'Bear'ing Down on Markets

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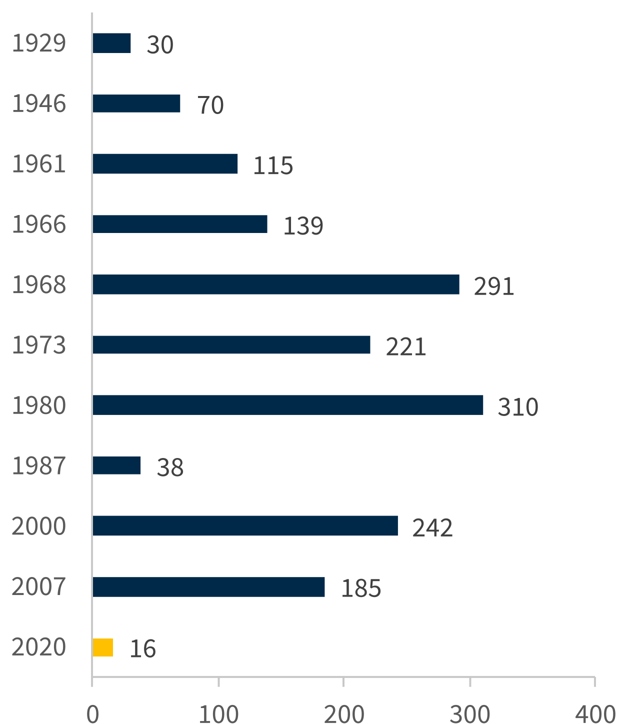
First 'Bear Market' in Eleven Years

With the S&P 500 down ~27% from its February 19 record high (including the worst daily decline today since 1987), this is the quickest reversal of a bull market in history—just 16 trading days. This unprecedented rate of decline, which ended an 11-year long bull market that ironically just celebrated its anniversary on Monday, is the result of a so-called 'Black Swan' event – the coronavirus – that has added uncertainty as to the extent of the downside risk to both the economy and earnings. These black swan events are inherently unexpected, and typically prompt investors to quickly recalibrate their market expectations without the benefit of historical precedence. Quickly attempting to reprice markets with no certainty as to the ultimate extent of the negative impact tends to exacerbate volatility.

However, in times like these there are two critical dynamics that investors should focus on: assessing their time horizon and pragmatically trying to determine what is priced into the market.

Number of Trading Days for the S&P 500 to Enter a Bear Market

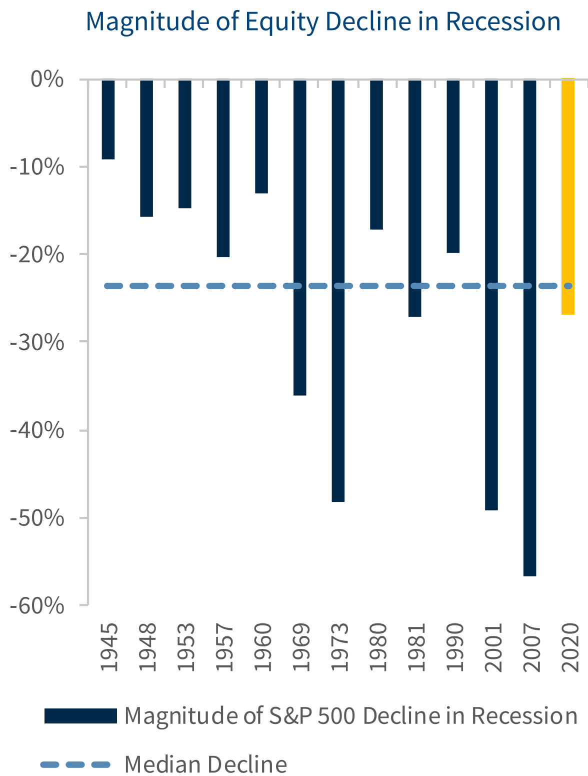


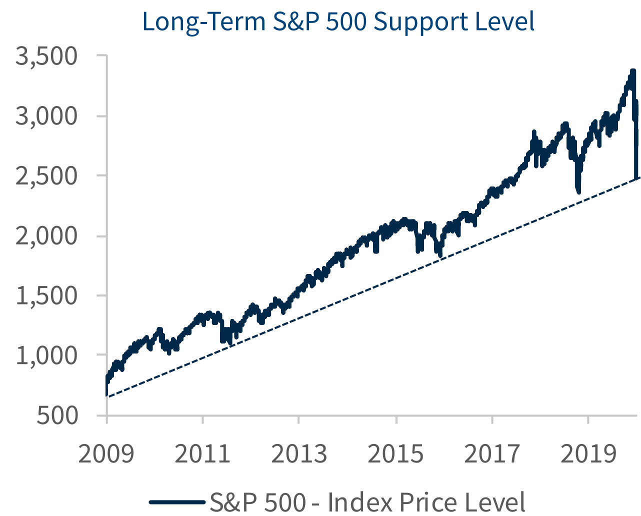
Time Horizon: Rightsizing Based on the Asset Class

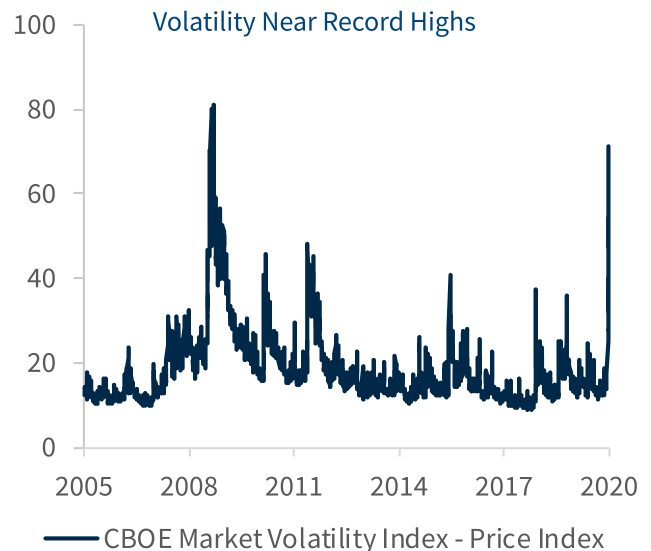
One of the most important decisions in allocating investment dollars is time horizon and the potential for loss of principal. Higher risk is traditionally accompanied by higher returns, but it is also accompanied by the potential for more frequent and substantial declines. A mitigating factor is time horizon, as longer time periods can reduce, but not eliminate, the probability of losses. While the steep declines we are experiencing lately are anything but enjoyable, it is important to put them in context. Historically, the S&P 500 has been positive 79% of the time on a rolling twelve-month basis; and over a rolling three-year period is positive 82% of the time. For bonds, the Bloomberg/Barclays Aggregate Bond Index has been positive 92% of the time on a rolling twelve-month basis; however, over a rolling three-year basis it has been positive 100% of the time. A 60% equity/40% bond allocation has been positive 82% of the time annually; however, over a three-year period, it has been positive 88% of the time. This reflects the importance of asset allocation and diversification in your portfolio to help weather periods of increased volatility.

Temporary, Mild Recession Probabilities Grow

Our base case is that the economy is likely to be on the cusp of a recession over the next few months. However, if the current pace of social distancing (e.g., major league sports cancelling seasons, the NCAA cancelling its College Basketball Tournament, closing of schools, canceled conferences, transportation reductions, etc.) accelerates, a mild recession (1% or less decline in aggregate GDP) is likely to occur that will lead to potentially one negative quarter of GDP—2Q20. The median S&P 500 price decline during all previous recessions is 24%. However, if a recession occurs, we believe this will be a milder than average recession based on economic contraction. As a result, if it occurs, a 15% to 25% decline in the S&P 500 should have priced in the potential for a mild recession. For comparison, a more severe decline (low probability) of 4% in economic activity (e.g., the Great Recession of 2007/08) would equate to a greater than ~50% decline in the equity market. The median recession decline of 24% is in line with the current pullback. Factors that could mitigate any potential recession and could initiate a rebound include aggressive Fed actions (specifically, the injection of Fed liquidity today and the expectation of another 50 bps of cuts next week) and more pronounced fiscal measures coming from Washington DC.







What is the Equity Market Saying?

- **Earnings Growth.** With the S&P 500 trading at 2,480, assuming our fair market P/E of 19.5x earnings, the market is currently pricing in ~$130 in earnings. That would represent an earnings decline of ~20%, which at this point, appears overdone given the likely temporary decline in economic activity. Our equity analysts believe a worst case scenario given a temporary recession is $150 (-7.5% decline in earnings).
- **Dividend-Based Valuations.** Looking at our dividend discount model, the current level of the S&P 500 is suggesting a decline in S&P 500 dividends of 15% this year. That would approach the level of declines during the Great Recession in 2007 (-20%) and is cumulatively greater than the declines from 2001 -2003 (4%). As a result, even if dividends are flat this year (which is a sea change from the ~8% average annual increase over the last five years), the S&P 500 is attractively valued.
- **Relative Value.** As interest rates decline, long-term valuation metrics become more attractive for equities. Analyzing our relative value models versus bonds suggests that corporate bond yields could move substantially higher (to 5% from the current level of 2.75%) before equity market attractiveness would be diminished relative to bonds at current levels.

Equity Outlook:

While no one can accurately and definitely call the market bottom in a panic-driven market, we believe that long-term investors should feel more comfortable with the current risk/reward trade-off of the equity market going forward. Make no mistake, volatility is likely to remain in the near term as headline risk will remain elevated until we get signs that the spread of the virus is abating, testing becomes more readily available and the negative impact on the economy is better known. As mentioned above, we believe the current pullback is overestimating the decline in earnings and dividends for the year. As a result, fundamentals are attractive at current levels. While technical indicators have provided limited value because of the speed of the decline, the S&P 500 closed today at one key long-term trend line that dates back to March 2009. Other 'contrarian' indicators that suggest a bottom may be approaching

include the VIX at the highest level since 2008, the put/call ratio rising to multi-year highs and the percentage of S&P 500 constituents trading above their 10 and 50-day moving averages near record lows. Our expectation is that over the next 12 and 24 months equities will be meaningfully higher from current levels, based on solid fundamentals and our expectations that the coronavirus will likely subside over the coming months and that the economy rebounds in the back half of the year.

Chris Meekins, Health Care Analyst, Equity Research

President Trump delivered a prime time Oval Office address, the World Health Organization (WHO) declared COVID-19 a pandemic, the NBA suspended its season, the NCAA cancelled its College Basketball Tournament, and we learned American icon Tom Hanks is infected - all on Wednesday. To be clear, we continue to believe the headlines around the virus will continue to get worse before they get better. We believe the next five to seven days will provide clarity on the likely duration and extent of the outbreak in the US. By next week, we will probably have a much clearer sense about whether we can be largely past this virus by the end of April, or if this will stretch to summer or longer. In terms of the market, the question to watch will be how quickly policymakers take action on fiscal stimulus and whether that will be enough to ease fears. We believe this will be a multi-step process with targeted relief for individuals before a systemic fiscal stimulus package comes together, possibly prolonging the timeline and related volatility.

Ed Mills, Washington Policy Analyst, Equity Research

From a DC perspective, the market has been looking for clarity on a response effort from policymakers. We believe a lack of details and what is looking like an increasingly extended timeframe for significant measures to combat the effects of COVID-19 are contributing to the volatility seen in recent weeks. The president's remarks this week cover broad strokes and a call on Congress to provide funding for small business loan support/enact a payroll tax holiday, but so far negotiations on Capitol Hill have not advanced on these measures in a meaningful way. Complicating the passage of a compromise economic response package has been the planned Congressional recess which, if shortened or canceled (the Senate has announced it will continue working), could see action come earlier than initially expected.

Speaker Nancy Pelosi on Wednesday released the House emergency response package which focuses primarily on providing support to individuals impacted by the virus in the form of paid sick leave and reimbursement for testing. There is no bill or text currently that would enact some of the relief measures that administration officials have signaled to the market such as deferred tax payments or targeted relief for significantly impacted industries. As such, the market volatility is likely to be magnified by the sentiment that DC at this stage has no real response lined up to the economic slowdown caused by the spread of the virus. We have highlighted that conditions will likely need to deteriorate before lawmakers see increased urgency around a comprehensive response package, and the uncertainty around the timing and specifics is likely to prolong volatility in the meantime.

Kevin Giddis, Chief Fixed Income Strategist

Credit spreads have been widening out since March 4 and saw a surge in bid wanted requests after the OPEC and non-OPEC nations failed to reach a production deal, which sent energy bond prices dramatically lower. By Tuesday, spreads in many credits had doubled and liquidity began to suffer as sellers outnumbered buyers by a 3 to 1 margin.

Municipals saw their percentages of taxable yields press even higher as not only did the Treasury market rally, yields on even the highest grade municipals rose. The average percentage grew from 76% of taxable to 130% of taxable and it has only moved higher from there as liquidity in a very safe credit space has been compromised in a way that hasn't been seen in years.

As we have been mentioning since last week, the situation has swiftly moved from a public health/medical issue to one where confidence and credit concerns are pushing the government into action. We saw the first steps of that today. With liquidity, even in Treasuries, appearing to be at risk, the Federal Reserve (Fed) announced a plan to flood the market with liquidity that can only be called QE (quantitative easing) in an effort to calm investors and keep the funding markets liquid. It announced that it would not only be buying Treasury coupons of many different maturities, but would offer $500 billion in a 3-month repo operation and repeat it tomorrow. The Fed also said it would offer a 1-month repo operation for $500 billion and do that every week until the end of the month. While this may confuse many investors, just keep in mind that these operations are being done to allow dealers to keep funding their Treasuries and help market flows stay intact.

My guess is that the Fed and the Treasury will keep doing this and other things until the markets return to 'normal'" and investors feel it is safe to start buying risk assets again. The timing of this is unknown, but will likely parallel the mitigation and containment of the coronavirus. Until then, look for volatility in credit to remain quite high, even in US Treasuries.

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Source for charts: FactSet

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