

Thursday was a difficult day within a difficult week. During the day, as markets plummeted, we heard some scary things:

- Thursday was the biggest single-day point drop in history for the Dow and S&P 500;
- The last six trading days represented the worst week since October 2008 (Financial Crisis);
- This correction was the quickest 10% decline from all-time highs in history; and
- 38% of S&P 500 stocks are in a bear market¹

While all of these things are true, at times like these, we need to remind ourselves that investing in the equity markets is a marathon, not a sprint. There have been 26 “corrections” since WWII (not including this one) with an average decline of 13.7% and an average recovery period of four months. During the most recent 11-year bull market, investors have been consistently rewarded for staying the course or even increasing their equity exposure after a correction.

To buy when others are despondently selling and sell when others are greedily buying requires the greatest fortitude and pays the greatest reward.

Sir John Templeton

Current State of Play

With markets on a blistering run since the end of the third quarter of 2019, it was finally tripped up by a biological “black swan” -- COVID-19. From an economic perspective with history as a guide, such an occurrence would typically cause a temporary economic setback with a concomitant “bounce back” of at least similar magnitude. Once identified and appreciated, markets usually adjust quickly to the new realities and deferred growth and eventually anticipate the recovery. While we believe this will ultimately be the case, other forces at work have made COVID-19’s impact harder to predict and quantify.

- We entered this downturn stretched from a valuation perspective, especially in the US. According to Bloomberg, since the beginning of the fourth quarter of 2019, the Forward P/E Multiple on the S&P 500 rose from roughly 17.8x to 19.4x through February 14, 2020.
- Meanwhile, corporate earnings growth had stalled since the second quarter of 2019 and a return to growth had been consistently pushed out farther into the future. With the most detrimental effects of the trade war behind us, most were expecting 2020 to finally deliver on growth’s promise. From our perspective, given how far the market had come, this was absolutely required for the rally to continue.

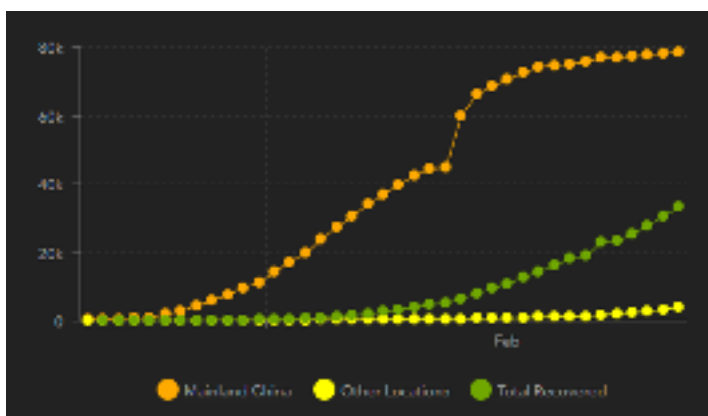
¹ Source: CNBC.

- Enter the Coronavirus. While diagnosed cases and associated deaths seem to be decelerating in China, the spread of COVID-19 outside of China in places like South Korea, Italy and Iran suggest that a new round of infections could be just beginning (see data from Johns Hopkins at right and link to their real-time dashboard -

<https://www.arcgis.com/apps/opsdashboard>).

This potentially leaves investors holding the bag for another quarter or two in terms of growth that hasn't materialized. On some basis, the market has a right to be disappointed.

- At the same time, Bernie Sanders has risen in the polls and some believe that he could actually beat Trump if he is the nominee. Not being political here, but this could lead to a scenario that the market really fears – a COVID-19 pandemic causes a recession that leads to a socialist being elected president and a sweep of both houses of Congress. If that were to happen, you might not get any “bounce back” at all. While this seems very unlikely, the probability is north of zero (unlike a few weeks ago).



Source: Johns Hopkins

Add into the mix the following:

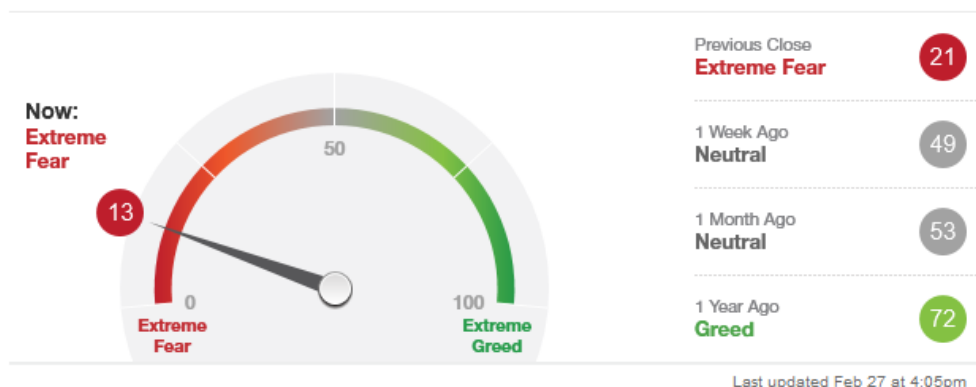
- US Treasury yields are falling, and falling fast. As of this morning at the intraday lows, yields on 10-year and 30-year Treasuries was 1.24% and 1.74%, respectively -- both all-time lows (by a lot). Keep in mind that two weeks ago the 10-year yielded 1.62% and the 30-year yielded 2.07%. Unprecedented. Much like the reaction in the summer of 2019, the equity markets usually react very negatively to such accelerated moves in bonds. What are bonds sniffing out that equities haven't yet priced in?²
- Finally, other than boosting confidence, many think the Fed can't do much to help. This crisis does not have a financial basis, it's biological. And, if the Fed reacts too quickly (by lowering rates before a meeting, for instance) this could be interpreted as a negative sign by the markets. So, the much vaunted “Fed put” is not as impactful in this situation.

While it was certainly reasonable to expect a pull-back of some magnitude as circumstances changed and greater uncertainty was added into the mix, the market's violent reaction certainly seems overdone. At this time, there are no indications that that such a “perfect storm” scenario is a high probability and that a recession is imminent. Yet, even before the opened Thursday, the market was massively oversold and it only got worse as the day progressed – closing at the lows. CNN Business' Fear & Greed Index is a good gauge of market sentiment and is often used as a contrarian indicator. By the end of the day it had fallen from an already low **21** to **13** – even farther into the “Extreme Fear” category.

² Source: Bloomberg.

Fear & Greed Index

What emotion is driving the market now?



This overreaction could present a significant opportunity. As long-term investors with a Bucket Strategy, we can have the confidence to take a contrarian approach and potentially capitalize on the advice of one of the world's greatest investors:

Invest at the point of maximum pessimism.

Sir John Templeton

This certainly seems to be a good time to review your portfolio allocation and risk appetite with your Lucia Advisor and consider whether it's appropriate, in a measured way, to take advantage of what appears to be a short-term dislocation.

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