North American Management

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INVESTMENT
LETTER

## Time Travel

The pace of events since COVID-19 awareness finally took hold in the U.S., and since global stock markets peaked on February 19, has been dizzying and often disorienting from every perspective — that of victims, first responders, medical personnel, citizens, businesses, governments, and investors. Things that feel "out of sync" today include: 1) the ratio of patients to hospital beds; 2) global supply chains for essential items like ventilators, masks, PPEs and yes, toilet paper; 3) equity-price gyrations versus long-term company fundamentals; 4) buyers, sellers and market-makers in the bond market; and lately, 5) the ferocious snap-back of global equities versus politicians' war analogies and dire headlines about economic depression (see table below). Most unsettling is the fact that coronavirus infections and mortality to date have far outpaced vaccine development, proven palliative therapies and testing. The age of just-in-time inventory management, miracle vaccinations and high-speed securities trading suddenly feels less dynamic and rather brittle.

*"The coronavirus has produced something new in economic history. Never before have governments tried to put swaths of national economies in an induced coma, artificially maintain their vital organs, and awaken them gradually."*

*The Wall Street Journal*
*March 30, 2020*

Financial market adjustments to these new realities have been abrupt and volatile, leaving investors with little time for preemptive measures amid a stunning lack of liquidity. By March 23, the S&P 500 had closed at 2237, very near its December 6, 2016 price, down 35% in just twenty-three trading days. Sixteen days later the S&P had risen 27%. Like fictional time travelers, we arrived here quickly but almost nothing is what it seems.

*March was perhaps the most volatile month in U.S. stock market history. The average daily move in the S&P 500, up or down, was a shocking 5%.*

| Index Total Returns as of March 31, 2020 | 1st Quarter | 1-Year Return | Mar 23-Apr 14 2020 |
|---|---|---|---|
| Barclays Bloomberg U.S. Agg. | 3.2% | 8.9% | 3.2% |
| MSCI USA Quality | -15.1% | 0.7% | 26.8% |
| MSCI USA Minimum Volatility | -17.3% | -6.5% | 28.9% |
| S&P 500® | -19.6% | -6.9% | 27.4% |
| MSCI All Country ex USA | -23.4% | -15.5% | 20.8% |
| MSCI USA Value | -25.9% | -16.9% | 28.0% |

## Disorderly Bond Markets

Ample liquidity conditions allow investors to transfer assets with minimal impact on price. The housing market, for example, is highly *illiquid*. Houses can take months or even years to sell, the difference between a buyer's bid and a seller's asking price can be 5% to 10% in normal times, and the seller usually pays high fees to a broker. In February, investment-grade bonds could be sold instantly with minimal transaction costs. In the depths of panic selling in March, however, the distance between buyers and sellers of investment-grade corporate bonds was about 5% and for high yield bonds it was sometimes 10% or more. Although most could still be sold quickly, in late March U.S. corporate bonds were by one important measure, at least, as illiquid as houses and fixed income plumbing problems were evident everywhere — in municipals, in securities backed by mortgages, credit cards and auto loans — even in U.S. Treasuries. Thus began the largest peacetime government intervention in history, a massive $8 trillion (and counting) injection of shock and awe to the U.S. economy. As fixed income liquidity conditions gradually thawed and some measure of investor confidence returned, equity markets responded to the change of sentiment.

## Our Perspective — Quality Persists

The U.S. economy is now echoing the kind of unprecedented disruption that financial markets experienced in March. By April 11, 22 million people had filed unemployment claims, which means roughly 13% of the U.S. employment base has been laid off in a month — another ugly, unwelcome record. Amid the tragedy, there are important portfolio implications to consider in the short term, now that earnings season is upon us:

- Owning companies with strong balance sheets is important, because not all businesses will be affected equally. Companies with leveraged, asset-heavy business models that thrive on dense populations spending freely (cruise lines, hotels, casinos, chain restaurants, malls and airlines) are at the epicenter of two crises, credit and medical. Avoiding or minimizing exposure to these types of operators has benefitted investors.
- While the duration of the pandemic and its precise impact on corporate earnings are at present unknown, vaccine testing on humans has already begun. In addition, antiviral therapies will continue to be tested and hopefully a consensus will develop around their use and efficacy.
- The first point above is a reasonable hedge against the timing and inherent unpredictability of the second. While all investors are betting on a positive outcome, some bets are riskier than others.

Longer term, there are potential changes in store for the global economy that could also affect portfolios. First, trends already underway that are shrinking retail footprints, reassessing global supply chains, changing energy delivery and digitizing healthcare records may now be hastened by greater pandemic awareness. Second, it is not too early to think about how the rate of withdrawal of enormous government programs, designed to bridge the gap between infection and vaccination, might affect the next business cycle. Too much debt and too much government involvement in the private sector may crowd out new investments, lowering productivity and growth (read: Europe). Their potential effect on currency and inflation cannot be understated and will contribute to asset allocation discussions in the months ahead.

*We are focused on:*

- *Maintaining portfolio diversification with disciplined portfolio rebalancing among asset classes, equity risk factors, managers and individual securities; and*
- *Identifying compelling opportunities for clients amid various recovery scenarios.*

While no one wants this heartache, isolation and uncertainty, there may be a silver lining. Because a “forced” recession has occurred before the usual suspects (structural imbalances and asset bubbles) could take their fullest toll, we might avoid a more protracted period of adjustment. The rapid, coordinated, almost preemptive government response will certainly help.

**Robert G. Scott**
*Chairman & CEO*

**Fraser J. McLean**
*Chief Investment Officer*

## Endnotes

Sources of graphs and data not specifically cited: FactSet, Strategas Research, MSCI and Blackrock. Referenced indexes in U.S. Dollars, unless otherwise stated. All equity returns include reinvestment of dividends. The MSCI Factor Indexes are rules-based indexes that capture the returns of systematic factors such as low volatility. All return data through March 31, 2020, unless otherwise stated. All data is in U.S. Dollars (USD), and Total Return represents the sum of the dividend, changes in earnings and multiple estimates for each ETF. Investors cannot invest directly in an index, nor is an index subject to fees and expenses associated with investment funds or accounts.