Situation analysis

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Investment choices when markets are volatile

Investors face three major decision points

Investment choices in the current environment remain extremely challenging. Investors are faced with three major decision points: (1) continue within their existing asset allocation plan, (2) change their current asset allocation plan to be more conservatively-oriented or (3) change their asset allocation plan to be more aggressively-oriented. While investors can always make those three decisions, when prices move as much as they are fluctuating now, the choice appears to be more urgent. We will get into these decisions shortly, but first want to provide some capital market context.

Capital market backdrop and news flow

The news cycle remains extremely active. The COVID-19 (novel coronavirus) remains a human tragedy and our thoughts are with all those affected. Among ongoing concerns about the novel coronavirus and its attendant economic growth impact plus ongoing election speculation, on Friday, a new issue emerged: an energy market price war following discord between major suppliers including Saudi Arabia and Russia. These suppliers met in Vienna to discuss production cuts to stabilize oil prices in response to the coronavirus and decreased oil demand, but those discussions broke down and energy prices have moved significantly lower, with oil down over 20% as investors anticipate potentially increasing supply while demand falters.

Energy market developments have spilled into other markets, and the largest focus for right now is what is happening within credit markets. Credit, by our definition, is the flow of funds between lenders and borrowers, and ensuring that transmission remains intact is critical. Within the high yield corporate credit market, which represents borrowers with weaker credit profiles, energy-related companies make up anywhere between 10%-20% of certain indices that track the high yield market. This market is seeing some pressure this morning, and we will continue to monitor developments therein. We are also monitoring how credit markets are functioning in general given the low interest rate environment around the world and the acute move lower in interest rates in the U.S. and abroad.

Investment choices from here

Given the capital market backdrop and highly active news flow, what actions should you take? Our mantra during this episode has been to engage in a clearly defined hierarchy of actions. First, have a plan that ties your spending and saving with your lifestyle through engaging with your investment professional. Second, affirm your asset allocation matches your risk tolerance; while everyone wants to be an aggressive investor when markets are moving higher, periods like this make that posturing much more challenging. Third, ensure your bond portfolio, no matter what the allocation might be, is a high quality one. Finally, if you feel the desire and urgency to raise cash, have a plan for how and when to redeploy it.

We have also discussed four economic scenarios for the path forward:

1. V-shaped market and economic recovery – COVID-19 outbreak abates in a few weeks and the economy rebounds to pre-outbreak trends.

2. U-shaped economic recovery with an overall positive market – COVID-19 outbreak lasts months, with volatile but net positive market trends and incremental economic improvements.

3. U-shaped economic recovery with an overall negative market – COVID-19 outbreak lasts for months with limited improvement. Altered economic behaviors ultimately recover but uncertainty damages markets in the near term.

4. L-shaped scenario – COVID-19 outbreak turns into pandemic, changing consumer and business behavior. A global recession may emerge with markets dropping significantly, even from current levels.

Previously, we felt scenarios 1 and 2 were the most likely, but with the oil news from over the weekend and what that could mean for the economy in the near term, we must increasingly respect the possibilities for scenario 3. Scenario 4 remains a possibility, but we still view as the least likely at this point.

As markets opened sharply lower this morning, prices for major U.S. equity index prices have fallen roughly 20% from their February 19th highs; clearly a significant movement in a short time period. Markets are "forward-discounting mechanisms," meaning current prices for assets like stocks and bonds reflect views for how the future may unfold. The most important part of that sentence is the word "may." Of course, we do not know what the future will hold, and a lot of negatives are currently priced into markets, including stocks, bonds, currencies, and commodities.

We are hearing increasing discussions about policy responses, including the potential for coordinated monetary (interest rate) policies across major central banks as well as fiscal policy (levels of government spending and taxation) actions. Policy responses could target specific industries or be more broad-based, but we do not want to pin hopes on policy responses to drive stabilization in markets. Coronavirus outbreaks peaking and reversing remains the key variable driving markets, with credit issues within certain industries also gaining focus should we see deterioration.

Investment decisioning from here

A concept outside of our industry that we find useful to reflect on is homeostasis. This is a biological concept that speaks to the "tendency over time for a stable equilibrium between interdependent elements."[1] Interestingly, 11 years ago today, domestic stocks bottomed from their lowest levels following the Financial Crisis and Great Recession. During that time period, the number of interdependent issues surrounding the economy and capital markets were innumerate, and eventually markets and economies recovered through the confluence of consumers, businesses, and governments. We believe the current environment and psychology may resolve through the same interactions.

Sharp price movements can stir a desire to do something in response. In terms of taking specific actions with your portfolio, we would stress engaging with your investment professional to go through the steps we emphasized earlier. That process will help frame what decisioning may make sense for your portfolios: staying the course, getting more conservative, or getting more aggressive. We will continue to keep you updated on our thoughts as we continue to monitor the situation at hand, and as always please do not hesitate if we can help with anything. Thank you for your trust.

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[1] Dictionary.com definition, accessed 3/9/2020.