SPECIAL INVESTOR UPDATE

April 7, 2020

Executive Summary

- Reports indicate that growth in new COVID-19 infections may be flattening in some of the hardest hit states and countries.
- Economic shutdowns, however, will continue as national and local governments seek to reduce the growth rate of new infections further and then avoid a second wave of infections.
- Consensus is for a deep recession into the second quarter, followed by a sharp recovery.
- However, we caution against making investment decisions solely on that scenario.
- U.S. equities saw their worst quarter ever, but markets were more optimistic by April.
- Expect more virus-related deaths, economic indicators to worsen, volatility to continue, and political wrangling to increase, before things get better.

Positive Signs Amid the Pandemic

While the world continues to battle COVID-19, there are finally signs of light at the end of the tunnel. New York, the hardest-hit state in the U.S., may be seeing a flattening growth curve of COVID-19 related deaths, although the number of deaths remained high.[1] Italy, the worst hit country, saw the growth of new virus infections decline, as did France, Germany, and Spain. China, the epicenter of the outbreak, is primarily concerned about imported cases now. Washington state had fewer infections than feared and will return 400 ventilators to the national stockpile. Deaths are expected to peak in the U.S. around April 16, according to a University of Washington model, while some states are believed to have already peaked.[2]

The economic shutdown will continue, however, as national and local governments seek to reduce the rate of new infections further and then avoid a second wave of infections. U.S. unemployment could hit 9% in the second quarter and could move above 20% in the following quarters.[3] Goldman Sachs believes that U.S. GDP growth was flat during the first quarter and projects that it will contract 5% (annualized) in the second quarter. However, the investment bank also projects a V-shaped recovery with GDP growing 3% and 4% in the third and fourth quarters, respectively.[4]

While the consensus is for a quick recovery in the second half of the year, the range of projections is wide, primarily because we have never seen such a rapid shock to the economy

[1] "Virus Toll in N.Y. Region Shows Signs of Leveling Off," *New York Times*. April 6, 2020.
[2] "When the Coronavirus Outbreak Could Peak in Each U.S. State," *Bloomberg*. April 6, 2020.
[3] "How high will unemployment in America go?" *The Economist*. April 1, 2020.
[4] "Goldman Sachs Predicts U.S. GDP to Shrink 5% in Second Quarter," *Bloomberg*. March 15, 2020.

and there are fears of a second wave of infections in the fall. The closest experience in the U.S. of a sudden stop in economic activity is the Great Depression, but as we have discussed in prior issues of *Market Matters*, the Great Depression was exacerbated and protracted by poorly informed and poorly timed monetary and fiscal policies. This time around, central banks and governments around the world have reacted more quickly and forcefully. The U.S. Federal Reserve recently lowered the federal funds rate to close to 0% and enacted massive quantitative easing. The U.S. Congress is discussing a second COVID rescue package and potential infrastructure stimulus package.[5] So far, the depth of the recession looks closer to that of Great Recession of 2007-2009.

We would caution against relying on a strong V-shaped recovery, but do believe the medium- to long-term outlook is positive. In the meantime, expect virus-related deaths and economic indicators to worsen, and U.S. partisan wrangling to increase as an election approaches, debt increases markedly (potentially foreshadowing higher taxes), parties disagree on how to deliver aid, and calls increase to restart economic activity.

Markets See the Light

While U.S. equities saw their worst quarterly performance in history, markets have been more optimistic since late March, albeit with significant volatility. That optimism has continued this month as the S&P 500 Index rose over 7% on Monday, April 6. The VIX index, which measures expected volatility and is known as the "fear index," came down from an all-time high of 84 on March 18 to close at 66 on March 31 and 45 on April 6.

J.P. Morgan estimated that the 12-month forward price-to-earnings ratio for the S&P 500 Index is 15.2 as of April 6,[6] compared to a 25-year average of 16.3. J.P. Morgan's research indicated that the below-average ratio usually results in positive returns in the following five years.[7] However, not all future declines in earnings may be factored in. FactSet projects that corporate earnings declined 5.2% year-over-year in the first quarter; will decline 10% and 1% in the second and third quarters, respectively; and will end the year with a 1.2% overall decline.[8]

Given the uncertainty and potential further volatility, we believe that a dollar-cost averaging approach is appropriate.

[5] "Pelosi eyes end of April to bring a fourth coronavirus relief bill to the floor," *The Hill*. April 4, 2020.
[6] "Weekly Market Recap," *Market Insights* from J.P. Morgan Asset Management. April 6, 2020.
[7] "Guide to the Markets," *Market Insights* from J.P. Morgan Asset Management. March 31, 2020.
[8] "S&P 500 Now Projected to Report a Year-Over-Year Decline In Earnings In Cy 2020," FactSet. March 30, 2020.

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Correction

In the previous issue of *Market Matters* we included a table showing the performance of the S&P 500 Index following the prior six occasions in which the index declined more than 30% from its peak. We indicated that returns excluded dividends, when in fact some did, which resulted in incorrect averages. We apologize. Below is a corrected table with returns and averages excluding dividends.

Change in S&P 500 Index After a 30% Decline from Peak						
Market Peak Date	30% Threshold Breach Date	3 Months Later	6 Months Later	1 Year Later	3 Years Later	5 Years Later
9/16/1929	10/29/1929	9.4%	21.1%	-14.1%	-65.3%	-57.1%
11/29/1968	5/14/1970	-0.3%	10.5%	35.5%	40.4%	22.3%
1/11/1973	7/5/1974	-25.5%	-15.5%	12.8%	19.6%	22.4%
8/25/1987	10/19/1987	10.9%	14.7%	23.2%	39.0%	84.6%
3/24/2000	9/17/2001	9.2%	12.3%	-15.9%	8.6%	27.0%
10/9/2007	10/6/2008	-11.6%	-21.0%	-0.2%	10.2%	60.0%
2/19/2020	3/20/2020					
	AVERAGE	**-1.3%**	**3.7%**	**6.9%**	**8.8%**	**26.5%**

Source: S&P, Advisor Group

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20 E. Thomas Road, Suite 2000 • Phoenix, AZ 85012 • 866-481-0379 • **advisorgroup.com**

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