STOKES CAPITAL ADVISORS, LLC

Market Commentary
March 31, 2020

Quarterly Market Review

Investors suffered a global takedown of risk assets as a pandemic (COVID-19) originating in the Wuhan Province of China spread across the globe and essentially brought the global economy to an abrupt halt. Equities fell sharply across the board with the S&P 500 Index recorded a -20% drop, the worst quarterly performance since the 2008 financial crisis following the collapse of Lehman Brothers when the index cratered -22%.

Small cap equities were the worst performing equity class for the quarter recording a -30% decline as the global pandemic inflicted severe strain on smaller companies which typically have less access to capital. The quarter's decline was the worst performance on record eclipsing the 1987 crash of -29%.

Reviewing foreign markets for the quarter, all major averages recorded double digit declines. Europe was particularly hard-hit relative to Asia/Pacific as China and Japan took early actions against the rapidly spreading virus and initiated quarantines and lockdowns. As a result, major averages in these regions faired better on a relative basis.

A perfect storm hit the global oil market during the quarter. In addition to an estimated 10 to 30 million barrels per day demand hit from the pandemic, Saudi Arabia and Russia looked to be engaged in a protracted "oil war". In a retaliatory move against the Russian Government, the Saudis announced plans to increase production and flood an already over supplied market bringing Brent Crude down -60% for the quarter to close at $26 per barrel, levels not seen in over 20 years. Breakeven prices for oil in Russia are estimated at $42/barrel while most of U.S. shale producers are not profitable at levels below $45. While this information is difficult to audit, Saudi's publicly traded Saudi Aramco struggled to breakeven with oil less than $45 according to recent public financial records. This brings into question how much pain OPEC and Russia are willing to take but also questions the long-term viability of the 9,000 shale producers in the United States. Clearly, the Saudis are looking to force new market arrivals and high cost producers out of business and emerge from the war as the swing producer with greater market share, a costly and risky maneuver indeed.

The oil shock aggravated the already fragile credit markets essentially bringing attention to an over levered corporate debt market. Credit spreads widened and dysfunction started to appear in the Treasury and cash markets during the quarter. The possibility of another 2008 liquidity crisis had appeared in late March and Central Bankers acted quickly to bring the "financial plumbing" back online. As a result, credit spreads tightened, and Treasury yields declined in a "whatever it takes" moment for the Federal Reserve. Once again reminding investors they should "never fight the Fed".

The global fiscal response has been equally impressive and unprecedented. Policy makers in Washington passed the CARES Act in late March committing $2.3 trillion in support of the U.S. economy. The coordinated monetary and fiscal policy prescription is expected to lessen the damage from the pandemic and a restart the economy with a "V" shaped recovery being the best-case scenario. The complexity and enormity of this stimulus is untested, and the shape of the recovery remains quite uncertain. In the meantime, capital markets are likely to remain volatile in the coming weeks and months ahead, but a financial crisis appears to have been averted at this point.

Investment Strategy & Outlook

Clearly, COVID-19 is a "Black Swan" event resulting in dramatic daily swings in asset prices and dysfunction across the capital market spectrum. For more on this topic please refer to our March 20th commentary, "Return of the Black Swan".

The pandemic and ensuing market volatility effectively forced markets to acknowledge the underlying issues in credit and leverage and promptly adjust prices accordingly. However, as with all panic-stricken markets, quality assets get jettisoned with junk, the calling card of the Black Swan. Historically, extreme market selloffs have been excellent buying opportunities for long term investors.

Moments like these will most certainly test any investor's resolve regardless of experience or investment objective.

When markets breakdown and the basic mechanics of asset management such as asset allocation and diversification fail, fear and panic over-ride market fundamentals. We have seen this movie before, we know how it will end. October 1987 and the collapse of Lehman Brothers in 2008 are the two such events in the modern era investors can reference.

However, the unprecedented moves by the Central Bank and Treasury this month and indeed over the last decade, bring into question the unintended consequences of such policy actions that will last well into the future. Excessive debt and leverage, negative real bond yields, deficits measured in trillions and below trend economic growth are just a few of the challenges investors will have to navigate in the future.

Not to diminish the human cost of COVID-19, but the pandemic will be remembered as an exogenous shock that triggered a massive risk off event in the capital markets much like one would expect from a natural disaster. However, it is the unsustainable amount of leverage or debt in the capital markets and unconventional Central Bank monetary policy that is creating distortions in financial assets, a broad mispricing of risk and effectively limiting the capital markets from operating freely to remove distressed and/or failed companies. In my opinion, we are only delaying the inevitable/necessary deleveraging of global capital markets and sovereign balance sheets. For more on this topic, please visit our market commentary published on March 13th which can be found on our website www.stokescaptialadvisors.com under the Blog section.

Clearly there are aspects of the recently announced $2.3 trillion stimulus program that are necessary if not critical. A sudden and protracted shut down of the global economy required an unprecedented global fiscal and monetary response. A rapid restart of the global economy will greatly depend on the successful implementation of these programs. However, it is the asset purchases component that provides the most indigestion for capital market participants. The Federal Reserve's $6 trillion balance sheet now allows for the purchase of ETFs holding non-investment grade or junk bonds via their Secondary Corporate Credit Facility, an unprecedented if not shocking move by the Central Bank that up until now has only purchased Treasury and mortgage-backed securities.

The price discovery mechanism is one of the basic operations for the capital markets. In simple terms, this is the process of determining fair value for an asset by allowing willing buyers and willing sellers to exchange shares at an agreed upon price. When Central Banks intervene in this mechanism, asset valuations can be distorted, and a mispricing of risk emerges. In extreme circumstances, financially compromised businesses continue to operate when markets would otherwise deem them to be impaired and "worth less or worthless".

The Central Bank's dual mandate is very simple, they are charged with maximum employment and stable prices. There is no mention of asset purchases and intervening in price discovery. There is a warning for investors and taxpayers here, there is nothing for free and the massive balance sheets, stimuli and other measures taken by the Central Bank will have consequences down the road for sure.

Finally, I liken my investment advisory role as a pilot or co-pilot guiding clients through an ever changing and elaborate maze of twists and turns so that you arrive at our financial destination on time and in one piece. Admittedly, some days my role is more like a "financial psychotherapist" counseling investors through market mayhem.

The last three weeks have been extremely challenging for everyone to say the least. If there is a silver lining to this crisis, we expect the duration to be less than the 2008 financial crisis and the probability of a "V" shaped recovery remains reasonable at this point. As always, call with your questions. Stay safe, be well.

Performance Scorecard

Benchmark Description	Q1	1 Year
U.S. Treasury 3 Month T-Bill	0.6%	2.3%
Barclays Aggregate Bond Index	3.2%	9.3%
Barclays US High Yield Corp Bond	-12.7%	-7.1%
S&P 500 Index Total Return	-19.6%	-8.0%
NASDAQ Dividend Achievers Index	-16.7%	-4.7%
Russell 2000 Index TR	-30.6%	-24.8%
Alerian MLP Index TR	-57.2%	-61.4%
U.K. FTSE 100 Index USD	-25.8%	-19.6%
German DAX Index USD	-24.8%	-14.9%
China SCI 300 Index USD	-10.0%	-5.2%
Japan Nikkei 225 Index USD	-17.5%	-10.0%
MSCI Emerging Markets USD	-19.9%	-14.8%

Performance Scorecard data as of 03/31/2020. Global economic outlook provided by Focus Economics. Stokes Capital Advisors, LLC is a Registered Investment Adviser. This market commentary is solely for informational purposes. Advisory services are only offered to clients or prospective clients where Stokes Capital Advisors, LLC and its representatives are properly licensed or exempt from licensure. Past performance is no guarantee of future returns. Investing involves risk and possible loss of principal capital. No advice may be rendered by Stokes Capital Advisors, LLC unless a client service agreement is in place.