Making Sense of Finance

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First Quarter 2020 Review

STOCK MARKET

After coming off a strong year and quarter for US stocks, the momentum abruptly ended. US stock indexes were at record highs on February 19th, capping an almost eleven-year bull market. By March 23rd, the S & P 500 index had dropped 34% from the record high and after recovering somewhat in the latter part of March, (rose 20% in three days) finished with a quarterly loss of 20%. Other major indexes performed poorly with the price weighted Dow Jones Industrial Index losing over 23% in the first quarter (Boeing stock a large contributor to that decline) and the tech laden Nasdaq Composite index performing slightly "better" with a loss of 14% last quarter. Volatility has been high. Every day in the month of March (except one day), the S & P 500 had a swing in price of at least 1%. The mood changes in the markets reflected the sentiment changes in our everyday lives, as news about the spread of the COVID 19 virus and its economic repercussions became a constant focus. We have all adapted to living differently for the moment and the behavior of stocks mirrors the uncertain underlying fundamentals for each individual company; amidst a discourse as to what changes are temporary and what is more of a long-term nature.

The decline in the market was broad based as all sectors tumbled in price. Not surprisingly, the energy sector had the largest loss, as a group declining 50%, with many individual energy stocks declining over 60% in the quarter. By the end of March, the oil and gas sector made up only 3% of the S&P 500. The price war set off between Saudi Arabia and Russia collided with a huge drop off in demand for travel, which created a perfect storm for the commodity price. West Texas Intermediate oil price decreased over 66% in the quarter (the worst quarterly drop ever), after having risen over 30% in 2019. Another sector which declined more than the overall market was financials (-32%), as concerns about extremely low interest rates affecting the earnings power of banks increased due to two more Fed Fund rate cuts in the first quarter. In contrast certain stock categories, although still posting losses for the quarter, performed better than the overall market. In keeping with last year's winner, technology stocks had the best showing last quarter with a loss of "only" 12%. (Microsoft was the only member of the Dow Jones Industrial Average which was up in the first quarter, up $0.01). Less economically sensitive stocks in the healthcare and consumer staple sectors also performed relatively well with category losses of 13% for each of them. Nine out of eleven sectors had dropped at least 20% from their 52-week highs. There was nowhere to hide in the stock market this past quarter.

Making Sense of Finance

Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

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Foreign markets also had dismal performances in the first quarter. The MSCI EAFE index, an index of developed country markets (measured in US dollars) declined 23% last quarter. Across the board, markets in Germany, United Kingdom, Italy, and Japan had losses of over 20%. An interesting note, the Shanghai index (at the origin of this global pandemic) only declined 10% in the first quarter.

BOND MARKET

Bonds in general had a positive performance in the first quarter, if you use the Bloomberg Barclays Bond Index to measure performance. That index which is primarily a blend of U.S. Treasuries, mortgage backed securities, and high-quality investment grade corporate bonds returned 3% last quarter. In a flight to safety, Treasuries in particular were the shining stars of the first quarter with yields declining dramatically to record lows (which means bond prices rose). The 10 Year Treasury yield ended 2019 at 1.92%. By the end of March, the yield was 0.70%. In mid-March the Federal Reserve announced a huge buyback of Treasuries and agency mortgage backed securities as well as cut the Fed Fund rate for the second time this quarter to a range of 0-0.25%. Many days within March yields were lower than they were at the end of the month. In fact, on March 25th, the 1,2 and 3 month-Treasury bills temporarily went to negative yields but have since rebounded into positive territory.

However, March saw a significant sell off in most other fixed income securities outside of Treasuries due to poor market liquidity. Later in the month the Federal Reserve stepped in to expand their buying to agency commercial mortgage backed securities. Together with the Treasury, many other programs were set up including a facility to purchase investment grade corporate bonds and exchange traded funds (unprecedented), which added much needed stability to the bond market. (Since the end of the quarter, the Federal Reserve said they will also invest in some lower than investment grade corporate bonds).

The Barclays Municipal Bond index had a slightly negative return for the quarter, -0.6% as investors worried about the soundness of many municipalities' finances at this time. Also unprecedented is the Federal Reserve recent announcement of buying short-term municipal debt. The Federal government hopes to help the local governments most affected by losses in revenues from the pandemic, in turn putting some much needed stability in the municipal bond market.

OUTLOOK

When GDP numbers come out in the next few weeks, it will likely show the largest drop in economic output in history. But this is different from a recession induced by excesses. When the government allows businesses to resume, it will be like a light switch, but with some bulbs flickering and other bulbs that will never reignite. With some evidence of the virus curve flattening already, the stock market has bounced from its lows. Volatility has been excessive of late, with markets rallying up to 20% in just three days. However, volatility is a concern for short-term traders, not long-term investors. The reality is that there will be long lasting damage to the global economy so our expectations are subdued after recent rallies.

The government stimulus package of $2 trillion is many factors greater than TARP from the 2008 financial crisis and there will be a cost to citizens which may include higher taxes when things do recover. Those who believed that crypto currency was a good hedge against traditional assets had a rude awakening. Real estate (REITS) with its large mortgages are worrisome, but banks and the government seem to be fairly reasonable with payments given the unique case we are currently in. Indeed, we think they have a similar risk profile as regular corporate stocks, even now. The Oil and Gas Industry remains a place we have, quite frankly, not done well in. Saudi Arabia and Russia's recent feud decimated oil prices and all global producers. Oil even sunk below the $20/barrel mark which for the majority of producers is unprofitable. The political and economic unknowns make this industry segment completely undesirable to us.

For those who succumb to believing the fear mongers in the media, the best bet would be to buy Treasuries with essentially no return potential. Many stocks though, especially from companies that make it through to the other side are sure to be better prepared and in better shape in terms of staffing and talent. The current environment does not allow much fat to exist on corporate structures. In the shorter time frame, safe asset classes like Treasury bonds and Gold sound like a good idea but in the long run, they tend to be lousy investments. Bonds for instance are called fixed income for a reason; a 30 Year Treasury bond with today's yields will only return 1.4% per year if held to maturity. Stocks, as a whole, allow for growth and innovation. How many times has AT&T reinvented itself in the past century? Think of the former as helicopter parents who won't allow their child to try anything or potentially get hurt (good luck to that kid as an adult); and the latter as a parent who allows their child to try new things and expose them to the risks of the world with some basic safety rules. That kid will most likely bump its head or scrape a knee from time to time, but live a more fruitful life; and those lessons pertain to stocks too.

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