MODEL CAPITAL MANAGEMENT LLC

Uncharted Territory

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Focus: U.S. Tactical Limit-Loss
Strategies: Tactical Growth, Tactical 2xGrowth, Tactical Income

Uncharted Territory

Our equity model continues with a defensive position

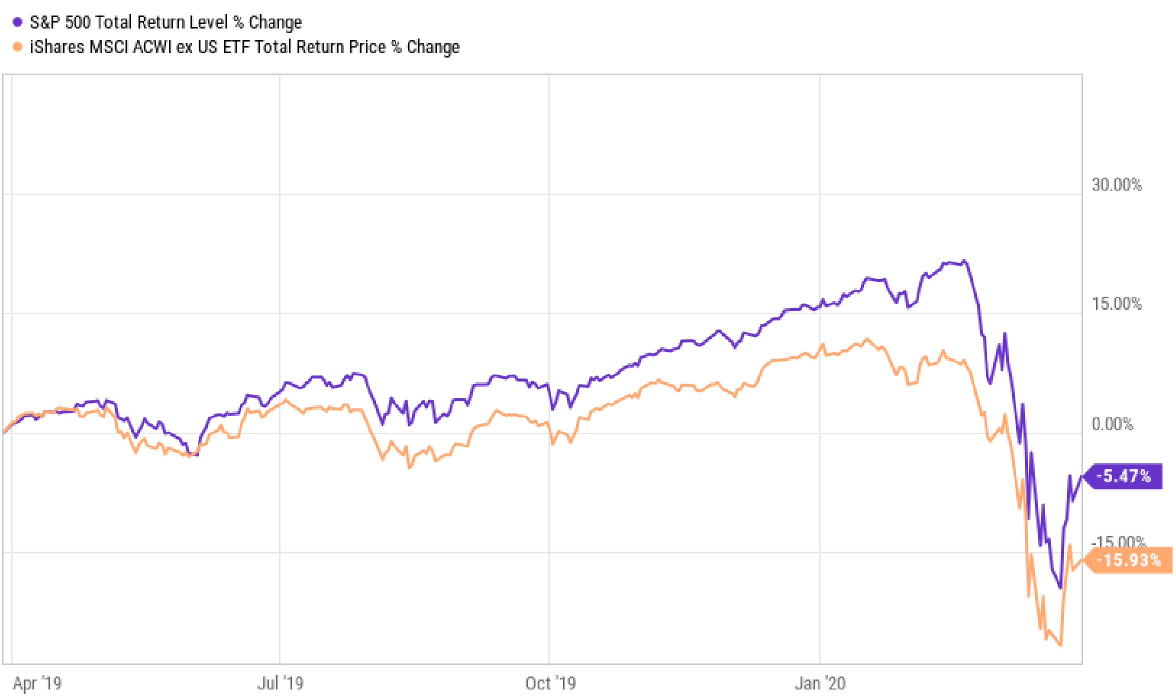
Roman Chuyan, CFA

March 31, 2020

- **Our fundamentals-based equity model continues with its negative outlook for the S&P 500.**
- **Economic factors remain negative, and market rebound has moved index valuation close to neutral.**
- **Economists are competing for the gloomiest projection, with some expecting a -25% GDP in Q2.**
- **Our Credit model gave a Buy signal, and we invested in corporate bonds.**
- **I give a possible scenario of when we might get back into the stock market.**

Financial markets continue to march to the drumbeat of news about the coronavirus pandemic. As the spread of the infection triggered harsh containment measures, expectations of an economic disaster roiled both stock and bond markets. At its low point on March 23, the S&P 500 closed 34% below its recent peak and -30.4% year-to-date, at a level last seen in 2017. However, the Fed stepping in to buy corporate bonds and Congress passing a $2.2-trillion stimulus package last week triggered a 17% market rebound from the lows. The S&P 500 index now stands at -23.8% year-to-date and -5.5% in 12 months, while non-US equities continue to underperform.

US And Global Stocks, 1 Year



Source: Ycharts, as of 3/30/20. It is not possible for an individual to invest directly in the S&P 500 index. Fund performance is shown for illustration only. Model Capital does not currently hold any of these funds, but positions may change at any time without notice.

The exponential spread of the coronavirus has taken a heavy toll in both human life and economic activity. As testing becomes more available, known infections have risen sharply and the US jumped to first place globally in total infections. New York City emerged as the new epicenter of the disease, and multiple states have closed non-essential businesses. In addition to the halt in all travel, entertainment, and public events, the entire manufacturing and retail industries were shuttered in several states, forcing employers to furlough millions of employees.

After protecting our clients against this downturn, **we continue to be defensive in our tactical strategies.** The stock rebounded from their lows increased their valuation. Combined with negative economic factors, this keeps our equity model negative (see Equity Return Forecast). Our Credit model turned positive after bond prices fell in March (see Fixed Income section), and we bought investment-grade bonds and loans.

Market Trends

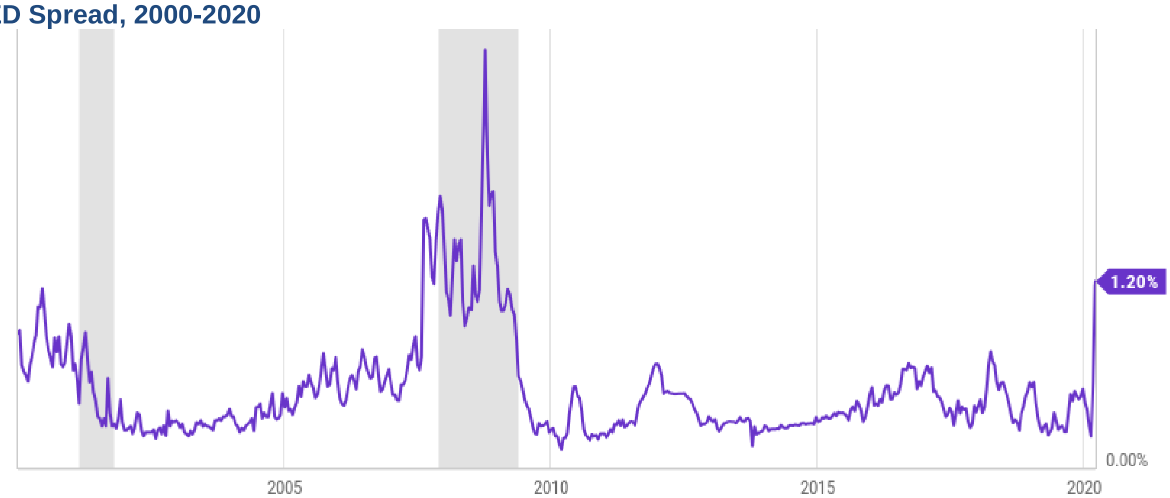
Years of over-investment in risk assets – stocks, bonds, asset-backed, high-yield – had to be unwound as the downturn began. Many investors trying to sell at the same time made the selloff especially steep earlier this month, resembling closely the steep selloff in October of 2008. The 2008 episode wasn't the end of that bear market, and this might not be the end of current one. Bear markets are characterized by:

- They coincide with economic recessions, and the two reinforce each other. A severe recession is underway this year (see Economic Focus).
- Bear markets last for awhile. The 2007-09 bear market persisted for 18 months, and the 2001-02 bear market lasted for about two years.
- The stock market tends to decline significantly. The S&P 500 dropped by at least 47% from its peak in the past two bear markets.

Don't get me wrong – I'm not saying that we will continue to be defensive for 18 months. During bear markets, stocks can overshoot on the downside and become very cheap, which creates an opportunity for upside. However, they aren't cheap yet. We will continue to rely on our fundamentals-based equity model to tell us when valuation and economic factors make an attractive combination.

The Fed has implemented several stimulus measures, including dropping its rate to zero and initiating a new round of quantitative easing. The latest announcement of unlimited buying of corporate bonds and bond ETFs calmed markets last week, but liquidity remains tight. One indicator, the spread between 3-month LIBOR and T-bill rates known as the "TED spread," shot up to 1.4% – a level last seen in 2008:

TED Spread, 2000-2020

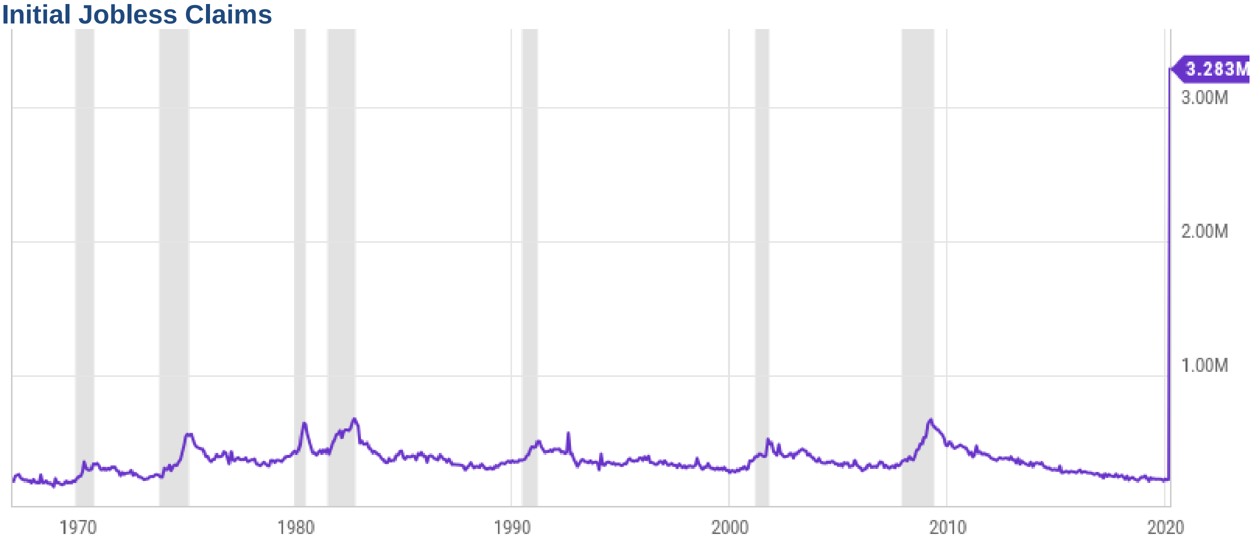


Economic Focus

Just two weeks ago, I think most of us expected a mild-to-moderate economic downturn because of virus-containment measures. In my previous report, I wrote that major banks would project a recession. It turned out to be a contest for the gloomiest projection. Many economists now expect around a 10% annualized contraction in Q1 and 25% in Q2. Goldman Sachs is winning the contest, announcing today that it expects the US economy to shrink by an annualized 34% in Q2 and unemployment to soar to 15%. If anything close to that occurs, it would be the largest economic downturn since 1946 when GDP fell by 11.6% as the manufacturing of war materiel ended. The deepest recent quarterly downturns occurred in 2008 (-8.4% annualized), and before that in 1958 (-10%).

Economic numbers for March are only beginning to come in, with initial jobless claims soaring to 3.3 million last week – by far the largest weekly job loss on record. We're in uncharted territory.

Initial Jobless Claims



Source: Ycharts

Some media reports are beginning to point to "warning signs" that appeared before the pandemic began of a fragile economy, high stock valuation, and excessive borrowing. Of course, these signs were obvious to anyone who cared to look. We wrote about them for most of last year and were defensive based on our models, which protected our clients against this downturn. But the economists at major banks and securities firms were too busy cheerleading the rising market. There should be no surprise, however – economists follow markets.

Fundamental Themes

To inform our investment thesis and add color to our model's negative forecast (see Equity Return Forecast), we continue to think about upcoming themes:

Economic projections: Economists are now competing for the gloomiest projection, with many expecting around a 10% annualized GDP contraction in Q1 and 25% in Q2. The March data has only begun to come in. While consumer confidence measures dropped only moderately, the timing of these surveys covered only part of the period of quarantines and layoffs. The 3.3 million jobless claims number was astounding and is expected to continue at a similar level in the coming weeks.

Earnings: Public companies will begin reporting their Q1 earnings in about two weeks – and the results will likely be terrible across many sectors. This might initiate another wave of market selling.

Institutions: While hedge funds employ all sorts of strategies, they tend to be long stocks during a bull market. Liquidating leveraged long positions likely accelerated the market plunge in mid-March. The subsequent market rebound gave funds and their banks an opportunity to complete liquidations in an orderly manner, but left them averse to risk-taking for a while. The next wave of selling is likely to come from pensions and retail investors.

Coronavirus: The epidemic continues to drive market moves. While China has been reporting few new cases, there's doubt about its numbers. Infections and deaths continue to grow exponentially outside of China and South Korea. The president's task force extended the social distancing guidelines to April 30th from early April – an unwelcome delay to investors who were hoping for a quick economic re-opening. An eventual "flattening" of the infections curve will be perceived as positive by investors. At least two potential cures are in clinical trials – an approval would be a positive as well.

Some clients asked us: **when will you get back into the market?** Aside from the fact that we always follow our fundamentals-based process, let me give a possible scenario. Another leg down in stock prices, perhaps 20% or more, would make them very cheap. At the same time, a flattening in the infections curve and/or FDA approval of a cure would allow the government to plan for reopening the economy. If economic factors, such as consumer confidence, don't deteriorate much further, along with very cheap valuation, this might turn our equity model's forecast positive.

Equity Return Forecast

The 6-month return forecast for the S&P 500 by our fundamentals-based statistical model **remains negative at -1.3%, which dictates continued defensive allocation**. Valuation measures are lower after the market plunge, and the model's valuation category turned positive. However, this was mostly offset by the decline in the economic category, which is now negative.

Overall 6-Month Forecast

-1.3% =
3.3% -6.6% +2.0%

Valuation (2 factors)

3.3%

Valuation improved after the market plunge, and the Price-to-Book Ratio dropped to 2.91 from 3.3 last month. The effect of this factor is now 5.3% – the most positive factor in the model. The model switched on the P/E Ratio in mid-March, and its effect is now -2.0% due to weak earnings growth in recent years. While the market is now undervalued, for the first time since 2012, it's not very cheap.

Economic (5 factors)

-6.6%

As part of its regular factor rebalancing, in the mid-March run, the model replaced New Home Sales with Homes for Sale and Consumer Confidence. The effect of Homes for Sale now stands at -9.5% – the model detects weakness in the data similar to what preceded previous stock market drops.

Market (4 factors)

2.0%

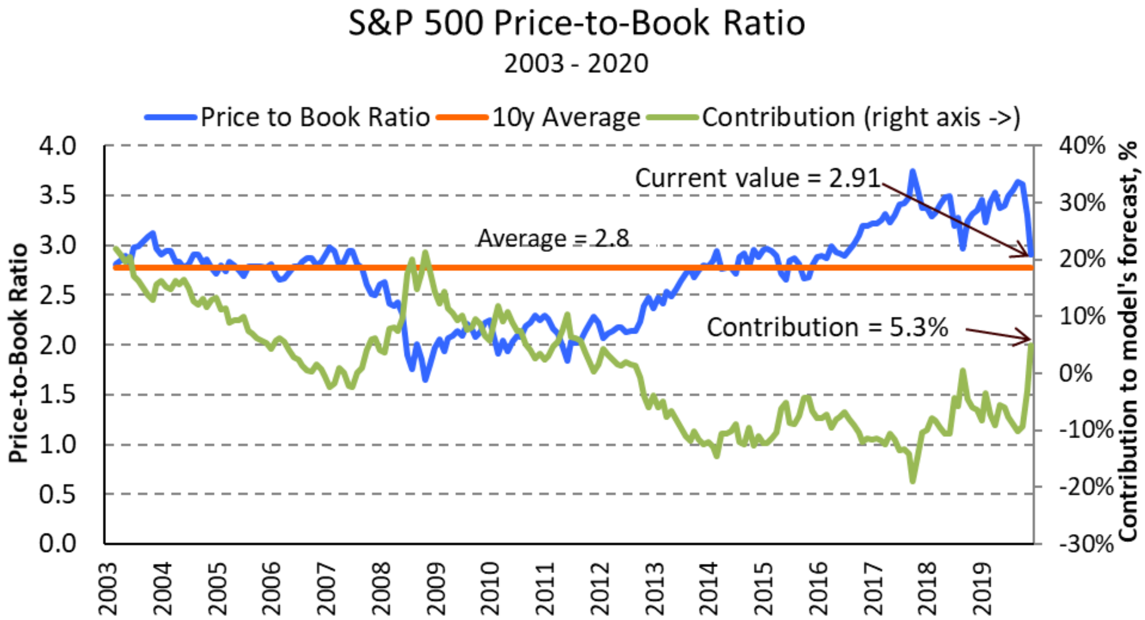
The effects of market factors improved this month, especially Fund Cash Allocations which improved by 1.7%. This moved the combined effect of market factors from negative last month to a positive, 2.0%.

Short-Term Risk

Model Component	Signal
Momentum	Neutral
Relative Strength (RSI)	Neutral
Volatility & RSI	Neutral
Investor Sentiment	Neutral

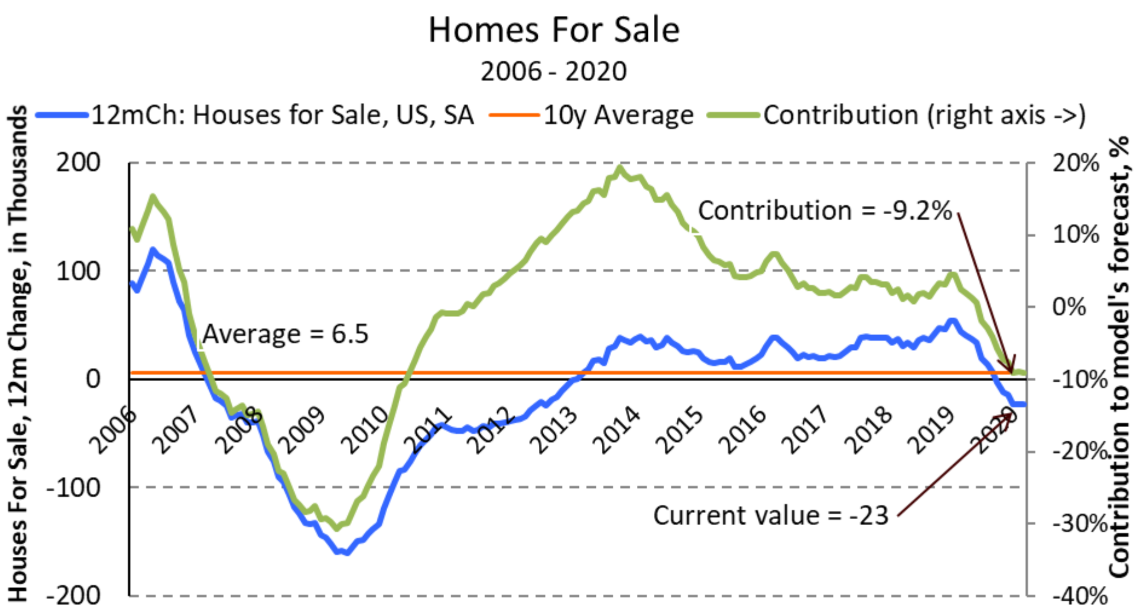
Our short-term risk model looks for technical patterns that preceded previous sharp market declines. Most recently, the Investor Sentiment component of the model gave a Sell signal on Dec 23 due to extreme investor bullishness (a contrary indicator). The model now shifted back to a neutral-risk "green" position. The round-trip performance of this latest model's signal was a remarkable 18% (the S&P 500 dropped by 18%).

The equity model's most negative and positive factors are shown below in historical context (assuming their current weights). The Price-to-Book Ratio dropped to 2.75 amid the market plunge in mid-March from 3.3 last month, but now partially rebounded to 2.91. The effect of this factor in the model increased to 5.3%, and this factor switched from the most negative to the most *positive* in the model:



Sources: Standard & Poor's, Model Capital Management LLC

Homes for Sale began to decline in recent months on a year-over-year basis. Our model finds this factor to be negative for expected stock returns – a pattern similar to that in 2007. The model calculates the effect of this factor at -9.5%, and this is now the most negative factor in our model.

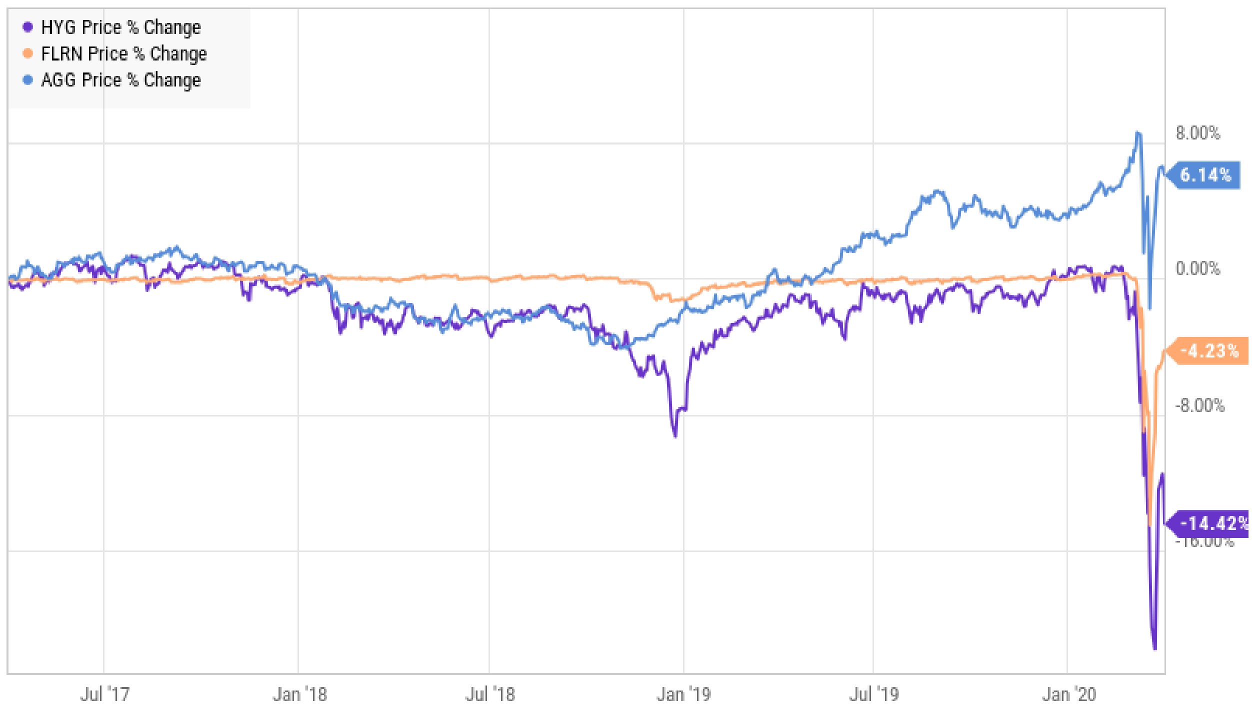


Sources: U.S. Census Bureau, Model Capital Management LLC

Fixed Income

We have just experienced a bear-market adjustment in bonds. Corporate and high-yield bond prices began to fall sharply in mid-March along with other risk assets, as years of overinvestment started to be corrected. Credit spreads widened: the investment-grade to 400 basis points (from 100 bps previously) and high-yield to 10.9% (from 3.5%), their widest since 2009. Around the same time, the Fed launched massive stimulus efforts, including zero rates and quantitative easing. In response, longer-term Treasuries - such as the 7-10 year Treasury ETF (IEF) - rallied, but not corporate or high-yield bonds as risk-aversion persisted.

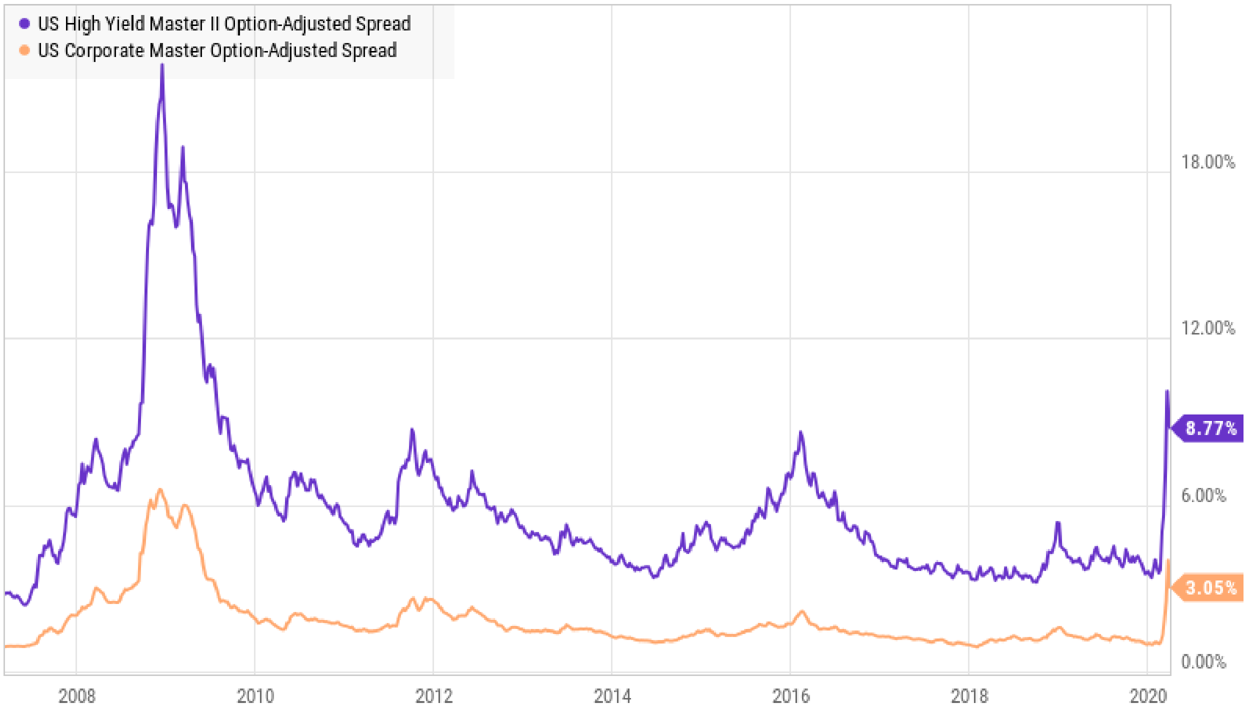
Credit ETF Prices, 3 Years



Source: Ycharts

The Fed then launched on March 23rd an unprecedented program of buying, through the US Treasury, bonds and bond ETFs. The Fed has never done this before, although the Bank of Japan has been buying bonds (and equities) since 2008. This program eased liquidity concerns and spreads began to tighten: corporate to 300 bps and high-yield to 8.8% (see chart below). Although volatility might resume in the short term, given the Fed/Treasury unlimited buying power, this virtually insures against further significant declines in bond prices/rise in their spreads.

Credit Spreads, 2007-2020



Source: Ycharts

We rely on our fixed-income models for bond allocations. Our Duration and TIPS models continue to be negative due to extremely low Treasury/TIPS yields (see chart). However, our Credit model now gives a Buy signal as corporate spread jumped above 300 bps:

Duration (Treasury) Model

Indicator	Value	Signal
2-10y YC Slope, %	0.47	Neutral
10y T-note Yield, %	0.70	Sell
3m Change	-1.22	Sell
12m Change	-1.71	Sell

TIPS Model

Indicator	Value	Signal
10y Real Yield, %	0.07	Sell
3m Change	-0.09	Neutral
6m Change	-0.08	Neutral
12m Change	-0.51	Sell

Corporate Model

Indicator	Value	Signal
Corp Master OAS, bps	305	Buy
3m Change	204	Buy
12m Change	178	Neutral

Source: Model Capital Management LLC

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