Hamilton-Bates
Market Update

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Summary: *The COVID-19 spread outside of China has sparked concerns the outbreak is evolving into a global pandemic, despite the WHO saying it is too early to re-classify. This has triggered a reassessment of downside risks which has seen a wave of selling wash across risk assets such as stocks.*

After seemingly ignoring the risks of the Corona Virus for weeks, the market flipped very suddenly from outright complacency to all out panic and risk assets were sold across the board this week as investors woke up to the realities of what has clearly been a huge mispricing of risk. Global stock markets had been remarkably resilient in the face of a double whammy demand and supply shock ready to hit economic activity, with investors taking an optimistic view that the virus outbreak would be contained within China and an impending cocktail of fiscal and monetary stimulus from the Central Banks would serve as a cure all. This week has shaken that complacency.

The Many Unknowns

It is far from clear how effective monetary stimulus and tax cuts will be whilst people are quarantined; and how will factories operate at reduced capacity and with many supply chain disruption. Uncertainty prevails. As investors have reassessed the real impact of the virus, the unwind in positioning has been violent, given the complacent positioning prior to the sell off and the increasingly stretched valuations that had left the market very over-extended and vulnerable.

The state of things is currently unprecedented and we do not have a good analogue to replicate, so the outcomes and ultimate impact is going to remain a moving target. We are not epidemiologists and don't pretend to be experts on viral outbreaks, so we stay focused on the data and until we see some sort of containment and verifiable recovery in economic activity, its better to advocate a more cautious stance.

The Fed

The Fed continues to sit on the sidelines for now, and recent musings from Dallas President Kaplan have said the Fed isn't likely to move right away. With so much riding on the performance of the market as a barometer of the economy, the market has the Fed over a barrel and they will eventually be forced to take action. We'd expect a cut or announcement of supportive monetary action shortly. Likely the first move is a continuation of their short-term repo plan which they had planned to end.

Market Outlook

Price action will continue be highly susceptible to virus related headlines as fears ebb and flow. We simply do not know how elevated the tail risks are at this stage and cannot rule out further panic selling. **The spread of the virus beyond China now means more transparent reporting from countries like South Korea, Croatia, Switzerland, Spain, Austria and Italy which could further heighten volatility and risk aversion–OR-it could help conditions as mortality rates outside of China fall dramatically.** As global markets finally face-up to the facts, its clear we are seeing a major disruption of the global supply chain, and earnings are likely to be affected. Just one week ago the markets were at all-time highs and a week later we are facing the worst week since 2008, and the fastest 10% correction since WWII.

Portfolio Strategy

The most important thing to do now is don't panic. For our portfolios we are doing some selective buying but only because we had raised a bit of cash at the end of January. The US market had become very extended from its long-term average (see chart on next page), which left it vulnerable to shocks. That is precisely what happened. Currently the market has now unwound much of those extended conditions, and risk has actually declined along with the market this week.

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Prices become more attractive as they move closer to and possibly below the long-term 200-day average.

Elevated cash levels and large bond holdings help to cushion portfolios during periods of volatility, and allow disciplined investors an opportunity to use the decline to position assets more advantageously. There is no need to panic out of stocks, but neither is there a need to panic into them. We'll be doing selective buying of funds and individual stocks over weeks not days, and in small increments.

Key support for the market is 3000 on the S&P 500. That is the area of the 200-day average and a zone of support. We'd expect to see stability around that area. We're still in a bull market right now and as of yet the long-term trend is not broken.

This is a severe human crisis and no doubt a severe test for the bull trend, but we do not believe the bull market is complete. The market is now extremely oversold and a relief rally is likely to occur very soon.

S&P 500 Chart

S&P Snaps Back to 200-Day Average

Markets mean-revert over time, meaning they follow a pretty well-defined trend and when they get to far above it or below it they tend to snap back toward that trend. To measure this we look at the distance or gap above or below the 200-day average. It is the red-line in the chart at left. At the January and February peaks the S&P was well over 10% above this trend level—a very extended condition which leaves the market vulnerable.

Those stretched conditions were wiped out in a about a week, as the S&P has fallen 10% down to its long-term trend. We have bought on each major down day over the past week. The market is now very 'over-sold' and some sort of rally is likely to develop over the next week. At the very least, periods where the major averages fall to or below their 200-day averages were 'buy' points in a bull market.