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FINE POINTS

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FIRST QUARTER REVIEW & COMMENTARY

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I attribute my success to this – I never gave or took any excuse.

Florence Nightingale (1820-1910)

The quote above is attributable to Florence Nightingale, who is credited with the founding of modern nursing techniques. While the bulk of this letter will discuss the economic and market ramifications of the coronavirus, we cannot ignore the human toll it is taking and want to begin by thanking all healthcare professionals, doctors, nurses, first responders, researchers, and others for their selfless dedication to their profession. The world critically needs their skills and knowledge. We are at the beginning of what will prove to be a long road in fighting the coronavirus, but we know that we will prevail in this crisis and come out of it stronger than ever.

FIGURE 1

RETURNS	Q1 2020
S&P 500	-19.60%
Russell 2000	-30.61%
MSCI EAFE	-22.83%
MSCI EM	-23.60%
Barclays US Aggregate	3.15%
Barclays US 5-year Municipals	-1.04%
Bloomberg Barclays US Corporate High Yield	-12.68%
HFRX Equity Hedge	-13.33%
Barclays BTOP 50	-2.29%
HFRX Global Hedge	-6.85%
WTI Crude Oil	-66.79%

Source: eVestment

In our last quarterly letter, we devoted substantial commentary to the very positive equity market appreciation that defined 2019 as well as the entire decade, measuring it against returns for prior decades dating back to the 1930s. A simple summation of that analysis is that the 2010s were a great decade to have been invested in equities, as equity market returns were far above average during that time period. Given where valuations stood at the end of 2019—and knowing that market returns tend to revert to the mean over time—we were cautiously optimistic about prospective returns over the next decade. But we clearly did not expect markets to deteriorate as quickly as they did in the first quarter of 2020.

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As illustrated in the table above, the market selloff was ferocious in degree and global in nature. Historically, bear markets develop on average over 10 months, however this bear market surfaced in just 16 trading sessions.

We are in the midst of a health threat unlike any we have seen in modern times. Some would describe the coronavirus as a "black swan" event (unpredictable), evoking Nassim Nicholas Taleb's 2007 book, The Black Swan, in which Taleb describes a risk eerily similar to this one. We doubt Taleb would characterize the current crisis as entirely random and unpredictable. (If you have not read Taleb's book, we would recommend it as a great way to spend some time during our continued days of social distancing.)

MARKET ALMANAC

Those of you who read our letter regularly know that we always look at history as a guide to what the future may hold. In this case, we will focus on two specific historical references average bear market duration and average bear market severity.

As you can see in Figure 2, in the past 90 years, the average bear market has declined by 39.4% and lasted 20 months. Within the context of the current market crisis, this data would indicate that the S&P 500 Index should bottom in October 2021 at a price level of approximately 2,052. To be clear, the end of a bear market does not mean the market has reached a new high, only that it has risen by 20% from its trough level.

FIGURE 2

S&P 500 BEAR MARKETS

START		END			
Date	Price	Date	Price	Duration (Months)	Percent Change
9/16/1929	31.9	6/1/1932	4.4	32	-86.20%
3/10/1937	18.7	4/28/1942	7.5	62	-60.00%
5/29/1946	19.3	6/13/1949	13.6	37	-29.60%
8/2/1956	49.7	10/22/1957	39	15	-21.60%
12/12/1961	72.6	6/26/1962	52.3	6	-28.00%
2/9/1966	94.1	10/7/1966	73.2	8	-22.20%
11/29/1968	108.4	5/26/1970	69.3	18	-36.10%
1/11/1973	120.2	10/3/1974	62.3	21	-48.20%
11/28/1980	140.5	8/12/1982	102.4	20	-27.10%
8/25/1987	336.8	12/4/1987	223.9	3	-33.50%
7/16/1990	369	10/11/1990	295.5	3	-19.90%
3/24/2000	1527.5	10/9/2002	776.8	31	-49.10%
10/9/2007	1565.2	3/9/2009	676.5	17	-56.80%
2/19/2020	**3386.2**	**3/23/2020**	**2237.4**	**1**	**-33.90%**
			Average	20	-39.40%

Another way to determine where markets might ultimately settle is through valuation. The most commonly used stock market valuation metric is the price-to-earnings ratio (P/E). Over the past 35 years, the S&P 500 Index has on average traded at 15x earnings. Currently, analysts' earnings estimates for the next 12 months average around $172 per share. We believe this number is very optimistic, as earnings were approximately $163 per share in 2019. We feel it is unrealistic to assume any growth in earnings in 2020 given the current environment. We are more comfortable using an EPS figure closer to $139, which would indicate the market is trading on about 18x earnings as of April 3, 2020. If the S&P 500 were to revert to its historical average of 15x earnings, the index would be trading at around 2,100. So, by both the historic bear market approach and the historic P/E ratio

method, it is not inconceivable that the S&P 500 could trade at levels of approximately 2100.

We are providing these market index levels and dates not as firm predictions, but instead what the future could hold based on how markets have behaved historically. Because this market sell-off developed much faster than average, it might abate more quickly and be less severe if the market can see through the economic uncertainty the virus presents. Historically, the market, a forward looking discounting mechanism, bottoms four months prior to the economy coming out of recession. In Figure 3 you can see how markets have generally recovered rather quickly from significant sell-offs. In the analysis above, which includes all periods after WWII, the next two quarters cumulative performance has been positive in every instance and has been positive in seven out of eight years after the drawdown. So, it is possible that the worst of this drawdown is behind us. Understanding the past enables us to make more intelligent and informed decisions about the future.

FIGURE 3

15% OR GREATER QUARTERLY S&P 500 DECLINES POST WWII

QUARTER	% CHANGE	NEXT QTR% CHANGE	NEXT 2 QUARTERS	NEXT YEAR
9/30/1946	-18.8	2.3	1.4	1
6/29/1962	-21.3	2.8	15.3	26.7
6/30/1970	-18.9	15.8	26.5	37.1
9/30/1974	-26.1	7.9	31.2	32
12/31/1987	-23.2	4.8	10.7	12.4
9/30/2001	-15	10.3	10.2	-21.7
9/30/2002	-17.6	7.9	4	22.2
12/31/2008	-22.6	-11.7	1.8	23.5
3/31/2020	-20	N/A	N/A	N/A
	Average	5.01	12.64	16.64
	Median	6.34	10.46	22.81
	% Positive	87.5	100	87.5

NEAR- AND LONG-TERM EFFECTS

We are loath to utter the most dangerous words in the investing world, "This time it's different." Yet we know of no other time in history when global governments purposefully shut down their economies to protect their citizens from a health crisis. The efforts of governments on all continents to prevent the spread of disease and "flatten the curve" of the coronavirus included using war-time powers to institute social distancing. The economic effect has been a massive global demand shock. The last time the world saw a global flu pandemic like this was a century ago when the Spanish flu ravaged the world. It claimed the lives of approximately 50 million people at a time when the global population was approximately 1.5 billion. Our superior medical knowledge and understanding of how viruses spread will certainly help us have a less tragic outcome with COVID-19, but the impact will still be substantial economically.

In the near term, the coronavirus will be deflationary, as it will cause a severe recession globally. Recessions by their nature are deflationary, and this one will be no different. We have already begun to see these effects in U.S. initial jobless claims data, which reached two, consecutive record-breaking levels, 3.3 million jobless claims for the week of March 20 and 6.6 million for the week of March 27. The total U.S. labor force consists of approximately 160 million people. Given the losses we have seen to date, as well as the severity of the contraction thus far, we expect the U.S. unemployment level to rise to the low- to mid-teens as further jobless claims are reported.

We believe that the coronavirus pandemic will be a watershed event, paralleling September 11, 2001 or the fall of the Berlin Wall. People will have a different view of life after COVID-19. One seemingly obvious consequence of this pandemic will be the de-emphasis of globalization, specifically with respect to China. If last year's U.S.-China trade war did not prompt multinationals to rethink their supply chains, the coronavirus pandemic has

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certainly done so. The benefits of globalization include lower product costs, higher standards of living, and the spread of innovation, so deglobalization will have some negative effects. We envision a diversification of supply chains and possibly more manufacturing in higher-cost areas such as the United States and Europe as a result.

Bigger government could be another major consequence of this crisis. This has seemingly already taken hold with the passage of the $2.1 trillion CARES Act and likely will grow larger depending on how long the crisis persists. The federal government is getting much more involved in determining which businesses will receive federal aid and ultimately may have to nationalize (however one defines that) a number of "strategic" industries.

In addition, it is likely that we will see more widespread access to healthcare in the United States. Again, we have already seen some of this come to pass in the recently passed stimulus bill, which included a tax credit for two weeks of paid sick leave, a refundable tax credit for 10 weeks of paid family medical leave, and $8.3 billion in federal aid to develop vaccines and therapeutics to combat COVID-19.

We would also expect to see businesses and consumers use lower levels of leverage in the future. This will result in lower returns on equity for corporations and a reduction in consumer spending for individuals as they increase savings rates and defer spending on goods they can't pay for in cash.

In summary, many of these effects of the coronavirus pandemic could lead to less productivity, higher rates of inflation, and greater government involvement in the economy.

CRUDE REALITY

In addition to the health concerns over the virus, the global economy is also dealing with a dramatic drop in the price of crude oil. Since the beginning of the year, the price of crude oil (as measured by West Texas Intermediate grade crude oil, or WTI) has fallen nearly 70%. As of 2019, the United States was the world's largest producer of oil, larger than Saudi Arabia or Russia. But U.S. oil producers are not able to compete at the current price level, and this could have a significant contagion effect on the economy. In December 2019, the Federal Reserve Bank of Dallas conducted a survey of executives at 93 oil and gas exploration and production firms. The survey indicated that 40% of firms could not sustain their capital expenditures with crude trading below $50 per barrel, while none of them said they would be able to sustain capex below $34 per barrel. At the time of writing, WTI currently trades for $29 per barrel. A combination of less exploration and production activity, higher rates of bankruptcies announced in the sector, and defaults on loan and bond obligations is expected as long as prices remain at these depressed levels. Currently there are negotiations underway between the US and both OPEC and non-OPEC members about possibly reducing some of the supply from the market.

WHEN AND HOW DOES THIS END?

Based on current estimates, the virus will peak during the second quarter. Since the virus started in China and spread throughout Asia before moving westward to Europe and then to North America, we look east to see what the future could hold.

Asian governments by now have begun to ease some of the restrictions on businesses and individuals. We believe the data out of China is unreliable and instead look to other countries such as Japan, South Korea, and Singapore for answers. Thus far, we see a gradual opening up for some businesses, while schools, museums, bars, and night clubs largely remain closed. To prevent new infections, these countries and others in Asia are implementing new border controls. These vary from country to country, ranging from barring foreign visitors entirely to requiring them to quarantine in government facilities and, in some cases, even requiring them to wear bracelets to track their whereabouts to confirm self-quarantine restrictions. In Singapore, many commercial buildings are instituting temperature checks before allowing people to enter. In restaurants and cafes, alternating seats are taped off to promote social distancing. Mass adoption of the use of masks in public places, which has been commonplace in Asia for years, may also take hold in the West. In fact, it may even be legally required as it was in parts of the United States following the outbreak of the Spanish flu.

In the United States, we expect to see continued economic contraction in the second quarter followed by a slow return to normal. Recovery should begin in the third quarter but will take some time to fully manifest; it may be a few quarters after that before we are back to where we started.

We do not see this developing into a 1930s-era economic depression as some have predicted. Again, we look at history as a guidepost. The U.S. is not committing the policy errors that were committed in the 1930s which included raising taxes, hiking interest rates, and starting a trade war with the passage of the Smoot-Hawley Tariff Act in 1930. We see nothing like this today. Instead, we have seen swift and decisive action from the U.S. Federal Reserve and U.S. Congress to provide market liquidity as well as relief for businesses and individuals. We believe similar supportive actions will follow, possibly in the form of an infrastructure spending bill this summer. In our opinion, this is an appropriate policy response that strongly differentiates this period from the 1930s and provides the framework for a recovery.

FINEMARK IS READY TO SERVE YOU

As you have seen through our updates via email and on our website, we have taken a number of actions to safeguard our associates and our clients. These include limiting lobby hours, closing certain offices, and encouraging meetings via phone or video conference instead of in-person whenever possible.

Regardless of what additional measures we may need to take, we will not change our commitment to client service. We have migrated many of our associates to a work-from-home environment so that we can serve you safely during this period. We are proud to say that our phones will continue to be manned during normal business hours.

If there is anything you need, please call or email. In the meantime, for your safety, the safety of our healthcare workers, and the welfare of our nation during this period, please stay home and practice social distancing. We look forward to welcoming you back in our offices as soon as it is safe to do so.

By Read Sawczyn
Senior Vice President & Private Wealth Advisor, Trust

GRAT PLANNING BENEFITS FROM LOW INTEREST RATES AND DECREASED MARKET VALUES

While COVID-19 has created many problems for the financial markets and our clients, the low interest rate environment and the ongoing market volatility make this an appropriate time to consider Grantor Retained Annuity Trusts in your estate planning. A Grantor Retained Annuity Trust ("GRAT") is a trust that allows you to transfer wealth to the next generation with little to no estate or gift taxes. In effect, you freeze the value of your estate while transferring the appreciation to the next generation.

While the current estate tax exemption per person is $11.58 million ($23.16 million per married couple) for 2020, this exemption sunsets at the end of 2025 and will revert to $5 million per person indexed for inflation. Congress could, however, change the estate tax exemption to even less than $5 million per person at any point in time. That said, if your estate exceeds $10 million today you could benefit from the creation of a GRAT.

Let's discuss how GRAT planning can help you now given the future uncertainty. A GRAT is created when a grantor contributes assets to a fixed term, irrevocable trust. The grantor then receives an annuity stream (fixed stream of payments) from the trust based on the hurdle rate set by the IRS. At the end of the term, the remaining appreciation of the assets in excess of the hurdle rate are distributed to the next generation. Thus, the goal is for the assets contributed to the GRAT to outperform the hurdle rate.

Today, the annuity stream the grantor must take is based on a 1.2% annual interest rate (current rate for April 2020). For historical perspective, from January 2000 through April 2020, the hurdle rate has fluctuated between 1.0% and 8.2%. If throughout the life of the GRAT the assets outperform the hurdle rate set when the trust is created, then any amount in excess of the grantor retained annuity goes to the beneficiaries of the trust with little to no estate or gift tax. Even if the GRAT assets fail to outperform the hurdle rate, there is no penalty to you, apart from the legal cost of setting up the trust and administration fees for managing the trust. Thus, with current interest rates and market conditions, GRATs provide a powerful estate planning tool.

While this article only discusses the basic concept of GRATs, if you are interested in learning if GRATs can assist you please contact your Private Wealth Advisor.

By Read Sawczyn
Senior Vice President & Private Wealth Advisor, Trust

CARES ACT AND YOUR RETIREMENT PLAN

Due to the impact of COVID-19 on the United State's economy, Congress passed the CARES Act to assist businesses and individuals weather the economic downturn. While the focus of the Act revolves around economic stimulus such as cash payments, increased unemployment benefits to individuals, grants, loan relief, and forgivable loans to businesses, also included in the Act are some benefits related to retirement plans.

While it feels like a long time ago now, at the end of 2019, Congress passed the SECURE Act which raised the required minimum distribution ("RMD") age from 70½ to 72. Now, only three months later, the CARES Act suspends required minimum distributions completely in 2020. This relief also includes inherited IRAs. If you need the funds to pay expenses, you are still able to take distributions from your retirement plans, but you are not required to take a minimum amount this year. While tax deferral is usually a good strategy, you should consult your tax professional to decide if not taking a distribution from your retirement plan this year is your most advantageous course of action.

Another benefit of the CARES Act is that you can take a withdrawal of up to $100,000 from most retirement plans in 2020 if you are affected by COVID-19 and the withdrawal is reported as income over three years and/or you can repay it within three years. Additionally, if you are under age 59½ there is no 10% penalty being applied for taking the early withdrawal. To be affected by COVID-19 means:

1. you are diagnosed with COVID-19,
2. your spouse or dependent is diagnosed with COVID-19; or
3. you experience adverse financial consequences as a result of:
   a. being quarantined,
   b. being furloughed or laid off or having work hours reduced due to such virus or disease,
   c. being unable to work due to lack of child care due to such virus or disease,
   d. closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or
   e. other factors as determined by the Secretary of the Treasury (or the Secretary's delegate).

If you have additional questions about how the CARES Act impacts your retirement plan, please contact your private wealth advisor.

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