BRIDGES | TRUST®

March 20, 2020

Dear Bridges Trust Client:

Below is our Market Commentary from Bridges Investment Management's Investment Committee as of March 20, 2020.

THE NATURE OF CYCLES

Our most recent *Market Commentary* letters began discussing the probability of a recession in the Summer of 2019. In them, we highlighted limited visibility, a slowing economy, decelerating earnings growth, and an inversion of the yield curve (*when short-dated bonds yield more than long-dated bonds, often seen as a predictor of recessions*).

With so many indicators flashing yellow, it's fair to ask why didn't we sell equities, move to cash and take a few months to work on our short game? In other words, why didn't we just 'time the market'? For starters, we didn't see equity valuations as particularly egregious. Many of our portfolio companies were and are continuing to grow at above market rates. And as we emphasized then, predicting recessions with any level of consistency is nearly impossible. While some may occasionally succeed, most fail, and the returns they forfeit often dwarf the downdrafts they avoid. Inherent in stock ownership is the risk of capital loss (both real and on paper) and it's precisely because of that risk, that over time, stocks have tended to provide better returns than other asset classes. It's also human nature to want to sell stocks at precisely the wrong time, which is one way we seek to add value as your investment manager.

We ascribe to the adage that investing is at its best when it is most business-like. And if one is going to own a business for any length of time, it is inevitable it will be owned through a soft economy. Since they cannot be predicted with any accuracy, you should only own businesses you would be comfortable holding through a recession. Unfortunately, it looks like that time is now.

THE NATURE OF SHOCK

We first published our thoughts on COVID-19 in late February. In it, we said there "will be an economic impact and earnings will come down," but that if previous epidemics were illustrative, the effects would be transitory in nature. Since then, the World Health Organization has declared a pandemic and U.S. cases have grown from 14 to over 10,000*. Epidemiologists are unable to predict how the virus responds to warm weather, if we will develop herd immunity or if it will be a recurring fact of life. Vaccines are being explored but timelines and their ultimate efficacy is unknown.

As it relates to investing, it's fair to say this is a new environment. Given containment measures to flatten the curve, prior health crises are no longer a useful frame of reference. The global economy is grinding to a halt. Airlines have cut capacity 70%, hotels are running at 10% occupancy and restaurants and stores have closed or curtailed their hours. Because these industries employ millions, we expect a meaningful increase in unemployment.

It's important to highlight the fundamental difference between a cycle and a shock. In a cycle, businesses and consumers have time to adjust to the operating environment and plan accordingly. Forecasts are made and scenarios tested. In a shock, demand plummets and businesses that were full three weeks ago find themselves closed indefinitely. Shocks are infrequent and, by definition, unpredictable. Sadly, many small businesses are likely to fail. But businesses with sound balance sheets, flexible cost structures and crisis management capabilities will likely emerge stronger and more resilient.

WHAT WE EXPECT

In the fourth quarter of 2008, U.S. GDP declined 8.4%. We would not be surprised to see a similar decline in the second quarter. There is little precedent for a quarantine of this magnitude. Many point to the Spanish Influenza of 1918, but we suspect that has limited relevance given both advances in health care and that we're a far more mobile, urban society.

The U.S. Federal Reserve has been aggressively easing, cutting interest rates first by 0.50% on March 3rd and another 1% less than two weeks later. We have seen signs suggesting a credit crunch, including gyrating rates, volatile commercial paper markets, rapid spread widening for credit-sensitive issuers and U.S. dollar swap rates roiling emerging markets. While the Fed's actions are welcome, especially around liquidity, we suspect lower interest rates will have little effect on demand as long as quarantine measures are in place.

Since no good crisis goes to waste, we should also mention the oil price war between OPEC and Russia. When negotiations for a further supply cut fell apart, Saudi Arabia implemented a volume-over-price strategy, flooding a market already awash in oil. Whether designed to curtail U.S. Shale production or incent Russia back to the bargaining table, a 60% decline in oil prices is a material headwind to economic growth. Combined with the virus impact, this is a one-two punch that would cause even the strongest of economies to stutter and stumble.

In short, we see a recession as extremely likely and its ultimate duration is unknown. Many are hopeful for a sharp recovery in the third and fourth quarters, but viruses frequently have a 'second wave.' Lawmakers are discussing over $1 trillion in stimulus measures that could help cushion the impact. But as previous measures have demonstrated, stimulus often softens the blow but does little to reverse an economy's trajectory. We expect further equity market volatility, disruptions in credit markets, a dash for liquidity and corporate bankruptcies, especially in energy and retail.

HOW WE'RE POSITIONED

Just because we've opted not to market time, doesn't mean we've sat on our hands. While each client's circumstances are different, the following broad strokes hold true across most portfolios.

1. Ensuring clients have sufficient liquidity to withstand market volatility.
2. Favoring strong balance sheets with ample interest coverage.
3. Pruning economically sensitive stocks while tilting towards durable growth.
4. Targeting companies with variable cost structures where profitability is less sensitive to changes in demand.
5. Investing in companies with excess cash who can capitalize on dislocation.

While our equities haven't been immune to the bear market, we believe our portfolio of companies are positioned to navigate challenging times. Many companies will report down earnings in 2020 creating the risk of further declines. But as we have often said, as an investor your time horizon is one of your most valuable assets. For those able to tolerate volatility, we see attractive companies trading at a fraction of what they were just a month ago and well below our estimate of long-term fair value, assuming an eventual economic recovery and normalization of valuation metrics. While times are trying, we maintain a strong conviction that corporate America will successfully navigate this shock, and over-time, increase earnings at acceptable rates.

We appreciate your confidence and trust in our firm, and as always, if you have any questions, please don't hesitate to reach out to your relationship manager.

Bridges Investment Management Investment Committee

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