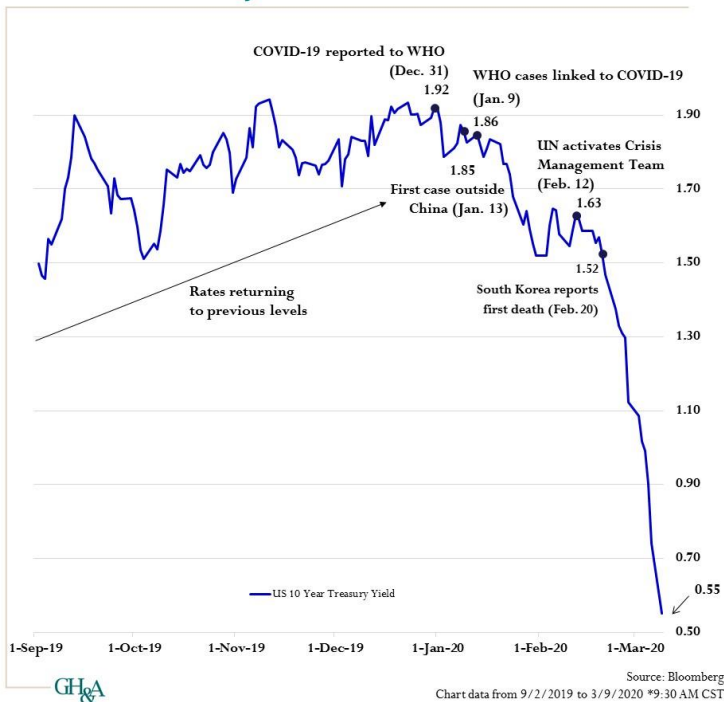


Don't Panic!

It's been a challenging 14 months for us. We've been positioned for a strong economy and for higher rates. We've been correct on our economic outlook as even Friday's recent non-farm payroll number was a huge upside surprise. But, we've been wrong on our interest rate positioning as trade issues and Brexit started a flight to quality last year. Now, all attention is on the COVID-19 ("Virus") outbreak in China. The first thing that comes to mind during this market hysteria is "Don't Panic!" This letter will explain why.

Chart 1
10-Year Treasury Yield

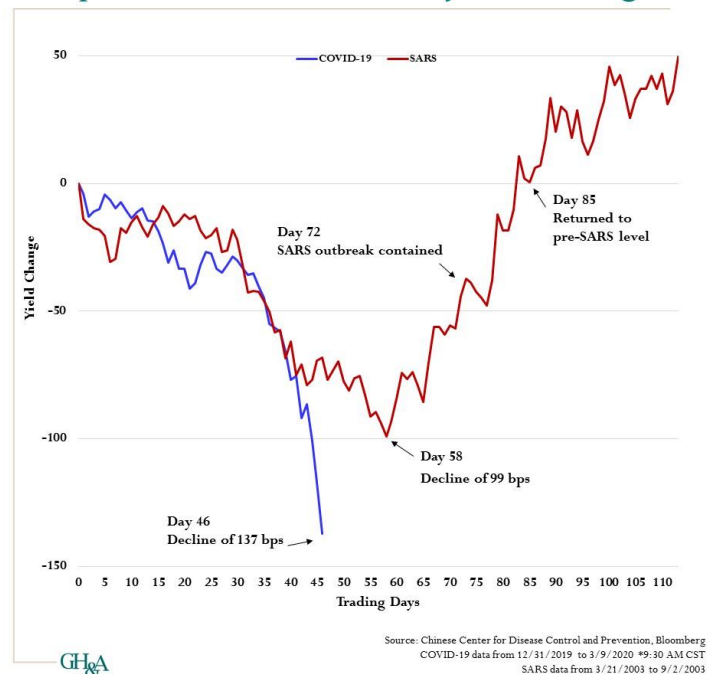


Taking a step back, by the end of 2019, most of the trade concerns had subsided. One can see on Chart 1 that the 10-year Treasury yield was resuming its upward trend by Q4 2019 and finished the year at 1.92%. The economy was expanding at a year-over-year rate of 2.3% and treasury rates had advanced approximately 45 basis points from the September lows. When the first news of the Virus entered the market at year end, we saw a marginal increase in volatility. Concerns grew in the region due to inconsistent reporting and unclear diagnostic criteria used during the early phase of the outbreak. On January 9th, the market's reaction was still muted when the World Health Organization ("WHO") linked cases in China's Hubei Province to the Virus, causing Treasury yields to decline to 1.86. Treasury yields moved lower to 1.63 on February 12th when the WHO

activated their Crisis Management Team. Market sentiment took an extreme turn when South Korea reported its first death on February 20th. Over the following days, the equity markets declined over 10% and the Treasury market rallied across the curve, with the 10-year yield falling to all-time lows. To put this in perspective, over half of all calendar years since 1980 have suffered a 10% (or worse) stock market correction, with 75% of those years still producing positive returns. The extreme Treasury market volatility we are currently experiencing are symptoms of panic and fear, not the result of informed investing nor sound fundamental research. Being completely ignored, several economic statistics have surprised to the upside over this same time period.

In 2002, many of us remember the previous China disease scare - Severe Acute Respiratory Syndrome (SARS). SARS is a respiratory disease similar to the Virus. It was technically never cured but naturally became contained. We compared the market reaction during SARS with today's Virus reaction to see clues of how the market may evolve from here. In Chart 2, the yield of the 10-year during both diseases are graphed, SARS in red and the Virus in blue. The lines are both scaled with time and yield change at 0, reflecting rates at the time just before the two diseases became widespread.

Chart 2
Comparison of 10-Year Treasury Yield Changes



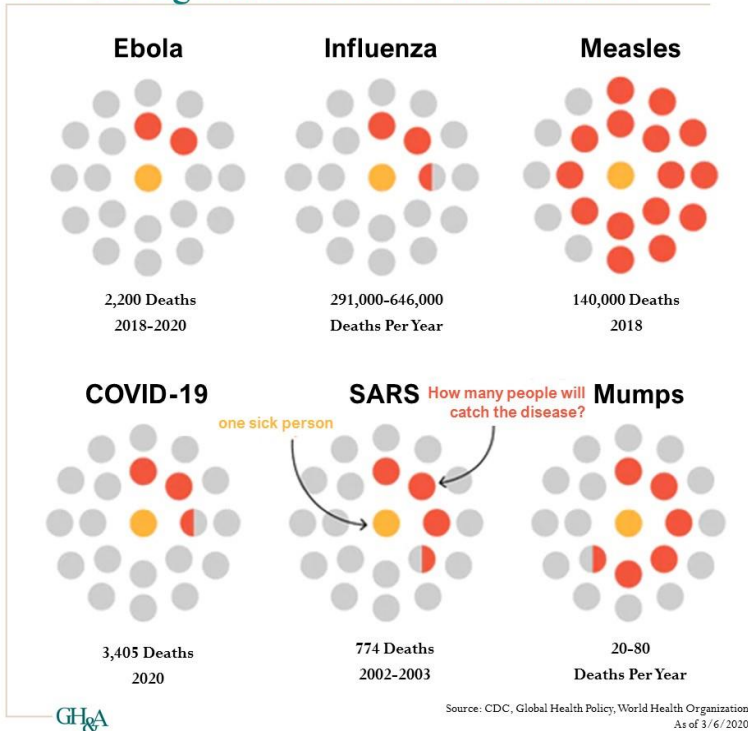
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The 10-year hit a bottom and declined almost 100 basis points during the SARS episode at 58 days after the outbreak. Interestingly, rates resumed their upward trend just before SARS became contained and returned to pre-SARS levels on day 85, less than one month after they bottomed. Rates continued to climb another 50 basis points over the next month.

With the current Virus, the 10-year yield decline tracked the SARS yield decline for the first 40 days, falling almost 80 basis points. As the Virus spread to the US, the lines deviated, and rates declined much faster during the Virus. Assuming rates have finally bottomed, the 137 basis point drop in the 10-year yield is just 38 basis points greater than the decline during SARS.

Chart 3
How Contagious is COVID-19 Worldwide?

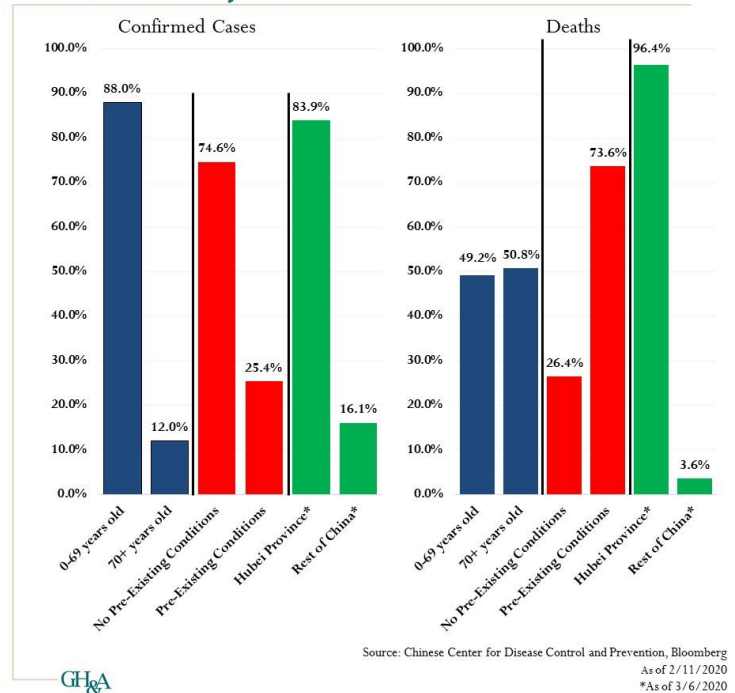


One major fear about the Virus is that it could become a worldwide epidemic. However, data does not support this fear. The statistic used in the scientific community to estimate the contagiousness of a virus is the average basic reproductive rate which estimates the average number of people infected from one person with the disease. Chart 3 illustrates the relative contagiousness of various diseases with the yellow dot representing one infected person and the orange dots representing how many people on average will be infected by that person. Notice that the Virus is much less contagious than the measles, mumps and even SARS. Listed under each disease is the number of deaths it caused. The

death toll from the Virus is dwarfed by the deaths caused by Influenza (“Flu”) or measles, yet the Virus has generated great panic.

During the recent Flu season, the Flu killed 34,157 people in the US according to the Centers for Disease Control (CDC). Worldwide, the Flu kills between 291,000 to 646,000 people each year! By comparison, there have been 3,527 Virus related deaths, and those deaths were primarily concentrated in the elderly, sick, and in one region in China.

Chart 4
China Mortality Details



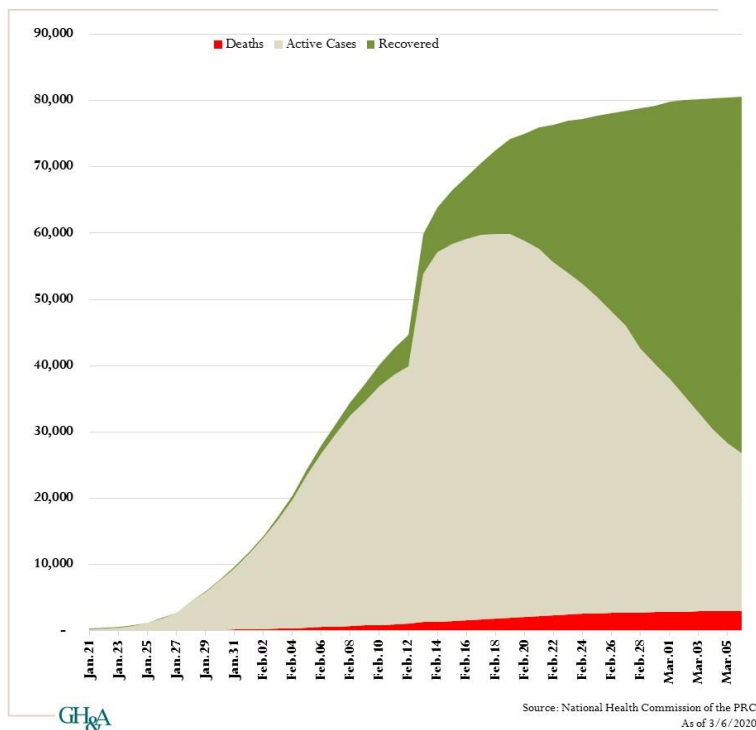
A study conducted by the China CDC analyzed confirmed deaths caused by the Virus. Chart 4 provides a breakdown of those findings with confirmed cases on the left and deaths on the right. First, the breakdown in age is represented by the blue bars. The bars show that the elderly (ages 70 and up) represented just 12% of the total cases, but accounted for more than half the deaths. Second, individuals who were sick with a pre-existing medical condition (cardiovascular disease, hypertension, etc.) are represented by the red bars. These bars show that just 25.4% of the total cases were already sick but accounted for 73.6% of the deaths. Lastly, the breakdown by location is in the green bars. These bars show that the number of cases in the Hubei Province represented 83.9% of the total cases, but accounted for 96.4% of the deaths. The Hubei Province is where the Virus originated. At the onset of the outbreak, people in the Province did not know the severity of the disease, hospitals were overwhelmed, and there were no protocols for treatment and containment.

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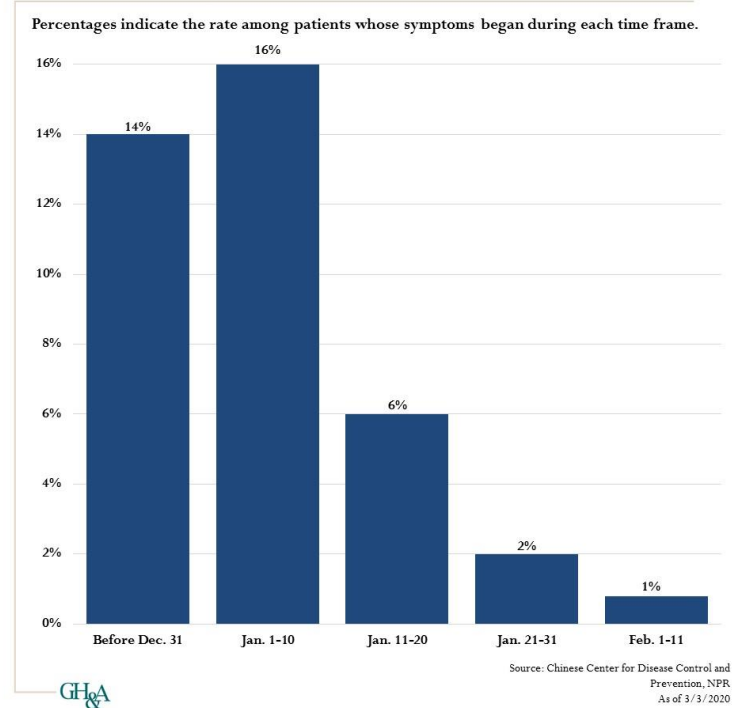
It is clear that recent preventative measures and rapid diagnosis have had a dramatic positive impact on the spread of the Virus. We can see this graphically in Chart 5. It shows for Mainland China, the number of cumulative deaths in red, active cases in beige and recoveries in green. The deaths in red, while concentrated in the elderly, the sick and in one Province, have had a very slow and steady increase. The active cases in beige grew rapidly at first, peaked in mid-February, and are declining at an accelerated pace. Now, recovered cases in green dominate the data. Recoveries were slow at first but began to increase dramatically. Recoveries now represent over 60% of all cases. This is an encouraging sign that an inflection point has already been reached in China.

Chart 5
COVID-19 Cases in Mainland China



Further evidence of the Virus slowing in China can be seen in the 10-day fatality rates in Chart 6. The fatality rate is the percentage of people with the Virus who have died. Chart 6 shows the fatality rate for different 10-day infection periods from before December 31, thru early February. For the reasons mentioned previously, the fatality rate was high at 14% - 16% rate during the first days of the Virus. Very soon, the fatality rate dropped precipitously and is now at 1%. This decline clearly demonstrates that the diagnosis and treatment cycle is now substantially improved. We expect the same health patterns experienced in China to be at least similar, if not dramatically better, here in the US.

Chart 6
China Fatality Rate Has Dropped Sharply



A comparison to pandemics puts the Virus into perspective. The 1918-1920 Spanish Flu caused an estimated 75,000,000 deaths worldwide and 675,000 deaths in the US. The impact of the 1968-1969 Hong Kong Flu was 1,000,000 deaths worldwide and 100,000 deaths in the US. Prior to the current Virus was the H1N1 virus ("Swine Flu") in 2009 that caused 575,000 deaths worldwide and 12,500 deaths in the US. As stated earlier, the current Virus has caused 3,527 deaths worldwide and 14 deaths in the US. The Virus represents a small risk when compared to these past diseases.

The evolution and response to the Swine Flu offers a road map to the resolution of the Virus. From the date the Swine Flu reached the US in April 2009, it rapidly spread to an estimated 60 million cases. This led to 274,304 hospitalizations with 12,469 deaths in the US. This is a death rate of 4.5%. At its peak in June 2009, 980 schools were closed affecting 610,000 students. By July 2009 a vaccine was created and by August 2010 the WHO declared the Swine Flu eradicated. The Swine Flu did not get the attention of today's Virus, probably because headlines were dominated by the financial crisis.

While the current Virus's death rate is running 4.2% in the Hubei Province of China, outside the Province the death rate in China remains low at only 0.8%. These results indicate that a swift governmental response to the disease can have a major impact on lowering mortality rates.

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Another important aspect is the early development of a vaccine. The ability to develop and deploy a vaccine is directly related to the level of resources devoted to the task. Given the advanced notice and enhanced preparedness of the response within the US, the timeline we experienced during the Swine Flu should be compressed, leading to a reduction in loss of life and only transitory disruption to our economy.

In contrast to slow governmental responses initially, the USAID Administration is now making \$37 billion from the Emergency Reserve Fund for Contagious Diseases available with funds dispersed through the WHO and other USAID partners. The World Bank has also announced the funding of \$12 billion of fast-track grants, and loans for immediate disbursement to bolster public health interventions. The US has cut short-term rates, increased repo operations to inject liquidity and has appropriated over \$8 billion in emergency spending so far. The largest aid disbursement is coming from the International Monetary Fund ("IMF") which announced \$50 billion to be distributed from the Rapid-disbursing Emergency Financing Facility to assist emerging market countries. This direct and immediate application of resources and funding will have a substantial impact on communities to quickly respond to outbreaks, fill deficiencies in public health needs and to ultimately find a vaccine/cure. This support will shorten the effective life cycle of the Virus.

As the Virus spreads, each new outbreak is met with an improved response further reducing the level of human suffering and economic dislocation. While the reported economic data remains strong, we are keeping a close eye on future data releases which the Virus will surely impact. If past market reactions repeat themselves, like during SARS, we should expect rates to rise as quickly as they fell when the Virus is contained. Any decline in economic activity from here should be transitory and cause pent up demand and an increase in future growth. More importantly, low interest rates are leading to historic low mortgage rates. Thus, we expect to see record refinance activity similar to 2003 and a boom in housing activity, both starts and purchases.

While it's been challenging, the best course of action is "Don't Panic."

The group Coldplay may have said it best at the end of their song "Don't Panic."

Oh all that I know
There's nothing here to run from
'Cause here
Everybody here's got somebody to lean on

In my 35-year market experience and Don's 28 years of experience, we have both been here before and have seen similar market panics, bubbles and overreactions. In every case, it paid to stay the course and focus on fundamentals to look for opportunities to add alpha to portfolios over time. So, we are not changing our outlook. As the Virus settles, we expect continued economic growth and a return to higher rates. We also suggest revisiting asset allocations to take advantage of temporary rebalancing opportunities.

Meanwhile, our clients can always lean on the entire Team at Garcia Hamilton. We have proven to be a steady hand in the past, and will prove to be again. Don and I, and the rest of the Team, are available 24/7 for follow-up calls or to review individual portfolios in detail and current Virus updates.

March 9, 2020

Gilbert Garcia
Managing Partner

Don Elsenbrock
Portfolio Manager, Partner

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