March 4, 2020

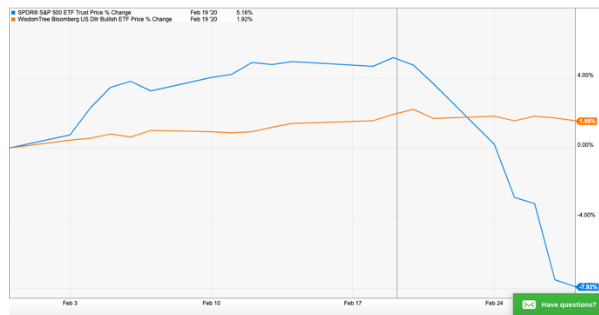
Overview

In February, COVID 19 finally overwhelmed US equity markets. The S&Ps' 500 lost 8.53%. The Russell 2000 went down 8.67%, while the Nasdaq fared a bit better, going down "only" 6.27%. Internationally all indices dropped, often more than their US counterparts as a result of a rising USD.
The S&P's EPAC BMI (developed economies) went down 9.28%.

After losing ground in January, emerging market equities fared a little better on a relative basis. The MSCI EM index was down "only" 5.27%.

The market in February had two phases: Before and after February 19. February 19 marks the date of the announcement of the epidemic reaching Italy and South Korea in a significant manner. Until then, equity investors had assumed that the situation could be contained.

The chart below Illustrates the behavior of the S&P's 500 (in blue). The vertical line marks February 19. The orange line illustrates The steady rise of the USD during the month.



Investors' fears caused the US Long Bond to rally by an astonishing 6.70%. The US 10-year note now yields about 1%...
Fixed income markets in general fared well as a result of this flight to quality. On the assumption that inflation is running at a 1.50% annual rate, a buyer of US Treasury notes is guaranteed to lose money (in real terms), unless interest rates continue to drop.

In February, our client portfolios lost between 3.21%.and 5.01%
A portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy) lost 2.95% during that period. On a YTD basis, client portfolios are down from 3.22% to 5.56% vs. 2.58% for our benchmark.

Our under-performance so far this year is entirely due to our under allocation to US long bonds compared to the index (AGG).

Market developments

February started on a positive note with US employment numbers for January, released on the 5th , significantly higher than expected . Fourth quarter corporate earnings meanwhile came in mostly as expected or better. Both sets of data contributed to pushing equity indices above their previous high reached on January 15.

All this came crashing down following the weekend of the 18th with the Italian and South Korean governments announcing a large number of COVID 19 cases in their respective countries.

Equity market investors were seemingly caught off guard and started their de-risking move. Heavy selling of equities worldwide ensued. Accompanied by offsetting purchases of US bonds, gold and other "safe haven" assets. The selling pressures gained even more momentum in the last few days of February as the State of California announced that they were putting about 8,000 of their residents under surveillance for possible COVID 19 contamination.

Until then, California (and other states) had not been able to test for COVID 19 as the CDC either did not have the sufficient number of tests or would not provide them. I guess, one way to not have an epidemic to contend with is to not test for it...

The full impact of this virus on the global economy is unknown. But it is already creating enough havoc in manufacturing supply chains and generating enough fear regarding overall consumption levels that serious economic consultancies and organisms have revised downward their forecasts for growth in 2020.

Below is the table produced by Capital Economic showing their "pre-virus" forecasts and their latest ones.

Table 1: Change in CE 2020 GDP Growth Forecasts

	Pre-virus	Latest	Change		Pre-virus	Latest	Change
Advanced	*1.2*	*1.0*	*-0.2*	*Emerging*	*3.9*	*2.8*	*-1.1*
US	2.0	1.8	-0.2	China	5.0	3.0	-2.0
Euro-zone	0.7	0.5	-0.2	India	5.7	5.3	-0.4
Japan	-0.2	-1.0	-0.8	S. Korea	2.5	1.0	-1.5
UK	1.0	0.8	-0.2	Brazil	1.5	1.3	-0.2
Sweden	0.8	0.5	-0.3	Mexico	0.5	0.3	-0.2
Switzerland	0.8	0.5	-0.3	Russia	1.8	1.5	-0.3
Global	2.9	2.0	-0.9	Turkey	4.3	3.8	-0.5

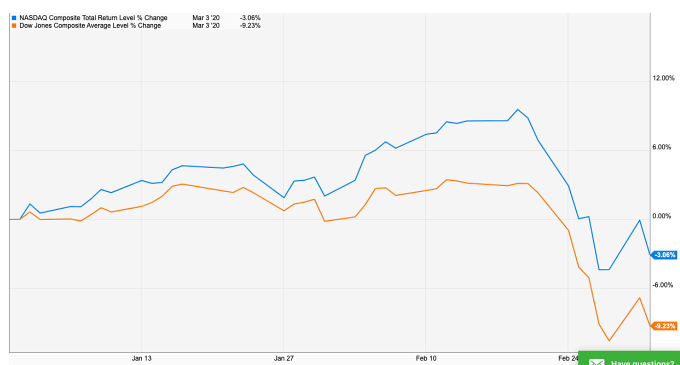
Sources: Refinitiv, Capital Economics

Based on their new estimates, global growth should be about 2%, down from an earlier 2.9%. This is not an insignificant reduction when one starts from a relatively low level, to begin with.

Tilts and Allocations

At the beginning of the month, I reduced our exposure to growth stocks and increased our investments in value stocks. The rationale for this was two-fold: 1) Reduce the overall risk in each portfolio, 2) Take profits from the high valuation stocks.

More often than not, when markets correct, the highfliers (growth stocks) tend to suffer more than other market sectors. So far, this has not proven to be the case. Growth stocks have continued to outperform all other equity sectors as illustrated below:



The Nasdaq (blue line-growth index) is down 3.06% YTD as of the March 3 close. The Dow Jones industrial (orange line-proxy for value index) is down 9.23% over the same period. Clearly, this is a rather peculiar type of correction.

The second action we took as the situation deteriorated was to sell half of our US small stock holdings. This move has proven positive so far. Small stocks remain as unloved in the US market as growth stocks are sought after. A reversal will eventually take place, but I do not know what the catalyst will be. Waiting for that to happen has been painful.

Finally, I could not conclude this section without highlighting the outstanding performance of the US long bond. It is up 14% so far this year. The long end of the US bond market (20 years and beyond) has rallied considerably amid fears of global recession. We have reached a point where the 30-year bond currently yields 1.66%.

Going forward, there is no (real) money to be made in bonds unless you believe that interest rates are going to zero. Any reversal of the trend (rising interest rates) would cause massive damages to bond portfolios. Yet, incredibly, over the past two years, US long bonds have been one of the best investments around.

Concluding Remarks

This epidemic will pass. It may take another two months before the full extent of the economic and human damage is fully captured. Nevertheless, it will pass. And when that happens, equities should start recouping some if not all of their losses.

There are no investment alternatives to equities, unless you want to park money in long term bonds at 1.66% and implicitly believe that the world economy is forever (or for a very long time) stuck into a low growth and low inflation environment. I have not yet reached that somewhat depressing conclusion.

Thank you for your trust,

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