FBB capital partners

April 1, 2020

A Light at the End of the Tunnel

Dear Clients and Friends,

As families adapt to more limited lifestyles in order to reduce the spread of the coronavirus, businesses are seeing less buying and selling activity, which is weighing heavily on the economy. Stock prices reflected this negativity by contracting 20% in the first quarter. In the face of deteriorating fundamentals, we anticipate a long journey ahead, but we are also looking for signs of light at the end of the tunnel.

In our last client letter on March 20, we discussed some of the fiscal and monetary tools that governments are using to offset the economic effects of the coronavirus. Since then, the President has signed a $2 trillion stimulus package, including cash that should reach individual bank accounts within weeks.

The stimulus may have eased some investor concerns, at least in the short term. We previously noted a daily pattern of 1,000-point moves in the Dow, but the fiscal stimulus may be giving investors some respite from this volatility. Part of the major market declines in late March stemmed from investor panic that many travel and tourism-related companies would fail. This panic was calmed, in part, by a rescue package for the commercial airline industry, which was already working through the challenges related to the manufacturing slowdown of Boeing's 737 Max—and, now, plummeting air travel.

Down the street from the White House, the Federal Reserve has executed on multiple strategies for improving the "plumbing" underlying our financial system. One way to gauge the Fed's actions is to look at its balance sheet: The Fed prints money to buy Treasuries and other securities, and its balance sheet is now more than $5 trillion (compared to less than $4 trillion at the end of last year).

As the executive and legislative branches work to offset the health and economic implications of the coronavirus, additional bad news continues to seep in. Virus cases and hospitalizations are rising sharply, particularly in urban areas such as New York. More states, including MD, VA, and DC are establishing "stay-at-home" orders, which will likely slow the virus's spread and keep people from working. We have been watching the labor market as a gauge for determining the depth and duration of the COVID-19 recession. So far, initial weekly jobless claims data suggest that more than three million Americans are currently unemployed.

Where does the Recovery Begin?

While fundamentals are likely to worsen before they get better, we are starting to look for signs of light at the end of the tunnel. Starting with healthcare, we are seeing a sharp increase in virus testing, including rapid diagnostics from Danaher, which should help identify patients and slow the spread of the disease.

Drug treatments appear unlikely to give an immediate boost to curbing the virus, but there are hopeful possibilities, including an older anti-malarial drug and a new anti-viral from Gilead that could have clinical data in May. Other heavy-hitters such as Johnson and Johnson, Roche, and Sanofi are working on vaccines that could prevent a recurrence of the pandemic next year.

Our sense is we need to turn the tide on the virus before the economy recovers. If testing, treatment, and quarantines bend the curve of new cases, we could start to see more people going back to work and recycling money back into the economy—likely several months from now.

Investing for the Long Term

Our investment process during this bear market has included keeping an extra cash buffer and exiting stocks that are either expensive or have a large exposure to an economic downturn. At this point we are using cash to buy more of the high-conviction stocks that we already own, and we have a “shopping list” of new companies we’d like to add to our portfolio at reasonable prices.

As a result of the market declines and sales, most client portfolios are “underweight” equities relative to their long-term “targets” or “allocations.” In the coming weeks, months, and quarters ahead, we plan to gradually add back equities according to long-term target allocations. In broad terms, we will be looking to add more large-cap, U.S. companies on the equity side as well as high quality corporate bonds.

We anticipate that Europe and emerging markets will struggle to recover from the coronavirus. While China, Korea, and Japan are seeing a rapid improvement from the virus (and stock market outperformance for China), we see longer-term challenges for demographics and earnings volatility that give us pause.

Turning to the bond market, we believe that investment-grade corporate bonds offer an attractive alternative to either low-yielding Treasuries or higher risk emerging markets bonds. Depressed commodity prices and a rising dollar are becoming a toxic combination for many emerging markets issuing debt in greenbacks.

By next quarter, we are anticipating more light at the end of the tunnel. For now, we are guided by our head lamps in search of potential risks and opportunities in the midst of extreme uncertainty. With cash waiting to be deployed, we will stay on track with our investment process looking to allocate capital toward companies with durable earnings growth and balance sheets that will allow them to handle the uncertainty that lies ahead. We remain committed to our core investment principles as we focus on capital preservation and attractive growth opportunities, while being ever mindful of your goals and objectives.

Holding the health of you and your families in our thoughts,

Michael Bailey, CFA	Michael Mussio, CFA
Director of Research	President

Note: The new fiscal package has extended Federal tax filing, payment and first quarter estimate deadlines to July 15th. Please keep in mind the deadline for your state return may be different. Additionally, the legislation has made 2020 Required Minimum Distributions from retirement accounts optional. If you have regularly scheduled distributions (monthly, quarterly etc.) that you would like to adjust, please reach out to your portfolio manager for assistance.