Westshore Wealth *Insights*

Riders on the Storm

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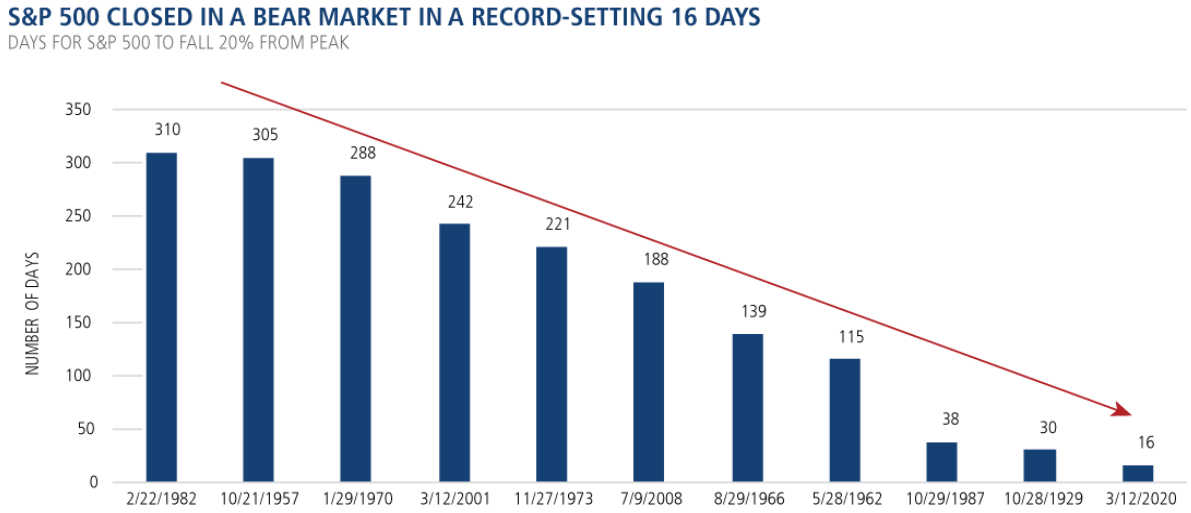
This last month has felt a lot like the Doors famous song, "Riders on the Storm." As the song lyrics go, "into this house we're born, into this world we're throw," this tiny virus managed in the blink of an eye to upend a fully employed economy, kill an eleven-year bull market, and plunge the world into global recession. Now that we are here, what do we do about it? Our contention has been, and continues to be, that the healthcare crisis will prove transitory. As the data is showing, infection caseload follows a bell curve. With appropriate remediation steps like social distancing, increased testing, and careful hygiene practices, the earliest impacted nations, China and South Korea, have shown that infection rates can be arrested and reversed. We have no doubt that the shelter-in-place programs in the United States will be effective at decreasing transmission. Additionally, work on prophylactic antibody serum, testing of therapeutics that treat and reduce symptom expression, as well as the development of new vaccines is progressing a breakneck speed. However, the economic toll is just starting to become clear. Now that the market has bounced, the key question becomes, are we in the eye of the hurricane or has the storm passed? In this note, we will lay out a framework to gauge a logical range of outcomes as we start on the path towards recovery.

To understand what might be next for the market, it's important to understand how we got here. First, the velocity of this decline marks the shortest time for the SPX 500 to record a -20% pullback (commonly defined as the start of a bear market).



Past performance is no guarantee of future results. The S&P 500 Index is generally considered representative of the U.S. stock market. Source: FactSet, 3/12/2020

Additionally, the magnitude of the SPX 500 peak to trough decline of -36% is also above the average bear market pullback of -28.8%. Juxtaposed to these downward movements, last Tuesday's 11% rally in the Dow Jones Industrials marked the best day since 1933. Why are we seeing this unprecedented volatility? It has to do with how investors assign value to companies. The most common valuation techniques involve using the sum of discounted future cash flows, or more simplistically, applying a multiple to earnings (known as P/E

multiple). However, when you don't know how much time will elapse before a resumption of business activity can commence, tremendous guesswork is required. The range of outcomes, as a consequence, can be quite wide. Naturally, that breeds uncertainty, and volatility is the byproduct. Unfortunately, this period of unpredictability is apt to continue, so we need to prepare for more volatility ahead.

The trigger of this particular market upset is different from others experienced in the modern era. That has the effect of amplifying the fear of the unknown. However, the same could have been said for 9/11 or the Great Financial Crisis. The good news lies in a Mark Twain quote. "History doesn't repeat itself, but it often rhymes." We as investors can draw on copious amounts of historical context that can be used to narrow the consideration set of outcomes and allow us to make reasoned decisions. Let's start with the first. Unfortunately, bear markets are rather common. On average, they occur once every six years. While the downdraft is terrifying, it's important to remember that the market generally recovers all of its losses in 3.4 years. Time is your friend in investing.

US Bear Markets Since 1945

Market Peak Date	Peak Level	Market Bottom Date	Bottom Level	Peak to Trough % Decline	Number of Months	Years To Breakeven
19-Feb-20	3386.15	?	?	?	?	?
11-Oct-07	1565.15	9-Mar-09	676.53	-56.8%	16	5.5
24-Mar-00	1527.46	9-Oct-02	776.76	-49.1%	30	7.2
16-Jul-90	368.95	11-Oct-90	295.46	-19.9%	2	0.6
25-Aug-87	336.77	4-Dec-87	223.92	-33.5%	3	1.9
28-Nov-80	140.52	12-Aug-82	102.42	-27.1%	20	1.9
11-Jan-73	120.24	3-Oct-74	62.28	-48.2%	20	7.5
29-Nov-68	108.37	26-May-70	69.29	-36.1%	17	3.3
9-Feb-66	94.06	7-Oct-66	73.25	-22.1%	7	1.2
12-Dec-61	72.64	26-Jun-62	52.32	-28.0%	6	1.7
2-Aug-56	49.74	22-Oct-57	38.98	-21.6%	14	2.1
29-May-46	19.25	13-Jun-49	13.55	-29.6%	36	4.0
			Average	**-31.0%**	**13.2**	**3.4**
			Median	**-28.8%**	**15.0**	**2.1**

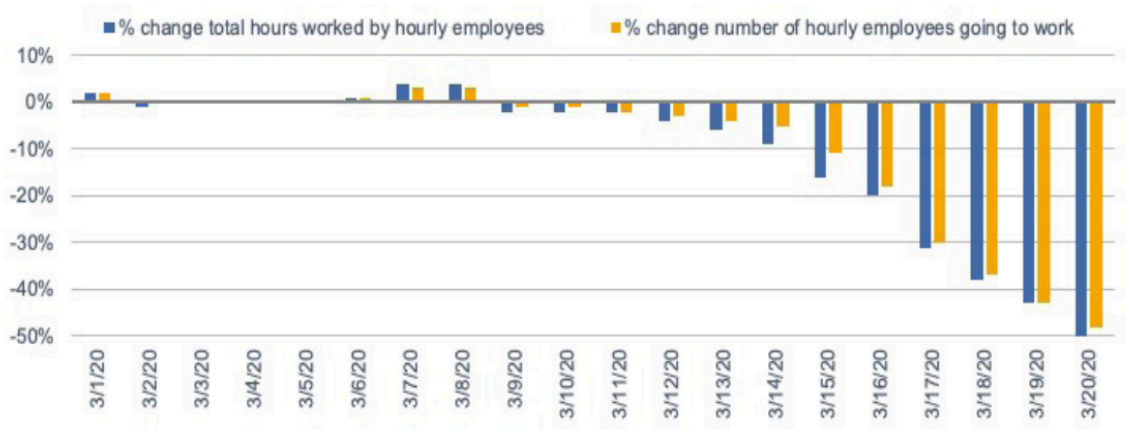
Source: Bloomberg, Turner Investments

Additionally, it's important to distinguish the type of bear market in which we reside. We believe this is an event-driven bear market, defined as one having an exogenous trigger (in this case a viral pandemic), as opposed to one rooted in a secular cause like the mania that unwound in the 2008-09 housing crisis or the speculative excess of the 2000 dot.com bubble. Secular problems take years to fix. In other words, the starting point matters. We enter this recession with record employment, solid consumer credit, low consumer debt service, and above average national savings rates. That's important because it means the return to normalcy should, in theory, be faster. If we look at other event-driven bear markets such as the Suez Crisis in 1956-57, the Kennedy slide of 1961-62, the enactment of Great Society legislation in 1966, and the Black Monday crash of 1987, each rebounded more quickly, on average in 1.5 years.

In our opinion, the pivotal variable to the market's path forward revolves around how long the economy remains frozen. We recognize this is a rather Captain Obvious insight, but let us illustrate why opening the economy is everything. For the vast majority of businesses, whether large or small, the greatest corporate expense is generally labor. In the absence of revenue, there is no need to have employees. We saw that theme in action this last Thursday when the Bureau of Labor statistics released weekly unemployment claims that shot up to 3.28mm people. That is roughly 4.25x the former historical peak. Still having trouble putting

that into perspective? Specifically, California lost 6% of its jobs while New York lost 10%. Hours worked by hourly employees fell by a staggering 50%.

Hours worked plunging



Source: Charles Schwab, Homebase, as of 3/20/2020. Percentages compare that day vs. median for that day of the week for the period 1/4/2020-1/31/2020. Homebase data covers 60,000 businesses and 1 million hourly employees.

The longer the disruption lasts, the more businesses will fail, and the greater the unemployment ranks will become. According to a Goldman Sachs survey of small businesses (conducted prior to the fiscal stimulus bill), 50% said they could operate 0-3 months in the current compromised revenue condition. Furthermore, Goldman estimates that 31% of Russell 2000 companies (publicly traded small caps) would see working capital completely depleted if the virus shock were to last beyond six months.

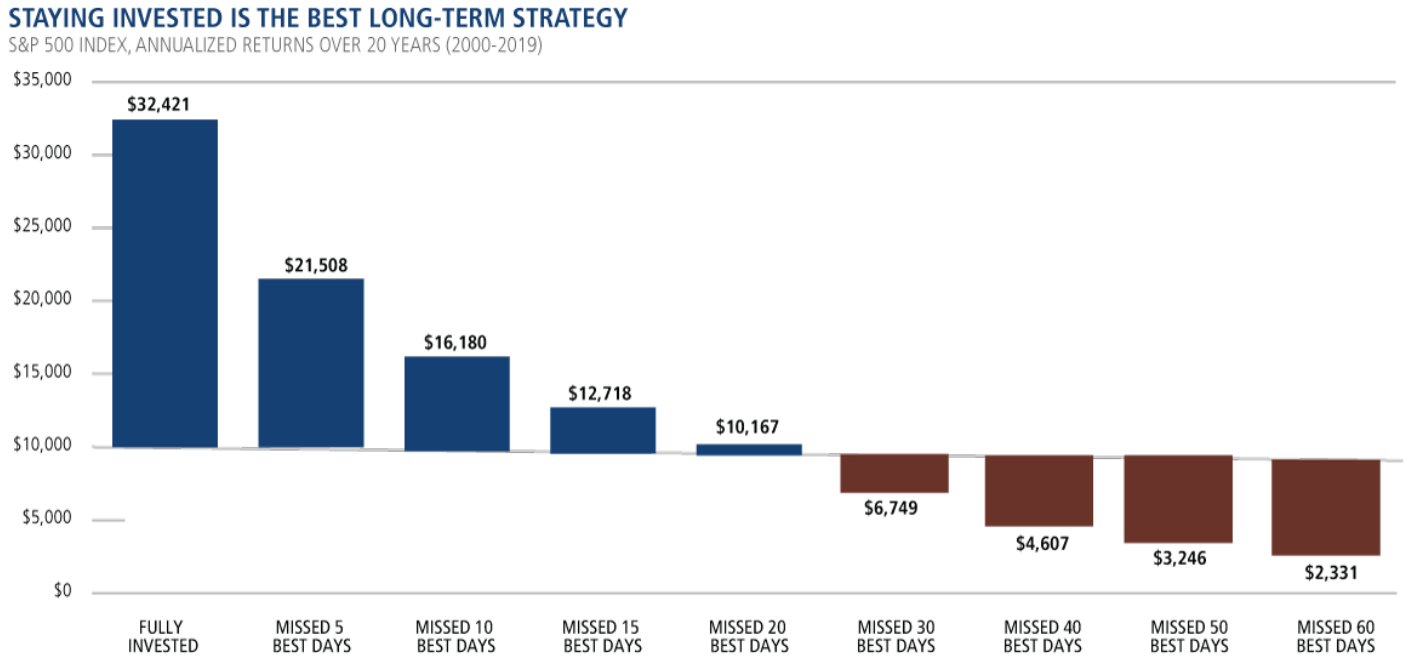
It is this line of thinking that has spurred so many doomsday projections and fueled panicked runs on the market. Fear is palpable. Consumers are hording cash, cleaning out supermarket shelves, and loading up on ammunition where sales are up >800% nationally. To get a sense of the fragile state of the American psyche, look no further than Google Trends where searches for the words "Great Depression" are up 2000% since December 2019. Why is that? Human beings are programmed to think linearly. In other words, we have a tendency to think in if-then terms. We understand that certain actions cause certain consequences. For example, you were taught at an early age not to put your finger in the electric outlet for obvious reasons. In general, this type of thinking serves us quite well. However, in certain circumstances it betrays us. Let's take the Goldman Sachs survey above as our case study. It is no doubt accurate, <u>but importantly, the results are premised on the assumption that nothing changes</u>. If you examine the causes of the Great Depression, the driver was actually a series of triggers that amplified the end result and locked the economy into a vicious circle. Speculative excess and overproduction lead to a massive stock market crash. That in turn caused a debt crisis. With rising defaults, there was a run on banks. Many collapsed, in turn evaporating individuals' savings. Job losses, foreclosures, and homelessness followed. Bottom line, nothing did change until it was far too late. The cycle was left to spiral.

What makes this time different? The answer revolves around two critical policy tools that the government has put into action to break the circular nature of this crisis. First, the fiscal stimulus program enacted Friday is a game changer and should provide a generous time bridge between present and when the economy can

resume its normal function. To put it into context, the $2 trillion package represents a 9.5% infusion into our $22T domestic economy. It's gets cash directly to consumers, expands benefits to those who temporarily lose their jobs, incentivizes small businesses to retain employment ranks using forgivable loans and considerable payroll tax credits, and stabilizes industries severely impacted by disruption allowing them to maintain their workforce. Furthermore, it actually is much bigger than it appears. It earmarks an additional $4.5 trillion that the Federal Reserve may loan companies with US Treasury backing. For reference, that is 4.5x the size of JP Morgan's loan book. It doesn't stop there. The Federal Reserve entered the fight with an arsenal of monetary stimulus and stabilization tools that we have literally never seen before. Short rates have been reduced to zero. They are liquifying the banking system with overnight repurchase agreements, providing a relief valve for commercial paper issuance, and making certain money market funds are provided the liquidity they need to maintain confidence. The credit markets saw dislocations in municipal, corporate, and mortgage backed securities in the prior week. This week, the Fed leapt into action with a facility to purchase all those securities. By providing such ample liquidity, credit markets are once again functioning normally. They have successfully broken the chain that could have caused financial disruption.

So where does that leave us? We believe fiscal and monetary policy has effectively taken away the tail risks that could cause a more dire outcome for markets and the economy. That said, the next few months are apt to be ugly. Depending upon when commercial activity is allowed to return to some form of normalcy (we assume in another three-four weeks), we would not be surprised to see GDP fall -20%-30% in the 1Q20-2Q20 period. The recession, while likely very short, will be quite severe. Consumer activity is likely to recover in waves. In the short run, there will be considerable pent up demand for dining out, concerts, sporting events, and other social occasions that have not been accessible for weeks. In the intermediate and longer term however, you can expect people to defer large purchases like autos and other durable items as they rebuild their wealth. The crisis will leave other scars as well. Savings rates of 7% nationally were already towards the higher end of the historical range, but will probably forge higher as people establish rainy-day funds for living expenses. The market recovery is similarly going to be a process. Waterfall declines like we just experienced are rare (1987 is a great example). They are characterized by persistent selling, surging trading volume, and a punctuated selling climax. Typically, they are followed by a very sharp rally and then a subsequent retest. According to work compiled by Ned Davis Research, in 69% of instances, waterfall declines saw the market break to slightly lower lows during the retest. The median time between the waterfall low and the bear market end is 1.8 months. Our sense is that the market will likely rally as the virus case load starts to drop and people get enthusiastic that the economy will restart. Then we will see the carnage in terms of earnings estimate revisions, jobless claims, and corporate bankruptcies. That sober reality will likely lead the market to some form of retest of the lows. Again, bottoms are a process.

Why shouldn't you go to cash and wait for that retest? Keep in mind the market doesn't report the past, it attempts to predict the future. In WWII, the market didn't bottom when we prevailed in 1945, it bottomed when it saw a path forward, shortly after we conducted the Doolittle Raid on Tokyo and subsequently scored a decisive naval victory in Midway. That was in 1942, nearly three years prior to the war's end. We have said time and again that we don't favor trying to time the market. The table that illustrates why is included below. Over the course of the 20-year investing period from 1/1/99 to 12/31/19 (a period that includes two wrenching 50% market corrections), a buy and hold investor better than tripled their investment. Had that same investor simply missed the best 30 days over that 20-year span, he would have lost money. Bottom line, we don't know if the bottom has been reached, if there will be a retest, or if the market will simply continue to rally. What we do know, with a lot of data, is that time in the market is your best friend.



Source: Morningstar. Data ranges from 1/1/99 through 12/31/19. Performance data quoted represents past performance, which is no guarantee of future results. The S&P 500 Index is generally considered representative of the U.S. stock market.

For those that are skeptical, let me prove it to you another way. Consider the following. What if you were the unluckiest investor of all time? Let's say you invested in the equity market at its peak, immediately before one of the 18 sell-offs in the last century? Despite enduring an average initial loss of -27.9%, over the long-term, you would have earned an average annualized return of 4.1% and 8.0%, over five-and 10-year holding periods, respectively.

MARKETS HAVE HISTORICALLY SHOWN AN ABILITY TO RECOVER UNREALIZED LOSSES

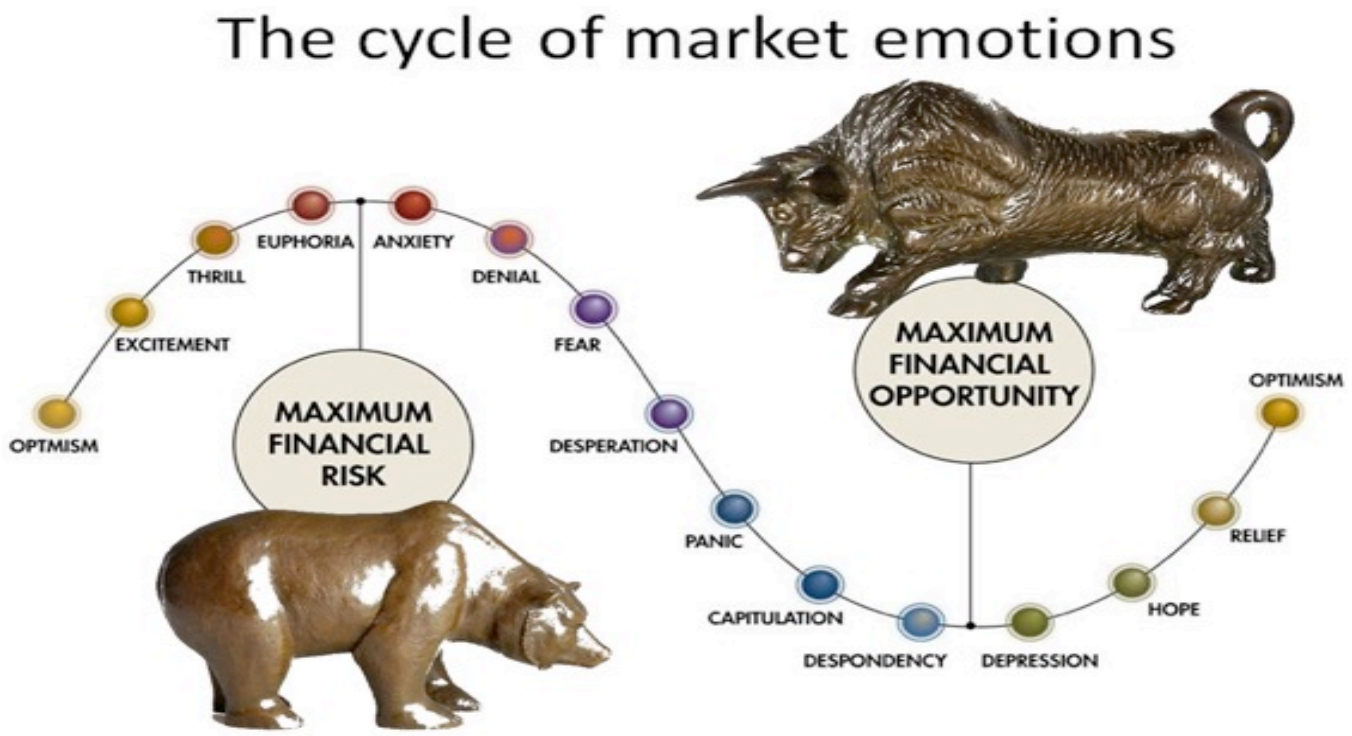
ALL U.S. STOCK MARKET CORRECTIONS (SELL--OFFS OF -10% OR MORE) SINCE 1926

DATE OF MARKET CORRECTION			DURATION (# OF MONTHS)		DEPTH OF DRAWDOWN	IF PURCHASED AT PEAK	
PEAK	TROUGH	RECOVERED	SELL-OFF	RECOVERY		5 YEARS	10 YEARS
Aug-29	Jun-32	Jan-45	34	151	-83.40%	-17.40%	-4.90%
Feb-37	Mar-38	Mar-44	13	72	-50.00%	-8.60%	4.00%
May-46	Oct-46	Oct-49	5	36	-21.60%	9.10%	15.50%
Jul-56	Feb-57	Jul-57	7	5	-10.20%	10.00%	9.00%
Jul-57	Dec-57	Jul-58	5	7	-15.00%	7.60%	10.70%
Dec-61	Jun-62	Apr-63	6	10	-22.30%	5.70%	7.40%
Jan-66	Sep-66	Mar-67	8	6	-15.60%	4.30%	4.00%
Nov-68	Jun-70	Mar-71	19	9	-29.20%	0.40%	3.10%
Dec-72	Sep-74	Dec-76	21	27	-46.40%	-0.10%	7.60%
Aug-78	Oct-78	Mar-79	2	5	-11.20%	17.10%	14.80%
Nov-80	Jul-82	Oct-82	20	3	-18.80%	12.10%	11.80%
Jun-83	May-84	Dec-84	11	7	-10.80%	12.80%	13.30%
Aug-87	Nov-87	Apr-89	3	17	-29.80%	7.70%	13.40%
May-90	Oct-90	Feb-91	5	4	-16.80%	11.50%	16.70%
Jun-98	Sep-98	Nov-98	3	2	-12.00%	-1.30%	3.60%
Aug-00	Sep-02	Mar-06	25	42	-44.10%	-1.60%	-1.10%
Oct-07	Feb-09	Mar-12	16	37	-51.00%	0.60%	7.60%
Sep-18	Dec-18	Apr-19	3	4	-14.30%	?	?
		Average	11	25	-27.90%	4.10%	8.00%
		Median	8	8	-20.20%	5.70%	7.60%

Performance data quoted represents past performance, which is no guarantee of future results. Source: Wilshire Associates Incorporated. The **S&P 500 Index** is generally considered representative of the U.S stock market.

With that said, what actions are we taking at Westshore to protect your wealth and posture for the future? We have consistently designed portfolios to include ballast in the form of capital preservation, added less correlated assets to dampen volatility and engineered shock absorbers to protect our downside. Those have worked to date. That said, we are making changes on the margin. We sold our investment in Alphacentric, a mortgage backed security fund, as we expected price compression in those assets. We sold our position in the iShares Short Maturity Bond ETF as near-term rates have been cut to near zero levels. We added to our position in municipal and preferred securities to take advantage of what we perceived to an illogical dislocation in price levels. We invested some proceeds into convertible bonds that offer compelling yields and also offer a link to equity market upside. Finally, for some, we purchased a structured note on the SPX 500 that provides significant downside protection if the market corrects further, but still offers an attractive future return profile when it recovers. Over the coming weeks, you can expect that we will engage in tax loss harvesting where we sell an investment with a capital loss and substitute that money into a reasonable proxy so as to minimize your taxable gains recognition in the future. Finally, as markets stabilize, you will see us rebalance portfolios by selling capital preservation securities and legging back into growth vehicles.

Rest assured, this storm will pass. If we can offer one piece of additional advice, take a break from CNBC and other news channels. They tend to reinforce the human emotions within us that cause some of the worst investment decisions. As we have frequently illustrated, maximum financial opportunity, ironically tends to accompany periods of extreme panic and despondency, while maximum financial risk generally accompanies periods of extreme optimism. We recognize that apocolyptic messages are omnipresent right now, but there are blue skies ahead.



Important Disclosures:

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