Morris Capital Advisors, LLC

Investment Commentary
March 31, 2020

Ripping Up the Playbook

In 2013 Jeffrey Laurie, owner of the Philadelphia Eagles, hired Chip Kelly as the new head coach of the Eagles. Kelly, head coach of the University of Oregon, came to the NFL and “tore up the playbook” installing his up-tempo offensive scheme, heretofore untested at the NFL level. Kelly lasted less than three years with the Eagles and Laurie replaced him with Doug Pederson, a coach with more traditional NFL background. Pederson essentially “tore up the playbook” once again, leading the Eagles to their first Super Bowl victory just a few short years later.

The playbook for the financial markets seemed solid as the new year began. Stocks traded up, interest rates were low, inflation remained quiescent, and Fed policy somewhat accommodative. The economy continued to grow, with expectations that Gross Domestic Product, a measure of the total economy, would grow faster than preliminary reports of growth in the final quarter of 2019. Strong job growth contributed to declining unemployment claims, an unemployment rate of 3.5% (among the lowest in recent memory) and discussions of labor supply shortages across many industries. The news, highlighted in the State of the Union address, may well have prompted Nancy Pelosi to “tear up the playbook” in frustration at the end of the speech. Little did she know that just a few short weeks later a combination of events would make those histrionics seem trivial.

As the stock market rose to new highs in mid-February, two unrelated events combined to disrupt everything. The novel corona virus delivered both a demand-shock and a supply-shock to economies throughout the globe, while an oil price war initiated by Saudi Arabia and Russia drove the price of oil to new lows and threatened the existence of domestic energy exploration companies. As Covid-19 quickly morphed from an outbreak in Wuhan China to a global pandemic, governments imposed stay at home orders with dramatic consequences. Demand dropped as consumers on lockdown curtailed purchases, while corporations were forced to curtail operations and furlough employees. Manufacturers that continued to operate struggled to overcome supply constraints as global supply chains were disrupted. In just 23 days the steep decline in the stock markets exceeded the crash of 1929. Stocks rebounded somewhat during the last week of the quarter but the rebound was not nearly enough to offset the steep decline.

The playbook for the Covid-19 crisis has been clear, the response for the oil price war less so. The Fed cut interest rates to near zero with two moves in rapid succession, and announced several measures to backstop the financial system. The Fed expanded repo operations and dollar swap lines to provide liquidity. They expanded asset purchase programs for mortgage securities, investment grade bonds, and for the first time included non-investment grade (junk) bond ETF’s, as well. The inclusion of non-investment grade ETF’s is significant because it demonstrates how far the Fed will go to keep the financial markets functioning. At the same time the Federal government announced stimulus payments directly to taxpayers, expanded unemployment benefits, small business lending programs, and a payroll lending program designed to compensate smaller companies who retain employees at 2019 levels. Remaining unresolved, however, was a strategic response to the willingness of Saudi Arabia and Russia to drive oil prices to unsustainable lows in an effort to crush US energy exporting capacity.

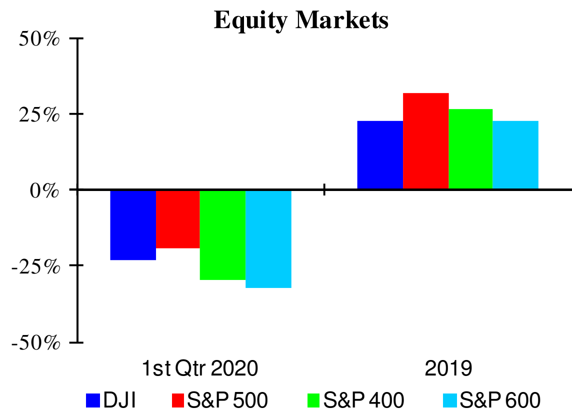
With no expertise in the coronavirus, my knowledge is limited to what I have read, analysis often written by those who have no more expertise in epidemiology than I do. So while I claim no medical qualifications, I believe that our market-based economy fosters innovation that will ultimately contribute to a cure for the coronavirus and defeat the pandemic. It will take some time to move past the pandemic lockdown, but as we do the dynamic nature of our economy will reassert itself. The process has been difficult, but it could yield structural changes that could potentially benefit our economy in the long-term. Companies that became overly reliant on global supply chains, based solely on cost considerations, could move essential operations back to the US, expanding domestic employment. Increased capabilities to work remotely could reduce employee costs and improve productivity. The adaptability of our economy and resourcefulness of our people will enable us to survive this crisis and emerge stronger for it. As that happens, we believe that the economy will rebound and the financial markets will improve. In periods of extreme uncertainty it is important to remember that market volatility can potentially create investment opportunities in structurally sound, well managed companies. While the current severe financial distress will impact companies throughout the economy, we believe that our focus on balance sheet quality may benefit our investors. Our playbook will be to avoid overreacting to emotionally-driven market moves and continue to invest in companies that have strong long-term prospects trading at attractive valuations.

Sincerely,
Daniel A. Morris

Market summaries on reverse page

Morris Capital Advisors, LLC

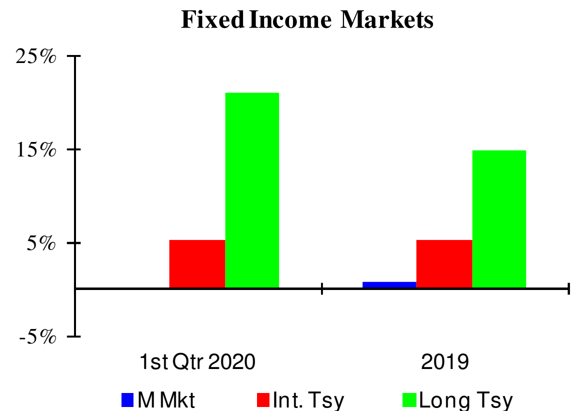
Market Summary
March 31, 2020



Stock markets began quietly in the first quarter of 2020, with momentum carrying over from a strong Q4 2019. That changed as markets reacted to news of the spread of the novel coronavirus in Wuhan during late January, but the reaction was muted as Chinese authorities seemed to react aggressively to contain the spread.

By the last week in February, however, it was clear that the virus was spreading globally. The equity markets responded with increasing violence as it became clear that public health authorities were reacting very rapidly by halting social interactions and with it many forms of commerce. Investors were forced to mark down revenue estimates sharply for commercial and public entities, which raised the specter of collapsing earnings and inability to service debt obligations. This rapid repricing of risk happened in the context of poor liquidity and markets that had started the year "priced to perfection" following more than a decade of very loose monetary policy. This in turn led to a forced unwinding of highly levered investment strategies that were suddenly caught wrong-footed.

The markets bottomed in mid March as the Federal Reserve unveiled an unprecedented array of lending and asset purchase programs, complemented by a massive surge in Federal government spending. Equity markets staged a sharp rally from the bottom, but closed the quarter with significant losses. Small cap securities underperformed large cap indices, and economically sensitive issues fared much worse than defensive names.



Yields on U.S Treasury bonds started 2020 at a relatively high level, having gradually priced in prospects for accelerating economic growth during 2019's fourth quarter. The markets pivoted quickly, however, as the COVID-19 contagion gathered steam. As the quarter progressed it became increasingly clear that the global economy was facing an unprecedented collapse in activity, exacerbated by a poorly-timed price war in the oil markets. By early March a massive flight to quality had pushed yields on US Treasury paper down to levels last seen in the financial crisis.

By mid March asset markets were being liquidated wholesale, and poor liquidity soon forced that selling into Treasury bonds. Over the course of a week yields had almost doubled, and there was mounting evidence that even the most liquid market in the world was unable to properly function. At that point the Federal Reserve stepped in with an unprecedented array of lending and asset purchase programs in the markets for US Treasury securities, mortgage-backed bonds, and even municipal and corporate paper. By the end of the month the balance sheet of the Federal Reserve had doubled in size.

Treasury yields by quarter's end had returned to their lows. As a result, longer-dated bonds enjoyed strongly positive total returns.