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Investor Strategy

Helping investors reach their long-term wealth goals

RICHARDSON GMP

Air pocket

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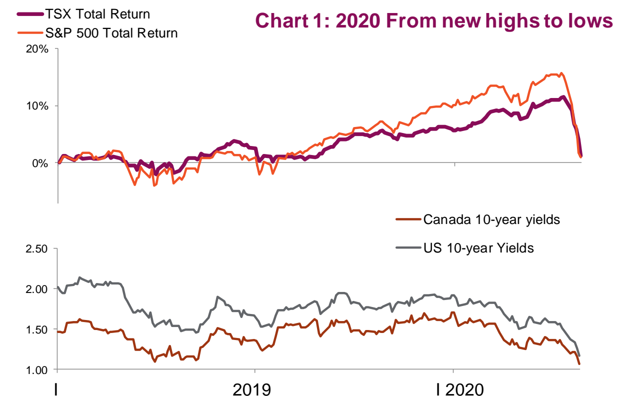
Summary

- **I. Market recap – From new highs to lows**
- **II. Market cycle**
  - Air pocket
  - Coronavirus
  - Correction update
  - Market cycle – Remain calm
- **III. Do earnings even matter?**
- **IV. Portfolio positioning**

I. Market recap – From new highs to lows

February started on the back foot following the initial coronavirus scare in late January. Overcoming the initial fears, and encouraged by slowing growth rates and increasing optimism that the tough containment measures enacted within China were enough, markets reached new all-time highs on February 19. At that point, the S&P 500 was up over 5% in February alone. Those gains would prove fleeting, as Chart 1 details how quickly markets can react to new developments and quickly go from new highs to new lows. The last week of February proved to be the worst week for markets since 2008, with the S&P 500 falling -11.5% and S&P/TSX Composite declining by -8.9%, driving major markets into correction territory.

Chart 1: 2020 From new highs to lows

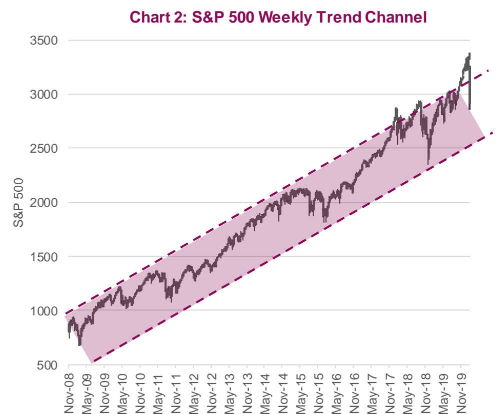


As volatility ratcheted up, sending the VIX to the highest level in years, bond yields plunged to fresh record lows. The risk-off environment drove U.S. 10-year Treasury yields to a low of 1.14% on the last day of the month. Following the move, traders are increasingly pricing in central banks to step in with further accommodative policies; however, central bankers have been relatively quiet on the issue. It would appear many are poised to start cutting soon.

Commodity markets were far from immune from the wave of volatility. Crude prices continued to decline on demand fears, falling another -13.2% in February to close the month at $44.76/bbl. Gold and silver had initially enjoyed a flight to safety, but finished in negative territory. The last day of trading in February saw gold prices plunge by -3.6%. The stock rout has been so severe that gold and other defensive stocks were sold off because of profit-taking and to cover margin calls.

This has been the fastest market correction in the history of the S&P 500, driving all sectors into correction territory. The coronavirus was the spark, but markets

were already full of tinder. Chart 2 shows the entirety of this bull market for the S&P 500 on a weekly basis. We've overlaid a simple trend channel to reveal just how overextended markets had become to the upside. This correction has only brought us back into the middle of the channel. For the past 10 years, we've been conditioned as investors to buy the dip continuously. To see seven consecutive major down days shows that any 'buy the dip' situation has failed to hold. With few similar playbooks to model, strategists across the street are split on how to play the most recent decline. With bond yields at current lows, some are trying to stay clear of stocks, while we have noticed selective buying to close out the week. On the surface, markets appear severely negative on the coronavirus – a fact that underscores the speed of the correction. There is a growing realization that the economic and corporate earnings fallout from the coronavirus will be material, but we continue to believe that the bulk of it will prove transitory and be contained within the first half of the year.



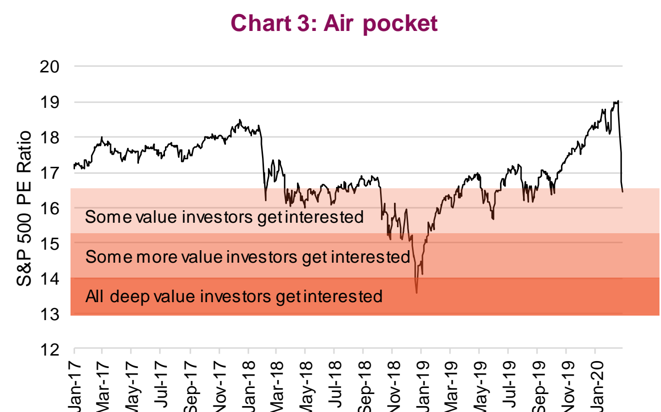
II. Market cycle

Air pocket

There are no shortage of headlines that continue to sap any remnant of confidence from the marginal buyer or seller of assets. *Virus, economic impact, companies pulling earnings guidance, someone sneezing on the subway* – the list is endless! The narrative has turned uber negative, driving uncertainty through the roof and the equity markets through the floor. And while we're not downplaying any real, long-term impact of this virus, which has a high degree of variability, this drop has been exacerbated by a clear air pocket in the market.

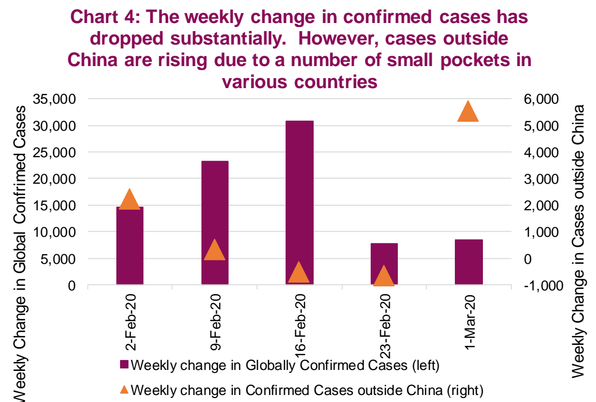
Equity markets rose substantially in 2019 and this continued into 2020. Initially these gains came on the back of central banks becoming more accomodative, a low valuation starting point to last year and the fading fear that a recession was imminent. The market then received a big boost in late 2019 and into 2020 with a trade-war truce and some signs that the slowing global economy was starting to pick up some momentum. The annualized gains for the S&P 500 from January 1, 2019 through mid-February 2020 was a 33% pace.

Clearly, gains of that pace are not sustainable. In addition, there was virtually no earnings growth during this period, meaning those gains almost all came from multiple expansion. **This pushed the price-to-earnings ratio of the S&P to over 19x and created an air pocket.** If the optimistic growth investor decides to hit the sell button, the market needs the value investor to enter as an opportunistic buyer. But starting at 19x, a 10% correction brings you to 17x. Well, that isn't low enough to get most value investors excited. Maybe at 16x or 15x? Hence, the development of an air pocket.



With the S&P 500 now trading at 16.4x, there are likely some value-oriented investors starting to weigh into the market. This should start to provide some stability after such a fast and furious decline in prices. Just over 30% of the S&P 500 constituents are now trading less than 12x earnings. This is up from 20% just two weeks ago.

Coronavirus



There has been a material decline in the number of new infections in China and the world as a whole. This is certainly good news and supports the playbook that once the active cases begin to decline, markets may bottom similar to SARs. However, we would caution that this data can change and cases outside China increasingly rising, albeit from materially lower numbers.

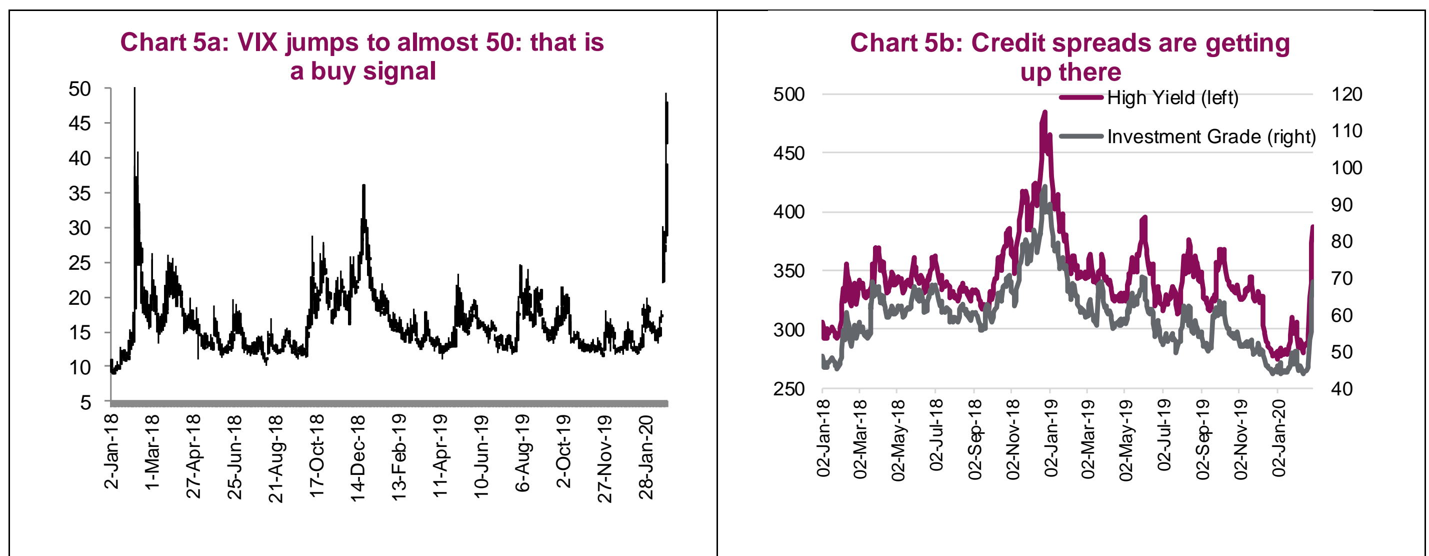
For the week ended March 1, there were 8,445 new cases compared to over 30K new cases two weeks back. The aggressive tactic of forced quarantine appears to be helping. The less-encouraging data relates to the rising cases outside China which hit 5,557 during the past week.

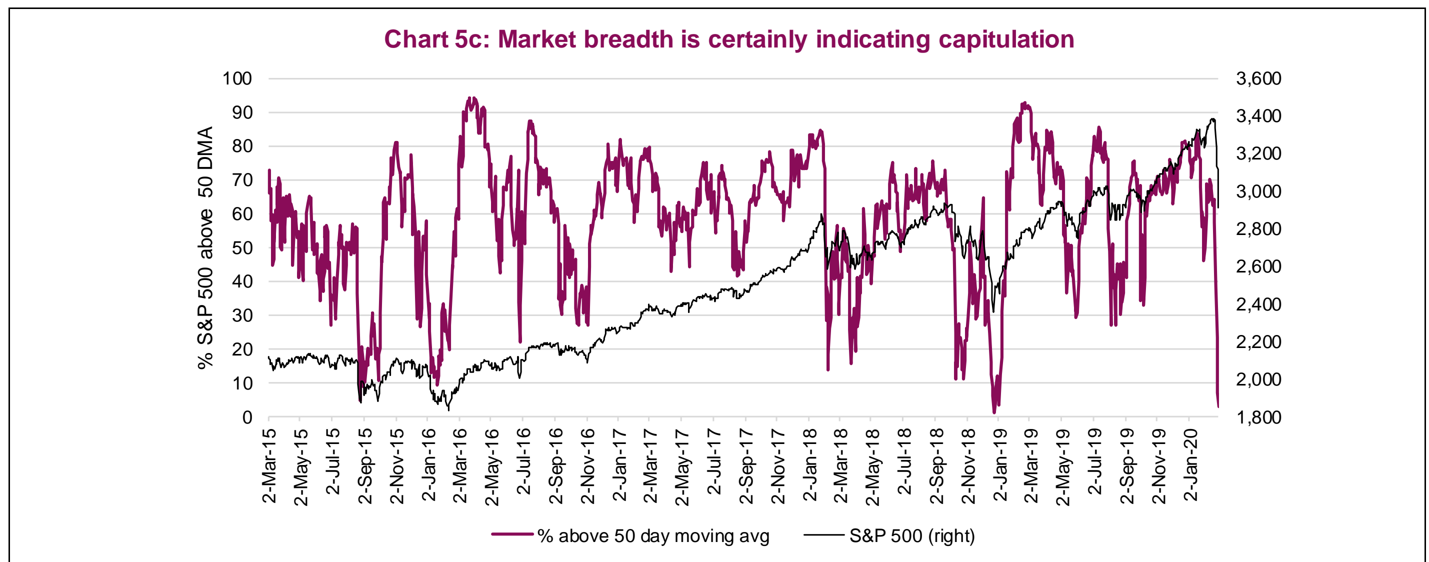
The good news is that the active cases in China appear to be declining; but the risk of a broader spread around the globe remains the big question at this point.

There is no question the virus will slow global economic growth and have a drag on upcoming company earnings. There will be disruptions to supply chains, travel and likely spending patterns. The trend this past earnings season, which represents periods before the impact, has been for many companies to highlight the risk and for some to remove forward guidance. All this adds to uncertainty. If investors were willing to pay 16x for earnings with guidance from the company, it's a safe bet those same investors will not be willing to pay as much for the same earnings without any guidance from the company.

Correction update

The drop in equity prices over the past week has been fast paced. If there is anything we have learned it's that markets do move faster in this day and age. In updating our correction metrics, we are now seeing many that are flashing 'capitulation' – historically, this has been a buying opportunity. The VIX, which tracks the implied volatility of index options, is almost 50 (Chart 5a). Credit spreads have risen materially (Chart 5b). And perhaps the most compelling metric, the percentage of S&P 500 companies trading below their own 50-day moving averages is down to a mere 3%. Chart 5c tracks market breadth over the past five years. (Market breadth refers to how many stocks are participating in a given move in an index or on a stock exchange. An index may be rising yet more than half the stocks in the index are falling because a small number of stocks have such large gains that they drag the whole index higher.) Typically, when this metric gets very low, markets tend to be materially higher over a few weeks or months as it often denotes capitulation. The big exception was Q4 2018, which saw markets fall, stabilize a little then fall again. It just goes to show, nothing is ever a given.





Portfolio action – There are plenty of unknowns: How far will the coronavirus spread? To what degree will it slow the global economy and impact company earnings? Will a slowing economy tip us into a global recession? Will Sanders win the Democratic nomination? The market is reacting and repricing itself based on numerous unknowns. At this point, we would say enough of our correction indicators are flashing 'buy' as an opportunistic entry point for dry powder. Oh, and if you think the risks are too great and it just doesn't feel right, it never does during corrections. If it helps, the S&P 500 is 14% safer today than a week ago and the TSX is 10% safer (those are the amounts these benchmarks have fallen).

Market cycle – Remain calm

While there certainly will be an economic impact from the coronavirus, investors can take some solace that the U.S. consumer remains very healthy, central banks are accomodative (and ready to act), and the global economy is slower but still on a reasonable footing.

Our Market Cycle indicators actually improved during February, rising from 18 to 22 (Chart 6). In the table (Chart 7), we have included a number next to some indicators that denote if the signal moved from bearish to bullish or bullish to bearish. The spike in high-yield spreads was a '-1' as was the drop in emerging markets. However, Canadian valuations improved with the sell off and U.S. economic data firmed up across a number of metrics.

This is encouraging, but we should also add some caution. Of all the indicators, 18 of them are priced daily. In other words, this data is relatively live and the impact is more immediate. There are 12 indicators that are based on economic or other data that is released monthly. The monthly data will certainly start showing some coronavirus-related weakness in the coming weeks so we would expect the bullish indicators to decline.

Portfolio action – The Market Cycle indicators currently support the thesis that we are experiencing a correction and not the end of the cycle. Even if a handful of indicators flip bearish in March, this would still support our current thesis as 22 is a fairly healthy starting point. This does embolden us more to view the market drop as an opportunity and we have started to do some tactical opportunistic buying.

In a previous Market Outlook report entitled 'Challenging' (January 6, 2020), we had the following to say about an upcoming market correction:

"As we have indicated, we believe there is a heightened risk of a period of market weakness that could come sooner rather than later. This could be triggered by a resumption of trade tensions, improved economic data calling into question the level of accommodation from central banks, rhetoric around the Democratic primary race and nomination process, or some unforeseen surprise. If this occurs while our Market Cycle signals remain encouraging, we would view it as an opportunity to increase equity exposure."

The big question now is when?

Chart 6: Market Cycle remains steady

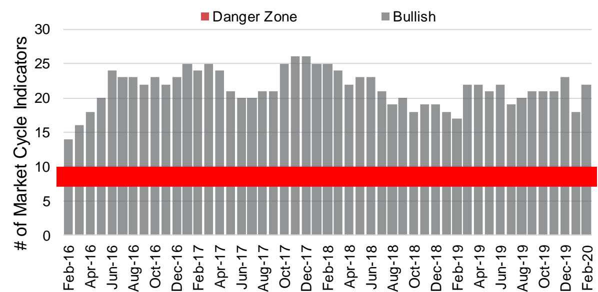


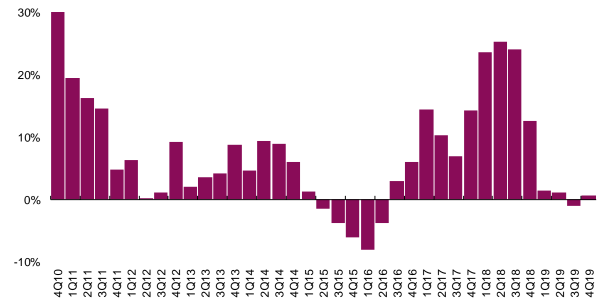
Chart 7: Market Cycle Indicators

Market Momentum	Δ				
Canada					✔
US					✔
Consumer Model			✔		
HY Spreads	-1		✔		
US Economy					
Leading Ind (3m)	1			✔	
Leading Ind (6m)	1			✔	
PMI	1			✔	
PMI New Orders	1			✔	
Cons Sentiment					✔
Cars	1			✔	
Homes					✔
Credit					✔
Chemical Activity				✔	
Rail			✔		
Energy Demand				✔	
Trucking					✔
Phili Coinc					✔
US Unemployment				✔	
Rates					
Fed Funds					✔
Yield Curve		✔			
Yield Curve Change		✔			
Fundamentals					
Valuation Canada	1			✔	
Valuation US			✔		
Earnings Growth					✔
Sales Growth					✔
Margins					✔
Global Economy					
CRB		✔			
Oil		✔			
Copper		✔			
Baltic Freight		✔			
KOSPI					✔
Emerging Mkts	-1		✔		
Global PMI				✔	
Total		6	5	10	12

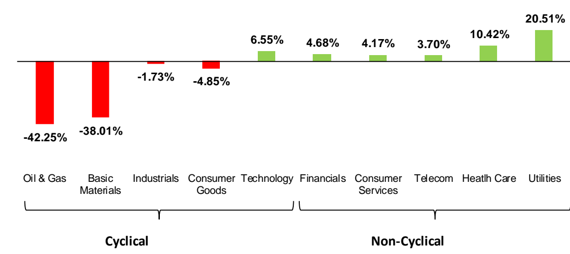
III. Do earnings even matter?

The 4Q 2019 earning seasons is nearing its end amid a tumultuous correction. Thus far, 95% of companies in the S&P 500 have reported, and the actual numbers are leaving many investors with much to be desired. Last quarter exhibited little in the way of EPS growth, to the tune of a mere +0.6%. Given how much investors had been willing to bid up valuations, it was clearly not on the back of earnings growth. It's also worth noting the disparity in earnings growth between cyclical and less cyclical sectors. Clearly, slowing global economic growth is having a disproportionate impact (Chart 8).

Chart 8: Q4 S&P 500 earnings, 95% complete, and showing yet another quarter of no growth

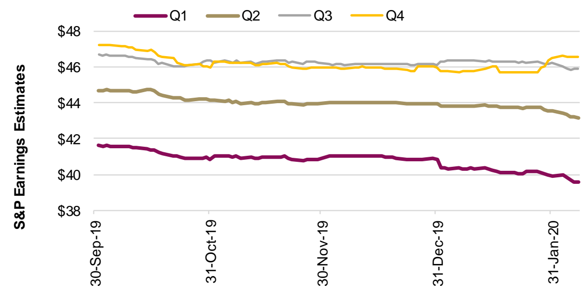


EPS Growth By Sector



As fears that the coranavirus/COVID-19 will expand from an epidemic to a pandemic heighten, earnings estimates for 2020 are starting to come down. Uncertainty breeds uncertainty – which is what many U.S. corporate management teams have acknowledged. Many companies have opted to pull their guidance outright based on their having little to no clarity on the extent of the virus's impact on their global business activity. Given we are only a couple of months into 2020, we are already starting to see S&P 500 earnings estimates revised lower. So far it has been mainly Q1 and Q2 earnings that have taken the lion's share of the revisions, but this may be pushing the return of earnings growth farther out (Chart 9).

Chart 9: S&P 500 earnings estimates for 2020 continue to be revised lower



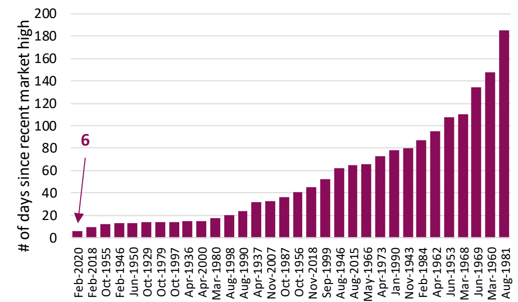
Now, we should admit that negative revisions were also widespread in 2019 due to an observed weakness in economic data. However, we have a firm conviction that the weakness we're observing in the soft economic data will eventually bleed into the harder data, at least for the first half of the year. Hence, we expect the pace of these downward revisions to continue as consensus estimates are slowly adjusted to reflect the uncertain global market. The pick-up in earnings that the market expected in the back half of the year, therefore, may come in at more muted levels or not at all.

U.S. equities, even after the recent abrupt correction, are still priced at the higher end of their historical range. Currently, the forward price/earnings ratio of the S&P 500 sits at ~16.4x. This is better value than a few weeks ago, but clearly not screaming value. The big question will be whether the market looks past a soft patch in economic data and earnings as a temporary blip or not.

IV. Portfolio positioning

Do you know which sport can often be the most expensive to play? Bottom fishing. We have now experienced the fastest correction in over the past 100 years, measured by the number of days it took the S&P 500 to drop from its high to the -10% correction threshold. There is now value in the market but a ton more uncertainty. Our correction indicators are flashing a 'buying opportunity' and Market Cycle indicators remain healthy. However, we expect these to deteriorate to a certain degree in the coming weeks/months.

Chart 10: Fastest S&P 500 correction in history



We have started to do some tactical opportunistic buying given the number of oversold equities and, conversely, overbought bonds. However we are not upgrading our equity allocation from market weight just yet. We acknowledge the economic data in the coming months will take a hit (China's February PMI of 36 is a good example). But if the virus/pandemic issue fades over the next few months, the data should rebound. We believe the market will cue off the trend in confirmed cases outside China. That is likely the most important number for the coming week(s) and it is rising. Valuations have become more compelling in some pockets but the overall market is not cheap.

This has us doing some selective buying as denoted in the nudge of equities to slightly above market weight and nudge of cash slightly lower (Chart 11).

Chart 11: Market Cycle Indicators

Overall Asset Allocation	-				+
Equities				■	
Fixed Income		■			
Cash				■	
Global Equities	**-**				**+**
Canada		■			
U.S.			■		
Euro Area				■	
Japan			■		
Emerging Markets	■				
Fixed Income	**-**				**+**
Canada		■			
U.S.			■		
Government			■		
Investment Grade		■			
High Yield	■				
EM Debt	■				
Prefs		■			
Duration		■			
Credit	■				
Currencies	**-**				**+**
CAD Short Term (3m)				■	
CAD Longer Term (1yr)		■			

Charts are sourced to Bloomberg L.P. & Richardson GMP unless otherwise noted

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