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Investment Insights

Stay Measured During this Uncertainty

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What has caused the latest downdraft in the markets?

Global capital markets have plunged in recent days on news of a significant rise of the Covid-19 virus (Coronavirus) outside of China—specifically in Japan, Italy and South Korea. To date, there have been 81,191 total confirmed cases globally across over 30 countries, resulting in 2,768 deaths.[1] Concerns over its effect on global supply chains have accelerated with companies guiding cautiously due to production shutdowns in China and restrictions on work and travel. China is in the midst of a pronounced slowdown with reports of auto sales plunging 92% in the first half of February and trading with critical supply chain partners like Korea and Japan taking a hit.

China's participation in global trade—both through traditional exports and exports that are part of the Global Value Chain (GVC)—has increased significantly since the Severe Acute Respiratory Syndrome (SARS) outbreak in the early 2000s. According to Cornerstone Research, China accounted for nearly 30% of global gross exports, as of 2015. About two-thirds of that was traditional trade, i.e., goods produced in China and absorbed by the destination country. The remaining third was GVC exports, where China was just one of many stops along the global supply chain. The longer factories stay shutdown in China, the more the likelihood of product shortages in other countries in the coming weeks.

U.S. equities have given up all of their gains for the year so far in just a matter of days, now down by 3.2% for the year, to go along with declines by China (-1.2%), Europe (-2.7%) and Japan (-4.4%). At the same time oil prices are down 18% for the year, the 10-year Treasury yield has closed at an all-time low of 1.35% while 10-year AAA-rated municipal bond yields are near 1%, as investors continue to price in a weakening environment for corporate earnings and global economic growth.[2]

Why do downdrafts tend to occur in such a rapid fashion?

Today's marketplace is comprised of traditional fundamental investors who have longer time horizons and those that primarily rely on machines and algorithms to capture short-term trends or rebalance portfolios. The latter has grown in prominence in the last decade with execution of orders on the stock market dominated by algorithmic traders. Some estimates attribute 90% of equity futures trades and 80% of cash equity trades

[1] According to Johns Hopkins University as of February 26, 2020, 8:03:03 AM.

[2] Equity indexes are the S&P 500, Shanghai Stock Exchange Composite, Nikkei 225 and STOXX Europe 600. Local currency. According to Bloomberg as of February 25, 2020.

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being executed by algorithms without any human input.[3] Equally impressive is that passive* U.S. equity funds have finally surpassed active* U.S. equity funds in assets under management—by the end of August 2019, passive U.S. funds had total net assets of $4.27 trillion, compared with $4.25 trillion in active U.S. equity funds, according to data provided by Morningstar.[4]

This makes modern markets more vulnerable to abrupt dislocations as quantitative investment strategies are programmed, quick and on autopilot. When volatility metrics spike and there are abrupt reversals in trends, they can accentuate turbulence by selling when markets are already sliding. Long-term fundamental investors have to bear through these periods of turbulence but disciplined investors can take advantage of such sell-offs to rebalance and potentially buy at more attractive prices.

What are potential responses as global and U.S. growth begins to show signs of weakening?

We believe policymakers in the U.S. and globally will ultimately implement easing measures to cushion the effect of Covid-19 virus on the economy. In China, we expect the government to step up the level of fiscal and monetary easing to help contain this Covid-19 outbreak and minimize its effect on economic growth. At the same time, the Bank of Japan has indicated that it is fully prepared to ease policy if the Covid-19 spreads further, while finance ministers across the eurozone have expressed their support for increased fiscal spending if downside risks to the European economy begin to materialize.

In the U.S., it seems as though the market and the Federal Reserve (Fed) have differing views as to the appropriate response to the Covid-19 outbreak. While the market is currently pricing in at least two interest rate cuts by the end of the year, Fed officials have not given the signal that they are ready to act. For example, Vice Chair of the Fed Richard Clarida noted in a speech on February 25 that it is "still too soon" to determine whether Covid-19 will materially change the outlook for the U.S. economy. We believe that if growth fears continue to pick up, the probability of Fed rate cuts will rise in the coming months.

We also expect U.S. health officials to continue their efforts to develop a potential vaccine as quickly as possible. Reports indicate that a major U.S. biotechnology company has shipped a vaccine to government researchers at the National Institute of Allergy and Infectious Diseases, which is expected to begin clinical trials by the end of April. We will continue to monitor updates as they become available.

What we expect in the coming weeks?

An acceleration in global growth, which was our base case for 2020, has been delayed, as a result of the Covid-19 outbreak. Q1 economic data is likely to be weak, pressuring analyst forecasts to the downside. Manufacturing data will be affected by production shutdowns in China, South Korea and Japan, which affects the flow of intermediary goods among them and shipment of products to the U.S. and Europe. Service sector data is likely to be affected due to restrictions on travel among others.

Corporate earnings globally are likely to be revised lower, especially for cyclical industries such as travel & leisure, transportation, retail and technology. Travel and work restrictions along with quarantines in China and parts of Europe, general consumer hesitation and lost or postponed retail sales will weigh on revenues. Company guidance will

* Active management requires frequent buying and selling in an effort to outperform a specific benchmark or index. Passive management replicates a specific benchmark or index in order to match its performance.

[3] "The stockmarket is now run by computers, algorithms and passive managers", The Economist. October 5, 2019.

[4] "Passive US equity funds overtake active peers in AUM, Morningstar", Citywire USA. September 12, 2019.

continue to reflect caution, especially for those dependent on global supply chains and Chinese demand.

The U.S. economy should remain strong on a relative basis. Consumer confidence levels remain elevated, the labor market is strong and the housing sector is improving, lowering the chance of a U.S.-led global recession. As rates have fallen to all-time lows, home purchase and mortgage refinance activity has picked up along with home prices, given tight inventory and rising demand from Millennials.

As mentioned, the Fed remains in a "wait-and-see" mode with respect to the severity and geographical spread of the Covid-19 outbreak and will be vigilant for any persistent signs of economic stress. (Re)Inverted yield curves, falling commodity prices, including crude oil and historically low 10-year and 30-year bond yields are signaling a deflationary mindset. If these conditions prevail for some time, then the Fed is likely to cut rates further, with the intention of supporting near-term growth and raising long-term inflation expectations.

If the Covid-19 outbreak is contained in the coming months then, a U-shaped recovery is likely in 2H of 2020. This is our central case. Leaner goods inventory levels will enable production to ramp sharply higher—specifically the automobiles and electronics cycle should resume enabling the global cycle to pick up. Countries more dependent on exports and manufacturing should exhibit significant improvement from near-recessionary levels.

What is the implication for investment strategy?

One can argue that many equity investors were complacent about Covid-19 fears that were being reflected by falling bond yields, commodity prices and a stronger U.S. dollar. With the outbreak spreading outside China, stock market sentiment finally cracked as uncertainty rose to a very high levels. The near-term "tug of war" is between fear of a global pandemic and a significant global slowdown versus fiscal and monetary policy easing plus a better understanding by authorities of how to ultimately contain the outbreak.

The S&P 500 had risen 15% since last fall before the Covid-19 outbreak and price-to-earnings ratio (P/E) had risen to 19x, which seemed elevated on an absolute basis. Now at 17.6x, the multiple looks more reasonable. We believe there could be more volatility but in our view, long-term investors should not panic as pullbacks and corrections are normal within a long-term secular bull market in equities. For example, 5%+ pullbacks happen on average three times a year going back to 1926. The median magnitude of all 5%+ selloffs is -8.2%. The average magnitude of all 5%+ selloffs is -11.9%.

It is important to fully recognize that this uncertainty is not "normal", however. The current concerns, at this time, are less controllable than other well-known previous outbreaks. In the coming weeks, we will get more transparent data that allow for more effective analysis on the path forward for investor sentiment, economic growth and policy response. In this highly uncertain and fluid environment, we want to stay measured, not overreact to the news of the day and remember prior times of similar stress and how we worked through them.

Recent market developments underscore the importance of diversification in portfolios, both within equities and across asset classes, to help mitigate periods of higher-than-expected volatility. Investors should remain focused on developments concerning the scope of the outbreak, as well as fundamentals such as trends in economic data and corporate earnings, and have plans ready to rebalance portfolios as appropriate. Given our view that we are just stalled within and not at the end of the current expansion, we believe that long-term investors could have opportunities to add to fundamentally attractive areas in the coming weeks. The capital markets are clearly going to remain in a volatile saw-tooth pattern through spring, in our view. Beyond the immediate concerns surrounding Covid-19, the other notable market catalyst this year will be the U.S. presidential election cycle as we head toward Super Tuesday.

Given this full backdrop, our portfolio strategy for 2020 remains unchanged: We expect equities to outperform fixed income, with a preference for U.S. large-cap equities relative to the developed markets and emerging markets (EM). We don't know what we don't know as it relates to when the peak of the Covid-19 outbreak will be. While equities could remain under pressure as news surrounding the outbreak develops, we maintain our 3300 fair value target for the S&P 500 based on the expectation that the global economy stabilizes and corporate earnings growth begins to improve later in the year. Furthermore, as the contagion is contained, the recent strength in the U.S. dollar is likely to reverse allowing a recovery in international markets as well. Additionally, we are ready to rebalance portfolios when certain asset classes become far too overvalued/undervalued through the year, in other words, to use the surplus gains in bonds to rebalance up in equities at more attractive prices.

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.

Shanghai Stock Exchange Composite is a stock market index of all stocks that are traded at the Shanghai Stock Exchange.

Nikkei 225 a stock market index for the Tokyo Stock Exchange.

STOXX Europe 600 is a stock index of European stocks designed by STOXX Ltd.

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