

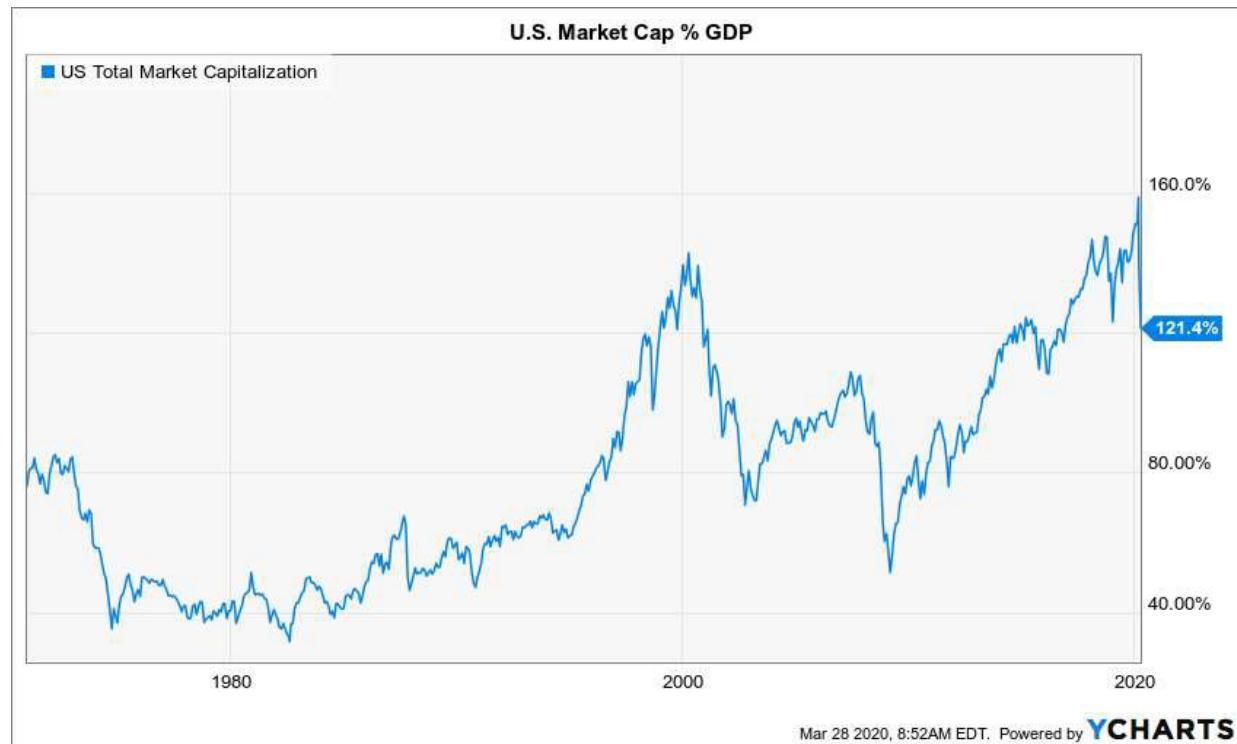
Market Perspective April 2020

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For several quarters of “Market Perspectives,” I cautioned that risk assets carried high valuations based on historical norms that made prospective returns lower. Beginning six months ago, I stated that, “Now is not the time to embrace risk assets.” Of course, no one could have forecast the arrival of the coronavirus. However, this exogenous threat is now deflating the valuation bubble. I refer to risk assets because the risk premiums afforded to these assets (e.g., domestic stocks, international stocks, credit-dependent bonds, real estate cap rates, private equity multiples, etc.) tend to move together when there is either a rush to safety or an embrace of risk.

Let’s look in greater detail.

At the market’s high on February 19, the Market Capitalization of US Companies as a percentage of US GDP was 159%. As of March 26, that ratio was down to 121%, a 24% reduction. Going back 50 years, the average for this statistic is 84%, a further 31% reduction from today. So, regardless of your assessment of the economic effect of the coronavirus, stock valuations have not fully returned to their average valuation based on a historical comparison to GDP. Moreover, GDP will clearly be materially reduced for some time by our actions to minimize the virus, putting even more pressure on this measure.



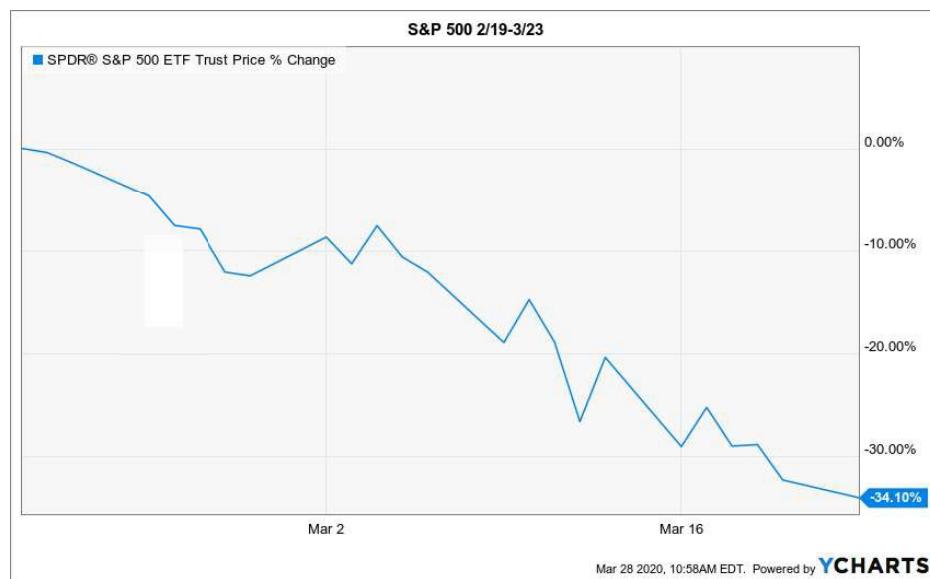
While the hyper valuation of the last few quarters has abated, equity valuations remain high. The attractiveness of today's market values is a function of one's views on the future direction of the challenged economy and corporate earnings.

Of course, markets have had major declines before. Shown below are all those declines that reached at least 20%.

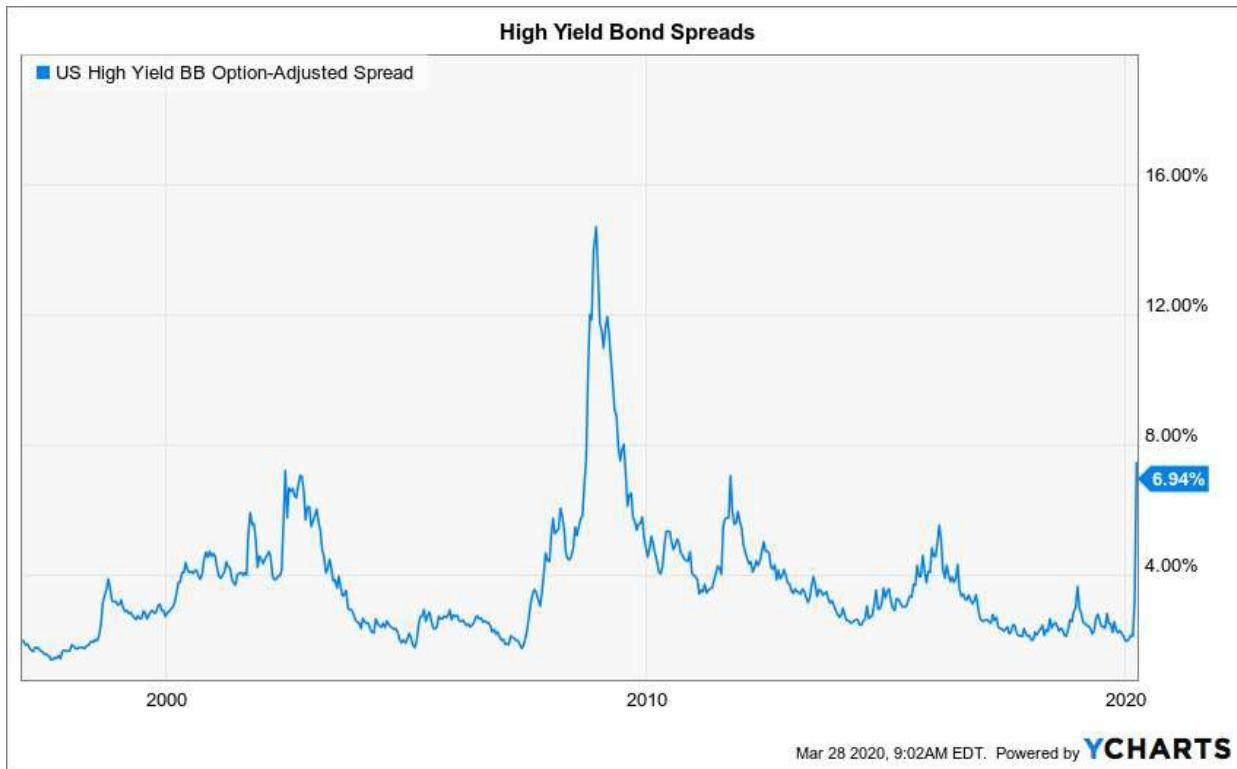
All 20%+ Declines from All-Time Highs in the S&P 500

<u>Date of All Time High</u>	<u>Max Drawdown in Period</u>	<u>Duration of Drawdown (No. Months)</u>	<u>Date of Recovery to Closing High</u>	<u>Duration to Recovery (No. Months)</u>
16-Sep-29	-86.19%	32.29	22-Sep-54	297.57
2-Aug-56	-21.63%	14.62	24-Sep-58	25.71
12-Dec-61	-27.97%	6.43	3-Sep-63	20.67
9-Feb-66	-22.18%	7.95	4-May-67	14.76
29-Nov-68	-36.06%	17.57	6-Mar-72	39.05
11-Jan-73	-48.20%	20.76	17-Jul-80	90.38
28-Nov-80	-27.11%	20.48	3-Nov-82	23.24
25-Aug-87	-33.51%	3.38	26-Jul-89	23.10
24-Mar-00	-49.15%	30.33	30-May-07	85.86
9-Oct-07	-56.78%	16.90	28-Mar-13	65.52
21-Sep-18	-20.21%	3.10	29-Apr-19	7.10
19-Feb-20	-26.95%	0.77	?	?
MEAN	-39.00%	15.80	MEAN	63.00
MEDIAN	-33.51%	16.90	MEDIAN	25.71

Our current decline bottomed (so far) on March 23 at 34% down from the all-time high on February 19. While that matches the median of the declines above, our current drawdown falls well short (in both severity and duration) of the declines during the Great Depression, the dot-com bubble or the Great Recession. I highlight these three comparisons because they had economic drawdowns representative of general expectations for the current crisis.



Valuations of risk markets other than equities are behaving much the same way. High Yield Bond spreads have widened considerably, though investors must be careful to avoid businesses that will go under in today's environment.



Last quarter, I referenced the CNN Fear & Greed Index. I noted that this measure was maxing out on the level of Greed. The implication was negative for risk assets. Before last week's equity rally, the measure was pegged at the opposite extreme, implying that better times may lie ahead for the performance of risk assets. It moved halfway to neutral after last week's rally.

Fear & Greed Index

What emotion is driving the market now?



While some of the overvaluation in the market has been wrung out in the recent downturn, we can't really call this moment a great valuation entry point. First, risky assets are certainly not undervalued currently. Second, we don't yet have a handle on how long and how deep our economic downturn will be. Nonetheless, there's no denying that equities are currently 24% off their highs. For those who were awaiting a downturn in the market to establish long-term investments, now may be the time to get started. However, while it's never possible to "call the bottom," the prospect of the economic effects of at least one more month of fighting the virus may yet provide the opportunity to invest at even more attractive levels. For that reason, I'd encourage investors who have a target allocation to equities higher than their current investment (including those who should be rebalancing after this big move) to cautiously begin closing that gap, but leaving some powder dry for opportunistic investing at even more attractive prices.

While I generally confine myself to discussing specific measures of the market, the current coronavirus impact on our economy is more pervasive than ordinary topics. Estimates for how the virus will impact GDP—and for how long—are all over the map. I don't have any special insight to offer, except for one item. I believe that after a couple of months of the economy being largely shut down and consumer/business cash reserves drawn down, it will be difficult for economic output to roar back to pre-virus heights. That is, our society and our workplaces may well adjust to different patterns of demand and supply. If this comes to pass, then GDP and corporate earnings levels may not just return to previous levels. I expect that this uncertainty over our economic future will weigh on market valuations of risk assets for some time.

In other words, while I have consistently warned against the high valuation of risk assets, that caution has somewhat abated. Investors, however, shouldn't expect a rapid return to the heady days of the pre-virus investment environment; rather, our new levels of higher volatility and lower valuation will be with us for some time.

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