Coronavirus: Panic vs. Discipline

The Recent Weeks' Response in the Markets

Monday March 9th witnessed the single largest point drop in the history of the Dow Jones Industrial Average after falling in excess of 2000 points. While not the largest percentage drop, the fall was significant and brought the Nasdaq and Dow to bear market territory with the S&P 500 within 30 points of one. While the size and speed of these moves are simply frightening, it is essential to view the market damage with the perspective of a long-term investor. When markets are high and risk is low, investors speak opening and loudly to their ability to buy low and sell high. However, when markets reach extreme levels of anxiety, they often do the opposite. Equity investors are accepting a higher level of volatility with the promise of higher returns over full market cycles (several years). Volatility is simply the degree of variability of return. Risk is different, it is the permanent loss of capital. Investors can turn volatility into risk by selling into a panic and locking in losses. As Warren Buffet says, the time to get rich is in a bear market, you just don't know it at the time. What is critical for all investors at times of extreme stress is to stay the course and keep the discipline of your asset allocation strategy. They are designed for long term investing and we must remain long term investors. We will look for opportunities to rebalance and put money to work at reduced valuations but stay within our disciplined allocation models. We believe it is important to focus on the facts instead of speculating on the unknown. In this white paper we highlight what we know, admit to what we do not know, discuss how the markets are reacting to what we do not know and lay out what we believe for the future of the economy and the asset classes.

Coronavirus – What We Know

We know that the coronavirus is a public health risk and brings back memories of the SARS outbreak in the early 2000s. As of the time of writing this piece, global coronavirus cases have surpassed 110,000 and the virus is present in more than 90 countries.[1] At this point the mortality rate is low (~3%) and this is likely to drop as the number of cases rise. However, we also know that the number of cases that we see in the headlines may not be accurate. While that sounds scary, it is because most coronavirus cases are mild and replicate similar symptoms to the common cold. Given that we are in the middle of cold and flu season, there may be many more individuals who have contracted the virus and do not even know it. While this makes the virus even harder to contain, it is reassuring that the recovery rate is high and according to the Center for Disease Control ~80% of the cases in China were mild cases. In addition, we know that the mortality rate increases for the elderly and those with pre-existing conditions so common-sense measures can be taken to stem the personal risk and spread of the virus (e.g. those at high risk can avoid public settings and travel). We do not want to downplay the human element of the virus or the public health risk, but it is important to put the outbreak in perspective in regard to the global population (~110,000 cases out of ~6 billion people).

Coronavirus – What We Do Not Know

It is impossible to put a definitive number on how much the U.S. economy will slow as a result of the virus because it is highly dependent on the level of future consumer trepidation. The U.S. is a service oriented economy so the magnitude of the drag on the economy will depend on how much consumers pull back from traveling, eating out, going to the movies, shopping and how many events get cancelled and what that means for industries such as transportation, leisure and hospitality. We also do not know for certain what this will do to corporate earnings. We have seen many major companies pull guidance on earnings for 2020 altogether. However, the impact will vary across different industries and it is not a unilateral effect. For example, while airlines and travel company earnings may be hampered, healthcare and select consumer staples may benefit. In addition, while financial earnings may be squeezed by the low level of yields, financial earnings have also proven to benefit from the surge in volatility through increased trading activity. We will have a better handle on the impact to growth when we begin seeing economic data that reflects the heightened period of the virus. In the coming weeks we will have to use soft data reports to gauge what impact the virus is having on specific areas of the economy. Soft data reports are real time surveys that can highlight the view from consumers, small businesses and manufacturers.

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Coronavirus – The Market's Behavior is Erratic

The recent weeks' reaction in both the stock and bond market look more like panic and fear are taking over discipline and reason. The daily intraday swings in equities are cementing the fact that investors and money managers do not know what the ultimate impact will be on economic and/or earnings growth and the moves are being exacerbated by algorithmic traders **(Chart 1).**

The dramatic move lower in bond yields is purely irrational. Long term bond yields in the U.S. are trading at historic lows and completely void of fundamental pricing **(Chart 2).** The move has been worsened by the collapse in oil prices, inflation expectations at lows not seen since the deflation scare during the Great Recession of 2008, emergency measures taken by the Federal Reserve and the fact that the U.S. is the only healthy economy that offers any level of positive yield to investors. In a world with over $14 trillion of negative yielding debt, global investors have nowhere else to go in a flight to safety except the U.S. bond market.

The Fed has also set a dangerous precedent by cutting rates before they could model what the ultimate impact on growth and inflation may be. This can be considered a proactive move, but it can also have an adverse effect. It can hamper investor confidence in the Federal Reserve as it looks like they are panicking or sparking concern that they will not have any tools left if the economy takes a sharp downturn. A misperception that they can control by being transparent and methodical with their policy changes. Instead, since the Fed made their surprising 50 bps rate cut (March 2, 2020), U.S. equity investors have lost approximately $3.6 trillion of wealth (using the Wilshire 5000 market cap), volatility as measured by the VIX Index has spiked to levels not seen since the Great Recession, circuit breakers have been triggered to halt trading for the first time since 2008 and the intraday swings, up and down, in equity markets have been difficult to comprehend. **(Chart 3).**

Chart 1: Major Daily Intraday Swings

Footnotes: Time period reflects June 3, 2019 to March 9, 2020.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

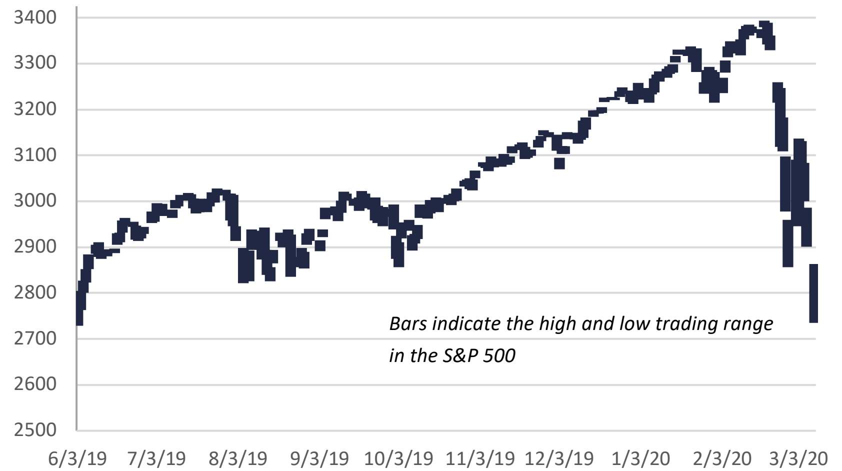


Chart 2: Long Term U.S. Treasury Yields at Record Lows

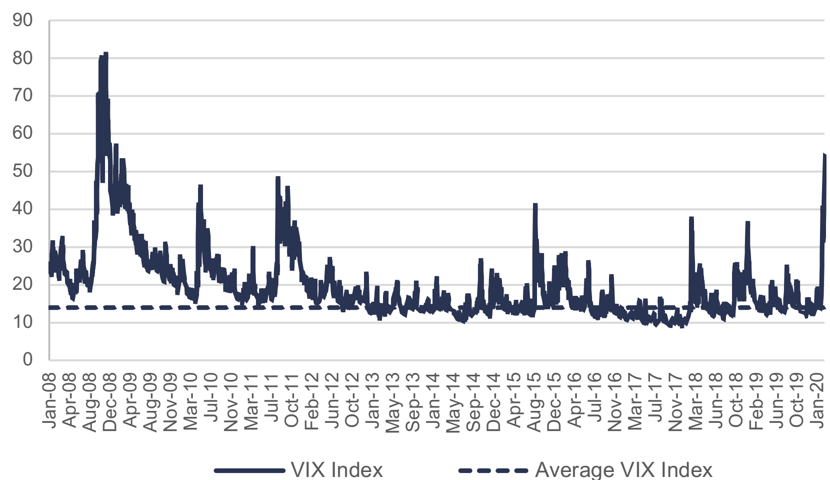
Footnotes: Data is as of March 9, 2020.

Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 3: Volatility Spikes to Levels Not Seen Since the Financial Crisis

Footnotes: Data is as of March 9. 2020.

Source: Bloomberg Finance LP, Verdence Capital Advisors.



What we Believe for the Future of the Economy and the Asset Classes

We have outlined many things that we do not know at this time. However, regardless of definitive numbers on growth or human toll, we can pinpoint four different things where we believe strongly.

1. **It is important to remember that the U.S. economy entered this health crisis on solid footing.** Because of this, there is a strong likelihood of a V-shaped recovery after the dust settles. The labor market is the strongest it has been since the 1960s, wages are rising, consumer balance sheets are healthy, and manufacturing was stabilizing and even improving. We realize there will be some economic impact in the near term. However, once the virus effects fade, there are certain policies and events that have been put in place thus far that are very stimulative for the economy.

    - The Federal Reserve has cut the benchmark rate for the fourth time and is likely to cut again this month. A lower benchmark rate and historically low long-term rates is supportive. We have started to see this in the surge in mortgage refinancing activity. This is good for consumers as refinancing a mortgage can be a direct and permanent reduction to monthly household liabilities.

    - The infighting with Saudi Arabia and Russia is out of our control and is causing oil prices to collapse. Crude oil posted its worst one-day decline since the Gulf war. This is damaging to specific areas of our economy (e.g. oil production) but good for the consumer and businesses, especially those transportation industries that have high commodity input costs (e.g. airlines).

    - The dollar has weakened to a two-year low as a result of the Federal Reserve's aggressive policy measures. A weaker dollar makes U.S. exports more competitive and aids our multinational corporation's earnings.

2. **A panic mentality is unpredictable.** It is impossible to pinpoint a near term bottom in equities or interest rates when uncertainty, panic and fear are driving market actions. In addition, we have written white papers about the risks that algorithmic trading may have in periods of heightened volatility. Algorithmic trading can exacerbate price movements and result in overshooting on both the up and downside in financial assets. In the near term, if interest rates keep racing to zero, oil fails to find support, cases continue to rise and scatter through the world and the government struggles with response measures we expect volatility to remain high.

3. **We still favor stocks over bonds and short-term bonds over long term bonds.** The broad S&P 500 market looks willing to test bear market territory (a decline of 20% from its high). It came very close to closing in bear market territory in December 2018 when the S&P 500 declined 19.8% and it flirted with a 20% decline Monday. **(Chart 4).** We have stated that pinpointing an exact bottom is impossible, but we still favor stocks over bonds for the long term. A 20% equity decline in an environment that looks to be caused by panic and uncertainty is hard to ignore for a long-term investor and may be pricing in the bulk of the expected slowdown in growth and earnings. Even if our economy enters a temporary, technical recession (two quarters of negative growth) equities look attractive on a valuation basis and especially relative to bonds. However, there are industries that may be affected more than others, so selectivity and active management is important at the individual stock, sector and regional level. On a relative basis, equities are historically attractive compared to the record low level of yields. **(Chart 5 – *next page*)** Roughly 100% of the S&P 500 companies are paying a higher earnings yield than the 10YR Treasury. Within fixed income, with interest rates at record lows, it is important to remain in the short to very-intermediate part of the maturity range as to mitigate interest rate risk as conditions normalize.

Chart 4: U.S. Equity Market Flirting with Bear Market Territory

Footnotes: Data as of March 9, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

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4. **We still like alternatives.** A well-diversified portfolio that has an allocation to alternative investments is recommended in these times of heightened uncertainty. Low volatility hedge funds should act to reduce the downside of a long only equity portfolio. History proves that in years where the S&P 500 sees more daily moves of 1% or more that hedge funds outperform the equity market. This year alone we have seen more than 60% of the trading days where the S&P 500 has seen a daily move of 1% or more. Private equity is also a place that we always recommend a healthy allocation. In the private market you are not forced to deal with the daily volatility swings in the market that can be driven and/or forced by computerized trading. In addition, private managers have a significant amount of money to take advantage of dislocations that present attractive investments in this environment.

The Bottom Line:

In these times of heightened uncertainty and immense volatility, we realize investor discipline is going to be tested and emotions may override your long-term objectives. We remain optimistic that the risk of negative long-term effects from the virus are limited but we are not complacent either. The global economy will likely slow and the chance of a recession in the next 12 months has increased alongside with uncertainty and fear. However, we have always implemented asset allocation with a long-term time horizon and regardless of the near-term strain on the economy, there are multiple stimulative measures being taken that can result in a solid recovery once the virus fades. We do not rule out fiscal measures to be announced as well, especially if a bear market in equities or economic recession were to threaten President Trump's re-election campaign. We continue to evaluate the moves across the asset classes and will gradually make asset allocation decisions as opportunities present themselves that are in accordance with our client's long-term objectives.

1 According to Johns Hopkins CSSE as of March 9, 2020 at 4:49 pm.

Chart 5: Stocks Historically Attractive Relative to Bonds

Footnotes: Data is weekly and as of March 6, 2020.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

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