HB Perspective on the Markets and Coronavirus

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Hi, this is Andy Berg. My partners and all of us at HB hope you and your families are doing well. I feel that it's important that we communicate with you today given the current market turmoil surrounding the coronavirus. I am joined by my partners Stephanie Lang, our Chief Investment Officer, and Ross Bramwell. Both are partners in the Investment Department and will give some additional commentary on the markets and our perspective.

Over the past week, markets became increasingly concerned with the news that total coronavirus cases outside of China significantly increased. Global stock markets are now in correction territory from their recent all-time highs.

Markets hate uncertainty, and unfortunately, that is what we've had since the coronavirus outbreak started. However, let's remember that last year markets had above average returns with the S&P 500 up over 30%, and as of February 28th, the S&P 500 had still returned 8.3% and 9.9% annualized over the 1-year and 3-year time periods, respectively.

Before the coronavirus outbreak, stock market valuations were already elevated, as an improvement in 2020 earnings growth was expected. We were not expecting a recession to occur in 2020. We were even beginning to see improved economic data in international economies.

As the economic impact is uncertain at this point, fear has gripped the markets. So we continue to be focused on first making sure that your portfolios are aligned with your goals and your financial plan – there will always be good years and bad years and we build your portfolios to best help you achieve your goals.

We also believe in diversification, which allows investors to have liquidity for short-term needs without forced selling during times like these so that you can ride it out or take advantage of opportunities as they happen.

So here's how we see things now right now – we are currently holding our positions and are making no stock market allocation changes now. While we're concerned with the negative market momentum, we still have the belief that the U.S. is not headed into a recession in the short-term and with equity valuations now cheaper, we're currently comfortable where we stand. But this is a fluid situation and we're monitoring the data constantly and we will adjust as needed.

I've been advising clients for over 30 years and seen many of these unforgettable market periods and many of you have been through them with me. We remain committed to our core investment principles and will continue to work with you to navigate through the good and bad markets.

Now I am going to turn things over to my partners in our Investment Department to help you see how we are looking at the current decline we're in, the current state of the economy, and what we're watching that would drive us to make allocation changes.

Hi, this is Stephanie Lang, Chief Investment Officer at Homrich Berg.

First, let me cover a little bit of where we were before the coronavirus outbreak. The global economy entered 2020 with a lot of positives, led by a healthy consumer, U.S. unemployment at 50-year lows, improving manufacturing sector, accommodative central bank policies, and even Europe showed signs of strengthening. Global equity market in 2019 reflected these positives in its performance, but valuations were looking stretched, especially in the U.S. where P/E multiples rose 30% over the last year.

Now, where are we currently?

- There are over 89,000 cases and over 3,000 deaths. There are reported cases in at least 60 countries.
- The coronavirus is hurting global economic activity on both the demand and supply side. Unfortunately, we still lack enough hard data on the virus itself, supply chain disruptions, and consumer spending to accurately quantify the impact.
- Evidence on growth suggests at least a 50% hit to China 1Q'20 GDP, and the impact outside China is evident with retail demand dropping by reportedly over 40% in South Korea.
- Global equity markets are down over 10% from their highs of Feb. 19. This is the most rapid sell-off in history from an all-time high.
- As investors have sought safe haven investments, U.S. Treasury yields have reached record lows. Also, credit spreads are widening with high yield spreads up 100bps YTD. These are all indicative of the fear that is in the markets.
- On the earnings side, global earnings growth estimates have started to be revised downward. Emerging Asia and specifically China expectations have dropped by over 2% in the past few weeks. U.S. earnings growth has fallen to slightly positive for Q1, revised down from 4%. Full-year growth is still at 7% but we expect that to be revised downward. Apple, Microsoft, and PayPal, just to name a few, have already withdrawn or lowered their earnings outlooks in response to the outbreak. In contrast, Starbucks reported that 88% of stores in China are open and seeing early signs of a recovery in the country. We expect there will be a mix of good and bad news as the virus spreads, but we also expect to begin to see some signs of recovery.
- We'll continue to watch earnings revisions over the next few weeks and company guidance along with other indicators of the ultimate impact. We expect markets will be volatile over the next few weeks as we monitor the spread of the virus in the U.S. and we begin to see the potential negative impact on the economy and consumers.
- Even after the current decline, given that stocks are still above historical valuation averages, there is still risk to the downside from here.

The health aspect and impact on families of the coronavirus is unquestionably a tragedy and its impact has spread into the economy and financial markets. A more than 1% hit to global GDP appears a very real possibility. The OECD revised its numbers down to 2.4% for 2020 from 2.9% in 2019 and suggests growth could possibly go negative in Q1.

We expect the Fed's hand to be forced by the markets for rate cuts to improve financial conditions. Markets are now pricing in possibly three or more rate cuts this year. China's Central Bank is already acting aggressively, an outcome that can be seen in the surprising relative strength of Chinese equity markets. Italy's government has moved to stimulate the economy through a fiscal response with tax credits for companies impacted and tax cuts and cash for the health system. A coordinated response from central bankers appears to be likely as G7 central bankers will be holding a conference call this week. While this won't stop the virus, the bankers stressed they will take the necessary steps to stabilize the markets.

To wrap things up before I pass it to Ross, the spread and ultimate effect of the coronavirus is uncertain, but we do believe that the virus will eventually get resolved whether by vaccine or by the virus running its course. We believe the supply chain will recover as will economic growth. Therefore, we will not try to time the peak of the virus but allocate client portfolios under this assumption. Clients have diversified portfolios and only a portion of their portfolios are allocated to stocks. It is important to remember that bonds are up for the year as we have seen a rapid decline in interest rates. We believe cash, bonds, and hedged securities will help carry portfolios through this time of volatility and uncertainty.

I'll now pass it on to Ross for a few additional comments on the markets and what could prompt us to make changes to portfolios.

I'm Ross Bramwell and I'll give a few comments on what we're watching as we discuss potential allocation changes.

We certainly acknowledge that the coronavirus most likely be a health issue for several quarters. However, what will be important for the stock market is when social and economic activity starts to recover and people are getting back to work.

This can make timing a potential allocation change challenging. Similar to recession periods, the stock market is often a leading economic indicator. Markets often fall before we know we're in a recession and they often rise before it's technically over, because it is always looking out a few months or longer into the future. It's a gauge of sentiment, how investors are feeling. So we could expect that the market may recover before the virus is actually on the downtrend. It may begin to recover even when news is still bad, but the prospects for the future are already starting to look better. In other words, for most investors the right time to buy could be when they least likely want to do it. It will be a challenge to market time the recovery.

For example in China, although there are still restrictions and issues, this week Starbucks said 85% of its stores in China are operating again. Apple announced that their factories are now open and are getting back up to speed, although slower than desired. Toyota has restarted production to some degree at all its China plants.

China's central province, the epicenter of the outbreak, reported less than 200 cases on of the new infections on March 1st, for the first time since January. There are caveats if there's another flare-up, but signs of activity are beginning in China's economy even as the epidemic is spreading outside the country. A number of key metrics of economic health have ticked up this week. Workers are returning, factories are getting back up, and even consumer-facing businesses are opening their doors. This is the result of declining number of new cases in China and the government's easing of policies that had essentially stopped everything.

One stat I saw was that over 43% of small and midsize enterprises in China's manufacturing sector had resumed production which is significant as many could survive for only one to two months on their savings. It will continue to be a process, but whether a significant portion of the recovery can occur before June or late spring, or if it goes into later summer/fall timeframe will significantly determine the eventual economic impact.

With it just starting to spread in the U.S., we could see similar measures taken in other countries that are currently dealing with the virus. So assuming it spreads here over the next month or so, there will be a short-term hit to economic activity, but we have not seen many analysts yet expecting this to impact the U.S. economy 12-18 months out given the current situation, and given that there is an expectation of a rebound as pent-up demand usually occurs.

So most are still expecting this to play out within two quarters. But if the impact time is extended or worse than what we've seen China, then it could certainly impact jobs, the U.S. consumer, and take us closer to the next recession, which would be the worst case. But that does not appear to be the most likely scenario currently.

Similar to the fourth quarter of 2018 when the stock market saw a 20% decline, we are sticking to our core principles even in this time of market pessimism. We look at three signals when we're reviewing our positioning in U.S. stocks: valuations, momentum, and risk of recession.

- As we mentioned price to earnings valuations were elevated as we began the year but are now at more reasonable levels with the market decline.
- The U.S. consumer has been very resilient the last few years and has supported the slow, but moderate growth, we've seen in the U.S. With low unemployment, rising wages, a good housing market, and consumers that aren't overburdened with debt, we do not believe we are entering a recession in the near term given current economic data that even saw a slight improvement as we began the year.
- Momentum has weakened with the recent stock market decline. Historically, extreme negative momentum and an increasing risk of recession have occurred close together, but that is not our current situation and why we feel this environment is unique.

As Andy said, the bottom line for you as our clients is that we are not making any major allocation changes at this time, although we will take advantage of rebalancing or opportunities, as always, for individual portfolios depending on your specific asset class targets and your specific financial plan. We will continue to monitor the signals, government response, and issues discussed on this call and adjust our approach as conditions change. Each of you has a unique situation and as always we encourage you to speak with your client service team about your personal portfolio and your financial game plan to ensure you stay on track. Thank you for listening.