MARKET MATTERS

SPECIAL UPDATE March 23, 2020

Executive Summary

- We are likely entering a severe, but perhaps short-lived recession.
- The length of the recession depends largely on fiscal stimulus and containing the COVID-19 outbreak. Federal and state governments are working on such measures.
- Investors may hear comparisons to the Great Depression, but that was a time when monetary and fiscal responses were poorly constructed, and welfare programs that help respond to recessionary pressures did not exist.
- In the last six times the S&P 500 Index dropped 30% from a peak, the index was up, on average, 25% in the next five years, excluding dividends.
- While volatility will persist for some time, it is important for investors with medium- to long-term horizons to remain invested, dollar-cost average, and rebalance as needed.

Dire Short-Term, Hopeful-Long Term Outlook

Short-term projections turned rather bleak during the week ended March 20, but there are reasons to believe that the long-term outlook remains positive.

In response to the weakening domestic economy and stress in fixed-income markets, the Federal Reserve in partnership with the Treasury Department announced on March 23 a massive new program that will include the purchase of Treasuries, asset-backed securities, corporate bonds, and municipal bonds along with a direct lending program to corporations. However, the focus this week will remain on much sought-after fiscal stimulus from Congress.

The good news is that with significant fiscal stimulus, the recession could be short-lived. There are signs that such a stimulus is coming shortly. The U.S. Senate has so far failed to pass a fiscal stimulus package of about $2 trillion, largely due to differences of opinion on how to deploy the stimulus. However, both political parties and the president seem to have a sense of urgency and the proposed size of the stimulus package (at about 9% of GDP) is in line with what economists would expect for a recession as deep, albeit not as long, as the Great Recession. We anticipate that both parties will come to a compromise soon.

Politicians can also look to lessons learned from the Great Depression, which was caused by a sudden negative demand shock from loss of confidence after the market crash of 1929 and by a decline in money supply due to bank failures. In retrospect, the recession was exacerbated and extended by poorly constructed and poorly timed policies. Contrast that to today’s response where the Federal Reserve has reduced the federal funds rate to close to 0% and is implementing extensive quantitative easing (purchases of bonds to bring down interest rates), while the federal government is negotiating an historic fiscal stimulus package. Additionally, many automatic stabilizers that did not exist in 1929, such as unemployment insurance, food programs, and Medicaid, help provide a fast response to recessionary pressures. The response this time around is more likely to preserve confidence and capital while COVID-19 is contained to allow demand to return shortly afterward. For example, industrial production is returning, albeit slowly, to Wuhan, the epicenter of the outbreak.

There are risks, of course. Monetary policy appears to be nearing its limits, a fiscal response needs to be coordinated globally, many countries are already highly indebted and running large fiscal deficits (including the U.S., although it has the benefit of being able to borrow at historically low rates in the world's primary reserve currency), and the underlying cause of the current demand shock must be addressed for monetary and fiscal policies to be effective. A frequently cited aspirational milestone is to "flatten the curve," or slow down the growth in new COVID-19 cases as soon as possible as the growth rate can be exponential if unchecked. South Korea, a country that implemented early widespread testing, is an example of a success story. The U.S. did not implement such early testing, but federal and state governments are taking steps to address COVID-19 and avoid an example of a bad case scenario, such as Italy. Thus, there is reason to believe that the medium- to long-term outlook of the U.S. economy is positive, even if the consensus is that we are now in, or about to enter, a severe short-term recession.

Volatility Now, Potential Growth Later

Last week was a very volatile one. The VIX index (known as the "fear" index) reached its highest level on record. The week of March 23 could be another volatile week as governments negotiate and disagree on fiscal stimulus packages, and as the spread of COVID-19 continues to develop. Unfortunately, volatility is likely to continue for some time until there is more concrete evidence that the growth rate COVID-19 infections has been tamed.

While such volatility and bleak projections can be scary, it can perhaps be useful to see how the S&P 500 Index has reacted in the prior six occasions on which it has declined more than 30% from its peak (as of March 20, the index was down 32% from its February 19 peak). The table below outlines the change in the level of the S&P 500 Index, excluding dividends, in the months and years following a 30% decline. Except for the Great Depression, which we indicated earlier may not be an appropriate comparison, the index proceeded to have positive returns in the following three and five years. The average for three and five years would be significantly higher if the Great Depression were not included.

Change in S&P 500 Index After a 30% Decline from Peak						
Market Peak Date	**30% Decline Date**	**3 Months Later**	**6 Months Later**	**1 Year Later**	**3 Years Later**	**5 Years Later**
9/16/1929	10/29/1929	9.4%	21.0%	-14.1%	-65.3%	-61.5%
11/29/1968	5/14/1970	-0.3%	10.5%	35.5%	40.4%	22.3%
1/11/1973	7/5/1974	-25.5%	-15.5%	12.8%	19.6%	22.4%
8/25/1987	10/19/1987	10.9%	14.7%	23.2%	39.0%	84.6%
3/24/2000	9/17/2001	9.2%	12.3%	-15.9%	8.6%	27.0%
10/9/2007	10/6/2008	-11.6%	-20.9%	-0.2%	10.2%	60.0%
AVERAGE		**4.4%**	**11.4%**	**6.3%**	**8.8%**	**25.8%**

Source: S&P

For those with a medium- to long-term investing horizon, it is therefore important to remain invested, dollar-cost average to avoid timing the market, and rebalance as appropriate.

We are here to support you and navigate these times of uncertainty together. Knowledge is power, and we're committed to equipping you and your financial professional with the tools and information you need to weather this storm. We are continuing to watch market developments and are here to assist you with evaluating and understanding these economic changes. Please contact your financial professional to discuss your portfolio or should you have any questions/concerns.

20 E. Thomas Road, Suite 2000 • Phoenix, AZ 85012 • 866-481-0379 • **advisorgroup.com**

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