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TAKING STOCK

The S&P 500 peaked on February 19, even as news of the spreading coronavirus and its potential danger to health and the economy continued to unfold. On that day, the VIX (CBOE Volatility index) closed at 14.4. In the ensuing weeks, volatility increased dramatically as markets began to react to unfolding global and local events. From the outset, we have highlighted the need to help companies, individuals and municipalities with liquidity, and to communicate a coordinated effort, consisting of public health measures, fiscal stimulus and a monetary response. Above all, we have emphasized that solving the liquidity issue is critical to preventing longer term economic damage.

The lack of a coordinated response on this major issue spooked investors, and the markets were unimpressed using the “old” tool kit of rate cuts. More recently, the U.S. Federal Reserve has announced help with commercial paper liquidity, municipal bonds, mortgage-backed securities and corporate debt to help liquidity in financial markets. We are grateful that global central banks are focusing on liquidity and not just interest rates, but the Fed and other central banks alone cannot solve this crisis.

Today the VIX hovers near 60 and it is very rare that the market can sustain volatility at this level. We may be entering a new, more thoughtful phase of market activity, one that is more informed by rational decision making. It is important to note the VIX is not predictive. Current high levels do not necessarily mean that volatility will *remain* high, particularly if the various liquidity measures we seek are implemented. One of the things that people sometimes get wrong about the VIX is that falling levels do not equate to a leveling out of the market. We may not have seen the market bottom in the current decline, but we may see the daily swings gradually get smaller.

Like most market turning points, there will be winners and losers. Our research will focus on identifying them at both the industry and company levels. Shocks to the economy can result in permanent structural changes, from the mundane, like the possibility of better hygiene across the population, to the more economically practical, e.g. “working from home” arrangements that may result in longer-term changes to the commercial real estate and video conferencing industries.

The short-term disruption in cash flows, the basis for stock and bond valuation, has caused multiples on the S&P 500 to contract 3 to 6 points. It is hard to be precise because of the uncertainty for earnings in 2020. I am intrigued by where we are now on valuation, as current valuations appear to be discounting a long-term disruption. For those who believe economic disruption will be relatively short-lived, as I do, opportunity is being created in financial markets. I see the possibility of 20% upside, or more, 12 months from now. We are coming to that bottoming process in my opinion, particularly if the markets get more confidence that coordinated measures around liquidity will be implemented very soon.

Bottom-up fundamental analysis at the industry and company level will be extremely important as we move forward. Some industries will suffer a greater impact than others from the fallout (e.g., travel and hospitality), but in aggregate, the long-term damage may now be over-estimated.

Our view remains that we will return to the aggregate economic activity level of the 4th quarter 2019 within 6 quarters of the peak infection rate. As discounting mechanisms, financial markets tend to move ahead of actual economic activity, therefore we should see markets normalize faster. As we have stated previously, this situation has numerous interdependencies that require extensive research, and this is where we rely on our research team. We know more than we knew a month ago, but this is still as dynamic a situation as we have ever faced.

The **Cboe Volatility Index® (VIX® Index)** is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX℠) call and put options.

S&P 500 Index includes 500 leading companies and covers approximately 80% of available market capitalization.

It is not possible to invest in an index.

Past performance does not guarantee future results.

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