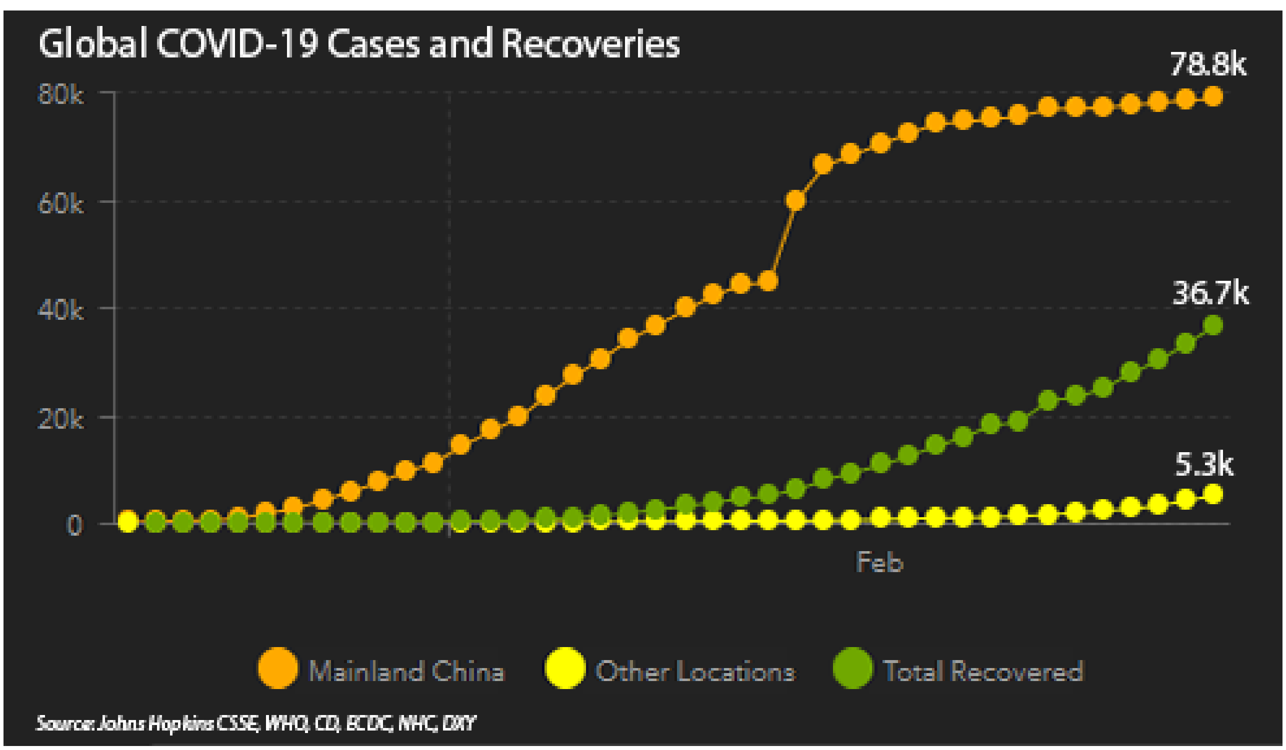
MONITORING THE MARKETS & the COVID-19 Virus

MARKET COMMENTARY

FEBRUARY 28, 2020

What started as a small outbreak of a flu-like virus in China has rapidly spread infections, fear, and uncertainty throughout the globe. Although we have not officially reached "pandemic" levels, according to the Centers for Disease Control and the World Health Organization, the virus appears to be systematically making its way westward out of China.

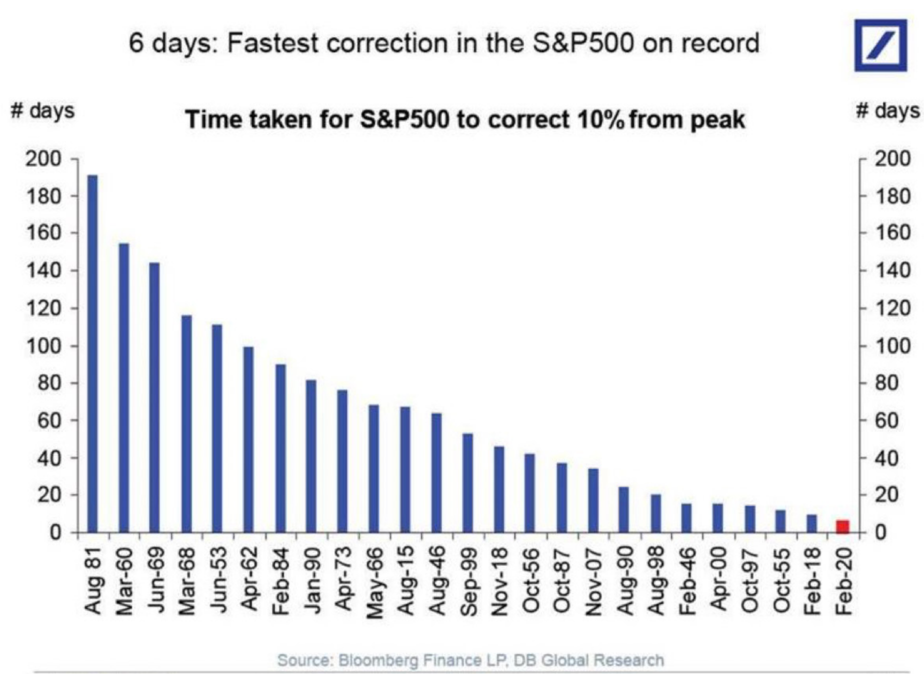
Immediate responses from governments, businesses, and individuals have led to border closings, supply chain disruptions, and canceled travel plans. It is impossible to predict the ultimate impact of the virus on the global economy, but as the past week and a half has shown, a growing fear has been infecting investors even faster than the virus itself.



How did we get here?

1. In early January, the bond market rallied sending yields lower and the oil market began showing signs of a pullback.
2. Later in the month, the number of COVID-19 cases in China surged and Chinese equity markets began selling off.
3. The US markets continued to rally heading into February as China's extraordinary measures to lock down one of its most populous cities appeared to plateau the number of confirmed COVID-19 cases.
4. US markets began showing cracks after China changed its testing measures for the COVID-19 virus and confirmed cases skyrocketed. Market leadership took a hit after Apple was one of the first companies to announce that the virus could significantly impact its supply chain, sales, and earnings expectations for 2020.
5. COVID-19 spread to South Korea over the weekend and the VIX saw its largest single day spike seen since the dramatic "volmageddon" risk unwinding in February 2018. Fears that China's new flu would become a pandemic pushed global markets into a correlated sell-off.

The dramatic sell-off was officially the fastest market correction in the history of the S&P 500 and has now lasted for an incredible seven straight days.



What are the issues and what can policy makers do?

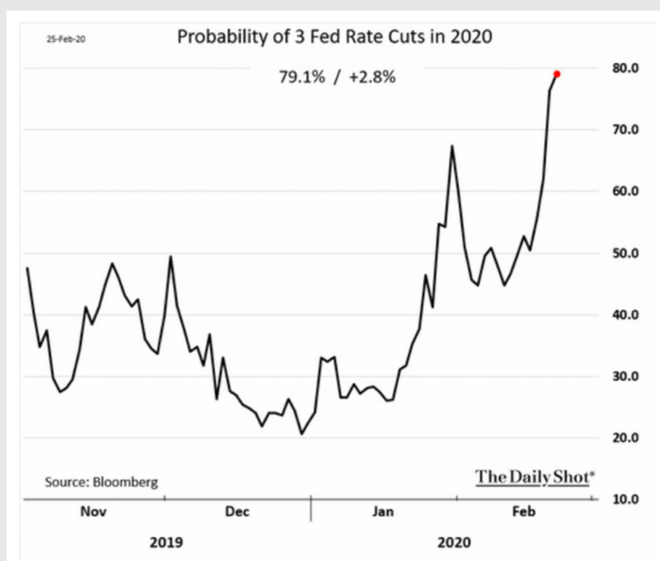
The fear is that we are entering a supply shock in which companies will be unable to produce goods or offer full services because of disruptions to the global supply chain and employee activity.

Additionally, the current prescription for avoiding the virus has been to stay put and stay away from other people. This recommendation is fine over the short-term, but if people are just staying at home, they most likely are not spending much money. The consumer has been the backbone of economic growth over the past year and an extended period of consumer stasis could also lead to a demand shock. If we begin to see more limits imposed on the population, future growth expectations for businesses and the economy will be reined in significantly.

Many investors are expecting the Fed to step in and cut interest rates again to help support the markets. Fed Chairman Jerome Powell recently released a comment indicating that the Fed would step in and do "whatever is necessary" to help the economy. Since the Global Financial Crisis, the Fed has been the markets' "rich uncle". Every time stocks needed a little help, the Fed was there to open up their wallets and keep the party going with quantitative easing. While policy makers may be able to put a floor under the current market decline, we are not confident that Fed policies can effectively halt the threats of COVID-19.

The Fed's typical policy tools are simply not designed to counter this type of economic supply and demand shock. A reduction in interest rates will not make people go out and spend money at the movies, restart supply chains, or remove travel restrictions from affected areas.

The Fed may be able to slow the decline in investor sentiment, but it is looking increasingly likely that the global economy will need to let this virus run its course and get ready for a healthy recovery.



What are we doing?

As we noted in our 2020 outlook, drawdowns have become more severe and more violent over the past 18-months and we expect the trend to continue.

It is increasingly important to be able to spot signs of a significant reversal in trends and begin shifting portfolio allocations before a full correction ensues. Our proprietary Newton model helps us do just that and has been essential in helping us position our asset allocation during these volatile times.

Our portfolio positioning was tilted risk-off heading into the year based on negative signals that we were seeing from the bond and commodity markets. Based on the momentum in the markets going into January, we tactically increased our equity positioning. During the week of February 17th, we began to see signs that equity market momentum was deteriorating, but was still positive. Our Newton models began flashing yellow heading into the last week of February, and we began shifting our target allocations towards risk-off by lowering our exposure to equities. Our long-term indicator, which was last triggered in September of 2018, gave us a sell signal during the last week of February, confirming a negative outlook for equity markets.

We are extremely pleased with how our equity team and our Newton models have operated during these volatile markets. Our current target allocations are currently overweight fixed income and significantly underweight equities versus our long-term allocation expectations. For now, based on our model output, economic research, and recent price action,we do not think this is a normal "buy-the-dip" scenario. Black swan events like the COVID-19 virus outbreak have been a part of the markets throughout history, and negative dislocations do tend to resolve upwards. Based on the data and the analysis we have seen so far on COVID-19 cases and recoveries, it looks like the virus' life cycle may be shorter than previously thought. We are already seeing signs that the rate of new infections is declining in China, and data from the worst effected countries are showing a similar rate of confirmed cases.

That being said, the situation is extremely fluid and if there is one thing the markets hate it's uncertainty. While it is impossible to say exactly when we will see a turn-around in the markets, we think the current repricing and temporary nature of the virus will set up equities for a positive turnaround later this year. We will be keeping our allocations tilted towards risk-off while we continue to learn more about the COVID-19 virus and its potential impacts on the domestic and global economy.

When we see a significant reversal in our Newton models, we will be ready to rotate assets back into equities and realign portfolios with our long-term allocation targets.

In times like these, it's important to remember that the primary defense to equity market volatility is your asset allocation. At Waterloo Capital, we design portfolio allocations to meet your long-term goals, which we measure in years and decades. Overall, our long-term outlook on global equities remains positive. Our primary focus will not stray from designing and implementing an asset allocation strategy to manage through short-term periods of risk while achieving your long-term investment goals.

Please don't hesitate to contact us if you would like to discuss this or any other questions or concerns you might have. We are always available.

Please contact us by calling: (512) 777-5900 or email us at: jchatmas@waterloocap.com

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