ALBION FINANCIAL GROUP

April 29th, 2020

In our first quarter letter of 2020 you will read a lot about what is happening in the world due to the novel coronavirus. Our President and CEO, John Bird, recounts the unprecedented volatility we've seen in the financial markets this year. Our CIO, Jason Ware, informs us that we are in a recession, but that does not mean we don't want to own stocks. Financial Planner, Patrick Lundergan, waxes behavioral finance in *Planners' Corner,* and in *Albion Community* we give you an update on what is happening with the Albion Team.

Thank you for putting your trust in us during these trying times. We look forward to deepening and strengthening our relationship with you during and after this pandemic runs its course.

The Albion Team

From John Bird's Desk

What a ride!

The first quarter of 2020 is one for the history books. The year opened with the S&P climbing 4.8% to a peak of 3,386.15 on Wednesday, February 19th. Then it fell 33.9%, bottoming out at 2,237.40 on Monday, March 23rd. Since then it has risen 26.7% through Tuesday, April 14th for a year-to-date loss of 12.3%.

As of this writing, despite the wrenching volatility, equity market indices are about where they were in the third quarter of 2019. If we were ok with our portfolios five months ago, we should be ok with them now. So why might we feel so unsettled?

Because:

Since Monday, February 24th there have been 12 days where the S&P 500 index declined more than 3% (with 4 more than 5%) and 10 days where it rose more than 3% with 5 more than 5%. The speed of decline – and subsequent rebound – is unprecedented. The following graph shows the number of +/- 3% and 5% days for the last decade:

	Down More Than		Up More Than	
Year	-3%	-5%	+3%	+5%
2010	5	0	3	0
2011	6	1	6	0
2012	0	0	0	0
2013	0	0	0	0
2014	0	0	0	0
2015	2	0	1	0
2016	1	0	0	0
2017	0	0	0	0
2018	5	0	1	0
2019	0	0	1	0
10 Years ending 2019	19	1	12	0
2020	12	4	10	5

The closest we've come in the recent past was 2011 when we had 12 days with moves greater than 3% and one day with a move greater than 5%. That was for the whole year. We've blown that away already; 22 days with moves greater than 3% and 9 days with moves greater than 5%; and we are just over a quarter of the way through the year. Anyone out there feeling whipsawed?

Given all we've experienced it's hard to believe that it's only been two months since COVID-19 started dominating our thoughts and actions. It's also eye opening to realize that with the dramatic hits to employment and whole sectors of our economy grinding to a halt that the S&P – as of this writing - is "only" down about 12% this year.

The volatility is directly related to the tremendous uncertainty around COVID-19. Markets do not like uncertainty. We do not know when we will return to normal nor do we know what "normal" will be. However, we are beginning to get glimpses.

A slow return to a new normal is most likely. As testing improves our ability to differentiate between those who've never had the virus, those who are currently infected, and those who've had it and are no longer contagious, those who are not infected or contagious can re-engage.

Some are calling for an end to the self-quarantine and social distancing in favor of a speedy return to our pre-COVID lives. Most of us know that such proclamations are largely unfounded. We will return to restaurants, stores, and our offices when each of us feels we can do so without putting ourselves, our families, our communities, and our health care workers at risk. It will take a while for us to gain such confidence.

And yet... There is progress. As described in previous communications we are clear that social distancing, and monetary and fiscal support are not long-term solutions, but rather they buy us time while we learn how to live with the novel coronavirus. Short of allowing the ailment to spread unrestricted in order to develop herd immunity - for which we as a country do not have the appetite - testing, treatment therapies, and vaccines are our path forward. While testing capacity is still far short of what is necessary, it is ramping up quickly. There is no magic bullet therapy, nor is there a clear winner in the effort to create a vaccine, but there are promising leads for both. And while we've lost over twenty million jobs – as many as have been created since the depth of the 2008-2009 recession – we do still have parts of the economy working. And most importantly; this won't last forever.

As mentioned above, the financial markets, while extremely volatile and certainly well off their highs, are not as bad off as the news would suggest. Please note that I'm not saying the market decline has not caused a lot of pain. It has. Yet given the magnitude of economic decline and job losses, markets have been relatively resilient.

The value of a company is directly related to what it is expected to earn, year after year, for the next few decades.

Yes, most companies will see a dramatic drop in earnings this year. And perhaps next. Yet the companies are still valid. Once we've learned to live with novel coronavirus, they will go back to providing products and services we desire. And earn money by doing so. While stock prices have been marked down due to the reality of weak earnings in the coming quarters they've not been marked down too far as their long-term earnings power is still intact.

We are certain you have much on your mind. The health of yourself and your loved ones; employment – or unemployment of those you care about; the psychological toll of social distancing and self-quarantine. While we recognize our ability to resolve many of these issues is limited please know we remain firmly focused on and committed to your financial well-being. And despite the incredible uncertainty we remain bullish on human ingenuity.

Economy & Markets

In describing what were sturdy economic conditions at the time, in last quarter's missive we stated: "*This isn't to suggest that recession cannot occur. They can, and at some point, will. Recessions are unavoidable as they are natural ingredients to the business cycle. Nevertheless, our present take is that the near-term probability here remains low*."

A lot has changed since that letter. More rapidly than we have seen at any point in our lifetimes. The complexity of the world has a way of, from time-to-time, making a mockery of even the highest probabilities. Indeed, the decade-long U.S. expansion came to an end in the first quarter, brought down by a menacing virus nobody predicted. A true Black Swan event. Just a few short months ago we were near full employment, the consumer was spending at record levels, general sentiment was good, and companies optimistic about their near-term fortunes. The economy was humming along. Then, out of nowhere and in what almost seemed like a Hollywood movie the novel coronavirus sprang forth spreading like wildfire across the globe. With it came mandated stay at home orders, lockdowns and other suppression measures that have shut down parts of our economy. Restaurants are shuttered, hotels vacant, air travel sunk, and gyms and theaters dark. According to a Wall Street Journal analysis, over 25% of the U.S. economy has completely stopped due to these actions.

This mandated closure of commerce has led to mass job losses for tens-of-millions of Americans. Jobless claims have spiked to once unthinkable levels over a very short period. This economic slump is more akin to a natural disaster than typical vagaries of the business cycle. The result has been a sharp and sudden loss of incomes, spending, and investment has created a major deficiency of aggregate demand. For the better part of the past decade, my tenure in writing this section of the letter, I have repeatedly presented both evidence and opinion as to why the economy was growing and prospering – even amid difficult months and quarters, and there were many, where the herd was shouting otherwise. But that stretch has ended. The data are clear – we're currently in recession. Consequently, the more relevant question now becomes how deep and for how long? Answering *that*

requires profound consideration of two primary factors: 1) the path of the virus and the science behind treating and vaccinating against COVID-19 (the disease caused by the novel coronavirus), and 2) the policy responses from the Federal Government and the Federal Reserve.

The first factor, the virus, is difficult to predict. While we have a responsibility to understand this pandemic and its impact, we also accept that we are not epidemiologists. Which is to say we have no edge in the ability to forecast how and when this runs its course. Despite this, the good news is that social distancing and other serious measures we have taken as a society – while surely having a negative effect on the economy over the short-run – appear to be showing positive results in slowing down the transmission of infections. This, along with testing, tracing and treatment, are critical steps toward getting the situation under control allowing us to better manage novel coronavirus and begin responsibly reopening the economy.

The second factor, policymakers attempts to aid the economy and financial markets, are fortunately much clearer. And they should be, for it makes no sense to impose social distancing without also socializing the real costs of that policy. The Federal Reserve acted quickly and massively in responding to the fallout in financial markets by cutting rates to zero and injecting *trillions* into markets. If there is any silver lining from the 2008-2009 Great Recession, it's evident in the framework and monetary policy tools that Ben Bernanke established and left behind for future Fed leaders to adopt. Too, the willingness to act is also an enduring and important Bernanke legacy that allowed the Jerome Powell Fed to respond with dispatch and without apology. In a similar vein, Congress seemed to have learned from the mistakes made in the fall of 2008 when lawmakers debated and delayed 'TARP' then arguably failed to provide enough fiscal firepower to arrest that substantial economic decline. Fast forward almost 12 years, and Congress, with the treasury secretary, acted much swifter and with larger more targeted programs to help assuage the damage. As of this writing, approved government spending to rescue the economy has surpassed $2.5 *trillion*, or ~12% of GDP, with likely more to come. We are of the view that it is only logical that the monetary and fiscal support will persist as we work through this health and economic crisis. This is unequivocally a good thing.

That's all a lot to process. But this is often the case in times of crisis. Answers can be elusive, uncertainties abound, and immense complexities are present. So, what is the path forward? That is the answer that everyone, including investors are focused on. The truth is we can't know over the short term what the cards hold for us. Nevertheless, what we can say with a high degree of confidence is that being longer-term bullish on the U.S. economy, believing in a better tomorrow, is ultimately a bet on science – a belief in ingenuity and innovation. This is a bet we are willing to wager. And in the interim between now and when we beat this virus, the full weight of the fiscal and monetary authorities are being brought to bear in an attempt to reduce, to the extent possible, the economic and financial impacts as we navigate this chasm.

The stock market, of course, has reacted to all of this violently. Not only was the drop the fastest bear market of -30% or more in history (22 trading days), but the rally off the March 23rd lows was equally as intense. Volatility in both directions underscores the impassioned tug and pull among the two competing market narratives surrounding this novel coronavirus event. It also demonstrates why being "all in" or "all out" based on momentary factors and guesswork is problematic.

Looking at it through the lens of our portfolios, that is, the quality investments representing ownership in a diversified cross-section of great American business, we ponder the following central question:

While undeniably having a major impact now, will COVID-19 upend and ultimately destroy the fundamental bedrocks of our 244-year old dynamic capitalist system as we know it? Will we still be facing this problem in three-, five- or even 10-years into the future? Or, will this be yet another bump in the road – a monumental short-run challenge – that America faces and overcomes on the path toward general and continued progress?

The answer to that question determines what you do today with your stocks. Do you wish to persist in owning a diversified collection of outstanding companies operating within what's been an unshakably long-standing and vibrant system? Or, is this the seminal event – the big one – that truly changes life as we know it, forever? We trust in the former as the likely outcome. If history is any guide, we can be confident in one thing: markets in extreme periods tend to overdo it to the downside. The 2008-2009 Great Recession was scary, but it eventually passed. Ultimately, this will too, and markets should stabilize. As such, we continue our tireless endeavor of finding and owning sound investments in your portfolios for the long run.

Planners' Corner

Often, the *Planners' Corner* is used to provide straight forward, actionable guidance from our planners and advisors. In these extraordinary times, it's a piece of behavioral psychology that will beset the following text. We are working hard to provide insights into the changing world around us using a plethora of mediums – conference calls, blog posts, emails, phone calls, video chats, TV appearances, social media posts, etc. Yet we can't discount that the world has seemingly tempered to a halt. As a community, we do our best to make do, but sometimes fear and anxiety permeate our best efforts at normalcy.

It was once thought that ostriches buried their heads in the sand to avoid danger. Although a reasonable assumption, it's wrong. This hasn't stopped the term "ostrich effect" from bleeding into the study of behavioral finance. The misconception about why ostriches bury their heads in the sand, led to a broad definition describing this effect as "avoiding exposing oneself to [financial] information that one fears may cause psychological discomfort." As with every

story, there are two sides – some tend to find themselves falling victim to the over monitoring of finances in periods of high uncertainty and volatility. Coined the "meerkat effect" due to a change in behavior that resembles more of a hyper-vigilant meerkat than a head in the sand ostrich. Regardless of whether we act more like ostriches, meerkats, or just humans – our built-in psychology can reinforce negative emotions in times of uncertainty.

Whether we like it or not, some aspect of the ostrich effect influences us within or outside of our financial lives – avoiding listening to a voicemail because we know its contents are undesirable, not checking financial statements for fear of unpleasant details, putting off an uncomfortable phone call, or unnecessarily rescheduling a filling at the dentist. We, as humans, experience this effect even with the most minor unpleasantries. Financial health is no minor detail. It's easy for financial advisors and investment gurus to repeat the same truisms over and over in times like this to aid clients who are wading in murky waters. However, we should never discount the unprecedented nature of this pandemic as it relates to all of our ever-changing situations.

So why do ostriches bury their head in the sand? They dig holes to keep their eggs, and occasionally insert their heads into the ground to turn the eggs. They are nurturing, not hiding. This is time we can spend nurturing our financial eggs, controlling what we can control. Below are 5 steps we can take, together, to manage our financial and mental health during and after the novel coronavirus.

Talk to us, talk to others - We do our best to reach out to all clients personally, both prior to and during this time. Discussing finance, family, friends, canceled trips, or plans for the future are all suitable topics. We are here to listen to you, regardless of the topic. Communicating with our clients does as much for us as it does for you – we all need the personal connection right now. Remember to connect with those you love via phone or video chat or catch up with someone you haven't spoken to in years.

Automate - Finances can fall by the wayside when our health is at risk. Manually making transfers, withdrawals, paying bills, and contributing to retirement accounts can feel tedious and stressful right now. Let us help you automate your financial life so that you can focus on what's important.

Plan with real data - Financial planning is probably not near the top of many lists right now. However, I would be hard-pressed to find a better time to properly plan. Working together to understand and finetune your entire financial picture can be a great way to confront both sides of this psychological coin. Planning with estimates is good, *planning with data is better*. When we understand what is coming in versus what goes out while factoring in all assets you have, we can act faster with real data in times of need (good or bad). Please reach out to discuss formal planning and we will work together to realize its benefits.

Get informed – We work with some of the most intelligent clients out there, but no one knows everything about everything. Albion employees are working as a cohesive unit

from home to deliver the most relevant insights and information for our clients. Following us on social media, attending our conference calls, keeping up with the blog, and dissecting our emails are great ways to understand where we stand on the most important topics facing the world today. We can't cover everything, but we are willing and able to research or answer any tough questions that you have – don't hesitate to make us your first call.

Take it slow, make a list – Whether we are busy or finding ourselves with too much free time, trying to tackle everything at once can be draining. We are here every day working to ensure your success but might not wholly understand what concerns you have for one reason or another – everyone has different worries and wants. Making a list of things we have been actively avoiding or overanalyzing is a logical first step. Acting on and completing this list over time yields the desired outcome. Small steps turn into big leaps with time.

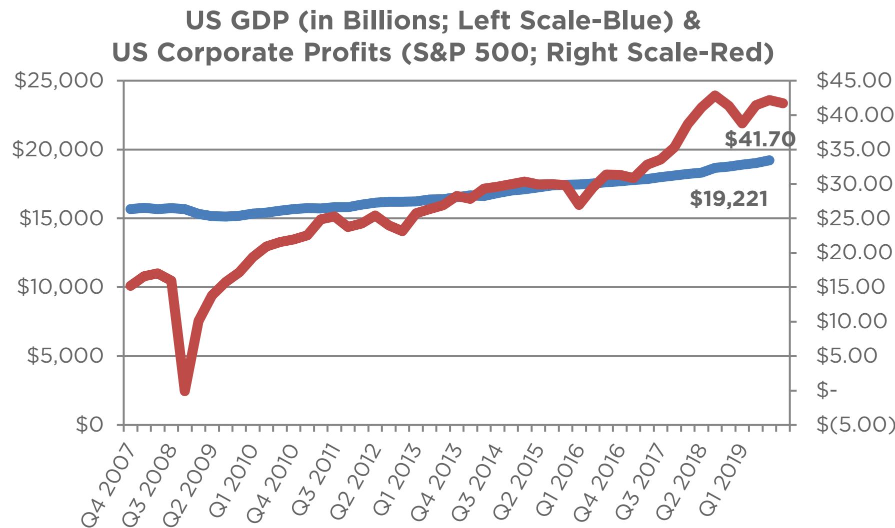
Albion Community

The Albion Team is operating with a new normal. Starting in mid-March most of our team is working remotely. Certain tasks must be done in person therefore we have 2-4 people in the office. For a team-oriented group with a corporate culture of eavesdropping and jumping in to lend a hand, working remotely is a major change. However, we are rising to the occasion. Technology is a marvelous thing and allows our team to stay in close communication with each other and our clients. We are thrilled with our ability to operate smoothly in a remote environment, but as social creatures, we very much look forward to seeing each other and our clients in the office again soon. For now, all client meetings are conducted virtually. We will keep you updated as our social distancing policies evolve.

Macroeconomic Highlights from the First Quarter

ALBION FINANCIAL GROUP

UNITED STATES GDP ANNUAL GROWTH RATE



A lot has changed in 2020. More rapidly than we have seen at any point in our lifetimes. Indeed, the decade-long U.S. expansion came to an end in Q1, brought down by a menacing virus nobody predicted. Just a few months ago we were near full employment, the consumer was spending, general sentiment was good, and companies optimistic about their fortunes. The economy was humming along. Then, out of nowhere novel coronavirus sprang forth spreading like wildfire across the globe. With it came mandated stay at home orders, lockdowns and other suppression measures halting down parts of our economy. Restaurants are shuttered, hotels vacant, air travel sunk, and gyms and theaters dark. The data are clear – we're currently in recession.

UNITED STATES INFLATION RATE

Using the Fed's preferred measure core inflation remains in-check with the most recent data showing a pace below the Fed's 2% target. Additional measures like CPI and "5-year, 5-year forward" data also reflect low price growth. But inflation is a lagging indicator. Given the recession due to COVID-19, our best guess is that inflation will fall further over the coming months. The Fed is clearly concerned about this too as evidenced by their recent actions regarding monetary policy.

Macroeconomic Highlights from the First Quarter

ALBION FINANCIAL GROUP

UNITED STATES 10 YEAR TREASURY YIELD

TRAILING 12M P/E RATIO: 10 YEAR

After delivering three "mid-cycle adjustment" rate cuts in 2019, the Federal Reserve looked to be on hold. Then suddenly the global economy was shocked by the effects of the novel coronavirus, and the Fed acted quickly taking interest rates back to zero. We said in our last quarterly update that if the Fed were to move off of "neutral" it was our best guess that move would be another cut, not a hike. This turned out to be the case. We also said that "the Fed stands ready to support the economy as needed and seems more focused on the potential 'downside risks' in the economy." This too was prescient as the U.S. central bank restarted several crisis era programs, plus more, to support the economy and financial markets. This ultra-accommodative monetary policy, coupled with fears of the novel coronavirus driving investors into "safe haven" U.S. Treasuries, have placed yields at new record lows.

The recession makes it's hard to say where the current market P/E sits as 2020 corporate earnings visibility is low. Using known earnings, S&P 500 settled at ~15.8x by the end of Q1. But this view is imperfect as it's a near-certainty that earnings come in significantly lower in 2020 thereby elevating that P/E multiple relative to prices. But stocks are also forward-looking, meaning they may already be seeing past a dismal 2020 and into 2021. Our base case presently suggests 2021 earnings should improve, though this will depend on the path of the virus (thus the economy). If correct, the P/E stabilizes allowing us to plot it against other data points - like inflation and interest rates - our preferred method of valuation. Both are extremely low. Perhaps it's best to summarize our contemporary views on valuation as: on balance, stocks are probably cheaper today than at the market peak provided earnings soon rebound on the other side of the pandemic, which we believe they will.