FINANCIAL

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Turbulent Markets and the New Normal

April, 2020

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Chief Executive Officer

It is unusual that I write the quarterly letter our firm distributes to our friends and clients. However, I want to express my sincere hope this letter finds you and your loved ones safe and well. At times like this, we are reminded of the importance of our family, friends, and health. The last thing anyone expected at the start of the new decade was the emergence of a novel virus that would infect over two million people around the world and inexplicably change the way we live, work, and play for the foreseeable future.

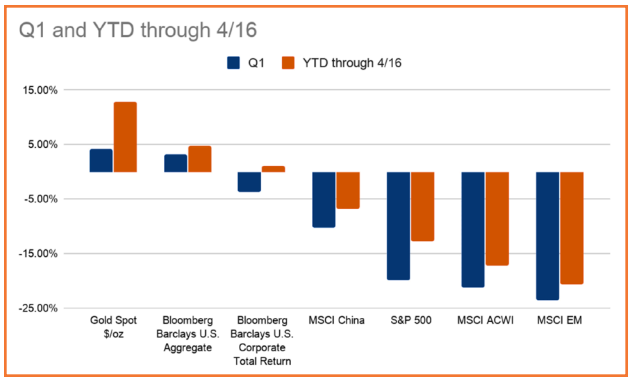
The end of the longest bull market in history

One of the many fallouts of the coronavirus pandemic has been the unprecedented speed of large equity market moves — both down and up — since the S&P 500 and the MSCI All Country World Index (MSCI ACWI) peaked on February 19 and February 12, respectively. The S&P 500 dropped 34% over 23 trading days and the MSCI ACWI dropped 32% over 28 trading days. The markets then reversed course with even greater speed, with the S&P 500 gaining 25% in 13 trading days and the MSCI ACWI advancing 22% over the same period.

COVID-19 began to spread beyond China's borders, global cases mounted, and investors began to panic. In addition, a price war between Saudi Arabia and Russia sent oil prices sharply lower, and the longest bull market in U.S. history ended on March 11. No market sector or geographic region was spared from the effects of the pandemic or from the panic selling that ensued. Rarely used trading halts kicked in as markets entered a freefall. Amid emergency interventions and stimulus from central banks and governments, stock prices recovered some of their losses. Still, even with the gains posted in the last week of March, the S&P 500 ended the quarter down 20%.

While still volatile, our core bond positions provided some relief as investors fled risk assets for the safety of U.S. investment-grade securities. The yield on the 10-year Treasury ended the quarter at 0.70%, down from 1.92% at year-end. Non-core bonds, however, followed equity markets and posted losses for the quarter. Investors seeking safety also turned to gold. As liquidity conditions remain uncertain, the drivers pushing our gold position higher are likely to continue.

Although there are uncertainties, market movement has been fluid. Interestingly, Chinese equities, which were the first to experience the selling effects of the virus, actually outperformed their equity peers in the first quarter. And, in just the two weeks since quarantine, many major asset classes have seen an uptick.



Central banks have been instrumental in their efforts to provide some cushion to the economy. The Federal Reserve has announced unlimited Treasury purchases and cut the benchmark federal funds rate to near zero. Overseas, the European Central Bank announced a €750 billion, or $820 million stimulus plan, and the Bank of Japan pledged $1 trillion.

Will it be an L, a U, a V, a W, or something else?

A recession is marked by an increase in unemployment, a drop in the stock market, and a dip in the housing market. Recessions are tricky as a recession cannot be officially declared until gross domestic product (GDP) shows two straight quarters of decline. By then, the effects have already been felt and the recession is sometimes over. According to many economists, the U.S. is already in a recession.

The question is - what kind of recovery will the economy undergo? There are several potential scenarios:

L - the most severe, occurs when the economy does not return to growth for many years.

U - while longer than other types, the effects are typically not as dramatic. Occasionally investors do not realize the recession occurred until it has ended.

V - the most optimistic of scenarios. The economy suffers a sharp but brief period of economic decline, followed by a quick, robust recovery.

W - also called a double-dip recession. As implied, the economy falls, recovers with a short period of growth, and falls back into a recession before finally recovering.

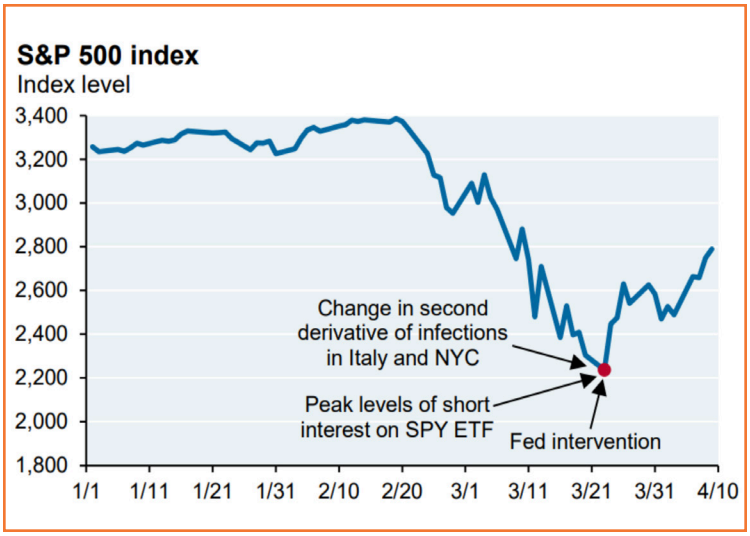
✓ or "Swoosh" - this type of recovery could occur with a limited return to economic output as social restrictions are slowly lifted. Still, activity does not resume to pre-virus levels for a year or more.

It is important to note that we can only attempt to guess the type of recovery once the effects of social distancing and clinical data and trials of therapeutics and treatments for the virus have been completed. The latest update from the Institute of Health Metrics and Evaluation at the University of Washington projected that the peak of daily fatalities in the United States occurred on April 15. They also estimate an astounding and sad 67,641 fatalities by August 4, which, although substantially more than the current fatality number, is quite a bit lower than earlier model projections of nearly 100,000 fatalities. The model assumes social distancing measures remain in place through the end of May.

Moving forward

As quarterly data and earnings start to report, we will see a more definitive sign of the damage of the virus and the social restrictions that followed. With large swaths of the economy virtually frozen in March, retail sales experienced their most significant month-over-month decline since the records began in 1992. Both industrial production, which measures factory, utility, and mining output, and manufacturing output suffered their largest monthly declines since the end of World War II.

During a crisis like this, at its essence our job is to continue to maintain high quality, well-diversified portfolios, avoid making emotional mistakes, and to sell high and buy low. Of course in practice, it is not quite so simple which is why we track quantitative, fundamental, and technical indicators to help us make these decisions objectively. As you may know from our communication after the 4th quarter, we were underweight equities heading into Q1 2020. With the rapid sell-off in late February and continuing into March, our weighting to equities was significantly below our target allocations. At the end of March we observed as market participants started to shift away from indiscriminate selling, central banks and governments achieved in days what took months during the last crisis, and we saw that certain counties were having success in containing and slowing the spread of the virus. These indicators, among many others, led us to the decision to rebalance portfolios ***back*** to their target allocations.



Source: Bloomberg. April 9, 2020.

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When do we return to normal?

The question on everyone's mind is when does this end, and when do we return to normal? At this point, do we even know what normal is?

A popular measure of market volatility is the Chicago Board of Options CBOE Volatility Index, more commonly known as the VIX. The VIX is used to predict future market volatility. As you can see in the chart below, volatility peaked mid-March and has since started to decline. While this is not yet cause for celebration, it indicates that markets may have priced in the worst of the pandemic.

Source: Powered by YCHARTS. April 19, 2020.

Recent signs of hope include plans by Germany's Chancellor Angela Merkel to reopen parts of the economy on April 20, and European Union officials setting guidelines for ending national lockdowns. South Korea is also set to relax social-distancing measures. In the U.S., individual states are grappling with the process of determining how they can reopen.

Markets will continue to be volatile, which is why it is more important than ever to have professional money managers who can participate in market advances while continuing to manage risk. We will continue to diligently monitor markets and economic conditions as an integral part of our collective long-term investment process. Above all, we will continue to support our clients and maintain high-quality, well-diversified portfolios.

Please do not hesitate to contact your team at KB Financial at any time with questions or concerns. In the meantime, we will be reaching out to all of you to schedule time to review your portfolio.

We hope you remain healthy, safe and optimistic, and we look forward to speaking to you soon.

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