CLIENT UPDATE

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OCIO

SILVER HAWK PRIVATE WEALTH
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"We continue to hedge our downside risk, but remain allocated in US Equities and Fixed Income in our Core Portfolios"

The S&P 500 index declined -34% from its February highs to the March 23rd lows in one of the quickest selloffs in market history. The Federal Reserve shot a "bazooka" of liquidity at the market, which helped to stabilize the selloff (at least for now). In addition, the Federal Government passed the CARES Act, pumping $2.1 trillion in fiscal stimulus into the Economy. The initial "end of the world" panic appears to have subsided, and the market has rallied back to the 2800 level, recovering about 50% of its losses from the selloff (called a 50% retracement in technical terms).

This sharp, upward move in the market is actually very common in bear markets preceding recessions. However, bear markets normally last 14 months, and we are currently only starting month 2 of this recent bear market. Also, there is a re-test of the lows historically after these rapid market rallies, and some analysts are putting a lower S&P 500 price target at 1750 to 2000 if the market cannot hold those March 23rd lows (around 2200).

But this time is different, right? This is unprecedented, this has never happened before, the Government is taking unprecedented stimulus measures because companies did not cause their financial distress by being bad companies, but because of the forced shutdown. While this may be the case, it does not guarantee that this recession (likely already a depression) is going to be any different than the 11 recessions we've had since 1950 alone.

As you will read in the following pages of the update, there still remains significant risks to the Economy and Financial Markets. We are headed into earnings season, which are expected to be absolutely brutal for most companies, and 15% of reporting companies on the S&P 500 index as of now are not even going to give guidance for future earnings (very rare).

We continue to hedge our downside risk, but remain invested in US equities and fixed income in our Core Portfolios as those of you that read these updates know that I don't believe in timing markets, but instead utilize options as a tool to protect the downside risk of the portfolios. One of the reasons it makes sense to be defensive at these price levels preceding the worst of the recession period is something called variance drain. The S&P 500 fell -34% from its highs back in February and has subsequently rallied 27% from those lows. So then why have we only recovered half of the loss? Wouldn't we need a rally of only17% if the losses were 34%? Confused yet?

This should make it clear:

If I have $100, and I lose 50% of that, then I would have lost $50. So now I have $50, and what type of return would I need to get back to my original $100? I would need a $50 increase in my portfolio to get back to $100, which would be a required return of 100% (I have $50, I need $50 gain, so $50/$50 = 100%). So I lost 50% at the start, but now I need a 100% return just to get back to my original balance.

This is why protecting the downside during times of high volatility is a methodology I believe in and stick to rigorously. Lagging an index by 1 or 2% during large market rallies will not derail a financial plan, but the effect of variance drain can have long-term damage (especially if investors sell near the bottom out of fear of losing everything, then wait to get back in). This can be managed through the use of options hedging.

We are also starting to consider certain asset classes and strategies that benefit in a higher inflationary environment but as stated above, we don't expect this thesis to play out in the short term and will continue to review more data as it comes in. On March 24th we also began shifting a portion of our passive S&P 500 exposure into an actively traded stock selection portfolio as we believe active management will play a larger role over the next two years than it has the past decade.

I hope that all of you are able to find a positive light at the end of this tunnel as I am trying to do myself. I firmly believe that we will come out stronger after all of this, and I am excited to see what the new normal is. If you want to discuss shorter-term details on financial markets, economics, or anything else that you believe would be valuable, email your advisor or give me a call and I'd be happy to have that discussion.

Before getting into the markets and economy, I want to start with some positivity. I always start my days by waking up around 4:30 am, reading my own personal list of things I am grateful for, and trying to fill my head with positivity and gratitude before the workday starts. The past few weeks, I have found this practice becoming more and more important for me as lock downs and stay in place orders continue to isolate me and my family from what we used to think was our "normal" lives. I have found that I've began to spend more and more time with my two daughters (Carter - 5; and Emma -1), and wife Morgan (can't say how old in public) not just doing our normal pre-bedtime routine and dinners, but going on walks, having longer dinners, and playing longer before bedtime and in the mornings. While the level of connection and engagement prior to COVID was most definitely rewarding, the stay at home measure has pushed that to a higher (even more rewarding) level for me. I have also realized that we spent entirely too much money on eating out, and the experience of cooking more and eating with the family at home is actually more rewarding (and in almost all cases, healthier).

I have to believe that there are a lot of people not just in America, but globally, that are adapting to this new (temporary) reality and are starting to realize what really matters to them is not "stuff" and "things", but experiences with those that we care about. This has clear implications for the trajectory of our economy and businesses operating within it.

I also want to talk about some recurring things I see in the media, and give my opinion based on what I know and the research I've done.

The Argument that people should just get the virus, get it over with so they can get back to work.

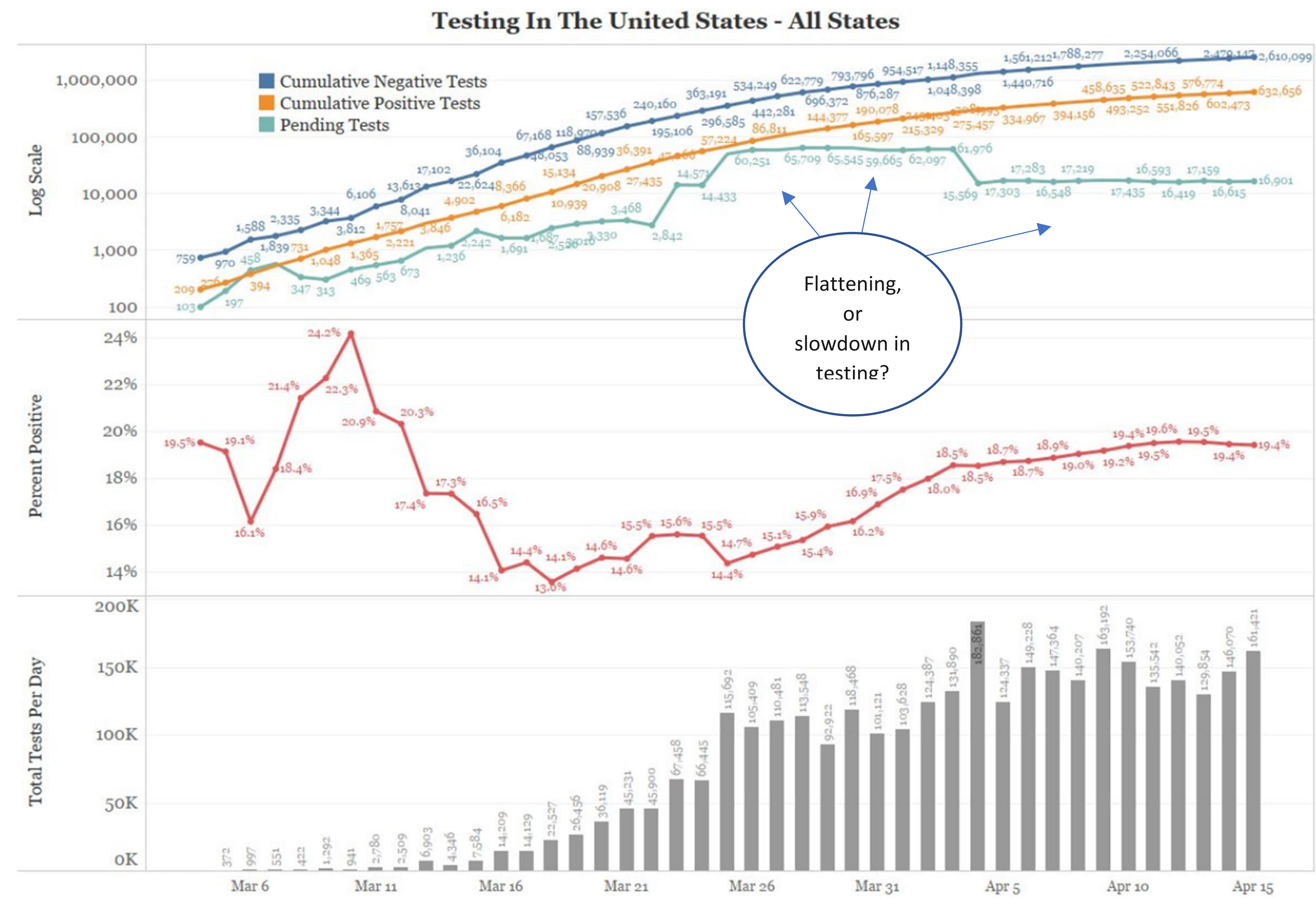
This isn't the chicken pox. I remember reading about "chicken pox parties" when one kid would get chicken pox, and the parents thought it was a good idea to just get all of them together to get infected, then the problem goes away. And what about the health issues we are likely to start seeing within the year of people who have recovered? Damaged lungs, cardiovascular issues, liver and kidney issues, endocrine system, your brain, these are all negatively impacted by the Virus and the lasting effects are unknown at this point. I find this argument to be very concerning and haphazard.

We are going to "Re-Open" the Economy, then the Economy will skyrocket

I'd like for people reading this to respond to your advisors with the answer to this question. If there is no vaccine, and we know people are still getting the virus because we simply flattened the curve and extended the period people would be getting it, are you going to start going to large crowded areas again? Movie theatres? Professional sports stadiums? Amusement Parks? Any crowded place? I don't know the answer to that, but "turning on" the economy does not mean we go back to normal and companies start generating revenue like they were in 2019. Maybe people won't care as much and that does return to normal, but are people going to spend as much money right away? I would say probably not. People tend to save more money coming out of crises, as evidenced by the lower Marginal Propensity to Consume ratios (amount somebody spends per dollar of discretionary income) coming out of major recessions historically. Are they going to take out loans to buy that new car that is twice what they make in a year? Maybe, unless they are one of the 22 million unemployed. That trip to Europe? Maybe next year, sweety? When companies don't generate the types of revenue they were prior to the crisis, they have less resources to hire meaning the unemployment rate will remain higher for some time. Higher unemployment means less income for people to spend, which means less revenues for companies, which means lower availably of credit from banks, and the cycle feeds back into itself. When companies had to borrow during this crisis to pay employees, rent, and expenses they may need to pay that back, which means less cash flow due to the loan payment, which means less ability to hire people and grow their company.

The Virus is Peaking

It appears that the Virus has peaked in New York and New Jersey based on data reported by CDC, but the other 48 states combined (the US minus NY/NJ) made a new daily case count peak on April 17th. Additionally, China, Russia, Saudi Arabia and other countries had new peaks in new cases on April 17th (Exante Data). Also, another metric that isn't talked about enough in these briefings (in my opinion) is the amount of testing that is done daily



Source: Bianco Research, L.L.C.
The COVID Tracking Project
https://covidtracking.com

In addition, just because the Virus may have peaked, doesn't mean that it is going to leave us alone as quickly as it wreaked havoc on us. We flattened the curve to allow our Hospital systems to operate within their capacity. This is a great achievement and I am proud of those involved that have made this a reality. But this also means that the virus is going to last longer and infect just as many people (assuming we don't develop a vaccine this year) as it would have but in a sustainable, controlled manner.

Rates are going to be near zero coming out of this, and businesses are going to borrow and expand like crazy.

Are we forgetting that this is a recession, bordering along the lines of a depression? Businesses are not going to just pop out of this without any damage to their balance sheets. They are going to have lost revenue (and for how many quarters?) which means lower retained earnings, and losses to their capital account. Banks have certain lending criteria when extending credit to businesses, and their debt to equity ratio is arguably one of the most important factors in that determination. Sure, they may get credit extended, but higher risk to the bank means they have to charge higher interest rates to compensate them for that risk. So, despite the Fed lowering rates to near zero, that does not automatically translate into lower cost of borrowing for most businesses.

The Crisis has been priced into the Market in March, and we have bottomed…

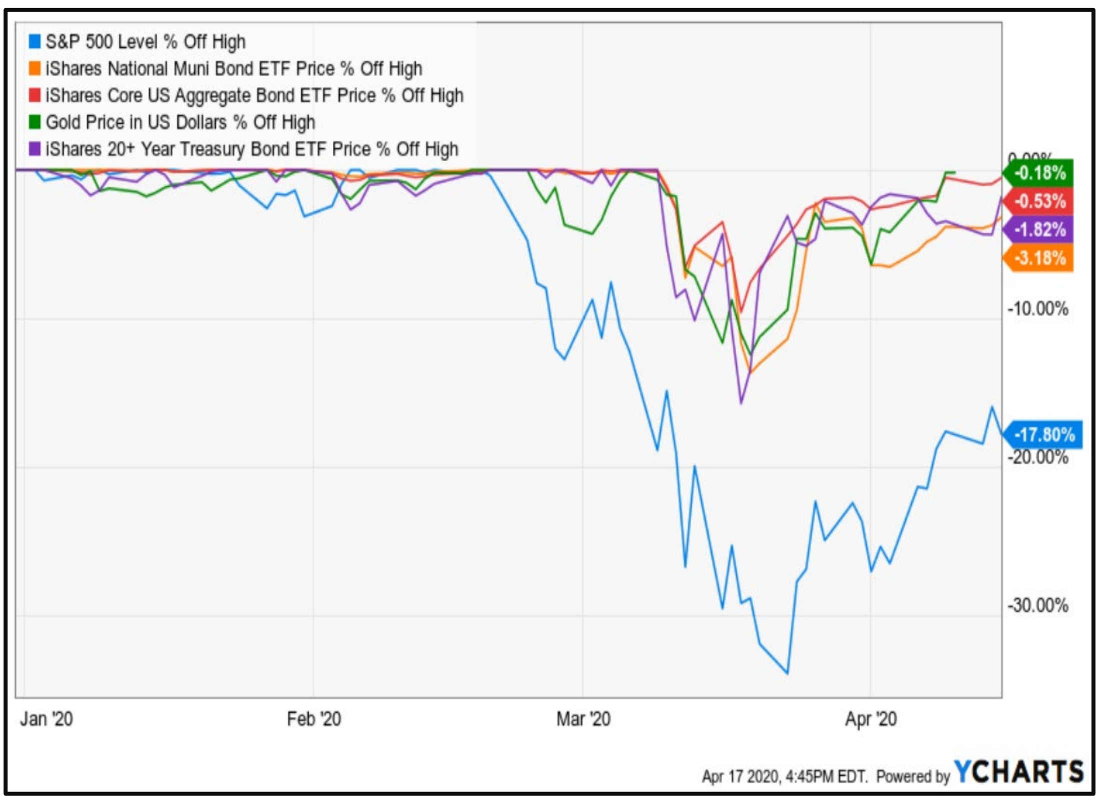
I touched on why I don't think we have seen the full selloff in markets yet, but this is the question that nobody can answer. If they tell you it has bottomed, don't listen. If they tell you it's going to 2000, don't listen. Nobody knows 100%. However, people who read my commentaries know that I generally tend to use most likely/least likely decision criteria that drives portfolio management decisions.

Do you believe that the US Economy and 2-year Financial Market outlook is the same as it was back in April 2019? If you think the stock market is fairly priced, then your answer is yes. Let's compare the two time periods:

Quantitative	Apr-19	Apr-20	source
US Jobless Claims (Total)	1.6 million	22.9 million	department of labor
TED Spread (Stress in Banking System)	0.2	1.08	St. Louis Fed (FRED)
10-Tear Treasury Yield	2.55%	0.61%	St. Louis Fed (FRED)
Federal Reserve Balance Sheet	3.9 trillion	6.3 trillion	St. Louis Fed (FRED)
Annual Fiscal Deficit	1 trillion	4-6 trillion	reuters; washington post; wsj
Forward YoY S&P 500 Earnings Growth Forecast	0.70%	-26.40%	Yardeni research
US Housing Starts MoM	5.95%	-22.25%	census bureau-residential construction
Anecdotal			
Number of US Professional Sports Canceled	0	All	anecdotal
Schools Closed	0	All	anecdotal
% Of Americans Under some form of Lockdown	0%	95%	anecdotal

The answer is clearly, no. We are not in the same position as we were back in April 2019. Hedge the downside. The last thing I'd point out is the NDX (NASDAQ 100; about 50% of the index is MSFT, AAPL, AMZN,

GOOG/GOOGL, FB, INTC, and NFLX) is actually up 15% from this time last year. Apparently, despite entering the worst recession (depression?) since the Great Depression, people are buying Teslas on Amazon, using their new $1500 iPhone while streaming Netflix and updating their status on Facebook. Something is not right with the markets. Hedge the downside.

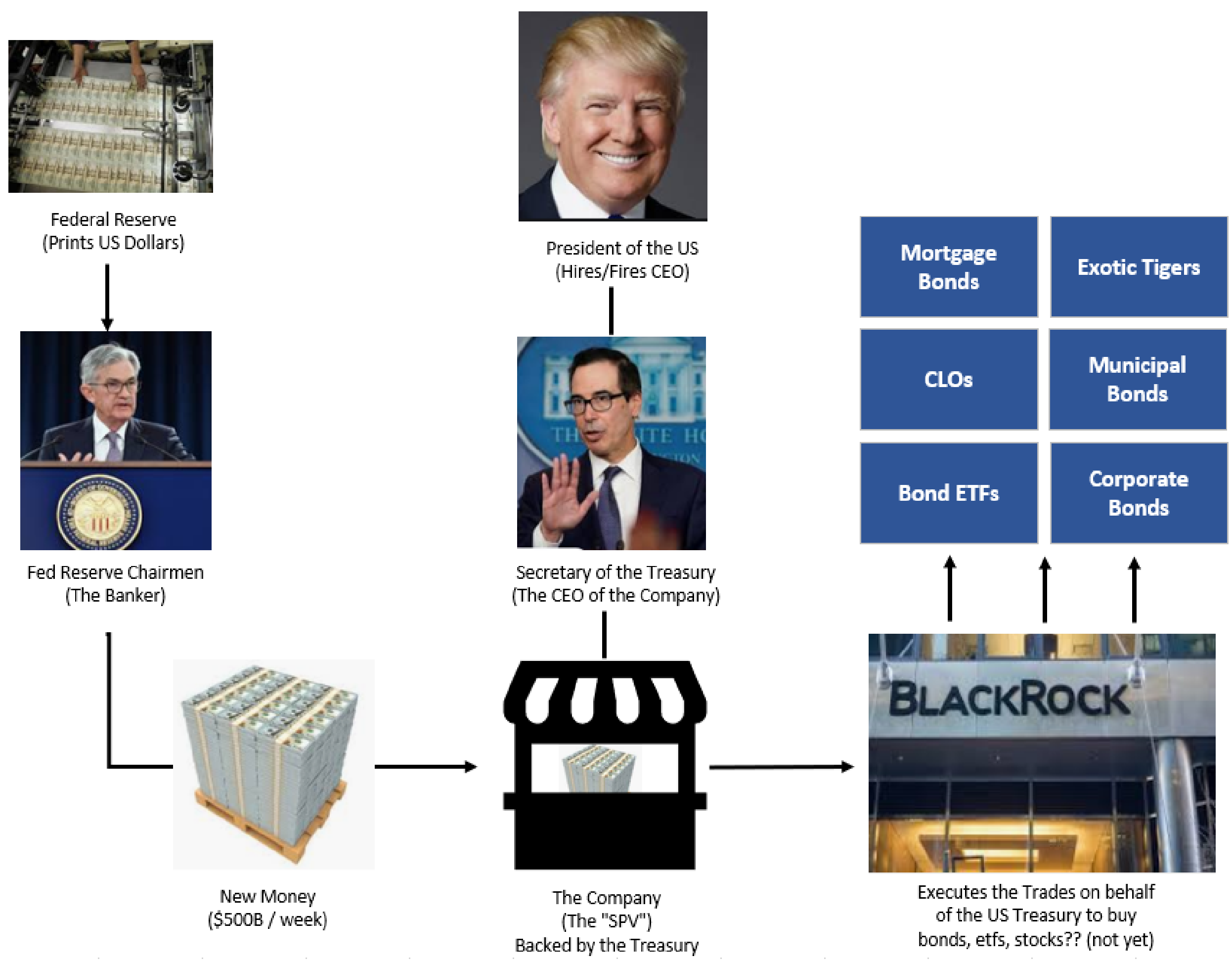


A lot has changed since January 2020, to now (April 17th). There are currently 22 million people unemployed, and this is expected to get worse. To put that into perspective, all of the jobs that were created from late 2010 to March 2020 have been erased. This magnitude of job loss has not been seen since the Great Depression. In addition, financial markets during March were not functioning properly. You had traditionally safe-haven assets such as gold, municipal bonds, and even treasuries along some parts of the curve decline in value as investors rushed to liquidate any and all assets they could in exchange for "cash under the mattress".

This panic also fueled stock market fears while the virus began to accelerate across the globe, ultimately leading to the March 23rd low in the S&P 500 index of 2118 (a -34% drop from the all time highs achieved just a month earlier on February 19th).

Municipal bonds (as measured by ETF MUB) dropped -14% in value in a matter of 10 days. The Barclays aggregate bond index (measured by ETF AGG) declined -10% in just 9 trading days and is supposed to be a diversification component to most "balanced" portfolios. Gold, a traditional safe haven asset where investors go in times of panic, fell -12.5% at its low. I could go on about the various asset classes that experienced similar (in some cases worse when you look globally) fate during this short period; however, this gives you a sense for why the Federal Reserve has taken such massive, unprecedented policy action during this crisis – a topic that most definitely needs to be discussed and understood if you are a long term investor.

What does it mean when the Fed says, "We are going to buy corporate bonds, junk bond ETFs, Mortgage backed securities, etc."? Do they actually go into the market, and purchase those bonds and hold them on their balance sheet? What we learned from the Great Financial Crisis (GFC) is that this is not the case and is much more complicated than most understand. To put it simply, The US Treasury (Steve Mnuchin) is the owner of a company (called a "Special Purpose Vehicle"). Steve Mnuchin is the CEO of this company and serves at the pleasure of the President of the United States (Donald J Trump). The Federal Reserve bank is the bank providing the financing (by printing half a trillion US Dollars a week) to the company to go out and purchase these assets from the financial markets. Did you catch that? If not, maybe this visual will help to better understand what just happened:



The treasury is not actually buying Exotic Tigers. I just finished The Tiger King on Netflix after weeks of peer pressure by friends and family. I am fairly certain the treasury is not suited to care for wild cats (but they continue to surprise me with what they are capable of so who knows).

So, what are the longer-term implications of this newly created "Special Purpose Vehicle"? **Fed Chairman Jerome Powell** has **stated multiple times** during press conferences that every time the start another one of these programs, **they need the Treasury's permission**. Steve Mnuchin, the "Treasury" for all intents and purposes, works at the pleasure of the President. So, Powell needs Trump's permission before they slow down if the data is telling them to do so. In the words of one of the most well-known Global Research Analysts Jim Bianco, **"The Fed just handed over the printing press to Donald Trump."** The Fed has said that when the time comes, they will start to unwind these programs and reduce their quantitative easing. Not to get political one way or another, but going into an election in November, do you believe that President Trump is more likely to say, "okay guys, you're right let's start slowing down and reverse course"? I'd argue the more likely scenario is something to the tune of "I want the printing press running 24/7 and the Dow at 30,000 by November". President Trump has been all over the Fed to push rates into negative territory and keep QE going for the past two years. The implications of him now having a say in how long, how much, and when it stops are concerning to say the least for the long-term health of financial markets and the American economy.

Probably the most obvious implication of these programs running too far, too fast, and too long is going to be inflation. Again, this isn't a short-term problem, but in 2021 and 2022 is when all of this money printing and asset purchases may begin to lead to inflation. The amount of inflation will be dictated by how long and how much the Fed continues to print, but if inflation starts to increase and they continue to print out of fear of what will happen to the markets if they stop, that is when the inflation figure can start to get out of control. They tried to stop QE back in 2013, and the market gave a "taper tantrum", where US treasury yields skyrocketed, and again in 2018 when the US Equity markets fell -20% until the Fed quickly reversed course completely and began decreasing interest rates, which then led to a 2019 rally of 28.9% in the S&P 500. There is essentially a feeling in the market (at least from my perspective) that the Crisis has been priced in, there are no more real risks to the economy, and the Economy is going to be flipped on like a light switch at the signs of a peaking virus. I'd draw one comparison to 2008 here, which was somewhat very similar in the way I believe this ***could*** play out ***if*** earnings come back worse than expected this quarter and next.

In March of 2008, the market had declined -16% from the highs made in November 2007, then we had a rally from March to May that "retraced" the decline by 50% (the market rally recovered half of the losses (8%)). What sparked that rally? The Federal Government's bail out of Bear Sterns, which got into financial trouble by holding highly leveraged sub-prime mortgage bonds (not unlike nearly all the big Wall Street Firms). JP Morgan secured guarantees from the Federal Government before they purchased Bear, essentially making this a Government bailout. The market subsequently rallied and recovered half of the losses by May, then traded relatively flat until the fall. Then that September, Lehman brothers (another long-standing Wall Street Bank) collapsed, and the market fell another 38% from that point until finally reaching its bottom. 50% retracements happen all the time throughout market history. The market has a panic selloff, the Fed jumps in, then everybody thinks it's over, and then the real damage in the economy becomes apparent as we get more data and the market then turns back over and decreases below the previous lows. Fast forward to March 2020 - this feels similar in many ways. The market fell -34%, then the Fed stepped in and released their stimulus to bail out companies and lend to small businesses. Then they announced they're buying assets to stabilize financial markets (discussed above with the exotic tigers). The Market from March 23rd until now has retraced nearly 50% of the losses, and analyst have revised their statements and projections that March 23rd, 2020 was the low, the Fed will save us, and we are out of the Crisis. I believe the parallel to 2008 will become apparent once we start seeing earnings come out this quarter, which ultimately gives us insight into what is happening with the balance sheets of US companies.

Watching balance sheets is going to be important, because if a company reports a loss of revenue of -50%, that isn't just an "earnings miss". That is a hit to their capital account and changes the structure of their balance sheet, which doesn't correct itself quickly and if people can't go out and buy that companies product, this will continue until they eventually fail. Nobody thought Bear Sterns or Lehman were going to collapse back in 2008. The earnings had not yet reflected the actual damage in the economy, and the short-term thinking of the market shrugged the crisis off and though we were headed to all-time highs again.

We are going to start seeing the initial impact and magnitude of these shutdowns when we get earnings statements over the next three weeks. During this past rally, we have been in this sort of "data-limbo" where some of the data reflected January and February prior to the Stay at Home measures and acceleration of the Virus, and the Fed bazooka stimulus created a sense of hope. Over the next three months we will have a better understanding of how bad this is, and how long this might take to recover.

The virus has changed (and will continue to change) the way our economy and the people living within it behave, and in my honest opinion, for the better. I think you are going to see a more rapid movement into the work-at-home trend that has been occurring the past 5+ years, as people have been forced to learn how to do this. I think businesses are going to see they have a lot of wasted real estate and may begin to leverage technology at a quicker pace (this was already occurring) to have more meetings through video conferencing and less travel. People also are going to likely save more money coming out of this and use less debt (not a bad thing) which would have clear implications on the pace of growth in the economy, but reduce financial burdens and anxiety for a lot of people. Perhaps the most interesting change that could come out of this (and something I believe you'll start seeing more and more of on the news) is the relationship between China and other World Economies. Japan has already said they are going to pay companies to bring their supply chains back within their borders. Larry Kudlow has hinted at this by saying we should be paying the cost that US companies would incur to bring their supply chains back to America. It will become a National Security question, where Congress and the Government will have to make a determination on how smart it is to have critical medical supplies, pharmaceuticals, and medical equipment made oversees. Consumers and businesses will have to adapt to the post-COVID world, and they will. We are a highly adaptable, innovative nation. Business owners have to ask themselves not "how do I rebuild my company" but "if I were starting a company today, what kind of company would I build?". The world after January 2020 will be very different than the one we knew before, some good, some bad. But embracing change is good and thinking of how you'll adapt and move forward is a worthwhile exercise.

Nearly all of our clients are long term investors. and over the next 2 to 3 years I believe the risk is to the downside of where we currently sit based on a number of factors, as discussed above. The stimulus cannot go on forever, the Virus can always re-emerge in the fall or next year (Vaccines generally take 4 years), companies are more likely than not to eventually default and some will go bankrupt, and 22 million (and counting) Americans don't just get back to work in short order.

Lagging the market during a false rally by 1-2%, while it might trigger a "fear of missing out" reaction in some people, is not going to derail a retirement plan or financial goals. But what will derail a retirement plan or financial goal is a locking in a 50% loss in a portfolio after a panic and subsequent liquidation of the portfolio for the classical investor mistake of selling low, and then being fearful to get back into the market (leading to buying high). Options hedging reduces this "tail risk" significantly and helps to lower the anxiety levels an investor will experience if the market begins to retest those March lows again. Our investors who were with us the past quarter experienced this first-hand, and experienced the tradeoff of slightly smaller upside, in exchange for catastrophic downside protection. There will come a time when these risks to the economy have subsided, and there is clear runway for a new bull market. Until then, we will continue to stay invested, and protect the downside risk of the portfolios.

General Disclosures