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Rockefeller Insights

Around the Markets

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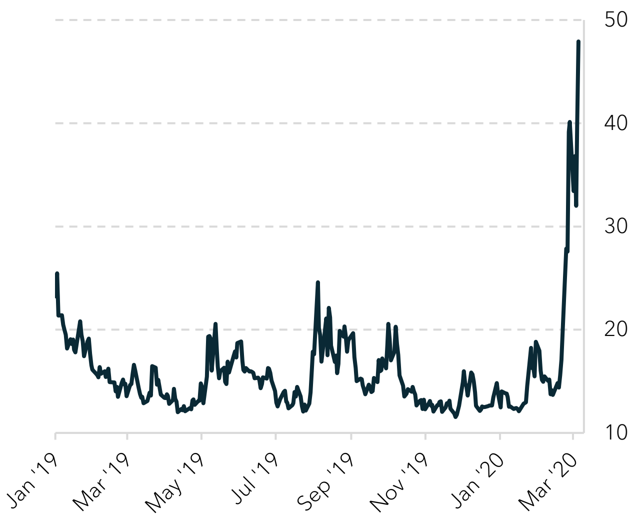
Cheryl Rowan / crowan@rockco.com
Chloe Duanshi / cduanshi@rockco.com

And March Came In Like A Lion…

The US stock and bond markets have taken investors on a roller coaster ride for the past two weeks as a lot of news and volatility have been compressed into a short period of time.

CBOE Volatility Index (VIX)[1]



News of the COVID-19 coronavirus spreading beyond its source in Asia to Europe, the Middle East and North America drove the stock market to do what it does best – panic selling into uncertainty. The S&P 500 Index was down 11.5% for the last week of February; shareholders lost $3.3 trillion.

As March rolled in this week, stocks got a classic rebound bounce on Monday – the S&P 500 Index was up 4.6% – fueled by speculation that central banks would rescue the markets by lowering interest rates. In a report out over the weekend, one prominent investment bank called for the US Federal Reserve to lower short-term rates significantly to help buoy markets as the spreading virus begins to impact global economies.

The Fed Does Not Have A Vaccine

The Fed's emergency action on Tuesday to lower the Fed funds rate by 50bps was far less of a cure for stock prices than Joe Biden's surprise showing in the Super Tuesday primary elections. Despite the rate cuts – to the point where the 10-year US Treasury benchmark yield dropped below 1.0% for the first time ever, stocks sold off again in violent fashion almost immediately after the Fed's announcement of an emergency rate cut. This was a clear mandate from the markets that interest rates are not going to solve the virus-induced economic woes.

10-Year US Treasury Yield %[2]

The yield on the benchmark 10-year Treasury bond is now below 0.8%, but lower rates alone are unlikely to engineer a demand for credit. After all, rates were already low prior to the recent violent market selloff. Corporates and households have had plenty of time to restructure debt, and the housing market has been fairly robust, with further

[1] Bloomberg; data as of 3/6/2020 9AM EST

[2] Bloomberg; data as of 3/6/2020 9AM EST

gains limited by a lack of supply rather than borrower demand.

However, record low interest rates are likely to have longer term impacts. Negligible returns from cash will no doubt force investors to seek higher returns in riskier assets; most stocks in the S&P 500 Index have higher dividend yields than the yield on 10-year Treasury bonds. The market reaction to the emergency rate cut on Tuesday is an indication that the Federal Reserve has seemingly lost one of its levers to pull in the event of an economic crisis. There is less room to maneuver rates lower, and the impact of such moves has become increasingly more muted. As investors contemplate the potential implications of the virus outbreak on the global economy, they are clearly looking for another source of comfort that is not in the arsenal of the central bank.

Gauging The Virus Impact Is A Challenge

COVID-19 has spread rapidly around the world; the number of new daily confirmed cases outside China continues to increase. It is certain that the virus outbreak's economic impact will be significant. Supply chain disruptions from Barbie dolls to apparel to semiconductors are already in place. Manufacturing hubs of China, South Korea and Japan together account for over 25% of US imported goods, and a majority of electronics and computer-related products.[3] Gauging the impact of a dynamic and rapidly changing disruptive source is a steep challenge. Analysts have begun the process; corporate earnings estimates will no doubt undergo several revisions in coming weeks.

The Organization of Economic Cooperation and Development (OECD) revised its forecast for 2020 global economic growth down to 2.4% from 2.9% prior to the outbreak, also lowering the forecast for China's growth to 4.9% from 5.7%. This is the lowest rate for global growth since the financial crisis of 2008-2009 and represents a scenario where the virus is contained to limited outbreaks outside China. Under a domino case where the virus is more widespread, global growth could fall to 1.5% or worse.[4]

Are Stock Prices Low Enough?

Company revenues and earnings are surely to be negatively impacted across a wide array of industries, especially those already adjusting to trade restrictions with China. Travel and leisure stock prices reflect expectations of avoidance of airlines, cruise ships, restaurants, and amusement parks. Energy stocks, already reeling from lower commodity prices, now must contend with expectations for reduced demand as global growth slows. Companies such as Apple, Disney, and Nike have issued warnings of business interruptions due to the COVID-19 outbreak.

Equity analysts have begun assessing the impact that the virus is likely to have on their expectations for earnings growth. Wall Street firm Goldman Sachs made news recently by revising its earnings growth estimate for US stocks down to 0% for 2020. While many other investment firms have also revised estimates lower, most are still calling for positive earnings growth. The current consensus earnings growth estimate for companies within the S&P 500 Index is 0.3% for the first quarter and 6.9% for the full year.[5] We expect potential further downward revisions over the coming months.

Stock prices have fallen this year, but are stocks cheap enough? Most experts would argue that the US stock market was badly in need of a correction after the sharp runup in 2019 when the S&P 500 Index advanced over 30% in total return. While no

[3] United Nations Conference on Trade and Development.
[4] The Organization of Economic Cooperation and Development (OECD)
[5] FactSet; data as of 3/5/2020

one desires a correction caused by a health care crisis, stock prices, now nearly 11% below their highs in mid-February, are certainly cheaper and therefore intriguing. Forward price/earnings multiples dipped below 17x earlier this week – compared to over 19x just two weeks ago.[6] Assessing the attractiveness of the current valuation is dependent on having conviction in the denominator (i.e. forecasted earnings over the next twelve months). Given the high probability of more negative earnings revisions, we would not be surprised to see further market weakness.

When markets sell off as in recent weeks, investment experts repeatedly espouse the virtues of calm, discipline, and having a long-term perspective. But in the throes of volatility, many investors think they should be "doing something." We continue to advocate the importance of periodic rebalancing; down markets always serve as a sobering reminder of disciplined portfolio management. For those investors who desire increased market exposure, we offer additional advice.

Nibble, Don't Bite

In our view, investors should be prepared for additional market volatility, as the virus spreads and human behavior changes. Already in the US, numerous corporate conferences and local/regional events have been postponed or cancelled, airlines have revised their flight schedules, businesses are instituting "work at home" policies, and travel to a place as innocuous as Italy has been restricted. If/when individuals in the US experience a personal disruption (e.g., school closures, restrictions at shopping malls, cancellation of sporting events, etc.), then the impact on spending will likely intensify, with greater earnings disruption across corporate sectors.

We suggest that investors nibble in areas of market interest, rather than going all in right now. For those inclined to commit to stocks, equities generally look more attractively priced than a few months ago. The Health Care sector seems like a logical place to find opportunities; the sector is generally less exposed to the global supply chain than many others. Further, a radical change to existing health care policy appears increasingly unlikely; the uncertainty surrounding specific policy initiatives had kept a lid on stock prices, particularly in health care services. Biden's Super Tuesday showing sent the market up over 4% on Wednesday, with health care stocks up significantly higher.

Energy and Financials have both been battered and offer opportunities as well, in our view. Financials, particularly banks, are impacted by economic slowdown along with additional challenges presented by lower interest rates and a flat yield curve. As many banks and insurance stocks offer attractive dividend yields, investors seeking income may find value here. Energy stock woes are well documented but selected higher quality stocks with ample cash flow may be interesting for investors with longer time horizons.

Bond investor Western Asset Management made news this week when one of the firm's investment officers suggested that US Treasury bonds have gotten too expensive, as prices have been driven up by investors seeking a safe haven in reaction to the COVID-19 virus.[7] Western is reportedly moving away from Treasuries into corporate bonds, which now offer more attractive yield premia versus Treasuries. As spreads have widened, bond investors are overall better compensated for assuming the additional corporate credit risk. For taxable investors whose core fixed income allocation is primarily composed of tax-exempt municipal bonds, the relative valuation of municipal bonds versus Treasury bonds has also improved materially as a result of the recent significant moves in Treasury yields.

[6] FactSet; data as of 3/5/2020

[7] The Wall Street Journal, 3/2/2020

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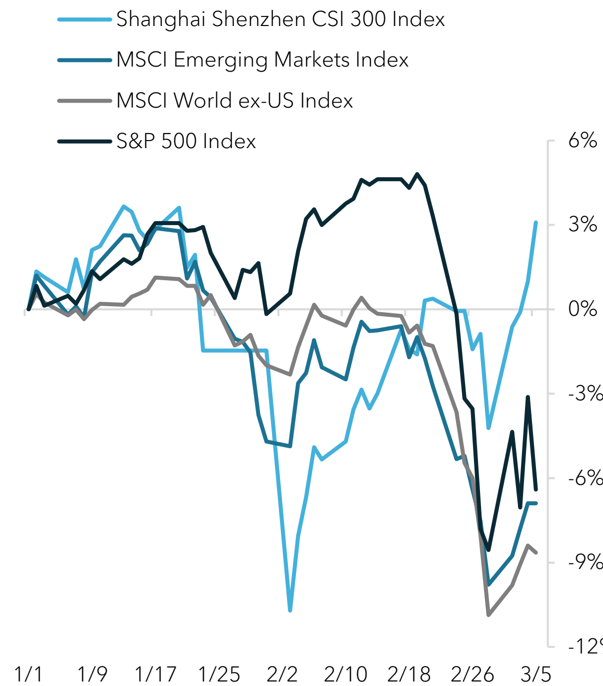
45 Rockefeller Plaza, Fifth Floor
New York, NY 10111

Muni Ratios %[8]

Cumulative Price Return YTD %[10]



Investors may find it ironic that Chinese stocks have been among the strongest performers in recent weeks. This is partly because the government has implemented strong fiscal stimulus, aimed more at neutralizing the effect of the global trade war than the coronavirus, but nonetheless well-timed for investors. It may be a good time to consider opportunities in emerging markets generally and China specifically. Expectations are low and Chinese industries are already starting to recover from the worst of the virus impact.[9] Further, the lower interest rates in the US are likely to keep a lid on the US dollar, which should help boost dollar-based returns of non-US assets.

Although we cannot quantify the full effect of the virus and we remain concerned about the impact on human life, we recognize that stock price adjustments offer opportunities for investors. We recommend that investors adopt a careful approach as they consider adding to equity exposure and we encourage regular portfolio rebalancing.

[8] Bloomberg; data as of 3/5/2020 close
[9] The News & Observer, 3/2/2020

[10] Bloomberg; data as of 3/5/2020 close

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