Inverness Counsel

1Q 2020 Commentary

Richard H. Chesterton, MBA, CFA

Chief Investment Officer

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During the quarter, the bull market that began in March 2009 abruptly came to an end.

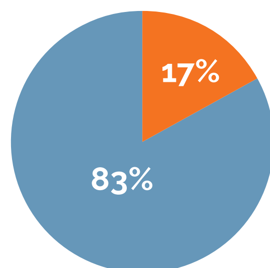
We are now in a bear market, which is typically defined as a decline in security prices of 20% or more and generally coincides with a recession (i.e. two or more consecutive quarters of economic contraction). As Coronavirus Disease 2019 (COVID-19) spread around the world, aggressive government quarantine measures were put in place, causing massive economic strain that will most likely lead to a global recession. The economies of Japan and many European countries were already weak, and a recessionary outcome seems inevitable for them. The U.S. had a fairly healthy economy after three rate cuts by the Federal Reserve in 2019, but now unemployment has skyrocketed, oil prices have crashed, and credit stresses and liquidity issues have started to appear. Current economic estimates call for a 15% contraction in the second quarter, which is twice the level of decline experienced in the fourth quarter of 2008 — the height of the Global Financial Crisis.

Employment

Consumer spending accounts for 70% of the U.S. economy. With full employment, rising home values, and higher wages, the U.S. consumer was feeling pretty confident prior to the pandemic. Then, the lights were literally turned off in large parts of the economy. Many small and medium-sized businesses, which represent the majority of employment in the U.S. (see Figure 1), were forced to close. Unemployment may climb above 30%, according to estimates by the Federal Reserve Bank of St. Louis. We have already seen 17 million people file for unemployment benefits in the past three weeks — the highest number ever (see Figure 2). During the Global Financial Crisis, unemployment reached 10%.

Figure 1

Small and Medium-sized Companies Play a Very Important Role in the U.S. Economy



■ Global employment in S&P 500 companies divided by total U.S. employment; 17%

■ Small and medium-sized businesses; 83%

Figure 2

U.S. Weekly Initial Unemployment Claims (scale in thousands)

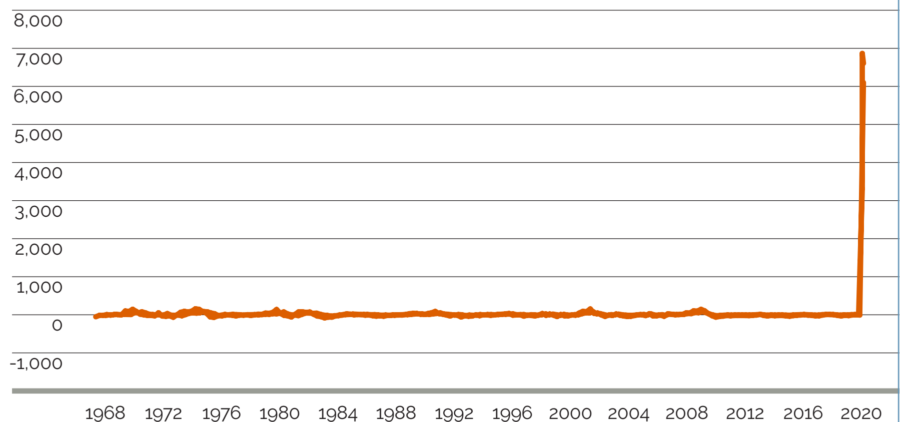


Figure 1 Source: Bloomberg Finance LP, BLS, Haver Analytics, DB Global Markets Research, Data as of February 2020.

Figure 2 Source: Bloomberg. Data as of 4/4/2020.

The Swift Government Response

From February 19 to March 23, the U.S. stock market saw the quickest meltdown in history, for a loss of 33.9% on the S&P 500. Lenders to fixed-income and equity investors moved to tighten standards, resulting in global margin calls and pricing disruptions in the fixed-income market. Levered investors were forced to sell anything they could, including gold and U.S. Treasuries. With 2008 as a guide, the Federal Reserve and Congress acted quickly with an enormous response. The Fed lowered interest rates to near zero in an emergency move and restarted quantitative easing programs (i.e. purchasing of government securities and mortgage-related bonds). Central banks around the world announced similar measures. In addition, Congress has already passed the $2 trillion CARES Act, which includes enhanced unemployment benefits and aid to many small and medium-sized businesses (see Figure 3). In addition, Congress is considering additional stimulus plans. These programs were larger than the ones that were enacted in 2008 and implemented in a much shorter time frame. In response, the market reacted with its best three-day stretch since the 1930s.

Figure 3

Details of the CARES Act

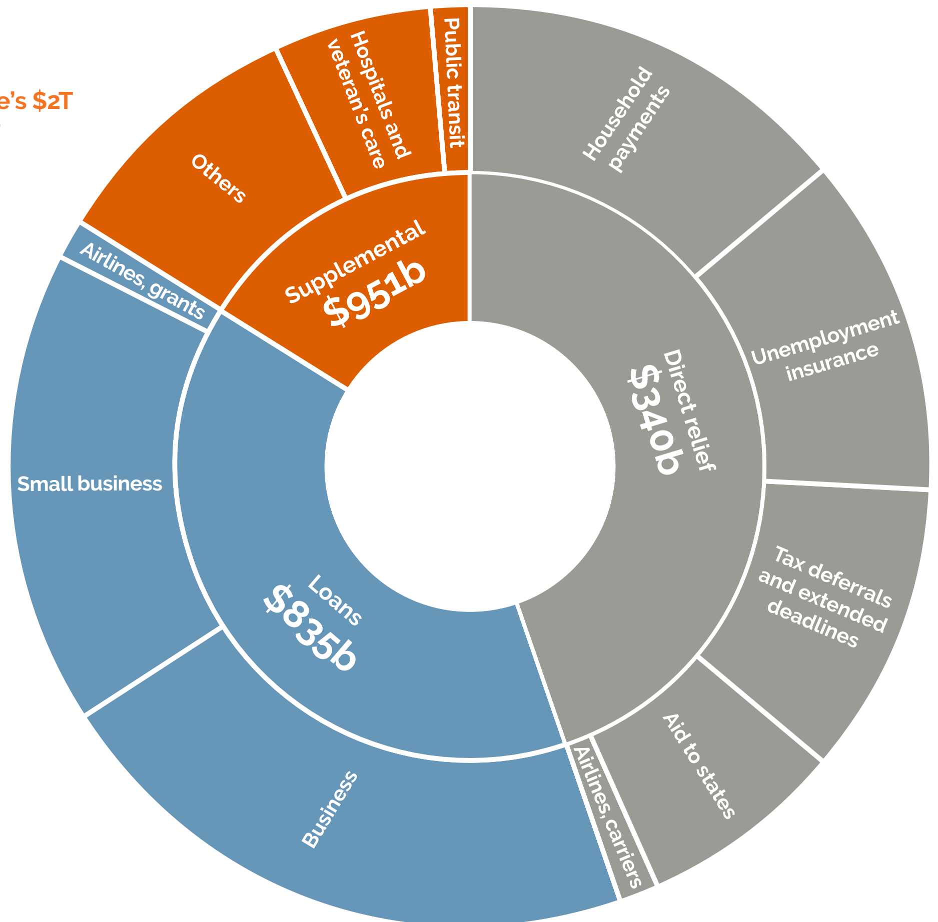


Figure 3 Source: *Wall Street Journal* Preliminary legislative text; estimates by aides, lawmakers and outside groups.

Several factors will be important in determining whether the consumer can return to pre-virus confidence levels quickly: the length of any quarantines, the timing and process for restarting the economy, and the level of impact from the CARES Act for people and businesses.

Some factors point to a strong and quick (i.e. V-shaped) recovery. Oil prices are down 50%, the largest U.S. banks are well capitalized, and corporate balance sheets were in pretty good shape prior to this downturn.

There are obstacles to a V-shaped recovery, though. First, we expect some lingering damage to the economy as a result of firms going bankrupt and the severing of employer–employee relationships. Key provisions of the CARES Act are designed to minimize this damage, but it remains unknown whether this effort will be sufficient to stem all the bleeding. Second, we expect the economy to be reopened gradually, and many businesses may find it difficult to realize profits at a reduced capacity and may not need the same level of employees.

The Road to Recovery

The average decline in the stock market during a recession is 40%, and bear markets tend to last about 24 months (see Figure 4).

Figure 4

Recession Period Characteristics

Market Description	Market Peak	Bear Return*	Duration (months)	Macroeconomic Environment		
				Commodity Spike	Aggressive Fed	Extreme Valuation
1. 1937 Fed Tightening – Premature policy move	Mar 1937	-60%	61		X	
2. Post WWII Crash – Demobilization, recession fears	May 1946	-30%	36			X
3. Eisenhower Recession – Worldwide economic downturn	Aug 1956	-22%	14		X	X
4. Tech Crash of 1970 – Economic overheating, civil unrest	Nov 1968	-36%	17	X	X	
5. Stagflation – OPEC oil embargo	Jan 1973	-48%	20	X		
6. Volcker Tightening – "Whip inflation now" (WIN)	Nov 1980	-27%	20	X	X	
7. Black Monday – High trade deficit, tax bills, NYSE shuts down	Oct 1987	-32%	2			X
8. Tech Bubble – Extreme valuations, .com boom/bust	Mar 2000	-49%	30			X
9. Global Financial Crisis – Leverage/housing, Lehman collapse	Oct 2007	-57%	17	X	X	
	Average	**-40%**	**24**			
10. Global Slowdown – COVID-19, oil price war	Feb 2020	-33%	1			

Figure 4 Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. All data as of 3/31/2020. *Bear returns are price returns

The markets experienced extreme volatility during the first quarter of 2020, with a total of 19 days seeing moves of 2% or more—both up and down—in the S&P 500. We started the year with most client portfolios fully invested, but as the virus spread, we moved quickly to protect portfolios. As our investment team positioned for a bear market, we reduced exposure to areas we found most vulnerable. With so many unknowns, we think the market is likely to remain volatile for a while. At its March low, the S&P 500 was near the average decline for a recession, and many stocks were pricing in a dramatic slowdown.

Course of Action

The S&P 500 just experienced one of the largest valuation multiple de-ratings in the last 30 years. Additionally, in a world of near-zero interest rates and low growth, U.S. equities are one of the few remaining higher-yielding assets, with a dividend yield of 2.3%. (The dividend yield is the amount of money a company pays shareholders over the course of a year divided by its current stock price.) Currently, a record 78% of S&P 500 stocks have a higher dividend yield than the U.S. 10-year Treasury bond (see Figure 5). Although earnings will be negatively affected by the virus, current valuations seem attractive compared to history, and record-low interest rates further increase the attractiveness of equity returns.

Figure 5

% of S&P 500 Stocks with Dividend Yields Greater than the 10-Year Treasury

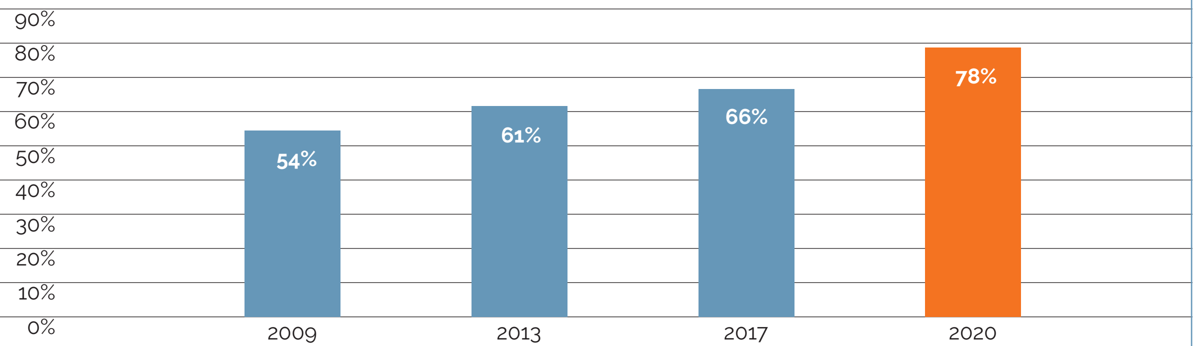


Figure 5 Source: Bloomberg. Data as of 3/31/20.

Figure 6 looks at the S&P 500 sector performance for the quarter. The blue line indicates each sector's percentage drop from the peak in February to the trough in March. The orange line indicates the total performance for the first quarter, which shows an improvement. Our meaningful exposure in the Communication Services and Technology sectors helped drive relative performance, along with our recently increased exposure in the Healthcare sector. For a long time, we have been very selective in the consumer-focused sectors, where disruption remains a pervasive theme. This caution and less exposure to the Energy sector were also positive factors. In general, equity exposure has been reduced in most portfolios, and we have the ability to add exposure as opportunities present themselves.

Figure 6

Sector Performance

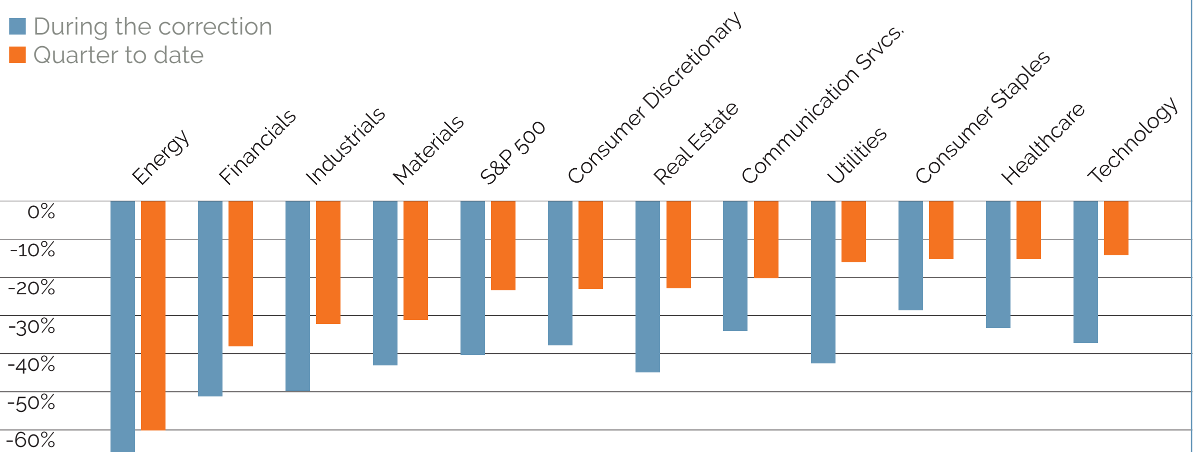


Figure 6 Source: Bloomberg. Data as of 3/31/2020.

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