CHIEF INVESTMENT OFFICE

Investment Insights

The Certainty Of Uncertainty and The Effectiveness Of Diversification

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After the quickest correction in the history of financial markets with the Dow Jones Industrial Average plunging more than 12 percent in a week, or over 3,500 points, it is critical to step back and assess what the underlying causes of the severe drop are and, equally, what the markets are already discounting for the foreseeable future. In the paragraphs that follow, we discuss the various types of uncertainty; what the markets are discounting; outline data from previous volatile downdrafts; and, what investors should consider in the weeks ahead.

Over the course of history, each decade has taught us many different lessons. But there is one that overhangs the capital markets perpetually—we can be certain that there is always uncertainty.

In terms of the global economy, geopolitics, monetary policy, or investing, in general, there are many different types of unknowns. Throughout history, investors have taken calculated active risks, even in cases of significant uncertainty. There are numerous examples over the past decade alone.

Some of these examples of uncertainty are fundamental in nature such as the level of economic or corporate profits growth, valuation of particular assets, or interest rate policy. In addition, other uncertain elements centered around new regulation, trade policy, tariffs, oil price spikes or declines, the sustainability of southern European or high-yield energy debt, the rise in the U.S. national debt, deflationary shocks, and even multiple currency crises and capital controls. The list could go on. However, through these examples, most analysts could examine the economic and corporate profit impact and the potential valuation adjustment with above-average probabilities. They could also assess the catalysts or policies needed to turn events for the better and allow the business cycle to restart or expand with reasonable assumptions and in some cases, with a high level of certainty. In 2018–2019, we experienced quite a few of these examples which ranged from overly tight Federal Reserve (Fed) policy, inverted yield curves, the U.S. trade and technology war, impeachment proceedings, and an attack on a major Saudi oil pipeline.

Moreover, heading into 2020 the big questions (high uncertainty) were about recession or global economic expansion, whether equities and fixed income were overvalued, "Phase 1" to "Phase 2" U.S.-China trade negotiations and the possibility of a resumption of this trade war post-November, how long will the Fed be on hold and when will they cut interest rates, liquidity in the funding markets, and, of course, the U.S. presidential election. We can deal with these elements by using various core analytical inputs, model analysis, and "real" economic grass roots data that helps determine the potential corporate profits impact and eventually the level of risk in capital markets.

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Prior to the Coronavirus (Covid-19) virus outbreak, the global economy was on its way to a V-shape recovery and back into expansion mode albeit on an expected slow path as deflationary winds continued to blow. Monetary policy was easy, asset prices were climbing the wall of worry and were in a market "melt-up" episode driving U.S. equity markets to all-time highs (S&P 500 approached 3400 in early February) and lifting non-U.S. markets as well. Our base case and most positive scenarios were materializing. Then the bond market began to tell a different story as long-term yields headed lower ultimately to reach record lows in the 10-Year and 30-Year Treasury yields. The bond market began to expect much lower global growth and inflation expectations were dropping again. Risk aversion was rising. We experienced "action" like this many times in the past few years but something was clearly different. How can this be the case if there are V-shape recovery signs across U.S. housing, earnings revisions turning for the better globally as manufacturing stabilized, and balance sheet expansion by the Fed while long-term yields accelerated to the downside and inflation expectations dropped?

The highest level of uncertainty unfolded with the onset of Covid-19 in China and now evident in over 65 countries with new cases developing. Daily information continues to be released with comparisons to prior novel virus outbreaks (e.g. SARS, MERS, H1N1) and, in some cases, the more common influenza. In time and with more epidemiological data (i.e. containment abilities, infection rates, mortality rates, etc.) we should have a better understanding of the current novel virus. At present, this type of uncertainty is not one in which you can use traditional analysis or models to help determine the impact on global economic data, consumer behavior, and business sentiment. The data is very fluid and the collateral effects on the global supply chains would be immeasurable for quite some time, in our view. At first there was an assessment of the potential supply shock to the economy and now markets have begun to try to factor in the impact on demand. Moreover, significant political uncertainty in the U.S. has added to investor nervousness as the Democratic primaries have begun. Through all of this, capital markets are likely to react to each hourly news item. At this point they are at their most volatile levels with investor fear at its highest and pricing in no earnings growth for all of 2020, negative China Q1 economic growth, and only a few percentage points away from pricing in a global recession, in our view. The most affected areas of the equity markets are cyclical sectors and companies most exposed to the global economy, tourism, travel and leisure, and high growth/high momentum shares that previously led the market upswing.

The severe drop in equity markets and the subsequent dramatic move lower in yields in the past week are discounting more of the "what if" scenario versus the "what's most likely," in our opinion. This is to be expected given the significant unknown elements of Covid-19 outbreak and, in financial relevance, the potential negative impact on business and consumer confidence.

We can only analyze the "real-time" impact as the days/weeks go by and substantive signs emerge that provide a better understanding of the demand side of the equation (how businesses and consumers are behaving). Cutting rates as well as short-term focused stimulus measures can help cushion the negative economic impact and alleviate the possibility of an adverse feedback loop. To this end, we expect the Fed to cut interest rates by 50 basis points at their March meeting (fed funds futures pricing in four cuts through this year and into 2021). With inflation expectations dropping and sentiment beginning to show early signs of fragility, being proactive with rate policy would help investor confidence, support credit conditions (and price-to-earnings multiples), and provide a lower cost of capital to consumers and businesses while we work through the eventual effect of Covid-19. Additionally, the policy responses to support the global economy are global in nature. Hong Kong announced a stimulus package that amounts to approximately 4 percent of gross domestic product (GDP) last week; Italy unveiled a package totaling over 3.5 billion Euros; and further China stimuli is expected imminently.

Given what we know at this time, the BofA Global Research Global Economics team recently downgraded various GDP growth assumptions for 2020 with global growth expected to reach 2.8% (previously expected 3.1%) — a level last experienced in 2009. U.S. GDP growth was also downgraded by one-tenth percentage point to 1.6% (2016 levels) from 1.7%. At present, we are not of the view that a prolonged economic recession materializes. We expect more of an U-shaped recovery in the economy versus the V-shape that was unfolding to start the year. Clearly, the level of growth for the rest of the year will depend on the length of Covid-19 outbreak and how quickly we snap back from supply chain disruptions and any consumer sentiment deterioration. We do expect second half growth and the expansion to re-emerge from the effects of the current situation.

Although uncertainty is at its highest level right now and data is still very fluid, what can we extract from prior downdrafts and what should investors consider through this period?

Trying to select a bottom in equity markets when fear is at its highest levels is not a successful strategy, in our view. We need to stick to the facts and gain more insight into the severity and duration of this virus outbreak. The most recent rapid decline gathered momentum as short-term positioning abruptly changed, quantitative programs (i.e. machines) sold once key index levels were breached, and systematic traders dramatically lowered risk as volatility rose to extreme heights. On the back of this, longer-term investors (e.g. asset managers) lowered risk in their portfolios which pressured the ability for any daily turnaround to stick in the past week. As we previously stated, we expect policy makers to step in and proactively cut interest rates to help stem any adverse feedback loop. This will help, in our view, while a better understanding of this outbreak can be assessed.

In addition, it's important to know that although the global economy was just beginning to stabilize, the U.S. economy is starting from a decent backdrop. Trend economic growth was expected for 2020 as the consumer was healthy, housing entered a V-shape expansion, and manufacturing bottomed out from the depths of the trade war in 2019. And we still expect a snap back in the second half as fear subsides and record low interest rates filter through into the broader economy. Moreover, an examination of prior downdrafts of major "uncertainty" lead us to believe that markets can turn around relatively quickly once better data builds and the worst-case scenario does not ultimately materialize. As Michael Hartnett, BofA Global Research Chief Global Investment Strategist, has often pointed out, "over multiple cycles markets stop panicking when policy makers start panicking"!

Furthermore, in examining historical data from prior "uncertainty" led accelerated downdrafts, we are encouraged by the potential for turnaround trends.

Trends and Market Data To Keep In Mind As Markets Remain Volatile

- The S&P decline was 16% at its worst level at 2,853 intraday on February 28, which represents initial support and is the level last reached in August and October 2019. The next support from that day's close is around 6-7% lower at 2746 or near the March and June 2019 low of 2728-2722, according to BofA Global Research.
- Since World War II there have been 26 market corrections (prior to this week) with average declines of 13.7%. Recoveries have taken an average of four months, according to Bloomberg Data.
- The S&P 500 fell six consecutive days with declines of greater than 8% cumulatively. This happened 10 times since 1948, accord to Fundstrat Global Advisors. In 10 of 10 times stocks were higher 12 months later (average rise of 27%, median rise of 28.5%).

- The Chicago Board Options Exchange (CBOE) implies Volatility Index (VIX) surged close to 50. Through this cycle this has been peak fear levels and only experienced in 2010, 2011, 2015, and 2018, which were all within days of the lows, according to Fundstrat Global Advisors.
- The percentage of S&P 500 companies with cash yields greater than the 10-Year Treasury yield is now above 80% and implied equity risk premium is at extreme levels, according to Bloomberg.
- We have often stated that market timing is not a successful strategy. It requires two optimal and timely decisions—getting out and getting back in. We stress the importance of diversification and time in the market. This can also include tactical allocation adjustments, periodic rebalancing, and effective portfolio construction.
- The importance of not missing the ten best days in the market is critical to understanding time in the market. If an investor had missed the ten best days of each decade since 1930, according to S&P and BofA Global Research, their return would have been 91% versus 14,962% (including ten best days). In the decade of 2010, this return difference was 95% (without the ten best days of the decade) versus 190% (including the ten best days).
- Although 10% plus corrections can be painful, they have occurred approximately one time per year since 1928, according to S&P 500 and BofA Global Research.
- Despite the challenges of analyzing this highly uncertain market, a foundational investment strategy and the power of diversification is highlighted. Year-to-date returns for all broad investment-grade fixed income sectors are positive; Treasuries, Munis, investment-grade corporates, mortgage-backed security (MBS), asset-backed security (ABS), etc. and have provided a ballast to risk assets. Most notably, the Bloomberg Barclays U.S. Treasury index is up over 5% and the 30-Year U.S. Treasury is up over 16%.

Amid this chaos there are some near- and long-term positives. We acknowledge these will likely remain under pressure in the weeks ahead, but could ultimately cushion ongoing economic weakness.

- U.S labor market is solid with unemployment rate at a historically low level.
- U.S. consumer savings rate has recently risen, potentially helping to cushion near-term slowdown.
- U.S. household debt serviceability is at historic highs.
- Housing market is strong helped by rising household formation and a lack of supply.
- Global central banks are likely to ease monetary policy further. Previous policy easing is still working through the economy.
- Governments are considering fiscal stimulus plans. Globally, corporate taxes are being lowered and infrastructure plans are being considered.
- Record low interest rates help consumer and corporates to refinance.
- Innovation cycle is accelerating with artificial intelligence and robotics deployment.
- Localization of supply chains has begun, possibly leading to a new capital expenditures (capex) cycle in the years ahead.

Given the expected policy responses, the turnaround data regarding highly volatile times historically, and our continued focus on the long-term prospects, we believe the long-term investor should consider developing plans to rebalance multi-asset portfolios given the large overvaluation in fixed income (namely U.S. Treasuries) and the overshoot to the downside in equities. As we gain a better understanding of the overall economic affect from this virus outbreak and as the short-term extreme fear subsides in the coming weeks, we would look to deploy rebalancing plans across a few episodes. Investors can point to important technical and fundamental levels within the equity markets to keep in mind when rebalancing. At 2900, the S&P 500 is currently discounting zero earnings growth in 2020 or an approximate 10 percent pullback on original profit expectations. This seems extreme (for the longer-term investor) even in the face of such uncertainty. The newly revised fair value target for the S&P 500, according to BofA Global Research, is 3100 (down from 3300) based on adjusted S&P 500 earnings of $169 (4% increase year-over-year versus 8-9% growth originally expected). Equities are a long-duration asset that over time are likely to accumulate profits that are lost in any one-given year. Stock prices ultimately begin to discount this once the level of uncertainty begins to fade.

Despite the lower return-estimate for fair value this year, we believe equities still represent an attractive total return in absolute and relative to fixed income terms (especially at current levels). In this regard, we will be analyzing the price trends of more cyclical industries—particularly those more exposed to the global supply chain such as semiconductors; the price pattern of copper and gold; and, the consumer-based industries in the travel, leisure, and entertainment space. We expect more clarity in the next few weeks and will be looking for opportunities to rebalance portfolios during this time.

Environments of the greatest uncertainty are when portfolio diversification proves its potential strength.

Index Definitions

Bloomberg Barclays US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States.

S&P 500 Index stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

The Volatility Index, or VIX, is a real-time market index that represents the market's expectation of 30-day forward-looking volatility. Derived from the price inputs of the S&P 500 index options, it provides a measure of market risk and investors' sentiments.

Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

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