May 4, 2020

Overview

In April, US equity indices bounced powerfully up from the lows reached at the end of March, recouping up to 50% of their peak to trough losses (February 19 to March 23). The S&Ps' 500 finished up 12.35%. The Russell 2000 jumped 13.74% while the Nasdaq continued to do better than all, rising 15.49%.

Internationally, all indices rose but once again less meaningfully than their US counterparts. The S&P's EPAC BMI (developed economies) rose 7.02%. Emerging market indices were up 9.16% (MSCI EM) and 6.28% (MSCI Frontier 100). The USD was mostly flat in April and the relative underperformance of international indices reflects the belief that the US economy will bounce back faster than the rest of the world from the current Covid-19 induced recession.

Below is a chart of SPY (the S&P's 500 ETF) that illustrates the magnitude of the rebound, as well as the still significant lost ground since the beginning of the year.

In technical terms, SPY (proxy for S&P's 500) has retraced 50% of its peak to trough losses. The vertical line above marks the level (280) and date (April 20) at which SPY "retraced" 50% of its losses. The longer it remains above 280 (it was at 282 as of Friday's close), the greater the chance that we will avoid another re-testing of the bottom reached on March 23. This is not out of the question. We are not yet out of the woods.

In April our client portfolios gained between 3.65%.and 5.93%. A portfolio consisting of 50% ACWI (World Equity Index ETF) and 50% AGG (US bond aggregate proxy) rose 5.78% during that period. On a YTD basis, client portfolios are down from 5.08% to 10.31% vs. 4.21% for our benchmark and 9.29% for the S&P's 500.

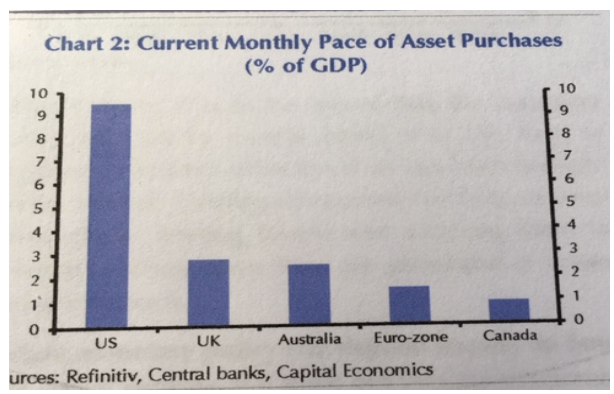
As a reminder, the equity allocation in our client's portfolios ranges currently from 30% to 60%, depending on risk profiles.

Market developments

In April, the social distancing measures justifiably implemented in the US and in other locations around the world started showing their devastating economic effects. In the US, unemployment claims rose to their highest level since the end of WWII. At its speak, unemployment should directly impact about 30 million people in the US or between 10% and 15% of the workforce. As expected in this context, by mid-April retail sales had slumped dramatically by a record -8.7% on a year-over-year basis. This caused markets to wobble in the first days of April. Then, as often, the Federal Reserve (FED) came to the rescue…

On April 9, the FED announced a significant development in their securities purchase program. Going forward, FED monthly purchases may include corporate bonds and, on occasion, below investment grade bonds ("junk bonds").

It is also relevant to mention that the FED's asset purchase program now dwarfs that of other countries and economic blocks around the world, as illustrated in the chart below:



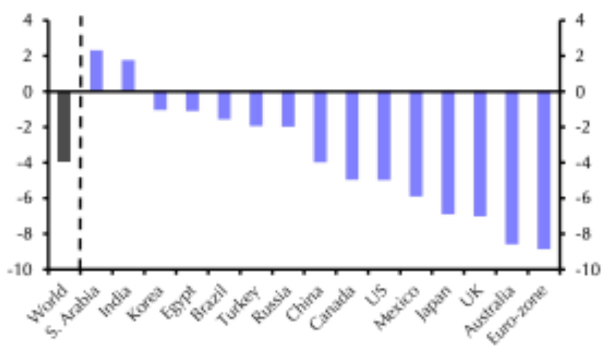
The vastly more decisive actions of the FED when compared to those of other similarly situated institutions around the globe, explains in good part the better performance of risk assets (equities and bonds mostly) in the US than in the rest of the world.
The FED is to be applauded for all of this….and, at the same time, its actions will not be sufficient to stem the tremendous economic damage inflicted by the forced cessation of activities around the country unless the fiscal response continues to be supportive of both businesses and individuals. So far, Congress has handled itself relatively well. Going forward, the proximity of the US Presidential Election in November may make it less likely.

Tilts and Allocations

In April, the lack of economic visibility combined to the continued lack of enlightened leadership out of the WH in dealing with this pandemic led me to remain extremely cautious and to keep client allocations unchanged.

At this stage, the economic recession induced by the social distancing measures in the US and around the world is difficult to evaluate both in its intensity and duration. The economic service that I use projects a worldwide contraction of 4% in 2020 with significantly variations on a national and regional basis, as illustrated below:

Chart 6: World GDP Forecasts (% y/y)



The US economy is expected to contract a little over 5%. Meanwhile, the Eurozone is projected to shrink by a more damaging 8.5% and Japan by 6.5%.

Going forward, I believe that the same type of variability in economic performance is likely to manifest itself across sectors and within sectors, across companies. The pandemic may be an "acid test" that will more clearly distinguish the winners and the survivors from those that will be left on the side of the road.

It is possible that in this post-pandemic world a more active money management posture that attempts to identify winning industries and winning stocks, may make more sense than in the past. With this in mind, I intend to carefully and slowly pivot to a more active portfolio management style over the next few months.

Instead of investing exclusively through ETFs and index funds in order to gain exposure to a specific region, industry or factor (small cap, tech etc…), I will more systematically combine individual stocks with them in order to achieve higher risk-adjusted portfolio returns.

Concluding Remarks

I assess the probability that the S&P's 500 will go down again to test its March 23 low at about 50%. If this were to happen, we could see the index fall from here by about 15% before bouncing back. A series of surprisingly bad corporate earnings could trigger it. A new policy mistake on the part of the Administration, nationally or internationally, could be another.

In this context, I will remain on the defensive with the equity allocation for each client remaining below its long-term target. About the only thing that would cause me to alter this defensive stance would be a breakthrough on the epidemiological front.

Thank you for your trust,

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