BRENTON POINT
WEALTH ADVISORS

March 22, 2020

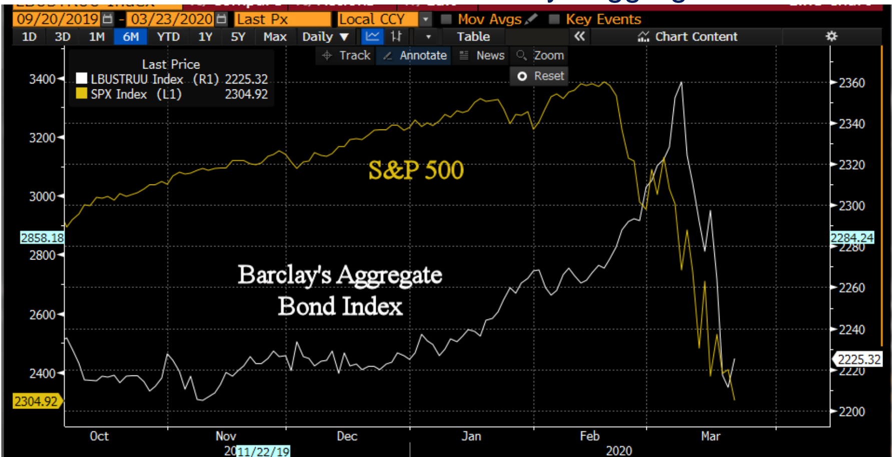
Given the dramatic news and market volatility, we wanted to review our latest research again this week.

The social distancing and isolation required to stop the corona virus is effectively freezing the world economy like we have never seen, and a recession is almost certain. The hourly news headlines are upsetting and certainly have added to the panic. The risk of debt defaults by leveraged companies worsens the already negative economic outlook, with some talking about a depression. However, there are significant positives being overlooked. The actions by companies and individuals will stop the virus spread, causing the "epicurve" of virus cases to roll over. The forward looking view will reverse at that point, with markets focused on the recovery. Secondly, the 6-10% of GDP government fiscal response will help to bridge the gap to a recovery. The Federal Reserve response has been massive, signaling they will do whatever it takes to keep markets functioning and increase the money supply. This was the fastest rate move to zero in history. A similar rate move was effective in 2008 and 1932 as unemployment moved higher. It was the start of QE 1 in March 2009 that marked the bottom of the 2008 bear market. Finally, the near record volatility is the best indication of the extreme fear, and in prior cases this stage was closer to the low than the high. In prior comparable cases in the first big move off the low, stocks made back over half the crash decline. For these reasons, despite the extreme volatility and negative news, we are maintaining our neutral 3 rating for U.S. stocks, developed stocks and emerging markets. We are also maintaining our negative 2 rating in fixed income and favor higher quality credit and lower duration.

Diversification

Diversification among asset classes is a traditional means to reduce and spread risk in a portfolio. During times of financial stress, investments with low correlation can become correlated, compounding losses and increase risk. Correlation is the measure of how different investments move—high correlation means when one goes up, the other does as well, while low correlation means they generally move in opposite directions. Over the past few weeks, with investor placing a premium on liquidity, volatility spiked driving an increase in correlations. Therefore bond allocations have also experienced higher volatility as credit tightens and selling further pressures spreads. Even gold declined as the dollar rallied sharply. It is another sign of the extreme, and unsustainable, level of panic by investors. Maintaining a diversified portfolio remains critical in managing risk as there will be reversion to the mean.

Chart 1: Correlation: S&P 500 vs. Barclays Aggregate Bond Index



Please also read the important disclosures at the end of this report.

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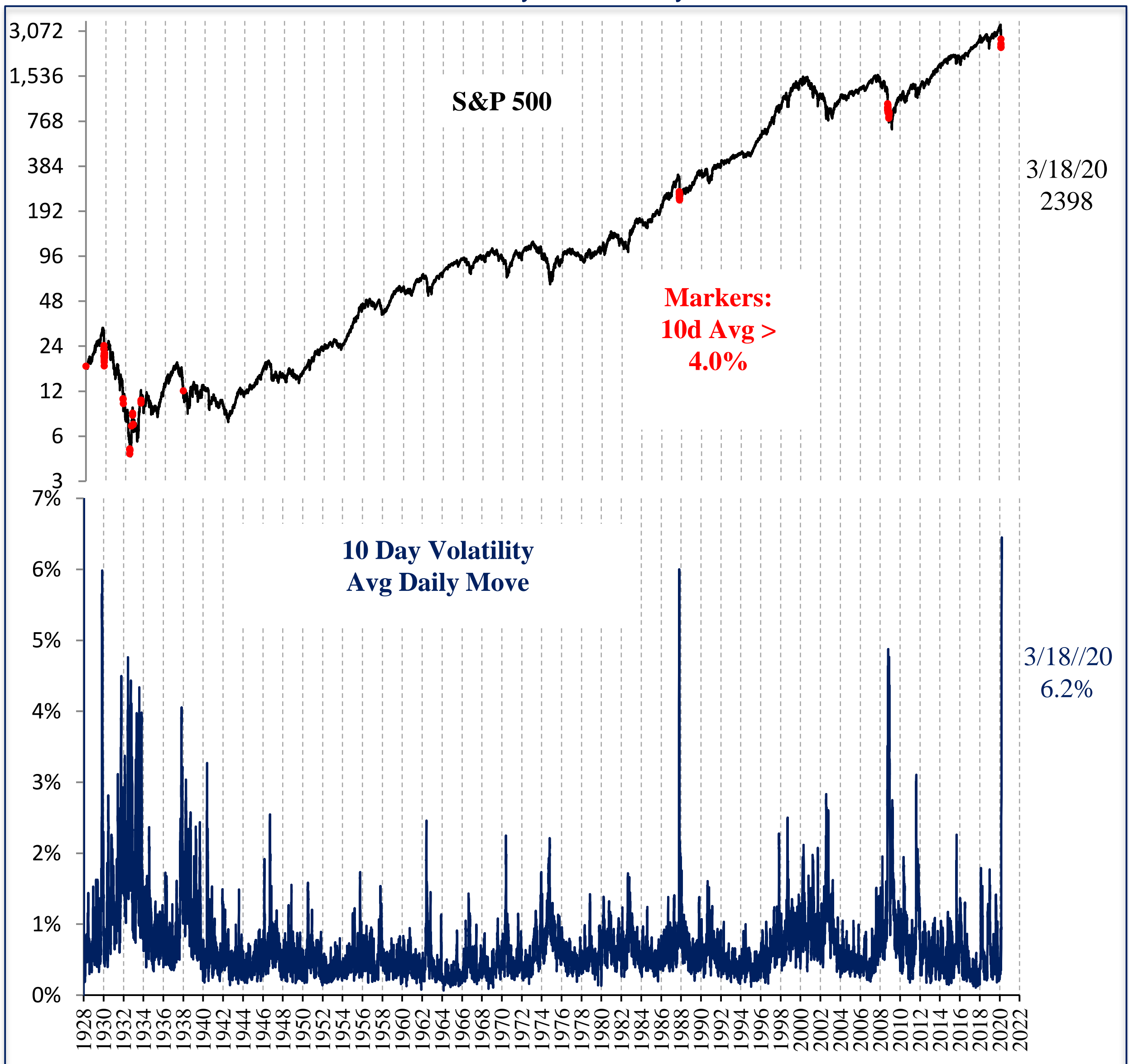
Market Volatility

In the last 10 days, the S&P 500 has moved up or down by an average of 6.2% each day, more than 20x the norm of 0.3%. For comparison it moved 3% during the European Debt crisis in 2011 and 5% during the Global Financial Crisis in 2008. Prior to that it briefly reached 6% in the 1987 crash and before that was in 1937 crash. Volatility occurs in periods of extreme fear, when market liquidity is extremely low. In other words, when there are few people willing to put their capital at risk in the market, even small orders will move the price since there are very few people willing to take the other side. In prior comparable cases, the market rallied back over half the crash decline in the first big move off the low. It is after this initial rally when volatility subsides that downside risk will be higher.

Chart 2: S&P 500 Volatility: 6.2% Daily Moves: 1928-1920



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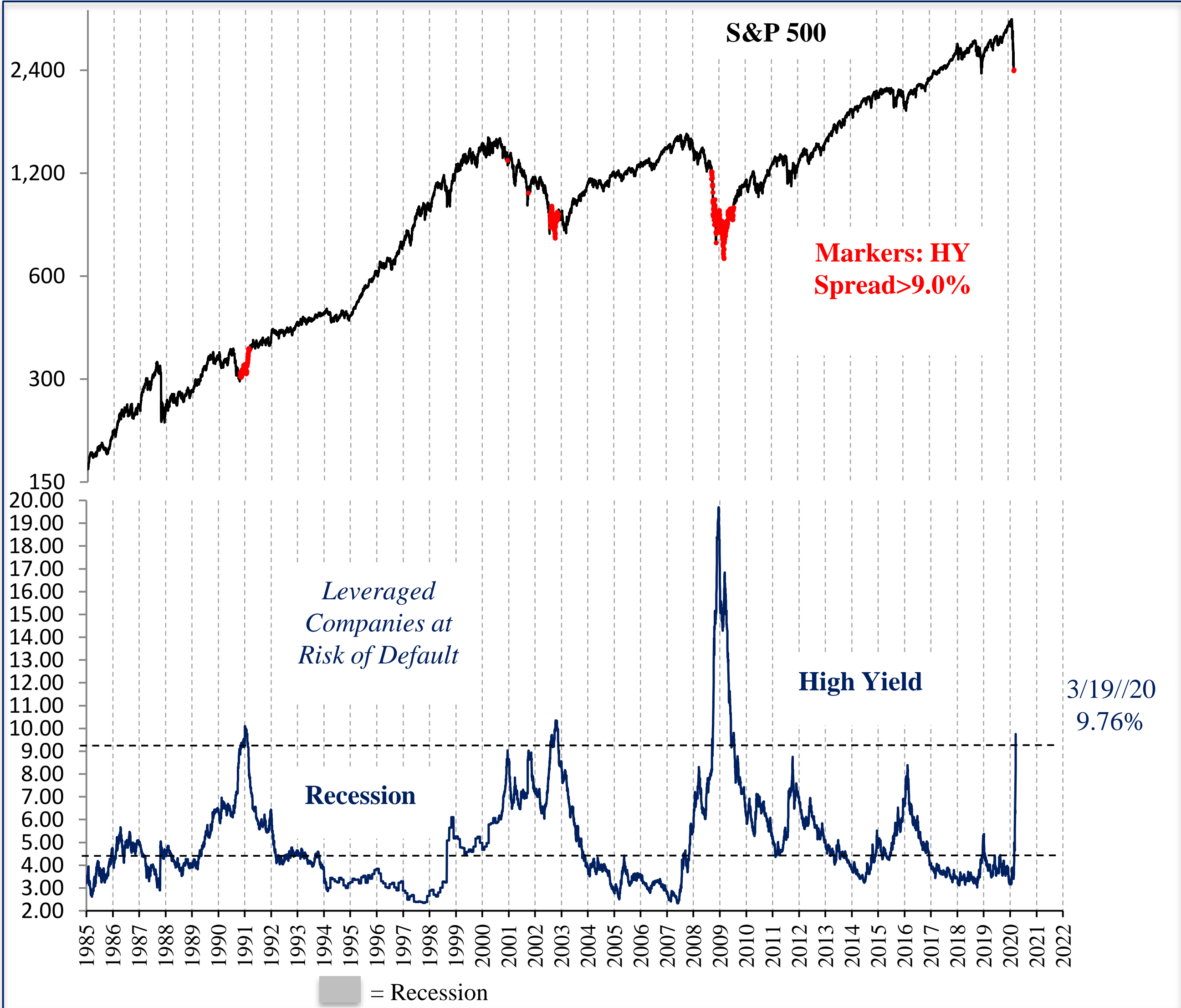
The Economy

With the world at a standstill, economist estimates for Q2 GDP are sharply negative in some cases. While there have been few official economic reports out yet, a recession seems all but certain. The issues begin with layoffs and a likely sharply higher unemployment rate. The pressure in the bond market is another issue. The High Yield Spread at 10.1% is the highest since 2008. It means that highly leveraged companies will not have access to funding for operations, putting them at risk of default. It can create a negative feedback loop, since defaults can mean business failures, more job losses, and lost income.

We don't know how negative Q2 GDP will be, so we looked at the worst quarters since 1950. These include 2008 as you would expect, 1982, 1980 and 1958. We know the stock market declined over 50% in the 2008 case, and that size decline might be the consensus on Wall Street. However, the S&P 500 decline was less than 30% in all three prior cases. In other words, the 30% stock market decline behind us may have already discounted the economic weakness likely ahead.

Chart 3: Leveraged Companies at Risk of Default



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Crude Oil Down 65%

Crude oil fell 65% in the last 3 months to $21 a barrel, the lowest since 2002. In the 1986 and 1990 cases, large oil declines were positive for stocks and the U.S. economy, since the U.S. was a net importer of oil. You can see that more recently declines were correlated with stocks and the economy. A sharply weakening global economy, the rise of electric cars, a price war between OPEC and Russia, and finally a strong dollar combined to cause the biggest decline since 2008.

Chart 4: Crude Oil Declines vs. S&P 500

In summary, we are maintaining our neutral 3 rating for U.S. stocks, developed stocks and emerging markets. We are also maintaining our 2 rating in fixed income and favor higher quality credit and lower duration.

Michael Schaus
Director of Market Research

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