COVID-19 Market Outlook

March 2020

We live in trying times that are unprecedented for the majority of us. This outlook offers our perspectives on the potential impact of the Coronavirus (COVID-19) on the economy and markets and includes our high-level suggestions for investing in the current market environment.

The Virus

COVID-19, a novel type of Coronavirus, was first discovered late last year in the Chinese province of Hubei and is now a global pandemic with reported cases in over 100 countries.[1] Since the virus is beyond the point of containment, the primary goal of governments has been to slow its spread to avoid flooding the healthcare system, a process referred to as "flattening the curve" (the curve represents the number of cases at different points in time). The most effective ways to achieve this are to test and quarantine sick populations and to enforce social distancing – banning public gatherings, limiting travel, and requiring people with non-essential jobs to stay home.

The Economy

While necessary to save lives, this sudden pause in economic activity has a tremendous cost over the near-term as people lose jobs and businesses struggle to stay afloat. No one knows how long these depressed conditions will last, but economic activity will likely bounce back once the debilitating effects of the virus pass.

From a longer-term perspective, we expressed concerns about the economy during the next recession even prior to the virus outbreak. We did not know what would ultimately cause the next economic downturn or when it would arrive, but we felt strongly that the normal stimulative responses would be challenged. This is because central banks typically lower interest rates to encourage borrowing/increase spending. With interest rates low before the virus and now at or below 0% in the major developed economies, this policy tool won't provide the needed boost. Central banks can also print money (or quantitatively ease), but we've had over $12 trillion in QE since 2009[2] which has supported over $10 trillion in negative yielding bonds,[3] so the benefit of additional QE is also questionable. From a fiscal perspective, a divided government, an upcoming election and large budget deficits raise challenging hurdles for coordinated government action.

The issue with potentially limited ammunition to counteract an economic contraction is the possibility of an <u>extended period</u> of low/negative growth. This would be markedly different from the 2008-2009 credit crisis, which despite its jaw-dropping collapse only lasted a year and a half because of extraordinary stimulus efforts to suspend the contraction. Therefore, this recession may persist for longer than historical analogs. Duration is critical because it can make surviving the trough more challenging.

The good news is that policy makers are well aware of these issues and are likely to be aggressive in their attempts to deliver the desired economic jolt. How this ultimately nets out is difficult to ascertain, but we will be closely monitoring economic conditions.

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[1] *Source: https://www.worldometers.info/coronavirus/*
[2] Source: Economic Cycle Research Institute
[3] Source: https://www.wsj.com/articles/as-negative-yields-ebb-making-money-in-bonds-is-still-a-slog-11578222000

The Markets

Predicting the future path for the virus in the U.S. is not easy, but we can reference the progress in other countries that have responded similarly as us to provide a reasonable guide. Anticipating the economic impact is incrementally more challenging because of the first-order unknowns of the virus and the limited ability of central banks to reverse a downturn (as described above). Predicting where the markets will go is exponentially more difficult than the first two.

This is because markets represent powerful discounting machines that price real-time as information and expectations are absorbed. This applies to all public markets including equities and fixed income. As of this writing, the global stock market has plunged over 30% over the past 30 days; Treasury yields have dropped from 1.9% to 1.1% since the beginning of the year (once even reaching a low of 0.3%); and high yield bonds have suffered a 17% loss during the past month.[4] These enormous near-term moves imply that the market has immediately repriced for a new reality of low/negative economic growth, low inflation/deflation and an extended period of low interest rates. These are ballpark estimates given the imprecision in deciphering the exact economic scenario that is currently priced in. In other words, the <u>markets are already expecting dire economic outcomes across the board consistent with the broadly negative consensus view</u>.

Market performance from this point forward will largely be based on how future economic conditions transpire <u>relative to what is currently discounted</u>. Therefore, even if the economy worsens from here, the market may go up if the ultimate outcome is not as ominous as expected. Many cases of panicked selling in the past have been followed by remarkable rebounds as markets oversold on bad news and overdiscounted the downside risks.[5]

Portfolio Construction

In times like these, portfolio diversification is an absolute must. We have spent our careers building portfolios that have the potential to produce sustainable long-term returns, but most importantly to avoid catastrophic hits. Even during benign market environments when investor emphasis inevitably shifted to not missing out on potential gains, we have remained focused on the anticipated stability of the portfolio during the next crisis, not knowing its timing or cause.

Study of financial markets history, our professional experience and counsel from the world's most accomplished investors have taught us that proper diversification is the single most critical requirement for long-term successful investing. This concept may sound logical, but the typical portfolio is overconcentrated in equities and other assets that go down with equities and is therefore poorly diversified. We have maintained a portfolio allocation that deviates from the conventional portfolio because we know that challenging environments will come that few will be able to predict sufficiently in advance.

Better diversification includes owning assets that may do best in an economic recession like Treasuries and gold or in inflationary periods like Treasury Inflation Protected Securities (TIPS) and commodities. Additionally, strategies that have flexibility to hedge or those that invest in reliably uncorrelated market segments can offer additional diversification benefits. The next edition of *ARIS Insights* to be published shortly will delve into this vital topic in much greater detail. We have made a concerted effort over the past decade to employ diversification strategies as described above in preparation for difficult times and will continue to work tirelessly to develop and deploy investment strategies to help investors and market participants achieve their long-term financial objectives.

[4] Source: Bloomberg. Global stock performance references the MSCI All Country World Index. Bond yields reference the 10-Year Treasury Note. High yield bonds reference the BofA US High Yield Index. All data is as of March 19, 2020.

[5] Consider 2008-2009 as one relatively recent example. The S&P 500 fell 37.0% in 2008 before rising 26.5% the following year and not experiencing another losing calendar year for 8 years. Source: Bloomberg.

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