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Market Review
First Quarter 2020

The first quarter was marred by a health and financial crisis that is hard to fit into historical context.

With the benefits of hindsight, we know the first hospitalizations for the coronavirus occurred in Wuhan, China in December 2019. In January, it was confirmed that the virus could be spread by human contact; by month-end, Wuhan was put on lockdown and Beijing extended the Lunar New Year holiday. But despite continued spread, it was widely dismissed as an overseas problem that had repercussions for business that sourced and sold product in China. It wasn't until the number of new cases in Korea and Italy outpaced the increases in China in late February that global stock markets took notice. Europe became the new epicenter of the pandemic, ravaged by high mortality rates and overrun hospitals and staff. Now attention has turned to the unfolding experience in the U.S., which has well surpassed China in incidence and deaths. Virtually all of the West is in varying forms of lockdown under the rallying cry of "flatten the curve".

Not surprisingly, the economy has ground to a halt, and markets have suffered historic losses. In the first quarter, large and small cap stocks, as measured by the S&P 500 and Russell 2000 indices, fell -19.6% and -30.6% respectively. The peak-to-trough declines were significantly worse before stocks bounced into quarter end. In the resulting flight to safety, the yield on the 10-year U.S. Treasury bond hit a record low of 0.5%. Credit spreads ballooned. Volatility exploded. The price of oil also fell below $20 per barrel, hurt by faint demand and a less-than-timely breakdown of the OPEC+ alliance.

Because the deterioration was abrupt, most recent economic reports have been rendered irrelevant. One exception is the Department of Labor's weekly jobless claims, which saw an unprecedented increase in filings from 282,000 in the week ended March 14 to 6.6 million two weeks later.

The (financial) response to the situation has been astounding. In less than a month, the Federal Reserve essentially deployed its entire 2008 financial crisis arsenal – lowering interest rates to zero, reviving the quantitative easing program, and introducing a litany of new lending facilities. In addition, the President signed a record $2 trillion stimulus package providing assistance to families, small business, and affected industries into law. But while we applaud the measures, it is very clear that "stimulus" is a misnomer for "emergency aid".

At this point, the bottom line for investors is that there isn't much of a playbook for coping with a novel virus pandemic for which there is no innate immunity. There also isn't much precedent for assessing the impact of (extended) shelter-in-place protocol. All analysis is further complicated because it is hard to gauge the early success of the public health response and the sustainability of the improvement.

Thus far, the stock market reaction has been particularly harsh for *Consumer Discretionary* stocks amid store closures, de minimis traffic, and an increasingly fragile customer. By contrast, the *Health Care* and *Technology* sectors have fared better, under the guise that drug makers are the solution to the crisis, and technology vendors, the beneficiary of work from home policies and remote learning. The divergence at the extremes of the benchmark was not only seen at the sector level, but in valuation as well. Perhaps counterintuitive in a steep decline, valuation was not a positive differentiator of performance. In fact, the Russell 2000 Value lagged the Russell 2000 Growth index by -9.9% in the worst period for stocks since 2008. Within the Russell 2000 Growth index, the highest P/E stocks and non-earners again won the relative performance game.

It's not surprising that investors initially held tightest to what worked in the latter stages of the bull…but it's early in this bear market. This decline will undoubtedly take months, not weeks, to run its course and its complexion will change greatly. In the near-term, the market has shortened its focus, unable to look past the pandemic and its drag on the economy, and we think will retest its March lows. Forward earnings estimates continue to drop and Wall Street analysts will overshoot on the downside, much as they overshot on the upside.

The implication is that the market still has a long way to go in discriminating between the medium-term winners and losers. The high P/E growth stocks previously deemed "untouchable" will almost certainly prove vulnerable to business disruption and weakening investor perception. We also wouldn't be surprised if the disruption to healthcare operations and profitability is longer in duration than it is for many harder-hit industries thus far. Over the next few months, however, we expect investors will begin to come to grips with these changes. As that happens, investment horizons will lengthen and broad-based earnings growth should capture attention. After an eleven-year bull market in which the fastest growing companies perpetually outpaced more bottom-line focused businesses, we are convinced that earnings, balance sheets, and valuation will matter again and drive investment returns in the remaining months of this bear market and into the next bull.

Sources: *FactSet, GICS Sector Classification*

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S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. S&P 500 is part of a series of S&P U.S. indices that can be used as building blocks for portfolio construction.

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Index Definition Sources: *Standard & Poor's; FTSE Russell*

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