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Keeping Investment Instincts in Check

In this edition of Investment Strategy, our industry experts explore the unprecedented market decline and volatility we have experienced recently, driven by COVID-19, and examine the U.S fiscal and monetary policy response and challenges of a cold restart of the U.S. economy.

This quarter's Investment Strategy arrives amid a novel backdrop. Global pandemics, although thankfully rare, have been powerful enough to alter the course of history. This time, a pandemic arrived in a world far more interconnected than ever before, causing disruptions akin to a global natural disaster.

The COVID-19 threat is particularly insidious because it represents a personal and public health emergency, as well as an economic one. Many have suffered and, unfortunately, many more will suffer, even as the virus curve is flattened and we begin to get a glimpse of life on the other side of the peak. As we start to tally economic costs, we must appreciate the human costs of the tragedy, above all else.

As millions of businesses closed their doors, tens of millions of Americans also faced job losses in the span of weeks. Millions more scrambled to adjust to a new work-from-home paradigm, amid a resounding nationwide call to action: For everyone's benefit, please stay at home.

We can draw an investment parallel to this call to action. In times of danger, the fight or flight human instinct compels us to favor action over inaction, a tendency that could also prompt us to consider selling risky assets at the worst possible time. As long-term investors, our home can be viewed as the strategic asset allocation best suited to our plans and goals. Even amid breathtaking market volatility, the best course for most is to stick to the plan and remain at home.

However, staying at home doesn't imply we can't work from home. This important work includes rebalancing portfolios, understanding the nature of risks within portfolios, evaluating the technical and policy forces that could shape future direction, and uncovering potential opportunities within dislocated

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corners of the market. On behalf of our clients, this work has been our focus over the past two months.

In this edition of Investment Strategy, we will recap a historic first quarter and consider some of the possible paths forward. We will also describe actions we've taken behind the scenes to assess and improve the strength of portfolios and uncover opportunities.

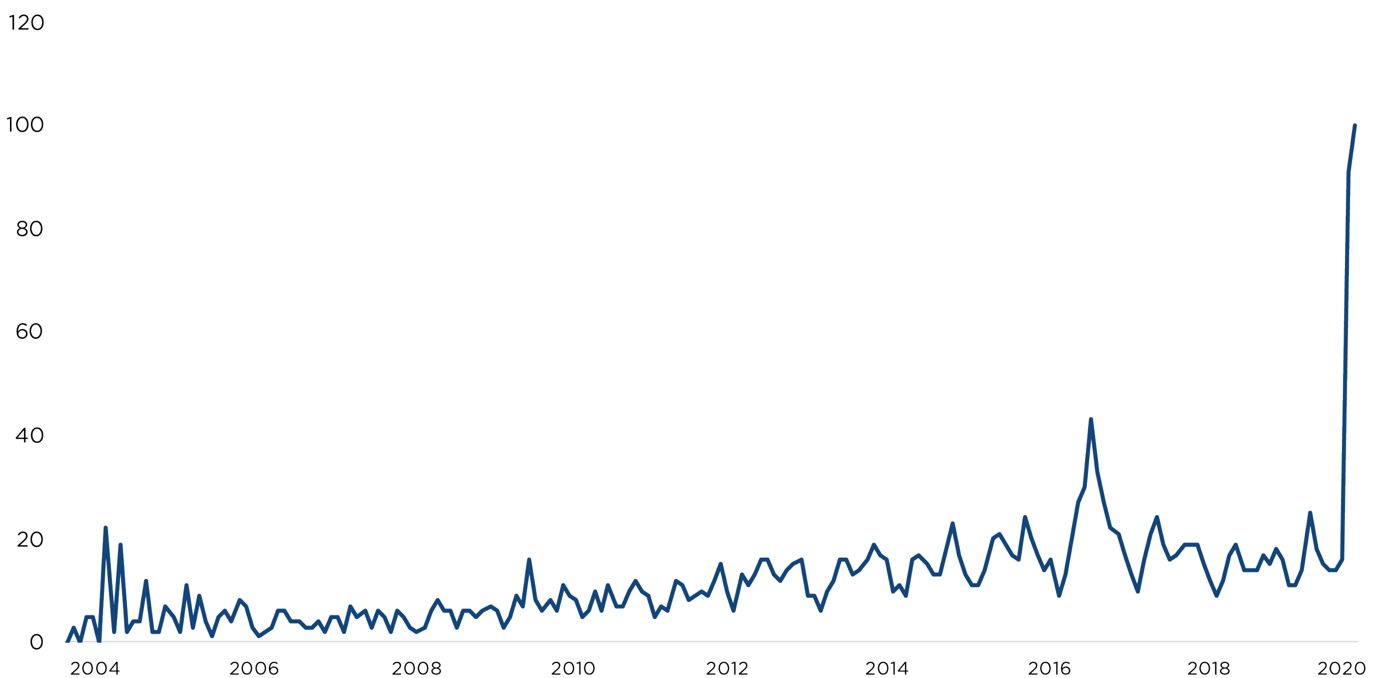
The Sudden Shock

As it became clear in February that a coronavirus outbreak in Wuhan, China, was not contained, global policymakers raced to enact measures to reduce catastrophic impacts to the healthcare system. These measures quickly shuttered large swaths of the economy, as 95 percent of Americans were asked to remain at home. The U.S. economy, along with significant parts of the global economy, came to an abrupt, full stop.

Only now can we appreciate how dramatic the drop-off in economic activity has been. Restaurant reservations are down 100 percent from year-ago levels. Airport traffic is down 95 percent, weekly retail sales are down 98 percent, and box office sales have dropped from levels of roughly $150 million per week to a mere $5,000 for the week of April 10. This degree of disruption in normal life would have been unimaginable just months ago.[1]

To illustrate just how unprecedented this situation is, Figure One shows Google search trend data for the word "unprecedented." Its search frequency spiked in March to—you guessed it—an unprecedented level.

Figure One: Google Search Volume for "Unprecedented"

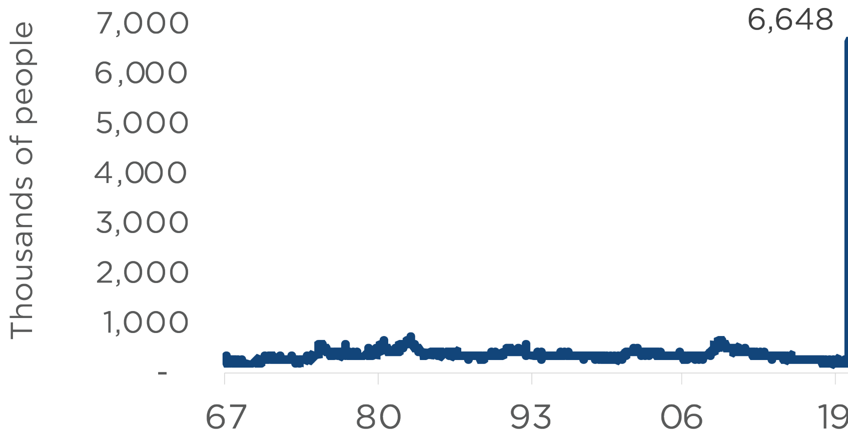


Source: trends.google.com

Most troubling of all the economic data is the impact to employment. As seen in Figure Two, weekly initial jobless claims soared to a never-before-seen level of 6.6 million for the week ending March 28.

Over the past five weeks, a total of 26.5 million of America's 165 million workers filed for unemployment benefits. Because employment is key to economic stability and growth, the evolution of the re-employment picture will play a large role in the shape of the recovery.

Figure Two: U.S. Initial Jobless Claims



Source: Bloomberg

The Policy Response

There is often a delay between the onset of an economic problem and its recognition within economic data. This creates risk if the policy response is either too late or sized incorrectly. This time, despite a highly polarized political environment, Washington's response was both quick and substantial.

Monetary Policy

The first actions came from the Federal Reserve. Despite the view that it was nearly out of bullets given the already-low level of interest rates, the Fed not only found ammunition, they also used entirely new weapons. The Fed's first rate cut of half a percent occurred on March 3, followed by an emergency full percentage point cut on March 15, taking its policy benchmark to the zero-bound.

In addition to rate cuts, the Fed dusted off programs last used during the global financial crisis. It restarted asset purchase programs—also known as quantitative easing—with the purchase of Treasury bonds, mortgage-backed securities, and, for the first time ever, corporate and below-investment-grade debt, with an open-ended timeframe. It pursued a wide range of programs to improve market liquidity, including operations to improve the functioning of commercial paper and currency markets and extended credit to banks for small business loans.

Taken together, these actions far exceed those taken in its response to the global financial crisis and represent an estimated 11 percent of U.S. gross domestic product.

Fiscal Policy

The fiscal policy response was also speedy by historical standards. Congress passed, and on March 27 the President signed, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, a $2 trillion

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relief package designed to help keep consumers, businesses, hospitals, and state and local governments afloat during the COVID-19 crisis.

For consumers, the package included direct cash payments to millions of Americans, an expansion of unemployment benefits, and an extension of tax filing deadlines. Hospitals and healthcare providers received $130 billion of assistance, and small businesses received $350 billion in forgivable loans to maintain payrolls. Larger businesses, particularly in hard-hit industries, received an additional $500 billion in loans. Thus far, 10 of the 12 largest airlines and the Treasury Department have agreed in principle to as much as $25 billion in loans authorized by the CARES Act.

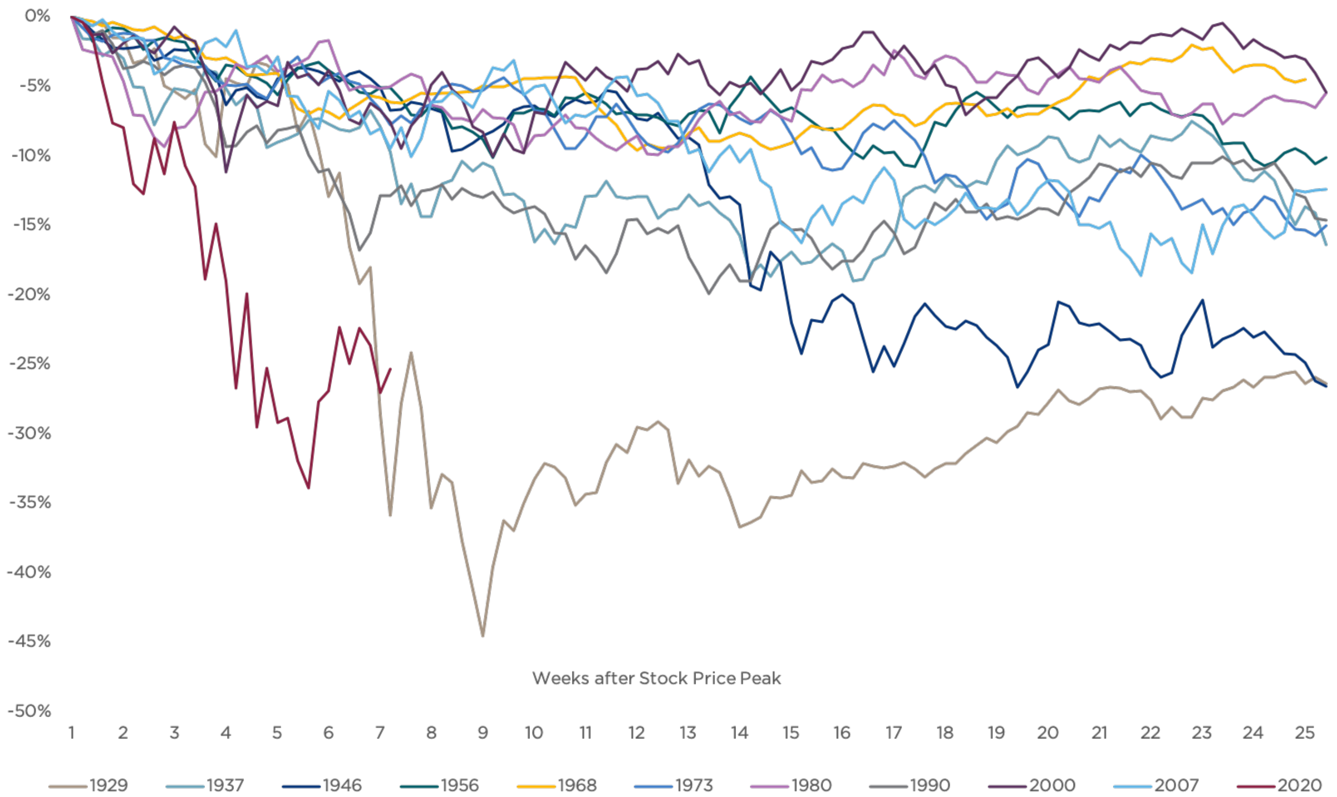
Within 13 days of its launch, the small business lending program fund had run dry, with many firms still waiting in line. On April 24, the President signed a follow-on $484 billion spending package to replenish the loan program along with additional support for virus testing and health care providers. Additional fiscal packages are likely on the way.

Taken together, the policy actions described above are staggering, and have likely—alongside similar policy actions across the globe—contributed to the dramatic change in market sentiment seen over the past several weeks. In fact, the period following March 23 ranks as the best 13-day advance of all time for the S&P 500, with a return of 25 percent.

The Market Reaction

As with the policy response, we quickly run out of superlatives to describe the market reaction to these events. Price movements were swift and severe. Within the span of just five weeks, the S&P 500 lost more than a third of its value, compared to an average of 13 months required for prior bear markets of this magnitude. The speed of the sell-off, illustrated in Figure Three, is a testament to the unique challenges posed by the virus, both for the fundamental economy and investor psychology. The only other times such rapid sell-off occurred were the Great Depression (1929) and Black Monday (1987).

Figure Three: S&P 500 Performance in Past Recessions



Source: Bloomberg

While all 11 S&P 500 sectors ended the quarter with double-digit declines, stark differences exist between the sectors. As shown in Figure Four, technology stocks fared the best in the first quarter, while economically sensitive sectors such as materials, industrials, financials, and energy suffered losses of 25 percent or more. Energy was hardest hit, amid the simultaneous shocks of a global price war-driven oil supply glut and virus-driven demand destruction.

Figure Four: 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: CAPTRUST Research

The COVID-19 crisis is a truly global one, as countries around the world sought to contain the spread of the virus on different timelines, at the same time as global production and consumption ground to a halt. As shown in Figure Five, for U.S. investors, equity returns across international markets were further dragged down by currency effects, as the dollar strengthened amid high global demand for safe haven assets. The outperformance of U.S. equity markets may also reflect the larger scale of its policy actions, relative to GDP.

Figure Five: 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%

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Source: CAPTRUST Research

The bond market did not escape the turmoil of Q1. Although the Bloomberg Barclays U.S. Aggregate Bond Index finished the quarter up 3.1 percent, the fixed income market could be viewed as ground zero for the panic selling that occurred in mid- to late March, as significant technical challenges and a lack of liquidity caused even Treasury bonds to suffer from price volatility and higher transaction costs. Only after considerable action by the Fed did order return to fixed income markets.

Interest rates declined for the quarter, as the yield on the 10-year Treasury declined from 1.92 percent to 0.7 percent. However, for corporate and other credit-sensitive bonds, concerns about credit risk negated the price impact of falling rates, leading to negative returns. Since the initial shocks in March, we have begun to see healing within credit markets, with narrowing credit spreads and recovering prices.

The Cold Restart

It is appropriate on the 50-year anniversary of the Apollo 13 mission to consider the challenges of an economic cold restart. On that ill-fated mission, a crisis prompted the crew to completely shut down many vital systems to conserve power. After being exposed to the raw cold of space for days, these systems had to be restarted in a careful sequence—a procedure never considered, let alone tested.

The economy now faces a similar challenge: a cold reboot of large swaths of the economy, following an emergency shutdown. The restart process will likely be uneven across geography and industries, and the right sequence of activation will be critical, as significant uncertainty remains about the potential for a second wave of outbreaks when lockdowns conclude—or a return of the virus in the fall.

CAPTRUST has been hard at work evaluating a variety of recovery scenarios, including base case (U-shaped), best case (V-shaped), and worst case (W-shaped, or even more exotically shaped) scenarios. As we consider these paths forward, it is important to remember that the economy is not the market, and the market is not the economy. Historically, we often see a significant lag between the time that markets begin to turn around and when fundamental data such as employment and sentiment begin to bounce back.

We are particularly focused on the long-term implications of the historically large and broad policy response described above. During a crisis, the only choice is to act—only in retrospect can we determine if the response was appropriate. These new policy actions have already surpassed those of the global financial crisis, which, at the time, caused many to fear that inflation would take off. Although there was a lot of kindling for inflation after 2008, the match was never lit.

This time may or may not be different, and much will depend upon the shape of the economic recovery. If the recovery is sharper and swifter than expected—for example, accelerated by sooner-than-expected vaccines or effective treatments—we could see a policy response that overshoots the mark, providing excess fuel for markets along with the potential for high inflation.

Another outcome we are considering is the risk of negative interest rates within the U.S., as we have seen emerge in recent years across Europe and Asia. Although negative interest rates would be challenging for savers and those seeking income, it could be devastating to a banking system that is sorely needed to support economic recovery. And because the U.S. banking system is the world's largest, stresses here could quickly ripple across the globe. We believe the Fed would take extraordinary actions to avoid this scenario—conceivably, even expanding its asset purchase programs to include stocks, a never-before-seen move that would bring profound investment implications.

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As we evaluate these and other scenarios, our approach, as always, will be empirical and evidence-based. We are still very early in a fast-moving crisis, and only now are we beginning to see hard numbers emerge about economic conditions. We will rely upon data to help manage our response.

Glimpse of Life on the Other Side of the Peak

The first quarter of 2020 was one for the record books, with heart-stopping volatility. However, if an investor had (somehow) not been paying attention to the violent day-to-day moves and instead looked at his or her investments on April 24, she or he would have seen a year-to-date S&P 500 decline of a much less anxiety-inducing 12 percent. The impact to a diversified portfolio would have been even less.

This point illustrates the structural advantage held by long-term investors with sound asset allocation strategies, who are not forced to react—investors who can remain at home.

Regardless of the environment, there is always work to do within portfolios. Our research staff has conducted hundreds of meetings as we've worked with asset managers to understand their preparedness and business continuity plans, in addition to impacts to portfolios and investment strategies. We placed special emphasis on areas such as money market funds and the target date and stable value funds frequently used by institutional clients. Finally, after playing defense, we've shifted to offense in the form of identifying investment opportunities that could emerge from market dislocations, uneven virus impacts, winners and losers created by policy response, and, eventually, from longer-term changes to consumer and business behavior. Although we do not yet know what those changes will be, we know there will be changes. We believe that things will get better, even if they are never quite the same.

[1] Strategas Research Partners, LLC, 2020

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