April 4, 2020

Overview

March was a month worthy of the record books. Investors suffered massive losses, on a worldwide basis. No significant asset class was spared. The S&Ps' 500 lost 12.35%. The Russell 2000 went down 19.49%, while the Nasdaq fared a bit better, going down 10.03%. Internationally all indices dropped, often more than their US counterparts as a result of a rising USD (up 3%).
The S&P's EPAC BMI (developed economies) went down 14.05%. Emerging market indices went down from 15% (MSCI EM) to 22% (MSCI Frontier 100).

Covid 19, with its human and economic consequences, took center stage. Throughout the month investors attempted to evaluate its impact, alternatively reacting to a haphazard response from the Trump Administration, a forceful one from the Federal Reserve and an encouraging one from Congress with its $2 trillion economic support legislation.

Market stress rose sharply, as evidenced in the below chart from the Federal Reserve Bank of St Louis.

The right-end side of the chart shows a sharp upward move, starting in late February. It reflects both the rising fears of equity investors and the dislocations taking place in the fixed income markets.
The month of March saw panic taking hold of investors. The economic collapse caused by the necessary "social distancing" needed to fight the epidemic led investors to sell corporate bonds in a manner not seen since the worst of 2008. Only the forceful Federal Reserve's intervention with the announcement of massive bond purchases avoided a complete meltdown in the credit sector.

In March, our client portfolios lost between 6.90%.and 9.94%
A portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy) lost 6.97% during that period.
On a YTD basis, client portfolios are down from 8.75% to 14.83% vs. 8.98% for our benchmark and 19.60% for the S&P's 500.

As a reminder, the equity allocation in our client's portfolios ranges currently from 30% to 60%, depending on risk profiles.

Market developments

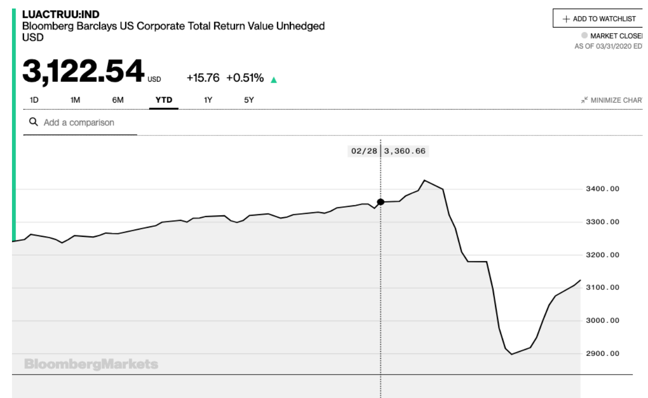
The inability of investors to assess the likely depth and duration of the economic depression caused by Covid 19 led markets to succumb to panic in the early part of March. By March 12 the S&Ps' 500 was down 35% from January 1.

The hesitant and at times barely coherent presidential address of the evening of Tuesday March 10 contributed to this near meltdown. While politics rarely intrude meaningfully on financial markets, in times of national crisis, the absence of robust Federal leadership can have devastating effects.

Since then, the combined responses of the Federal Reserve with its massive bond purchase program, of Congress with its $2 trillion economic package and the presence of Dr. Anthony Fauci in the daily WH briefings on the status of our fight against Covid 19 have all contributed to giving the markets a measure of stability. Equities rallied close to 15% in the second part of the month.

We are likely to experience more of the same violent ups and downs in the coming weeks.

Oil prices have collapsed, leading to a significant stress in part of the US economy. The near meltdown in the corporate bond sector shows how fragile some sectors of our financial infrastructure are. Finally, most economists and analysts remain unable to predict the length of the recession and its depth with any degree of conviction. In this context, the speed at which markets turn, one way or the other, will remain uneasily elevated. An example of the sharp market moves that we saw and that are likely to re-occur in the coming weeks is illustrated in the chart of one of Bloomberg Barclays' corporate bond indexes below. The vertical line marks the end of February.

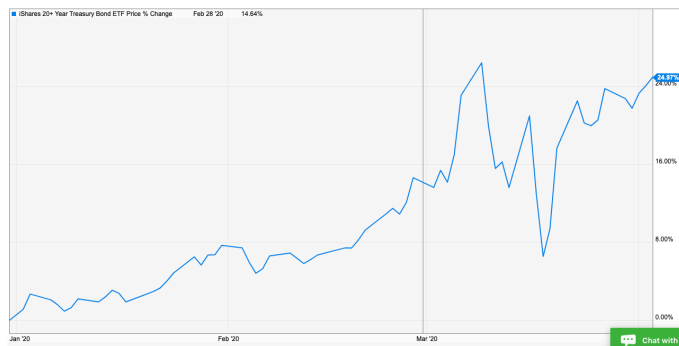


Tilts and Allocations

In early March I sold completely out of our small cap positions (VTWO) and cut another large US equity investment in half, thereby reducing equity allocations by close to 10%. The panic behavior in the market at that time justified these risk mitigating actions.
During the second part of the month, as the effect of the Fed's muscular intervention started materializing and market stabilized somewhat, I partially reversed course and bought SPY (S&P's 500 ETF) and Schwab shares.
These combined selling and buying actions have proven positive, and still could not reduce our losses in March meaningfully.

The equity meltdown induced by the abrupt cessation of economic activity globally had a knock-on effect on the corporate debt market. The fear of a wave of corporate defaults caused investors to sell all sorts of corporate debt securities and to pile into the US long bond, pushing along the US dollar to new heights (up 6% this year by one measure). These dislocations, partially mended by the forceful intervention of the Federal Reserve, have had devastating effects on most investors' portfolios. Especially for those who have shunned US long bonds and remained invested, even prudently so, in non-US equities.

Below is a chart of TLT, the long bond ETF. It illustrates how the US long bond has performed this year, as well as how treacherous the sector can be.



YTD holding a position in US long bond investment has generated a stunning 25% performance. This month, that investment gained 6%. Note however how volatile this asset is. The vertical line marks the beginning of the month. The peak that follows occurred on March 9 as investors were panic buying the US long bond and selling everything else. The Fed's intervention shortly thereafter caused a sharp reversal. Since then, the US long bond has continued its rise on the back of disheartening economic and epidemiological news.

Concluding Remarks

Covid 19 has induced an economic recession and a sharp market correction. We may have entered a bear market as a result. For now though, this correction has made equities more attractive than they have been in a long time. The picture is even brighter if we look beyond the next three to six months.

The table below, from Capital Economics, illustrates this reality. On an absolute as well as a relative basis, once the epidemic has subsided and a lasting response has been found to the threat it represents, equities should recoup most in not all of their losses. With interest rates close to zero, the competition from other asset classes should be rather limited.

Table 1: Outlook Summary

Asset class	CE view	Now – End-2021	Long Term**
Cash	There will be little to choose between returns from USD cash and DM government bonds.		
Bonds	Central bank support will limit weakness in DM gov't bonds after virus spread slows.		
Equities	Equities should rebound strongly once the outbreak is under control.		
Commercial Property	The recovery in equity REITs will be similar to that in ordinary equities.		
Commodities	Energy commodities will not make back most of their recent losses.		
Currencies	The dollar will weaken when risky assets recover, boosting unhedged returns.		

Colour coding refers to US dollar performance *relative* to all the other asset classes in the table.
*Projections assume that global spread of coronavirus slows from mid-2020.
**This document covers the outlook for 2020-21. Prospects further ahead are covered in our *Long-Term Asset Allocation Outlook*.

Negative ⟷ Positive

The speed at which this might occur is still a question. The disruption to our daily life is massive and could trigger changes in consumption patterns and tastes. It will lead inevitably to changes in supply chains around the globe. As a result, it is hard to predict when the recovery will start and how different the world will be when we get to the other side of this health emergency.

My hope is that we get out of this mess a better nation and a better world. In the meantime, "Let's be careful out there!".

Thank you for your trust,

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