We See No Need for Stock Market Decline to "Go Viral"

As our clients well know, we had been noting for some time now that volatility was abnormally low and that stocks, following a tremendous advance in recent quarters, were ripe for a correction. Of course, never in our wildest dreams would we have imagined that any such correction would play out as quickly as the current one is unfolding (and, yes, for now we believe what we are dealing with is a correction).

The S&P 500 just put in its worst week since the 2008-2009 financial crisis, declining some -11.5%, lopping roughly $3 Trillion off the aggregate stock market value in the process. The obvious culprit? Why, the coronavirus, of course – what else?! Well, although we would have to concede that fear surrounding the potential scope and impact of the virus certainly has played a meaningful role in fueling the market's decline, we do think some other factors – uncertainty around the upcoming Presidential election, for example – may also have played a part.

We also believe that the market's (and the public's) reaction to the virus may turn out to be overdone. Yes, there is a lot of uncertainty around how the spread of the virus will evolve; in the event this ultimately does turn into a global pandemic, we could be facing some dire conditions (financial and otherwise). For the time being, however, things are still well short of that point. Thus, when we hear that sales of disinfectant wipes and hand sanitizer are up over 200% year-over-year and that surveys are showing a full one-third of U.S. respondents planning to stockpile supplies, we also note – with some amusement, if that's possible at times like this – that nearly 40% of U.S. shoppers also plan to avoid Corona beer in the future! Clearly, if this is the same logic they are carrying over to their financial decision making as well, then recent market action could quickly prove itself to have been a massive, collective misstep.

While there's no arguing the past week has been anything but brutal, it was, ultimately, just one week; certainly, the return numbers above sound ominous but, placed within some context, all the market really did was wipe out the impressive gains we saw in the 4th quarter of last year (i.e., the market is actually flat since 9/30/2019). If, however, we were to take even a slightly broader view of things to, say, a one-year window, the S&P (including dividends) is still up north of +8%. Meanwhile, as noted in a recent research piece by Gunnar Ildhuso, a member of Pacific Portfolio's Investment Management & Research team (call or email if you would like a copy), there have been 42 corrections (including the current one) in the post-WWII era, or roughly one every 1.8 years. Of these, only about a quarter turned into full-blown bear markets. The average decline over these periods was just under -23%, though once we strip out the "bear markets" and focus strictly on "corrections", the average decline was considerably less: -14%, or only very slightly worse than the current decline of roughly -12.5% since the stock market's all-time high reached on February 19th. While it may sound strange, the current market decline is, for all intents and purposes, thus far relatively routine (except, perhaps, in its speed).

Meanwhile, the current economic backdrop within the U.S. remains on track. Yes, some of the effects of the virus-induced global slowdown will have not hit the hard data yet; in addition, growth elsewhere in the world (read: China) is going to take an egregious hit this in Q1 (albeit, one that could easily snap back in Q2 if efforts to contain the virus can gain traction). We continue to monitor these conditions but note that, for now, the near-term risk of recession in the U.S. remains low (see Appendix A for an update to our Recession Monitor).

Finally, we note that the reaction of both stock and bond investors has been not only swift but severe. Our measures of investor risk appetite recently have dropped sharply (see chart in Appendix B), as investors have experienced a "risk-off" swing in sentiment so severe as to leave them seemingly dumping risk-assets "willy-nilly" (with apologies for the highly technical jargon). This is not to say that this correction is over, by any stretch; nonetheless, we do appear to be approaching a point where – short of a material failure to contain or treat the disease leading to a broad, prolonged slump in global economic activity (which, of course, is not something that no degree of modelling or analysis can reasonably predict) – the market's risk-return tradeoff is looking increasingly attractive.

As always, we remind you to remain disciplined and to temper the degree to which you allow emotion to impact your decision making; we believe investors with diversified portfolios allocated in a manner appropriate to their long-term risk tolerance and return objectives should stay the course and, in fact, begin to view current conditions as an emerging opportunity to put new cash to work. We encourage you to reach out to your advisor to discuss any material changes in strategy you may be considering. Please feel free to reach out with any questions or concerns you may have with regard to the market or economy to either your advisor or Jim Ayres, our firm's Chief Investment Officer.

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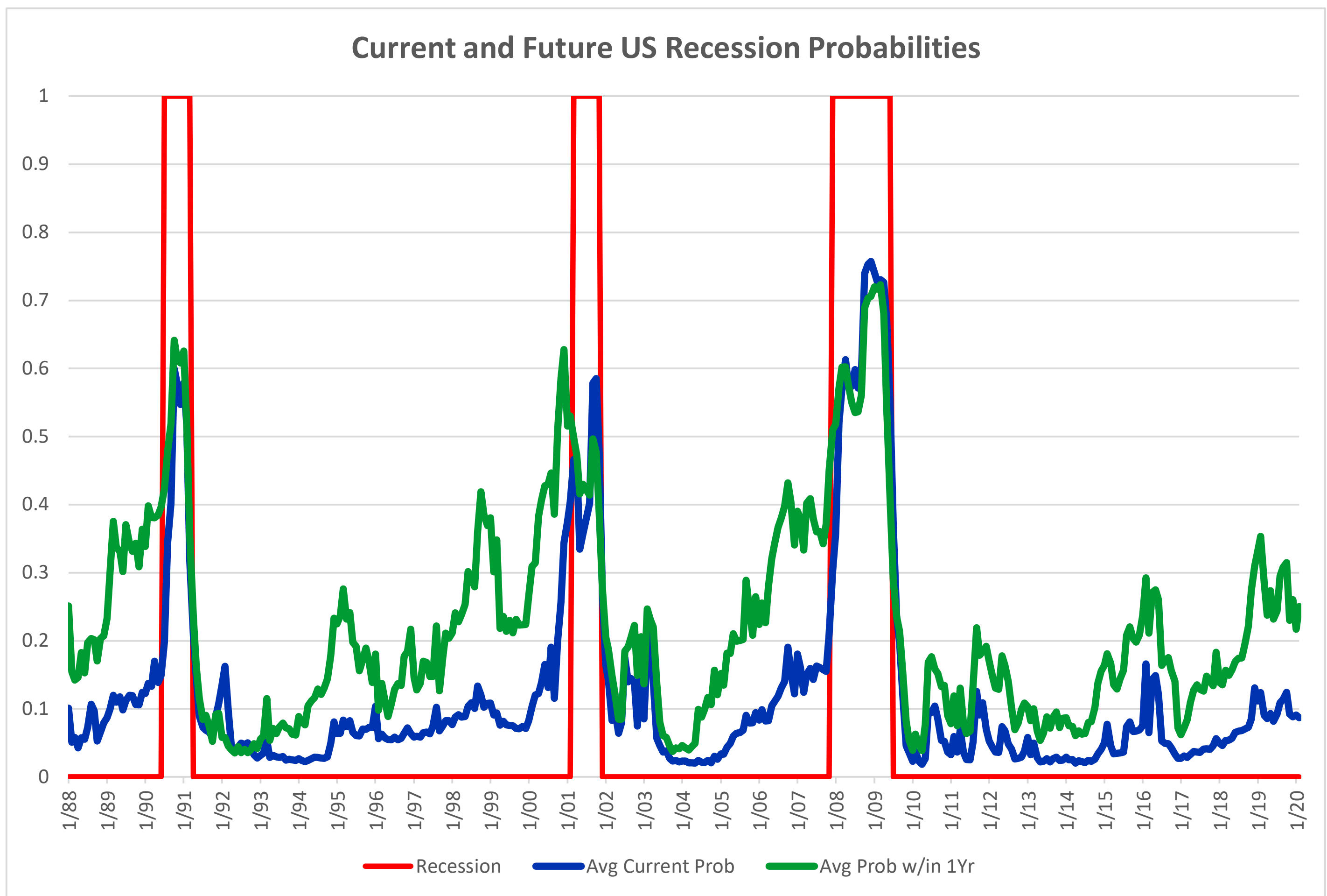
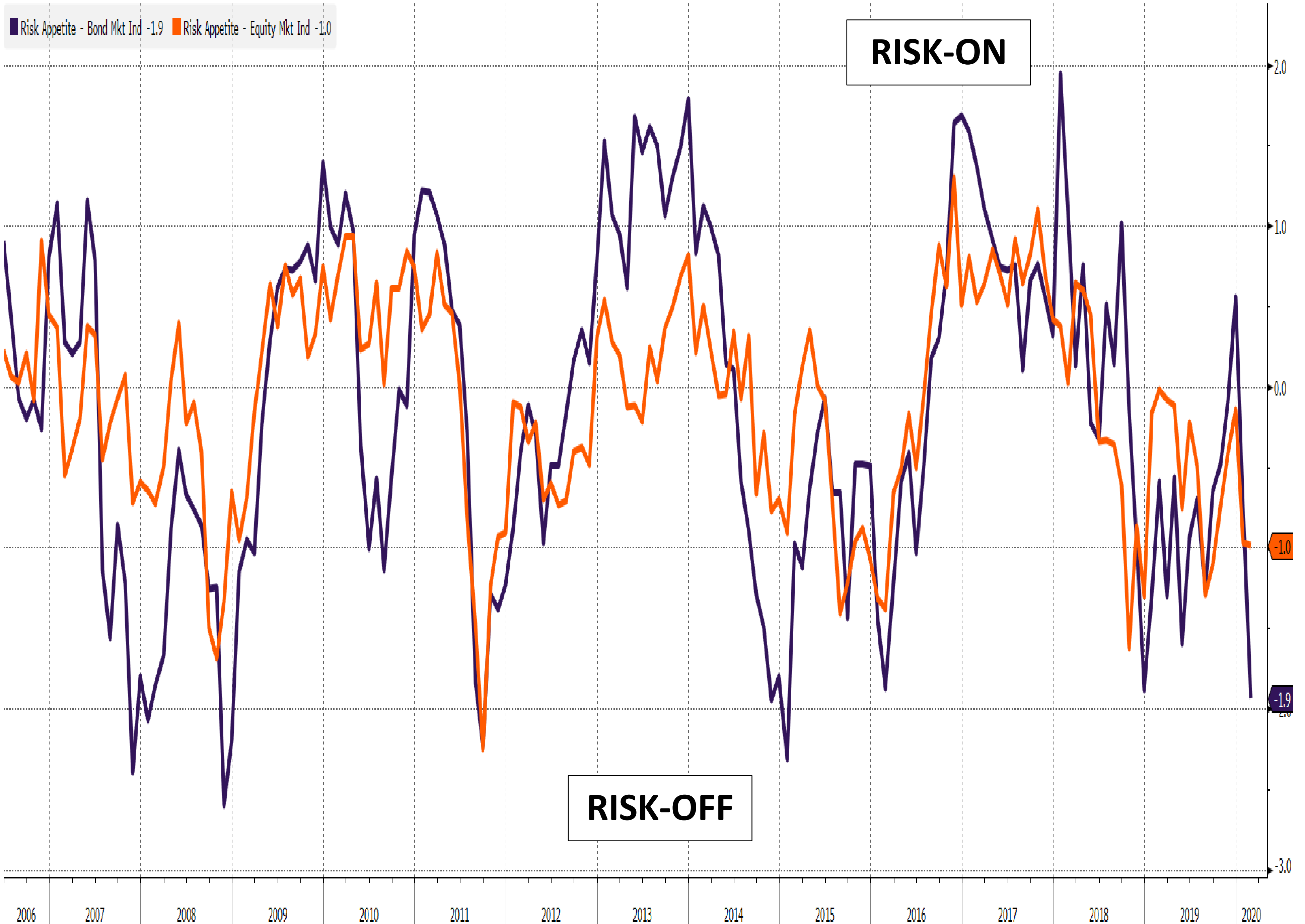
Recession Monitor - Data Through: 2/28/2020



	Recession Probability	
	Current	**w/in 12m**
Economic Indicators		
Business Activity Surveys	2.08%	24.01%
Confidence-based Indicators	2.98%	48.52%
Labor Market Indicators	0.38%	21.06%
Housing Market Indicators	0.21%	0.65%
Average	1.41%	23.56%
Interest Rates		
2s-10s Yield Curve Slope	38.29%	37.64%
3m T-Bills Bps Chg	12.12%	23.24%
Market-based Indicators		
YoY % Chg S&P 500	15.84%	46.32%
YoY Bps Chg HY Credit Spreads	5.75%	18.15%
Combined Market Model	4.58%	19.98%
Overall Average	8.79%	26.04%

Forecast probabilities have been calculated using a logistic regression process on data available as of the date indicated; they are provided for informational purposes only and are based on the information available at the time and are subject to change based on economic, capital market, and other conditions. Any investment decision should be based on an individual's own goals, time horizon, and tolerance for risk.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Risk Appetite - Equity Mkt Ind -1.0
RISK-ON
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