Market Commentary – Sharp Selloff amid Competing Crosswinds

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It's important to remember, rational or not, that in a world full of cascading and compounding events, sentiment regarding the correct current or future price of stocks and bonds can shift rapidly and suddenly.

What was seen as the cogent direction for securities one day is turned on its head the next when a blur of headlines changes the narrative of the economy, public health and government actions. Thursday's market action and heightened volatility was another example of the natural course of how market participants attempt to reset prices in an atmosphere of high anxiety and uncertainty.

It is human nature to try to quickly assign either causation or "blame" for Thursday's dramatic events that included a 6 percent drop in the U.S. large-cap-oriented S&P 500 Index, an 8 percent drop in the small-cap-oriented Russell 2000 Index, and a 13 percent drop in the yield for the benchmark 10-Year U.S. Treasury Note.

Based on the current narrative, the selloff's causal factors are as follows:

1) Market Sentiment / Stock Market Valuation
2) The Coronavirus
3) The Fed and U.S. Monetary Policy / Economic Outlook

Market Sentiment / Stock Market Valuation

In my opinion, the most likely reason for this sharp selloff was simply that there has been too much bullish sentiment building over the last month. As pointed out by Mark Hubert at MarketWatch, "Only this week did bullishness among short-term market timers start to reach a dangerous extreme; contrarians therefore were not particularly surprised by Thursday's decline. As recently as a week ago,

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short-term stock market timers were surprisingly subdued."[1] Bloomberg analyst Gina Adams warned just a few days ago about “overheated” and extremely bullish options positioning. Adams suggested that “stocks are likely to go through some short-term consolidation.”[2]

On Monday, the S&P 500 Index capped its fastest 50-day rally since the Great Depression to wipe out all its losses in 2020. According to Bloomberg’s Sarah Ponczek, “At one point, there wasn’t a single stock in the benchmark that was lower since the rebound began.”[3] The Nasdaq 100 Index surpassed 10,000 for the first time ever, and by Wednesday’s close, that index was up 16 percent this year.

MarketWatch’s Hubert suggests that, after this severe market selloff, it will take more skepticism to support higher stock prices in the near term. He notes that just a few days of extreme volatility could “do the trick”, but “it also could be a long, hot summer for stock investors.”[4]

Relative to history, traditional valuation metrics, such as Price-to-Earnings (P/E) ratios, are quite high now. However, as I have mentioned before, on a cash-return basis, the S&P 500 Index is not necessarily overvalued. When comparing the expected return for corporate debt right now in the face of the U.S. Federal Reserve’s (the Fed) actions to keep interest rates low and to suppress bond yields through quantitative easing, stocks appear reasonably valued.

That being said, ultimately for stocks, the biggest concern over the next three to six months will be corporate earnings. We won’t know just how bad this recession is, or how good this recovery may appear to be, until we see how earnings play out over the next two quarters. A consequence of ultra-low interest rates and bond yields is that the proportion that longer-term expectations contribute to current security prices is potentially higher than they traditionally would be in a higher-rate regime. So, if earnings aren’t as bad as feared, stock prices may have plenty of support as compared to credit.

Coronavirus

An apparent heightened concern about the persistence of COVID-19, and the growth of new cases in some U.S. states, can hardly be blamed for a dramatic selloff. It may be a convenient excuse, but it more likely is a resurgence of the media’s daily diet of fear-mongering designed to keep viewers. The “fear” is that a dramatic rise in cases would force states that are reopening to lock down again.

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[1] Marketwatch, Mark Hubert, “The real reason for the stock market’s 7% plunge shouldn’t surprise you – and it happens every time.” June 11, 2020

[2] Bloomberg, Sarah Ponczek, “Overheated Momentum Doomed Stock Market to Quick Reversal.” June 11, 2020
[3] Ibid.
[4] Marketwatch, Mark Hubert, “The real reason for the stock market’s 7% plunge shouldn’t surprise you – and it happens every time.” June 11, 2020

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In virtually all states over the last six weeks, significant increased testing for the coronavirus has revealed new cases, even as the percent positive rate decreases. Across the country, the most intense spread of COVID-19 continues in the same areas of vulnerable populations – long-term care facilities, prisons, and some lower-income urban neighborhoods.

In the U.S., the Case Fatality Rate (CFR)[5] from COVID-19 has been declining over the past four weeks.

Lately, focus has been on case growth in several states that "reopened early" such as Florida, Georgia, Arizona and Texas. Attention is also focused on COVID-19 case growth in California that has been, and still is, under some of most severe restrictions. Some states have seen increases in the overall number of people hospitalized with COVID-19, yet their hospital systems remain fully able to handle the current case load with room to spare.

Finally, headlines of certain high-profile public health groups modeling the path of the pandemic have played into the persistent anxiety about COVID-19. A recent update of one such model predicts wildly and scary levels of virus cases starting this September because schools and universities will return to in-class instruction. That model relies on some surprisingly bold assumptions that virus transmission will occur rapidly within schools, despite the fact that early studies show that children are not natural vectors for COVID-19. A child is more like to catch the virus from an adult than to give the virus to an adult.[6] Fewer children seem to get infected by COVID-19 than adults, and most of those who do, end up with mild symptoms, if any. But do they pass the virus on to adults and continue the chain of transmission? We will likely find out this fall when schools reopen to in-class instruction.

For the time being, as far as the coronavirus is concerned, the level of severe cases and fatalities will do more to dictate policy and behavior, and thus the impact on the economy than the absolute number of cases.

Analysts at Evercore ISI espouse that, at this point in the pandemic, one should focus on hospitalization levels and outcomes rather than the growth in the number of cases. If the level of COVID-19 hospitalization remains within capacity and doesn't meaningfully change over the coming weeks, this pullback in risk assets will "prove to be a buying opportunity."[7]

The Federal Reserve and Its Economic Outlook

The stock market's selloff and the treasury market's rally comes on the heels of Wednesday's June Fed meeting where Chairman Jay Powell issued dramatic forward guidance for the Fed Funds rate. The Fed's

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[5] Source: European Centre for Disease Prevention and Control. The Case Fatality Rate (CFR) is the ratio between confirmed deaths and confirmed cases It differs from the Infection Fatality Rate, which is the number of the disease deaths (confirmed and unconfirmed) divided by the total number of infected people (confirmed and unconfirmed).

[6] *Changes in contact patterns shape the COVID-19 outbreak in China,* Authors Juanjuan Zhang et al. Publication: Science. Publisher: The American Association for the Advancement of Science. April 20, 2020.

[7] Evercore ISI, Dennis DeBusschere, Unified COVID Charts. June 11, 2020

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assessment of the economy was also a bit weaker than the market expected. Powell struck a tone that was dovish and downbeat. He emphasized that, "(the FOMC) is not thinking about raising interest rates. We're not even thinking about thinking about raising rates."

The Fed's internal plan for the Federal Fund Rate is that it will likely remain effectively ZERO for the next two-and-a-half years. This is unprecedented. Powell is quite concerned about the labor markets. Despite the recent rebound in activity, the U-6 underemployment rate has tripled from 7 percent to 21 percent. Powell said that even if most laid-off workers get their jobs back, there will still be a significant group struggling to find work, and the Fed will provide accommodation in response.

The Fed's updated economic projections were more downbeat than many expected.

The Fed is now forecasting the U.S. economy as measured by Gross Domestic Product (GDP) will *contract by 6.5 percent* for the full year of 2020. They also are predicting the unemployment rate will still be close to 10 percent by the end of this year. All in all, the Fed comments see a very weak economy on the horizon, yet Powell has shown through the announcement and implementation of scores of new market support and lending programs that he is determined to maximize every tool possible to support the economy.

With the Fed giving no hint of raising rates, attention now focuses on the Congress and the President to see what kind of additional fiscal stimulus is in the offing for "Phase 4."

Conclusion

As I stated at the top, in complex situations such as a global pandemic or a worldwide financial crisis, investors tend to act quickly, but there are a wide range of interpretations – both short- and long-term. Social media has fueled the vast quantity of quickly spreading opinion and theory (though not necessarily facts) being circulated. Consequently, it's less clear that the initial market reaction is an accurate reflection of the eventual consequences.

As this new spate of severe market volatility returns, investors should remember these six things:

1) **Breathe, and Try to Relax** – Making rash decisions about portfolio changes during times of emotional stress often have negative future consequences and can potentially threaten long-term financial goals.
2) **Separate Fact from Opinion** – With thousands of "expert" voices within earshot, it's important to focus on the facts when reviewing market and economic stories in the media. The markets don't go up or down for one or two reasons – try to look beyond the scary headlines to get a better pulse of the agendas of those delivering the message.
3) **Remember Your Long-term "Why"** – Why are you investing for the long-term? Commonly, the reason is to set aside some current assets and income for future needs. Ask yourself, "Has that changed?"

4) **Discuss Your Fears and Concerns** – During this time of high anxiety and uncertainty, investors should actively engage their Financial Professional to gather their valued perspectives. Your Financial Professional can assist in re-examining or reviewing your long-term financial goals, and the plan to pursue them.
5) **Know Your Needs** – Investors should always know their needs for their money. If you need to use some of your investment assets in the short term for a major purchase or living expenses, it's wise to re-assess where those monies are located and into what they're invested.
6) **Stay Diversified*** – When appropriate, a well-diversified portfolio of stocks and bonds can often alleviate concerns about being invested in the right place at the right time. Properly allocating your assets among various asset classes and diversifying your portfolio among several investment vehicles is meant to provide you with a strategy that can reduce volatility.

According to Columbia Threadneedle Investments CIO Collin Moore, "The future is capricious, which is why forecasting is very hard and partly why financial markets exist in the first place. We should expect markets to try to anticipate complex future events, but experience additional volatility as those expectations change with events."[8]

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Martin Landry is the manager of the PMG and a senior portfolio manager at Avantax, where he oversees the planning, execution and success of the PMG, a role that includes implementing the VestAdvisor Select, IMS Select and RMS Select Portfolios discretionary model portfolios. Martin has over 21 years of investment experience. He began his career at Avantax in 2010 and previously served as an investment due diligence analyst and a portfolio manager prior to stepping into his current position in 2016.

Martin received his Bachelor of Science degree in communications from Texas A&M University — Commerce and his Master of Business Administration degree in management from the University of Texas at Tyler. After a 14-year career in broadcast television news as a video photojournalist, reporter, editor and producer, Martin was drawn to the financial services industry because of his interest in how the capital markets work and his desire to help others make sensible decisions regarding their savings and investments. He sees the responsibility of his current role as an important and humbling endeavor and appreciates the trust and care it entails. Before joining Avantax, Martin gained experience in the industry as a financial consultant at Merrill Lynch, a portfolio manager at Bank of America, and as a senior investment analyst at GuideStone Capital Management. He is a member of the CFA Society of Dallas-Fort Worth, the CFA Institute, the CIPM Association, the Investments & Wealth Institute, the Texas Chapter of the CAIA Association, and the Dallas chapter of the Financial Planning Association. He holds the Chartered Financial Analyst® designation and has passed the FINRA Series 7 and 66 exams.

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The S&P 500 Index is a free-float market capitalization index of 500 large publicly held U.S.-based companies, capturing 80 percent coverage of U.S. equities. It is often used as a proxy for the American stock market.

The Nasdaq 100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the NASDAQ stock exchange. The index includes companies from various industries except for the financial industry, like commercial and investment banks. These non-financial sectors include retail, biotechnology, industrial, technology, health care, and others.

The Russell 2000 Index represents the smallest 2000 stocks in the domestic-oriented Russell 3000 Index. It is often used as a proxy for small-cap investing in the U.S.

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