Key Investment Perspectives

March 2020

by Brett Hillard, CAIA, CFA, Senior Investment Analyst and Portfolio Strategy

Global equities

Introduction

The literal translation of the French phrase déjà vu is "already seen," and it was an expression we heard a lot as observers described last month's market. However, perhaps a more apropos definition of market performance in February is from the Oxford English Dictionary: "tedious familiarity."

Similar to January, US equities raced out to all-time highs in the first 12 trading sessions of the month, then declined over the final two weeks due to fears over the breakout of the COVID-19 disease and the potential for damage to economies and corporate earnings. The decline in stocks in February was more severe and historic in terms of rapidity than in January: US equities dropped 8.2% for the month, resulting in a year-to-date (YTD) loss of 8.3%. Domestic equities fell 12.7% from the peak on February 19.

Relative performance in February echoed January as well. Given continued concerns over the level and trend of global expansion, growth stocks continued to outperform value equities as investors favored companies with better structural growth prospects. Commodities and commodity-related sectors underperformed as a result of higher sensitivity to global growth and demand from China. International equities (-7.94%) declined in February as well, but outperformed US equities (-8.19%). The outperformance was driven by emerging markets (EM), which declined 5.0% in February and 9.06% YTD. Developed market international equities fell 8.95% in February and YTD returns declined 11.03%. In EM, China equities performed relatively well (1.13% in February -3.75% YTD) as investors anticipated that stimulus measures would prove salutary and incremental positive developments to contain COVID-19 were reported.

February Market Data

	1 Month	3 Month	YTD	1 Year
US All Cap	-8.19	-5.64	-8.29	6.90
US Large Cap	-8.17	-5.42	-8.07	7.82
US Small Cap	-8.42	-8.80	-11.36	-4.92
US Large Cap Growth	-6.81	-1.85	-4.73	15.11
US Large Cap Value	-9.68	-9.20	-11.63	0.54
US Small Cap Growth	-7.22	-6.14	-8.24	-0.72
US Small Cap Value	-9.72	-11.60	-14.59	-9.29
Developed International	-8.95	-7.72	-11.03	-0.90
International Emerging Markets	-4.99	-2.82	-9.06	0.18
US Treasury	2.65	4.57	5.16	12.15
US Investment Grade	1.34	4.05	3.71	15.81
US High Yield	-1.41	0.59	-1.38	6.10
Municipal Bonds	1.29	3.42	3.11	9.46
Real Estate	-7.03	-5.27	-5.85	7.98
Commodities	-5.04	-7.59	-12.03	-11.05

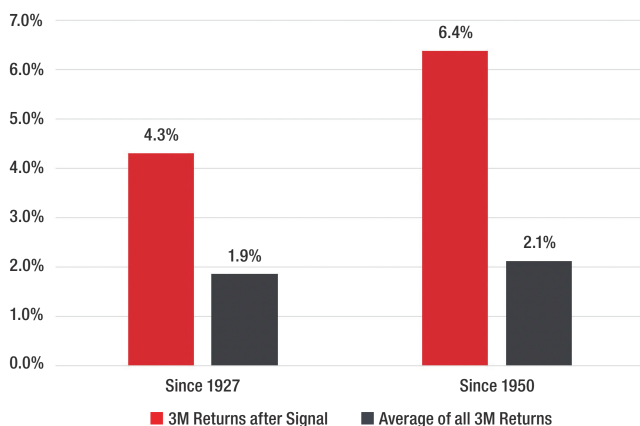
Sources: S&P GSCI, Russell, Barclays, Key Private Bank

The decline of US equities was historic in terms of its speed. If measured by the S&P 500 Index, US equities went from an all-time high on February 19 to a correction (defined as a decline of at least 10%) in only six trading sessions by the end of February 27. The second-quickest decline from an all-time high to a correction occurred in January and February of 2018. At that time, the market was significantly overbought as measured by a multitude of technical indicators, and equities subsequently declined 10.2% in nine trading sessions. The burst in volatility led to the collapse of several leveraged volatility trading vehicles.

Looking farther back and using daily data for the S&P 500 from December 30, 1927, to the present, there have been 23,151 rolling four-day market trading periods. The four-day period ending February 27, 2020, saw the S&P decline by 10.8% — the 52nd worst four-day period for the S&P 500 during the period under review. The decline was in the bottom 0.2% and a 4.6 standard deviation event. The last time the market incurred such a rapid decline was in August 2011: The fall was triggered by the European sovereign debt crisis and the downgrade of the US credit rating from AAA to AA+ by S&P.

When such a rapid decline occurs, is there any information regarding the prospects for future equity returns? While it depends on the time horizon of the forecast, there is some evidence of higher prospective returns over the subsequent three months. We looked at forward three-month returns after a four-day selloff that ranked in the bottom 1st percentile. Based on the data in Chart 1, three-month forward returns are higher than average. If we exclude the Great Depression, which had a clustering of signals, the increase in returns is even greater. However, the statistical power of these signals is weak, and the direction and durability of the gains for longer periods was dependent on the path and strength of the overall economy. Signals such as these can be incorporated on the margin and perhaps guide investors who are looking to deploy capital over time to achieve a planned asset allocation target.

S&P 500 3M Returns after Drawdown



Historically, this signal did not mark the end of the drawdown. In nearly 89% of the signals since 1927, the market fell further. The average drawdown after an extreme four-day period is -10% since 1927 and -5.5% since 1950. As of March 16th, 2020 the market declined -16.7% from the February close. Given the pace of the decline from all-time highs in February, this period has similarities to 1987.

Key Private Bank's tactical asset allocation process has a longer forecast horizon of 12—18 months and considers many data points. Our proprietary Dynamic Allocation Research Tool (DART) systematically measures many data points across three categories: Corporate Fundamentals, Investor Sentiment, and the Macroeconomic Environment. Relying on a systematic, data-driven process is especially critical in emotion-driven markets.

Coronavirus: What are the historical analogues?

The Severe Acute Respiratory Syndrome Coronavirus 2 (SARS-CoV-2) was first detected in Wuhan City, China, in December 2019 and caused the disease now known as COVID-19. While US markets were paying attention to the outbreak, the initial consensus estimate was that SARS-CoV-2 would largely be contained in China and economic disruptions would be mild to moderate. However, the calculus changed in the middle of February, when the virus was detected in other countries, including South Korea, Italy, Japan, and the United States. Markets shifted to high alert and quickly priced in a potential adverse impact to the US economy of 2—3% of GDP and a 20—25% reduction in corporate earnings. While the final impact is currently unknowable, the market has discounted severe declines in a short period of time.

Based on the latest statistics from Johns Hopkins University (March 20, 2020), there are 266,082 confirmed cases of COVID-19 in 165 countries. Unfortunately, 11,153 deaths have resulted from the outbreak for a preliminary fatality rate of 4.2%. Investors with a bearish outlook mention the Spanish Flu of 1918 in terms of potential severity. While there are universal metrics, comparing impacts to economies and markets is

challenging given material differences in economic and market structure. For example, when the SARS outbreak occurred in China in 2003, the Chinese economy was only 4% of global GDP compared with nearly 17% today. Additionally, several of the historical analogues occurred when other major events were also impacting markets, such as World War I during the Spanish Flu outbreak.

We have identified six cases of notable pandemics comparable either in scope or new forms of pathogens. If COVID-19 approaches the severity of the Spanish Flu Pandemic in 1918—1919, markets and economies may continue to be under pressure. Although data quality is substantially lower for the earlier pandemics than it is today, there have been numerous studies of the Spanish Flu. It is estimated that 500 million people contracted the disease, or nearly 27% of the global population. Deaths from the disease have been estimated to range between 30 million and 50 million people, or 1.6% to 2.7% of the global population. If COVID-19 resulted in similar amounts of cases and deaths, this would equate to 2.08 billion cases and 123 million to 208 million deaths. To date, there have been 6,705 deaths due to COVID-19, or 0.17% of the midpoint of the Spanish Flu extrapolated to today's population. Given the attention of global governments to containing SARS-CoV-2 and developing treatments, comparing the current outbreak to the Spanish Flu appears extreme based on the data we have today.

However, vigilance is required to control the outbreak. Global governments are recognizing the need for strong social-distancing measures to slow the outbreak and make it more manageable. These measures will create severe economic disruptions in the short-term.

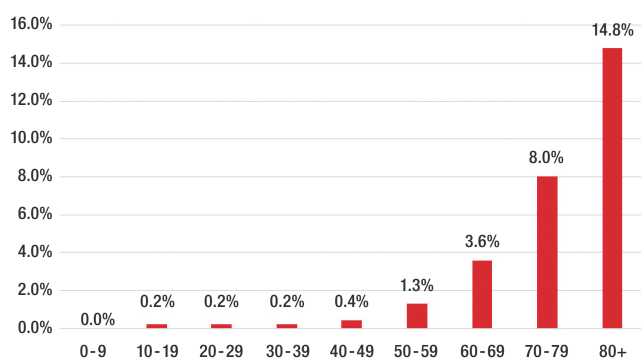
Historical Pandemics and Outbreaks

	Spanish Flu	Asian Flu	Hong Kong Flu	SARS	H1N1	MERS	COVID-19
Years	**1918–1919**	**1956–1958**	**1968**	**2002–2003**	**2009**	**2012–2015**	**2019–2020**
GLOBAL CASES	500MM	N/A	200MM	8,096	700MM–1,400MM	2,506	266,082
% of Population	27%	N/A	5.7%	NMF	11%–21%	NMF	0.004%
Deaths	30MM–50MM	1.1MM	1MM	774	150K–575K	862	11,153
% of Population	1.6%–2.7%	0.04%	0.03%	NMF	0.002%–0.008%	NMF	NMF
Fatality Rate	6%–10%	N/A	0.50%	10%	0.01%–0.08%	34%	4.2%
US CASES	N/A	N/A	20MM	27	60.8MM	0	16,605
% of Population	N/A	N/A	10%	NMF	19.8%	0	0.005%
Deaths	675,000	116,000	100,000	0	12,469	0	216
% of Population	0.6%–0.7%	0.07%	0.05%	0	NMF	0	NMF
Fatality Rate	N/A	N/A	0.50%	0	0.02%	0	1.3%

Sources: US Centers for Disease Control and Prevention, World Health Organization, Goldman Sachs, Brainerd, E., Siegler, M., "The Economic Effect of the 1918 Influenza Epidemic," June 2002

Another key difference with the Spanish Flu is that mortality rates were materially higher among working age people compared with the elderly. Preliminary data from China suggests that the elderly are at much greater risk of contracting COVID-19 compared with individuals under the age of 60. For people aged 10–49, the fatality rate is roughly 0.3%, a fraction of the total 4.2% fatality rate. It is not uncommon for total fatality rates to be elevated at the front end of a pandemic as the most severe cases get the most attention. Additionally, fatality rates may vary greatly by country based on demographics, health care access, policy responses, level of social distancing measures and several other factors. With COVID-19 affecting the respiratory system, factors such as air quality, patients' comorbidities, and smoking prevalence may impact severity. China has low air quality and higher smoking prevalence. Given these factors and others, it would not be surprising if fatality rates were lower in other countries. Moreover, while it is impossible to precisely determine the specific drivers of equity prices, there appears to have been little impact from the Spanish Flu on the market: The S&P 500 increased 16.2% in 1918 and 13% in 1919; global events such as World War I were more significant drivers of equity markets.

COVID-19 Case Fatality Rate by Age Group



Source: China Centers for Disease Control

Another comparison in terms of possible scope is the Hong Kong Flu in 1968. There were over 200 million cases globally, or 5.7% of the population. In the US, there were an estimated 20 million cases, or 10% of the population. The epidemic is estimated to have caused 1 million global fatalities, including 100,000 in the US. Extrapolating to today's global population, this would equate to 440 million cases and 2.3 million fatalities. Similar to the data with COVID-19, the Hong Kong Flu disproportionately affected persons over the age of 65. US equities increased 11.8% in 1968 but tipped into bear market territory in 1969, ultimately bottoming in July 1970 after a 28.9% drop. In reports that chronicle this bear market, the reasons most cited for the decline were accelerating inflation, concerns over budget deficits, the Vietnam War, and high valuations in the Nifty Fifty. None mentioned the Hong Kong Flu.

While the historical analogues provide little insight in predicting the path of COVID-19 in terms of economic and market impacts, they do provide some historical context in terms of severity. There are a number of differences in terms of global connectedness in terms of trade and travel and the relative size of economic regions. However, medical technologies and data systems are far superior today than they were in earlier pandemics. In the historical cases, we could not find the same degree of attention or concern by global markets. It should be noted that the lack of global concern may have contributed to worse health outcomes There could be multiple reasons for this, but some of these pandemics occurred during major global events. However, we are curious why severe historical pandemics did not capture investors' attention. Perhaps global connectivity and the 24/7 news/social media cycle is affecting sentiment this time around. Another factor could be the increased awareness of the value of social distancing. Countries that were at risk during the SARS outbreak learned the value of social distancing and initially appear to be containing the spread of COVID-19 more effectively. Social distancing improves health outcomes but hurts economic activity in the short-run. However, long-run economic activity benefits if the health outcomes are milder and shorter. In periods of high degrees of uncertainty and emotion, following a disciplined, data-driven process such as DART is even more critical in achieving long-term investment goals.

Key Private Bank Asset Allocation Recommendations as of March 2020

Stocks	Bonds	Cash	Alts/Diversifiers
De-emphasize	Neutral	Emphasize	Emphasize

Equity Geographic Emphasis

United States	International – Developed	International – Emerging
Emphasize	De-emphasize	Neutral

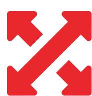
Fixed Income Sector Emphasis

Treasuries	Investment Grade Credit	High Yield
Neutral	Neutral	De-emphasize

Based on DART and discretion allowed by our Asset Allocation Committee, we are underweight equities, neutral fixed income and overweight cash. Within equities, we favor higher-quality companies and lower-volatility stocks. We favor US equities compared to Developed International given greater defensive attributes. We are neutral Emerging Market Equities as China is furthest along in managing the pandemic. Within fixed income, we recommend maintaining a neutral-to-benchmark stance on duration and an underweight to high-yield bonds given valuations and uncertainty. Where alternatives are considered suitable for an investor, we also believe that these investments can provide valuable diversification benefits to a portfolio. Low yields suggest lower future total returns for bonds, and thus a diversified hedge fund portfolio offers the potential for higher returns with similar volatility. Additionally, a diversified hedge fund portfolio provides exposures to return drivers other than interest rates and credit.

Fixed income

US Treasuries remained the global safe haven during the sell-off in February. US Treasuries gained 2.65% for the month, bringing the YTD return to 5.16%. Long-duration bonds continued to provide valuable portfolio diversification: The 10-year Treasury note yield fell from 1.51% to a record low of 1.15% while the total return was 3.67% for the month and 7.52% YTD. The Treasury curve moved back to inversion, suggesting that the bond market views current Federal Reserve policy as overly restrictive relative to future growth conditions. Investment-grade corporate bonds increased 1.34% in February and 3.71% YTD, with all of the gains due to duration as a result of widening credit spreads. High-yield corporate bonds fell 1.41% in February and are down 1.38% YTD with wider spreads.



Alternatives

Hedge funds

The HFRX Global Hedge Fund Index declined 1.44% for the month to leave YTD returns at -1.03%. Given the heterogeneity of strategies, there was wide dispersion. Equity hedge (includes long-short equity and equity market neutral) declined 3.83% in February and 4.14% YTD. Discretionary global macro strategies have held up better: The HFRX Macro Discretionary Thematic Index increased 0.2% in February and 0.2% YTD. Hedge funds approved and recommended by Key Private Bank generally performed better than the broader peer group in February and YTD. Given the substantially lower return potential of bonds in the intermediate to long term, we believe that a diversified portfolio of high-quality hedge funds can potentially deliver higher returns with a similar risk profile. Hedge funds can provide exposure to a multitude of return drivers compared with duration and credit spreads for bonds.

Real estate

US real estate investment trusts (REITs) declined 7.03% in February and 5.85% YTD, outperforming the broader equity market given the domestic exposure and with the impact from falling interest rates. Lodging-related REITs plummeted 13.85% in February and 23.25% YTD as a result of prospects for materially lower travel given the COVID-19 outbreak. Retail-oriented REITs continue to underperform (-7.47% for the month, -10.58% YTD), driven by secular risks due to e-commerce. Data centers (-2.68% in February, -1.57% YTD) and manufactured housing (-5.91% for the month, -0.54% YTD) REITs continued their outperformance after a strong run in 2019.

Commodities

The Bloomberg Commodity Index declined 5.04% in February, leaving YTD returns at -12.03%. Energy has led to the downside with sharp declines in crude oil and natural gas. For February, the sector fell 12.37% and is down 25.47% YTD. Oil declined with concerns over global demand with the COVID-19 slowdown in China. Natural gas fell with continued oversupply and warmer weather. Precious metals performed relatively well, declining only 1.92% in February and posting a YTD gain of 1.67%. Commodities most exposed to the global economy and demand from China fared the worst.

For more information about how the market climate is impacting your portfolio, contact your Key Private Bank Advisor.

About the Author

Brett Hillard, CAIA, CFA is a Senior Investment Analyst with the Portfolio Strategy Team and has over 10 years of investment analysis experience. He leads the alternative investment research and due diligence process at Key Private Bank and provides quantitative modeling for portfolio construction. Brett has expertise in evaluating hedge fund strategies, private capital strategies, and traditional investments. He is integral in the management of several multi-asset strategies across high-net-worth individuals and institutions.

Brett joined Key in 2007 as an equity analyst with a focus on the Consumer Discretionary sector. Prior to joining Key, Brett worked at Apple Growth Partners, providing valuation analysis and reports for closely held companies. Brett holds a BA in Finance and Business Economics from Ohio University. He has also earned the Chartered Alternative Investment Analyst and Chartered Financial Analyst designations.

This piece is not intended to provide specific tax or legal advice. You should consult with your own advisors about your particular situation.
Any opinions, projections, or recommendations contained herein are subject to change without notice and are not intended as individual investment advice.
Investment products are:

NOT FDIC INSURED • NOT BANK GUARANTEED • MAY LOSE VALUE • NOT A DEPOSIT • NOT INSURED BY ANY FEDERAL OR STATE GOVERNMENT AGENCY

©2020 KeyCorp. **KeyBank is Member FDIC.** 200309-758091