R Thoughts – Market Update #2 – March 12, 2020

Within the past 24 hours most equity markets worldwide have entered a "bear market"- generally classified as a decline of 20%+ from their previous and most recent highs. (1) As of this writing (9:30am March 12, 2020) the Dow Jones Industrial Average and the S&P 500 Index show declines of over 25% from their highs established in late February of this year. (2)

In our opinion the stock markets are currently dealing with three issues which are obviously causing a dramatic downward repricing of assets – the Coronavirus, the Credit Markets and the 2020 Presidential election.

We discussed the effects of the Coronavirus on the equity markets in our Market Update which we emailed out on February 27th. It has now been classified as a "pandemic" by the World Health Organization. According to the World Health Organization a pandemic is declared "when a new disease for which people do not have immunity spreads around the world beyond expectations." (3) This one event has led to a tremendous amount of uncertainty and angst as its' ultimate effect on economies worldwide is impossible to predict at present. The one thing that we do know is that stock markets hate and do not deal with uncertainty well. This has become a very emotional topic as this virus will likely have some effect on all human behaviors worldwide.

The Credit Markets – Corporate, Municipal and Government debt markets – are becoming more concerned with the repayment of principal and interest of corporations and municipalities at maturity. Yield spreads (the interest rates) between lower quality corporate bonds and U.S. Government bonds are currently expanding and the pricing of corporate bonds in the marketplace is currently declining. This, with the backdrop of U.S. Treasury Bonds interest rates declining to record levels indicates, to us, a concern by investors that some corporations may find difficulty in meeting debt service obligations out into the future. This is currently especially acute in the energy sector where oil prices have collapsed to multi-year lows.

The uncertainty on how the Coronavirus affects the economy and therefore the potential to influence the results of the U.S. Presidential election in November are also adding to list of concerns for market participants. Any movement away from the pro-growth, lower regulatory, lower tax policies currently in place would, in our view, be met with an initial negative response by the U.S. stock markets.

As we stated in our Market Update on the 27th of February, "As stewards of clients' investment capital we are in the business of identifying and pricing risk in the securities markets. For this reason we have been preparing for this increased volatility for several months now and have continued to lower the risk profile across accounts by increasing cash levels and other measures – even before this recent bout of anxiety regarding the Coronavirus has surfaced."

In our Tactical Growth Accounts in which we manage on your behalf we have continued to hold to and increase our overall defensive postures (increase cash levels lowered net equity exposure) which, at present, has allowed the accounts to generally accept significantly less downside capture than that of the overall equity markets. (4) We have preached about risk management strategies in the concept of overall portfolio management for a number of years now and those principles are, at present, finally being rewarded.

Given a 25% decline in stock prices over the past month one might be correct in asking the question what would make you more constructive on stocks and begin reallocating funds from cash back into risk assets?

Quoting Mike Wilson Morgan Stanley's Chief Equity Strategist in his research piece this morning, March 12th, "The virus and oil shocks are very real threats to the economy and financial markets have appropriately moved to price a U.S. recession. We are now trading slightly below our downside case on the S&P 500 and believe it is time to start adding to equity risk for longer term investors. Fed action is likely to be imminent, swift and substantial. While that will not prevent a recession it is part of the bottoming process especially if fiscal policy flows from multiple regions of the world." (5)

Mike's opinions hold weight with us as he was one of the many sources that we used in order to get more defensive in our managed accounts in the second half of 2019.

We concur with Mike – there is a time to start adding to stocks, especially after a 25% decline – but we are not so sure it's just right at this time and price. Currently, the supply of stocks for sale is overwhelming the demand for stocks resulting in lower prices. As we observe positive changes in the supply/demand relationship for stocks we would then become more constructive on risk assets in general.

The time period between February 19th and March 12th, 2020 is the shortest period of time ever for the market to decline 25% and as such the latest drawdown stands out for its speed more than its size. (6) The velocity of this decline has been disconcerting even for those of us with many decades of market experience.

The last few weeks have been an unnerving period for all of us. We have no idea on how long this period will last and ultimately what happens to the financial markets in the short run. What we do know is that we entered this period of increased volatility and uncertainty with a generally defensive stance in the accounts we manage on your behalf and these risk management concepts have served us well throughout this market decline.

Moving forward we will continue to adhere to our investment principles, strategies and unemotional disciplines' and will adjust the "dimmer switch of risk" as necessary in either direction depending on market conditions and outlooks.

Please don't hesitate to reach out to one of us with any questions or concerns.

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Links to our Recent Written Newsletters and Updates:
R Thoughts – Winter 2020
R Thoughts – Market Update – February 27, 2020

Sources and Footnotes

(1) Capital Market Indices – MS Wealth Management, March 12, 2020.
(2) Thomson One Market Monitor – March 12, 2020.
(3) The Guardian – March 12, 2020.
(4) LYDIA – QTD/YTD Account Returns, March 12, 2020.
(5) Michael J. Wilson – U.S. Equity Strategy – March 12, 2020.
(6) Michael J. Wilson – U.S. Equity Strategy - March 12, 2020.

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