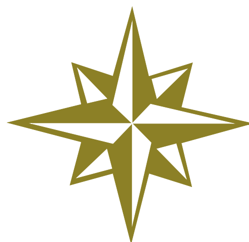

MARQUIS
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Personalized Financial Services

First Quarter 2020 Market Review & Outlook

April 2020

As we write this Market Outlook, we are struck by how quickly and profoundly our world has changed over just the past few weeks. We view this newsletter as a routine but important part of our service to clients. We use it to explore, frame, and retest our opinions about markets that in turn serves as a starting point for our advice in managing each client's unique and personalized investment portfolio. But we would be remiss if failed to acknowledge the magnitude and gravity of the global healthcare challenge we currently face and we considered the present time to be anything but routine. Our thoughts are foremost for the continued health and safety of each of our clients, team members, and families. Our prayers are with all those on the frontlines battling this virus and for a medical breakthrough in treating those infected. We take comfort in the collective power of human ingenuity, compassion, and resolve to shepherd us through to the other side of this ordeal (hopefully sooner rather than later!) and into a renewed era of health and prosperity. In the meantime, please continue to be kind, to practice patience, to give where you are able, and to check in on elderly family and friends.

Executive Summary

- Global financial markets experienced "waterfall" declines in March that pushed first quarter returns deeply negative in most asset classes. Long-term US Treasury Bonds, Gold, and trend-following managed futures strategies were the only market sectors to produce positive returns. (Page 2)
- We are living through an unprecedented time, wherein policy makers have temporarily and purposefully ordered the vast majority of economic activity to halt. We don't currently know how long the isolation protocols will remain in place, how the economy will look once businesses are allowed to restart, or what the longer-term unintended consequences of this policy action will be. The heightened levels of uncertainty have led to similarly extreme market movements across most asset classes. (Pages 2 & 3)
- Even during this time of elevated market volatility, we know that rebalancing portfolios to long term asset allocation targets and selectively "harvesting" tax losses produce value and help keep your financial plans on target. (Page 4)
- The performance of our recommended investment strategies substantially met our expectations in the first quarter. Equity managers generally protected against the worst declines and our allocations to alternative investments produced positive returns adding significant value. Bond managers underperformed due to a lack of ownership of long-term US Treasury bonds, but we have experienced this dynamic before and fully expect it to be temporary in nature. (Pages 4 & 5)

6216 Whiskey Creek Drive, Suite A   Fort Myers, FL 33919   Phone 239-454-1117   1-877-454-1117   Fax 239-454-0249

www.marquiswealthgroup.com

First Quarter 2020 Financial Markets Review

Global stock markets started the year on reasonable footing, but declined dramatically in the second half of the quarter as COVID-19 spread into a global pandemic and brought economic activity worldwide to a screeching halt in late March. The declines in commodity markets were even more calamitous as Saudi Arabia and Russia engaged in a price war that sent oil prices tumbling. Trend-following managed futures were a lone bright spot in the sea of declines, managing to eke out a flat return. Below are selected index total returns for the first quarter of 2020:

- Large company US stocks, as measured by the S&P 500 index, declined by (19.6%).
- Mid-sized company US stocks, as measured by the Russell Mid Cap Index, declined by (27.1%).
- Small company US stocks, as measured by the Russell 2000 index, declined by (30.6%).
- International stocks, as measured by the MSCI All Country World (Excluding US) index, declined by (23.4%).
- Commodity prices (oil, gold, metals, grains, etc.) declined by (31.2%).
- Managed Futures Strategies, as measured by the Credit Suisse Managed Futures Index, were flat for the quarter with a gain of 0.03%.

The US investment grade bond market, as measured by the Bloomberg Barclay's US Aggregate Bond Index, earned a total return of 3.2% in the first quarter. Unfortunately, the gains were limited only to the US Treasury market and even there, concentrated in long term Treasuries. As fears spread in March, liquidity (the ability to buy or sell quickly without meaningfully moving the market price) evaporated, even amongst Treasuries and other high-quality bonds, leading to "waterfall" declines across the bond market. Quick, aggressive, and unprecedented actions by the Federal Reserve began to restore liquidity and stability, but most bond sectors only registered partial price recoveries by the end of the quarter. Below are the sector total returns within the bond market for the fourth quarter of 2019 and full year time periods:

- Short Term US Treasury Bonds earned a 0.8% total return.
- Long Term US Treasury Bonds earned a 20.9% total return as long-term interest rates fell to new all-time lows.
- US Investment Grade Corporate Bonds declined by (3.1%).
- US High Yield Bonds declined by (13.1%).
- US Floating Rate Bank Loans declined by (13.1%).
- US Municipal Bonds declined by (0.6%).
- Developed Market Foreign Government Bonds declined by (2.7%).

Market Commentary

There are words or phrases that we usually avoid using in communicating with clients: "always", "never", "this time is different", or "unprecedented" each imply a degree of certainty or uniqueness that typically runs counter to the unpredictable but generally cyclical nature of financial markets. Yet, our present time is quite literally without precedent in so many ways. Many market participants have taken to comparing our present economic state with the

global financial crisis of 2008. But we find one stark difference between the two: in the fall of 2008 through the spring of 2009 policy makers took a series of increasingly bold steps to forestall the worst effects of the financial crisis in an (ultimately successful) attempt to keep the economy running; Today the response to combat the health crisis has been to purposefully halt wide swaths of the economy, albeit temporarily. We find ourselves in the midst of the first policy-mandated global recession. There is no playbook for how to navigate through this crisis, and no parallel to be drawn from prior events. As noted investor Howard Marks recently wrote:

> "These days everyone has the same data regarding the present, and the same ignorance regarding the future. Most of what we have today is opinion, and much of it tilts either optimistic or pessimistic. The gulf in between is massive: if you read just the optimistic pieces, you'd think the virus will soon be eradicated and the economy brought back to health, and if you read just the negative ones, you'd think we're all done for."[1]

The point is, nobody knows what will come next. We don't know how long isolation protocols should remain in place, or if the virus will reassert itself after they are lifted; We don't know if or when an anti-viral treatment or vaccine will be proven safe, effective, and be widely available; We don't know what economic activity will look like in the presumed interim time between the lifting of quarantines and availability of a vaccine; We don't know how high the unemployment rate will go, or how many of those layoffs will prove to be temporary rather than permanent; We don't know if or how consumer, business, and government behavior will be permanently changed as a result of this viral pandemic; and we don't know what the unintended consequences will be of all the fiscal and monetary stimulus necessary to keep the economy "on life support" until isolation protocols can be lifted. The sheer magnitude of the uncertainty has driven market activity to highly volatile extremes. Here's a sample of some of our observations:

- Over the course of five weeks spanning late February to early April, the S&P 500 registered more days of 3% price changes up or down than in the previous 5 years.
- In the same time span, the 10-year US Treasury bond yield fell from 1.52% to 0.50%, increased back to 1.27%, and then fell back to 0.59%. These sorts of movements typically occur over years, not weeks in the Treasury market.
- Municipal bonds at one point traded at yields between 3 and 6 times higher than Treasuries of the same maturity. The normal relationship is somewhere between 0.8 and 1.2.
- The price of oil collapsed in the face of radically reduced demand and temporarily increased supply due to the Saudi-Russian price war. This drove the price of contracts for May delivery of oil briefly negative on April 20 on fears that oil storage capacity would soon be exhausted, while contracts for delivery in the fall remained in the $30 range.

[1] Howard Marks, "Calibrating", https://www.oaktreecapital.com/docs/default-source/memos/calibrating.pdf

Portfolio Positioning

Even in the face of such radical uncertainty and extreme market movements, certain timeless principles continue to have value and do not require any forecast of the future. Among them: Current asset price declines, while painful, serve to increase potential future returns; The bottom, by definition, is the day before prices start to permanently move higher, and is therefore impossible to forecast; And price changes, up or down, only become permanent when you sell – until then, as discomforting as it can be in the interim, they are only numbers on a page. Using these as our guiding principles, we can offer these thoughts about portfolio positioning in the present time:

1. We carefully constructed each client's portfolio to meet their personal objectives and goals over their specific time frame. For most, that time frame includes multiple decades and therefore included an assumption of one or more economic recessions, deep market declines, and eventual recoveries.
2. Regardless of your positioning entering this downturn, the market price movements in the various asset classes – stocks, bonds, and alternatives – have been substantial enough to move your asset allocation away from its intended target. Rebalancing back to your target or neutral allocation is the best way to maintain your long-term plan and has the added benefit of "buying low and selling high" in a disciplined, systematic way. Because the outlook is currently so uncertain, we do not feel it is appropriate to shift asset allocations into an outright aggressive or opportunistic stance by overweighting stocks.
3. For clients with taxable investment accounts, the stock market decline offers an opportunity to "harvest tax losses" – a process of selling positions at a loss to capture the tax benefit for future use and then reinvesting in similar, but not identical positions to maintain the appropriate investment posture.

That said, we also wanted to provide some brief comments about the performance of our recommended strategies during the first quarter. The stock managers we generally utilize had mixed results that ended up producing returns slightly better than or roughly in-line with the global market. There were some disappointments, particularly those managers with a heavier focus on "value style" stocks. But there were also several strategies that materially protected against the worst of the declines. Overall, this part of the portfolio substantially met our expectations in an extreme market environment. We expect our strategies to further distinguish themselves as time goes on now that the initial crisis phase - where every asset declined regardless of merit – seems to have passed.

The various strategies that make up our "alternatives" sleeve – managed futures mutual funds, private real estate, and the gold ETF – each earned positive returns in the first quarter and were a significant source of value for client accounts. The managed futures funds earned mid-single digit positive returns and once again shined in a market downturn. Gold had a bumpy ride in the quarter, along with most other assets, but finished with a positive 3.9% return. The private real estate fund we own for some clients earned a small positive return in the quarter as well, although it has seen a moderate markdown in price since quarter-end.

The only significant source of underperformance we experienced in client portfolios came from many of the bond managers. As we noted earlier in this letter, every sector of the bond market except for US Treasury bonds produced a negative return in the first quarter.

However, because of the composition of the bond market index, and the extraordinary return of long-term US Treasuries, the overall index produced a positive return. If you didn't have at least 40% of your bond portfolio in long-term US Treasury bonds in the first quarter then your bond positions likely declined in value over this timeframe, and our bond allocations were no exception. We have seen this dynamic several times before and each time it has proven to be a temporary phenomenon. Once the fear mentality fades (and it always does), the prices of Treasury bonds and all other high-quality bonds will converge back to normal relationships, and our bond allocations will significantly outperform for a time. In fact, that has already started to happen in the first 15 days of April, as all but one of our bond funds has outperformed the index, some by over 1%. Over time, bond returns are almost entirely a function of the income yield (there can be gains from price appreciation or losses from defaults as well, but these tend to be minor components in most high-quality bond portfolios). The mix of our recommended managers produces a portfolio that is of similar overall credit quality, has a higher income yield, and a somewhat shorter maturity profile as compared to the index. This combination has produced a higher overall return with a lower overall amount of risk (but also periodic episodes of elevated price volatility) over time, and we have every confidence that it will continue to do so into the future.

We are all feeling a heightened sense of anxiety and even fear as we face the uncertainty of battling and containing this new virus. But at the same time, we know that making financial decisions out of emotion can be highly detrimental to your long-term wealth and we take seriously our obligation to help guide you through this period in a thoughtful and disciplined way. Please do not hesitate to contact us if you have any questions, or if you would like to discuss your portfolio or financial plan in detail. We will get through this together.

Best Regards,

Richard Krichbaum, CFP®, MBA
President

Trevor Whitley, CFA, CFP®, AIF®
Partner, Financial Advisor

Brian O'Connell, CFP®
Partner, Financial Advisor

Kim Sands, MSM, AIF®
Client Services Manager

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