HIGHTOWER
Texas

An Unprecedented Shock

April 2020

Historic Fall-out from COVID-19

Key Observations

- Amidst all-time highs in volatility, the S&P 500 declined 34 percent from its February peak to its intra-month trough. With the decline came the quickest end to a bull market seen in history, ending the 11-year run in the S&P 500, which saw a 401 percent return over that time.
- Congress passed the $2.2 trillion "CARES Act" and the Federal Reserve ramped up asset purchases and rolled out lending facilities aimed at stabilizing financial asset prices and supporting household access to credit.
- The longest economic expansion ever likely ended in February, with expectations that the second-quarter contraction in GDP will be the most severe in history.

The emergence of COVID-19 in the U.S. as well as the subsequent measures to stem the spread of the virus sparked a rapid deterioration in markets and the economy that has no clear parallel in history. The U.S. economy is likely in the midst of the most severe contraction in recent memory, precipitated by widespread measures to shut down businesses and socially distance, all in hopes of slowing the acceleration of COVID-19. Fear and uncertainty surrounding the virus and expectations for a sharp decline in corporate earnings led to the most volatile month for equity markets in history ending the 11-year bull market. In response, the fiscal and monetary policy measures employed were swift and aggressive, helping to stabilize markets toward month-end.

Market Recap

The depth and pace of the equity market decline in March were historic. The S&P 500 500 fell 34 percent from its high in February in just 22 days. The index was in bear market territory, defined as a peak to trough decline in stocks of 20 percent or more. While the shift from a bull market to a bear market was the fastest in history, March also proved to be the most volatile month for the S&P 500 in history!

The CBOE VIX Index ("VIX") peaked at 82.7 on March 16, and fell to 53.5 on March 31, but remained well above its historical average. For context, 53.5 on the VIX implies average daily moves in the S&P 500 to be +/- 3.4 percent. As such, we believe this level of volatility is not suitable for tactical overlay strategies for long-term investors. Therefore, we favor adhering to a disciplined strategic investment philosophy anchored in fundamental valuations.

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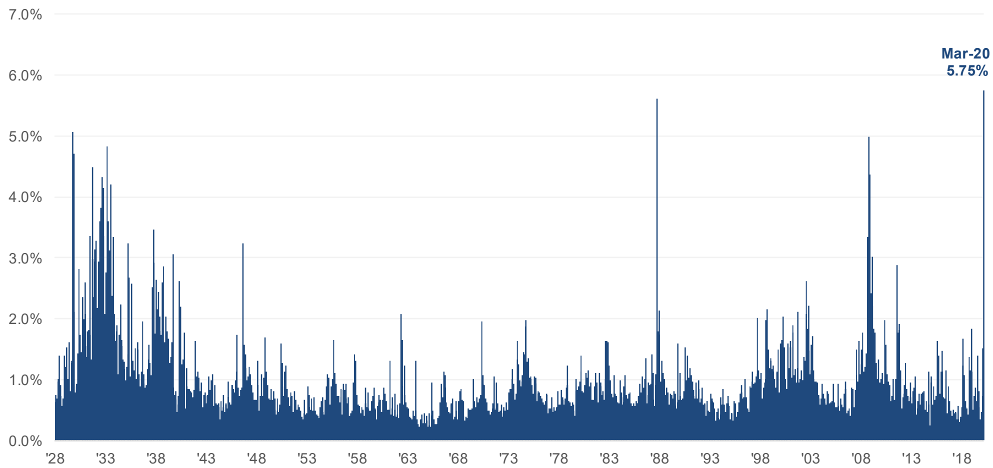
The Most Volatile Month Ever

If history serves as a guide, volatility in April could reach historic levels.



Rank	Month	Realized Volatility
1	03/31/2020	5.75%
2	10/31/1987	5.60%
3	10/31/1929	5.06%
4	10/31/2008	4.98%
5	03/31/1933	4.83%
6	11/30/1929	4.71%
7	10/31/1931	4.49%
8	11/30/2008	4.36%
9	09/30/1932	4.31%
10	07/31/1933	4.20%

Source: Yahoo! Finance. Monthly realized volatility calculated using daily price changes beginning in 1928.

No equity investment style or region was immune to the sell-off. Within the U.S. market, growth stocks outperformed value stocks, while large-caps outgained their small-cap counterparts. Losses outside the U.S. were modestly worse, with 13.2 percent and 15.4 percent declines for International Developed and Emerging Market equities, respectively. Dispersion in sector returns was wide, demonstrated by a 29.4 percent decline in global developed market energy stocks and only a 4.9 percent fall in global developed market staples.

Returns varied widely across fixed income sectors. The highest quality segments of the fixed income market benefitted from lower U.S. Treasury yields, but higher credit spreads weighed on corporate and emerging market debt. The 10-year U.S. treasury yield fell 43 basis points during the month to 0.70 percent, while U.S. corporate investment grade and high yield bonds fell 6.6 percent and 11.5 percent, respectively. Emerging market debt fell 11.1 percent.

A surprise decision from OPEC+ to increase oil supply exacerbated market volatility and sent West Texas crude down 46 percent to $20.5. In response to global COVID-19 mitigation efforts, the increase in oil supply coincided with lower expected demand. We will continue to monitor this dynamic and its effect on U.S. shale producers.

Policy Response

In late March, Congress approved the $2.2 trillion Coronavirus Aid, Relief and Economic Security Act “CARES Act.” The package includes small business loans and debt forgiveness, assistance to distressed industries, particularly airlines, one-time cash payments to individuals, expanded unemployment benefits and $454 billion to the Federal Reserve to cover potential losses from its lending facilities. For more information on details of the bill and how it may affect individuals and plan sponsors, please see, [In Focus: Stimulus (Hopefully) to the Rescue.]

U.S. monetary policy has been equally aggressive in its response to the pandemic. The Federal Reserve first cut rates by 50 basis points (bps) on March 3, and then by another 100 bps on March 15, bringing the Federal Funds rate down to zero. The U.S. Central Bank also pledged to buy unlimited amounts of treasuries, mortgage-backed securities and corporate debt.

Following recent measures, the Federal Reserve's balance sheet rose to a record high of $5.2 trillion, from its low in August 2019 of $3.8 trillion. The Federal Reserve took additional steps to act as the lender of last resort and restarted several facilities used during the Global Financial Crisis. It also created new ones to support the commercial paper market, primary dealers, money markets, the primary corporate credit market and the secondary corporate credit market. While early, these programs appear to be effective. We will continue to monitor the most vulnerable credit sectors for signs of trouble.

Central Banks outside the United States announced supportive measures as well. The European Central Bank unveiled a new €750 billion bond-buying program to buy government and corporate bonds. In comparison, the Bank of England cut interest rates to 0.1 percent and increased its bond-buying program to $752 billion. Meanwhile, the Bank of Japan said it would double its previous pace of stock purchases to $56 billion per month. In total, 63 global Central Banks took action in March.

Economic Data

The 129-month economic expansion – the longest on record – likely ended in the first quarter. J.P. Morgan expects GDP to contract only one percent in the first quarter, and to decline 25 percent in the second quarter. However, it's worth noting the economic fallout is unknown.

For example, Charles Schwab reported GDP forecasts for the second quarter range from -9.0 to -40 percent. The median forecast was for second quarter GDP was -12.5 percent. To put this into perspective, quarter-over-quarter GDP declines of five or more percent only occurred during the global financial crisis, the 1979 oil crisis and the 1973 oil crisis. While some economists estimate the unemployment rate may reach 20 percent, we acknowledge the future is unknowable and the economic fallout from COVID-19 is uncertain. However, we believe markets are forward-looking and may begin to reflect optimism once the health outlook improves.

Outlook

In the coming months, economic data and corporate earnings will begin to clarify and quantify the economic impact of COVID-19. Although economic indicators are likely to reflect some of the weakest readings seen in history, markets are forward-looking and price action will eventually reflect post-COVID-19 growth expectations.

Despite elevated volatility, we already see this in consensus earnings estimates for S&P 500 companies. Through March 31, 2020, estimates fell more than 17 percent to just 3.5 percent, but 2021 estimates were on the rise. At some point, we believe the S&P 500 will rebound (possibly sharply) on future growth expectations.

Since we cannot time markets, we think investors should stick to their long-term strategic allocations. Recall, tactical overlay strategies require an investor to time the market not once (to get out) – but twice (to get back in)!

Disclosures

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