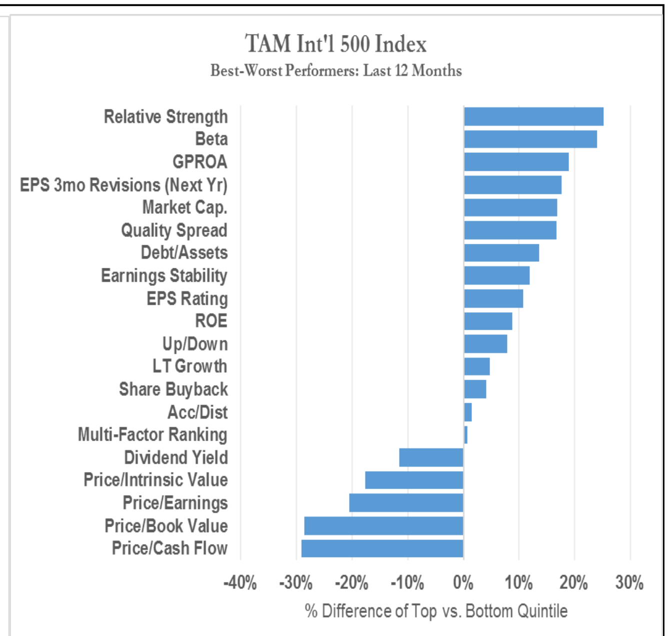


Looking at the winners and losers during the quarter, China and Japan both outperformed most other markets. Those markets tend to be somewhat more insular and may not have had the pressure of foreign holders selling out of positions. Local investors are encouraged to hold during stressful periods.

The laggards included the less financially strong emerging market countries and several oil and commodity related markets. Looking at both the spread of Emerging Market debt to developed market debt, investors worry they will not be able to meet their obligations. Commodity price weakness on coronavirus concerns explains the weakness in Mexico and Australia.

Factor performance



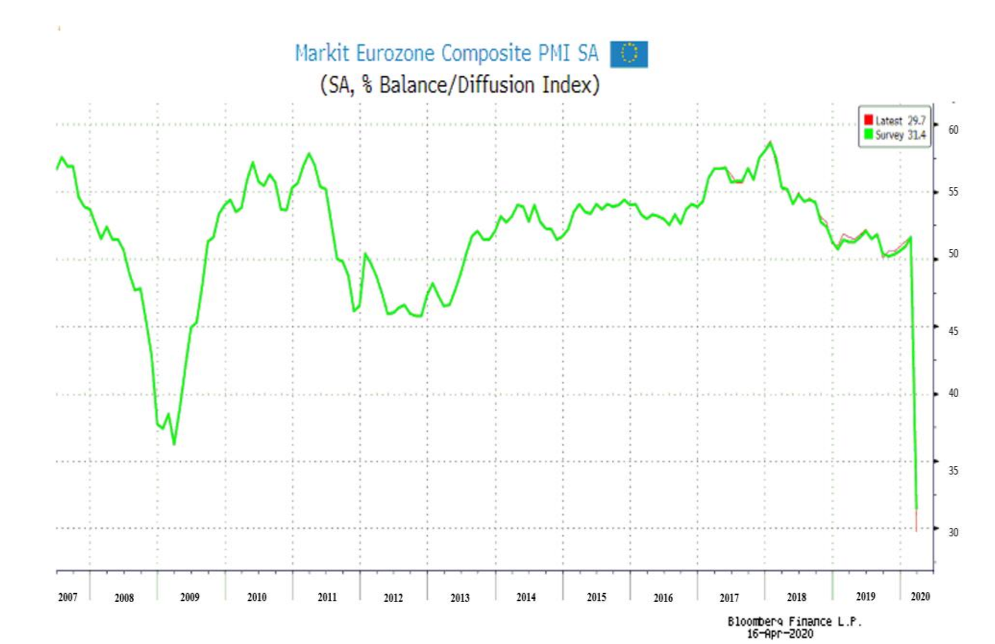


Source: Bloomberg, William O'Neill + Co. and Todd Asset Management

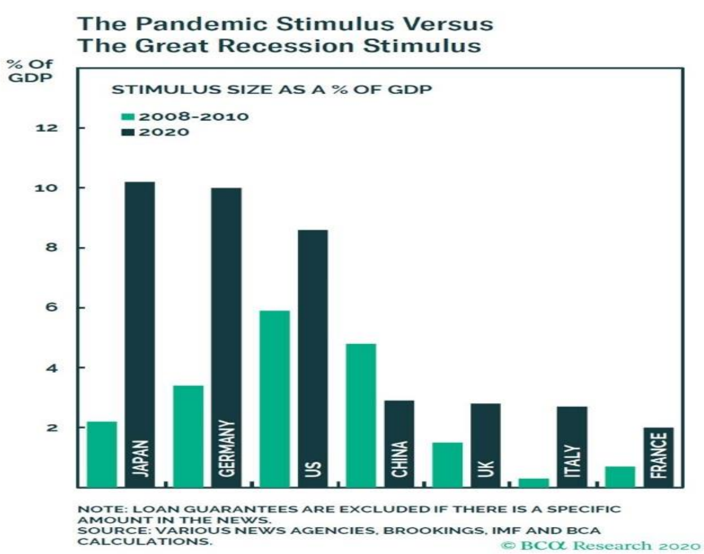
Like the US, International value investors saw dismal returns over the past quarter and twelve months, while investors favored Visibility and quality measures. Value tends to underperform in periods of economic weakness, like the current government/medically required recession we are currently in. Following that, when economic visibility returns, investors regain comfort and a recovery for the style usually follows.

Coronavirus Shutdown Prompts "Instant Recession"

- Eurozone PMIs just had the largest plunge on record since 2007.
- This order of magnitude rhymes with experiences seen in the Chinese PMI numbers reported during their lockdown.
- Shutting down large portions of the economy got an "Instant Recession."



Stimulus- Go Big Early



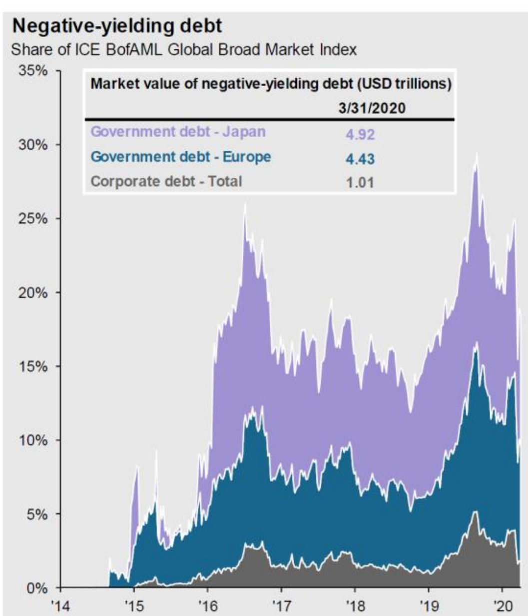
- Governments/Central banks learned to "Go Big Early" with stimulus and intervention.
- Consider the size of this stimulus vs during the global financial crisis, and then realize we have not seen the worst of the economic reports yet.

China- A "V" Shaped Recovery?

China -- 1Q20 Real GDP -20% y/y; Imported COVID-19

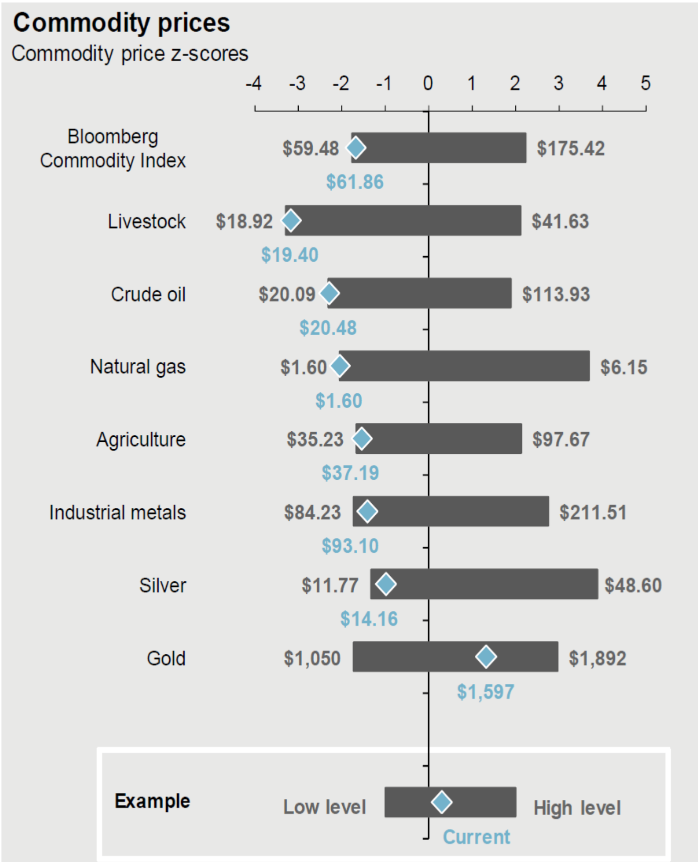
Source: Evercore ISI

China has been a leading indicator for world economy responses to the shutdown. While Q1 GDP is expected to be pretty ugly, a strong recovery is expected according to ISI, the author of this chart. While short term demand may be weaker due to western lockdowns and travel bans, if worldwide economies can reopen, this type of recovery does not seem unreasonable.



The chart to the left, compliments of JP Morgan, illustrates the share of the global bond market that has negative yielding debt. Given the central bank actions, a casual observer might expect that more negative yielding debt would have resulted. While there has been a modest increase off recent lows mainly as a result of Japan, we see a decline in the amount of negative yielding Corporate and European Government debt. We would also point out that German rates are higher now than they were at the end of February. This suggests that the market may be less worried about deflation as a result of stimulus and progress in dealing with the Pandemic.

Commodity Prices are Rock Bottom



The chart to the left, compliments of JP Morgan, shows where current commodity prices (the blue diamond) are in relation to their past 10 year range (the gray bar). The scale at the top is the z-score, an educated term for how many standard deviations an observation is from the average.

Commodities have generally been poor investments over the past ten years, as most observations except Gold are near the bottom of their range and have negative z-scores indicating these prices are statistically rare.

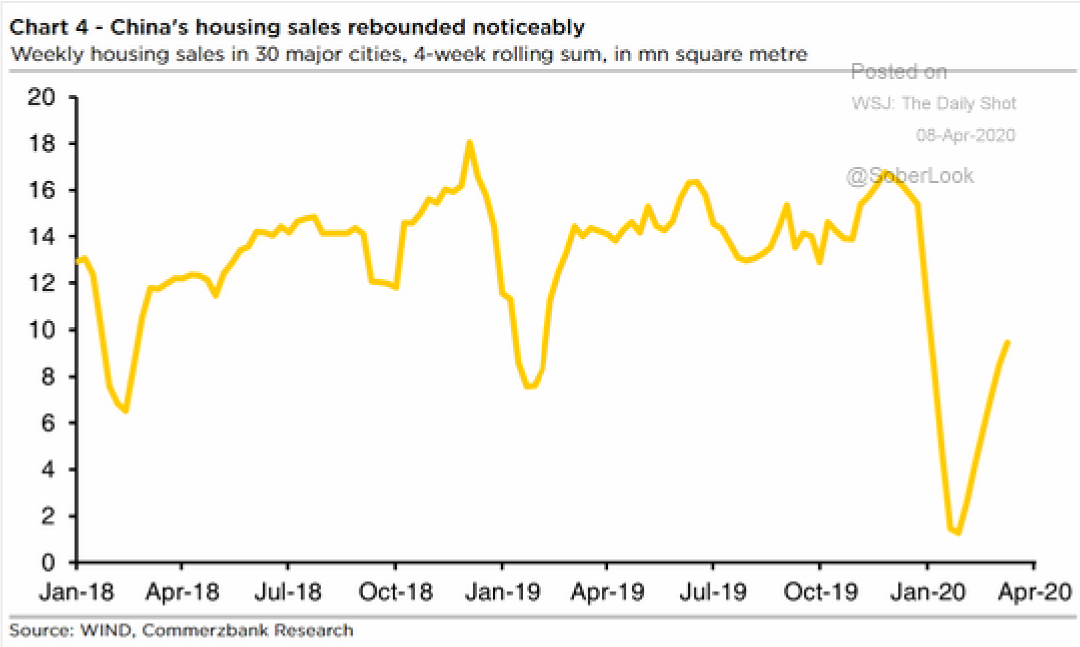
Timing is tough, but when we see an economic re-opening and ultimately a recovery in demand, our sense is most of these should perform better over the next few years.

Interbank Lending Rates Signal Caution

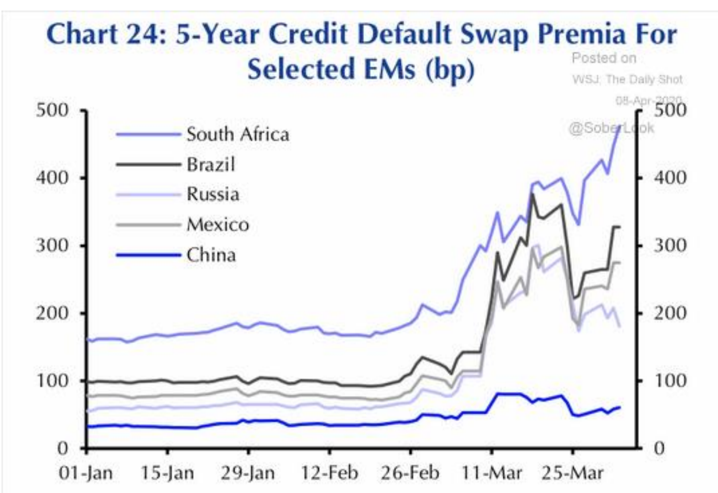
Source: The Daily Shot

Stresses are appearing in the market for European Interbank lending. While the ECB has forced banks to recapitalize over the past 10 years, they have not cleaned up their balance sheets as much as their US counterparts have. This bears watching, as those banks will have a role to play in getting European small and medium sized businesses back on their feet after this crisis.

China's housing market is seeing a rebound



This should be a constructive leading indicator if the experience translates to other economies that have experienced coronavirus induced shutdowns. The Emerging Market Consumer seems to be recovering after the crisis.



The chart to the left, from Capital Economics, shows the pricing of 5 year Credit Default Swaps for selected emerging markets. Prices for insurance for most of these countries have started to decline after a spike in March. Funding pressures have eased with the Fed's actions, indicating a better outlook than was the case in March.

South Africa is the exception as they lost their Investment Grade rating due to strained public finances.

Summary

We have experienced a fast and deep bear market as the government mandated economic shutdowns will likely lead to record breaking economic declines. Fortunately, governments and central banks have stepped up forcefully and quickly to relieve some of the stresses that will result from mass unemployment and business closures. Not all of the stresses will be alleviated, and we expect that further stimulus programs will be undertaken by governments worldwide. Markets have reacted with strong rallies off of depressed levels, even without having seen most of the negative economic reports arising from the lockdown. Our sense is that now some patience is needed as markets probably need to get some economic information, and clarity on when economies will reopen. We believe economies should start to recover sometime in the third quarter (between July and September) which should mean that the March 23 low is probably the bottom of the market. Given the extraordinary amount of government support globally for the economy, visibility for growth should improve once the economy is reopened. If that is the case, then the recovery should have further to go before year end, and will likely have new value oriented leadership.

Even in a Coronavirus lockdown, we are here to support you. We are available via email or phone and welcome your calls. If you have any questions, please feel free to contact any of us for further information.

As always, if you need any additional information, please feel free to contact any of us.

Curt Scott, CFA
Jack White, CFA
Jack Holden CFA
Shaun Siers, CFA

04/20/20
MSCI ACWI ex-US- 240

Refer to the following page for more information on the commentary presented. This is pertinent to this letter and should not be reproduced or duplicated without this disclosure.

Asset Management

MSCI ACWI ex-U.S. (net) Index is a float-adjusted market capitalization index that is designed to measure the combined equity market performance of developed and emerging market countries excluding the United States. The ACWI ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments. The Net Index takes into account the impact of foreign tax withholdings on dividend income.

The MSCI ACWI ex U.S. Value (gross) Index captures large and mid-cap securities exhibiting overall value style characteristics across 22 Developed and 26 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

MSCI ACWI (net) Index is a float-adjusted market capitalization index that is designed to measure the equity market performance of developed and emerging markets.