Retirement Income Solutions

Helping to grow and preserve your wealth

Extreme Market Conditions

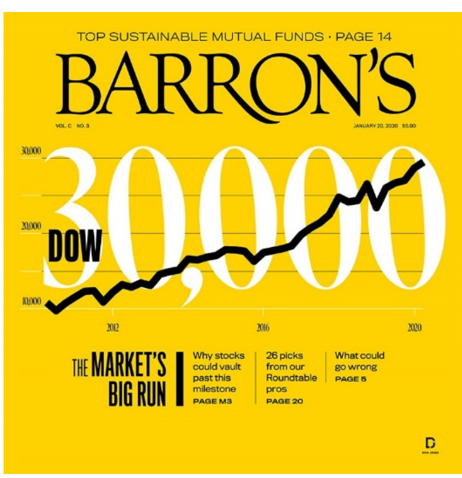
March 2020

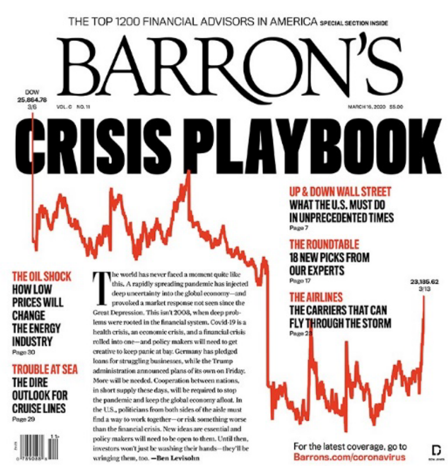
Summary

Fear of the Coronavirus and its impact on the economy has created extreme volatility in financial markets. Less than a month ago, the U.S. stock market was at an all-time high, economic growth was steady, and tensions from the trade war were abating. The changes in the last month occurred at a blistering pace. Note the change in sentiment from two covers of Barron's Magazine published just six weeks apart (see below) – from "The Market's Big Run" to "Crisis Playbook." As a result, swings in financial markets have been extreme. Two of the six worst days in the history of the stock market occurred in the past week, and stock markets are down roughly 30% from the highs of just a few weeks ago.

The eleven-year bull market has ended. A period of remarkable stability (no drawdowns over 20% occurred since the Financial Crisis) ended with swift losses. The expansion was the longest on record, and, a few weeks ago, most pre-recessionary indicators were still positive (payrolls, profits, inflation, central bank policy, etc.). Exogenous shocks (wars, natural disasters, and pandemics) are not predictable and therefore very destabilizing to financial markets.

In response to the concerning outlook and potential for the stock market to reach even lower levels, risk levels in client portfolios have been reduced over the last week. Some bond investments with higher credit risk were sold, and most clients' exposure to equity markets was reduced by roughly 10%.





Quarantines & Closures

The market responses run much deeper than the virus. The primary concern is over the magnitude of the pending economic contraction. Government actions taken to limit spread of the virus are dynamic and increasing daily. Travel restrictions, border closings, and limits on group gatherings are important to public health but can have a significant impact on the state of the economy.

The response to the virus has resulted in numerous outcomes; a few are listed below:

- Layoffs have begun in the U.S. (airlines, hotels, event companies, etc.).
- The governor of Michigan (and many other states) have banned events with over 50 people.
- Local school districts announced closures for weeks.
- Most colleges have moved entirely to virtual classrooms.
- Major sporting events are canceled or suspended (NCAA basketball, NHL, NBA, etc.)
- Disneyworld and Broadway Theaters are closing.

The recent stock market decline is a reaction not only to the existing breakdown in spending, but also to the worry that such a decline in spending will continue and compound. Will layoffs in some industries lead to the same in others? Will temporary delays lead to long-term damage?

Challenging Variables

There are three significant variables that will impact future market response to the crisis: 1) the virus itself – how widely it spreads and the development of new treatments; 2) the degree to which fear of the virus negatively impacts the economy through reduced activities, spending, jobs, etc.; and 3) the government's policy response.

The first… the path of the virus is not knowable. The second… the economy is likely to dip into recession. The outstanding question is how painful the recession will be and whether the current lower stock prices already reflect such a poor outcome. Will the layoffs in airlines, restaurants, hospitality and small businesses snowball into layoffs in areas not directly impacted by limited travel and activities? The third… government response may be both monetary and fiscal. In terms of monetary policy, the Fed has already made significant moves to lower short-term interest rates essentially to zero. These provide some help to shore-up banks and ensure liquidity in the financial system. However, monetary policy is a blunt instrument and is not much of help to those most directly impacted by the virus (households, small businesses, or larger businesses with weak credit). It is likely fiscal policy can have a meaningful impact, but it may be difficult for Congress to find agreement on initiatives that stimulate where it is needed most.

Waterfall Declines

In the past few weeks, the U.S. stock market fell by roughly 30%. Such a rapid decline is almost unprecedented, perhaps with the exception of Black Monday in 1987. In addition to the accumulated change over the last few weeks, the daily swings in stocks has been astonishing. Two of the six worst days in the history of the stock market occurred in the past week. The U.S. stock market (S&P 500) moved by more than 3% (up or down) in 12 of the 50 trading days in 2020. In the prior eight years (over 2000 trading days), there were only 11 days with moves of 3% or higher. The cause of large daily swings is not entirely clear, but the nature of trading has changed over time and is likely driven by algorithmic traders, social media and the 24-hour news cycle.

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S&P 500 Drawdowns of Over 15% in 3 weeks

1950-2020

Date	Initial Decline over 3 weeks	Returns next 6 mo	Returns next 12 mo	Maximum drawdown next 12 mo	Environmental Note
10/19/1987	-30.1%	15.5%	23.6%	-0.4%	Black Monday
9/20/2001	-16.9%	17.0%	-9.5%	-19.0%	9/11 & beginning tech bubble
7/22/2002	-15.4%	11.6%	21.2%	-5.3%	Tech bubble
10/8/2008	-18.4%	-17.2%	4.1%	-31.3%	Near beginning of Financial Crisis
2/27/2009	-15.4%	39.8%	48.9%	-8.0%	Near end of Financial Crisis
8/8/2011	-15.6%	20.1%	22.8%	-1.8%	European debt crisis
12/24/2018	-15.7%	25.3%	35.7%	0.0%	Recessionary worries
3/9/2020	-18.5%	15.5%	23.6%	-0.4%	Coronavirus
Average	-18.2%	16.0%	21.0%	-8.8%	Source: Bloomberg

There are only seven prior cases of waterfall declines (defined as over 15% decline in a 3-week period). Generally, stocks recover well after a year following a waterfall decline. Seven of eight cases were positive after 12 months, and six of eight cases realized returns over 20%.

At first glance, the potential for recovery seems high. Looking more deeply, the results are mixed. The cases in 1987, 2011 and 2018 all saw continued volatility, but markets found a way to move higher over the next year. After the initial decline, markets saw very little additional drawdown over the next year.

The other cases, in particular 2001 and 2008, are less favorable. Both economies were in the early stages of a recession and major market declines. Although both had temporary recoveries, both also saw double digit drawdowns (-19% and -31%) over the next year. Both recessions had different causes and factors – the 2001 recession was a result of the tech bubble and extreme valuations, while the 2008 financial crisis was caused by excessive risk-taking in the housing market. After a waterfall decline, those periods that occur outside of a recession are relatively mild and short-lived. However, those rapid declines that occur in a recessionary environment can have further downside in months to come.

What Comes Next?

Unfortunately, since the path of virus is not predictable, markets are likely to continue to be volatile. There are few precedents to analyze, but big swings in markets can often continue for months after waterfall declines. It will not be a comfortable time for investors.

Governments will pursue policies to support the economy. The Fed has taken short-term interest rates to zero but still has some tools in its toolbox. It may take a while to put other fiscal relief packages into motion. Getting 535 members of Congress to align on tangible efforts that can support areas most affected by the crisis may take time.

One of the challenges in assessing what comes next is limited data. This level of stock market volatility has not been seen before, with perhaps the exception of Black Monday in 1987 where stocks fell by 23% in one day. The study on waterfall declines (above) only has seven cases, and the environment in each case is different. If the virus is contained relatively quickly and dies out mostly over the summer, the economic impact may be mild and short-lived, and the stock market recovery may be swift. If the layoffs compound and government stimulus is lackluster, further downside may be ahead.

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Final Thoughts

It is also important to remember that long-term investors will see volatility in portfolios. The drawdown seems a bit shocking since there has been very little volatility over the past ten years. The U.S. stock market (S&P 500) has not fallen by 20% since the Financial Crisis, and such a rapid decline has only occurred in one other year (1987) since 1950. While the investment environment may be uncomfortable, stocks are also the best place to be to achieve portfolio growth in the long run. The recent bumpy ride can be nerve-racking. However, on a 3- or 5-year basis – particularly with bond interest rates so low – returns from a stock portfolio should outpace most of the other options available to investors today.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our website at www.risadvisory.com.

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