HIGHTOWER
RDM Financial Group

Market Update

April 8, 2020

A Look Back and a Look Ahead

Key Takeaways

- This time really is different.
- We are starting to see tentative signs of a peak in COVID-19 cases.
- Economic data will continue to look very weak in April.
- A peak in claims may provide a clue for the economy.
- The Fed and U.S Government have taken important steps.
- Market technicals provide a possible guide looking forward.
- Economic rebounds and market recoveries have historically followed recessions and bear markets.
- Credit markets are starting to recover after recent volatility.
- The markets will likely start to recover before the economy.

One phrase that has been used by investment strategists over time to describe certain market periods is "this time is different." You always have to be careful using this phrase because while market cycles do not repeat themselves exactly, they can be somewhat similar.

However, to us, this time really is different because never before have governments decided to shut down a good portion of the world's economy in response to a health crisis.

The past couple of months have clearly been challenging. It's hard to believe that equity markets (based on the S&P 500) were at all-time highs as recently as mid-February, 2020. This past quarter, U.S. equity markets experienced their fastest decline into a bear market (generally referred to as a decline of 20% or more from recent highs). All of the major global market indices ended last quarter down 10% or more with several down 20% or more. One small positive to share is that some historical market indicators, for example the number of net 52-week market lows, has been so extreme that it already reflects a significant amount of fear and anxiety incorporated into current equity markets.

Coronavirus has hit the U.S. hard but there may be signs of improvement.

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Following the spread of the virus around the world, first in Asia, then into Europe, last month was the month when the virus really spread and hit hard in the U.S. In recent days, a significant portion of the population in the U.S. now finds itself under some kind of quarantine. Businesses across the country have shut down leaving an increasing number of people out of work and wondering when their jobs will come back. Economic data (more on that below) is just now starting to reflect the slowdown in the economy.

On a more positive note, over just the past couple of days we may finally be at a stage where the number of new COVID-19 cases may be starting to slow. While the data on new cases can be quite volatile from day to day, the number of new cases in New York came in at 8,658 on Monday which compares with a peak of 10,841 this past Saturday. Outside of New York State, the U.S. reported 17,390 new cases on Monday which was also below Saturday's reading of 23,227. The U.S. may now be following in the footsteps of Italy, where the number of new Covid-19 cases appears to have peaked in late March.

A big change for the U.S. economy.

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Shutting down the economy is starting to have a big impact on economic data. For reference, the April employment report last week indicated a loss of 701,000 jobs in March (the largest one month jump since March, 2009) and jobless claims surged to over 6 million last week compared with over 3 million the prior week. Ten million people have now filed for unemployment insurance over just the past few weeks. As a result, the unemployment rate jumped from 3.5% in February to 4.4% last month representing the biggest one month jump since January, 1975 (Source: FactSet). Following ten plus years of economic growth, these job losses represent a sea change for the economy, as well as for those individuals who have been affected. As the damage has mounted, the big question is when will the economy start to re-open for business again.

The Federal Government and the Federal Reserve Bank have stepped in.

Responding to the growing economic crisis, both the Federal Reserve Bank and the U.S. Government have stepped in to provide a bridge until the economy starts to get back on its feet. The Federal Reserve Bank has quickly cut short-term rates to zero and introduced a number of important programs to help stabilize financial markets and provide increased liquidity for market participants. The Federal Reserve Bank's balance has quickly grown to over $5 trillion dollars, which represents an all-time high. The government also put together a $2 trillion stimulus plan which represents about 10% of GDP (compared with about 5% of GDP during the last downturn). The broad goal of the plan is to help support large and small business as well as displaced workers until the economy starts to recover. Another stimulus bill may be coming although details of the plan are still in the early planning stages.

To recap, the policy response to the virus crisis appears to be rapid and unprecedented in both speed and magnitude. Once government programs are up and running, cash payments should start flowing into the economy to those in need. While this will not end the virus and help everyone, it may help alleviate some of the panic and anxiety that has been building in recent weeks. Once workers and small business owners start to feel more confidence that that their incomes will at least be supported for a period of time, that could help put a floor under sentiment. This improvement may take several weeks but should be underway as we head through the next several weeks until things ultimately start to get better.

Partial Recovery for Markets

At this stage, financial market participants appear uncertain about whether enough has been done to help the economy before the virus truly peaks and starts to recede. U.S. Equity markets declined sharply over a short period of time and established a bottom (for now) on March 23, 2020. Following that decline, equity markets jumped higher and experienced their second largest 5-day advance ever. We looked back at past decades to see what strong 5-day market advances have meant for equity markets going forward. For investors, this kind of market advance has historically generated mixed short-term results but more positive longer-term results. Specifically, looking at the 10 times that the S&P 500 generated the highest 5-day market returns, equity markets produced mixed results over the following 1 to 3 month periods but much more positive results over the following 6 to 12 month periods (source: Strategas).

We also wanted to share some other commentary on market technicals. In recent weeks, there were more than 1,000 net (i.e. new highs minus new lows) new lows on the New York Stock Exchange. Selling this extreme has only happened ten other times dating back to 1950 (source: Oppenheimer). Looking ahead over the next 1, 3, 6 and 12-month periods, returns were somewhat mixed over the short term but once again much more positive over the following 6 and 12 months periods. This fits in with the data cited above and reflects the fact that extreme selling (which is what we have seen in recent weeks) has historically occurred near or around market bottoms. We may not be at "the bottom", but historical data indicates that market returns are likely to improve in the year ahead as the economy gradually recovers.

A look ahead – we could see more scary headlines before signs of improvement.

As we start April, the pandemic continues to expand to additional states and cities in the U.S. and this may continue over the next several weeks or possibly into May. As mentioned above, the economic damage to the economy is just starting to be seen and will be more visible as we go through the month. April is likely to be a tough month with rising unemployment, further weakness in manufacturing, a decline in consumer and business confidence and a downturn in corporate profits. Various estimates for second quarter GDP range from about down 5% to down 35%. These are numbers that most of us have never seen before. Keep in mind that following a very weak second quarter, most economic forecasts show an economic rebound starting in the third quarter. One question we don't know the answer to right now is what the shape of the economic rebound will look like.

Will a sharp and steep downturn be followed by 1) a sharp and rapid recovery; 2) a U-shaped and more moderate rebound or 3) a more protracted and slower rebound in employment, corporate profits and GDP. Over the near term, investors are likely to continue reacting to day to day economic and virus-related headlines which will likely mean continued volatility in financial markets. However, at some point, investors will start to look ahead to a potential rebound in the economy and financial markets.

Historically, after significant market selloffs over the past several decades, equity markets have tended to hit an extreme bottom, have rallied somewhat and then re-tested the initial market low about six weeks or so later. We don't know if equity markets will follow the same script this time around, but we will be watching for further signs of additional equity market weakness over the next several weeks along with an improvement in various technical factors such as a decline in 52 week lows, a peak in the put to call ratio and a lower level of market volatility. We will also be watching for some improvement in fundamental factors such as credit spreads, copper prices and the number of people filing for weekly unemployment.

Fixed Income Markets

Since most RDM clients have some percentage of fixed income corporate bonds in their investment portfolios, we wanted to share a brief update on this part of the market. Multiple factors have come together in recent weeks and created short-term uncertainty in the fixed income credit markets. There is the economic effects of the coronavirus and its impact on the global economy, a sharp decline in oil prices and its impact on the energy sector and the fact that overall liquidity temporarily dried up as some trading counterparties showed an unwillingness to add investment-grade corporate risk to their balance sheets. Importantly, following the announcement of the Federal Reserve Bank's corporate credit buying program (outlined in a recent Blog of mine on our website), liquidity and pricing have started to return over the past week.

The data below illustrates the significant and abrupt downturn in the investment grade corporate bond market in recent weeks, followed by a partial recovery at the end of last month. After setting a record-low yield of 1.90% on March 5, the intermediate investment-grade corporate bond market registered 11 straight days of negative returns, nearly pushing the month-to-date loss into double-digit territory by March 23 (source: FactSet). The rapid deterioration in investor confidence caused credit spreads, which seldom exceed 250 basis points (i.e. 2 ½%) to jump from 110 basis points to 395 basis points., a level that has previously only been seen during the last credit crisis. To put the magnitude of this price action into perspective, the 2008 / 2009 credit crisis resulted in a record-setting drawdown of 14.6%, which took place over the course of 282 days. The recent sell-off caused by the coronavirus produced a maximum drawdown of 10.7% over just 17 days.

Looking ahead, liquidity has started to return among market participants, companies have been able to issue an increasing amount of investment grade corporate debt in the new issue market and the Fed's corporate bond purchase program is currently forecast to start up over the next several days (which should create increased demand for new issues and stronger pricing for currently outstanding investment grade corporate bonds). We believe it's encouraging that the intermediate investment-grade corporate bond market finished last month on a positive note. During the last six trading days of the month, the market returned positive 4.8% and credit spreads tightened by over 100 basis points. Despite this late month movement, the current spread of 306 basis points remains historically wide. While the month of March was a challenging one for corporate bond investors, it appears that we may be past the worst of it and that fixed income investors will likely be rewarded for staying the course in the period ahead.

Some Signs of Progress

There are growing signs that people are taking the idea of social distancing and quarantining themselves seriously. Many states have issued "stay at home" orders although not all governors are on board with this strategy right now. We are not epidemiologists, but from listening to various medical experts, at some point the growth rate of new cases will likely peak and start to recede over the next several weeks (which may be happening already). After a slow start, testing availability has also started to increase across the country. In addition, multiple companies are working on treatments and vaccines which could lead to a positive outcome in the period ahead. According to research from The Royal Bank of Canada (RBC), there are currently 202 different drugs in various stages of clinical trials to fight the virus right now.

A Look at Bull and Bear Markets

One positive fact to share is that historically, bull markets have lasted much longer than bear markets and returns during bull markets have (on average) also been significantly higher than returns in bear markets. According to data from Strategas Research, since 1929 bear markets have lasted an average of 63 months (with a range of 26 months to 131 months) and generated average returns of 183%. Bear markets, on the other hand have lasted an average of 20 months (with a range of 3 months to 62 months – 31 months without the great depression) and generated average declines of 39%. So, while the current period has clearly been challenging, it's important to think of the long-term. Investors with equity exposure will likely benefit in the years ahead when the next bull market arrives (and it will at some point ahead).

In summary, March was a tough month and April will likely bring challenges as well. Job losses and unemployment are going to continue to get worse over the next several weeks due to the fact the U.S. economy has shut down temporarily. In the end, it will all come down to the virus. On this front, we recently heard some positive news out of Italy and it's possible (although still preliminary) that new cases in New York and the rest of the U.S. may also be peaking as well. Markets will likely remain volatile during this period of uncertainty. At the same time, even as news may get worse, at some point investors will start to look ahead in anticipation of a rebound in the economy and corporate profits. On average, financial markets have historically started to rebound several months (about 4 on average) before the end of economic downturns (source: Strategas). Real improvement for the economy may take longer than we would like. Regardless, a rebound in jobs, consumer confidence, corporate profits and the U.S. economy appears likely in the quarters ahead. We all just need to hold on and get through the current period.

As always, please do not hesitate to call us with any comments or questions you may have.

Respectfully,

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S&P 500 Index - The S&P 500 is a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States.

Nasdaq Composite - The NASDAQ Composite is a stock market index of the common stocks and similar securities (e.g. ADRs, tracking stocks, limited partnership interests) listed on the Nasdaq stock market.

MSCI ACWI (Ex USA) Index – The MSCI ACWI (Ex USA) captures large and mid-cap companies across 22 of 23 Developed Markets (DM) countries (excluding the US) and 26 Emerging Markets (EM) countries.

MSCI Emerging markets Index - The MSCI Emerging Markets Index captures large and mid-cap companies across 26 Emerging Markets (EM) countries.

RDM Financial Group

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