February 2020

Perspectives
The Pandemic of Fear

REQUISITE
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February 27, 2020

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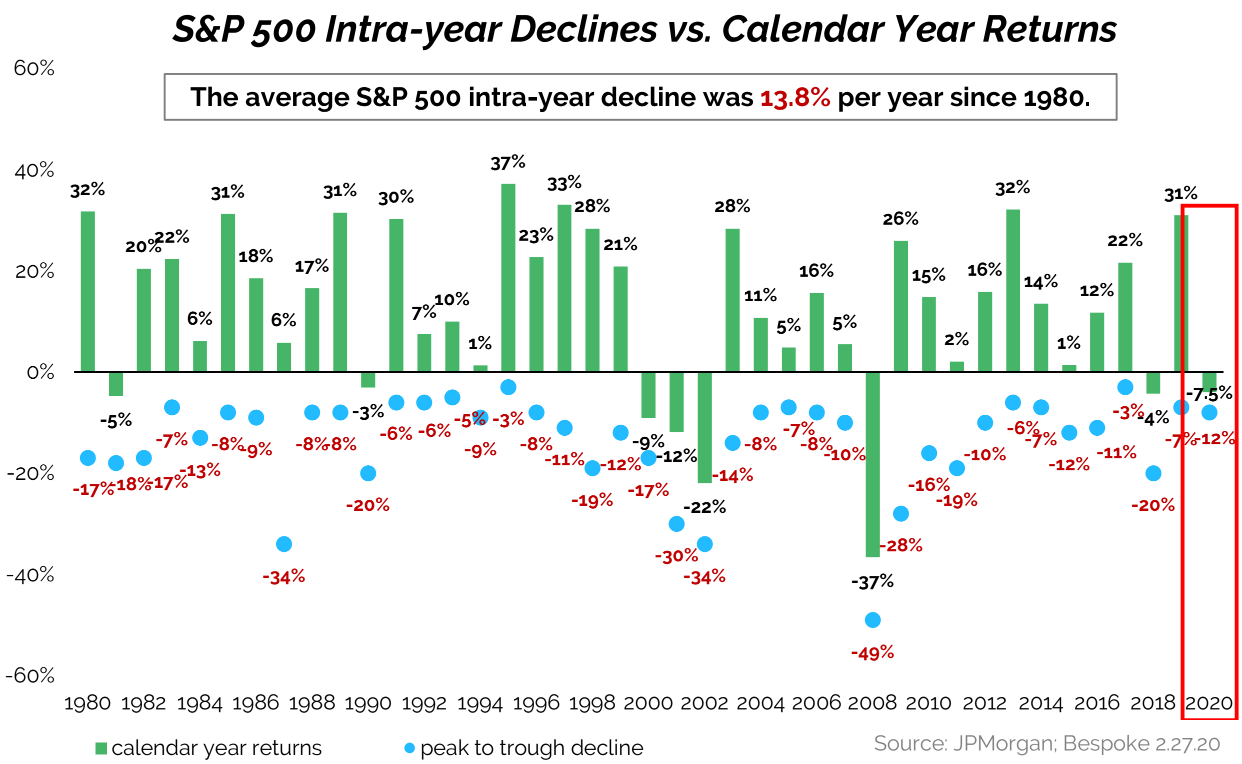
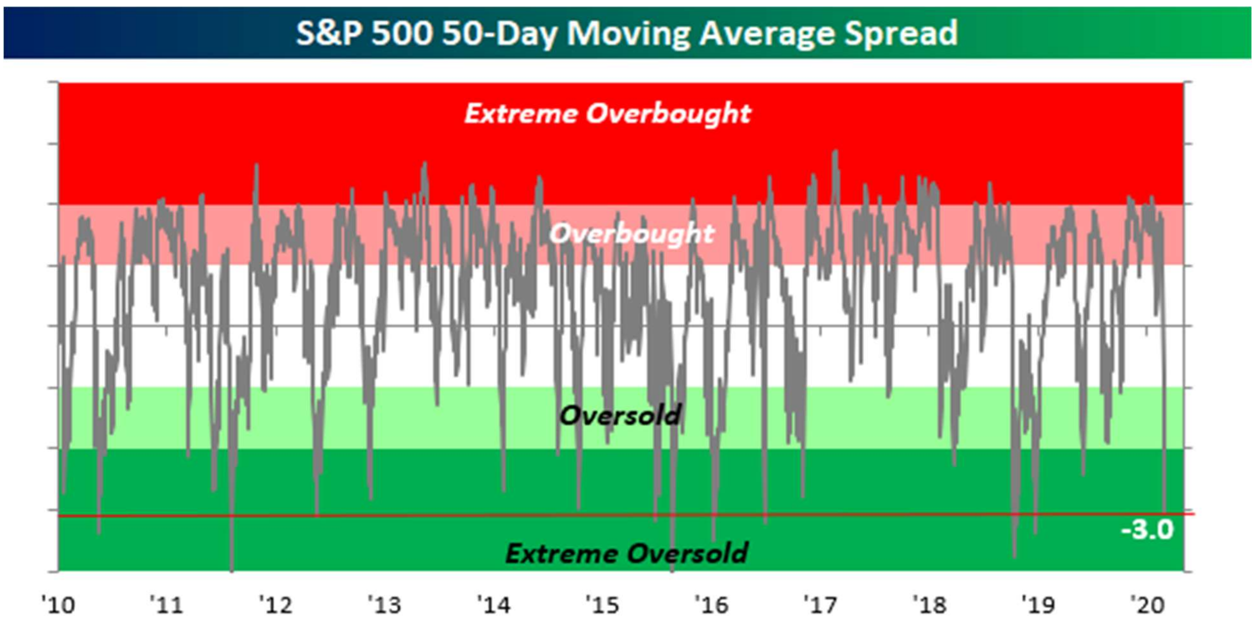


The S&P 500 hit an all-time high of 3393 on February 19th. As the COVID-19 coronavirus continues to spread globally, in six unsettling days of trading, the S&P 500 now stands down ~12% from its all-time high as of today's close. The fear of the virus is spreading far faster than the virus itself. In addition, Bernie Sanders' continued position as the Democratic front runner is weighing on the market. As we wrote at the end of 2019, markets were entering 2020, with a tremendous amount of optimism. We noted that over 80% of companies in the S&P 500 were over their 200-day moving average and that markets were susceptible to a pause. How quickly things can change. When exogenous events occur, like the coronavirus, stock market fundamentals take a backseat to fear of the unknown. That fear has manifested itself into the largest weekly sell-off since the Financial Crisis. Looking back 10 years, markets have experienced eight, 10% + intra-year declines. The declines are driven by their own unique circumstances, but the feeling during those times is always the same. It never feels good when stock markets decline. Another important dynamic for investors to understand is the amount of algorithmic, or machine, trading that occurs daily. It is estimated that ~80%[i] of the daily moves in the U.S. stock market are machine driven vs ~15% in the early 2000's. This type of trading will undoubtedly cause more volatility and will magnify moves on both the upside and downside. We bring this up, because, although the machines can cause 1000-point declines in one day, those same machines can pivot on a tweet and go in the other direction. Over time, earnings, not algorithms, drive returns. Understanding this dynamic can help ensure that investors don't turn temporary declines into permanent losses.

T0 illustrate how quickly this sell-off occurred and what it means from a short-term technical reading, our friends at Bespoke put together two graphics of the 50-day moving average ("DMA") and what happened after these extreme periods of selling. The 50-DMA provides technical insights into whether the market is oversold or overbought on a shorter-term basis. The 50-DMA of the S&P 500 went from overbought to extremely oversold (3 standard deviations) in a matter of six days.



Extreme Overbought (Oversold) = 2+ Standard Deviations Above (Below) 50-DMA
Overbought (Oversold) = 1+ Standard Deviation Above (Below) 50-DMA Source: Bespoke 2.27.20

S&P 500 3+ Standard Deviations Below 50-DMA

	S&P 500 Performance (%)				
Date	**One Month**	**Three Months**	**Six Months**	**Max Gain**	**Max Decline**
5/20/10	4.29	0.01	11.96	14.40	-4.57
8/4/11	-2.17	4.43	12.07	10.50	-8.40
5/17/12	2.91	8.68	4.22	12.33	-2.06
10/13/14	8.78	7.91	11.61	12.94	-0.65
6/29/15	2.48	-8.43	1.01	3.43	-9.24
1/7/16	-3.24	5.09	7.97	9.06	-5.87
6/27/16	8.30	7.97	13.41	13.56	0.00
10/11/18	1.93	-4.84	5.86	6.56	-13.83
Average	**2.91**	**2.60**	**8.51**	**10.35**	**-5.58**
Median	**2.69**	**4.76**	**9.79**	**11.41**	**-5.22**

From Bespoke, " The table to the left shows the performance of the S&P 500 following each of the prior eight periods in the last ten years where the S&P 500 traded down more than three standard deviations below its 50-DMA after not having done so in the prior three months. As the results show, equities typically bounced back rather nicely with an average one month return of 2.9% (median: 2.7%). Three months later, the S&P 500 was up 75% of the time with an average gain of 2.6% (median: 4.8%). Finally, by the time we were six months removed from the initial leg lower, the S&P 500 was higher all eight times for an average gain of 8.5% (median: 9.8%).

For each of the periods listed, we have also included the maximum gain and loss for the S&P 500 in the six-month span following each period. What's important to note about these results is that in all but two of the periods shown, the S&P 500 saw a decline of at least 2% at some point following the initial oversold reading. In other words, it's more likely than unlikely that the short-term low for equities has not been seen. However, for anyone with a time horizon of longer than a few days, these readings have been followed by outsized upside returns."

As the world is taking precautions in this globally connected economy, it is reasonable to assume there will be a near term hit to corporate earnings. 2020 consensus estimates for S&P 500 earnings before the coronavirus were ~ $175. With the S&P 500 closing at 2978 and an assumed reduced earnings estimate of $165, the price-to-earnings (P/E) on the S&P 500 would be ~18, slightly above the 25-year average of 16.3.[ii] An 18 P/E multiple can also be expressed as a 5.5% earnings yield (18 /100).

How do we compare the earnings yield of the S&P 500 to the yield of a 10-year Treasury? Although Treasuries give investors a fixed income stream, we would argue the current pre-tax interest rate of 1.27% over the next 10 years is a recipe to grow poor safely.

We are reminded by the current sell-off that markets can and will be volatile and the hardest thing to do in many cases is to simply sit still. As the table on page one reminds us, the average intra-year decline over the last 40 years is -13.8%. These declines, although unsettling, do pass, and are the price of admission for equity investors.

Equities vs. Fixed Income **as of 2/27/2020**	
Equity	
S&P500	2978
P/E ratio (fwd)	18.0x
2020 Earnings Est (revised)	$165
Dividend yield	2.00%
Earnings Yield (E/P)	5.50%
Bonds	
10-year Treasury	1.27%
P/E ratio (100/1.27%)	78.7x

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[i] Seeking Alpha 1.1.2019
[ii] JPM Guide to Markets 2.26.20