Economic Overview

Steve Scranton, CFA, Chief Investment Officer and Economist

Part of me wondered if I should even provide a 1st quarter overview since our world changed in the middle of March. Since it is still instructive to understand where the economy stood before the social distancing actions were taken, I will proceed with the overview.

It may be surprising to some, but we may actually have positive growth reported for the 1st quarter. That is because the major damage to the economy did not start until the last two weeks of the quarter. The Atlanta Federal Reserve's GDP Now index was actually estimating GDP growth above 3% until the last two weeks of March. The index is still estimating first quarter growth at 1.3%. That may come down more as more of the March economic data is released, but as of now it is still in positive territory.

January started with a degree of optimism because the Phase 1 trade deal had been agreed upon with China and the risk of more tariffs was off the table for the foreseeable future. Consumers came off of a good holiday season and their confidence level remained within shouting distance of the all-time high. Consumers were buoyed by continued jobs growth as the nation added 214,000 jobs in January. Income was also on the rise as wage growth continued in the 3% range. That led to real personal spending rising 2.8% in January. **Since consumer spending makes up almost 70% of GDP growth that would imply that real GDP was growing in the 1.5-2.0% range in January.** The industrial side of the economy was still struggling as the benefits of the new trade agreement had not filtered through yet and the impact of Boeing shutting down its 737 MAX production in December was starting to bite. Although the first case of the coronavirus hit in January, it was viewed as more of a one-off event. Everyone thought the virus would remain in China since they had locked down the district where the outbreak occurred.

February continued the same trend as January with consumers leading the way while the industrial side of the economy continued to struggle. The nation added 275,000 jobs in February and consumer confidence remained elevated. This translated into real consumer spending rising at a 3.0% annualized rate. Using the same math, this implied that real GDP remained on track for annualized growth in the 1.5-2.0% range. The virus was now starting to gain attention as it hit South Korea and then Italy.

By March, it was clear that the virus was spreading, as Italy went into full lockdown mode for their country and more cases were developing throughout the world including the US. March 2020 will be marked in history as the point in time where most major governments made the decision to use the economic equivalent of putting the global economy in a medically induced coma. Throughout the US, states were instituting social distancing policies, including closing schools, major events and non-essential businesses. By the end of March, more than half of US states had implemented these policies. As March closed, the economic data had yet to show the damage being done because most economic data is reported with a one-month lag. That did not mean that the damage had not been done; simply not yet reported. **The first evidence of the damage started to surface in the weekly initial unemployment insurance claims data.** This data is reported with only a one-week lag so, by the last week of March we got the first breathtaking report of jobless claims exceeding 3 million people. The following week was 6 million. The Federal Reserve responded with massive fiscal policy actions that total $4.5 trillion if all of the programs are fully utilized. Congress also responded with three different pieces of legislation to provide financial aid. The largest was just over $2 trillion.

It is important to understand that the virus itself is not causing the economic damage. It is the response to the virus that is causing the damage. The longer the social distancing policies remain in place the higher the risk that the damage is more severe and longer lasting. **Congress and the Federal Reserve have responded and will probably need to keep responding depending on the length of the shutdown.**

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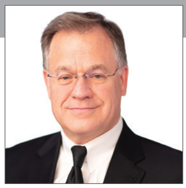
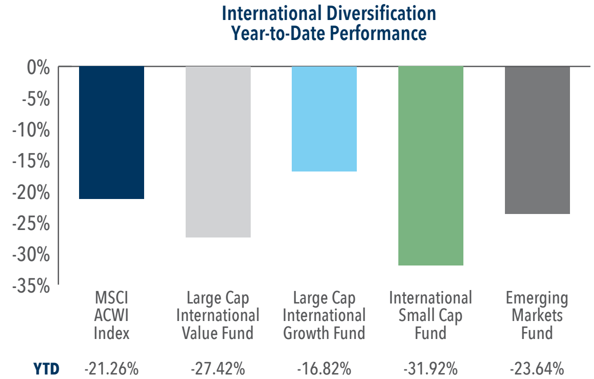
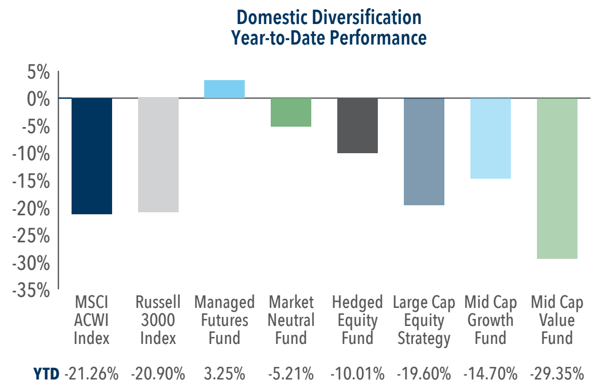


Alternative Strategies

Rick Cloutier, CFA, Chief Investment Strategist

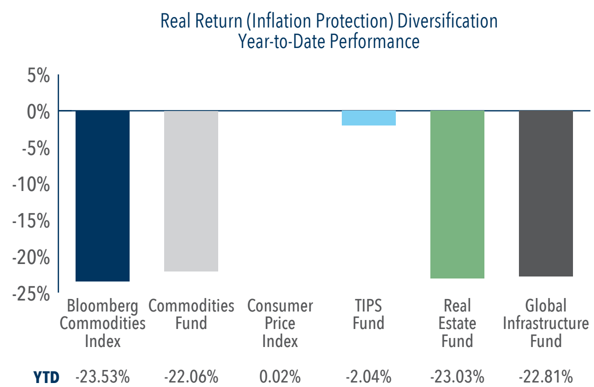


Although we began the year with a continuation of the long bull, we witnessed the S&P 500 dropping over 35% from its peak before the quarter ended and the first bear market since 2008. We saw this decline happen in 22 days, by far the quickest retreat into bear territory on record. By quarter's end the S&P 500 returned -19.6% with other stock indices falling in similar fashion.



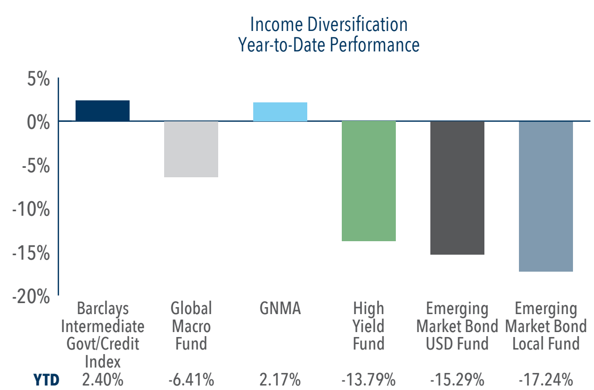
The year started off with the signing of the Phase 1 agreement with China, basically ending the trade war. However, this quickly gave way to the fear surrounding COVID-19 and the subsequent shutdown in economies trying to combat the disease. To make matters worse, Saudi Arabia and Russia instigated an oil price war which pushed oil prices down to near $20/barrel by the quarter's end. As a result, commodities declined 23.3%. Other real return strategies fell similarly with real estate dropping 27% and global infrastructure losing 29%.

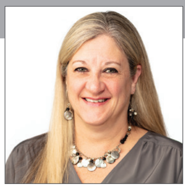
While equities declined, high quality bonds appreciated due to the drop in yields. However, lower quality bonds followed stocks down as concern grew that their ability to meet their commitments would be impaired.



Absolute return, or our risk management strategies, helped to reduce the decline in portfolios. Equity market neutral was down 5.2%, global macro was down 6.4%, and managed futures produced a positive 3.3% return. In addition, our dynamic hedging strategy, which reduces exposure to the most volatile asset classes during market stress, helped to further protect portfolios against losses.

This pandemic is different from previous outbreaks because of the government's shutdown of a good portion of the economy to contain the spread; however, there is no reason to believe the outcome will be any different. The economy was strong going into the pandemic and the government has signaled that it will do all that is necessary to keep it moving forward. For now, the primary concern is controlling the spread of the virus, as it should be. **Once containment is achieved, the markets and the economy will recover.**





Domestic Equities

Gayle Sprute, Senior Portfolio Manager

The 1st quarter of 2020 was difficult for stocks. **The 10-year bull market came to an abrupt end and a bear market was ushered in by two unexpected events.** First came the outbreak and aggressive spread of COVID-19 from China to virtually every corner of the globe. This was compounded by an oil pricing war between Saudi Arabia and Russia. Quarantines and stay-at-home measures to battle COVID-19 caused declining crude oil demand, while Saudi Arabia's threats to increase production fueled concern about a supply/demand imbalance. Oil prices fell from $63/barrel at the beginning of the quarter to $20/barrel by March 31st.

The efforts to battle COVID-19 have been unprecedented, as several countries and US states shut down non-essential businesses and recommended or required people to stay at home. **The effect on economies, as well as companies' and individuals' financial stability, is a difficult and concerning question.** On the positive side, the magnitude of monetary and fiscal response has been powerful, with anticipation of more to come. Nevertheless, effectiveness in offsetting damage is not yet known.

Investors are struggling to quantify impacts to corporate America's financial positions. Measures taken to fight COVID-19 will increase unemployment and decrease spending, while closed businesses will not be able to generate revenue. Meanwhile, extent and duration is uncertain, as is the recovery path. This uncertainty has led to a reduction in willingness to pay for risk. In mid-February, the market's price/earnings (P/E) multiple was 18.8X forward 4-quarter earnings estimates. By quarter's end, that multiple declined to 13.9X.

Regarding earnings, on January 1st, earnings growth for 2020 was estimated at +9.4% year over year. This estimate has fallen to a decline of 4.5%. During the upcoming 1st quarter earnings season, results will show the impact that has occurred thus far. In addition, investors will be eager to hear any outlook provided by management teams.

Such commentary may be limited because no one yet knows the extent and duration of the virus — and how long measures to fight it will remain in place. **Nevertheless, 1st quarter earnings season information may provide some help in "modeling" how the future could unfold.**

Fixed Income

Brian Brill, CFA, Senior Portfolio Manager

The 1st quarter of 2020 will be remembered for quite some time as the traumatic events surrounding the COVID-19 (coronavirus) and its global repercussions have reshaped society and the financial markets.

Starting in mid-January, news of the growing coronavirus began to dominate fixed income investors' concerns. Ignored at first by most other investors, fixed income investors began to worry about contagion and the impact it could have on global commerce, thus driving the demand into the safety of US Treasury securities. These fears only grew with each passing day as more and more countries began reporting cases and deaths.

As February ended and March began, the coronavirus outbreak turned truly global and fears exploded into a panic. **The US equity indexes had some of their steepest and quickest losses since the recession of 2007–2009.** As equity markets panicked, investors stampeded into the safety of US Treasuries.

Trying to stem the growing panic, the Federal Reserve (Fed) acted very aggressively. It made two emergency rate cuts totaling 150 basis points within two weeks. **Liquidity became a major problem everywhere as investors sold anything they could to raise cash.** Even older "off the run" Treasury securities began to see very wide bid/offer spreads. With many communities basically in quarantine and businesses shutting down, the finances of companies and municipalities were called into question. As a result, yield spreads dramatically increased for these asset classes versus Treasury securities to levels not seen since the Great Recession. The volatility experienced in the various fixed income asset classes was truly spectacular.

Realizing the liquidity problems, **the Fed revisited its playbook from the Great Recession and quickly began to institute many of those programs.** At the same time, elected officials realized how urgent action was needed and passed $2 trillion in fiscal policy measures.

As the quarter ends, the coronavirus and its accompanying negative economic consequences are unfortunately still front and center. Liquidity and credit concerns for municipalities and corporations have eased but are still not great. Monetary and fiscal policy have helped so far (with maybe more on the way) but **how society confronts the virus will ultimately dictate how financial markets respond.**

International Review

Derrick Wilson, Portfolio Manager

Coming off a strong 2019, bolstered by an even stronger 4th quarter, it was setting up a great start to the New Year for global equity markets. Economic data in Europe looked to be making a turn in the right direction, the trade dispute with the US and China was seemingly on the mend and nearly all was right with the world. How quickly things can change.

It goes without saying, the spread of COVID-19 was like watching the bouncing ball as the virus made its way around the world. **A global pandemic presented a "black swan" event that not many, if any, would have been anticipated.**

News of the novel coronavirus within China, specifically the city of Wuhan, was coming through in January, but it wasn't until mid-February that **global equity markets took a nosedive with declines upwards of 30% in a matter of weeks.** Up to this point, markets were reaching all-time highs. As new cases began to pop up outside of China, and more so as deaths began to occur elsewhere, concerns increased this may not be contained.

The response to impacts of the virus by governments and central banks has been profound, and in some ways unprecedented. While necessary to combat the spread of infection, governments forced economies to nearly shut down, putting a damper on near-term growth for many companies, disrupted global supply chains and economic activity going forward. Both monetary and fiscal measures have been taken to help stabilize and support economies. Major global central banks made emergency cuts to interest rates and asset purchases ramped up. Substantial fiscal packages providing loans and support to businesses and in some cases direct cash payments to individuals.

Not to be overlooked, oil prices plunged nearly 67% in the quarter as a dispute deepened between Saudi Arabia and Russia. Russia defied coordinated production cuts proposed by Saudi Arabia to keep prices stable as demand for oil has been waning due to the coronavirus.

This quarter was one for the history books and has seamlessly carried through to the 2nd quarter. Although it is unknown how much longer the world will have to endure this, with time, it will pass. **Markets, just as the human spirit, are remarkable and always find a way.**

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

Contact Our Advisors

Western Washington

Seattle
601 Union Street, Suite 4747
Seattle, WA 98101
206.667.8954
888.254.0622

Bellevue
10500 NE 8th Street, Suite 1100
Bellevue, WA 98004
425.467.1781
888.445.7166

Spokane
717 West Sprague Avenue, Suite 900
Spokane, WA 99201
509.353.3898
800.725.4449

Portland
760 SW Ninth Avenue, Suite 1900
Portland, OR 97205
503.778.7060

Southern Idaho / Boise
945 West Bannock Street
Boise, ID 83702
208.345.3343

North Idaho
218 Lakeside Avenue
Coeur d'Alene, ID 83814
208.667.7993