Advisor Group
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MARKET MATTERS

SPECIAL UPDATE March 9, 2020

Economic Indicators				
	12/31/2019	1/31/2020	2/28/2020	3/6/2020
3-Month Treasury Rate	1.55%	1.55%	1.27%	0.45%
10-Year Treasury Rate	1.92%	1.51%	1.13%	0.74%
ICE BAML High Yield OA Spread	3.60%	4.03%	5.06%	n/a
Fed Funds Rate Upper Target	1.75%	1.75%	1.75%	1.25%
Unemployment Rate	3.50%	3.60%	3.50%	n/a
WTI Crude Oil Spot ($/bbl)	$61.06	$51.56	$44.76	$40.28
VIX Index Level	13.78	18.84	40.11	39.62
U.S. Mfg PMI (IHS Markit)	52.4	51.9	50.7	n/a
U.S. Service PMI (IHS Markit)	52.8	53.4	49.4	n/a
China Mfg PMI (Caixin)	51.5	51.1	40.3	n/a
China Service PMI (Caixin)	52.5	51.8	26.5	n/a

COVID-19, Oil Price War Prompt Selloff

Developments over the weekend point to a difficult week in financial markets. On Friday, global markets were already bracing for uncertainty as the spread of the coronavirus ("COVID-19") had already significantly reduced economic activity. Now an oil price war between Russia and Saudi Arabia has exacerbated concerns of a global recession, prompting large selloffs in futures across asset classes. After disagreeing on production cuts, each country has opted to materially increase production to avoid losing share in a market that is already seeing declining demand. Commentators indicated that there is still a possibility of the two countries coming to an agreement.

As of this writing at 6:00 a.m. ET on Monday, March 9, 2020:

- WTI crude oil futures were down 19% to $33.47. Brent crude oil futures were down 19% to $36.84 but were down 31% earlier in the day in its worst decline since the Gulf War in 1991.
- S&P 500 futures were down 4.9% but had reached the 5% decline limit earlier in the day.

- In European trading, the FTSE 100 (England), CAC 40 (France) and DAX (Germany) were down 6.2%, 6.2% and 5.7%, respectively.
- In Japan, Hong Kong, and Australia, where the market day has finished, indices closed down 5.1%, 4.2%, and 7.3%, respectively.
- 10-year and 30-year U.S. treasuries fell to record-low yields of 0.48% and 0.88%.
- Safe haven currencies, such as the euro and yen, appreciated, while commodity currencies, such as the Norwegian krone and Mexican peso, depreciated in significant moves.

Recession Fears

The spread of COVID-19 and the oil price war have exacerbated fears of a recession. A Reuters poll last week found that economists' projected probability of a recession within the next year increased from 23% in February to 30% in March.[1] Economists may not be able to predict a recession, but survey probabilities generally do reflect underlying trends.[2] An indicator-based model used by the Federal Reserve (the "Fed") projects a 2% chance of a recession as of January,[3] while a yield-spread model produced by the Federal Reserve Bank of New York projects a 31% chance of a recession as of February.[4] Those probabilities will likely increase if the futures sell-off materializes.

As the oil price war highlights, markets are currently very fluid, which makes it difficult to establish a market outlook. U.S. employment data for February, for example, was strong but largely ignored by the market since it did not yet reflect the impact of the virus outbreak. By comparison, China's manufacturing and service producer indices fell deep into contraction territory in February (over two months into the outbreak), although business sentiment for the future reached a five-year high.[5] China, as the epicenter of the outbreak, represents a bad case scenario. The economic impact in other countries will be highly dependent on how well governments react. Prior to the oil price war, the IMF still projected a minimal impact on global

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[1] "Fed to cut rates again in March, but effectiveness challenged: Reuters poll," *Reuters*. https://www.reuters.com/article/us-fed-rates-poll/fed-to-cut-rates-again-in-march-but-effectiveness-challenged-reuters-poll-idUSKBN20T1SJ. March 6, 2020.

[2] "Recession Forecasts Are So Bad, They're Good," *Bloomberg*. https://www.bloomberg.com/opinion/articles/2019-07-19/recession-forecast-for-2020-economists-are-so-bad-they-re-good. July 19, 2019.

[3] "Smoothed U.S. Recession Probabilities," Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org/series/RECPROUSM156N. Visited March 7, 2020.

[4] "Probability of US Recession Predicted by Treasury Spread," Federal Reserve Bank of New York. https://www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_Rec.pdf. Visited March 7, 2020.

[5] "Global Markets Weekly Update," T. Rowe Price. March 6, 2020.

GDP growth for 2020, having reduced its projection on February 22 from 3.3% to 3.2%. Other models expect a 1.3% to 2% reduction in global GDP growth.[6] Even the models might be conservative if Russia and Saudi Arabia do not come to an agreement soon.

Governments and central banks are attempting to preempt a more severe economic impact with fiscal and monetary measures. The Fed in the U.S. on March 3 announced a 50 basis point cut to the federal funds rate, which, somewhat ironically, actually caused equity markets to decline for fear that the Fed was basing its decision on deeper, more current insights into the economic impact of the COVID-19 outbreak. Central banks, including the Fed, are more likely to provide additional monetary stimulus in the coming weeks if the oil markets pose a risk to other sectors.

Not a Time to Panic

Outbreaks are eventually contained and recessions are part of market cycles. While the short-term market outlook may be discouraging, the intermediate- to long-term outlook remains more positive. Clients may wish to consider using dollar-cost averaging while rebalancing their portfolios and even re-evaluate their risk tolerance, but should maintain a long-term investing approach. Such a strategy can allow clients to sell appreciated bonds in favor for depreciated equities over time without having to time the market.

Change in Market Indices				
as of 3/6/2020, not annualized	**MTD**	**YTD**	**1 Year**	**3 Year**
S&P 500 PR	0.61%	-8.00%	6.55%	24.73%
Russell 2000 PR	-1.84%	-13.14%	-7.59%	3.95%
MSCI EAFE PR USD	0.22%	-10.96%	-3.27%	3.21%
MSCI Emerging Markets PR USD	0.65%	-9.20%	-4.08%	8.70%
Barclays U.S. Aggregate Bond TR	0.84%	4.63%	12.62%	17.55%
Barclays High Yield Corp TR	0.87%	-0.53%	7.01%	16.14%
Barclays Global Agg Bond TR USD	2.99%	3.56%	8.72%	17.16%

Equity Valuations Unclear

Equity markets remained relatively unchanged for the week ending March 6, but volatility remained high. The S&P 500 Index had declined 8% for the year to March 6. According to data

[6] "Covid-19 is now in 50 countries, and things will get worse," *The Economist*. https://www.economist.com/briefing/2020/02/29/covid-19-is-now-in-50-countries-and-things-will-get-worse. February 29, 2020.

from Morningstar Direct, equity markets in most countries were significantly undervalued as of March 5. However, FactSet indicates that analysts and companies have been slow to revise earnings down in light of COVID-19,[7] and estimated that the forward 12-month P/E ratio for the S&P 500 Index was 17.0 as of February 28, compared to a five-year average of 16.7 and a 10-year average of 15.0.[8] Overall, we believe that the S&P 500 Index was still slightly overvalued. Recall that the index was still up 7% from a year ago and 25% from a three years ago when we were already deep into a bull market. However, the index had a dividend yield of 1.9%, which looks favorable compared to Treasury rates now yielding well below 1% and exhibiting negative real yields (after adjusting for inflation). If the futures sell-off materializes, equities may look more attractive depending on the impact on earnings.

Treasury Rates Decline, Spreads Widen

Some of the largest impacts from the spread of COVID-19 and central bank moves have happened in fixed-income markets. On Tuesday March 3, the Fed announced a 50-basis point cut in its federal funds rate to a range of 1.0% to 1.25%. Fed Chairman Jerome Powell stated that "the virus and measures being taken to contain it will weigh on economic activity here and abroad for some time." Equity markets initially reacted to the cut favorably but then sold off as investors worried that monetary policy changes would not help the economy in the short term and that the Fed could run out of dry powder if they continue to cut rates. By Friday, federal funds futures indicated that investors and traders believed that the Fed could cut rates by another 50 to 75 basis points at its next meeting on March 17-18. Our belief is that a smaller cut in the Federal Funds rate, if combined with a large fiscal stimulus, would be much more effective in helping to bolster confidence.

The result of the spread of COVID-19 and the Fed rate cuts led to a sharp decline in Treasury yields. At the start of the week, 10-year Treasury yields were at a record low of 1.10% but yield declines only accelerated throughout the week with the 10-year Treasury yield falling to 0.74% by the end of the week. In overnight futures trading on March 8, 10-year Treasury yields fell below 0.5%. Meanwhile, one-year Treasury yields fell to a record low of 0.39% and, at the long end of the curve, 30-year Treasuries fell as low as 1%. At the same time, the divided yield on the S&P 500 finished Friday at 1.96%, meaning that the dividend yield on the benchmark equity index was nearly triple that of the yield of a 10-year Treasury. In the high-yield market, credit spreads increased during the week, although the price declines were relatively orderly. The

[7] "Are Analysts Slashing S&P 500 EPS Estimates for Q1 Due to the Coronavirus?", FactSet. https://insight.factset.com/are-analysts-slashing-sp-500-eps-estimates-for-q1-due-to-the-coronavirus. February 28, 2019

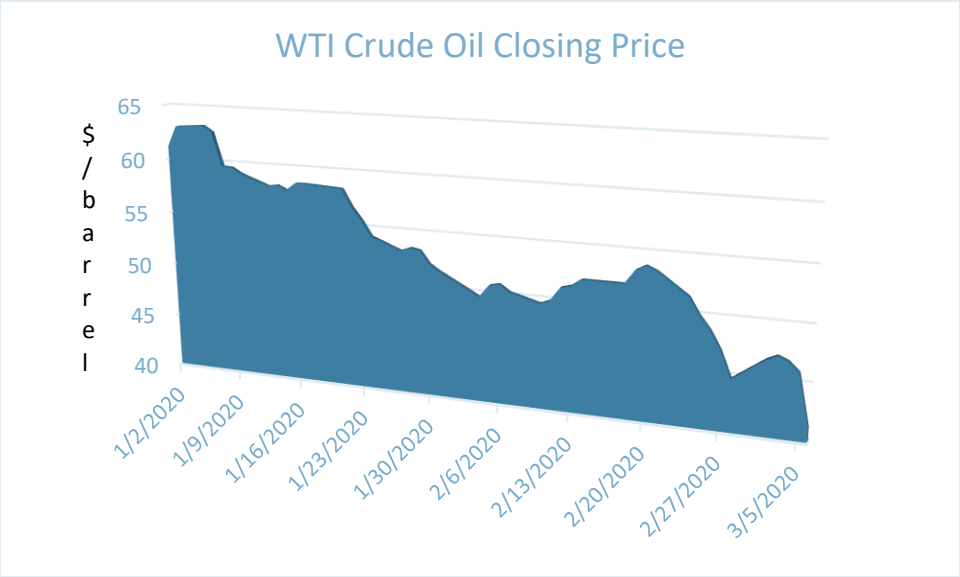
[8] "Earnings Insight," Factset. https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_030620.pdf. March 6, 2020.

Bloomberg Barclays High Yield 100 Index had spreads widen to 491 basis points at the close of trading on Friday over Treasuries, well up from its low of 271 basis points in the last year. Despite the increase in spreads, the high-yield index is only down 2.38% for the year and remains 5.5% higher than a year ago. Many investors came into 2020 expecting the Fed to remain on pause throughout the year, so one of the areas most impacted has been the leveraged loan market where prices dropped by about 3% with concern that some CLOs could be trouble. If the futures selloff materializes, equities may look more attractive depending on the impact on earnings.

An Oil Price War Breaks Out

Another area that has been materially impacted by COVID-19 has been the energy sector as global demand has softened year to date. Energy demand started to decline after the first cases of COVID-19 in China and has continued to drop as the virus has spread across much of the globe. According to reports from IHS Markit, oil demand is likely to drop by as much as 3.8 million barrels per day in the first quarter of 2020, to 96 million barrels per day. If this drop in demand was to materialize, it would be the largest decline on record.

The table below shows the decline in WTI crude oil prices from the start of the year, when prices were over $60 per barrel, to a closing settlement price of $41.28 per barrel on Friday, March 6. In overnight futures trading on March 8, WTI crude oil prices fell sharply, reaching as low as $30 per barrel in early trading.



The most recent developments in the energy sector have not been due directly to COVID-19 but instead to significant political developments. On March 6, OPEC+ was meeting to discuss a potential cut in crude oil supply to help stabilize pricing, but in a surprise move, Russia said that it was unwilling to cut production. In what many consider a retaliatory move on March 7, Saudi Arabia cut its official selling price for all crude to all destinations by as much as $10.25 per barrel while also announcing that they will increase production. Many analysts immediately lowered price targets for crude oil after the moves by Russia and Saudi Arabia, with some citing a potential $27.10 target, which was the low seen in 2016 during the last price war between the two countries. Unfortunately, the typical sectors that would benefit from a decline in energy prices such as transportation, are facing at least short-term issues due to the spread of COVID-19, which has hurt short-term demand for travel. We would advise caution at this point in time with owning more highly leveraged energy companies as the impacts of the energy pricing declines may cause additional distress to some of the companies with weaker balance sheets. At the same time, energy prices will not decline forever. So, long-term investors who have diversified portfolios and a long-time horizon may want to consider adding positions if prices were to significantly decline from current levels.

Research Guidance Model

In January, Advisor Group made shifts to the asset allocation of our five risk-based guidance models. The shifts were made based upon absolute valuation in certain sectors and resulted in tilts away from high-yield fixed income, absolute return and multi-alternative, having an overall underweight to equities and an overweight to domestic and international core fixed-income strategies. At this time, we are not making any changes to the asset allocation of the models. However, we would recommend that investors consider rebalancing their portfolios if the allocations significantly differ from the target allocations set earlier this year. We are continuing to watch market developments and may make asset allocation shifts in the near future, should market conditions and valuations warrant.

New Information Portal

Be sure to visit the new Coronavirus Market Impact page on Advisor Portal – your one-stop online hub for resources on Coronavirus' impact on the markets. On the page, you'll find relevant and timely insights from the Advisor Group Product Research Team and our Strategic Partners. Check back frequently for the most up-to-date information.

Advisor Group is closely monitoring market conditions and is here to assist you with reviewing developments. The current volatility serves as a reminder to your clients of the importance of maintaining diversified portfolios across multiple asset classes. Timing the market is a very difficult task as market conditions can change abruptly. It is prudent for clients to maintain a long-term investing approach.

If you have any questions about financial markets or investments that are offered at Advisor Group, please feel free to contact the Sales Desk at 800-558-7735 or you may reach Product Research by email at agr@advisorgroup.com.

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