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**Updated Market Comments**, *March 12, 2020*

- Market volatility has entered a new chapter as Russia and Saudi Arabia brought about a dispute on oil. This unexpected action caused the price of Brent crude to drop over 20% since its close last Friday, one of the largest and fastest declines in history. Increased solvency risk for energy companies and commodity-dependent regions is yet another concern for a global market already pummeled by COVID-19 (coronavirus).

- We anticipate that the long-term economic and earnings effects from COVID-19 will be minimal. We also believe that the longer-term effect of low oil prices tends to be a major positive for U.S. consumers.

- Recognizing that the short-term impact to earnings and economic data could be significant, we anticipate continued volatility. While we recognize the potential for additional downside over the coming weeks/months, the recovery in stocks may well also be rapid and will be very hard to predict. We believe investors will begin to look through earnings or economic disappointments; either when the number of new coronavirus cases peaks or if health the virus proves to be less dangerous than currently feared.

- Typically, events of this magnitude take days or weeks to unfold, and markets are allowed to adjust as we go. Though oil prices and U.S. government bond prices are typically the key barometers for economic health, the oil market is currently in uncharted territory, with pressure in terms of both supply *and* demand. With so many unknowns, one of the primary challenges is how to know whether the signals are artificial. In our view, it is premature to mark the beginning of a recession at this juncture.

- Financial markets have already priced a large component of the economic impact that is expected from measures being taken to reduce transmission rates, namely reduction or restriction of activity (travel halts, event cancellations, less time in public shopping, eating at restaurants, etc.).

- We disagree with pundits who see default risks as cataclysmic and see concerns over credit risks as an over-reaction. It is too early to understand the full extent of global virus transmission or credit defaults, so we believe most of the pricing is based on sentiment [fear] and hypothesis, not data.

- We maintain hope that things will smooth out in the weeks and months to come.

- We are encouraging people to maintain proper perspective: the declines in stock prices are as much a function of panic selling over fears of what could happen as a reasonable update to the likely trajectory of the economy and risk assets.

- We continue to seek value and opportunity and see different areas for optimism. We are not selling on panic/fear; rather we manage portfolios using trailing and coinciding economic data [fundamentals].

## **Reminders of previously communicated positions**:

- Complacency is finally being put to the test with regard to the impact of the coronavirus on global/U.S. growth, earnings estimates and stocks. Global supply chains are being put to the test with the virus representing a massive supply shock.

- U.S. and global central banks are expected to ease policy; but the impact is likely to be limited.

- Since the beginning of January, estimates for S&P 500 earnings per share have been cut for every quarter this year, with the largest cut to the first quarter in consumer discretionary, industrials, and materials sectors in particular. This has resulted in a move from expected growth of nearly 10% for calendar year 2020 to less than 8% at present. It is hard to imagine there aren't more cuts to come, especially if the U.S. dollar continues to strengthen.

- Many comparisons have been analyzed between the coronavirus and the SARS outbreak in 2003. Economically, the impact is likely to be felt much more globally, not only due to China's increased share of global gross domestic product (GDP) – which has quadrupled – but also because China's consumers have become a global powerhouse as well. Today, China represents 16% of global gross domestic product (GDP), up from 4% in 2003. It is also substantially more integrated into the global economy and more extensively linked into global supply chains.

- Analysis of 13 global pandemics over the past 50 years shows that once the number of newly identified cases starts to decline, economic activity and the stock market tend to rebound quickly. Historically, epidemics have had relatively minimal long-term effects on stocks. The market impact of the 2003 SARS outbreak was largely limited to one or two quarters, though it is too early to draw such a conclusion today.

- In our opinion, riskier segments of the bond market, like high-yield and emerging-market bonds, are likely to underperform Treasuries because they tend to be more dependent on rising economic growth, trade, and commodity prices.

- Investors may have little need to take action in the near-term if their portfolios are diversified and aligned with their long-term strategic equity-allocations. Use swings in either direction to rebalance back toward those targets, if necessary.

- Assuming that earnings have been delayed and not destroyed, we believe that the S&P 500's valuation will have fallen significantly when the dust settles, resetting investor expectations and creating a more reasonable backdrop for the market to find a floor when volatility finally subsides.

- Oil price shocks create near-term market risks. First, U.S. energy is one of the largest sectors in most high-yield indices. Smaller energy companies need stable oil prices to remain a going

concern, creating solvency concerns for high yield issuers. Defaults on these loans could have an indirect effect throughout the U.S. financial system.

- It is said that markets go up on an escalator and down on an elevator. On February 19, the S&P 500 hit a new all-time high. Seven business days later, it was down over 15%. Additionally, daily swings of 3% or more make market timing particularly dangerous. The best time to plan for a correction is before it happens.

- Our base case for the global economy in 2020 is still for a modest pickup in growth, with a slight rise in U.S. inflation pressures. This, in turn, limits recession risks. Financial vulnerabilities are climbing, but our overall gauge of vulnerabilities across the economy stands well short of its peaks ahead of the last recession. We still view this as a favorable backdrop for risk assets over a 6-12 month time horizon, even considering the impact from the coronavirus outbreak. Over the same time horizon, we still see potential for a bounce in cyclical assets.

- We do not believe this is the beginning of the next recession. However, we fully acknowledge that modeling the range of potential scenarios for this type of viral outbreak is imprecise because the unknowns make the range of possibilities wide.

- We continue to favor a quality bias in equity markets. Among the S&P 500 Index sectors, we are currently favorable on information technology, communication services, consumer staples, and financials. We are less favorable on energy, industrials, and materials.

Although we are not recommending portfolio allocation changes for the long-term investor at this time, if you are uneasy with the short-term volatility please call our office at 239-920-4440 to discuss potential changes to your allocation.

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