Eastern Bank
wealth management
JOIN US FOR GOOD®

INVESTMENT PERSPECTIVES
>> SECOND QUARTER 2020

The shape of things to come

By Michael A. Tyler, CFA
Chief Investment Officer,
Eastern Bank Wealth Management

It's often said that markets ride up escalators and go down in elevators — but sometimes they just hurl themselves over cliffs, as happened this year. The way back up the hill usually involves many switchbacks, a few surprising descents, and a tough slog; ask any experienced hiker.

The Covid-19 pandemic will crest and fall, as all viral epidemics do; it may come back in a second or even third wave. As the virus works its way through society and as society collectively adapts to its presence in our lives, we are faced with two simultaneous challenges: How to invest our clients' funds in the near term (see overleaf), and how to think about investing in a post-pandemic world.

The current episode is just a moment in time; it is not the new normal. But what will the new normal look like? Many investors initially expected a steep "V-shaped" market reaction to Covid-19; the economy would take a deep but temporary hit, stocks would be battered for a while and then jump right back to prior levels, and life would resume right where it left off. That outcome seems to be naïve and unlikely. True, the left half of the V was steep; the economy followed the markets right off the proverbial cliff. But the recovery is likely to be more spasmodic, prolonged, and challenging.

Human nature is eternal; we are who we are. Economies and markets, like all human creations, are subject to the ebb and flow of our collective emotions. We can invest successfully through this episode by setting our own emotions aside and by learning from past crises. Perhaps the most important lesson from recent recessions and bear markets is that recovery takes time. As Karen Carpenter memorably sang,

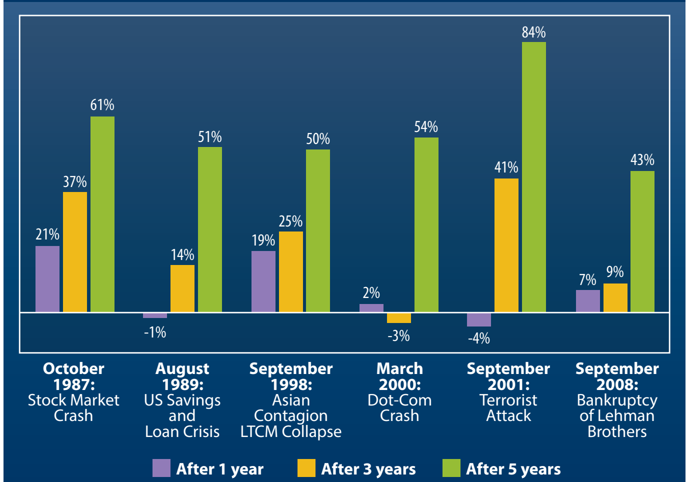
But it's going to take some time this time
And we can't make demands
But like the young trees in the wintertime
We'll learn how to bend.
So, it's one more round for experience
And we're on the road again.

Americans are resilient, and so is our economy; our jobs, our incomes, our spending, and our assets will all recover, but they need time. Following the crest of the pandemic itself, companies may be slow in recalling their workers, fearful of shattered supply chains and vaporized demand; some companies may have gone out of business awaiting a recovery that came too late. Workers may not want to head back to their jobs if they fear infection there. Consumers may stay away from restaurants, movie theaters, and airports until they regain confidence in public health. All of these impediments to recovery will fade over time.

In each of the two previous bear markets of the 21st century, investors were similarly paralyzed by their fears. Corporate earnings rebounded ahead of risk appetites, so equity markets took a long time to recover. We think this pattern may recur, resulting in a slow recovery with several false starts along the way. Some sectors and companies will find new vitality, while others may never fully recover. In other words, equity markets may skip the escalator in favor of a hard trudge up the stairs.

Then why invest in stocks at all? Why not wait a few months, or years? As the chart nearby shows, a disciplined approach of regular rebalancing has resulted in superb five-year returns, even when measured from bull market tops (i.e., from the very beginning of every one of the past eight bear markets). None of us can pick market bottoms or tops with any consistent skill; it is the discipline to stick with the program — including buying and holding stocks through a bear market — that brings about the best long-term results.

CUMULATIVE RETURN FROM BULL MARKET TOPS — 60% STOCKS, 40% BONDS



Even from the tops of bull markets, long-term returns through bear markets have been robust.

Source: Dimensional Funds Advisors

>> FOCUS ON PLANNING

Is now the time for a Roth IRA conversion?

By Sarrah Samraoui, CFP®, CISP, CTS™
Financial Planning Officer,
Eastern Bank Wealth Management

A volatile stock market can offer a great opportunity to diversify your asset location — taxable, tax-deferred, tax-free — by converting some or all of your tax-deferred assets into a Roth IRA. Converting holdings that suffered a loss during the 2020 bear market allows you to acquire a larger number of shares at a lower price, and potentially to recover the gains tax-free in the new converted Roth IRA account.

Not only does a Roth IRA conversion reduce future tax liability and allow you to grow some assets tax-free, but it can also be a great technique to transfer tax-free wealth to the next generation. Additionally, with a Roth IRA you are not required to take a required minimum distribution during your lifetime.

The converted amount is considered taxable income in the year of the conversion, taxed at your current marginal ordinary income tax bracket rate. That's why transitioning to a Roth in the midst of a bear market can be advantageous, as the converted amount is likely to be smaller, therefore generating a smaller tax liability. If the Covid-19 pandemic has adversely affected your income from work, that may also reduce the tax rate applied to the conversion. Even though you will pay taxes sooner and lose the benefit of tax deferral, the long-term advantage is that the account can grow tax-free and penalty-free — and if the IRS requirements are satisfied, future withdrawals could be tax-free as well.

Furthermore, in addition to the market volatility, two recent law changes make a Roth IRA conversion a potentially wise planning strategy. First, the Tax Cuts and Jobs Act lowered the tax rates, but the lower rates will sunset on December 31, 2025 and then revert to higher 2017 brackets. Second, the SECURE Act ended the "stretch IRA" for certain non-spouse beneficiaries and added a new 10-year distribution rule, which will accelerate the liquidation of an inherited IRA and consequently could be a tax burden for some beneficiaries. Therefore, inheriting a Roth IRA can save heirs significant taxes.

To learn more about how a Roth IRA conversion strategy may fit into your financial plan and your current tax situation, please reach out to your Relationship Manager or your tax advisor.

>> FOCUS ON FIXED INCOME

Investors flock to safe assets

By Tom Bussone
Fixed Income Strategist,
Eastern Bank Wealth Management

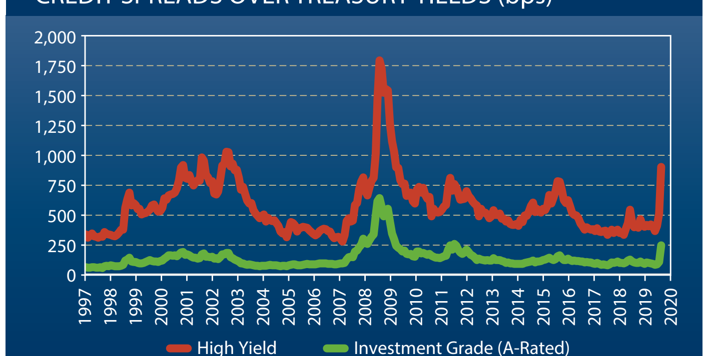
Investors fled risk as the coronavirus spread throughout the country, leading to a sharp downturn in business activity as governments implemented shelter-in-place guidelines to protect public health. As uncertainty spiked, equity and corporate bond prices plunged, with money flowing from risk assets into U.S. Treasury debt. The 10-year U.S. Treasury yield collapsed by 125 basis points (1.25 percentage points) during the first quarter to end March at 0.67%, slightly off the all-time closing low of 0.54% earlier in the month.

Credit spreads (the extra yield versus comparable-duration Treasury debt that an investor receives to take on credit risk) gapped open to 353 basis points compared with 76 bps at year-end 2019, while the spread on high-yield debt soared to 1,095 bps from 360 bps on December 31st.

At these extreme spread levels, investors in our view were finally being adequately compensated for taking on credit risk. To take advantage of this opportunity, we recently purchased mutual funds that focus on a combination of high-yield, preferred, and bank loan securities. (In a similar vein, the stock market's 35% freefall in March gave us an opportunity to add to long-term growth companies while valuations were especially attractive.)

These trades were entirely opportunistic; they did not meaningfully alter our essentially defensive posture. Even after the Covid-19 pandemic has subsided, we think it will take a long time for the American economy to reabsorb the millions of displaced workers and to get fully back up to full strength. As the uncertainty persists, we will continue to look for opportunities to position our portfolios for a second-half recovery.

CREDIT SPREADS OVER TREASURY YIELDS (bps)



Credit spreads are higher than at any other time since 2009.

Source: FactSet