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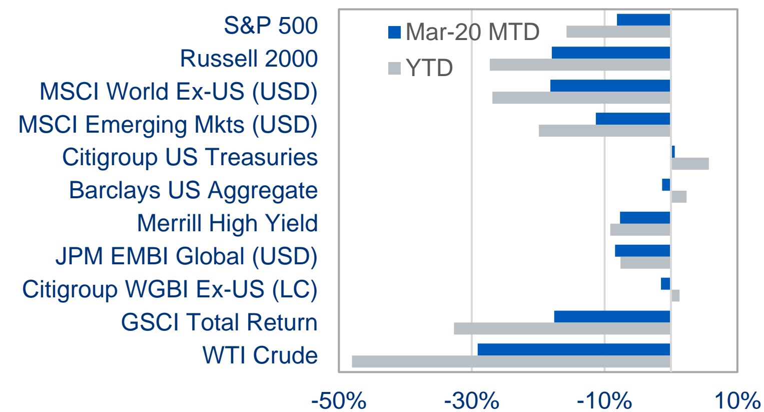
STRATEGIC THINKING • INSPIRED INVESTING

Market Update

The uncertainty created by the Coronavirus roiled markets in the two first weeks of March (Exhibit adjacent).[1] Last week saw the worst day in U.S. equities since Black Monday in 1987 and was the worst week in U.S. equity markets since the Great Financial Crisis (GFC). Non-U.S. developed and emerging equity markets also suffered steep declines. Equity and fixed income volatility indicators have spiked and there have been liquidity bottlenecks in the U.S. Treasury market, normally the world's most liquid safe haven. Yields on U.S. Treasury securities have collapsed across the maturity spectrum, reflecting expectations for declining growth and mounting disinflationary pressures. Credit spreads have widened, especially in the energy sector, and high yield markets are down. Commodity prices, led by oil, have plummeted because of expectations for a virus-induced global economic slowdown as well as a particularly ill-timed price war, which is flooding the market even as demand falls. Governments are taking a wide range of policy measures to contain the contagion and mitigate the economic impact of the containment measures. Notwithstanding a coordinated easing of rates and liquidity by the Fed and other major central banks on Sunday and this morning, global equity markets continue to decline. Through this period of turmoil, we remain committed to our disciplined, valuation-based approach to active portfolio management. We have taken taking advantage of the opportunities created by recent wide market swings to actively manage our portfolio posture.

Performance of Major Market Indices

Sources: S&P, MSCI, FTSE Russell, Barclays, Citigroup, Bank of America Merrill Lynch, J.P. Morgan, HFR, Bloomberg.



Extent and Evolution of the Contagion

As of Sunday, March 15, there were 153,648 confirmed Coronavirus cases worldwide reported by 146 countries. Deaths from the disease stood at 5,746. The evolution of cases in the most seriously affected countries has followed a similar pattern of an early period of rapid growth followed by a collapse in new infections and a plateauing of confirmed cases (Exhibit 1 below is in log scale to emphasize the rate of change). This pattern is most evident in the case of China, where the virus first appeared, and South Korea. In both cases, the cumulative number of confirmed cases has flattened, largely reflecting the massive containment efforts involving widespread testing and quarantines. In China, the time it takes for cases to double has stretched out to 27 days. In Korea, where containment efforts have also been vigorous, the doubling time has increased to 13 days. Elsewhere, notably in Europe and the U.S., confirmed cases are doubling in as few as 3-5 days.

[1] Unless otherwise indicated, return data are through Friday March 13, 2020 and expressed in U.S. dollar terms.

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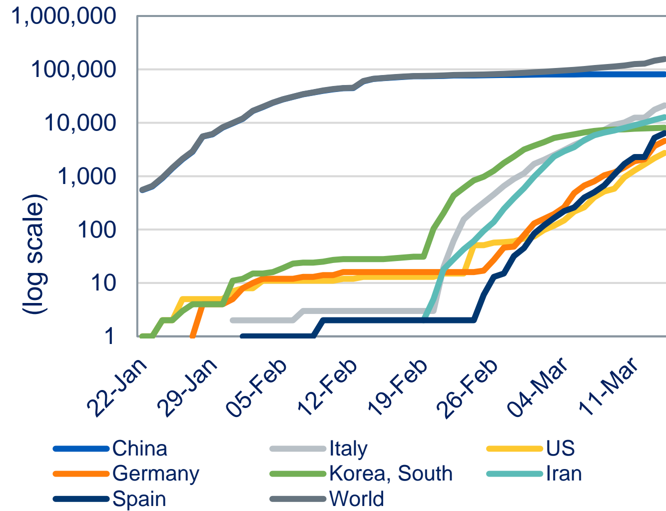
Exhibit 1. Confirmed Cases
Source: https://ourworldindata.org/coronavirus.



Global Economic Impact

The ultimate impact of the Coronavirus on global economic output depends on the extent and duration of the contagion, as well as the interaction between the sudden downturn triggered by the disease and underlying vulnerabilities. Most notable among these vulnerabilities are very high corporate and sovereign debt levels accumulated during a record long cyclical recovery.

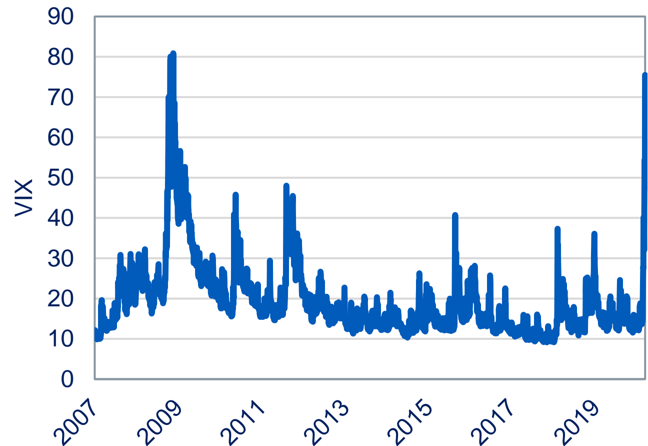
The Coronavirus poses both a supply and a demand shock. China is the world's second largest economy, accounting for a high share of global industrial output (22%), GDP (17%), and trade (11%). Its pivotal role in complex global supply chains means that a shock in China is widely felt, especially in industries like computers, electronics, pharmaceuticals, and transport equipment that are heavily reliant on Chinese intermediate inputs. On the demand side, China represents a high share of global demand for key commodities, including aluminum (55%), copper (50%), nickel, zinc, lead, rubber (40-45%), and oil (12%), and accounts for 9% of global tourism. Coronavirus' effect on confidence undercuts consumer and business spending, as well as business and leisure travel, further depressing demand. Containment measures that restrict mobility and large gatherings also hit consumer spending and businesses. Coincident economic indicators through February do not register the underlying impact of the virus on growth and employment outside of China. In China, recently released data show sharp falls in industrial production (13.5% yoy) and retail sales (20.5% yoy) in January and February because of disruption caused by far-reaching measures to contain contagion. High-frequency trade indicators, such as the price of Baltic freight shipping, suggest a large drop in the volume of international trade (Exhibit 2 below). So far, the most striking and reactive indicators of an impending slowdown have been the sharp fall in global equity markets, commodity prices, and safe haven bond yields (see below).

Exhibit 2. Baltic Dry Exchange Price Index
Source: Bloomberg.

Markets React to Heightened Uncertainty

Volatility spiked in equity and fixed income markets in March as the ultimate human and economic toll of the Coronavirus remained unknowable (Exhibit 3 below). Volatility in recent weeks has approached the heights seen at the worst of the Great Financial Crisis. A similar spike in volatility is also evident in the U.S. Treasury market, where yield swings have been wide, and at times reflected liquidity bottlenecks (see below).

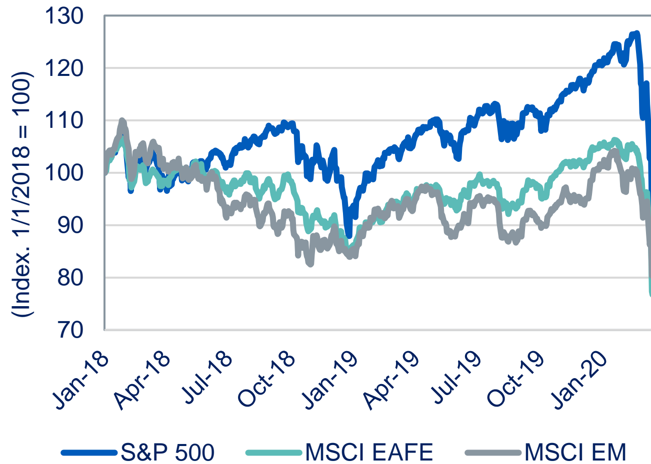
Exhibit 3. VIX Volatility Index
Source: Bloomberg.



The speed in the decline in equity markets has been particularly striking. The S&P 500 is down by 15.7% so far this year and 19.9% since its record high in February (Exhibit 4 below), having now fallen back to the level reached in February 2019. Small cap stocks have underperformed large, and value stocks have lagged growth so far in 2020. Non-U.S. equity markets have also declined sharply. Developed non-U.S. equity markets have lost 26.9% this year and are 28% below

their peak. Emerging equity markets have fallen 19.9% so far in 2020.

Exhibit 4. Global Equity Markets Plunge
Source: Bloomberg.

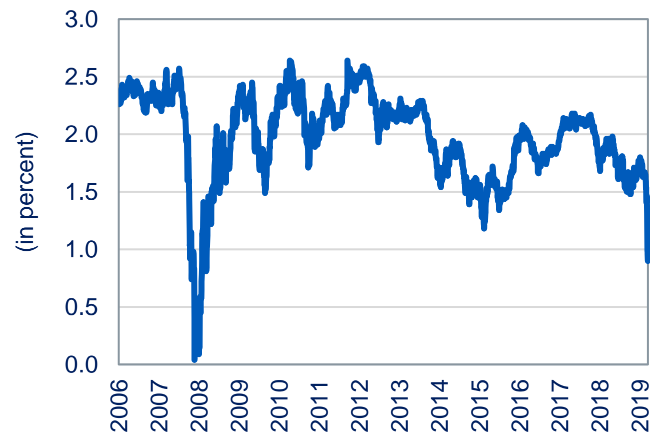


Amidst a flight to safety and fears of a sharp economic downturn, yields on safe haven assets have hit all-time lows. The yield on the 10-year U.S. Treasury note briefly touched 31 basis points intra-day, and the 10-year German bund yield fell to -55 basis points. The disinflationary forces expected from a Coronavirus-induced slowdown are evident in the sharp downward movement in U.S. Treasury yields and oil prices, which have also been buffeted by the unexpected supply surge of a price war (Exhibit 5 below).

Exhibit 5. Disinflationary Forces Evident in Oil Prices and Treasury Yields
Source: Bloomberg.

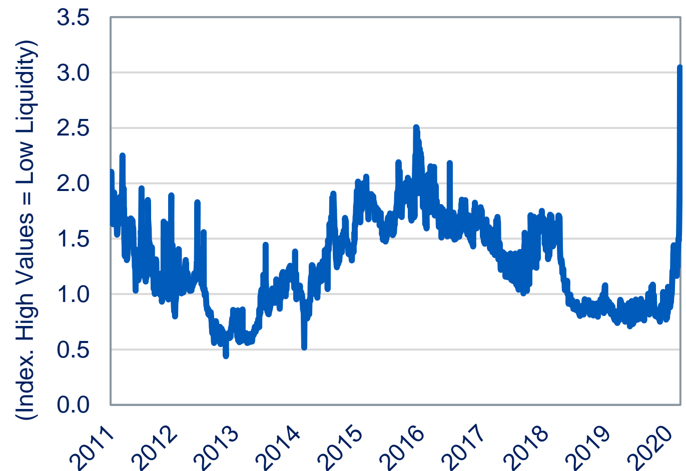
As a result of these forces, inflation in the U.S. is now priced by the TIPS market to average less than 1% over the next 10 years, a post-GFC low (Exhibit 6 below). The combination of falling yields and lower asset prices has resulted in a significant reduction in the funded status of U.S. defined benefit pension plans.

Exhibit 6. Implied Average 10-Year Inflation Rate
Source: Federal Reserve's Economic Data (FRED).



Trading volumes have been extraordinarily high, in part driven by resurgent volumes from retail investors. While trading has largely been orderly, there have been signs of illiquidity in the U.S. Treasury market, normally the deepest in the world (Exhibit 7 below). These have resulted in anomalous price movements across cash and futures markets and different asset classes. Most notably, U.S. Treasury yields rose during the height of the equity and credit market sell-off last week, a most unusual occurrence that highlights the extent of the liquidity strains. ETFs on bond indices have been trading at a large discount to underlying asset value, suggesting that the inherent tension between the liquidity of the underlying assets and that of the ETF is under strain in the current environment. Other evidence also suggests significant frictions in credit markets.

Exhibit 7. Bloomberg Treasury Illiquidity Index
Source: Bloomberg.



Policy Response Mixed, but Gaining Momentum

As markets were attempting to discount the scope and intensity of the looming economic slowdown, the global policy response had been, until yesterday, mixed and uncoordinated. In a surprise move on Sunday, the Fed cut its policy rate to zero, announced asset purchases of at least $700 billion over the next few months, and expanded swap lines to foreign central banks to ease dollar funding in moves reminiscent of similar measures during the GFC. The Bank of England, the ECB, the Bank of Japan, the Bank of Canada and the Swiss National Bank all announced measures to facilitate access to dollars for their financial institutions. In addition, central banks in the U.S., euro area, the U.K. and other developed economies have increased liquidity injections to promote orderly markets and ease financial conditions. China, Japan, Korea, Germany, Italy, the European Union and the U.S. have already increased or are about to significantly increase fiscal spending, while all affected countries have increased budgetary allocations to support healthcare systems and are considering targeted measures to help hard-hit businesses and households. Banks, public utilities, and regulators are exercising forbearance in the case of payment arrears. More measures are likely to be required as the contagion spreads. Despite the coordinated global monetary easing over the weekend and today, global equity markets suffered large losses in today's trading. With monetary stimulus already at its limit, fiscal policy measures will be increasingly important. Much depends on the effectiveness of the policy response.

Strategic's Guiding Principles

We are price sensitive, risk aware investors. This philosophy has served our clients well for over 30 years, starting from the firm's launch in the immediate aftershocks of the 1987 crash, and extending through dislocations including the Nikkei overvaluation, the tech bubble, the Russian default/LTCM crisis, 9/11, and the Great Financial Crisis. We express this philosophy both in collaborating with our clients to customize appropriate long-term strategic asset allocation policies for their unique needs, and in our ongoing active management of our portfolios.

In setting long term investment policy, the current environment reinforces the importance of our focus on broad diversification and liquidity management. While no portfolio can be fully insulated from a global growth shock, our portfolios are well diversified. Our regular practice of stress testing our portfolios has also shown its value in setting sound expectations, calibrating risk tolerance, and anticipating potential liquidity needs.

In actively managing our portfolios, we continue to be keenly focused on deviations between market prices and fundamental values. While forecasting the short-term evolution of the current crisis is extraordinarily difficult and unlikely to yield an edge, maintaining a focus on equilibrium over a multi-year horizon has proved to be a sound approach to adding value during the alternating waves of panic and elation that characterize periods of market stress.

Opportunities Created by Market Swings[2]

Our prior stance of protecting our portfolios from fully valued equity and credit markets has been rewarded through the current market stress. As global equities declined to our fair value levels and become slightly cheap, we have bought back our underweight and initiated a small overweight. While our underweight to already-expensive Treasuries has meant that we have not fully participated in their decline in yields, we have taken advantage of their move by making moderate additional sales of Treasury exposure, locking in unprecedented pricing. We are also initiating TIPS exposures targeting what we believe to be the significant underpricing of future inflation. As market prices continue to be exceptionally volatile, we will continue to be vigilant in seeking to identify and capture dislocations that pull prices away from fundamental value. Finally, we remain in continuous communication with our managers, through whom we target similar dislocations at the security level. We believe that the disciplined execution of our philosophy creates a very constructive outlook for alpha over a multi-year horizon.

Conclusion

The Coronavirus has created tremendous uncertainty and a cascade of direct and indirect effects in global markets. As we have done in weathering prior storms, Strategic continues to execute its investment philosophy with discipline and vigilance.

[2] The following discussion reflects Strategic's directional positioning in the current market. Positioning in a particular portfolio may vary from these indications due to differences in portfolio benchmark weights, liquidity needs, guidelines, and other factors. In addition, positioning may change significantly through time as both fundamentals and prices evolve.