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Economic Review & Outlook

SECOND QUARTER | 2020

Looking to Principles in Turbulent Markets

Unprecedented. Uncharted. Unsettling. These are a few of the words being used to describe coronavirus (COVID-19) and the impact it has already had on the economy, financial markets, and our very way of life. Not only is it surprising how quickly and comprehensively things have changed in a short time; it's astounding that none of us even knew this threat existed a few short months ago. When an unforeseen event pushes stocks into a bear market and the economy into potential recession, some see it as an opportunity to buy cheap, while others are tempted to hold cash until things stabilize. Which is the right choice?

In this Economic Review & Outlook, we outline our six investment principles and how they relate to the coronavirus crisis. After that, we will explain how we are positioning our portfolios to balance short-term risk with long-term opportunity. Before we begin, let's review key economic events and where we stand in the markets.

Economic Review

IMPORTANT, BUT OVERSHADOWED GEOPOLITICAL EVENTS

Everyone was expecting trade discussions and the U.S. elections to dominate markets in 2020; so far, that has not been the case as coronavirus has dominated the news cycle. The U.S.-China trade war took a step towards resolution as a phase one agreement was signed. Additionally, President Trump was impeached and acquitted, Great Britain officially left the European Union, and the U.S. and Iran exchanged missile strikes. These events all took place in January, and by the end of the quarter, all would feel like distant memories because of what came next.

CORONAVIRUS, OIL PRICE WAR SENDS GLOBAL ECONOMY INTO A TAILSPIN

Coronavirus began its rapid spread in Wuhan, China in late January. By February, most began to understand just how serious this would be; by the end of the quarter, most of the world was on lockdown and markets were in a freefall.

Adding fuel to the fire, on March 8, OPEC members Russia and Saudi Arabia could not reach an agreement to cut oil production to combat falling global demand. Saudi Arabia responded by flooding the market with oil, driving crude prices down to their lowest levels in two decades and sending an already shaky market reeling.

CENTRAL BANKS AND GOVERNMENTS RESPOND WITH FULL FORCE

Going into the year, the Fed signaled it would likely be in a holding pattern with rates, barring unforeseen and extreme economic difficulties. It's safe to say we hit that mark in the first quarter, and the Fed came out swinging on March 3, cutting rates by 0.5%. This emergency rate cut did little to calm markets, so the Fed responded once again, slashing rates all the way down to zero and announcing they would begin purchasing bonds on the open market (known as quantitative easing). Central banks around the world followed suit, cutting their own rates and doing everything they could to stabilize markets.

With the perception being that the Fed was running out of "bullets," the U.S. government stepped in with a nearly $2 trillion stimulus package, which included expanded unemployment benefits, corporate loans, and direct payments to households. This massive stimulus is expected to bridge the gap while a large portion of the global economy shutters itself to slow the spread of the virus.

Asset Class Performance

January	February	March	YTD
Gold 4.0%	Diversified Bonds 1.8%	Gold 1.8%	Gold 4.5%
Diversified Bonds 1.9%	Gold -1.2%	Diversified Bonds -0.6%	Diversified Bonds 3.1%
U.S. Stocks 0.0%	Emerging Market Stocks -5.3%	U.S. Stocks -12.4%	U.S. Stocks -19.6%
Int'l Developed Stocks -2.1%	Commodities -7.6%	Int'l Developed Stocks -13.2%	Int'l Developed Stocks -22.7%
Emerging Market Stocks -4.7%	U.S. Stocks -8.2%	Emerging Market Stocks -15.4%	Emerging Market Stocks -23.6%
Commodities -8.7%	Int'l Developed Stocks -9.0%	Commodities -24.3%	Commodities -36.1%

Source: FactSet. Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

While many expected increased volatility as this situation unfolded, few could have predicted how quickly things escalated. During the quarter, the S&P 500 reached bear market territory (20% decline from peak) in just 16 trading days, ending the longest bull market in history with record speed. U.S. stock declines reached 34% from previous highs before somewhat rebounding, ending the first quarter down 19.6%. International equities did not fare better, with international developed and emerging market stocks dropping 22.7% and 23.6%, respectively. Commodities (-36.1%) were hit hard by declining growth estimates and the oil price war.

While gold and bonds, traditional safe-haven assets, earned positive returns during the quarter, they too had their share of struggles. Gold started the quarter strong, but fell nearly 12% in mid-March, as investors flocked to cash. It recovered soon after, finishing up 4.5%. Bonds were a mixed bag; while treasuries rallied from record low rates, corporate bonds struggled mightily, as liquidity dried up and default worries increased. Overall, the bond market finished up 3.1%.

Our Perspective

THE IMPORTANCE OF PRINCIPLES DURING DIFFICULT MARKETS

While the world is ever changing, we believe that our biblically-based principles are timeless and can serve as a guideline on how to approach these events. We are often told to be patient and "stay the course," but this can be difficult as our portfolios lose value and our goals seem further away every day. Below, we will outline our principles and how they apply to what we are seeing in today's market.

UNCERTAINTY/INSTABILITY

We know that the world is fundamentally uncertain, so we're not surprised when periods of uncertainty hit.

What has made this high volatility particularly shocking is how it seemed to come out of nowhere. After years of historically low volatility in U.S. equity markets, in the first quarter we experienced large market swings unlike any we've seen in some time:

FREQUENCY OF DAILY MARKET MOVES

	2/24/20 – 3/31/20	2012 – 2019	4Q2008
> 3%	19	11	29
> 4%	14	2	22
> 5%	8	0	15
> 6%	6	0	11
> 7%	5	0	5
> 8%	4	0	4

Source: FactSet. Figures represent daily return of the S&P 500.

Because these large market swings were relatively absent for over eight years, it's understandable for investors to underestimate the potential for volatility.

The Principles of Uncertainty and Instability tell us that no one can predict the future, and we cannot rely on recent trends to continue indefinitely. Markets can be stable for years and still fall apart quickly, with little warning. Recoveries can be just as unexpected. Acknowledging this ahead of time can help lessen anxiety and build an appreciation of why diversification is so important.

HUMAN PRODUCTIVITY/ LEADERSHIP & GOVERNANCE

While the coronavirus crisis is a huge blow to productivity right now, we believe it is human productivity that will lead the way forward. Shortly after it appeared, scientists went to work developing a vaccine, finding ways to understand and contain the spread, and testing treatments to help those already infected.

Nothing shines a light on leadership like a crisis. So far, it's been clear that government action (or inaction) has played a major role in how quickly the virus has spread across the globe, and countries that are well organized and focused on their people will likely bounce back more quickly.

Even in challenging times, we will always believe in human ingenuity, and as long as there are strong systems of leadership to protect, incentivize, and cultivate that productivity, we remain bullish on the future.

INHERENT VALUE

The Principle of Inherent Value states that investments have a fair price, tied to their economic fundamentals and expected future cash flows. The metrics can change over time, and prices should move to accurately reflect these changes, but markets can respond irrationally.

In March, when economic concerns rattled markets, assets that should fundamentally benefit from an economic slowdown, like gold and treasuries, temporarily sold off as investors became desperate for cash.

This example highlights the risk of a solely short-term investment horizon, as even a fundamentally sound investment can go sideways. As economist John Maynard Keynes famously quipped: "Markets can remain irrational longer than you can remain solvent."

However, a long-term value investor can turn this risk into an opportunity, buying assets at a discount and selling at a premium. While this sounds easy, it often takes years for a price to return to fair value. In today's fearful market environment, we are out looking for opportunities. While this may lead to some short-term pain, we believe sticking to this process will ultimately pay dividends for our clients.

APPLIED WISDOM

By taking these principles and applying them to our portfolios, we believe we can help keep clients on track with their financial goals even during difficult times like this. We do this by acknowledging uncertainty through diversification, leaning into markets and companies that are positioned to take advantage of human productivity through strong leadership, and by taking the opportunity to buy further into areas of the market that may be oversold during short-term market disruptions.

Next, we will give some specifics on how we are using this "Applied Wisdom" to navigate the current environment.

Our Investment Strategy

Let's start with what we are not doing – attempting to time the market. While tempting, market timing simply destroys value. Shown in Exhibit A are net flows into and out of the stock market, along with corresponding returns. More times than not, investors end up buying high near market peaks, and fleeing near the bottom. This action is strongest during periods of high volatility, when people are most likely to be driven by their emotions.

Our process takes the emotions out of investing by using a time- and principles-based approach. Here's how it works: Cash equivalents should be used for very near-term needs (generally around a year), as nothing else can be as safe from volatility. Since cash offers little in the way of return, adding a few additional years of reserves in high-quality, short-term bonds should earn you a higher yield with only modest price fluctuations.

For intermediate-term needs (typically 3-9 years), you should target a return that will preserve your purchasing power, typically with a core fixed income portfolio, potentially supplementing with other asset classes to boost diversification and potential returns. Changing rates and default risk can impact prices, creating the potential for volatility; however, these declines are usually temporary and lower than you'd see in equity markets.

Having the previous buckets filled allows us to look through short-term volatility and focus on long-term opportunities as the growth engine of your portfolio. That means owning equities and other assets with the most attractive prices or growth rates. Unsurprisingly, this sleeve is most susceptible to periods like the first quarter, and indeed that is where most of our losses have been concentrated. But the beauty of this approach is that with proper planning, we go into it already knowing that we have over a decade to ride things out.

So how does this approach impact our current positioning? Currently, we expect a sharp decline in economic growth and increased volatility as long as the virus remains an issue. However, most economists are predicting a period of above-average "catch-up" growth once we have a resolution to the virus, followed by a return to trend. In other words, this is not expected to have a material impact on long-term growth, but it has definitely affected prices, which we see as an opportunity. We are positioning our portfolios to attempt to take advantage of this opportunity.

Specifically, this means leaning further into the deeply-discounted corporate bond space, while cutting exposure to safe-haven assets like treasuries whose yields are hovering near all-time lows. This potentially allows us to increase our yield while protecting against the risk of default by not being overexposed to any single company or industry and maintaining a strong overall credit quality in our portfolios. While stocks mostly fell uniformly, we believe some regions present a better value going forward based on their position in the market. U.S. stocks are starting to look attractive again, though we are still limiting exposure as they are coming off higher valuations than international equities.

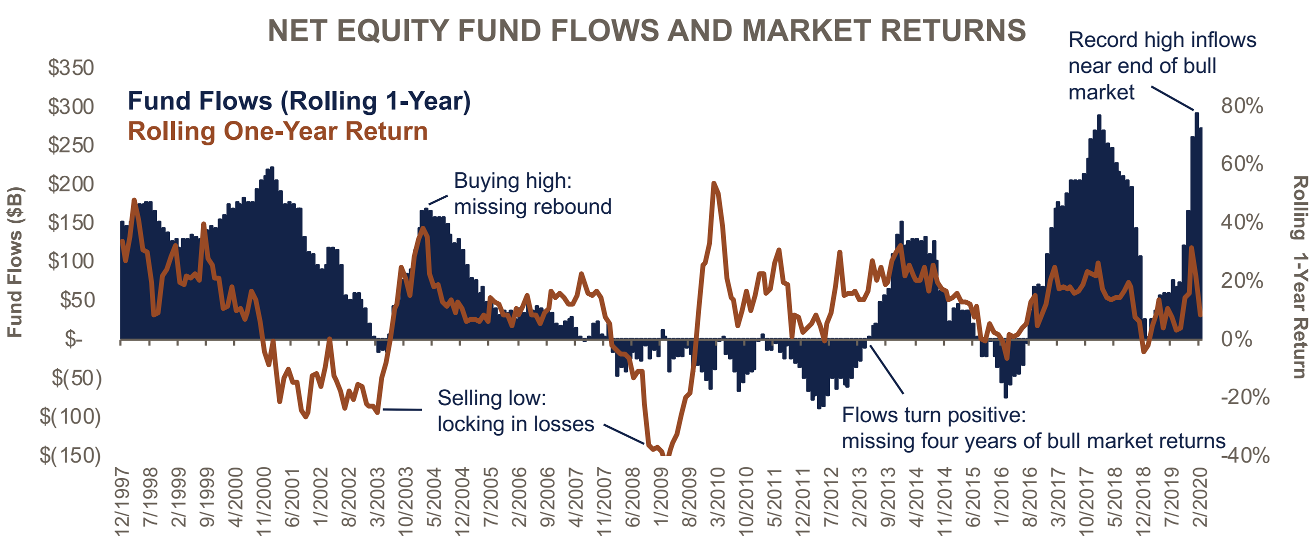
Finally, diversification continues to matter. We do not know for sure which economies will be hit the hardest as this develops; therefore, we see not being overexposed to any one country as a prudent decision. We continue to hold defensive positions like gold in some long-term solutions to further protect against falling economic growth.

Conclusion

We believe having an investment approach based on biblical principles, with an emphasis on financial planning, has never been more important. While it can be tempting to abandon your process as volatility spikes, doing so comes at a high risk, both for your portfolio and psyche. While taking a long-term approach and sticking with a plan can feel inadequate, it is often the very anchor that can help to weather the storm.

We feel it appropriate to close with our prayers for those who have been, and will be, impacted by coronavirus. We also want to express our thankfulness – that our young children have been relatively spared from this virus, for access to innovative healthcare technologies and heroic healthcare professionals, and most of all, for our assurance that this world is temporary, God is still sovereign, and we will one day be united with our Savior.

Exhibit A



Source: FactSet S&P 500 Returns, Morningstar U.S. Equity Fund Flows

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For more information, please contact your financial advisor,
call us at **800.841.0362**, or visit our website at **www.ronblue.com**.

"Peace I leave with you; my peace I give you. I do not give to you as the world gives. Do not let your hearts be troubled and do not be afraid." – *John 14:27 (NIV)*

10023202-04-20