Thursday, April 9, 2020

Different This Time

As the nation combats the physical, financial, and emotional toll of COVID-19, James Underwood, principal and portfolio strategist with CAPTRUST, provides a fresh perspective on the capital markets. From unprecedented monetary and fiscal programs to the latest for fixed income and equity markets, it's all here.

It was truly a historic quarter for all the wrong reasons, and the physical, financial, and emotional toll of COVID-19 will likely create lasting scars for an entire generation, while future generations will read about this period in history books.

I have been writing quarterly capital market reviews for over two decades, including two of the worst bear markets in history—the dotcom bust and Great Recession—but Q1 2020 was unquestionably different.

The dotcom bust and the Great Recession were market crises that crushed Wall Street. COVID-19 is a humanitarian crisis that has crushed all "streets." Words are no match for an experience, and these words cannot adequately capture this difference, because words lack the emotions we are all experiencing.

Combatting the virus has been the top priority, and governments have been forced to take unprecedented actions. Many global economies have been placed in essentially government-mandated comas, while monetary and fiscal policymakers have reacted swiftly, and massively, to provide economic support until the virus can be contained. The level of economic disruption will reset historical scales as unemployment soars and GDP contracts over the next few months.

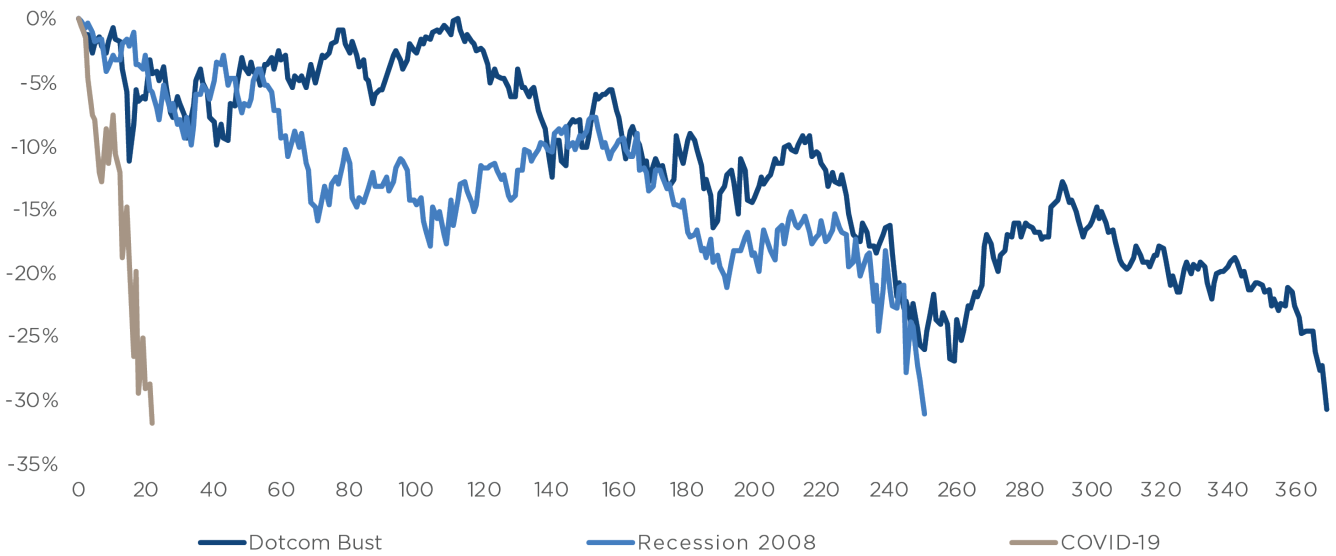
The investment result was indiscriminate selling of risk—low risk, high risk…all risk. Richard Bookstaber's paper, "A Framework for Understanding Market Crisis" (1999), captures this panic selling mentality, stating, "In a normal market, investors have time to worry about the little things. …As the energy level goes up in the market, investors no longer have the luxury of considering the subtleties of this particular stock or that stock. They need to concentrate on sectors. …Turn the heat up further to a crash environment and all that participants care about is that it is a stock and that they can sell it." During the second half of the quarter, global equity and credit markets were in crisis mode, and very few areas were unscathed. A closer look at the capital market environment follows.

Domestic Equity Markets

Heading into mid-February, U.S. equity markets had maintained the 2019 upward momentum, reaching new highs as concerns surrounding the coronavirus were isolated to China. However, during the second week of February, reports of increasing virus infections across Korea, Japan, Italy, and Iran sparked a wave of fear and uncertainty. The seemingly overnight realization that COVID-19 was not a China problem, but rather a global pandemic, resulted in one of the fiercest market selloffs in history.

As shown in Figure One, the downside velocity was extreme. It took 16 trading days for the S&P 500 to swing from an all-time high to a bear market (as defined by a 20 percent decline) and another six trading days to reach a 30 percent drawdown.

Figure One: Extreme Downside Velocity



Source: CAPTRUST Research

The response by the Federal Reserve has been swift, decisive, and seemingly unlimited. In a rare interview in late March, Fed Chairman Powell responded to questions surrounding the Fed's capacity to support the economy, stating, "We're not going to run out of ammunition. That doesn't happen."

Coinciding with the monetary policy support, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, a fiscal support plan that totals nearly 10 percent of GDP. The unprecedented monetary and fiscal programs allowed investors to partially catch their breath, contributing to a quarter-end rally, but the quarterly damage was severe, with the S&P 500 finishing the period down 19.6 percent.

All 11 sectors ended the first quarter with double-digit declines, as shown in Figure Two. The technology sector held up best, falling 11.9 percent as social distancing policies forced employees to work remotely, supporting companies like Citrix Systems (+28.0 percent) and NVIDIA Corp (+12.1 percent). Another area that performed relatively well was the healthcare sector (-12.7 percent), particularly companies within the biotechnology area that are all racing to find a medical breakthrough to combat COVID-19. Finally, the long lines at grocery stores in preparation for extended stay-at-home mandates contributed support to certain industries within the consumer staples sector (-12.7 percent).

Figure Two: 2020 First Quarter Performance by Sector

Sector	1st Quarter 2020 Return
Technology	-11.9%
Health Care	-12.7%
Consumer Staples	-12.7%
Utilities	-13.5%
Communication Services	-17.0%
Real Estate	-19.2%
Consumer Discretionary	-19.3%
Materials	-26.1%
Industrials	-27.1%
Financials	-31.9%
Energy	-50.5%

Source: Morningstar Direct, CAPTRUST Research

At the bottom of the list was the energy sector, which lost more than half of its value during the quarter, including a 34.8 percent decline for the month of March.

Oil prices were caught in the perfect storm. As demand for oil cratered with major economies shutting down, a dispute between Saudi Arabia and Russia resulted in a massive increase in new supply by Saudi Arabia. The result was a 66.5 percent freefall in the price of WTI crude oil, the worst quarterly drop since 1983, according to U.S. Energy Information Administration records.

Figure Three: Capitalization Style Performance

		Value	Growth
Large	Q1 2020	-26.7%	-14.1%
Large	One Year	-17.2%	-0.9%
Mid	Q1 2020	-31.7%	-20.0%
Mid	One Year	-24.1%	-9.5%
Small	Q1 2020	-35.7%	-25.8%
Small	One Year	-29.6%	-18.6%

Source: Morningstar Direct, Russell Indices

Liquidity can play a critical role in downside volatility. Liquidity simply means how quickly an investment can be converted into cash without impacting the price. Generally, larger-cap companies are considered more liquid as millions of shares are routinely traded every day. As shown in Figure Three, as you move down the capitalization spectrum, volume and liquidity can greatly diminish, resulting in severe downward price pressures during periods when getting out fast is more important than getting out at a good price. This was evident during the first quarter as large-cap companies outpaced their smaller-cap counterparts by more than 1,000 basis points.

Finally, from a style perspective, growth indexes, with nearly 40 percent of their assets in the technology sector, dramatically outperformed value indexes, continuing a decade-long trend that has resulted in relative performance spreads last seen during the technology boom of the late 1990s.

Non-U.S. Equity Markets

COVID-19 is truly a global event with no place to hide. The MSCI All Country World Index (ACWI) tracks large- and mid-cap stocks across 23 developed markets and 26 emerging markets. Remarkably, every country within the ACWI Index posted a loss during the first quarter, with only New Zealand and Denmark avoiding double-digit declines.

Compounding the problem for U.S. investors was the global surge in demand for U.S. dollars, a perceived safe haven. As a result, the dollar strengthened against most currencies, further detracting from local market results, as shown in Figure Four.

Figure Four: Foreign Market and Currency Impact

Regional Performance	Local Return	Currency Impact	U.S. Dollar Return
ACWI ex U.S.	-20.1%	-3.2%	-23.4%
Developed Markets	-20.6%%	-2.3%	-22.8%
Europe	-21.8%	-2.5%	-24.3%
Japan	-17.3%	-0.6%	-16.8%
Pacific ex Japan	-21.2%	-6.4%	-27.6%
Emerging Markets	-19.1%	-4.6%	-23.6%

Source: Morningstar Direct, CAPTRUST Research

Fixed Income Markets

The Bloomberg Barclays U.S. Aggregate Bond Index finished the quarter up 3.1 percent; however, the solid result masked significant volatility within underlying sectors. Treasurys soared as yields collapsed across the curve. The 30-year Treasury yielded 2.39 percent at the end of December and 1.35 percent at the end of March, translating to a 25.8 percent return for the quarter. However, outside of the Treasury sector, credit markets faced tremendous challenges.

Unlike equity markets, where there are centralized exchanges for buyers and sellers to come together to transact, bonds are traded over the counter, generally through dealers. Normally, the system functions smoothly, but during periods of stress, trading inefficiencies can create significant price dislocations as liquidity evaporates. These dislocations were extreme during the quarter—for both taxable and tax-exempt issues—as sellers were forced to accept massive discounts for immediate liquidity despite the Federal Reserve's aggressive actions to keep the credit markets functioning.

Investment-grade corporate bonds ended the quarter down 3.6 percent, including a 7.1 percent decline by Baa rated bonds. Further down the quality scale, high yield bonds suffered even greater losses, falling 12.7 percent as spreads approached 1,000 basis points. These quarterly losses do not remotely capture the challenges credit investors faced during the period. The system functioned, but only with unprecedented Federal Reserve support.

Author(s)

James Underwood, CFA

https://www.captrust.com/people/james-underwood-cfa/

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