Market Commentary
First Quarter, 2020

We are fighting two serious battles, a global pandemic and a necessary self-induced economic coma to slow the spread of the virus.

The Pandemic

COVID-19 may be the most significant global health threat of our generation. It has expanded rapidly and is now in all 50 states. According to a widely reported model* tracking the pandemic, our country is projected to have 60,415 total deaths from the virus, provided ***strict*** guidelines on social interactions are effective in "bending the curve" of transmission. The model is dynamic and changes as more data is known about the pandemic's trajectory in both the US and around the world. If there is a subsequent resurgence of the virus, deaths are projected to be higher than what is currently included in the model.

The success of other countries in slowing the spread of the virus was due to early efforts to enforce widespread social distancing, shelter in place mandates, extensive testing to identify those who were infected and quarantining the infected from everyone else. Unfortunately, we were not adequately prepared for the pandemic and did not have adequate quantities of medical equipment, supplies, or hospital beds for people requiring hospitalization for treatment.

When the virus was first detected in Washington state on January 21, we did not (and still do not) have the capability to conduct widespread testing to identify people who have the virus and quarantine them from others. Without comprehensive testing and no effective treatment or vaccine, strict guidelines on social interaction are the only methods for curtailing the spread of the virus. These initiatives were embraced inconsistently by each state and community, causing confusion about the severity of the virus and enabling it to spread further. States and communities that adopted preventive measures early are faring much better than those that deferred action.

Most forecasts regarding the virus assume it will be brought under control in the coming months due to the effectiveness of isolating those infected, infected people developing immunity to the virus, and the presumed availability of treatments for virus symptoms. It is unlikely vaccines currently under development will be available until next year. Until then, there is no medical solution.

We believe our country will come together and be better prepared for the next crisis once COVID-19 subsides. We hope the measures we are taking will be effective sooner rather than later. We are in a race to contain the virus, develop a cure and save lives before permanent harm is done to the global economy. Our challenge is to maintain the health and welfare of our citizens while minimizing the adverse impact to our economy.

The Economy

The economy is close to a full stall and many households and businesses are on life-support. We have never seen anything quite like this before.

The restrictions on social interactions have shuttered a large swath of businesses and industries, displacing millions of workers. Recent estimates for unemployment next quarter range from 15% (Goldman Sachs) to 30% (St. Louis Fed President Jim Bullard). The estimates are very high with an unusually wide range, reflecting the severity and uncertainty of the economic impact. With 165 million

*Data as of April 8, 2020, University of Washington's Institute for Health Metrics and Evaluation (IHME)

jobs in our country, that translates to 25-50 million unemployed people. The upper end of the unemployment forecasts is worse than the U.S. suffered during the Great Depression. Although these statistics seem extreme, there are 35 million employees that work in transportation, leisure & hospitality, and retail. All of these industries are experiencing a disproportionate negative effect from social distancing practices. During the last three weeks, over 16 million people filed new claims for unemployment insurance benefits.

Gross Domestic Product (GDP) is a broad measure of economic activity and is a useful indicator for the general health of the economy. GDP last year was $21.4 trillion. Consumer spending is the largest component at about 70%. Goldman Sachs is forecasting GDP will shrink 34%, or $1.8 trillion, during the second quarter due to the expected spike in unemployment, shelter in place restrictions and reduced consumer spending.

We are including these forecasts for illustrative purposes to reflect the potential magnitude of the impact to the economy. It is a foregone conclusion there will be a severe economic contraction, and the effects will likely reverberate for several quarters. We are in uncharted waters, both in terms of the expected decline in economic activity and the fiscal and monetary policy response.

The Fiscal Policy Response

The fiscal policy response by our government leaders is both unconventional and appropriate. Ordinary fiscal and monetary stimulus is designed to increase economic activity through increased household spending and business investment, while to contain the pandemic our government leaders need to discourage and restrict much of our usual economic activity. Until the pandemic is contained, traditional stimulus is not a viable alternative.

The $2.2 trillion CARES (Coronavirus Aid, Relief and Economic Security) Act is an emergency rescue and support package for individuals, businesses, hospitals and local governments most affected by the shutdown of certain parts of the economy. It is the largest single injection of cash into the economy in history.

The Act provides for an immediate payment of up to $1,200 per taxpayer plus $500 per child for those with incomes of $99,000 or less. To prevent unemployment from increasing further, the Act authorizes forgivable loans for employers to keep people on their payroll. For those who are unemployed, it provides enhanced insurance benefits for four months. For certain industries, such as airlines, there are designated funds to offset some of the short-term financial impact. States and municipalities will receive financial assistance to partially offset higher costs and lower revenues caused by the virus.

In summary, the Act is a short term safety net for those adversely affected by the government's response to curtail the virus. The economic slowdown today is not due to bad actors or an overheated economy, but is instead directly tied to government interventions to slow the spread of infection. The Act is designed to buy time until the spread of COVID-19 wanes.

These measures should be viewed as a short-term stabilization initiative. They will partially offset the adverse impact and preserve the capacity for the private sector to rebound once the virus is contained. Unless the virus is contained quickly, pressure will increase for additional government support.

The CARES Act is economic stabilization, not economic stimulus.

The Monetary Policy Response

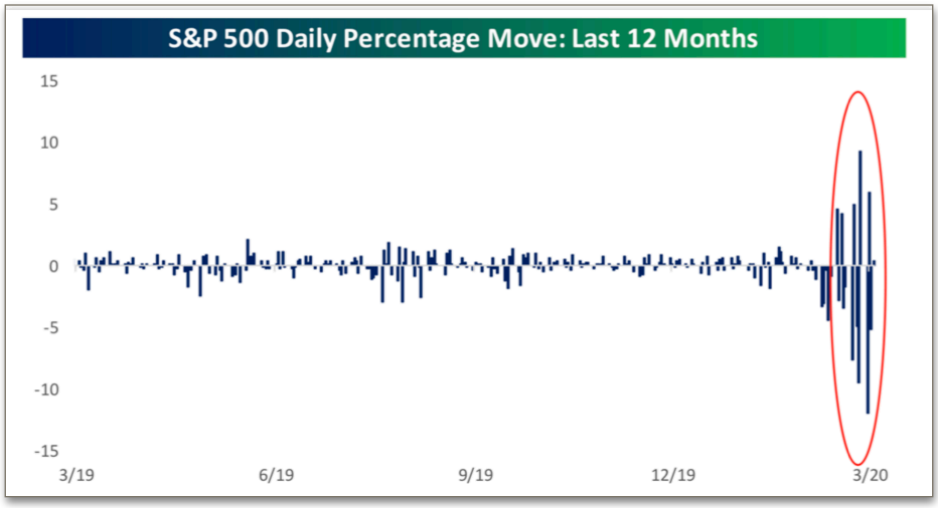
The financial markets were dysfunctional until the Federal Reserve Bank's "Whatever it takes" response on March 23 to stabilize the markets. The Fed cut interest rates on consecutive Sunday emergency meetings to bring its target rate to zero, authorized an unlimited expansion of its bond purchasing program and several new credit facilities to support critical market functioning. Included in the bond purchasing program are corporate bonds, municipal bonds and securities backed by credit card, auto and real estate loans. In addition, the Fed announced new credit facilities for direct lending to companies, municipalities, and money market funds, elimination of bank reserve requirements, and expansion of central bank liquidity programs. In total, the Fed is providing many trillions of support to promote the stability of the financial system. The speed and amount of support provided was orders of magnitude greater than any previous intervention, including during the Global Financial Crisis in 2008-09.

On March 27 the Fed's balance sheet was $1trillion larger than it was a year ago, and growing rapidly. It will take some time to understand the magnitude of these programs and their unintended consequences, if any.

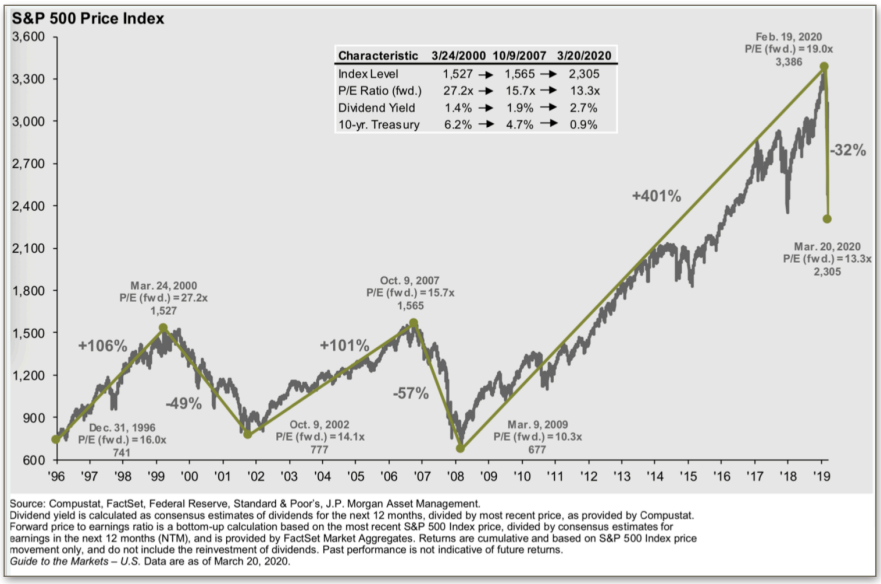
The Markets

The longest US equity bull market ever ended February 19 in extraordinary fashion. The steep sell-off and volatility in the equity market during the following weeks was unprecedented. From its peak on February 19, the S&P 500 declined 34% before bottoming on March 23, the most rapid decline ever, which was followed by a three day gain of 17%. There were eight consecutive days when the S&P 500 moved up or down by 4% or more, including the second largest decline since World War ll and the largest gain since the Great Depression. We won't know if or when the market has bottomed without the benefit of hindsight, as these market cycles often include short term rebounds at inflection points when the market is in the process of stabilizing. Volatility will likely remain elevated until the health of our nation and the economy are showing signs of recovery.

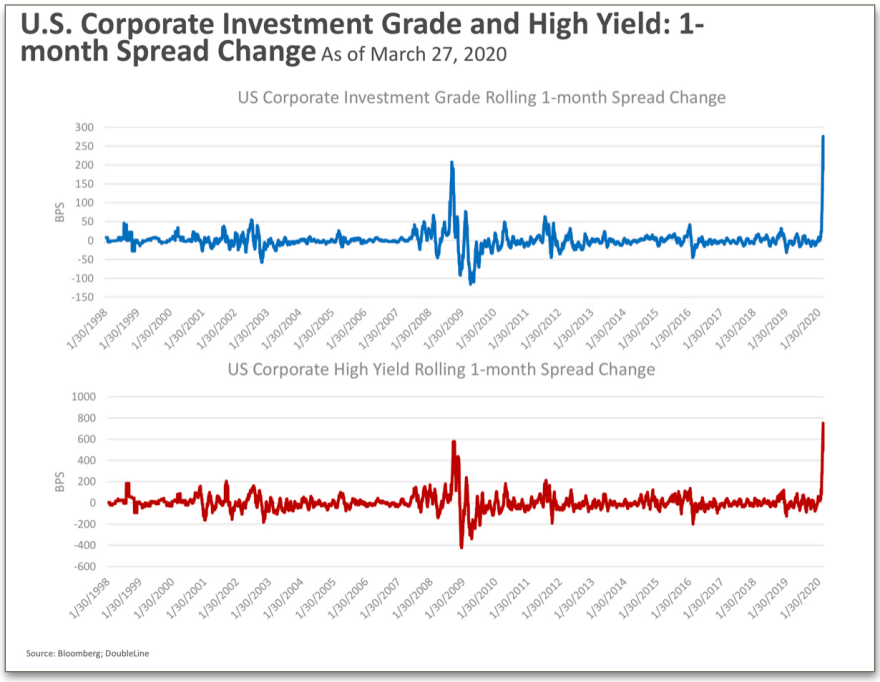
The following chart illustrates the extreme volatility of the S&P 500 prior to the Fed's market stabilization efforts.



The following chart illustrates the sharp decline in the S&P 500 prior to the Fed's market stabilization efforts.

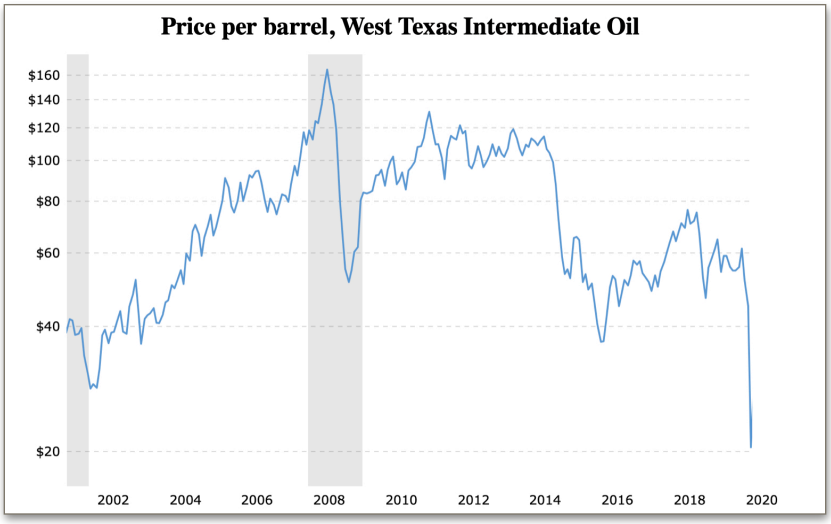


With the exception of U.S. treasury bonds, fixed income did not function as a safe haven as investors fled the equity markets. Credit spreads on all types of fixed income securities increased dramatically, causing yields to spike higher and prices to decline. For example, between March 9 and March 23, the yield on the Bloomberg Barclays Municipal bond index tripled, rising from 1.14% to 3.52%. Investment grade and high yield corporate bonds fared much worse as noted in the charts below.



Preferred stocks were not spared in the market downdraft. Current yields on mortgage and energy related preferred stocks have increased from about 7% to low double digits. When markets stabilize, we expect prices will recover and asset category correlations will normalize.

Due to reduced consumption and the production disagreement between Saudi Arabia and Russia, the price of oil declined from $61 to $20 per barrel during the quarter. Current prices are uneconomical for oil producers and countries relying on oil revenues to support their government programs. We expect significant reductions in capital expenditures and production until consumption and prices return to historical levels. We are running out of storage and producing more oil than we are consuming by many millions of barrels a day. Low prices normally encourages more consumption, but shelter in place is restricting travel. The following chart illustrates the magnitude of the price drop during the first quarter, with recession periods indicated by the grey bars.



Correlation is a statistical measure of the tendency of one asset category's returns to move in tandem with that of another asset category. When we construct diversified portfolios, we include asset categories such as fixed income, preferred stocks and alternative assets to reduce risk and volatility, because their performance does not normally have a strong correlation with equites. However, when markets are under extreme stress and dysfunctional, as they were in March, asset category correlations synchronize and normally diversifying asset categories decline in sympathy with stocks. Volatility in all asset categories last month was extreme, and all asset categories posted negative returns for the quarter.

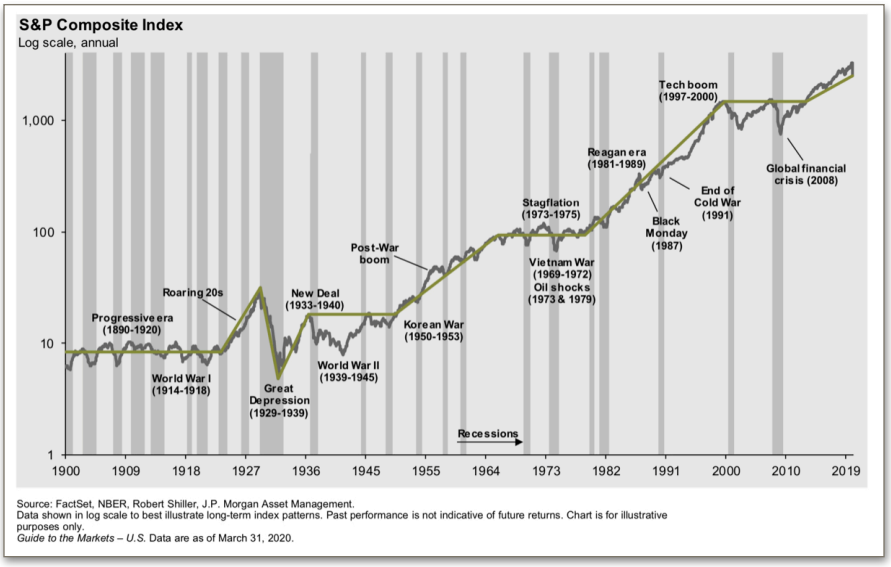
Longer term outlook

We will close with a few thoughts about the longer term outlook. There are many reasons to be optimistic.

The economy was in a relatively good position before the pandemic hit. At the beginning of the quarter, job growth was solid, unemployment was at a 50 year low, corporate earnings were rising, and we had recently resolved trade disputes with China, Canada and Mexico. There were some signs of weakness in manufacturing, but overall the economy was doing well and consumer sentiment and business confidence were high. Market valuations were at or slightly above their respective long term averages

and it appeared investment returns in 2020 might be less than historical averages, probably in the low to middle single digit range. The markets were calm and functioning normally.

Below is a chart of the S&P 500 composite index since 1900. It illustrates the long term returns from the index in spite of multiple wars, the Great Depression, the tech boom and bust and the most recent Global Financial Crisis. Following each of these challenging times, we emerged stronger and better, the economy recovered and patient investors were rewarded. There is no reason to believe this challenge will be any different from the others we faced during the last 100 years.



We will develop a vaccine and the pandemic will end. Market selloffs end when the problem that caused it is expected to be under control. Capital markets will likely recover before economic data and corporate earnings do. We will develop a safe "return to work" program and employment and consumer spending will recover. Schools will re-open. Travel restrictions will end. Sporting events and large public gatherings will resume. Investment in energy production will recover and we will remain energy independent. Supply chains will return to normal and there will not be any shortages of goods or services. And the list goes on and on.

We will learn a lot from this pandemic and we will be stronger, more resilient and much better prepared for the next crisis when it occurs.

Thanks again for your trust and confidence. Should you have any questions or would like to discuss your financial goals and investment portfolio please let us know.

Be safe and stay healthy, we will get through this.

Respectfully,

The JRM Investment Counsel Team
Jack, Phil and Lauren