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# Hunker down

## The market is trying to find a bottom. Stay diversified. Focus on the long term.

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**Key takeaways**

**✔ Recent indiscriminate selling could be a sign that the correction is closer to the end than the beginning.**

**✔ When we hit bottom will depend on a variety of factors, including when the growth rate of the coronavirus peaks, the government response, and the impact on corporate earnings and employment.**

**✔ Assuming a 10%-20% earnings hit, the US stock market now looks roughly fairly valued, in my view.**

**✔ A recession is all but a given. The question is how quickly we will recover.**

**✔ Diversification works. Despite a swift 30% decline in the S&P 500, a hypothetical 60% stock/40% bond portfolio is still roughly flat, as of March 18, since the January 2018 valuation peak.***

The recent surreal market volatility, combined with an equally unsettling vibe out on the streets (and in the grocery store aisles), is certainly something that we will all remember and be talking about for a long time to come.

For a few days, bond yields lurched around dramatically as equities moved as much as 10% per day, and other perceived safe havens like gold and utilities fell more than the stock market. Safe haven one day, collateral the next.

We saw the same thing in 2008 when previously "immune" asset classes all succumbed to forced selling by highly leveraged investors (e.g., hedge funds). The good news is that this type of forced selling is more likely to happen toward the end of a correction than at the beginning.

As of the low on Wednesday, March 18, the S&P 500 had declined 32% from the highs—the fastest decline of this magnitude ever.

## Lurching yields

Meanwhile, credit spreads (the difference in yield between Treasurys and lower quality bonds) moved sharply higher on the heels of the news that the Saudis are now in a price war against Russia. This brought the price of crude oil down to around $23, which is below the level that allows some marginal oil producers in the US to make a profit. That created contagion in the high-yield credit market where the energy sector has a large weight (12% in the Barclays high-yield index vs. 3% in the S&P 500).

The yield on the 10-year Treasury briefly fell to 0.30% last week, a level that was unimaginable to most investors. The yield moved around violently all week, at first down and then up, so this tells me that the bond market got caught up in these problems as well. Today, Wednesday, March 18, the 10-year closed at 1.18%.

## More questions than answers

For now, we continue to look for answers to the following questions:

- When and at what level will the growth rate of COVID-19 peak in the US and around the world?
- How big will the earnings hit be? How long will it last? How swift (or slow) will the recovery be?
- What's the proper valuation for a market with this much uncertainty?
- What will be the full extent of the monetary and fiscal response?

Getting a handle on the parabolic growth rate in COVID-19 cases is essential to figuring out the depth and duration of the demand shock. Based on what I am reading, the US is still at least several weeks away in terms of a potential peak in the growth rate. Until we know when the virus peaks, we won't know how long and how severe the lockdown will be and what the economic implications are.

But lockdowns and social distancing are now happening at a large scale, which is good. My daughter is a nurse in the pediatric ICU at one of the big Boston hospitals. For her sake and our health care system, I hope that the current measures prove effective.

## A double policy bazooka?

As for the policy response, we do know at this point that the Fed is doing whatever it takes. Two weeks ago the Fed cut its benchmark fed funds rate by a half point and launched a $1.5 trillion liquidity program. On Sunday, it went even further, cutting rates another point and injecting another $700 billion into the financial system.

The fiscal response, as of Wednesday, March 18, is shaping up to be significant. The White House is seeking a relief effort that may cost more than $1.2 trillion and Congress is working to hammer out the details on several different bills. The US Treasury secretary, Steven Mnuchin, has openly advocated for sending checks directly to Americans. Hopefully, more concrete details will emerge soon.

## What shape will the recovery be—V, U, or L?

While the health dimension is, of course, the most crucial part, getting a handle on the economic dimension is also critical. While earnings estimates are getting revised downward, we won't really have a firm handle on the magnitude until first quarter earnings season, which is still 3 to 4 weeks away. For now, I am assuming a 10%-20% hit to earnings per share (EPS) for the S&P 500 over the next 2 quarters, followed by a rebound. But it's anybody's guess at this point.

The consensus estimate for the expected growth rate for 2020 EPS is currently 4.4%, down by half in just the past few weeks. If we use 1998 and 2015–2016 as a guide, the 2020 number will fall to at least zero and probably lower. My guess is that the recovery will be more in line with the growth trend in place prior to the COVID-19 shock. For earnings, that was about 8% per year. So my guess is we fall 10% over 2 quarters and then we could grow 8% per year off this lower base.

The good news is that the market has priced in a lot of bad news already, in my view. Using the rule of 20 (P/E = 20 - inflation), if we take a 17x P/E multiple and apply it to EPS of $145, I get an S&P 500 price of 2,466. At 18x it's 2,611. On Wednesday afternoon, we briefly dipped below 2,300. In other words, the market has priced in a lot of downside already. That tells me that unless earnings fall a lot more or stay down longer, the market is now clearing at roughly fair value.

## Is the bear market predicting recession?

Not all bear markets have recessions. When they do, the bear market typically starts 2 months before a recession begins and typically ends 4 months before the recession ends. That makes sense, given that the market is always trying to discount the future. Something to keep in mind as we will start reading more and more about a recession in the coming days.

It's important to remember that every recession is different, as this one will be, should it happen. And not every recession is a financial crisis. The global financial crisis in 2008 was a perfect storm with financial contagion spreading to all corners of the market. The current episode certainly has some of the contagion aspects now that an oil shock has been added to the mix, but the overall degree of leverage in the system seems far less today than 2008. Households are clean, the banks are clean, and most of the leverage in the corporate sector seems to be on the financial engineering side (for acquisitions and share repurchases) as opposed to old-fashioned capital expenditures.

Another important angle to consider when thinking about recessions is that the response function of the Fed and the trend in interest rates and inflation is also important. For example, the 1974 recession produced a 48% bear market in part because the Fed kept on raising rates throughout the entirety of that bear market. Only when it stopped in October 1974 was the market able to recover. It's a far cry from today's situation.

## The power of diversification

For most long-term investors who have a properly diversified portfolio, the market storm has been scary but manageable, at least so far. A 60/40 stock/bond portfolio since the valuation peak in January 2018 is flat, even though the drawdown in the S&P 500 from the February high is 32% as of the March 18 intraday low. This is why it's important to (a) have an all-weather portfolio that is appropriate for an investor's financial situation, risk tolerance, and liquidity horizon (i.e., when the investor needs to draw from it), and (b) sticking with that plan through thick and thin, and (c), rebalance from time to time. At some point, that last one should be the next step for many investors.

For now, as we wait for COVID-19 to peak, for earnings season to kick in, for the policy response to take shape, for the contagion across asset classes to abate, and for the margin calls to be fulfilled, I think it's safe to say that we will see plenty more volatility across all markets. But technically, the market is very oversold now, and hopefully, we reached levels last week from which we can start building a base.

Typically, the market will form a momentum low, followed by many weeks or even months of base building, followed by a retest of sorts, and then finally a new bull market. So, even if last week was the low (unknowable for now), it will take time for the market to regain its health.

So, in the days ahead, stay safe. If you have a plan that's right for you, stick with it. Selling now means locking in losses. If you don't have a plan or are wondering if yours is still right for you, talk to a financial professional. In life and finances, now is a good time to hunker down.

*Source: FMRCo. based on Bloomberg 60-40 stock-bond portfolio using S&P 500 Index and Barclays US Aggregate Bond Index.

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