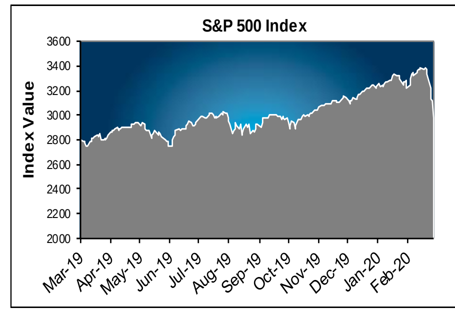
This Month in the Markets

February 2020

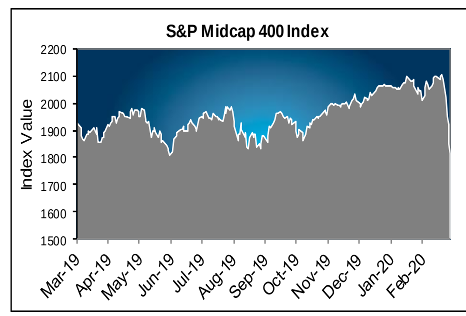
EQUITY COMMENTARY

Coronavirus Crisis

Pandemic concerns continue to cause volatility in equity markets. The MSCI ACWI Index fell 8% in the month with the U.S. S&P 500 Index tumbling 8.2%. International markets, as measured by the MSCI EAFE Net Total Return Index fell by 9%, and the MSCI Emerging Markets Net Total Return Index sank 5.3%.

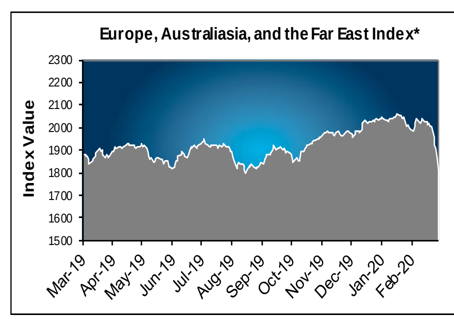


The MSCI ACWI Communications sector was the top sector, falling 5.7% as investors held on to more defensive names. The MSCI ACWI Energy Index was the underperformer again – falling nearly 14% with the collapse of energy prices on fears of plunging worldwide demand and the growing glut of products. When does this end? How bad can it get? The honest answer is nobody knows. I wouldn't spend too much time listening to health or financial experts to determine how far or fast this will spread- it's just guesswork overall. Markets hate uncertainty. The volatility markets are now experiencing is uncomfortable. It may be peak panic when the virus starts popping up all over the United States. There is a reasonable probability that the outbreak is coined as a "pandemic" officially at some point. History suggests that disease outbreaks do cause short-lived sell-offs. Both SARs and the Zika virus saw drawdowns of about 13% each in the S&P 500. The coronavirus has already led to an intraday-day plunge of almost 16% (as at 2/28 – 1:35 pm). But markets do tend to recover. In fact, after just six months after the outbreak of SARs, Zika and MERS the MSCI World Index was up 21.5%, -.6%, and 8.6% respectively. According to Goldman Sachs, there have been 26 market corrections since 1945 with an average decline of 13.7% over four months and have taken four months to recover. There is, of course, no guarantee this plays out the same or that the economic ramifications are similar to history.

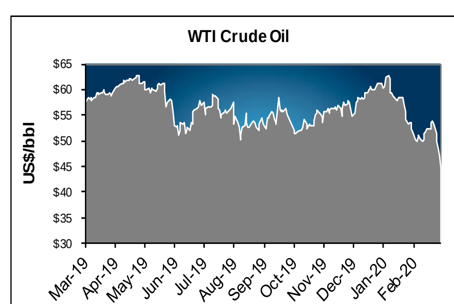


Its periods like this that we like to remind clients about three things:

1) Excellent long-term returns are not about trading around event-driven news stories. It's about building portfolios of high-quality businesses at excellent prices with a longer-term perspective. It most cases, "doing nothing" is the correct course of action, but most do not appreciate this statement. In some cases, like now, the market presents an opportunity to increase the quality of the portfolio by trading into great companies at great prices because the market indiscriminately sells everything.



2) Let's mention some good news. Diversification is working. Bond portfolios are rallying – especially treasuries. It seemed silly to own bonds a few weeks ago when the equity rally was outstripping the bond rally. I think we can now agree, however, that the bond market was right, and the equity market was wrong when it comes to Covid-19, at least in the short-term. Although balanced accounts are still likely to see some pain, this has been mitigated with diversification. Bonds at some point can also be sold and become a funding source for rebalancing. We are also taking advantage of credit spread rallying and booking gains in treasuries while buying quality bonds that offer a pick-up in yield. This is why we run balanced accounts.



*MSCI EAFE Index

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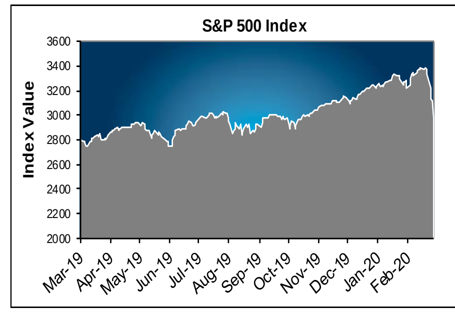
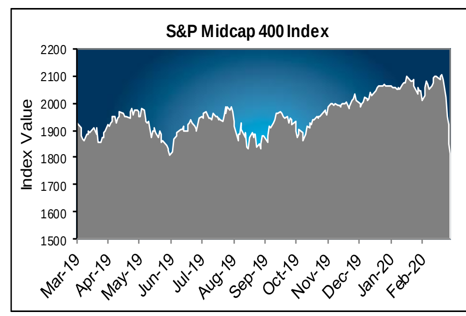
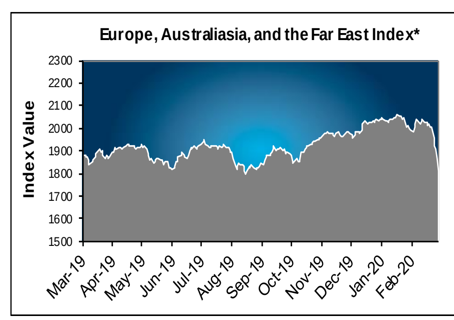
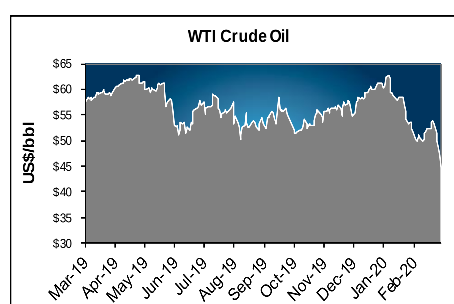
3) Asset allocation decisions should be based on one's ability to take risk and one's willingness to take risk. It is often the case that the later gets tested when markets sell-off and the news is dire. It is essential to note the two comments above, however, and that portfolios are built with an intermediate to longer-term perspective in mind. If the recent sell-off has you questioning your risk tolerance, it is best to revisit your asset allocation once markets become less volatile rather than making large wholesale decisions in periods of dislocation. Please remember that if your life circumstances have changed, we would request you contact us so we can do a review of where you are and if you need to adjust your allocation.

If history is any guide, there will be a point that the market dispassionately ignores the virus-related headlines and looks towards the future and when it does, quality companies with secular growth should perform exceptionally. As a result, we did up the quality in the portfolio swapping out Aramark for about a 9% gain into Danaher, a company with approximately 70% of its revenue recurring in nature and in sectors of life sciences, diagnostics, and environmental/applied solutions. We feel Danaher offers exposure to areas of high secular growth in more defensive industries. It is a company in industries of high switching costs and benefits from its razor/razor blade model that offers higher margins and recurring revenue mentioned above.







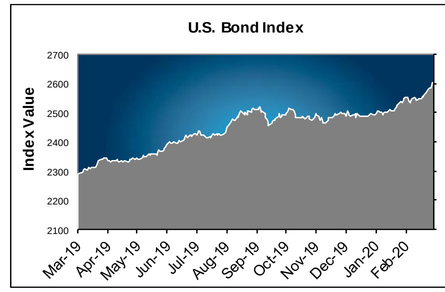


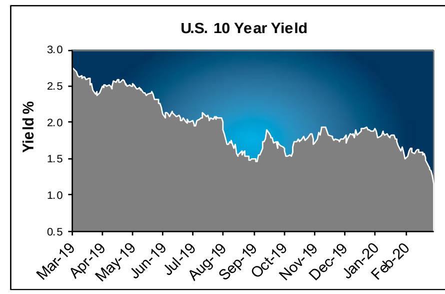
*MSCI EAFE Index

FIXED INCOME COMMENTARY

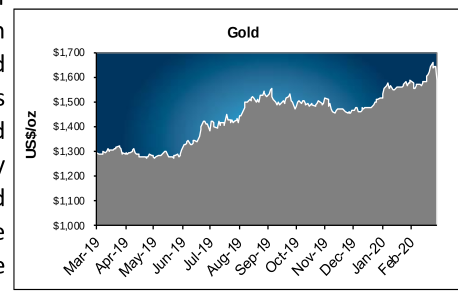
Coronavirus 'Spreads'

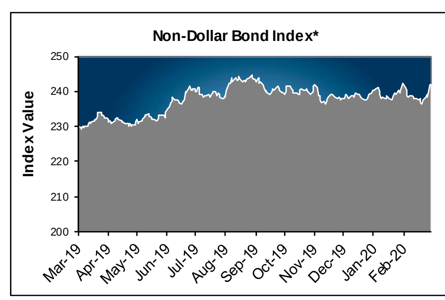
February was all about the spread of the Coronavirus. Even as more and more cases sprouted up around the globe, it was only in the final third of the month that risk markets took it on the chin. It should be noted that over this same time frame, Bernie Sanders became the clear front-runner in the polls to become the Democratic candidate for president. Sanders is very left-leaning and it would be unequivocally bad news for risk markets if he were to become president. A combination of growing coronavirus mania, Bernie Sanders gaining in the polls, and risk markets that were at/near record highs in the longest ever US economic expansion was the perfect elixir for a correction.



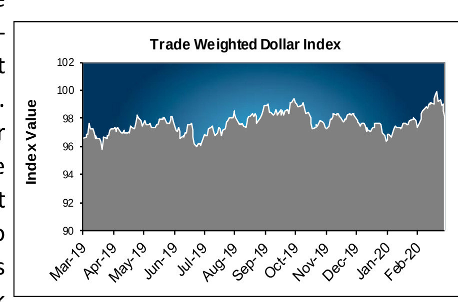


The USD, as measured by the DXY index, rose sharply for two-thirds of February before falling to end the month up only 0.76%. The weakness in the latter part of February was unexpected because often the USD strengthens in times of market stress. The yield on the US 10-year Treasury, a safe-haven for investors, fell 0.43% in February, ending the month at a record low yield of 1.14%. Note, the 30-year US Treasury also rallied and ended February at a record low (1.67%). The Anchor fixed income portfolio maintains a core position in Treasuries as a hedge against market stress – February was a great example of why we do so. As of the time of this writing, futures markets are pricing in almost four rate cuts from the Fed this year compared to two cuts as of the end of January 2020. The disruption to global activity caused by the Coronavirus is likely to be deflationary. This is reflected in inflation expectations as evidenced by inflation swaps, which plummeted in February. With inflation already running below the Fed's 2% target using the Fed's preferred measure, the Fed can easily use this as an excuse/reason to lower rates. Whether this will have any real economic benefit is up for debate, but lower policy rates are on the way regardless. Perhaps this explains why the USD fell in the final third of the month despite there being an apparent risk-off sentiment.





Investment-grade spreads held up quite well and overall experienced only modest widening. Technical support for investment-grade bonds will likely remain in place due to supportive central banks and a reach for yield given the plunge in Treasury yields. As of the end of February, there was approximately USD-equivalent $14.5 billion in negative-yielding debt (+$3.3 trillion from year-end 2019). However, the same cannot be said for the high yield market where credit spreads widened almost 5x more than the investment-grade index. The spread differential between the lowest quality rating cohort in the investment-grade market (BBB-rated) and the highest-rated cohort in the high yield market (BB-rated) blew-out materially, indicating a widespread flight from high yield. Indeed, on February 25th, the largest high yield ETF experienced its biggest ever outflow, surpassing the previous record set in January 2020. For some time now, the Anchor fixed income portfolio has maintained a conservative credit risk position, with high yield exposure consisting of relatively short (<3 years to maturity), high-quality names. We have been underweight one position in this market versus our neutral allocation. Shortly after month-end, we took advantage of the spread widening and added an attractive high yield position, switching out of a Treasury.



*Merrill Lynch Global Broad Market, Ex US Dollar Index

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