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# A bottoming process begins: 10 themes to consider

*This was a week for the history books: The coronavirus, oil price collapse, liquidity pressures and rising quarantines, travel bans and business and school closures caused widespread panic, pushing stocks into a bear market. The S&P 500 fell 8.7% (including nearly a 10% gain on Friday), with other indexes down more.<sup>1</sup> Energy and the usually defensive utilities sector fared the worst.<sup>1</sup> In other markets, Treasury yields plunged to below 1% across the curve, the dollar rose 3%, gold fell 9% and oil was off 23%.<sup>1</sup>*

## HIGHLIGHTS

- **In our view, the fear and countermeasures surrounding COVID-19 are more serious economic issues than the virus itself. The reactions of governments and individuals are likely to push the world into a recession.**
- **We think stocks are bottoming, but that process will take some time. A decline in new cases, falling credit spreads, rising Treasury yields and oil prices and stable weekly jobless claims are potential signals of when the market might turn higher.**



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## 10 themes to consider

**1. The sharp drop in stock prices was unprecedented, and we think most of the panic stage is in the rearview mirror.** U.S. stock prices climbed 44% from December 2018 to February 2020.<sup>1</sup> Stocks then dropped more than 20% in just 16 trading days, marking the fastest bear market in history.<sup>1</sup> This will take some time, but we think the bulk of the panic selling has already occurred, setting the stage for relief rallies like what we saw on Friday as an extended bottoming process begins.

**2. A U.S. and global recession looks likely.** The world has never witnessed such widespread shutdowns and quarantines outside of wartime. As daily activity around the world is reduced, economic growth will slow to a crawl. We peg the odds of a recession at more than 50% as we see deflation, supply and demand shocks, rising unemployment and falling wage growth. We expect the economy will experience sharp, but hopefully short-lived slowdown.

**3. The plunge in oil prices is causing a credit crisis.** Oil prices fell close to 25% on Monday following price cuts from Saudi Arabia.<sup>1</sup> Falling oil prices caused a spike in credit spreads, particularly within the energy sector. We expect to see ratings agency downgrades, which could cause further liquidity issues. However, unlike during the financial crisis, banks are well capitalized, which should provide an economic buffer.

**4. Market liquidity is also under pressure.** The pandemic and oil carnage caused the worst week for corporate credit markets since the financial crisis, as spreads widened sharply. Bid/ask spreads in the Treasury market also widened, which is a classic sign of reduced liquidity. In our view, bond market liquidity would need to improve before we could call a bottom for equities and other risk assets.

**5. More fiscal and monetary stimulus is needed.** The proposed \$50 billion congressional package focuses on outlining public health responses and extending the safety net, but doesn't address the likely sharp economic demand shock. An impactful stimulus package would probably cost between \$300 and \$500 billion and would include a combination of tax rebates, payroll tax cuts, employee retention credits, small business loans and industry-specific relief for hard-hit sectors. For its part, the Fed has already cut rates to zero, injected massive liquidity into the markets and will be expanding and broadening its asset-purchase programs. The real economic stimulus is coming from financial markets, as global short rates have plummeted, the 10-year Treasury yield dropped over 2% in 15 months, refinancing activity increased and oil and gasoline prices declined sharply.<sup>1</sup>

**6. The strength of the banking sector is a positive for the U.S. economy.** Banking stocks have significantly lagged the broader market in the selloff, amid widespread worries over credit conditions that could cause defaults and loan losses, hurting the banking industry. The ultimate depth of the economic damage remains unknown, but bank stocks are already discounting a grim outcome. Banks remain well capitalized, however, maintaining their strongest balance sheets in several decades. The financial system is significantly more resilient than during the financial crisis a decade ago.

**7. The ongoing turmoil has hurt President Trump's reelection prospects.** According to the PredictIt predictions market, Donald Trump's reelection probability was 59% at the market peak, but has since fallen to 46%. Prior to the coronavirus, Republicans hoped to retake the House of Representatives. Now, Democrats are eyeing the possibility of taking both the White House and Senate.

**8. Market technicals suggest the start of a bottoming process.** Last Thursday, the New York Stock Exchange saw over 1,300 new 52-week lows, on par with some of the most significant market bottoms over the last 75 years.<sup>1</sup> Put/call ratios on Thursday were also historically low, a sign of peaking bearish sentiment. The sharp bounce on Friday is also part of a familiar multi-week pattern during which markets retest important lows. This happened during the market bottoms of 1987, 1998, 2008, 2011 and 2015.<sup>1</sup> While it is too early to tell, we think the bottoming process is starting. Market bottoms are a process, not an event. This will take some time.

**9. More volatility is likely, but stock prices could start to climb this year.** The S&P 500's low last week was 2,478, higher than the December 2018 low of 2,346.<sup>1</sup> We expect markets to retest last week's low, but unless corporate earnings expectations deteriorate more seriously, we think testing the 2018 low is less likely. While we think volatility will remain elevated, we expect markets to move more sideways with both selloffs and rally attempts. We think the S&P 500 could end the year around 2,950, or slightly lower at 2,750 if the economic and earnings damage is more severe than we expect (Friday's close was 2,711).<sup>1</sup>

**10. Now is not a time to abandon long-term investment plans.** For investors who had previously planned to buy or sell stocks, we suggest continuing to dollar-cost-average into and out of the market. Within the markets, some shifts in relative value that could affect buying decisions. The widespread price dispersion between sectors and individual stocks makes security selection critically important. In particular, we see significant price advantages in value styles, which could be poised to pop when markets eventually recover. Additionally, we suggest focusing on those companies with pricing power, the ability to put free cash flow to work and the potential to grow their dividends.

#### 2020 PERFORMANCE YEAR TO DATE

	Returns	
	Weekly	YTD
S&P 500	-8.7%	-15.7%
Dow Jones Industrial Avg	-10.2%	-18.3%
NASDAQ Composite	-8.1%	-12.0%
Russell 2000 Index	-16.4%	-27.3%
MSCI EAFE	-18.4%	-27.0%
MSCI EM	-11.9%	-19.3%
Bloomberg Barclays US Agg Bond Index	-3.2%	2.4%
BofA Merrill Lynch 3-mo T-bill	0.1%	0.5%

Source: Morningstar Direct, Bloomberg and FactSet as of 13 Mar 2020. All index returns are shown in U.S. dollars. Past performance is no guarantee of future results. Index performance is shown for illustrative purposes only. Index returns include reinvestment of income and do not reflect investment advisory and other fees that would reduce performance in an actual client account. All indexes are unmanaged and unavailable for direct investment.



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<sup>1</sup> Source: Bloomberg, Morningstar and FactSet

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the *Nasdaq*. The **Nasdaq Composite** is a stock market index of the common stocks and similar securities listed on the NASDAQ stock market. The **Russell 2000 Index** measures the performance approximately 2,000 small cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. **Euro Stoxx 50** is an index of 50 of the largest and most liquid stocks of companies in the eurozone. **FTSE 100 Index** is a capitalization-weighted index of the 100 most highly capitalized companies traded on the London Stock Exchange. **Deutsche Borse AG German Stock Index (DAX Index)** is a total return index of 30 selected German blue chip stocks traded on the Frankfurt Stock Exchange. **Nikkei 225 Index** is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. **Hong Kong Hang Seng Index** is a free-float capitalization-weighted index of selection of companies from the Stock Exchange of Hong Kong. **Shanghai Stock Exchange Composite** is a capitalization-weighted index that tracks the daily price performance of all A-shares and B-shares listed on the Shanghai Stock Exchange. **MSCI EAFE Index** is a free float-adjusted market capitalization weighted index designed to measure developed market equity performance, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. **Bloomberg Barclays U.S. Aggregate Bond Index** covers the U.S. investment grade fixed rate bond market. The **BofA Merrill Lynch 3-Month U.S. Treasury Bill Index** is an unmanaged market index of U.S. Treasury securities maturing in 90 days that assumes reinvestment of all income.

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