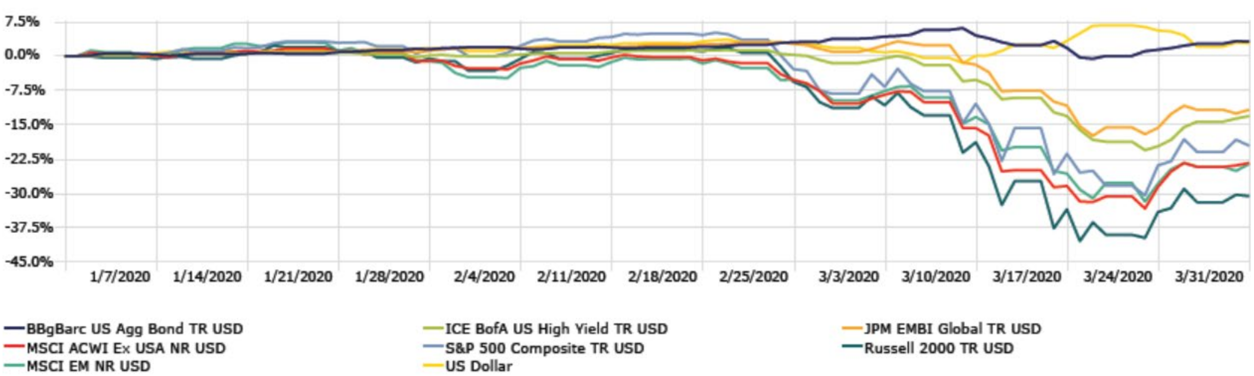
Q1 2020 Market Commentary

After a positive end to last year, the first quarter of 2020 saw the Dow Jones Industrial Average experience its worst quarter since 1987. The culprit: COVID-19. As the world adjusts to self-quarantines and social distancing, businesses and economies must adapt to commerce in this brave new world.

Global Markets Performance

The US stock market, as represented by the S&P 500, ended the quarter down 19.6%, erasing nearly all of the gains from the prior year. Smaller US stocks[1] endured a tougher quarter and dropped over 30%. International stock markets[2] and emerging markets[3] split the difference and returned -23.36% and -23.6% to close out the quarter, respectively. On the fixed income side, core bonds[4] rose 3.15% while high yield bonds[5] tracked closer to equities, down 13.12% for the quarter, impacted by lower rates which were significantly offset by wider spreads. Emerging market (EM) bonds[6] fell sharply as well, down 11.76% on the quarter.

Historical Performance



Calendar Year Returns

	YTD	2019	2018	2017	2016	2015
BBgBarc US Agg Bond TR USD	3.15	8.72	0.01	3.54	2.65	0.55
ICE BofA US High Yield TR USD	-13.12	14.41	-2.26	7.48	17.49	-4.64
JPM EMBI Global TR USD	-11.76	14.42	-4.61	9.32	10.19	1.23
MSCI ACWI Ex USA NR USD	-23.36	21.51	-14.20	27.19	4.50	-5.66
S&P 500 Composite TR USD	-19.60	31.49	-4.38	21.83	11.96	1.38
Russell 2000 TR USD	-30.61	25.52	-11.01	14.65	21.31	-4.41
MSCI EM NR USD	-23.60	18.42	-14.57	37.28	11.19	-14.92
US Dollar	2.76	0.22	4.40	-9.87	3.63	9.26

Coronavirus: Where We've Been

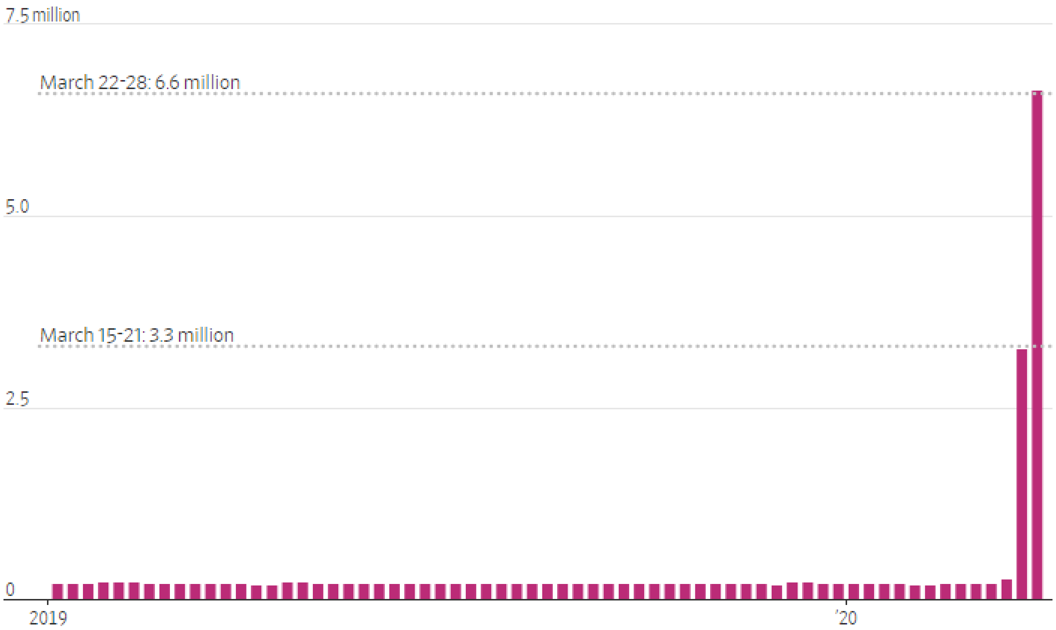
The first confirmed case of coronavirus in the United States was identified on January 15th in Washington state, which subsequently experienced the first initial outbreak of the virus in the country[7]. Since then, all fifty states and Washington, D.C., as well as 4 territories (Puerto Rico, Guam, Northern Mariana Islands, US Virgin Islands), have reported cases. As of April 8th, the total case count for the US came to 395,011 cases and 12,754 fatalities[8]. Nearly 40% of the current confirmed cases have been reported by New York.

As we've detailed previously, both the Federal Reserve (Fed) and federal government have taken drastic steps to combat the economic slowdown caused by this pandemic. On March 30th, Congress passed the $2.2 trillion Coronavirus Aid, Relief and Economic Security (CARES) Act and the president subsequently signed it into law[9]. The act provides for various support programs including unemployment insurance, business loans and grants, state and local support, and direct payments to Americans.

The Fed has echoed similar urgency in its programs to support markets and lending. It has lowered the rate at which banks can borrow from it, relaxed collateral requirements to encourage lending, and established six special funding facilities to support asset prices and liquidity in markets.[10] The sheer number of programs has led many to refer to Fed support now, as was done in 2008-2009 as well, as an alphabet soup of response mechanisms.

Despite these efforts to fight the economic downturn, one of the most recent and visible effects has been the massive spike in unemployment. In the last two weeks of March, unemployment claims rose by over 2,300% from the first half of the month[11]. Going forward, the Congressional Budget Office expects US unemployment in this second quarter to exceed 10%. That level hasn't been seen since the depths of the Global Financial Crisis in October 2009, when the unemployment rate briefly hit 10% before rebounding[12]. However, many of the larger banks on Wall Street expect a sharp recovery in unemployment and economic growth in the back half of this year and into next[13].

Initial Jobless Claims



Note: Seasonally adjusted, latest figure is preliminary. Source: Labor Department, Wall Street Journal.[11]

A Most Testy Market

One of the key debates on Wall Street and among investment professionals right now is whether the markets will decline back to the trough that occurred in late March. In technical terms, this is called retesting the lows. Some strategists, including those at Goldman Sachs and Richard Bernstein Advisors[14], believe there's a higher probability of retesting than the recent positive returns.

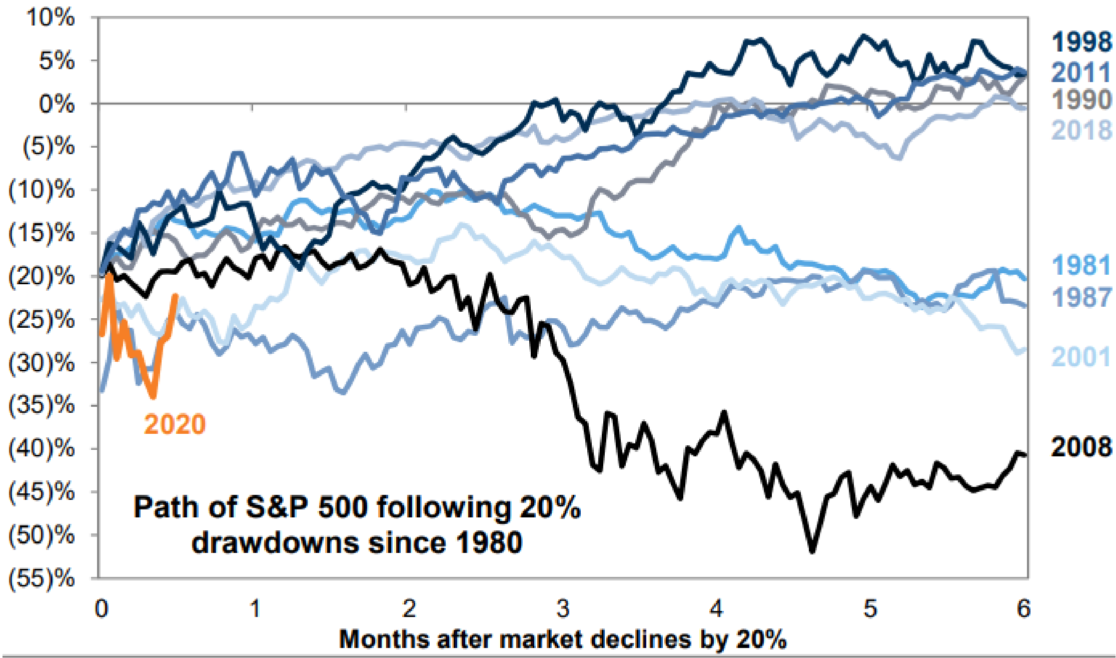
So, what should we actually expect? Predicting the future in the markets isn't possible with any accuracy, but we can look back at history to give us an idea. In a study of market declines greater than 20% since 1980, analysts at Goldman Sachs identified eight different episodes and their respective returns for six months after the initial decline[15]. Half of those return series retested their lows or declined lower, and the other half still experienced volatile returns on their path to recovery.

As you can see from the chart below, the current period thus far most closely matches the drawdown from 1987. However, where we go from here is unlikely to follow in a similar path as no two crises are the same and the response won't be either. What we can gather from this study is that whether or not this market retests its prior lows, the period of recovery will likely take at least a few months, if not longer.

And as we've noted in prior missives during this crisis, markets anticipate future events and adapt as those events progress. Thus, we are likely to see an improvement in the markets ahead of an improvement in fundamentals such as GDP growth, unemployment, and corporate earnings. But given the novel and global consequences from this pandemic, we are likely to see volatility in both directions as countries around the world try to fight back.

S&P 500 performance after 20% declines since 1980

As of March 26, 2020



Source: Goldman Sachs Global Investment Research[15].

Looking Ahead

The second quarter of 2020 is likely to be one of the toughest quarters in the nation's history, with millions seeking unemployment and countless businesses seeking financial support. In addition, various states are in different phases of dealing with the pandemic on both economic and health levels, and in many instances, things are likely to get worse before they can get better. This could be a significant risk to a uniform response and recovery.

However, over time markets should recover and economies should find their footing. Making long-term investment decisions based on shorter-term developments is contrary to the idea of a strategic financial plan. Investing is all about planning for the future and focusing on that long-term.

As the famous quote goes, 'these are the times that try men's souls.' But emotion is the enemy of investing, and it is for times like these that we develop strategic plans. Stay safe, stay healthy, and contact your financial advisor for any updates to your financial circumstances.

As of April 8, 2020.

mABC LLC Investment Advisors

References:

Smaller US stocks[1] – as represented by the Russell 2000 TR Index, data provided by Morningstar 2020.

International stock markets[2] – as represented by the MSCI All Country World ex-USA Index, data provided by Morningstar 2020.

Emerging markets[3] – as represented by the MSCI Emerging Markets TR Index, data provided by Morningstar 2020.

Core intermediate bonds[4] – as represented by the Bloomberg Barclays US Aggregate Bond Index, data provided by Morningstar 2020.

High yield bonds[5] – as represented by the ICE BofAML US High Yield Index, data provided by Morningstar 2020.

Emerging market bonds[6] – as represented by JPM Emerging Market Bond (EMB) Global Index, data provided by Morningstar 2020.

First US coronavirus case[7] – sourced from Centers for Disease Control and Prevention (CDC), "First Travel-related Case of 2019 Novel Coronavirus Detected in United States," 21 January 2020. https://www.cdc.gov/media/releases/2020/p0121-novel-coronavirus-travel-case.html.

US cases and case distribution[8] – sourced from Centers for Disease Control and Prevention (CDC), "Cases in U.S.," updated 7 April 2020. https://www.cdc.gov/coronavirus/2019-ncov/cases-updates/cases-in-us.html.

CARES Act[9] – sourced from Tax Foundation, "Congress Approves Economic Relief Plan for Individuals and Businesses," 1 April 2020. https://taxfoundation.org/cares-act-senate-coronavirus-bill-economic-relief-plan/.

Fed response & programs[10] – sourced from NY Times, "What the Federal Reserve Has Done in the Coronavirus Crisis," 31 March 2020. https://www.nytimes.com/reuters/2020/03/31/business/31reuters-health-coronavirus-fed-programs-explainer.html.

Unemployment statistics[11] – sourced from The Wall Street Journal, "Record 6.6 Million Americans Sought Unemployment Benefits Last Week," 2 April 2020. https://www.wsj.com/articles/another-3-1-million-americans-likely-sought-unemployment-benefits-last-week-11585819800.

Unemployment in the GFC[12] – sourced from U.S. Bureau of Labor Statistics, "Labor Force Statistics from the Current Population Survey," https://data.bls.gov/timeseries/LNS14000000.

Bank predictions on economy/unemployment[13] – sourced from CNBC, "Goldman sees 15% jobless rate and 34% GDP decline, followed by the fastest recovery in history," 31 March 2020. https://www.cnbc.com/2020/03/31/coronavirus-update-goldman-sees-15percent-jobless-rate-followed-by-record-rebound.html.

GS/Richard Bernstein Advisors[14] – sourced from CNBC, "Stock investors are hunting for positives, but many on Wall Street see a move back to the lows," 8 April 2020. https://www.cnbc.com/2020/04/08/stock-investors-are-hunting-for-positives-but-many-on-wall-street-see-a-move-back-to-the-lows.html.

Goldman Sachs Market Research[15] – sourced from Goldman Sachs, "US Weekly Kickstart," 27 March 2020.

Glossary:

COVID-19 – the official name for the disease caused by the 2019 novel coronavirus outbreak.

Spreads – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

Fed funding facilities – formal financial assistance programs initiated by the Fed to provide loans and backstop lending for targeted companies and assets, e.g. Primary Dealer Credit Facility (PDCF) and Money Market Mutual Fund Liquidity Facility (MMFLF).

Drawdown – peak to trough decline for an investment over a specified period of time

Fiscal spending & budget deficits – fiscal spending relates to all government expenses, and a budget deficit implies a government is spending more than it is receiving from taxes, interest, etc.

Liquidity vs Solvency – liquidity relates to having enough cash on hand to continue operating in the short term, while solvency relates to the long-term and whether or not equity is sufficient to continue operating.

Repos (repurchase agreements) – in repurchase markets, borrowers needing cash offer lenders collateral, generally in the form of safe bonds (such as US Government bonds), and in return receive a short-term loan. Repo agreements can be as long as one year, but are generally three months or less, and the most popular tenure is an overnight loan.

Federal funds rate – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Goldilocks – describes an economy that's neither too hot as to spur rapid inflation or too cold to cause a recession; it characterizes an economy operating in an optimal state from a macroeconomic standpoint.

Yield curve – the graphic representation of US Treasury securities as defined by their yield and time to maturity.

One-month & ten-year rates – on the US government yield curve, the securities issued with maturities of one month and ten years, respectively. The US Treasury also issues securities between one month and ten years, and longer than ten years.

Asset location – the tax-arbitrage strategy of placing high-tax exposure assets in low tax-paying accounts, and vice versa. The theoretical benefit is to lower taxes from investments and compound higher long-term capital.