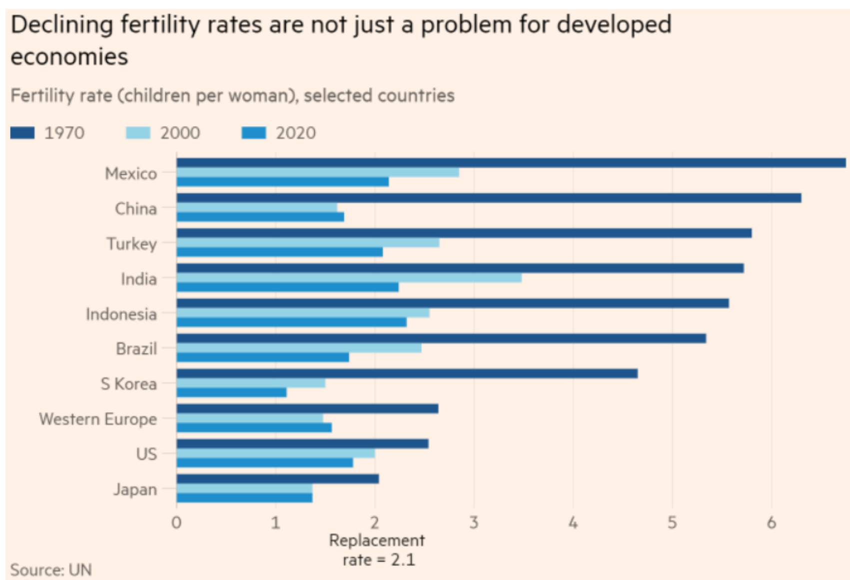
Investment Commentary: 2/2020

Stocks generally remained in rally mode the first half of January. Sentiment quickly shifted amid mounting fears about the spread of China's coronavirus, and markets experienced a global flight to safety in the month's final weeks. Among the major U.S. equity style categories, large-cap stocks were the top relative performers for the month with basically flat returns compared to small-cap stocks down 3.2%. Within the large-cap segment, growth stocks outperformed their value counterparts, up 2.2% vs. down 2.2%. Foregin developed stocks were down 2.1%, while emerging market stocks were down 4.7%. In both asset classes growth outperformed value.

"Markets experienced a global flight to safety in the month's final weeks."

"Risk-off" investing in the second half of January drove global yields lower and bond prices higher. The yield on the benchmark 10-year U.S. Treasury note dropped 41 basis points in January as investors fled risk assets amid mouning coronavirus fears. Against this backdrop, the U.S. Treasury sector was a top performer for the month. At its January monetary policy meeting, the Fed held rates steady and indicated it was unlikely to change rates in the near term. However, policy makers also suggested they were more inclined to cut rates than to raise them, given global-growth risks and weak inflation. This low rate environment and reassurances from the Fed have contributed to the recent outperformance of quality bonds and growth stocks. **In this month's commentary we touch on several topics: why we shouldn't be surprised by slower U.S. economic growth, an overview of the coronavirus, and a potential opportunity to invest in energy stocks.**

We Shouldn't Be Surprised By Slower Growth



The current economic expansion is 10 ½ years old and is now the longest in history. However, it has also been the weakest. According to Leuthold, real GDP growth since the mid-2009 trough has averaged just 2.3%, far below any previous U.S. expansion.

The length of the recovery has surprised almost everyone, but its sluggish pace shouldn't. Leuthold explains, it's mostly due to demographics. Growth in the working-age population has slowed dramatically in the U.S as it has in many countries around the world. In fact, labor force growth of around 1% per year combined with productivity growth of 1.0-1.5% per year suggests "potential" U.S. economic growth of 2-2.5% per year, and the rate for the current expansion falls right in the middle of that range. No big surprise!

It's important to note this isn't just an U.S. issue, we're seeing slower economic growth in many parts of the world that will impact global economic growth for years to come. Investors should keep the above chart illustrating the decline in fertility rates in mind when making investment decisions.

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The Coronavirus

The coronavirus outbreak has been widely covered by the media, so we're not sure how much we can contribute to the conversation. That being said, we recently listened to a Fidelity Institutional conference call that provided some insights that may be of interest and useful to investors. Here are the highlights:

What is a Corona Virus?

- Corona Viruses get their name from their crown-like shape. A corona virus can infect both animals and humans. It causes respiratory infection symptoms like nasal congestion, cough and sore throat. But if it spreads to the lower respiratory tract (windpipe & lungs), it can cause pneumonia in older people, people with heart disease, or people with weakened immune systems.

How does it spread?

- The corona virus spreads the was as cold-causing viruses do: through infected people coughing and sneezing, by touching an infected person's hands or face, or by touching things such as doorknobs that infected people have touched.

What has happened?

- On 12/31/19, the World Health Organization was alerted to several cases of pneumonia in Wuhan City, China.
- As of 2/9/20 the coronavirus has sickened more than 43,000 people in Asia and at least 1018 people have died, all but two in Mainland China. The disease has been detected in at least 24 other countries, most involving people who have traveled from China. The U.S. has 12 confirmed cases.
- Nearly 60 million people have been affected by partial or full lockdowns in Chinese cities as the country's government steps up its response. So far, the Chinese government has been more proactive than previous virus outbreaks.

Market Impacts

Global financial markets started to react to the news and sold off in late January. The Chinese government reacted quickly to inject liquidity into its financial markets and investors seem to be looking past the immediate impact of the outbreak. Goldman Sachs estimates global growth will be negatively impacted by the virus, reducing first quarter GDP by 2%. However, they estimate almost all of that lost growth will be made up by the second and third quarters of this year. The closest economic parallel to the recent virus outbreak is the 2002-03 SARS crisis, in that case the economic impact was relatively short-lived, supporting investor's decision to look past the current crisis. In terms of the financial markets the chart below suggests prior fear driven outbreaks and market sell-offs have often created good buying opportunities.

Summary

- There are still many unknowns at this stage on the new Coronavirus. However, if it repeats the pattern of prior outbreaks, its impact should be short-lived.
- The structure of the Chinese and global economies are vastly different today compared to what they were in 2002-03. Therefore the response of economies and markets could be different relative to the SARS epidemic.

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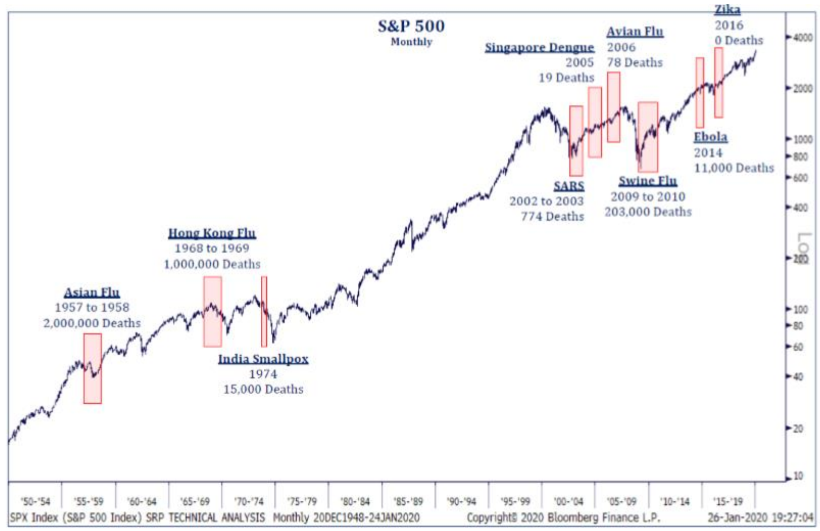
- The monetary policies across DM and EM central banks are currently easy. The synchronized nature of the current easing cycle suggests the global economy may get a lift. China recently injected huge liquidity into its financial system and may add more if needed.
- Even though financial conditions are positive, many asset valuations are towards the high-side, especially in the U.S. The best strategy for most investors is to stay the course and focus on the appropriate asset allocation that reflects their goals and objectives and will protect against the unknowns of the coronavirus.



Source: Strategas, as of 01/27/2020

In Search of Opportunities

Sometimes the best investment opportunities happen when things look their bleakest. When investors completely give up on a security or asset class it can drive valuations to extreme lows and create good buying opportunities. One sector that investors seem to be capitulating on today is energy. The table shows the energy sector has significantly lagged the S&P 500 and other sectors the past 10 years, up a meager 39% compared to the S&P 500 up 257%. Over that time, the weighting of energy stocks in the S&P 500 has dropped from close to 14% to roughly 3.8% today, which seems like capitulation to us. We recognize the sector faces challenges (over supply, cheap financing, transition to renewables, etc.) but at current levels we think the risk vs. reward warrants adding some exposure. Rather than try to pick the perfect stock, we'd suggest buying a broadly diversified sector fund for broad exposure. Most of which are yielding over 4%, more than twice the dividend yield on S&P 500. We think patient investors will be rewarded.

10 YEAR PERFORMANCE 12/31/09 – 12/31/19

	TOTAL RETURN
S&P 500	257%
Information Technology	402%
Consumer Discretionary	388%
Health Care	296%
Industrials	253%
Financials	218%
Consumer Staples	214%
Utilities	205%
Communication Services	151%
Materials	140%
Energy	39%

If you have any questions on this commentary or would like to discuss investment strategy give us a call.

- AWM Investments (February 2020)