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How can investors make decisions when so much is unknown?

Summary

1. **Investors are currently facing an unusual amount of uncertainty with more questions than answers about the novel coronavirus and its implications for the economy and markets**. While there are lots of conflicting theories about how the stock market, interest rates and the economy will playout over time, there is no consensus point of view. In addition, the unique catalyst of this recession may make historical comparisons of limited value.
2. **Despite the unknowns about the disease and the economy, a few things are known; in particular, that we are entering what appears to be a deep recession with unemployment rates not seen since the Great Depression**. Keeping those things we know in mind can inform investment decisions.
3. **Knowledge that we are entering a deep recession of unknown duration provides a road map, at least for short-term investment decision rules** e.g., tilt towards ”safer,” liquid assets such as domestic securities and large-cap stocks of companies with low debt levels and strong cash flow. And in fixed income, assume that interest rates will remain low for the foreseeable future based on Fed rate cuts and bond-buying programs.
4. **Investors may want to consider adding one or more tactical or diversifying equity strategies to a well-diversified equity core to automatically adjust their portfolios based on prevailing market dynamics**. This can make sense because it becomes much more challenging to forecast which market themes and strategies will be leaders vs. laggards over the intermediate-term
5. **Trying to time market entry points is not a useful endeavor. More important is that investors and their advisors believe that, over the long term, current equity market valuations allow for investors to earn returns consistent with those assumed in their financial plans**. Broad market equity investing remains a long-term exercise and makes sense, regardless of the market’s current uncertainty, and rebound in value even in the face of worsening economic news.

Background

Investors today are scared and looking for reassurance, but wherever they turn they are reminded that no one has the answers. The news, in particular, tends to highlight all the unknowns around the virus, how we are managing it and its likely impact on the economy. There are lots of theories, but no definitive research or studies. To be clear, the issue is not that there is a shortage of well-supported opinions and theories. The issue is that these theories are all grounded on assumptions that may, or may not, turn out to be true. Consequently, investors are only left with questions. The number of questions remaining unanswered is long but to list just a few: How long before a vaccine can be broadly distributed and available? As we relax current policies on social distancing, should we expect a second wave of infections and deaths worse than today’s? How much of this year’s expected economic downturn has already been factored into the markets’ pricing? Will retail consumers ever return to their “old normal” behaviors and if not, how will the “new normal” be different? Will the recovery be steep like a V, or extended over time like a U, or saw-toothed with a series of starts and setbacks? Is the stock market going to re-test its low point from earlier this year?

Again, there is no shortage of commentators and analysts with points of view, but all of them would acknowledge that their points of view are based on a set of assumptions, the accuracy of which is currently unknown. Some level of risk is just part of investing, but the current environment has more unknowns than usual and we lack historical precedent. Maybe the most relevant precedent we have is the Spanish Flu global pandemic but even that has important differences from today, given advances in science and medicine over the past 100 years and the recent government-mandated business closures.

Things that are Known

Given the many things we don’t know, we should use those few things we do know to guide our investment decisions. We know the virus is unusually contagious and that while social distancing has slowed the spread of the virus and prevented it from overwhelming hospitals, the virus is still with us and may accelerate again. We know that yields on Treasury obligations (depending on the term) are between 0.09% on a 3-month bill and 0.64% on a 10- year bond, as of April 30, 2020[[1]](#endnote-1). We know that the dividend yield on US stocks is roughly the same as the yield on investment-grade corporate bonds but with upside potential for price appreciation. We know that despite the partisan divide in US politics, Congress has demonstrated a bipartisan willingness to finance multi-trillion dollar relief/stimulus programs above and beyond the trillions of dollars in loans/bond purchases approved by the Federal Reserve to shore up markets. We know that even the most optimistic studies do not suggest the United States is even close to having the 60-70% level of population immunity required in order to slow the spread of the virus. Finally, we know that the time required to manufacture and distribute sufficient doses of a vaccine should not be underestimated and any potential for a return to the “old normal’’ will be no earlier than 2021. Perhaps most importantly for investment purposes, we know we are entering a severe recession. The Conference Board’s Index Of Leading Economic indicators dropped 6.7% in March (compare this to the 3.4% drop in October 2008). The US unemployment rate is already expected to rival that of the Great Depression. Beyond the impact of job losses on consumer spending, we know the financial impact of people staying at home and practicing social distancing varies dramatically across industries and sectors.

What we know can give us some rules of thumb for short-term investment decisions such as:

1. Interest rates close to zero favor stocks over bonds The Fed has cut overnight rates and announced bond purchases to lower rates and flatten the yield curve.
2. The Fed’s purchases of shares in investment-grade (IG) bond ETFs argue for IG bonds over high-yield or emerging market debt
3. The recession will depress the revenues and earnings of businesses. Large companies and companies/industries/sectors with low debt levels and strong cash flow are best positioned to endure the next 12-18 months and to successfully come out the other side of this recession.

One motivation for the Fed to cut rates and to buy bonds was to prevent markets from seizing and to ensure the availability of credit to businesses and make it easier for them to rollover their debt without increasing their interest expense and reducing their profits. Another motivation may have been to ensure that the massive deficit spending associated with the coronavirus relief bills passed by Congress could be financed at extremely low interest rates, close to zero. We think interest rates will remain low for at least a few years given the last time interest rates were close to zero was in 2008, and the Fed waited seven years to begin raising rates. When raising rates coming out of a recession, the Fed generally needs to move slowly and gradually in order to calm market worries that it will raise rates too quickly and short-circuit a nascent recovery. Whatever motivates the Fed, a good rule of thumb when central banks are intervening in markets is ”Don’t fight the Fed.”

Year-to-date, the best performing sectors of the S&P 500—both prior to the market’s peak on February 19th and subsequent to its low point on March 23rd— have been high-beta, large-cap growth companies. The worst performers have been small-cap, low-beta value stocks.



Source: S&P Dow Jones Indices

However, I think a framework of risk factors and investment styles may obscure the real story of what’s happening in the market, which can be more easily explained to the lay investor in terms of the impact of recent events on specific industries and sectors. For example, as people stopped travelling for work and recreation, demand for oil cratered at the same time the supply of oil was relatively high, with little-to-no remaining storage capacity. While this remarkably led spot oil prices to effectively go to zero for a day, it also caused energy companies, which typically carry high levels of debt, to see earnings plummet. Similarly, industrial companies, especially airplane manufacturers, suffered because people were staying home and not travelling. Financial services companies, in particular banks, were hurt by a likely increase of loan defaults and also the Fed’s rate cuts and flattening of the yield curve. While clearly welcome by corporate borrowers, the Fed flattening of the yield curve reduces the spread income earned by banks borrowing at the short end of the yield curve and lending money at the higher yields associated with the intermediate-to-longer maturity portion of the yield curve. For this reason, the worst-performing sectors of the S&P 500 year-to-date were energy, financial services and industrials returning -35.70%, -25.40%, and -20.68%[[2]](#endnote-2), respectively. The best-performing sectors year to-date have been those that enable us to socialize and work from our homes and help us to manage through this pandemic, namely: technology, communication services, and healthcare. While these themes have been rewarded year-to-date and are likely to continue to be rewarded at least in the near term, historically the end of bear markets have been led by gains in high-beta, small-cap, value stocks which have been out of favor for more than a decade now.



Source: S&P Dow Jones Indices

No one knows for sure what will be the best performing sectors, industries or stock selection styles in the future. Since, over the long term, every risk factor and equity investment style that has an academically supported risk premium will have its “turn in the sun” as well as its “turn in the barrel,” we recommend investors use a broadly diversified core equity strategy plus a smaller allocation to tilt the portfolio at any given moment in time to prevailing trends. We recommend diversifying equity risk with trend-following strategies like managed futures, which have returned approximately +3.69% year-to date[[3]](#endnote-3) in contrast to the -12.78% return for global stocks[[4]](#endnote-4) and the +1.18% return for global bonds[[5]](#endnote-5). Investors don’t need to chart out in advance every twist and turn for the full journey toward their financial goals.



Sources: Société Générale, MSCI, Bloomberg

They can also rely, at least in part, on road signs that appear along the way. By allocating some portion of their portfolio to tactical strategies such as those that automatically de-risk and re-risk adapting to the prevailing market environment or that use trend-based strategies to rotate stock holdings among countries or industries based on recent performance. It is rare for tactical trading signals to work in every environment so investors should consider diversifying among tactical trading strategies as well as across asset classes and strategic categories.

What’s next for the Stock Market?

Unfortunately, the question most frequently asked by investors is not *where* to invest but rather *when* to invest. They want to know whether the market has already hit its low or whether it will retest its March 23rd low. While this may be an important question if an investor’s primary objective is bragging rights to having bought at the market low or avoiding the feelings of embarrassment of waiting too long and buying in at the market high point, this is the wrong question for the typical investor whose realistic goal should be to earn returns roughly consistent with the capital market estimates used in formulating their financial plan (recently in the 6% to 8% range). Regardless of whether it is fear or greed keeping an investor on the sidelines, the individual investor rarely has the tools to successfully invest in the stock market, and often suffers badly in the attempt.

There have been over one million confirmed cases of COVID-19 in the U.S. alone and more than 60,000 deaths, so far. Together, with record levels of unemployment and small business failures, this creates a backdrop that can bias investors to negatively assess the likelihood of the stock market continuing to rise. This view may turn out to be correct, but there is also a case to be made that the stock market’s resilience in the face of worsening economic news does not necessarily mean it is overvalued. Reasons for this include: 1) in what might sound like a piece of circular logic the US stock market has been an important leading indicator of the economy and the fact that it has been rising may suggest that the market is looking through the anomalistic earnings of 2020 to the prospects for American companies in 2021; 2) in a year when some stocks may have zero or even negative earnings, P/E multiples may not be the best approach to stock market valuation. Another approach is to compare the relationship of the dividend yield on stocks to the yield of the 10-year Treasury bond over time. As of the end of the first quarter of 2020, this equity risk premium was almost one standard deviation above its 25-year historical average, suggesting the stock market by this measure was not overpriced; 3) it is important for investors to remember that publicly held companies with access to capital and strong margins and cash flow are very different from the “mom and pop”-owned local small businesses that are likely to fold over the next 6-12 months. Even small-cap public companies have valuations that are at least $300 million up and may be as high as $2 billion; 4) the Fed’s lowering of interest rates and flattening of the yield curve keeps interest rates low and allows corporations that have taken on record levels of debt to continue to rollover that debt or to at least continue to service it without reducing earnings; and 5) although the anatomy of a bear market typically includes a steep sell-off at the tail-end of the bottoming process, a notable exception to this “rule” is the Spanish Flu of 1918/1919 when the market dropped 32% from its peak and then began to climb back without retesting its low-point.

Diversification Remains the Best Strategy for Navigating Uncertainty

When market prices are volatile and there is a wide divergence of returns across stock sectors and styles, it is human nature to want to be able to perfectly anticipate the market’s highs and lows, and the leaders and laggards among sectors and styles. Given that no one has a crystal ball to make this possible, we would, in more usual times, look to past recessions and recoveries to forecast the current economy but there are limits to such comparisons which can be informative but not predictive. The larger lesson of the history of investing is to be prepared for the unexpected which leads us to building portfolios diversified across assets and strategies because, ultimately, each recession and recovery is different. We must be humble enough to recognize that the catalyst for this recession is different from anything in the past, and the pattern of this recession and the subsequent recovery may turn out to be as novel as the coronavirus that set it in motion.

**IMPORTANT INFORMATION**

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1. U.S. Dept. of the Treasury [↑](#endnote-ref-1)
2. S&P Dow Jones Indices [↑](#endnote-ref-2)
3. Societe Generale [↑](#endnote-ref-3)
4. MSCI [↑](#endnote-ref-4)
5. Bloomberg [↑](#endnote-ref-5)