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CHIEF INVESTMENT OFFICE

Investment Insights

Double Exogenous Shock: Short-Term and Long-Term Implications

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The opinions are those of the author(s) and subject to change.

AUTHORED BY:

Chris Hyzy
Chief Investment Officer

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CURRENT MARKET ENVIRONMENT

We are currently witnessing a highly volatile market with frequent wild swings across equities and rates which also impacts the trends in currencies and commodities. Capital markets that are dealing with imperfect and uncertain information often remain volatile for extended periods of time as they attempt to price in various scenarios including a contraction in the broader economy not to mention the magnitude of impact on corporate profits. We are experiencing "known unknowns" that are changing behaviors and affecting the economies of many countries. The solid starting point of the U.S. economy and financial system heading into these "unknowns" should help to cushion the ultimate impact, in our view.

In addition, in terms of daily trading, professional programmatic investors can alter the volatility through short-term momentum positioning as markets gyrate. This can create less liquidity and potential gaps in pricing in the riskier segments of asset classes. Therefore, we prefer to keep to the facts regarding COVID-19 developments, assess the economic and profit growth impact over time as more data is released and, as possible policy responses are announced. In the coming weeks, we believe investors should consider rebalancing portfolios—which may include more than one episode as the bottoming process unfolds—across and/or within asset classes as markets stabilize. At the height of fear, it is important to have investment plans ready and take action according to your stated goals and objectives. Market timing is not a successful strategy, in our view. Rather, time in the markets with a disciplined rebalancing plan when markets overshoot help maintain diversified portfolios for the future. Although short-term panics such as this one tend to dismiss relative valuation and long-term fundamental attractiveness, we believe it is still very important to focus on historical data. Since 1928, 10% or greater corrections in the S&P 500 have occurred on average 1x per year. And since 1930, the work highlights that if an investor "sat out" the 10 best performance days of the S&P 500 per decade, potential returns would be just 91% versus 14,962% overall as stated by BofA Global Research.

MACRO OVERVIEW

- Macro: uncertain given double shocks to the system due to this virus and oil price war
- Healthcare: crisis due to COVID-19 concerns and the effect on consumer and business behavior is still highly uncertain
- Oil price collapse: market share game theory continues to unfold as the demand for oil drops significantly while the supply builds

- West Texas Intermediate (WTI) forecasts: lowered to a $41 per barrel average for 2020 from $49 with expectations into the $20s per barrel in the weeks ahead if the market share battle continues
- Growth Assumptions are fluid: at this point, the BofA Global Research team is pricing in a "borderline" global contraction in the middle of the year (virus spread outside China, slow initial response to containment, oil price war, central bank policy can help support but not fully fix)
- Gross domestic product (GDP) growth: subject to frequent adjustments—current base case is for modest growth for full year at about 1.2% in U.S. and 2.2% for global down from 1.6% and 2.8% respectively with potential adjustments lower as this virus and/or oil shock builds
- Interest Rates: now forecasting Federal Reserve cuts by 100 basis points (bps) at their March meeting which moves the federal funds rate to zero percent.
- U.S. dollar: weakens during recovery period
- Deflationary shocks: continue to build as inflation expectations drop and commodity prices plummet. This should keep yields from backing up too much in the next 6 months.

POTENTIAL LONG-TERM BEHAVIORAL CHANGES

- Consumer and business behavior undergoes major long-term changes such as greater awareness to health and wellness, expansion of experiential culture, greater use of digitalization and virtualization, risk mitigation practices, waste management, climate control, infrastructure investments, new capital expenditures and productivity initiatives, etc.

POTENTIAL POLICY RESPONSES:

- Monetary and fiscal policy is needed
- Monetary policy adjustments include lower rates (100 bps cut in March taking fed funds to zero) and potentially targeted non-traditional tools plus forward guidance
- Policy must be highly coordinated globally
- Fiscal policy plans could be numerous but some recently discussed include a payroll tax cut and/or other targeted "lending" relief. Payroll tax cuts and direct payments to households have largest multiplier effects.
- Timing uncertain for fiscal plans, given the needed coordination and Congressional approval, but imminent for monetary response

EARNINGS

- $160-$165 on S&P 500 earnings based on new growth and oil forecasts. Earnings subject to further adjustment as economic growth and/or oil price assumptions may change.
- Most impacted industries include tourism and travel related groups such as airlines, cruise lines, sports related industry groups, film, hotels, gaming and entertainment plus retailers, pubs and restaurants; and, economic cyclicals including energy and materials.
- Lower rates tend to pressure financials but ultimately help consumers in time.
- Consumer staples, utilities and healthcare are least impacted by economic downturns.

MARKET INTERNALS

- S&P 500 dropped into bear market territory (a decline of 20% or more during the week of March 9) and, as of Thursday mid-day March 12, equity markets experienced their largest drop since the 1987 market crash. All sectors are well into correction territory.
- Quickest correction in history over the course of 6 days in U.S. equities as volatility, measured by Chicago Board Options Exchange Volatility Index (VIX), rose above 60 and remains at the highest levels of the year at this time.
- At the lowest levels, dividend yield on S&P 500 was 4.4x the 10-year Treasury yield and 80% of companies' dividend yields were greater than a 10-year yield; 75% had yields greater than the 30-year yield; and 50% had yields greater than the average Investment-Grade bond yield, according to Bloomberg data.
- Unprecedented moves in the Treasury market on a daily basis.
- We believe this to be a sharp, accelerated cyclical bear market in a long-term bull market but shorter-term in nature.
- At 2600 on the S&P 500 with $160 in price-to-earnings ratio would be 16.25. The question is at what valuation level do long-term equity buyers feel comfortable beginning to add to equities? At close to record low yields, is 16x (from a peak of around 19x earlier this year) attractive enough? This is approximately 2560 on the S&P 500. In our view, markets are likely to try to price this equation in over the coming days and weeks given the fluidity of earnings adjustments and risk appetite.
- At 2350 (a P/E of 14.7x using $160 in earnings), which was the December 2018 low for the S&P 500, the decline would be about 30% from the highs in February 2020 around 3400. Interestingly, this would represent approximately the average decline in bear market, according to Bloomberg data.
- We emphasize high-quality companies with solid balance sheets, attractive dividend yields with stability across healthcare, parts of industrials and technology, consumer staples, utilities, and financials through the bottoming process.
- Build positions in these type of companies and use active managers* over the coming weeks and into the summer.
- Maintain preference for equities relative to fixed income but focus on diversification overall.

LONG-TERM: WE NEED TO THINK THROUGH THE UNKNOWN AND FOCUS ON WHAT IS MOST LIKELY TO UNFOLD LATER THIS YEAR

- COVID-19 spread and oil price war are expected to accelerate the impact of the 2018-2019 trade and tariff war through a major change to the global supply chain.
- Stimulus placed into the system in a 2020 shock year is difficult to remove until the economy is on much firmer ground. We expect stimulus to move from "cushion" status to "tailwind" later in the year.
- Growth equity investing remains but now total return dividend based investing is on equal footing in our view. We would stay balanced and also use allocations to defensive sectors to increase diversification.
- Rebalance portfolios as volatility begins to recede and clearer data on the effect and containment of this virus comes into focus.
- Fixed income, particularly Treasurys, remain a risk mitigation portfolio solution versus equities but vulnerable to sizable back up in yields. Short-end looks to be more attractive.

* Active managers rely on analytical research, forecasts, and their own judgment and experience in making investment decisions on what securities to buy, hold and sell.

- Investment-grade high-quality preferred versus high yield. We would suggest using active management** in this area.
- Equities become more attractive in absolute terms and much more attractive in relative terms given the collapse in yields and correction in the price to earnings multiple of U.S. equities.
- Demographic wave likely to increase allocations to equities in search of total returns given the record low yields in fixed income.
- Behaviors: potential changes are likely to include greater awareness to health and wellness, expansion of experiential culture, greater use of digitalization and virtualization, increased risk mitigation practices, waste management, climate control, infrastructure investments, new capital expenditures and new productivity initiatives, etc.
- Demographic wave: likely to increase allocations to equities in search of total returns given the record low yields in fixed income as a new business cycle develops, in our opinion.
- Our view: focus on diversification and have plans ready as the uncertainty ultimately begins to fade.

**Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio.

Index Definitions

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

Chicago Board Options Exchange Volatility Index (VIX) is the ticker symbol and the popular name for the Chicago Board

Options Exchange's CBOE Volatility Index, a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

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