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OCTAVIA'S OUTLOOK
MARCH 2020 – WHAT IS DRIVING MARKET MOVEMENTS

Over the past 7 trading days ending February 28th, the S&P 500 declined 12.4% from its closing all time high on Wednesday, February 19th. For the year, the S&P 500 is down 8.0%. The rapidity of the decline is one the fastest in history. With this as context, I'd like to share my thoughts on what caused the decline and my thinking going forward.

But, first, I want to provide context. Stock markets are volatile. Pullbacks such as this are normal, even if the speed of the pullback was extraordinary. Your investment portfolio should take into account when you need to access your investments. If you are several years away from needing to access your investments, then you should just view the pullback as normal. If you currently rely on your investment portfolio as your source of funds for living expenses, then your portfolio should be constructed in a way such that large drops in the stock market do not adversely impact you and you have plenty of time to recover before needing to sell the stocks component of your portfolio.

With that, here are my views on the current market decline. From reading the media, you would believe that the decline is 100% due to the global coronavirus. But, I believe there are three fundamental factors and one technical factor which contributed to the market decline, the coronavirus being one of them.

The S&P 500 increased 31.1% in 2019 despite the fact that profits in aggregate for the S&P 500 companies were largely unchanged. The US stock market was looking forward and assumed that the US-China trade dispute would be resolved, global economic activity would rebound as a result, and companies' earnings would grow in aggregate about 7% in 2020. The coronavirus outbreak and resulting reduction in economic activity has put 2020 earnings growth at risk, which is causing the market to reassess company valuations.

So, yes, the coronavirus matters. But, two other things happened the week of February 17th that also matter.

First, Bernie Sanders took a commanding lead in the Democratic primaries and in polling. The markets are very concerned about a Sanders presidency's negative impact to economic growth and corporate profitability. As the probability was increasing, investors were starting to discount company values.

Second, several federal reserve bank presidents stated that they still did not see a need to cut interest rates. Yet, the markets were (and still are) pricing in three to four interest rate cuts in 2020. We saw this same thing happen in Q4 2018. In October 2018, the Fed stated they were on autopilot to raise interest rates three times in 2019. The US stock market then proceeded to fall over 20% as the market thought that Fed policy would cause a recession; that the Fed was out of step with what was happening in the real global economy. The Fed then changed their tune and ultimately cut interest rates three times in 2019 (and the US stock market increased 31%). On Friday, February 28th, around 9am eastern time the markets were indicating an open down 1.5%. Then St Louis Fed president Bullard made the statement that he does not yet see the need to cut interest rates. Immediately, the markets indicated a 3.5% decline at the open.

Finally, from a technical standpoint, an index that tracks volatility in the market increased dramatically. For many large trading strategies, this triggered sell orders of US stocks. But, the sales then made the volatility index go higher, which then triggered even more selling. It was feeding on itself. For many of the sell-offs over the past 10 years, these algorithmic computer programs exacerbated market declines, although they are always short-term in nature.

So, the above four factors lead to the market decline. Looking forward there is only one factor that concerns me:

1. The technical trading is always short-term in nature and will reverse itself.

2. The Fed will ultimately follow the markets lead and cut rates.

3. The coronavirus will ultimately work itself out and the global economy will get on a growth path again. That said, its only after the rate of increase in daily infections starts to decline that this risk will start to be taken out of stock prices.

4. But, the possibility that Bernie Sanders will be president is a structural, fundamental threat to the US stock market as his stated policies are anti-growth and anti-corporate profits. The thing I am watching most closely are the Democratic primaries, and specifically Super Tuesday this week. If a moderate such as Biden or Bloomberg can make a strong showing, this will be very bullish for stock markets. If Sanders becomes the presumptive nominee, I believe markets will sell off on Wednesday. Interestingly, as I am writing this, Pete Buttigieg announced he is dropping out of the race. Immediately, the US stock market futures rallied, the thinking being that moderates that would have voted for Buttigieg will now coalesce around Biden or Bloomberg. Maybe this is coincidence, but I don't think so.

I hope you found this letter of value. My goal is to make good investment decisions, and I welcome any input.

Warmest Regards,

Andre Kovensky
Octavia Investments LLC

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