February 27, 2020

What Happened in the Markets?

- US stocks fell for the sixth consecutive session on Thursday as the S&P 500 declined 4.4% to close at 2,979. With Thursday's losses, the S&P 500 is now down 7.8% year to date. The index is also now in "correction" territory, down 12% since the recent peak on February 19.
- Renewed concerns over the spread of the COVID-19 virus (coronavirus) have driven a "flight to safety" across financial markets in recent sessions, with global equities sinking while US Treasuries have surged. With a growing number of cases now being confirmed outside of China, markets appear to be pricing in a higher likelihood of economic disruption.
- All 11 S&P 500 sectors finished lower Thursday, with Real Estate (-5.6%) and Energy (-5.5%) the worst-performing sectors. Industrials (-3.8%) and Health Care (-3.3%) were relative leaders on the session.
- Outside of equities, Treasuries rallied with 10-year yields falling to 1.28% as of the 4 p.m. equity market close. While rates were lower across the curve, front-end rates fell more than long-end rates, driving a steepening in the 2s-10s yield curve, as the front end of the rates curve has moved toward pricing in Federal Reserve rate cuts. Gold was little changed on the session, while the US dollar weakened modestly as measured by the US Dollar Index.

Catalysts for Market Move

What a difference a week makes: After rallying to a new all-time high near 3,400 just last Wednesday, the S&P 500 has now declined for six consecutive trading days, with the index now in correction territory, having fallen 12% from last week's peak. With the week-to-date losses eclipsing 10%, the S&P 500 is on track for its worst weekly loss in more than a decade. What has changed? Last week, the equity market appeared to take an optimistic view with regard to the COVID-19 virus, as data pointed to a stabilization in new case growth in Mainland China. This week, however, concerns have re-emerged as a growing number of cases have been identified across the globe, sparking concerns that the virus' impacts are set to have a more pronounced and prolonged effect on the global economy. Amplifying these concerns, several large multi-national companies have announced in recent days that they are likely to miss their first quarter guidance as a result of the virus' impact, and strategists across Wall Street have been reducing their earnings forecasts in kind. As profit estimates have been reduced, markets have attempted to price in the potential impacts of the 'known unknown,' which is the virus, and this has resulted in a swift equity market correction, with cyclical sectors most exposed to global economic growth getting hit the hardest; year to date, the S&P 500 Energy sector is down 26%, Materials down 13%, and Financials down 12%. On the flip side, "safe-haven" assets have rallied, particularly long-end US Treasuries, as 10-year and 30-year yields have moved to all-time lows.

With the S&P 500 now down 8% year to date, compared to dramatic strength in Treasuries as 10-year yields have moved nearly 70 basis points lower on the year, the relative attractiveness of equities from a valuation standpoint has certainly improved. Using current consensus forward earnings estimates, the S&P 500 trades at less than a 17x P/E ratio, down from a recent high of 19x. While earnings estimates likely need to be reduced in light of the virus' impact and this could be understating current valuations against a backdrop of low interest rates, stocks would likely still appear to be reasonably valued. While assessing the impact of the COVID-19 virus on earnings and economic growth is still very much a fluid exercise, we would continue to remind investors that historically similar events have tended to have little long-term impact. Two recent examples that come to mind include the Ebola concerns in 2014 and the SARS outbreak in the early 2000s. While near-term demand is likely to be displaced and company supply chains may be disrupted as a result of the virus, over the intermediate and long term the economic impact from these types of events has generally seen a delay in growth, not a derailment. Further, governments and central banks around the world have already noted the potential impacts the virus could have on the economy, and may move to enact stimulus that could help offset some of the virus' related weakness. As a result, we would caution against overreacting to headlines from a portfolio standpoint, and near-term volatility may even create opportunity for long-term investors.

Looking ahead, next week will be a big week for economic data, with the ISM manufacturing survey released in the US on Monday, and the February non-farm payrolls report due out on Friday. The political calendar also heats up with the South Carolina Primary this weekend, and the "Super Tuesday" primaries on March 3.

The Global Investment Committee's Outlook

Global equity markets had an exceptionally strong year in 2019 with markets re-rating on lower interest rates along with anticipation of global growth troughing and a new round of quantitative easing by central banks. Beginning in January 2019, the dramatic pivot by the Federal Reserve helped ease financial conditions and improve market sentiment. While 2019 portfolio returns were strong, the GIC continues to advocate investors exercise patience, as opposed to chasing performance to begin 2020. While the GIC believes a modest recovery in the global economy, led by international and emerging markets, will take hold this year, US growth is forecasted to only stabilize, or even decelerate, in 2020. With significantly more good news currently priced into markets, the GIC advises caution as US stocks appear fully valued and earnings forecasts may have further to fall. While the GIC remains overweight equities relative to fixed income, they believe international stocks may offer the most upside potential going forward. Within fixed income, the GIC remains underweight corporate credit, and prefers high-quality, short-duration bonds as a proxy for cash, which it will look to deploy as opportunities arise. The GIC also recommends a moderate allocation to long-duration Treasuries as a defensive portfolio hedge against the risk of a future equity or credit market correction.

Market data provided by Bloomberg.
Dow Jones Industrial Average (DJIA): A price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.
NASDAQ Composite Index: A broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.
S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.
US Trade-Weighted Dollar Index: A weighted average of the foreign exchange value of the US dollar against a subset of the broad index currencies that circulate widely outside the US.

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The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer. **High yield bonds** are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. **Duration**, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Alternative investments may be either traditional alternative investment vehicles, such as hedge funds, fund of hedge funds, private equity, private real estate and managed futures or, non-traditional products such as mutual funds and exchange-traded funds that also seek alternative-like exposure but have significant differences from traditional alternative investments. The risks of traditional alternative investments may include: can be highly illiquid, speculative and not suitable for all investors, loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than open-end mutual funds, and risks associated with the operations, personnel and processes of the manager. Non-traditional alternative strategy products may employ various investment strategies and techniques for both hedging and more speculative purposes such as short-selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss. These investments are subject to the risks normally associated with debt instruments and also carry substantial additional risks. Investors could lose all or a substantial amount of their investment. These investments typically have higher fees or expenses than traditional investments.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

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Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

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