MARKET UPDATE **CORONAVIRUS OUTBREAK**

MARCH 9, 2020

An ugly couple of weeks for global investors continues to get uglier. A steep decline at the open triggered a halt in trading on US exchanges this morning as fears over the spreading coronavirus outbreak were exacerbated by the biggest decline in the price of oil since the Gulf War in 1991. While stocks briefly bounced once traded resumed, they have remained depressed throughout the day, with the Dow Jones Industrial Average on pace to have the worst day since December of 2008. Yields have also plunged, and the entire US Treasury yield curve is below 1.0% for the first time in history. Investors had few places to hide, with only eight of the five hundred issues in the S&P 500 positive on the day. But energy stocks were hit the hardest, as the sharp decline in the price of oil in recent days makes it next to impossible to predict what near-term future earnings will be. Haliburton, the oil field services provider, exemplifies the situation in the energy sector; shares in HAL were halted 3 times within an hour on Monday morning, after falling 7%, 13%, and 20%, respectively, an unprecedented event.

Facing a sharp decrease in demand, OPEC+ were unable to reach consensus during meetings last week, leading Saudi Arabia to instigate a price war in the face of Russian refusals to institute coordinated productions cuts over the weekend. Oil prices subsequently plunged to the lowest levels since 2016, and are now down more than 43% on the year. Given that energy represents an input cost for the majority of US companies, lower prices would traditionally be interpreted as a positive for the broader macroeconomic environment. In this case, however, the decision to ramp up production is aimed squarely at US energy companies, in particular those in the shale space, which tend to be highly leveraged and thus vulnerable to a credit crunch. Credit spreads have widened out substantially in the last few weeks, and after this weekend, high yield energy credit spreads are approaching a record. Weakness in the energy sector has the potential to spread into the broader credit markets if sentiment continues to decline, and the record high number of BBB credits in investment grade credit indices heightens the risk of a sentiment driven sell-off.

Against this backdrop, cases of the novel coronavirus continue to expand around the globe outside of China. While the evidence continues to suggest that the virus poses little danger to most populations, the likelihood that the efforts to contain the virus will cause significantly slower economic growth than previously forecast has increased over the course of the past week. Italy is in the midst of implementing a quarantine in Lombardy, the most significant region for the national economy, which will undoubtedly lead to lower economic growth. In the United States, the private sector is taking a leading role, with many organizations preemptively canceling or postponing events and ordering employees to work remotely. The annual South by Southwest festival, which in 2019 contributed nearly $360 million in economic activity for the host city of Austin, TX, was canceled on Friday over concerns over the virus. Many more public events will likely suffer a similar fate in the weeks ahead, and the impact to economic growth will be unavoidable. The result will be a unique supply/demand shock that will need to be met with a government response through a combination of policy decisions in the monetary, fiscal, and public health spheres. Uncertainty will remain elevated for the foreseeable future in the near-term, and a turnaround will likely require a peak in infection rates combined with an underweight position in risk assets and exceedingly cheap prices in those same risk assets. Today is unlikely to be the turning point, and more downside is possible from here.

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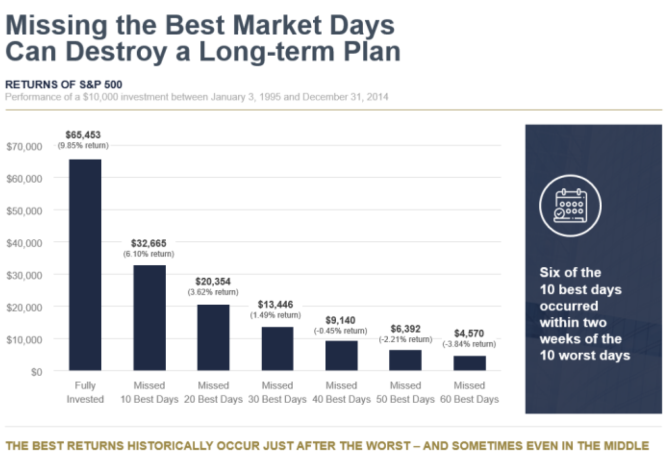
In times of perceived crisis, it is natural to have the urge to sell out of risky assets such as stocks to stem the bleeding. Engaging in this type of market timing, however, is difficult if not impossible to pull off successfully, because one has to be right twice: both getting out at the right time, ***and*** getting back in at the right time. Historically, the biggest up days in the market are intertwined with the biggest down days; the market does not go down in a linear fashion, nor does it go back up that way. Missing just one or two of the big up days can mean missing the rally entirely, so the odds are decidedly against an investor who attempts to time the market in this fashion.



Source: JPMorgan Asset Management

Investors can best manage risk through a diversified long-term asset allocation matched to unique goals and time horizons. One of the best additional tools available to manage risk in addition to investing in an appropriate asset allocation is rebalancing portfolios regularly and, more importantly, in times of market stress that cause major deviations from that long-term target allocation. We have been looking for opportunities to actively rebalance portfolios where warranted while remaining mindful of potential tax implications.

We have also continuously monitored our tactical portfolio positioning decisions, and believe we remained positioned well to both weather the sell-off and benefit from the inevitable rebound.

- We remain underweight developed international and emerging markets exposure in portfolios. International economies are much more levered to overall global economic growth than the US economy, and the outbreak will undoubtedly lower global economic growth in the first half of the year.

- We remain overweight US large cap stocks (vs. small cap) and overweight growth (vs. value). Large cap growth stocks have weathered the market sell off best thus far, and will likely rebound strongly once market sentiment inevitably turns.

- We also have been positioning portfolios to best take advantage of the expected duration and impact on businesses and economies of the coronavirus outbreak. Positions in energy stocks have been reduced or eliminated, have increased or initiated positions in health care, information technology, and communication services companies expected to best weather the current environment or in some cases even benefit from it. Health care firms have been working around the clock to fight the outbreak, and those that are working towards a vaccine for the novel coronavirus have seen positive stock performance despite the recent sell-off. Opportunity also exists in the technology and communication sectors, as the number of large-scale public events that have been canceled is increasing by the hour, and firms and organizations are rapidly adjusting, seeking to conduct meetings and business activities remotely or in smaller group settings. Companies that enable firms and organizations to easily adapt to these changes will benefit both during the downturn and long after and have been one of the few bright spots in the equity markets in recent weeks.

We have also adhered to a disciplined rebalancing process. We typically rebalance a portfolio when the allocation deviates 5% from the long-term target. While every client has unique circumstances and the rebalance decision may be overridden (most often for tax reasons), rebalancing during times of market stress enables us to sell assets that have quickly appreciated and purchase assets that have recently depreciated while keeping portfolios in line with risk targets. Academic research overwhelmingly shows that the rebalancing process is one of the most powerful tools we have to manage risk during fluid, fast moving market environments like the one we are experiencing today.

In times like these, it is important to remember that volatility is a feature of the stock market, not a bug. The superior long-term returns of equities are generated because of sell-offs like the one we are experiencing now, not in spite of them. Uncertainty will remain elevated in the near-term, and more downside is likely in the days ahead as more information about the outbreak becomes available. We hold diversified portfolios precisely because the future is uncertain. We are monitoring the situation very closely and are in regular conversation with our partners who provide us with access to the best information and research in the industry, and we remain informed and ready to take further action where needed. While it is natural for investors to feel unease and nervousness during times such as these, they are best served by remembering to put the current state of the markets in the proper historical perspective, and sticking to their long-term strategy.

Matthew T. Brennan, CFA®
Portfolio Manager

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