Commerce Trust Company
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April 13, 2020: UCM Foundation

Amy Pieper:

Good afternoon. My name is Amy Pieper and I am joined by my colleague Matt Schmidt. Matt and I are privileged to serve as the client service team for the UCM Foundation, working with Courtney Goddard, her staff, and your dedicated board members. We deeply value our 25-plus year relationship with the University of Central Missouri. We commend the university on its commitment to its students and faculty as they navigate this complicated situation.

We all know that we have been experiencing unprecedented times. As we make our way through the current pandemic health crisis and its effect on our economy, Courtney Goddard asked us to share Commerce Trust Company's current view on the situation along with the recently enacted CARES Act, which is designed to provide some immediate economic relief. Matt, can you provide an update on the current economic situation we are facing?

Matt Schmidt:

Thanks, Amy. We are clearly headed into a recession and it's likely to be the deepest recession this country has ever experienced from peak to trough except for the Great Depression. The depth and speed of this recession were highlighted by tracking those recently unemployed. New unemployment claims grew by roughly 10 million people in the last two full weeks in March. Note that there were about 158 million employed in February.

These new claims, filed weekly via each state's unemployment office, suggest unemployment has already surged from its 50-year low of just 3.5% towards 9 to 10% today. To put that in context, 10% was the peak unemployment rate during the Great Recession in October of 2009. Furthermore, the near total shutdown of most states, including California, the world's fifth largest economy, which is just a touch bigger than the United Kingdom, Florida, and even the country of India recently, suggests the second quarter of contraction is still likely underestimated, although estimates have fallen in recent days.

While we expect first quarter growth to be reported as modestly negative, the second quarter GDP could easily contract between 6% to 10% nominally. This equates to a minus 24% to minus 40% headline number since GDP is annualized. Right now, that is still worse than market consensus, but the consensus is quickly catching up.

Amy Pieper:

Matt, when do we feel forward economic progress may be made?

Matt Schmidt:

Well, while GDP will show a sharp and unprecedented rapid fall over the first half of the year, by the end of the third quarter, we should be improving off a very low second quarter bottom. Ultimately, in the fourth quarter, we could show signs of normalcy and see positive signs of growth when employment returns, schools reopen in the fall, retail slowly gears up for Christmas, and pent up demand provides positive momentum to battle a second round of winter coronavirus concerns.

The average historical recession in the US has lasted 11 months. We believe third quarter GDP will look better than second quarter and find it hard to envision the US economy won't be making significant forward progress before the end of the year. While there are comparisons to show the US is already behind most other country's virus curve, a better comparison would be to compare the US to the entire European Union, which has a comparable population and a regional approach to controlling the virus.

It is fair to say we have just started to see a slight bend in our overall infection curve, giving hopes that we are starting to see a flattening of the curve with some progress made in Washington State and New York. The next two weeks will be very telling and optimistically it appears material progress is likely to be made after mid-April in our fight against the virus.

The key event we believe will provide a signal to the markets to fully bottom and make forward progress will be when the rate of acceleration in new coronavirus cases begins to decline and eventually fall on a day over day basis. This should happen first in Europe, new cases in Italy are falling already, and then just after that in the US since we seem to be on a similar path.

Amy Pieper:

What about the recent federal stimulus package?

Matt Schmidt:

The CARES relief package helps stabilize a falling market. In late March, Congress passed a $2 trillion fiscal package representing a bit less than 10% of yearly GDP. Equally important was the Fed's announcement of additional quantitative easing plus the reinstatement of several programs designed to provide liquidity to the high-quality fixed income security market.

One of the most impactful programs from the stimulus package is going to be some leveraging of risk capital that the Treasury will provide to the Fed so they can buy riskier non-government investment grade bonds and lend money directly, helping to free up markets that have become frozen and tamp down the widening of credit spreads in short term high quality bonds.

Fortunately, the potential positive impact of these programs has already reversed some of the risk off trade and is assisting the markets in finding a bottom. So, we doubt it is the only near-term catalyst needed to reverse this risk off trade entirely. We still need to see tangible progress on slowing the coronavirus outbreak to see further market stabilization.

Amy Pieper:

Now, let's discuss the stock and bond market. When will the stock market bottom or has it already? Also, what has all of this meant for interest rates and bond investors?

Matt Schmidt:

Well, while none of us know how the coronavirus spread will end, we do know how equity markets historically have reacted after a sharp 30 plus percent decline. With the S&P 500 falling almost exactly 34% from its record high on February 19th, the equity market made a violent reversal to the upside, rising by an impressive 20% which generally lasts a few days spurred by some news. In this case, the news of the CARES relief package.

Unfortunately, the rally stalls and over the next couple of months, the markets test the lows from March 23rd, with a 69% chance of a new lower low. While the relief rally was comforting, we unfortunately believe there will be further testing of the low over the coming months. The average bear market finds a bottom about a year after its peak and four months prior to the recession's end. If our recession quickly ends by the end of the third quarter of 2020, that would optimistically suggest we can get an all clear signal at the end of this May.

Well equity markets can decline further; they have already declined two thirds of the total average decline we have experienced in the worst bear markets since 1900. Those being 1938, 1974, 1921, 1907, and 1903, with the exception of the 1929 to 1932 bear market when the markets fell 80%.

Interest rates at the short end of the curve will be planted at zero for years and Treasury rates are likely to decline as the year progresses. The initial round of quantitative easing is taking hold and driving mortgage rates down, affording many homeowners a chance to refinance. This has begun to spill over to the credit and municipal markets, helping to contain the initial jump in interest rates and decline in prices for those assets. It is quite possible we've already seen the maximum widening of investment grade credit spreads early in the week of March 23rd, as we saw municipal and corporate bond yields decline in the latter part of that week.

Most bonds, even investment grade bonds, have some credit risk and when stock prices fall, risks clearly arise and impact the credit spreads, investors demand to own riskier bonds. The spreads have stopped rising as the stock market finds a bottom. In addition, as investors look for any type of liquidity, they sold whatever they could and that tended to be their bonds. The securities have experienced the lowest losses, the return from the investment grade corporate index from the first quarter was negative 4.05%.

Amy Pieper:

Matt, what guidance would have for investors listening to this message today?

Matt Schmidt:

The best advice we can give to investors is to remain calm and avoid the panic that can come with subjecting yourself to the barrage of negative reports about both the COVID-19 pandemic and the economic crisis. Often the worst times in the stock market tempt investors to change their long-term strategy at inopportune moments.

We encourage investors to examine upcoming needs they may have for liquidity and ensure they are in a position to meet those obligations. It is also important for investors to review the risk tolerance and ensure it meets their long-term objectives in more normalized economic circumstances. Commerce Trust has been working with our personal trust clients to re-examine financial plans and have also been developing relationships with new customers that may not be receiving the level of information and guidance they need from their current financial advisor.

Your financial advisor is in place to help you understand what is going on right now and react in a way that removes the emotion out of your investment decisions, while still meeting the financial goals that you have for you and your family. Every situation is unique, and it is important for you to work with your advisor to create a customized investment plan that works well for you.

Now, Amy, let's switch gears a bit. Outside of investments, are there any other areas that individuals should be aware of as it relates to the CARES Act?

Amy Pieper:

Thanks, Matt. With the impact on both the health and economy of our nation, the CARES Act provided some additional charitable giving incentives as well. With the situation we are in, it will take continued donor support to ensure nonprofits can serve their mission within our communities, including the UCM

Foundation. Some of the provisions of the CARES Act make giving more advantageous from a tax standpoint.

First, every taxpayer will receive an above the line tax deduction for qualified charitable gifts up to $300. This applies to all 2020 cash contributions to qualified charities. Next, the Act increased the qualified charitable deductions limit for cash gifts in 2020. For individual taxpayers, cash contributions to public charities are subject to a limit of 100% of adjusted gross income in 2020. This is up from the 60% limit.

This increased incentive does not apply to donations to supporting organizations or donor advised funds. Additionally, cash contributions made by corporations to public charities in 2020 are subject to a limit of 25% of pretax income, up from 10%, and the excess contributions over this limit may be carried over.

Matt Schmidt:

Thanks, Amy.

Amy Pieper:

On behalf of Commerce, we appreciate your time and listening to our podcast designed for the alumni and supporters of the University of Central Missouri. If you have questions or would like to discuss your personal situation, please reach out to Courtney Goddard and she can provide our contact information. We wish you all a safe and healthy spring.

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