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State of the Markets - March 2020
Virus crisis or buying opportunity?

With the latest virus crisis that no one could have predicted - more like in the "Act of God" category, is this a good time to add more investments and take advantage of the downturn? However, you don't want to try and catch a falling knife.

Historically the worst thing would be to bail out and lock in what often is a temporary market decline (assuming you have no immediate cash needs). "Do it yourself" investors over the long term underperform the market averages, since they tend to act on emotion and bail out in a decline, and miss the usual rapid recovery in the rebound.

We have had wild swings in the market since hitting an all-time high on February 19th. There has been panic selling and lots of “buy-the-dip” buying, which usually in the long-term is the best investment strategy.

Marketwatch 3/4/2020 after the market close:

"After the worst week since 2008, the Dow is now on pace for its best week since 2011. 1,000 points here, 1,000 points there, and now you’re taking about real stock moves." Of course, with the wild swings, by the time you read this it may be proven right or wrong - we are in uncertain times. Fears of the COVID-19 outbreak injected a great deal of fear into the market - even though more people die of the regular flu, and prior virus-related market panics resulted in relatively quick recoveries.

Even more volatility has been seen intraday with larger stunning market ups and downs, as there has been a tug of war between panic selling and opportunity buying. We have been moving 1% in a few minutes and 2% and 3%+ in daily moves.

Let’s look at the facts

The fundamentals in the U.S. economy so far remain strong - among the best in the global markets. While the US economy will be negatively affected by the virus crisis the extent is still unknown and how long it will last.

3/4/2020 Economic reports

Private sector hiring added an unexpected 180,000 new jobs in February, beating estimates mostly in the service producing sector.

The ISM survey report showed in February the non-manufacturing (services) sector NMI index grew for the 121st consecutive month and at an increasing rate (index 57.3 vs 55.5 in January - above 50 shows expansion). This is the highest level since February 2019. With services activity representing over 70% of the economy, the data suggests underlying strength in the economy is holding firm despite the COVID-19 outbreak.

Further, the business activity index was at 57.8, reflecting growth for the 127th consecutive month. The New Orders Index was at 63.1, rapidly expanding from the already healthy 56.2 reading in January. Most respondents are concerned about the coronavirus and its supply chain impact. They also continue to have difficulty with labor resources, since it is hard to find skilled workers. Nevertheless, they remain positive about business conditions and the overall economy.

Construction spending rose to an all-time high and mortgage applications jumped 29%. Activity jumped as interest rates plow lower amidst fears over the COVID-19 contagion.

The United States is in a period of historic, continuous economic growth, with GDP climbing every quarter since mid-2009.

US manufacturers and tech companies are largely dependent on their parts supply chain from China. For example, March 4th CNBC reports "Apple, Google and Microsoft have looked to move some hardware production from China to places including Vietnam and Thailand. Assembly of products such as phones could feasibly be moved

quickly, experts told CNBC. But moving component manufacturing outside of China will be difficult given how entrenched it is and how long it would take to build capacity in another country."

Global Central Banks Emergency Actions

The US Fed in a preemptive move delivered a 0.5% emergency rate cut as did the Bank of Canada. However, with interest rates near zero or negative in much of Europe and Japan the US Fed has more wiggle room than the European Central Bank (ECB) or Bank of Japan. Throw in the fact that the Eurozone is likely to have been more adversely impacted by the spread of the coronavirus, a hesitant ECB could be quite damning… And that's before considering how difficult it can be to push member states into loosening their purse strings.

March 5 Wall Street Journal: "While central banks in Australia, Canada, China, Japan and the US have already moved aggressively to support their economies, the ECB has so far held back, even though the bloc's economy has been weak for a year. On Wednesday, a day after the Fed cut rates by 0.5 percentage points, Eurozone finance ministers were discussing the region's response to the crisis on a call that was joined by Ms. Lagarde, the head of the ECB.

"The ECB has fewer obvious tools to combat any slowdown than the Fed. The ECB already cut its key interest rate to minus 0.5% last September to support the economy and restarted a controversial program to purchase €20 billion ($22.3 billion) a month of Eurozone government and corporate debt.

"But the bank still has a broad toolbox. It could push negative interest rates further below zero—although that could put pressure on the region's banks—and it is considering rolling out targeted loans for banks and businesses hit by the virus."

While Central Bank action cannot stop the spread of the virus, it can provide liquidity and stimulus to the credit markets. So far, there are no major market liquidity concerns like there were in 2008.

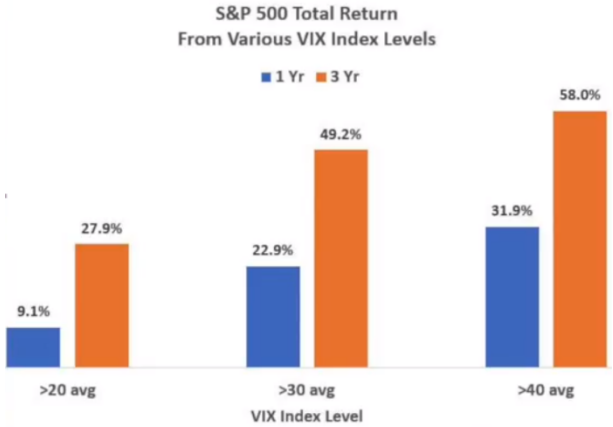
March 5 FOREX.com: "The supra-national body, the IMF, has pledged $50bn of support to low-income countries, whilst in China there will be a package of 100bn yuan (c. $16bn) for its own coronavirus prevention."

March 6 Marketwatch

"In China, where the virus outbreak has been steadying, stocks trading in Shanghai have rallied nearly 12% since scraping bottom on Feb. 3. Factories there are gradually reopening, and a return to a sense of normal life may even be on the horizon following swift and severe actions by the government to corral the new form of coronavirus.

"But elsewhere in the world, the mood is darker. There are about 17 times as many new infections outside China as in it, according to the World Health Organization."

March 6- Buy the Panic?



Alger points out in this chart that when the VIX "fear" Index has gone high, especially to 40 as it did a few days ago, historically, when the VIX does reach 40, the subsequent 1- and 3-year returns are very strong. In fact, investors may want to consider buying *into* that type of panic, rather than running away.

The risks

The S&P500 selloff marked the fastest decline of more than 10% from an all-time high in the history of the index. The decline reflects growing uncertainty regarding the scope of the virus and its impact on global profits potentially due to 1) supply chain disruptions especially from China, resulting from factories shutting or curtailing operations; 2) Destruction of demand for products and services, especially from foreign buyers of US goods. This will more impact corporations with large foreign earnings.

Most US factories in China's manufacturing hub around Shanghai have reopened, but the severe shortage of workers due to the coronavirus will hit production and global supply chains, according to the American Chamber of Commerce in Shanghai. – continued -

While about 90% of the 109 U.S. manufacturers in the Yangtze River delta expect to resume production, 78% of them said they don't have sufficient staff to run at full speed, according to a survey by AmCham. The biggest reasons for that were travel restrictions on their staff returning from holidays, and the requirement to quarantine them for two weeks once they do come back.

Almost 60% of the firms expect demand to be lower than normal over the next few months. Nearly half said their global supply chain had already been affected by the business shutdown, and about a third of them will consider moving operations out of the country if this continues, according to a survey.

As of March 4th, CNBC reports that China is now back to about 40% manufacturing capacity and is expected to be at 90% by the end of the month.

While as of now, the hit in the US overall appears to be nominal - unless the virus becomes widely uncontrolled. Airlines, travel and some specific industries will likely be hit hard in the short term. Most expect this to be temporary.

Conclusions

Market declines have always returned to new all-time highs and trying to bail out of the market has proven to be the wrong move. This "act of God" type virus crisis, like previous major virus outbreaks will eventually be contained - hopefully soon as it appears to be in China with new rates of infection declining. The US is possibly in the very early stages with fewer than 500 cases. The US Congress has voted for a $8.3bn emergency funding package to fight the coronavirus.

Rather than panic over a virus - or other major events that create uncertainty - investors can potentially benefit by focusing on fundamental business outlooks that can help firms rebound more quickly from what may be temporary adversity. Investors should take a long-term perspective.

That is why we have never recommended index funds, but managers with analysts evaluating specific company outlooks, who have historically outperformed vs. the risk taken in a diversified portfolio.

While nothing can be assured, it appears this market decline may be more of a buying opportunity for new investment funds than a time to panic and bail.

Action Plan Recommendations

I can discuss individually specific recommendations based on one's goals, objectives, and risk tolerance.

In general, I suggest investors have a diversified portfolio to include both value and growth managers, with long-term track records of outperformance compared to the category they invest in and compared to the risk taken (Alpha vs. Beta in investment terms) – not just raw returns. While U.S. growth is slowing, the US has comparatively stronger economics than most global economies. US Small-Mid Caps often have the potential for faster growth, and with so many more smaller companies than large, good research can potentially find hidden gems. Smaller companies' stocks are often more volatile with less trading volume, but over the long term have rewarded investors.

I avoid "dumb" index funds with no stock selection based on individual company outlooks, or similar ETF's (only make sense for traders, not investors). For those seeking income or for the more conservative allocation in a diversified portfolio, I suggest various bond alternatives, without the interest rate risk of many bonds at this point in the economic cycle.

Part of our "participate-yet-protect" strategy in a growth-oriented portfolio is to have alternative investments so that in a significant equity market decline when you also need cash, you do not have to lock in large losses in a market downturn. Markets have always returned to new highs - only the timing is uncertain.