Colorado Capital
MANAGEMENT

QUARTERLY MARKET UPDATE / APRIL 2020

Economic Outlook

Overview

Before the surge in market volatility that started in February, the U.S. economy was on a solid footing. A buoyant job market had fueled rising household income and strong consumer spending. That spending in turn cushioned the economy through the choppy waters created by the trade war with China, weakness in our manufacturing sector, and slowing global growth.

Then came the coronavirus—a global public health emergency that created an economic crisis. At this point, both the magnitude and duration of the economic effects of the virus are highly uncertain. Its future impact will depend on how effective government policy and public health initiatives are in flattening the curve.

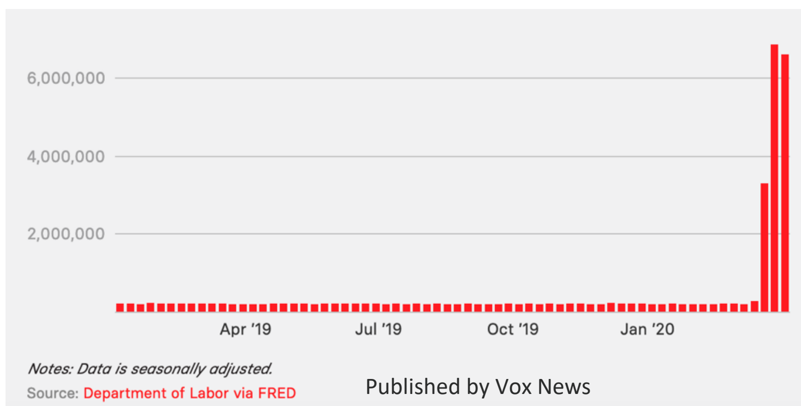
The fallout from the coronavirus outbreak will have a significant and negative impact on U.S. economic prospects. A recession is now all but certain and will in some ways rival—and possibly surpass—the severity of the 2007-09 slump. A record-setting rate of economic contraction in the second quarter is essentially a foregone conclusion as businesses curtail operations and unemployment soars.

CCM Key Economic Indicators

Indicator	3.31.20	12.31.19	3.31.19
US Economy			
Quarterly GDP Growth	not available	2.1%	3.0%
Unemployment Rate	4.4%	3.5%	3.8%
U.S. CPI -Core (Inflation)	2.1%	2.2%	2.0%
Interest Rates			
Fed Funds Rate	0.00%	1.50%	2.25%
10-Year Treasury Rate	0.9%	1.9%	2.6%
Currency & Commodities			
Crude Oil (WTI)	$ 20.50	$ 61.10	$ 60.20
Gold Price	$ 1,604	$ 1,523	$ 1,291
Trade Weighted Dollar Index	121.3	116.0	114.7
Confidence			
Consumer Confidence Index	120.0	126.5	127.2
ISM Purchasing Managers Index	40.5	47.8	55.3
Stock Prices			
Dow Jones Industrial Average	21,917	28,462	25,928
S&P 500 Forward P/E ratio	15.4	18.2	16.4

Employment

National Unemployment Claims Since 2019



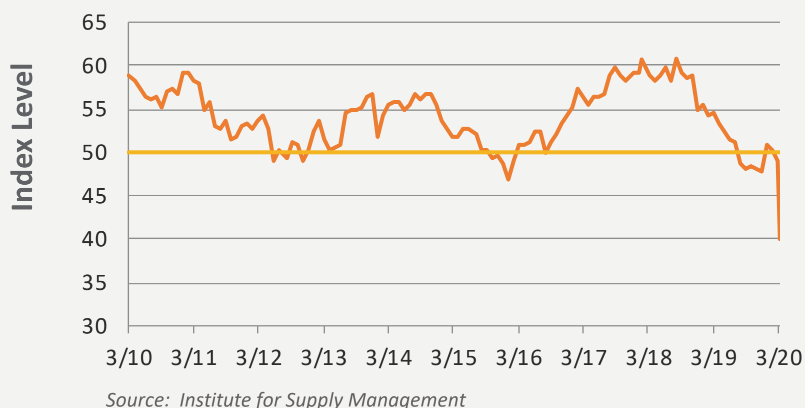
The strong labor market that kept the U.S. economy humming for a decade has ground to a halt. Due to falling demand, employers have severely cut payrolls. Close to 17 million people (over 10% of the workforce) have applied for first-time unemployment benefits over just the past three weeks.

The overall unemployment rate, which recently dropped to a 50-year low of 3.5%, is generally expected to jump to 15% to 20% in the second quarter, but to also recover dramatically when furloughed workers are rehired after the pandemic has eased.

Business Outlook

The composite purchasing managers index (PMI) for the U.S. dropped sharply from a seasonally adjusted 49.6 in February to 40.5 in March. Readings below 50 indicate a contraction in the manufacturing sector.

ISM Purchasing Managers Index



Source: Institute for Supply Management

Gross Domestic Product (GDP)

The US economy is almost certainly in recession. Based on the projections of several global investment banks, GDP is projected to contract at a single digit rate in the first quarter, and to plummet in the second quarter by as much as 20% to 40% (on an annualized basis).[1] These same firms project a sharp recovery starting in the third quarter with the net effect that U.S. GDP for the year will likely contract in the 3% to 6% range.

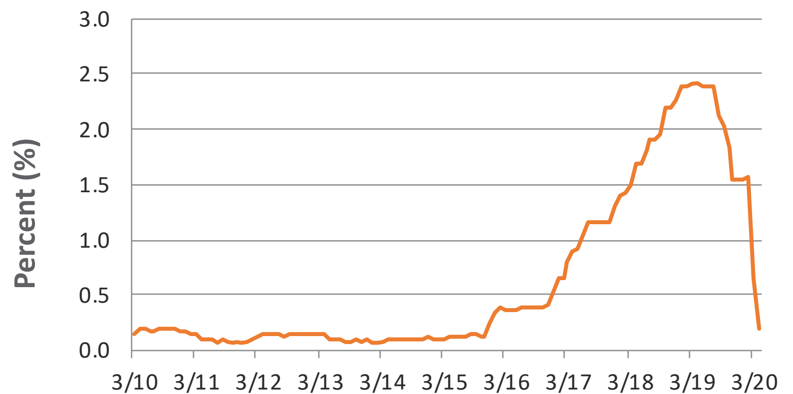
Personal consumption expenditures, which make up 2/3 of GDP, account for the majority of this volatility. Several categories of consumer spending, such as travel, hotels, restaurants, and entertainment have experienced "sudden stops." Many personal services, manufacturing operations, and retail storefronts have also shut down. Not only will sharp declines in spending in these categories directly depress personal consumption expenditures, but there will also be indirect negative effects on overall spending as newly unemployed workers curtail discretionary consumption.

[1] *Goldman Sachs, JP Morgan, Morgan Stanley, Credit Suisse, Wells Fargo*

U.S. Government Policy Measures

Both the Federal Reserve and the Congress have taken unprecedented actions to help ensure economic activity can resume as soon as the coronavirus pandemic is under control.

Monetary Policy: The Federal Reserve has lowered the interest rate to almost zero and will likely keep its target range for the fed funds rate between 0.00% and 0.25% indefinitely. It has also taken steps to keep credit flowing to businesses and households. Specifically, the Fed has provided much-needed liquidity to markets in corporate bonds and asset-backed securities and just announced details about a facility that is designed to support lending to small and medium-sized businesses.



Source: Board of Governors of the Federal Reserve System

Fiscal Policy: Congress responded by approving the $2.3 trillion CARES Act, the largest relief package in U.S. history. It will extend aid to many struggling Americans through, among other things, increased funding for unemployment insurance and tax rebates to individuals and families. Also, the legislation will provide generous loans and grants to businesses so that the hit to economy-wide spending does not force them into bankruptcy, thereby exacerbating the downturn. It will also augment drained state coffers and send additional resource to sapped health-care providers.

Global Economic Outlook

The global economy is headed into uncharted territory. Previous slowdowns were due to sharp falls in demand, exacerbated by poor consumer and investor confidence. But this time, economic activity has also been directly disrupted by strict measures imposed to curb the spread of the coronavirus.

In the last four decades, China has not experienced a year in which real GDP has contracted. That string should come to an end in 2020. Chinese GDP will likely fall by about 1% this year. In Europe, annual GDP is expected to fall by at least 4%. And emerging markets are expected to experience a wide range of difficulties arising from the pandemic and economic turmoil including lost manufacturing and tourism revenues, price shocks for commodity exports, currency declines, and capital flight.

The International Monetary Fund projects global GDP will contract 3% in 2020, down from its pre-pandemic forecast of 3.3% growth. Global annual GDP has only declined one other time in the past 60 years, a 1.7% drop in 2009 during the Great Recession.

Market Commentary

Overview

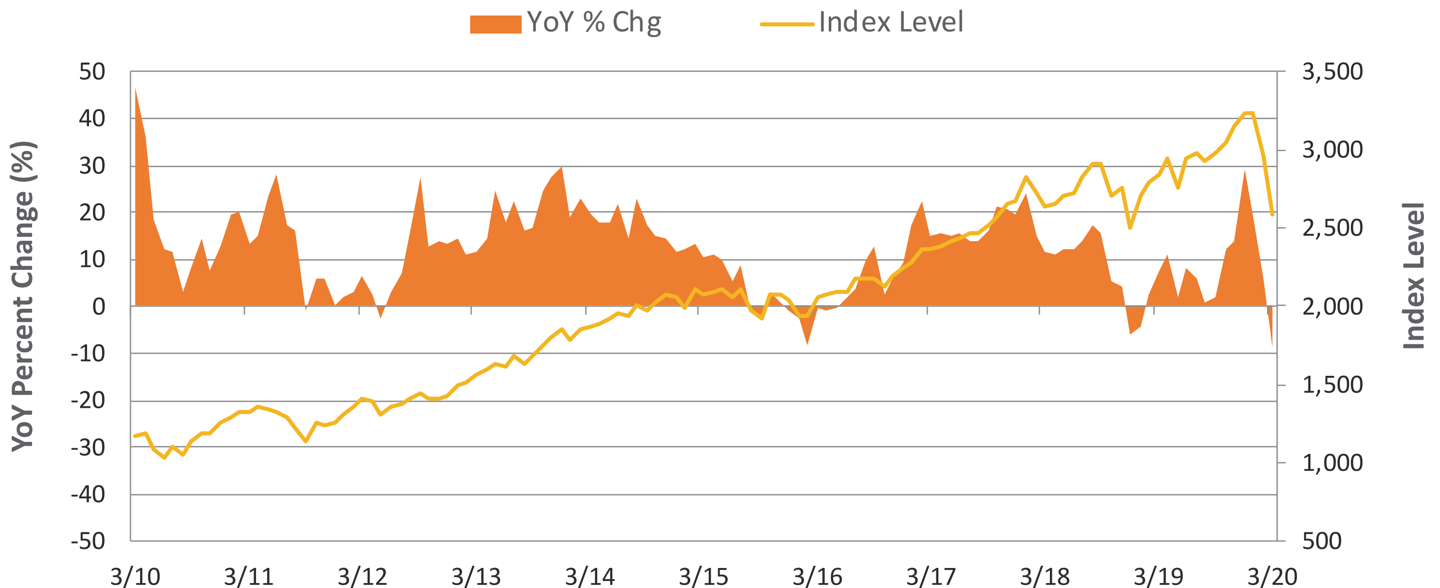
The first quarter of 2020 was difficult for investors. As the year began, the consensus opinion was that the U.S. and much of the world were in the later stages of the current economic cycle. No one knew that global economic activity would largely grind to a halt as a result of the coronavirus pandemic. U.S. equity markets continued to set record highs, eventually peaking on February 19th.

While conversations early in the year were centered on whether there would be a recession in 2020, the debate soon shifted to how long and deep the recession would be. Until there is clarity regarding the virus's rate of spread and time until containment, market volatility and uncertainty will be the new normal. Given this environment, markets have fallen sharply.

U.S. Equities

Against the backdrop of an escalating health crisis, the nearly eleven-year bull market came to a sudden halt, falling from its all-time high into bear market territory in just twenty-six days. The U.S. benchmark S&P 500 ended the quarter down 19.6%. Small stocks were harder hit than large companies, with the Russell 2000 index dropping over 30% during the quarter. Value stocks also underperformed growth, with the Russell 3000 Value Index dropping 27% during the quarter, while the comparable growth index only fell 15%.

S&P 500 Index



Source: Standard & Poor's

International Equities

During the quarter, the MSCI EAFE index of foreign stocks slid 22.8%. European stocks were particularly hard hit, as Spain, Italy, France, Germany and the UK reported the most Covid-19 cases of any country after the US. The UK also had continuing Brexit woes and its leader contracted the virus. These factors contributed to a 24% drop in the MSCI Europe index.

In Japan, stocks outperformed broader international indexes, generating a quarterly loss of about 17%. As of quarter end, Japan had experienced a slower spread of the coronavirus and a lower than average mortality rate. As a result, Japanese government officials have been less aggressive in curtailing economic activity, although this may change soon.

The MSCI Emerging Markets Index declined more than 23% during the quarter. Amongst the largest (BRIC) economies, China was the clear winner, falling about 10% as the number of new COVID-19 cases declined and economic activity began to resume. Brazil was the weakest member of the index, falling more than 50% during the first three months of the year.

Fixed Income

Government bond yields declined during the quarter as investors sought safety amid rising fears driven by the coronavirus pandemic. The U.S. 10-year Treasury yield dropped below 1% to reach new all-time lows. Government bonds outperformed corporate issues, and high yield bonds suffered, given the risk-averse environment. The Barclays U.S. Aggregate Bond Index rose 3.2%, but muni's fell 0.6% and the high yield index lost 12.7% on credit risk concerns.

Market Outlook

While the coronavirus pandemic will probably weigh on the world's economy beyond 2020, a recovery of equity indexes during the second half of the year is a possibility, particularly given the tailwind of massive government stimulus and record low interest rates. Historically, as a leading economic indicator, the stock market typically bottoms before a recession is over.

The recent low in the S&P 500 was nearly 35% less than its peak on February 19th. To put this in perspective, since the end of the Great Depression 80 years ago, there have only been three stock market downturns with peak to trough declines of more than 36% (the OPEC Embargo in 1973, the Tech Bubble in 2000, and the Great Recession in 2008-2009).

Internationally, China was the first country to enter the crisis and the first to see a downward trend in the number of new cases. Its stock market has since outperformed global averages. Europe has had by the far the most deaths from the virus and has high exposure to global trade. The Eurozone is likely to experience a deeper recession than the U.S. but may also experience a bigger economic bounce when the coronavirus subsides. Emerging markets should also fare well in the recovery phase due to increased trade, global government stimulus, and likely increases in local currency and commodity prices.

While markets have already recovered substantially in the past few weeks, there is no guarantee that the rebound will last. Substantial risks remain. A retest of the March 23rd lows is certainly possible. Any optimism must be tempered by the unknowns surrounding the current health crisis and economic shutdown. Nonetheless, assuming the virus is contained soon, a short recession is possible. If that is the case, financial markets should offer attractive opportunities.

Sector Valuations (as of 4/10/20)

While future earnings are currently very difficult to predict, most U.S. stocks do not appear to be cheap. As of April 10th, The S&P 500 was only down 14% for the year and 18% from its all-time high in February (a level that was likely overvalued to begin with--before taking anything virus related into consideration). According to JP Morgan, the S&P was priced (as of April 10th) at 17.8x projected earnings, which is about 15% more than historical averages (see the large blend box in the style grid below). This analysis also shows the relative price advantage of value stocks vs. growth stocks, with small value firms appearing to be the most attractively priced compared to historical norms.

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	**108.1%**	**115.5%**	**117.6%**
Mid	**98.2%**	**106.2%**	**119.5%**
Small	**90.2%**	**118.2%**	**175.9%**

International stocks also appear attractive on a valuation basis. While they have had lower price-to-earnings ratios than their U.S. counterparts, the deviation (25% lower) is especially extreme today. They become even more attractive if the dollar declines in value over time, which seems entirely possible given our sharp drop in interest rates and the large increase in our federal debt.

For fixed-income investors, the environment remains challenging with yields on 10-year Treasuries ending the quarter below 1%. Assuming the economy gets past the coronavirus driven recession and begins to expand again, yields are unattractive. While high quality bonds provide a valuable hedge against market downturns, riskier bonds seem less appealing. Although there may be select opportunities within the high yield asset class, and issues are attractively priced, caution is appropriate as increased defaults are likely in the months ahead. The prospect of an economic recovery, especially one accompanied by high government debt loads (which imply rising inflation and/or interest rates), should temper overall enthusiasm for fixed-income investments.

Sources: Capital Market Consultants, JP Morgan Asset Management, Goldman Sachs, Vox, Wells Fargo

INVESTMENTS / PLANNING / IMPACT

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Colorado Capital
MANAGEMENT
Enriching Lives

4430 Arapahoe Ave.
Suite 120
Boulder, CO 80303

Phone: 303.444.9300
Fax: 303.444.2027
info@coloradocap.com
www.coloradocap.com

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