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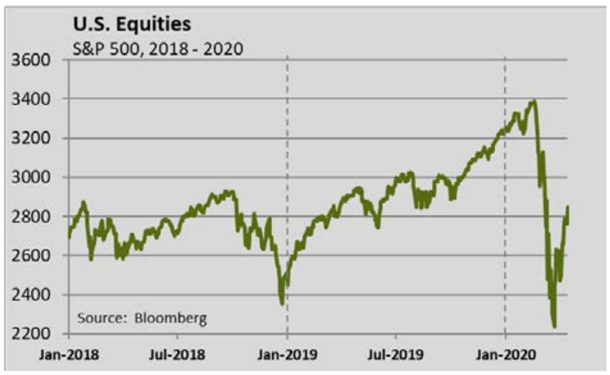
Shock, Recovery & Strategy

March 2020

Summary

The world changed dramatically over the last six weeks. A recovery is coming, but it will take a while for the economy, financial markets, and every-day life to return to normal. Fear of the virus and its impact shocked the stock market, which fell sharply in March. Some of the damage has been recovered in recent weeks, but expectations about what happens next adjust daily.



Financial markets are complex, and there are limited data to draw on for historical comparisons. There are several important considerations in evaluating the current financial environment:

- This is the **first ever recession by government decree**. Stay at home orders are damaging to the economy. It is a difficult choice. Reopen too early and risk a faster second wave of infections. Reopen too late and risk institutionalizing unemployment.
- The market is following a **recurring pattern that occurs after waterfall declines**. Studies of such periods indicate risks are still elevated.
- News in the **next month is likely to be brutal** – large spikes in unemployment, significant reductions to corporate profits, and scary headlines about the growing number of deaths.
- The typical stock market **drawdown during a recession lasts 18 months**. Only two recessionary bear markets lasted less than six months. Records are meant to be broken, but it seems unlikely that risks posed to the economy from this crisis will be concluded in only 40 days.
- **Government stimulus has been swift and significant**. Both the Federal Reserve and Congress have signaled they will take extreme measures to mitigate the downward economic spiral.

Currently, forward-looking risk appears to be asymmetric, with more potential for a return to the downside than continued advance to the upside. Accordingly, most client portfolios have been moved to a more defensive position through further equity reductions (note: some clients were already at the targeted risk level, and some asked to be more or less conservative during this period, so recent actions incorporate those prior moves or expressed instructions).

Peter Berezin, Chief Global Strategist at BCA Research, put the crisis into context by writing, “At times like these, it is easy to despair about the future. Yet, there are three reasons to think that the worst of the economic damage will be over within the next few months: 1) The measures necessary to control the virus are likely to be relaxed without this leading to a new wave of infections. 2) Recessions following exogenous shocks, such as the one we are currently experiencing, tend to produce faster recoveries than those stemming from endogenous slowdowns. 3) Policy will remain highly supportive, mitigating possible adverse second round effects."

Investment Returns

March was a tough month for equity investments. From peak to trough, U.S. large cap stocks fell by -34%. Smaller companies are typically more economically sensitive and therefore saw greater losses. Stocks started the year with gains, then fell significantly, and have since recovered some of the losses. Therefore, from a year-to-date perspective, equity market returns are negative but not as extreme as they were in late March. For the year through April 15, large cap stocks were down -13%, developed international stocks were down -21% and emerging markets down -20%. Financial market risk and a price war within OPEC participants weighed heavily on Oil, which was down by -68%. Gold, often a safe haven in times of crisis, was the strongest performer on a year-to-date basis.

Asset class	2019	2020 thru 4/15
U.S. large cap stocks	31.5%	-13.3%
Small cap stocks	25.5%	-28.7%
International	22.0%	-21.4%
Emerging	18.4%	-20.0%
Bonds	8.7%	4.8%
Commodities	10.0%	-28.2%
Oil (WTI Crude)	34.5%	-67.5%
Gold (spot)	18.3%	13.2%

Source: Bloomberg

Waterfall declines

The month of March saw the swiftest bear market decline in the history of the stock market. It took 40 days for the market to drop by over 30%. There have been 13 other cases of waterfall declines since 1920. Ned Davis Research summarized these periods, "There is no quantifiable definition of a waterfall decline because they are so rare and each entails, in fact requires, a unique trigger. Most waterfalls include persistent selling over multiple weeks, no more than two up days in a row, a surge in volume, and a collapse in investor confidence."

The cause of this most recent waterfall decline in stocks is unique, but the market reaction is not. In 2008, investors were concerned that banks were not solvent. In 2011, the market feared that the European Union was going to dissolve. The cause of each panic is different, but the market dynamics are very similar.

The recent market recovery has been a welcome relief. However, the data on waterfall decline periods are worrisome. It is common that the stock market will bounce after a waterfall period. In general, the initial recovery in stocks is typically 25-30% of what was lost in the waterfall decline. The most recent case from March saw a bounce (so far) of almost 50%. The swiftest decline was followed by the biggest bounce. After an initial bounce, in 12 of 13 cases, the market went down again at least to retest the initial lows. In 9 of 13 cases, the market went down to hit lower levels. Noting there are very limited examples over the past 100 years, the history of such periods is not encouraging.

Bad news ahead

It is going to be a brutal month or two for news headlines. This does not mean that a depression period is coming, but some very negative news is likely to weigh on investors in the near term.

- Initial jobless claims jumped from 211,000 to almost 7 million in three weeks. Total claims over the last three weeks were 17 million. Unemployment could rise to 15%, higher than any period during the financial crisis in 2008-2009. The large numbers should be temporary but are astonishing, nonetheless.
- The International Monetary Fund changed their global growth forecast for 2020 from +3% to -3% – a 6% swing is a significant change in economic expectations.
- Business closures and debt defaults will be concerning. Government efforts to support businesses are significant, but many companies with thin margins and low cash reserves will not survive.
- Consumer sentiment plummeted in March. The University of Michigan Consumer Sentiment Index fell from 101 to 71 in two months, a level not seen since the European Debt Crisis in 2011.
- Corporate profits are likely to fall by 10-30% this year, and warnings will increase during the April / May earnings season.

Unprecedented volatility

The daily swings in the stock market have been both unnerving and unprecedented. Stocks moved by more than 1% all but one day in the month of March. Stocks moved by 3% or more in 16 of the 22 trading days in March. In comparison, from 2012 to 2019, stocks moved by 3% or more only 11 times out of over 2000 trading days.

It is a good sign that volatility has been slowing recently. However, big moves are likely to continue due to the lack of data for analysis. The economic system is being reset, so information from a month ago is almost irrelevant. That data void is filled with small pieces of news that can cause artificially large moves. It will take some time to establish a new baseline for evaluating the health of the economy and markets.

Bear markets

Stock market drawdowns in recessions are deeper than those outside of a recession. A study by Ned Davis Research found there have been 36 bear markets since 1900. The median bear market associated with a recession has declined -36% over 517 days (17 months) versus -23% over 224 days (7 months) for bear markets not associated with recessions.

Bear Markets

Post WWII (1948-2019)

	Recession	No recession
Cases	23	13
Median change in stock market	-36%	-23%
Median number of days	517	224

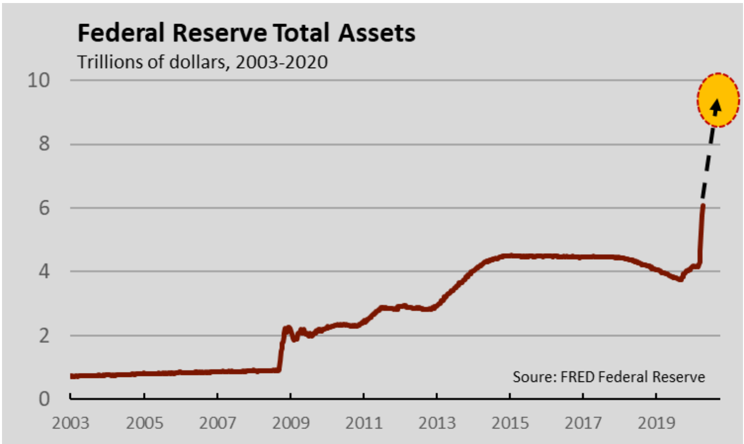
Source: Ned Davis Research

Interestingly, all 36 bear markets have lasted longer than the 2020 period. Currently, the drawdown from February to March lasted 40 days resulting in a drawdown of -34%. The stock market losses are “average” compared to prior recessions, but it is by far the fastest drawdown on record. The only other two bear markets that lasted less than two months were 1987 (Black Monday occurred after stock prices had doubled in only 2.5 years) and 1998 (during the Asian currency crisis). While the consensus view is that a quick recovery is underway, recessions tend to linger for much longer. Barring a miracle cure, it seems unlikely that risks posed to the economy from this crisis will be concluded in only 40 days.

Unprecedented stimulus

Actions from the Federal Reserve and Congress have been swift and meaningful. Both have announced several rounds of stimulus to prevent further economic decline. Reflecting on the 2008 financial crisis, it took the Fed and Congress 10 to 14 months to take action to prevent further deterioration. In March, both organizations took major steps within three weeks of the start of market turmoil. In addition, the sizes of the stimulus packages were significantly larger than those in 2008.

The Fed has taken several actions, two of which are most notable. The first was to reduce short-term interest rates to zero to make it cheaper to borrow money, which eases financial pressure on companies and individuals. The second was to create liquidity for financial markets by purchasing numerous bond securities. In times of distress, “cash is king,” and many investors avoid not only stocks but bonds as well. If no one is buying bonds because they prefer zero risk in cash, bond prices fall artificially, which can add panic to such an environment. The sum of these purchases could add $6 trillion to the Fed’s balance sheet this year.



Fiscal stimulus from Congress has been significant as well. In the U.S., various programs in the CARES Act surpassed $2 trillion in direct aid to businesses and individuals. Governments around the world have followed similar strategies. In total, $4 trillion in stimulus around the world represents roughly 6% of global GDP.

Final thoughts

Looking out a year or two, there is very strong potential for stocks to recover. Monetary and fiscal stimulus from the Federal Reserve and Congress will help prevent an extreme downward spiral and hasten the economic recovery. The stock market will recover and will likely be the best source of returns over the next five years. However, in the short run, the risk to the economy and financial markets remains quite elevated.

While it is a very welcome development that markets have recovered some of the March losses, volatility will continue to be quite high, and risk is asymmetric in the near term – the potential for renewed negative movement in the stock market is greater than the potential for a straight-line upward recovery.

Although apocalyptic news in the last six weeks has been unrelenting, there will be many twists and turns to come. There is no precedent for recent events in the modern world. The fast-paced nature of the decline makes data-driven analytics difficult, and much of the recovery is dependent on people's behavioral responses. Government actions are buying time for the economy to resume its prior path, but it may take longer than expected. How close to "normal" will things be? If people are scared about transmission, testing or lack of treatments in hospitals, then conditions will not return quickly to normal. Consumer spending makes up 70% of the economy and strong, confident U.S. consumers were a major underpinning of the stock market in recent years. How soon will that confidence be restored? The economy and markets will recover, it may just take a little more time to adjust to a new normal.

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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