Foundation Stakeholders:

It has been several weeks since our last communication piece, so we felt as if it is time to provide another update on the COVID-19 pandemic, market conditions, the economy and the portfolios.

The first thing I’d like to do is provide a bit of reflection. While there have been warnings about a pandemic for years, the current situation seems to have caught us all unprepared. In 2015, Bill Gates advised us of the dangers of a pandemic based on his experiences dealing with medical crises in Africa. In some cases in the past, we have had drugs to minimize the symptoms of the disease, but in the case of COVID-19, we have none. Gilead’s Remdesivir seems to be the leading candidate at the moment—but that treatment will not be ready until the fall (and initially for emergency use only). Morgan Stanley published the below projected timeline and milestones for a return to work in the US. You can see our firm still believes it is June of 2021 until a vaccine is broadly available to the public. We do identify a potential second wave of infections coming this winter.

At the moment, our only defense is to avoid contracting the disease, which is why we are all hunkered down and wearing masks whenever we go out. During previous flu epidemics, 9/11, the World Wars, etc., we have usually been able to go about our daily lives in a reasonably normal way. We have never before been confined to our homes like we are now. This has triggered new perspectives and discoveries. COVID-19 forced many companies to operate without a large real estate footprint for the first time ever. Relative success will tempt management teams to free up the capital on their balance sheets in hard real estate assets by integrating more work from home policies into their service models. Satya Nadella, Microsoft’s Chief Executive, recently claimed “we’ve seen two years’ worth of digital transformation in just two months.” There will be social changes. Are snow days now obsolete? Will airlines ever again reach the volumes attained in Q4 2019? Will Uber Pool still be a viable business on the other side of this? As humans, sometimes we tend to over-sensationalize expected change in the near term. Maybe the world will not change as much as some anticipate.

There are silver linings. Historically, crises have stimulated creativity. Innovation originates from challenges, and there are plenty of those to go around at the moment. About three weeks ago I stumbled upon a video of two quarantined ten-year old
Italian brothers performing a violin duet of Coldplay’s *Viva La Vida*. It was absolutely beautiful. Please check it out. Creativity also expands to entrepreneurship as the following companies were born out of recessions: WhatsApp, Venmo, Instagram, Uber, Airbnb, GE, GM, IBM, Disney, HP, Trader Joe’s, Hyatt, Microsoft, Electronic Arts and FedEx. Further, the following inventions were born during recessions: chocolate chip cookies, the basketball, scotch tape and, appropriately, Monopoly.

In our humble view, much of the economic expansion we have experienced in the last decade has been due to globalization and monetary policy. Manufacturing, as we all know, has been outsourced to the lowest-cost producers. Supply chains have gone global, and fast. The Apple iPhone touches 43 different countries during its assembly. Apple is a design and marketing company – not a manufacturing business. Manufacturing is capital intensive and the corporate playbook for decades now has been to outsource this function to Asia. Companies in the post COVID-19 world may very well want domestic control of manufacturing. This could be a boon to domestic manufacturing here in the US, but it also has to result in higher costs of production, lower corporate profit margins, and thus potentially lower stock markets. Are the markets pricing in the effects of a move further towards de-globalization? What are the long-term effects of this?

Our firm’s base case remains that the economy is likely bottoming this quarter and next, and will be followed by a slow and gradual U-shaped crawl back to pre-pandemic economic output no sooner than Q4 of 2021. We would be foolish, however, not to recognize the degree of uncertainty prevalent in the world today. Daniel Kahneman, the Nobel Prize winning behavioral psychologist, points out that as humans we like to assign meaning to past events and let a deceptive narrative in our heads give us a false sense of confidence in forecasting future events. The correct lesson to learn from surprises is that the world is surprising. The range of possible outcomes right now is wide, which is why we remain approximately right at our investment policy asset allocation targets. There will be concerns about a second wave. Consumers and companies could very well be cautious in their spending and borrowing for several quarters now. Banks are likely to be cautious in their lending for the foreseeable future. It seems safe to say that restaurants, travel and leisure companies may not be back to “normal” for quite some time. The Government can re-open the economy – but that doesn’t mean the economy will re-open. Fundamentals in the economy are very, very poor right now. Sadly, unemployment will likely reach the highest levels on record. Many Americans, having lost their jobs, are struggling, and are waiting for assistance which may not come because of the ineligibility of some workers. Graystone’s forecast for Q2 GDP, via Morgan Stanley economists, is -38%. "Off the charts" never literally meant “off the charts” for me until now. These economic figures are jaw dropping, and that is what is so perplexing about the equity market having bounced back like it has from the trough of the 34% decline in the S&P 500. Bear market rallies have the propensity to claw back about 30% of the initial fear driven selloff. In this case, the S&P 500 recovered about 60% of its initial decline before some softness over the last couple of days. It appears as if the equity market is looking through 2020 earnings and in to next year. There remains an astounding level of dissonance between (1) the real economy and (2) corporate earnings/equity markets. Congress and the Fed’s response to COVID-19 has been massive (understatement) and inordinately fast. Asset markets have benefited from the Fed having much of the piping and infrastructure in place from the Global Financial Crisis (GFC) for expedient monetary stimulus. This has raised moral hazard issues and questions like “what is capitalism without bankruptcy?” The Fed was the buyer of last resort in 2008/2009. In 2020, they have in some ways been the “buyer of first resort”, quickly injecting liquidity into risk assets like corporate bonds for the first time ever and effectively underwriting the American economy. Taxes will have to increase. If Trump is re-elected, they will go up slowly. If Biden wins, they will go up quickly. When the Government saves you on the way down, many would argue (sans Libertarians) that they then have the right – or, candidly, the need – to tax and regulate you on the way up. The Federal Deficit will reach levels as a percentage of GDP (or economic output) not seen since we levered up the American economy to win World War II. Below we illustrate that the fiscal response has been much larger than during the Great Depression:
Now, let’s shift gears towards the Foundation’s investments and positioning. We are firmly in the camp that we will continue to see volatility in the equity markets through, in all likelihood, the rest of the summer. The Catholic Foundation investment portfolios have experienced quite the recovery rally from their lows in tandem with risk assets from the March 23rd bottom. We believe, however, that the recovery in asset prices may have gone too far and too fast. We remember the 2000-2003 bear market during which equities rallied 20%+ four different times during the 2.5-3 year decline, only to make new and lower lows after each recovery rally or “dead cat bounce”. We have a very different Federal Reserve psyche today, however, and we cannot ignore this fact. Our strategy moving forward is to take opportunities to buy high quality assets at inexpensive prices incrementally through the summer with a continuation of the systematic rebalancing measures we have employed. This assures we are buying into weakness, as we do believe better days are ahead for the US economy. We are of the view that in Q1 2021 we could very well be looking at 8% y/y GDP growth which should buoy manufacturing businesses, energy companies, banks, autos and other more pro-cyclical assets. We are of the view that bear markets end with recessions, and that a new business, economic and equity market cycle exists on the other side of this severe economic contraction.

We have initiated a position in high yield credit, which has been a consistently attractive return generator for patient investors looking out 12, 24 and 36 months following recessions. Further, our distressed debt manager, Oaktree, had their most active quarter in five to six years.

Please see estimated performance below as of 4/30:

Strategic Growth Fund: -7.21%
Moderate Growth Fund: -4.78%
Capital Preservation Strategy: -1.07%

Please note that the performance of the Capital Preservation Strategy should continue to improve as the underlying short term bonds incrementally mature at par value (or 100 cents on the dollar) and the credit markets continue to heal with Government intervention.

As always, please do not hesitate to reach out to us.

Many thanks –

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