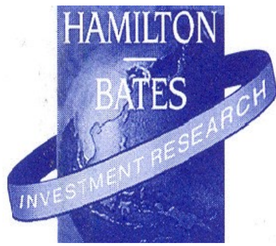

Hamilton-Bates

Market Update

March 16, 2020

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The coronavirus has spread beyond Asia to virtually every country in the world, and the pandemic will have a stifling effect on global growth. The Federal Reserve is doing all it can to provide liquidity to the markets and ensure stable financial conditions, but no amount of rate-cutting or quantitative easing will make a difference in the progress of the virus. Until the spread of the disease is arrested, we will be in uncharted waters as to the length and severity of the human and economic impact.

Nothing in our collective experience compares to the circumstances that we now face. In just a very short time we went from going about our days to now having the soundness and safety of our lives and those of our friends and families is threatened in a fashion nearly none of us have faced.

The Spanish Influenza and the polio epidemic stand as examples where we have pulled together to not only survive but ultimately conquer the threat to our common welfare. Everyone needs to practice the appropriate prudence for the protection not only of your health and that of your friends and loved ones but also for our neighbors and communities.

It is human nature that our surroundings and situations affect us and our emotions, and those emotions in turn affect our investment decisions. We feel good so we take more risk than usual, we feel threatened, we take less or even none—moving assets completely to cash. We take solace in the fact that our investment process will guide us through this challenging period. We have maintained the discipline of our investment process and it has already helped reduce portfolio volatility and drawdown significantly.

What is an investor to do when confronted with such a highly fluid and potentially overwhelming situation? In the following we'll lay out our thoughts and steps investors can take to get through whatever challenges that lay ahead.

Investors with long-horizons or the ability to let assets sit for 5 years or more.

If you're a young investor in a 401K or your retirement is 5 years out or move, history suggests you should do nothing. The market will come back. Why? Because humans get through tough situations and move on—its what has let us survive through millennia. <u>If you bought the top of the market in 2008 and sat through a gut-wrenching 50% decline, you were whole in 2012</u>. If you have a long-time horizon and are also making contributions—your recovery period will be earlier as you buy more and cheaper shares. Anyone in their 20s-30s to early 40s and in a 401K plan would be in this group.

Managed Accounts

For accounts that we manage we were fairly defensive heading into 2020, for reasons more technical in nature than having anything to do with the Corona Virus. Our work told us the market was pretty extended—and that after the late 2019 run-up that stock prices got ahead of themselves. That condition left stocks vulnerable to nearly any bad news, and starting in late January we got a lot of it. The majority of our managed accounts have had 60% or less exposure to stocks, most 50% or so. Bonds act like ballast keeping your portfolio steady, as well as dry powder to put into stocks at lower prices. Most managed accounts are down 1/3 to 1/2 as much as the market. We have a lot of dry powder. We have to decide when and how to deploy it.

Economic Outlook

The disruption of the Corona Virus is likely to tip the economy into a recession, the depth and severity depending on how long the disruption and how severe it becomes. We do know that the US economy was on firm if not robust footing through February, shown by the strong Feb Jobs Report. Government stimulus and support is likely to start and keep coming throughout the duration of disruption. The US economy also has a history of rebounding very quickly from set-backs.

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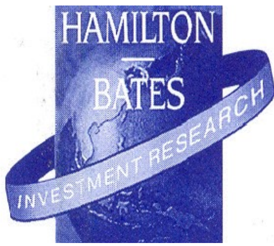

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No matter how long it lasts governments around the world will do whatever they can to boost their economies and their stock markets—all governments know their markets are reflections on their governance. Believe me they will do what it takes to boost prices. Japan's Central Bank has bought Japanese stocks and it can and would happen here as well. In the long-term the market will be higher.

Market Outlook and Investment Strategy
We can't all live in the 'long-term' and we must get through the next few months and quarters. For investors and money-managers, at least the best of them, a guideline of assumptions and a plan of action based on how events unfold helps guide things in a systematic way. In our view there are 2 scenarios from here, as our hope for a scenario where we avoid it entirely is passed. The two options are based on severity and length of disruption, and their descriptions are as follows:

Option 1
The corona virus disruption lasts 2 quarters or so, and is mild to moderate—with significant disruption to economic activity during the outbreak but things normalize quickly thereafter. Government support is broad and helps most get through without job losses from good companies going under due to lack of activity from the virus.

Schools and businesses are closed temporarily (for weeks not months), and people that can work from home do so. Life is disrupted moderately but after 2-4 weeks of social separation the spread is no longer geometric. We have what is in effect a very, very bad flu season with many people sick and deaths about what we have in a given flu year but less people affected. People will stop going out and take precautions so as not to get sick or get loved ones sick. Life is on lock-down or partial lockdown for 4-8 weeks, but life starts to get back to normal by summer.

In this case the market is likely to bottom sometime in late Spring. **During a typical recession the market drops on average 30%. A drop of 30% from the peak would take the S&P 500 to 2350—a level it nearly reached last week.** In fact we saw a lot of buying come in as prices neared this level. Keep an eye on 2300 on the S&P 500.

Option 2
If the virus avoids attempts to slow the spread, and economic disruption is much worse, with lockdowns across much of the economy that last beyond the summer, the negative economic effects will be deeper and more lasting, likely lingering into 2021. This would stress the economic contraction and disruption that would put off any bottom in stocks until the Fall. In this scenario we would have even greater concerns for the many small businesses that would struggle greatly with any length of closure.

In this case the economic disruption could be deep enough to stress small and medium companies' balance sheets, and those concerns would send stocks lower than 2300 toward 2000 on the S&P 500. The Great Recession of 2008 was the most disruptive event in our financial lifetimes, and that saw a 50% decline. In this case we would be looking at a bottom in the S&P 500 between 1750 and 2000. It would be painful but the economy and market would recover just as it did then, and investors that have the chance to buy assets lower would shorten the recovery period needed considerably. **The majority of our clients were back to their 2008 levels by the end of 2009. Even Buy/Hold investors who held on through 2008 were whole by 2012.**

We are leaning on the situation pointing more to Option 1 right now, but we are prepared for events no matter how they unfold. Even the worst declines do not go down in a straight line, there will be pauses and partial recoveries along the way until the final low is reached. After a shocking 30% decline we would

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not expect a 'V' bottom here. We are likely to see a lot of chopping around between now and the ultimate final low.

For Investors Who Need to Sell
For investors who must sell, we'd suggest selling only to the level of finding your 'sleeping point'. If you don't need to touch assets for years we'd sit as tight as you can. If you definitely have need to take assets within the next two years, then you probably want to keep those assets liquid in cash. **2600 and above on the S&P 500 would seem good levels to sell.**

For Investors Wanting to Buy
For those looking to buy, S&P 500 Index funds at 'appropriate levels' would be the way to go. The 2300 area on the S&P 500 would be a level we'd consider for perhaps half of what you want to buy, keeping the rest dry. Buying index price levels prevents one from putting too much at risk at once. Buy a level and wait. As for individual stocks, many blue-chip companies have come way down; we prefer those with proven records, have lots of cash, and have little debt. Large-caps such as these would be our focus. [MSFT,UPS, ABBV, D, DIS, and WFC are a few examples]. Do not rush to pick a low, in markets or in individual stocks. Buy market levels saving dry powder for down the road. Do not rush to buy too soon—we can't say this enough.

Managed Accounts
For managed accounts our approach from here will be to remain cautious—market lows are usually a process not an event, and they take time to develop. We will look to continue to buy periods of weakness, and cut back on any rallies that seem too sharp or too soon. We'll continue to hold very high levels of cash and bonds, since as we saw in 2008, sometimes periods of volatility take longer than expected.

Take care of yourself and family. If anyone has any questions –anyone, they can direct email me at abates@hbir.com. I am happy to answer questions or help anyone as needed during what could be a very stressful time.

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