MARKET Insights

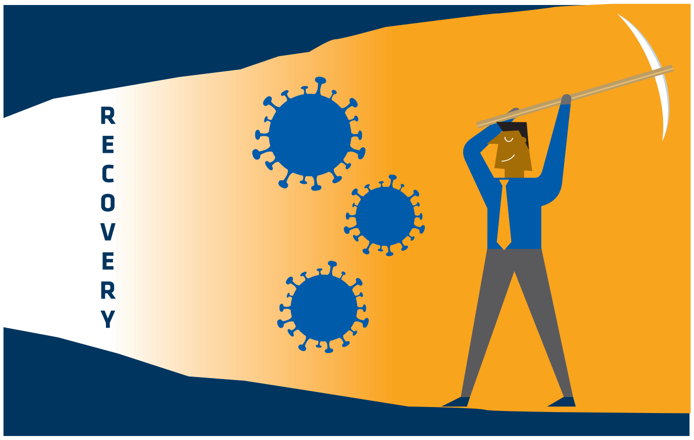
May 2020

Light at the end of the COVID Tunnel?

Market Insights: Mid-Quarter Update

As we hit the halfway point in the second quarter of 2020, COVID-19 continues to completely dominate the global news cycle as its impact continues to be felt in the global economy & capital markets. In our first quarter Market Insights newsletter, we noted 882,751 COVID-19 cases, and 44,150 deaths globally as of March 31, 2020. As of May 15th, there are over 4,660,000 total cases and 309,000 deaths globally (Source: Worldometer). US Unemployment for April spiked to 14.7%, its highest level since tracking began in 1948, and U.S. Gross Domestic Product declined 4.8% in the first quarter of 2020. The second and third quarters are likely to bring even greater challenges, as more states begin to reopen their respective economies.

As painful as these numbers are, they do represent progress. Quarantines and social distancing have flattened new case curves substantially country by country (with the notable exceptions of Russia, Brazil and India), and a light may be visible at the end of a long tunnel.



Index	March 2020	April 2020	Q2 April 1st – May 15th	YTD 4/30/20
S&P 500	-12.35	12.82	11.08	-9.29
Russell 2000	-21.73	13.74	9.17	-21.08
MSCI EAFE	-13.35	6.46	2.61	-17.84
MSCI Emerging Markets	-15.40	9.16	6.43	-16.60
Barclays US Aggregate Bond	-0.59	1.78	1.66	4.98
Barclays US TIPS	-1.76	2.78	2.92	4.52
BBgBarc US Corp High Yield	-11.46	4.51	4.47	-8.75
HFRX Global Hedge Fund	-5.88	2.88	N/A	-4.17
MSCI US REIT	-21.79	8.18	-3.44	-21.28
Bloomberg Commodity	-12.81	-1.54	-0.30	-24.47

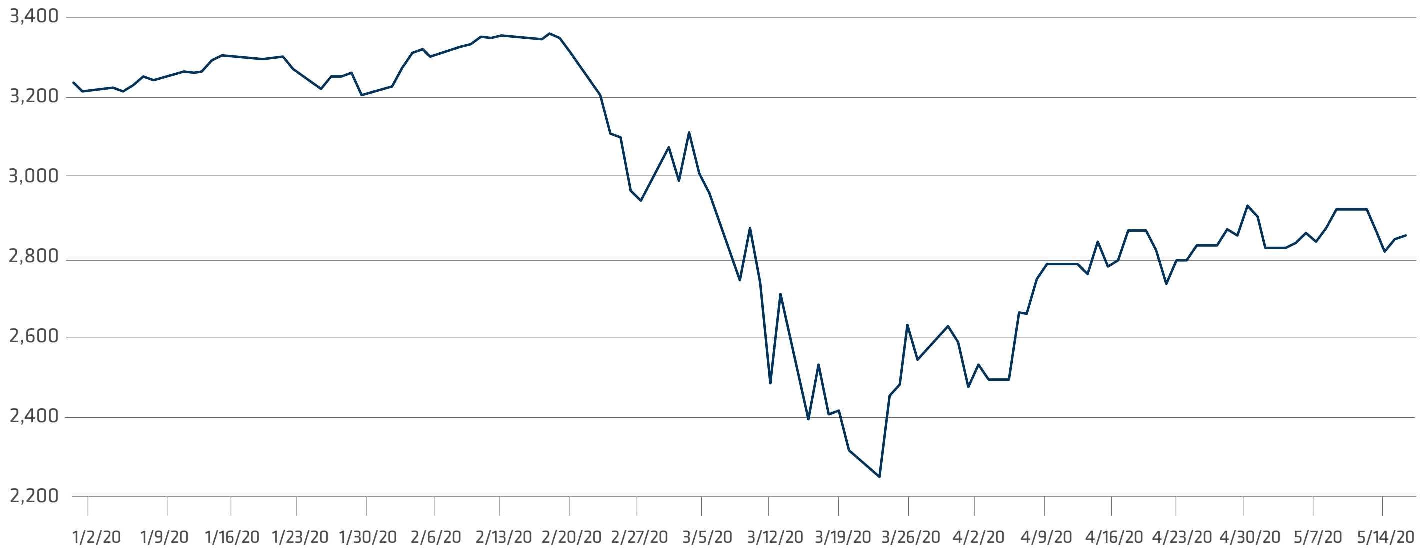
Source: Morningstar, FactSet

Recovery - V, W or something else?

US policy makers have moved swiftly and decisively to provide unprecedented levels of monetary and fiscal support to the economy. As a result, the extreme levels of volatility experienced in late February and March dropped to more manageable levels in April. After the fastest **30%** market decline in history, April saw the S&P 500 rally over **12.8%**, notching one of the best monthly returns for the market in history. Our equity portfolios performed well in both March and April, generally down less and up more than broad equity market averages. In bond markets, the liquidity panic that hit markets in March reversed itself in April, after the Fed provided ample assurances that they would provide as much liquidity as needed to keep markets functioning properly. High yield markets returned over **4.5%** in April as the Aggregate Bond Index advanced just **1.8%**.We had favored credit risk rather than duration risk, and lost considerable relative performance to the benchmark in March, but narrowed the gap during the month of April.

The question now is where do we go from here?

S&P 500 - Price Return YTD Through 5/15/2020



Source: FactSet

The line chart above shows year-to-date returns for the S&P 500 in 2020. The shape of the line appears to resemble either a partial V, or the first half of the letter W. A sustainable V shaped recovery would be one where markets drop and then quickly return to pre-crisis levels. In such a scenario appropriately calibrated public health and economic policy would need to be implemented flawlessly by government authorities. A recovery shaped as a W would result from a less-than-flawless execution of the steps associated with both public health and economic policy. Markets and the economy would heal in fits and starts in such a scenario.

Flying Blind

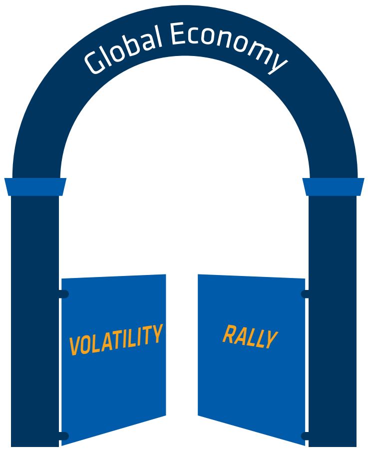
With over **86%** of US corporations having reported Q1 earnings, the estimated earnings decline for S&P 500 companies is approximately **-13.7%**. The forward 12 month Price-Earnings Ratio is currently 20.3, which is higher than the 5 & 10 year averages of 16.7 and 15.0 respectively. With a great deal of speculation around earnings (and, in turn, valuation) for the coming quarters, the question is, does the high level of the P/E ratio matter? The market is forward-looking, and pricing in a future recovery. As earnings decline P/E ratios will rise by definition.

Coupled with a lack of clarity in the near-term as companies suspend earnings guidance, Wall Street will be flying blind in estimating results. The likely result is increased market volatility as Q2 earnings forecasts clash with actual results. As earnings eventually recover, P/E ratios should normalize. The market, however, is not currently trading on fundamentals, in our opinion. Investors are forecasting the coronavirus recovery, and the recent market strength is a reflection of that.

Ultimately, this increases the likelihood that we experience a "W" shaped recovery, as earnings disappointments and setbacks relating to the reopening of the economy spook the markets over the coming months. April's rapid ascent is likely to be challenged in the short term. As the "brakes come off" our economy and more concrete progress is made toward a vaccine, there will be several tailwinds for markets given the favorable monetary and fiscal policies we have enacted. Despite the mixed signals, there is reason for long term optimism ahead.

Market Outlook – *Near-term volatility followed by strong rally.*

Our outlook calls for increased volatility in the near term as the economic reopening efforts pick up, followed eventually by a very strong rally. The historically high market volatility of March has subsided, at least temporarily, as the curve has flattened and the worst case scenario appears to have been avoided. Looking ahead, the looming issue is reopening the global economy without having sufficient testing capabilities or a vaccine in place. As we let our collective guard down, the risk of new cases accelerates and potentially introduces a second wave of infections. As a result, markets may give back recent gains.



While volatility in markets is disconcerting to everyone it is important for investors to remember that investing is not a sprint, but rather a marathon. Over the longer term concrete progress will be made toward treatments and a vaccine for COVID-19. Some encouraging news on this front occurred last week, as results from clinical trials indicated that Gilead Sciences' antiviral drug Remdesivir was effective in shortening COVID-19 recovery times.

When this crisis ultimately ends, consumers should emerge in relatively good shape due to the economy being strong prior to the health crisis and monetary and fiscal policy now being implemented by government leaders.

Investment Implications

In the meantime we continue to believe that investors should stick to their long term asset allocation plan and augment favored positions on market weakness. We advocate keeping a neutral weight to stocks with a bias toward US large cap stocks with healthy balance sheets and sustainable long term business strategies, an underweight bond position focused on shorter dated corporate or municipal bonds, and an overweight to alternative investment strategies that exhibit low correlation to stocks thereby enhancing portfolio diversification and helping to reduce portfolio volatility.

As always, we are grateful for our clients and take the awesome responsibility of managing your assets seriously. Our team continues to function well in this "new normal" of working from home. We hold regular conference calls, and interact on a continuous basis to ensure we are calibrating portfolio strategy appropriately. Please be safe, and as always feel free to reach out with any questions or concerns you might have about your individual portfolio.

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