CHIEF INVESTMENT OFFICE

Investment Insights

Markets Trying To Price In The Worst-Case Scenarios

March 10, 2020

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After one of the most rapid corrections in the history of the financial markets with the Dow Jones Industrial Average plunging more than 19 percent in a little more than a week (approximately 7-8% across U.S. equity indices on March 9), Treasury yields dropping to record low levels, new developments each day and more information regarding the spread of COVID-19 is now creating further concerns that the initial global supply chain disruption and supply shock is shifting into pressures on demand. And when you combine this with the latest news regarding the current oil price war that could push oil prices into the $20 dollars per barrel range in the coming days or weeks, volatility and negative investor sentiment is expected to remain at high levels.

At the time of this report, Gold prices were around a 7-year high; 10-year Treasury yields had moved below 0.5%; oil prices fell by more than 25% to near $31 per barrel as measured by West Texas Intermediate (WTI) in one day marking the largest drop since the Gulf War in 1991; 30-year Treasury yields falling below 0.9%; and, in our view, global equity markets were trying to price in the worst-case scenarios.

In time and with more data, including new policy responses, we should have a better understanding of the eventual economic and market impact. As this unfolds, we expect markets to stabilize and begin to discount the potential for an improved second half of 2020. But, in our view, there is quite a bit of work to do before that materializes. Bond yields need to bottom and begin to turn up while oil prices need to stabilize at higher levels and equity markets need to come to grips with the rising probability of a contraction in the economy. This helps create a reset in which long-term investors can begin to rebalance portfolios back into equities by using the gains in fixed income.

In the immediate-term while markets continue to attempt to price in a contraction in the economy—the timing and magnitude are still unknown—(BofA Global Research's current forecast is now potentially 1% for Q2 versus the previous 1.6% with potential for further adjustments lower given additional developments), zero to negative corporate earnings growth, potential credit issues in lower-quality corporates particularly energy, retail, and consumer entertainment or travel space, investment sentiment should remain in a very fragile state. This obviously creates an environment that is highly uncertain. We believe it is important to examine positioning, profits, and policy to help determine when a period of stability is around the corner. From a positioning perspective, many fear gauges are at or close to prior crisis levels as volatility has yet to subside. In addition, investors have become very defensive in their allocation across and within asset classes. The initial risk-off move occurred in late February and now the second move has become more technical in nature. The S&P 500 is attempting to find a near-term floor that correlates with prior index levels from which the original latest market advance began. During the

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lows in Q4 2018, the S&P 500 fell to around 2350 only to advance to successive new highs as the price-to-earnings (P/E) multiple rose without an expansion in earnings in 2019. These areas include the low 2700s (2728-2722 March 2019 lows, 2746 June 2019 lows) then around 2637, which is the 200 week moving average—a time induced level (a fall of over 20% from the highs of 3400 in mid-February)—that has held in prior secular bull markets, according to BofA Global Research's Market Analysis. Short-term traders sometimes use technical levels to adjust their positions which can lead to excessive daily volatility, and this is what we believe we are witnessing at this point. We look for this action to subside before positioning has priced in a worst-case scenario. In terms of positioning, we are close from a technical perspective. The key question is still the fundamental denominator or the level of profits, all things considered.

It is important to assess the ultimate recovery factor most notably in terms of the economy and corporate profits. In this regard, the starting point matters a great deal, in our view. The global economy was still in a slow-growth mode with prospects for a bottoming out increasing with each passing month in 2020. The U.S. economy was heading back toward trend and actually showing signs of strength. Manufacturing was bottoming, the consumer was strong, housing was powering ahead, and job growth was healthy. The U.S. economy was on solid footing. This helps with whatever magnitude of negative economic effect comes our way in the coming quarters as this relates to profits for corporate America. We see the market attempting to price in zero to negative earnings growth. If the market is correct this would place S&P 500 earnings in a range at around $160-165 per share for 2020. This is a preliminary assumption and, of course, will ultimately depend on when this virus fear recedes and the collateral effects of the accelerated collapse in oil prices. Needless to say, given that there are high probabilities of wide outcomes, we expect imperfect data in the near-term. But in the coming weeks and months, we should have a much better understanding of what is fully priced in and when the eventual recovery is beginning.

In order for stabilization to ensue in the capital markets and fear to subside there needs to be a defined-policy response, in our opinion. Michael Hartnett, Chief Investment Strategist in BofA Global Research, has often cited, "when policy makers panic, markets stop panicking." For this to unfold this time around, we believe a fully coordinated global response is needed with a combination of both monetary and fiscal stimulus. On the monetary side, the Federal Reserve (Fed) in addition to lower overnight rates (Fed Fund futures are discounting another 86 points lower) could announce further short-term liquidity measures to help the funding markets. The Fed could also announce the use of additional lending tools, expand the money supply, and/or announce new asset purchases. These would be designed to alleviate credit concerns and/or cushion the fall in cash flows and lessen the adverse feedback loop that may endure. Moreover, a fiscal response—financed by all-time low rates—that targets consumers and/or small businesses would help cushion household cash flows that are most affected. Therefore, a coordinated fiscal and monetary response that is designed to foster both supply and demand for money, stabilize cash flows in specific areas plus provide relief to businesses and households that are enduring short-term pain (given this extreme uncertainty), is very important in our opinion.

Given our view of positioning, profits, and potential policy let's examine some important data for longer-term investors. Consider this: At current levels in the S&P 500, as an example, more than 80 percent of the companies have dividend yields above the 10-year Treasury yield, 75% above the 30-year Treasury yield, and approximately 50% above the average Investment-Grade bond yield, according to Bloomberg. In addition, at the index level, the S&P 500 now has a dividend yield over 4x the 10-year yield. This ratio is around a 70-year high, according Savita Subramanian, BofA Global Research U.S. Equity and Quantitative Strategy head. Savita also states the ratio had three peaks during this cycle at 1.4x. Following those peaks, the S&P 500 outperformed the 10-year by 31 percentage points on average over the next 12 months. Furthermore, 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 percent or greater corrections in the S&P 500 have occurred on average 1x per year. And since 1930, Savita's work highlights that if an investor "sat out" the ten best performing days for the S&P 500 per decade, hypothetically returns would have been just 91% versus 14,962% overall. Market timing, in our view, is not a successful strategy.

From our Chief Investment Office perspective, we will continue to examine all of these trends in the coming weeks and remain of the view that diversification is one of the most important portfolio strategy factors one can deploy especially during the most volatile times. As risk assets eventually correct, more conservative assets such as Government bonds can help provide a ballast in portfolios and potentially mitigate some of the declines we are presently witnessing.

With panic appearing to grip the markets at this time, we believe it is important to let the volatility subside in the near-term but given our current view that equity markets are likely to recover with additional policy responses and as some signs emerge that the economy could benefit from recent stimulus, we will look for opportunities to rebalance portfolios and stay diversified over the coming weeks and months.

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.

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