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Transitory But Tumultuous: Part 2

TIME HORIZON SHOULD DETERMINE RISK MANAGEMENT

Market volatility entered a troubling new chapter over the weekend, with Saudi Arabia starting an oil price war with Russia. This action was so unexpected that the price of Brent crude is down over 20% since it's close last Friday, one of the largest and fastest declines in history. Increased solvency risk for energy companies and commodity-dependent regions is yet another concern for a global market already buffeted by COVID-19. What is RiverFront's view of the path forward for investors?

- **Transitory:** We anticipate that the *long-term* economic and earnings effects from COVID-19 (coronavirus) will be minimal. We also believe that the longer-term effect of low oil prices tends to be a major positive for US consumers.
- **Tumultuous:** Recognizing that the *short-term* impact to earnings and economic data could be significant, we are anticipating continued volatility. While we recognize the potential for additional downside over the coming weeks/months, the recovery in stocks may well also be rapid and will be very hard to predict.
- **A Path Forward:**
    - **Risk Management**: At RiverFront, we continue to focus our risk management attention on our two shortest-time horizon balanced portfolios, reducing stocks in those portfolios by between 8 and 12 percentage points since late February. The longer a portfolio's time horizon, the lesser the need to make portfolio adjustments, in our opinion.
    - **We believe the sharp declines in prices reflect investors' concerns about upcoming data.** Thus, we believe that investors will begin to look through any earnings/economic disappointments when either new COVID-19 cases have peaked (like they appear to have done in China) or if health authorities can show that the virus is less dangerous than many fear.

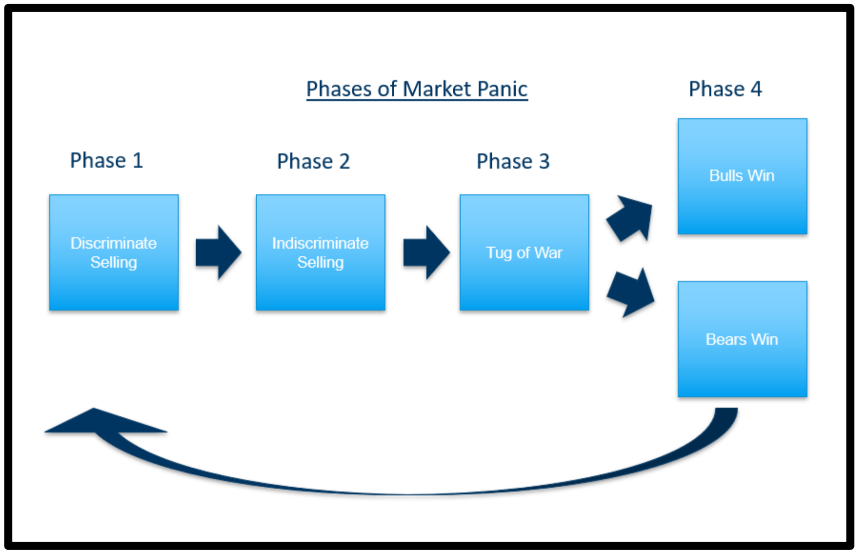
THE MARKET PHASES OF A PANIC (ACCORDING TO RIVERFRONT):

1. Discriminate Selling: When concerns arise, investors sell the risk assets that they love the least. Examples include stocks that are most vulnerable to the crisis (airlines, casinos, cruise lines, etc.), serial underperformers (energy, small-caps, etc.) and stocks that have recently performed well but don't have a long track record (IPOs/"trendy" industries, etc.) **We believe this occurred in the days preceding February 24, 2020.**

2. Indiscriminate Selling: As selling progresses, it becomes more indiscriminate as investors exhaust their supply of low-conviction stocks to sell. At this phase, most risk assets decline at roughly the same rate. Today, this phase tends to be amplified by computer/algorithmic trading. **We believe this occurred during the week of February 24, 2020 where less-affected segments of the market, such as low-volatility stocks and growth stocks fell along with the broad market. With today's weakness at the**

open, however, the market may still be mired in this phase.

3. **Tug of War:** Following the indiscriminate selling phase, the bulls and bears battle it out. A hallmark of this phase is intra- and inter-day volatility. Indexes swing significantly back and forth for little apparent reason. During this phase, support and resistance levels will often be re-tested and sometimes broken for short periods of time. **We believe the first attempt at this occurred on February 28, 2020 but we may have reverted back to phase 2 with today's oil price collapse.**



Source: RiverFront: Shown for illustrative purposes only.

4. **Winner Declared:** The winner of the "tug of war" can be identified, in our view, by judging the quality of the bounce. We believe that the quality of the bounce can be determined by analyzing (1) the length and (2) the magnitude of the bounce. Some of the data points we are watching include (all levels refer to S&P 500):
   - **Bears Win:** A low-quality bounce would occur if the S&P 500 cannot stay above its 200-day moving average (currently around 3050) for a sustained period of time (more than 5 days). This would suggest that a retest of support levels will be likely; these levels currently sit at around 2845 (August 2019 support level – which is likely to be violated today on the open) and 2750 (June 3, 2019 lows). If the bears win, it's back to phase 1.
   - **Bulls Win:** A high-quality bounce would suggest that the bulls have won and a return to the old highs are likely. We believe that such a signal would occur if the S&P 500 retraces at least 50% of its pullback (around 3150) and stays above that level for a sustained period of time (more than 5 days). Other levels to watch are 3050: 200-day moving average; 3100: 38% retracement; and 3205: 62% retracement. Since 2008, the bulls have won all of these "tug of war" games; however, it was not always on the first attempt. When the bulls eventually win, we would not be surprised to see the market recover in a V-shaped fashion. Therefore, a dollar-cost average approach during the "tug of war" phase may be appropriate for long-term investors, in our view.

When COVID-19 and Oil Concerns Lessen, Prior Positives May Be Back in the Spotlight:

- **Politics:** With Sen. Bernie Sanders fading in the polls and Sen. Elizabeth Warren exiting the race, the Democratic field appears to be moving away from the extreme left, which we believe raises the likelihood of a more stock market friendly election outcome.
- **Economy:**
   - **US Housing Data Remains Robust.** We see home buying as a powerful economic accelerator since it creates high-paying jobs and leads to additional durable purchases (furniture, appliances, etc.). Housing is also more attractive when mortgage rates drop, which is happening in conjunction with falling US interest rates. For example, the 10-year US Treasury Note is now well below 1%, which is more than 100 basis points (bps = 1/100th of 1%) lower than its level at the start of the year. We also think that

virus fears motivate individuals to move from densely populated apartment buildings and urban areas to homes in less densely populated communities, which may be less susceptible to virus spread.
  - **US Consumer Remains Resilient:** As millennials enter their prime spending years, we expect consumption to remain resilient. We also see lower gasoline prices – particularly after this weekend's bombshell news in Saudi - and potential savings from mortgage refinancing as additional stimulus that should keep consumers spending.
- **Valuation:** Assuming that earnings have been delayed and not destroyed, we believe that the S&P 500's valuation will have fallen significantly when the dust settles, resetting investor expectations and creating a more reasonable backdrop for the market to find a floor when volatility finally subsides.

Additional Reflections:

- **Why are Low Oil Prices Bad in Near-Term for Stocks?** Oil price shocks create near-term market risks. First, US energy is one of the largest sectors in most high-yield indices. Smaller energy companies need stable oil prices to remain a going concern, creating solvency concerns for high yield issuers. Defaults on these loans could have a knock-on effect throughout the US financial system, including stresses for private equity. Also, many energy-based economies (Saudi Arabia and United Arab Emirates, for example) now face the threat of recession, and some of these nations' sovereign wealth funds (which represent some of the largest capital pools in the world) may be forced to liquidate equities, creating additional pressure on equity markets.
- **Virus Data Still Fluid:** We believe virus data regarding rates of infection and mortality is premature and may be inaccurate. We are viewing negative and positive headlines with the appropriate 'grain of salt' while we await more uniform testing data and more time to elapse.
- **Sell-offs can come quickly and are difficult to foresee:** Markets go up on an escalator and down on an elevator. On February 19th the S&P 500 hit a new all-time high. Seven business days later it was down over 15%. Additionally, daily swings of 3% or more make market-timing particularly dangerous. Therefore, the best time to plan for a correction is before it happens.
- **Lower interest rates mean savers shoulder the burden:** We expect that the economic consequences of COVID-19 will ultimately be shouldered by the 'savers' and not the 'risk-takers' as was the case in the aftermath following the 2008 Financial Crisis. 'Savers' are those with the majority of their assets in fixed-return vehicles like cash, CDs or bonds. 'Risk-takers' describe those that choose to invest through variable-return vehicles, like stocks and real estate.
  - **Policy-Makers' intentions are clear**, in our view. Lawmakers and central banks around the world have stated that they will act quickly and collaboratively to minimize the economic impact from the virus.
  - **Rate cuts and quantitative easing (money printing) are not good for savers** over the long-term since it lowers the yields on bank accounts and bonds and can lead to currency weakness which impacts purchasing power. According to Cornerstone Macro, the Fed's 50bp rate cut last week marked the 83rd central bank easing move since last May. Currently, according to the Fed Funds futures market, US short-term interest rates are expected to fall by an additional 75-100bps by year-end.
  - **Fiscal stimulus (government spending) can also be expected to penalize savers** over time, since spending programs have the potential to create an uptick in inflation further eroding purchasing power. A number of countries including Japan, Italy, South Korea, Germany, and the US have enacted or are considering significant fiscal stimulus programs.

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In a rising interest rate environment, the value of fixed-income securities generally declines.

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You cannot invest directly in an index.

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

The 200-day moving average is a popular technical indicator which investors use to analyze price trends. It is simply a security's average closing price over the last 200 days.

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