

April 2020

## Navigating the Pandemic

The coronavirus outbreak and ensuing lockdown delivered an unprecedented hit to the global economy and the financial markets. Though recent weeks have seen millions of Americans file for unemployment and historic losses in the stock market, it does appear that the worst has passed. Government officials across the nation are beginning to implement plans for the economy to reopen, and the stock market has recovered about half of the losses it had seen. We have made great strides in containing and treating the virus, and the crisis becomes



more manageable every day. While no one can predict precisely what the economic recovery will look like, we believe that the overall direction of the economy is positive. The recovery will likely be choppy, and there will be increased periods of volatility over the next year, but these periods will allow us to make strategic moves, confident that the economy is heading in the right direction.

We have seen a substantial rebound in the stock market, but the recent gains have been mainly contained to large cap U.S. stocks. The Russell 1000, an index that tracks large cap stocks, shows total returns are down 11% year to date. Mid and small cap stocks have not yet seen a significant turnaround, and the Russell 2000, which tracks mid and small cap stocks, shows that total returns remain down 23% for the year. Foreign stocks also remain significantly down, and these losses are further exacerbated by the weakness of foreign currency in comparison to the U.S. dollar.

The VIX, which tracks fear in the stock market, indicates that anxiety, is down significantly from recent peaks, but remains historically high. Investors are waiting to see the larger macroeconomic impact of the virus and what the recovery will look like. The likely outcome will be V-shaped, where a steep decline is quickly followed by a rapid increase, or U-shaped, where the recovery is delayed. The worst case would be an L-shaped recovery, which would mean a prolonged slowdown and a recovery that could last years before returning to the previous highs. Regardless, there will be an inflection point where investors feel confident enough to reenter the market, driving it back up.

It is important that we are ahead of the curve on this and are positioned to catch the rebound as soon as it begins, instead of being stuck on the sidelines waiting for the right time to jump back in. To that end, we are currently focused on rebalancing our portfolios and rebuilding our stock holdings in anticipation of the economic recovery.

Despite recent events, the long-term prospects for the American economy remain strong. The U.S. has the best distribution channels in the world, from domestic shipping along the Mississippi River and across the nation's railroad network, to international shipping that has the confidence of knowing that the U.S. Navy can



secure our trade routes. We also have the lowest energy costs in the world. American workers are more productive than those in any other nation, allowing us to manufacture more while using less labor. Seven of the top ten research universities in the world are in the U.S., meaning that America will continue to drive innovation in technology and medicine. Our country has been hindered in a way that no one could have predicted, but once the threat of the virus passes, our economy will not just survive, but thrive.

### **U.S. Stock Market**

The first quarter of 2020 saw the economy and the stock market upended in a way not seen since World War II. The Russell 3000, a broad index that tracks the essentially the whole of the stock market, fell 37% from its peak on February 19 before bottoming out on March 23. While the nature of this downturn is unprecedented, downturns in and of themselves are not. There have been 20 market corrections, meaning a drop of at least 10%, and 9 bear markets, where the market falls by 20%, since 1980. The lesson to be learned from previous downturns is that patient investors will be rewarded.

There are concerns about the economic fallout and corporate earnings, but our conviction in the U.S. stock market remains strong. The underlying economic fundamentals are strong, and accommodating fiscal policy should support the recovery. While the coronavirus outbreak may be giving some investors flashbacks to 2008, they are not comparable. The 2008 crash was caused by a collapse of key financial systems, which then spread to the rest of the economy. The economy was on much more stable footing before the COVID-19 outbreak, and it is unlikely that we will see the sort of gradual, prolonged L-shaped recovery that followed the 2008 crisis.

The beaten-down stock market presents a unique buying opportunity, and to that end, we are currently deploying cash back into the stock market. We are focused on sectors that align with our investment objectives. This is a good time to buy stocks across the whole market. We are, however, wary of companies with high leverage. If the economic downturn is longer than we expect, companies with high debt ratios could fail to generate enough profits to service their debt and may fall into bankruptcy.

### **Fixed Income**

In the coming months, the bond market will be dominated not only by the COVID-19 outbreak, but by the response of the central banks as well. The Federal Reserve has acted aggressively, lowering the benchmark interest rate to near zero. It has also increased its balance sheet to \$5 trillion and introduced a special-purpose vehicle to purchase investment-grade corporate bonds, all in an effort to shore up the financial markets and ensure that credit is flowing. The downside of this is that interest rates are very low across the yield curve and are likely to remain there for some time.

As the coronavirus roiled the markets, investors fled to the safe harbor of U.S. Treasuries, and as a result, these were one of the few assets to generate positive returns in the first quarter. We were heavily weighted toward U.S. Treasuries for our conservative and moderately aggressive investors, which has provided a valuable buffer against losses in the stock market. Now, as the market begins to recover, they are less attractive. Yields will likely remain low and the Treasury will be issuing a record amount of new debt to pay for the government's massive stimulus bill.

In the near-term, we prefer high-quality investment grade corporate bonds. In the current moment, credit rating is particularly important. Though the Fed's actions should support and stabilize the market, we are still wary about credit downgrades. The massive amount of BBB rated bonds poses a risk to the market, and we anticipate some corporations will see their rating drop to "junk" status, which could destabilize the market. We are also wary of high-yield, or "junk" bonds, as we feel they still offer too little return for the increased risk that they carry.

Municipal bonds were not spared from the recent turmoil, as volatility has roiled the market. While the Fed's actions should help to stabilize the muni market, we are still cautious about munis. The main reason is



the lack of liquidity in the market. Significant outflows from muni mutual funds and ETFs have made it difficult to get a reasonable price in a reasonable timeframe. Even as liquidity issues subside, the drop in revenue from sales taxes and income taxes could put a strain on many municipalities. We recommend only muni bonds that have a high credit rating and are from issuers that will be able to manage an economic downturn. Bonds from municipalities like Georgia are generally more secure than those from a state like Illinois, which is in a more fiscally precarious position.

### **International Markets**

We were underweight on non-U.S. holdings before the coronavirus crisis, as the rest of the world was in the midst of a broader economic slowdown and ongoing trade tensions. The comparative strength of the American dollar continues to limit the appeal of international stocks, but as foreign markets begin to recover, we will look for attractive opportunities to rebuild our position.

The world's eyes are focused firmly on China. The nation was the original epicenter of the virus and now offers a glimpse of what a recovery could look like. Just over two months after the lockdown began, business has resumed in the country, and estimates claim that activity is back up to about 90% of what it was before the virus.

Recently released figures show that the country's economy shrank 6.8% in the first quarter, as compared to a year prior. This is the first year-over-year GDP decline since the country began releasing quarterly numbers in 1992. There is always reason to be skeptical of the official numbers Beijing releases, and the real economic contraction could be even more severe. The government can exert substantial pressure to restart manufacturing and state-run industries, but it remains to be seen when Chinese citizens will begin to feel comfortable engaging in face-to-face business. Retail sales were particularly hard hit in the first quarter, falling by a staggering 16% annually.

Japan, with its reliance on Chinese tourism, high population density, and elderly population, was expected to be hard hit by the coronavirus. However, the country has seen a modest number of COVID-19 cases as compared to the rest of the world. While this is welcome news, the country's economy was struggling even before the outbreak. An increase in sales tax caused an economic contraction at the end of 2019. Now, with tourism drying up and the postponement of the Tokyo Olympics, a recession is all but inevitable.

While Spain and France have struggled to deal with the virus, none of the continent's countries have been hit as hard as Italy. Like Japan, Italy was on shaky economic ground before the epidemic. The nation saw GDP decline in the fourth quarter of 2019 as its manufacturing struggled with global trade uncertainty. Germany, which has handled the virus better than other European nations, also saw manufacturing contract in the



weeks and months before the outbreak. The U.K. was expected to see strong economic growth in the first quarter now that Brexit had officially gone through, but while the virus's transmission is lagging behind the rest of Europe, it now appears that the U.K. will follow a similar trajectory.

Central banks across Europe already had near zero or even negative interest rates, so they are left with little room to maneuver. For most European central banks, the aim is to stabilize the economy, but they may not be able to stimulate the way that the U.S. has.

Emerging markets may fare worst of all as the virus spreads across the globe. Dense urban populations and a lack of resources make Asian markets like Thailand and the Philippines particularly vulnerable. Markets in South and Central America and Africa face similar issues. For many emerging markets, the biggest economic challenge comes from the collapse of many commodity prices, as commodity exports is the cornerstone of many nations' economies.

Commodity prices have suffered from the widespread lack of demand for raw materials. Oil, which has seen unprecedented losses, faces issues on both the supply and demand fronts. The standoff between Russian and Saudi Arabia over cutting production has led to massive surpluses. Reserves are overflowing and demand has plummeted with travel grinding to a halt globally. Despite this, we are bullish on oil's prospects in the coming years. Low oil prices are a self-correcting problem, as low prices will eventually force production cuts. Some of the smaller companies may not be able to weather the storm, but these can be absorbed by the larger corporations. These corporations have stronger balance sheets, so they are more prepared to handle the boom and bust cycle of oil production. This will also give larger corporations access to the shale industry, which is currently dominated by smaller companies. Consolidating shale production will lower the break even point price for American energy companies and solidify our status as the world's leading energy producer.



### Hanover Advisor Bulletins

#### Special Reminders to all Hanover Clients

- ◆ The Hanover Advisors website can be accessed at [hanoveradvisorsinc.com](http://hanoveradvisorsinc.com). There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).
- ◆ **New enhancements to our portfolio reporting system.** All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. The system will have a new look and major enhancements starting this fall. Our office is available to assist in accessing and utilizing the Black Diamond system.
- ◆ As a reminder to our clients that Hanover Advisors, Inc. now has an office in Greenville, SC. Meetings can be scheduled at either the Greenville office or our conference facilities at Concourse Parkway in Atlanta. Please see our website, [HanoverAdvisorsInc.com](http://HanoverAdvisorsInc.com), for detailed contact information.
- ◆ We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.

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