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THE ADVISOR

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Does a V-Shaped Economic Recovery Make Sense to You?

You don't need to be told May was a chaotic month for America. It began with the highest one-day coronavirus death count since the start of the pandemic[1] and ended with violent street protests and renewed trade tensions with China.[2] In between we saw states cautiously reopen, even as the economic damage caused by the pandemic continued to mount. In fact, the only things that seemed relatively calm in May were the financial markets. The Dow ended the month nearly 2,000 points higher than it started, having recovered by nearly three-quarters from its low point in March. The bond market was also calm, with the yield on the 10-Year Treasury rate up slightly by month's end, although still below 1%. What does it all mean?

Well, some Wall Street cheerleaders argue that it means a V-shaped recovery from the coronavirus recession is possible. Even with unemployment and economic shrinkage at historic highs, they claim the economy has already bottomed out and will only keep trending upward now that businesses are reopening and quarantines are being lifted.[3] They say the stock market supports their argument because if big investors are confident in the midst of all this chaos and bad news, then everyday Americans should be, too. They argue further that the unprecedented aid provided by Congress and the Fed in response to this crisis (which includes open-ended quantitative easing) will also help ensure a V-shaped recovery. Never mind history and the fact that the stock market dropped by nearly 60% during the Great Recession, and by 90% during the Great Depression. These analysts say, "This time will be different"!

On the Other Hand

Of course, certain analysts will always make this argument during any economic crisis or pending crisis, and maybe this time they'll be right. Anything is possible. On the other hand, many more have been arguing that a V-shaped recovery is highly unlikely for many reasons.[4] We believe a W-shaped recovery — where the markets see at least one more major downturn — is more probable. The fact that the stock market is currently down only about 10% from its peak highs only reinforces that belief. Here's why:

For one thing, it illustrates the dangerous disconnect between the stock market and economic fundamentals. We've been talking about this disconnect for years, but the coronavirus crisis has made it (like so many other things) more obvious — and potentially more dangerous.[5] The argument for a V-shaped recovery conveniently ignores the possibility of another major virus outbreak, and how it might set back the economic recovery.

However, even without another outbreak, consider some of the following facts. Though states are reopening, the unemployment rate is still historically high, and rather than decrease steadily, those numbers are likely to ebb and flow for the rest of the year. With restrictions and partial shutdowns still in place, some businesses will have to try to get by on 50% of their normal revenue, and many simply won't be able to do it. It seems likely that unemployment will still be at around 10% (at least) by the end of the year, which is slightly higher than it was at the peak of the Great Recession.

What about growth? Let's say we do see growth get back on track in the third quarter, as advocates of a V-shaped recovery are predicting. That would be great, of course, but remember, the GDP was only at about 2.5% before the crisis, not 5 or 6%. Then, in the first quarter it shrank by nearly 5%, and even the Congressional Budget Office has forecast it will shrink by as much as 30 to 40% in the second quarter.[6] So, how will all of

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The Yield Curve as an Economic Indicator

There's an old saying on Wall Street that the stock market is the prisoner of the bond market. What this is supposed to mean is that the bond market sets the interest rates businesses have to pay for loans, and how high or low

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Does a V-Shaped

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that balance out by the end of the year? Mathematically speaking, a GDP of -10% for 2020 would probably be a best-case scenario!

Common Sense

So, the question is: does any of that sound like it should justify steadily rising stock prices? Does it sound like the makings of a V-shaped recovery? Not to most global fund managers, of whom only 1 in 10 believe a V-shaped recovery is possible.[7] We concur, and continue to believe that the stock market will experience at least one more major pullback before it truly starts to recover. It may not be as precipitous as the first drop, but it will return the market to bear territory and possibly test its low point from March. We also believe the drop may be more gradual (two days up, three days down, two more up, etc.) and more segmented. In March, there was a flight to cash, and everything dropped: stocks, bonds, and bond-like instruments. This time, investors and advisors will have had time to analyze what should and shouldn't be sold, meaning riskier holdings may drop more than conservative ones.

In the mist of all this disconnection and uncertainty, income-based investors can continue to take comfort in the knowledge that their portfolios are, generally, better protected from loss and shrinkage than those of growth-based investors.

If, on the other hand, you still have significant investments elsewhere in common stock or stock mutual funds (or you have friends or family who do), you might want to re-read this newsletter and ask yourself: "What do I think? Do I hold with the analysts who claim 'This time will be different?' Do I believe the stock market makes sense right now considering all the economic data, and that we're on our way to a V-shaped recovery? Or do I believe another pullback sounds more likely?" Those are crucial questions because smart investing isn't just about numbers and textbook formulas. It's also about plain old-fashioned common sense!

[1] "Stocks Slightly Higher Amid Unrest, US-China Tensions," Yahoo Finance, June 1, 2020

[2] "The US Just Reported it's Dealiest Day for Coronavirus Patients, CNBC, May 2, 2020

[3] "US Economy to See V-Shaped Recovery: Morgan Stanley," Fox Business, May 11, 2020

[4] "A V-Shaped Recovery is 'Off the Table,' Fed's Kashkari Says," MarketWatch, May 14, 2020

[5] "A Dangerous Gap: The Market vs. The Real Economy," The Economist, May 7, 2020

[6] "What is a V-Shaped Economic Recovery & How Likely is It," MercuryNews.com, May 27, 2020

[7] "Just One in Ten Fund Managers Expect a V-Shaped Recovery," Financial Times, May 2020

How and Why to Build a Bond Ladder

While bonds are subject to several types of risk, two of the main types are interest rate risk — the risk that interest rate changes will change your bond's value — and reinvestment risk — the risk that interest and principal cannot be reinvested at the current bond's interest rate. It is difficult to simultaneously reduce both, since a rise in interest rates reduces reinvestment risk and increases interest rate risk. Thus, you need to find a balance between the two risks.

Using a bond ladder strategy can help investors strike this balance. The idea of a bond ladder is simple: instead of investing in bonds that all mature at roughly the same period of time, or in a haphazard pattern of maturities, you spread your portfolio out in roughly equal amounts over maturities that are evenly separated from one another. Ideally, these bonds are from the same issuer or issuers with the same credit quality.

For instance, a $100,000 portfolio might consist of 10 different bonds of $10,000 each, maturing in 10 consecutive years. When a bond matures, the principal is reinvested in another bond at the bond ladder's longest maturity date (10 years in this example).

If interest rates are higher then, your annual bond income will go up; if rates go down across the board, your income will still benefit from the relatively higher rates on the rest of your portfolio.

Building a Laddered Portfolio

To build a laddered bond portfolio, there are four basic interrelated decisions to make:

- **Decide on the average maturity.** This will be an arithmetic average of the maturities you use to build your portfolio, which will determine your portfolio's overall price sensitivity to changes in interest rates.
- **Decide how many rungs your portfolio will have.** This will determine how much of the span of available interest rates you'll be capturing (shorter maturities tend to come with lower interest rates and longer maturities with higher rates).
- **Decide how many years apart each rung will be.** This will determine how often you'll be reinvesting in the long-maturity end of your portfolio. The closer together the rungs, the more often you'll be buying current market rates for the longer bonds. Depending on which way rates move, this can help or hurt you.
- **Decide on the sector or sectors of the bond market you want in your portfolio.** Do you want safety? Then go with U.S. government bonds. Do you want tax-exempt income? Then go with municipal bonds. Do you want a higher level of interest than either of these sectors provide, but still want financially reliable issuers? Then go with high-grade corporate bonds.

The major advantage to laddering is to smooth out the changes in the bond income you receive year-to-year, thus making it more predictable. But there are also downsides to laddering. One is that you will have more transactions than a portfolio with one far-off maturity date.

And it could generate less income than if you put all of your money into the highest-yielding maturity available. The tradeoff is that if rates rise significantly long before your bonds mature, you're stuck with all of your money earning less than if you were to reinvest funds from maturing bonds in the higher yields.

Is a bond ladder the best choice for you? Only a thorough review of your circumstances and needs can answer that question. Please call if you'd like to discuss bond ladders in more detail.

Economic Indicator

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they are is a key determinant of future profits and stock prices.

As with many Wall Street sayings, it's interesting, but can it help predict the direction of the stock market? Surprisingly, there is a bond market-derived indicator that has been correlated with the future direction of the stock market. It's a leading indicator called the yield curve. But the yield curve has predicted more recessions than have actually occurred (in other words, it's not a perfect indicator).

The yield curve is a line on a graph that traces bond interest rates by maturity, and the major one tracks U.S. Treasury debt securities. With interest rates plotted on the vertical axis and time until maturity on the horizontal axis, in normal times for the U.S. economy, the yield curve traces out an upward sloping shape.

A normal economy is one that is growing at a healthy, sustainable rate, with interest rates stable in a comfortable range and stock prices rising steadily. The general reason for the normal yield curve's shape is that bond investors demand to be paid for risk — the longer the maturity, the more return investors require to compensate for the risk that inflation will push up interest rates and the prices of existing bonds will go down.

But when the economy isn't faring so well, the yield curve changes. If, for example, inflation expectations are low and the economy is weak, the Federal Reserve Board will often cut short-term interest rates, and the steepness of the rise from very short-term yields to intermediate yields increases. The result is a steep yield curve, which is generally a sign that the economy will start to improve somewhere in the foreseeable future. The question, as always, is when.

On the other hand, when the Fed believes inflation is too high, it raises short-term interest rates. The result can be short-term yields that are higher than intermediate- or long-term yields. In this case, the yield curve is said to be inverted, and the indication is that the economy is headed for a recession. And given that stock market prices tend to move ahead of the economy, the implication is that the stock market is headed for a decline.

A 1996 study by economists at the Federal Reserve Bank of New York found that one particular detail of an inverted yield curve was an accurate predictor of recessions: the difference between the yield on 10-year Treasury notes and the three-month Treasury bill.

The study found that when the yield on the three-month bill was one percentage point higher than the 10-year note, there was more than a 50% chance of a recession within the next 12 months. When the difference was more than 2 percentage points, the probability of a recession rose to more than 80%. The point to note is that the yield curve can't predict a recession with 100% accuracy, and observers note there have been at least two false signals since 1996.

So, as accurate a forecaster of recessions as an inverted yield curve may be, many issues remain for the investor:

- Will a recession actually occur this time, and if so, when?
- When will a bear market begin, how long will it last, and how deep will it be?
- Which stocks and sectors will be affected?
- Is there any reason to keep a significant portion of a portfolio invested in stocks?
- Does it make sense to continue to buy stocks through a bear market to take advantage of dollar cost averaging?

Please call if you would like to discuss this in more detail.

Bond Price Fluctuations

There are two primary factors that affect bond prices — interest rate changes and credit rating changes. Interest rate changes typically will cause a bond's value to fluctuate more than credit rating changes.

As interest rates rise, a bond's price adjusts down, while the bond's price will increase when rates decrease. Simply put, bond prices and interest rates move in the opposite direction. Also, bonds with longer maturity dates are more vulnerable to interest rate changes, since the difference will impact the bond for a longer time period.

Credit ratings also influence a bond's price. When a bond is issued, rating agencies assign a rating to give investors an indication of the bond's investment quality and relative risk of default. Typically, higher-rated bonds pay a lower interest rate than lower-rated bonds. After the bond is issued, the rating agencies continue to monitor it, making changes if warranted. A bond's price tends to decline when a rating is downgraded and increase when a rating is upgraded. The price change brings the bond's yield in line with other similarly rated bonds. However, these price changes are typically minor if the rating changes by only one notch. Certain downgrades are more significant, such as a downgrade that moves a bond from an investment-grade to a speculative rating, a downgrade of more than one notch, and a series of downgrades over a short period of time. In those situations, you should review whether you want to continue to hold the bond.

If you want to minimize the risk of price fluctuations, consider these tips:

- If you hold a bond to maturity, you receive the full principal value, so you won't be affected by any price fluctuations.
- Consider investing in bonds with shorter-term maturities, which are less susceptible to interest rate changes.
- Design your bond portfolio using a ladder, so you'll have bonds coming due every year or so. This strategy typically lessens the effects of interest rate changes. Since the bonds are held to maturity, changing interest rates won't result in a gain or loss from a sale. Bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest rates. A bond ladder keeps your bond portfolio invested in a range of maturity dates.
- Choose bonds that match your risk tolerance. Safer bonds, such as U.S. Treasury bonds or investment-grade corporate bonds, are less susceptible to credit rating risks.

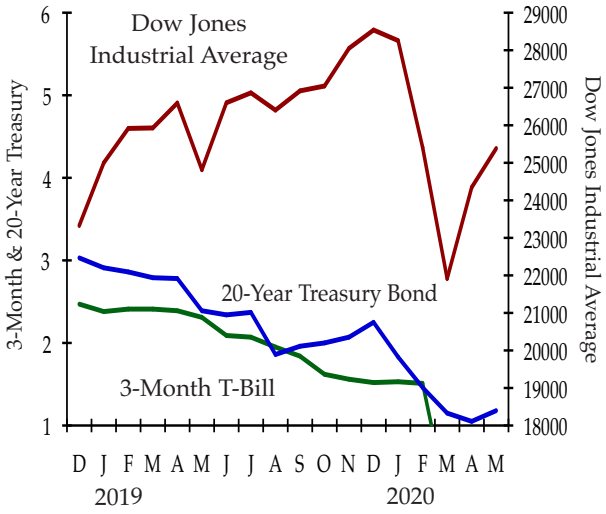
Business Data

Indicator	Month-end Mar-20	Apr-20	May-20	Dec-19	May-19
Prime rate	3.25	3.25	3.25	4.75	5.50
3-month T-bill yield	0.09	0.12	0.13	1.52	2.31
10-year T-note yield	0.70	0.64	0.65	1.92	2.14
20-year T-bond yield	1.15	1.05	1.18	2.25	2.39
Dow Jones Corp.	3.81	2.72	2.63	2.84	3.63
GDP (adj. annual rate)#	+2.10	+2.10	-5.00	+2.10	+3.10

Indicator	Month-end Mar-20	Apr-20	May-20	% Change YTD	12 Mon
Dow Jones Industrials	21917.16	24345.72	25383.11	-11.1%	2.3%
Standard & Poor's 500	2584.59	2912.43	3044.31	-5.8%	10.6%
Nasdaq Composite	7700.10	8889.55	9489.87	5.8%	27.3%
Gold	1608.95	1702.75	1728.70	13.5%	33.4%
Unemployment rate@	3.50	4.40	14.70	320.0%	308.3%
Consumer price index@	258.68	258.12	256.39	-0.3%	0.3%

— 3rd, 4th, 1st quarter @ — Feb, Mar, Apr Sources: *Barron's, Wall Street Journal*
Past performance is not a guarantee of future results.

18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield
December 2018 to May 2020



Consider Maturity Dates

Bonds can be purchased with maturity dates ranging from several weeks to several decades. Before deciding on a maturity date, review how that date affects investment risk and your ability to pursue your investment goals.

Typically, yield increases as the maturity date lengthens, since you assume more risk by holding a bond for a longer time. Investors are often tempted to purchase bonds with long maturity dates to lock in higher yields, but that strategy should be used with care. If you purchase a long-term bond knowing you'll need to sell before the maturity date, interest rate changes can significantly affect the bond's market value. Two fundamental concepts about bond investing apply:

- **Interest rates and bond prices move in opposite directions.** A bond's price rises when interest rates fall and declines when interest rates rise. The existing bond's price must change to provide the same yield to maturity as an equivalent, newly issued bond with prevailing interest rates. You can eliminate the effects of interest rate changes by holding the bond to maturity.
- **Bonds with longer maturities are more significantly affected by interest rate changes.** Since long-term bonds have a longer stream of interest payments that don't match current interest rates, the bond's price must change more to compensate for the interest rate change.

Although you can't control interest rate changes, you can limit the effects of those changes by selecting bonds with maturity dates close to when you need your principal. In many cases, you may not know exactly when that will be, but you should at least know whether you are investing for the short, intermediate, or long term. Please call if you'd like to discuss bond maturities in more detail.

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