Market Update

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“While we expect a ‘dead cat bounce’ in the coming days, we also expect greater market losses over the completion of this cycle – and view safety nets as essential."

Apart from counting the novel coronavirus as a catalyst – a completely unpredictable “black swan” which triggers volatility – it’s also one of many factors that has created the current environment of *risk-aversion*. While I want to avoid adding to the “infodemic” of misinformation about COVID-19 that’s spreading quickly by well-meaning people on social media, and sometimes in real media too, it is important to know that the COVID-19 outbreak has added stress to an already weakening economy. **Stress often reveals vulnerabilities that hadn’t previously been visible to a great number of investors and, it would be misguided to imagine that the full-cycle market risk would somehow go away if the coronavirus was to abate (which is my hope).**

We continue to expect the S&P 500 to lose 50-65% from its speculative run to record highs in mid-February, to the trough of the next bear market. The potential for a “dead cat bounce” aside, we simply wouldn’t dream of removing our safety nets against a significant market decline (*this phrase, a term derived from Wall Street, comes from the idea that “even a dead cat will bounce if it falls from a great height”*).

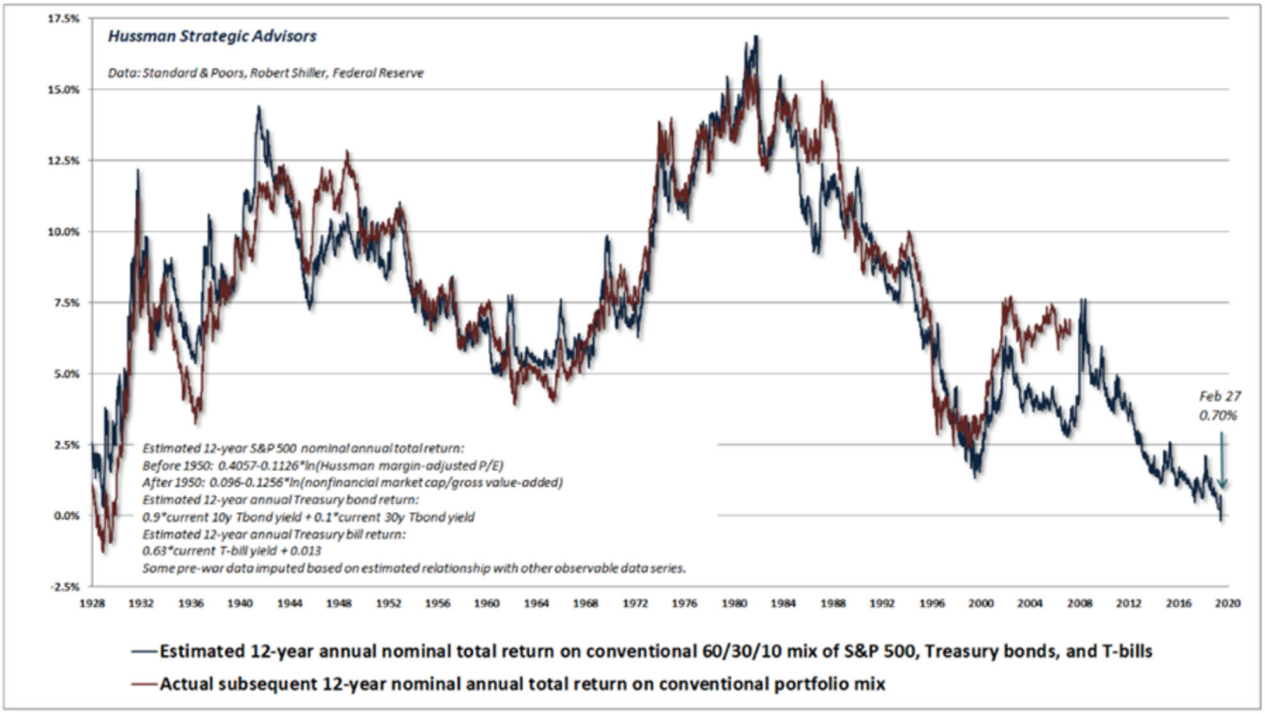
There are two key drivers of future investment returns: one is *valuations*, which simply measures the price an investor is willing to pay for every $1 of earnings. The other is the condition of *market internals* which is driven by the psychology of investors – specifically, their inclination toward *speculation* or *risk-aversion*. It’s important to recognize that sustained risk-aversion related to COVID-19 may prove far more persistent. That’s certainly my expectation.

Valuations Remain Extreme

To offer some historical context and illustrate the relative insignificance of this year’s market loss from a full-cycle perspective, the chart below updates our estimate of 12-year average annual total returns for a conventional, passive asset mix invested 60% in the *S&P 500 Index*, 30% in *Treasury bonds*, and 10% in *Treasury bills*. While the estimate of 12-year returns is back above zero from a mid-February low of -0.16% (which was weaker than even the prospective return at the August 1929 market peak), **as of February 27th, it’s still only 0.70%.**

John R. “Jack” Hooper
President and Chief Investment Officer

Presently, we continue to observe extreme valuations, coupled with unfavorable market internals. The problem with this combination is that it creates the risk of the "trap door" market collapses. We are not "bullish" from a full-cycle perspective, and *we continue to view safety nets as essential*, including government money market funds, long-maturity U.S. Treasuries, and hedged-equity investment strategies. **Maintaining this margin-of-safety discipline has allowed us to put protection in place before the market risks became self-evident.**



Across a century of market cycles, the most favorable environments to invest are invariably when investors have the capacity to imagine a complete market cycle, the willingness and patience to *lean away from risk when the market is richly valued and unsupported by favorable market internals*, and to have the courage to *lean toward risk when market valuations retreat to reasonable or depressed levels and is joined by an improvement of favorable market internals*. I have every expectation that we will observe such opportunities over the completion of this cycle.

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