SFA
Santa Fe Advisors

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The Coronavirus Panic of 2020

Black Swans and Asteroids

Financial market commentators often refer to black swans, a metaphor for extremely rare events that are virtually impossible to anticipate and which have a very significant market impact. Asteroid is another metaphor for the same phenomenon – certainly financial markets and the global economy have shuddered in recent weeks as if they have been hit by one. The financial and economic impact of the coronavirus pandemic has been particularly acute because it was unexpected, and thus represented a risk that was not reflected in market prices. Since a pandemic is an event with few modern precedents, it is not surprising that financial markets have been extremely volatile, as investors struggle to re-price risky assets amidst uncertainty about a future that will (at a minimum) involve a very deep multi-month global economic contraction.

As governments across the world rapidly shut down large portions of their economies in an effort to contain the spread of the virus, markets have attempted to estimate the depth of the contraction as well as the pace of the ensuing recovery, and to reflect the new expected reality in revised lower prices. While the record 11 year US economic expansion is now over and it is virtually certain that we have entered into a severe recession, estimates of the extent of the recession differ greatly: we have seen major banks estimate US unemployment peaking at rates between 15% and 32%, and GDP temporarily declining by anywhere between 10% to almost 40%. There are also wide variances in forecasts about the speed of the eventual recovery, with some forecasters predicting a sharp bounce when the economy re-opens, and others predicting multi-year stagnation and a slow pace of economic renewal. Against a backdrop of such widely differing opinions, we must be prepared for considerable volatility.

Rewriting History…Again

While the 35% high-to-low 2020 stock market correction is not particularly severe (in fact, it matches the historical average bear market correction, whereas stocks dropped 57% during the '08/'09 global financial crisis [GFC]), it is without precedent in its speed: this year marked the fastest 30% stock decline, the worst first quarter, and the 2nd and 5th worst weeks in US history. Foreign stock markets suffered similarly.

It's not just stock markets that have been hit hard. Oil has fallen 63% this year, hit by the double whammy of the global economic shutdown's demand destruction, as well as a supply glut as OPEC and Russia failed to agree to production cuts. In recent weeks, oil experienced the largest one day decline in 39 years (25%), as well as the largest one day gain ever (24%). Volatility and price declines of this nature are certain to hit leveraged energy companies hard, a fact that further weighs on stocks as well as on high yield bonds.

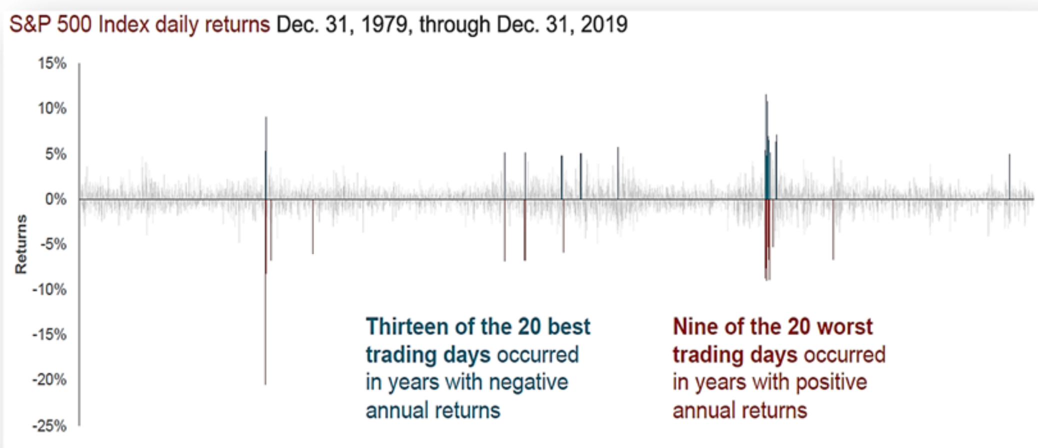
However, all is not doom and gloom. The governmental policy response, both in the US and abroad, has been rapid and massive. The passage of the CARES Act and other fiscal stimulus measures intended to cushion the shutdown's severity total well over 10% of the size of US GDP, and represent more than double the fiscal stimulus measures enacted during the entire GFC. On the monetary front, the Federal Reserve quickly cut short interest rates to essentially 0%, and enacted numerous lending facilities intended to keep money flowing freely and cheaply. Additionally, they swiftly embarked on asset purchases far broader than during the GFC. While these measures will come with a price (waste and far higher national debt among them), there can be no doubt about the speed and strength of the regulatory response. Essentially, the Fed is now buying most types of bonds, which will support their prices. And as lower risk bond investments become pricier, the Fed hopes that riskier stock investments will be perceived as being relatively more attractive, thereby attracting investor capital.

The last crisis had the benefit of creating a clear roadmap for policy programs that could support markets and the economy. The speed and scale of this policy action should mitigate the worst case scenario, a fact that should not be overlooked by investors. This is important since too often investors extrapolate the recent past, a tendency that can lead to complacency following a period of rising markets, as well as an inability to see the opportunities that emerge during every crisis.

Market Timing during Periods of Extreme Volatility

While we often note the importance of trying to think differently than the crowd, hoping to identify risk during periods of complacency and opportunity during corrections, this does not mean that it is advisable to try to trade amidst extreme volatility. The graph below illustrates the extent to which big up and down days in the stock market tend to be clustered together - and that many big up and down days occur during down and up years, respectively. This suggests the futility of trying to aggressively trade portfolios during periods of violent swings. Luck rather than skill dominates the results of such activity.

Graph 1



Source: Vanguard

Instead, the best approach is to have an appropriate amount of risk in portfolios in before a crisis hits, and to then take advantage of crises by patiently adding risk as lower prices present opportunities.

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High Yield Bonds and Armageddon

Along with stocks, all major asset classes perceived as "risky" (essentially anything other than the safest government bonds) were hit hard during the recent sell-off. High yield bonds were no exception, with prices on average falling over 20%, and spreads (incremental yield above Treasury bond rates to compensate investors for default risk) rising to levels rarely seen. It is possible to observe high yield bond spreads and to calculate the default scenarios that they imply: the spreads recently hit when high yield bond prices collapsed ***implied several consecutive years with defaults at the worst level ever experienced in a single year in history***. While such a scenario is possible, prices reflecting such a scenario provide significant cushion, and considerable upside for investors should a "less bad" scenario materialize. Graph 2 shows historical examples of high yield bonds' returns following periods when spreads hit similar levels, and suggest that the lows hit in March represented a significant opportunity for investors. Indeed, last week the Fed announced that they would be buying high yield bonds, which subsequently enjoyed a powerful rally.

Graph 2
Source: Eaton Vance

Our Positioning and Strategy

We entered the recent crisis with our portfolios positioned with a slight stock underweight relative to our strategic benchmarks, and roughly neutral overall risk positioning given overweights in high yield bonds and real estate securities. We had a significant underweight to US Treasury bonds, given the paltry yields they offered. Since Treasury bonds were basically the only asset class that rallied in early weeks of the crisis, our portfolios significantly underperformed their benchmarks during the first quarter. Over the last two weeks, our portfolios have benefitted and rebounded significantly. Additionally, during early March, we modestly increased our allocation to stocks. While we have contemplated and discussed levels at which we might make a second risk addition, for now we are comfortable with our portfolio positioning, which we feel is well positioned to benefit from a recovery in asset prices.

Thank you for your trust, and don't hesitate to call a SFA team member with any questions. We hope you and your loved ones are safe and remain healthy, and we look forward to seeing you in person when this crisis passes.

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