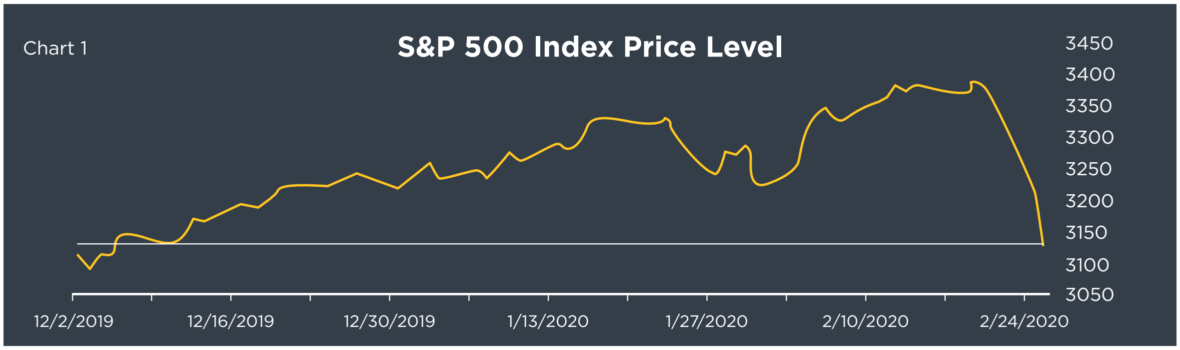
A Quick Guide to Market Volatility

February 26, 2020

By now you have probably seen the headlines. Equity markets have had a challenging few days. As Table 1 below shows, the recent drawdowns have been broad-based across both domestic and international equities. Safe haven assets like U.S. Treasuries have seen increased demand, driving the 10-Year yield to an all-time low. When markets fall so aggressively in such a short period of time, it's tempting to take action. Here are a few factors that we believe are driving markets, some context around the recent moves, and what to consider before making any changes to an investment strategy:



Source: S&P 500 Index (SPX) from Bloomberg L.P.

- Coronavirus (COVID-19) concerns are growing. The flu-like virus has spread globally, reaching parts of the Middle East, South Korea, Japan, and Italy. The market's initial belief that this would be contained to China no longer holds, and cross-asset price action suggests a material negative, global (but not necessarily U.S.), economic growth impact, followed by a V-shaped recovery, as a result of the virus.
- U.S. Presidential politics are coming to bear on markets. Virtually 100% of the "explanation" for the recent weakness focuses on the Coronavirus, but Senator Bernie Sanders has been rising in the polls and currently is the favorite to win the Democratic nomination (about a 60% chance for Sanders versus a 20% chance for any other individual candidate[1]). Prior to Saturday's Nevada primary, Sanders' broad-sweeping, democratic-socialist policies had not yet been widely priced into the market - it is difficult to determine how much of this week's equity market decline is attributable to his ascent.
- Despite the sharp drawdown in the S&P 500 from February 21th to the 25th, the market has only fallen to a price level that we saw in early December of last year. Year-to-date, the S&P 500 Index is down just 2.9% as of Tuesday's close -- or simply back to where we started the year (Chart 1).
- Since 1928, past episodes of similar market performance (S&P 500 down 6-9% over a 4-trading day period) suggest a strong bias to a sharp recovery: median S&P 500 performance over the following week is +1.6% (positive 78% of the time) and median S&P 500 performance over the following 3 months is +7.7% (positive 89% of the time).
  - Historically, sharp selloffs like we have experienced are typically the market's reaction to a large amount of new uncertainty. Once more information becomes known, the market is able to price in a more narrow range of likely outcomes that have historically been slightly more positive than the initial "panic reaction".
- We think it is critically important that the Chinese equity market (SHSZ300) has outperformed the S&P 500 in February and is positive thus far for this month - all despite China being the epicenter of the virus outbreak.
  - The Coronavirus' impact may be nearly fully "priced in(to)" the market where it all started, about a month after the virus became public knowledge.

1 Source is Bloomberg L.P. from PredictIT, https://www.predictit.org/

Market	1 Week Return	Return Since Outbreak	YTD Return
S&P 500	-7.2%	-6.0%	-3.2%
Nasdaq	-7.9%	-4.5%	-0.1%
International Developed	-4.7%	-6.8%	-5.8%
Emerging Markets	-3.6%	-7.9%	-5.2%
U.S. 10 year Yield (bp)	-21	-26	-29

Source: Index data from Bloomberg L. P. & Horizon Investments l As of 2/25/20 close l "Return Since Outbreak" start date is 1/17/2020
Table 1: Returns of headline broad market segments

What are we watching going forward?

The rate of new infections globally, as well as the efficacy of containment efforts both in China and elsewhere, are key to determining the impacts on economic growth and investor risk sentiment of the coronavirus from here.

The Federal Reserve and other central banks are on high alert. We believe the Fed will cut rates if sentiment deteriorates and equities go lower -- just like they did last summer and markedly different from their actions in Q4 of 2018.

The impact of last night's Democratic debate heading into the South Carolina primary and Super Tuesday is the thing to watch on the political front. The moderate portion of the Democratic party needs to coalesce around one candidate or Sanders is very likely to be the nominee. If we see candidates cancelling fundraisers or appearances in the coming days, that would be a signal that the Democratic party has started the winnowing process, which the market would most likely view favorably.

As we have discussed in the past, volatility is not irregular in markets. Unexpected events can happen, and it is important to be prepared with a thoughtful and well-disciplined investment process. Should you have any additional questions or comments, please reach out to your primary Horizon Investments contact.