March 26th, 2020

SPECIAL REPORT: INVESTING IN THE TIME OF CORONAVIRUS

ASK FORSTRONG: WHAT ACTION IS THE INVESTMENT TEAM TAKING IN CLIENT PORTFOLIOS TO RESPOND TO EXTREME MARKET VOLATILITY?

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Coronavirus and all its catchphrases — flattening the curve, social distancing and so on — has taken a wrecking ball to daily routines. Working from home has brought new challenges. Calendars have been emptied and commute times cut. But occupational hazards have emerged: cabin fever, the close proximity of the cookie jar and, for some of us, new colleagues of the Crayola-wielding kind (prompting a military-like enforcement of office hours in the case of this money manager).

But the pandemic that is ravaging routines around the world has also claimed a more subtle victim: rational thinking.

In many ways, this is understandable. The public doesn't know who or what to believe. And why should they? They are drinking from a fire hose of information. The rise of social media has exacerbated the problem. News now travels much more quickly. Yet faster data flows have disadvantages. Misinformation arrives into the world fully formed. No supporting evidence is required. Ultimately, hysteria is transmitted more effectively (for more on this topic, see our recent report "Straight Talk On COVID-19").

Fear is now spreading faster than the virus. The financial community is frothing at the mouth. Pundits, presumably speaking from their hastily arranged bunkers, are falling over each other to describe Mad Max-like futures. Dystopian metaphors are running out. And, apparently, some of us are now experienced epidemiologists.

All of this has led to a level of indiscriminate selling that has never been witnessed. In fact, this is the fastest bear market in history (defined as a peak-to-trough decline of more than 20%). Meanwhile, markets continue their streak of new records. Volume in State Street's largest S&P 500 ETF (NYSE:SPY) has surged to more than 180% of its 6-month average. This is the most rapid spike in history (hat tip to the analysts at *Sentimentrader*).

Forstrong Portfolio Positioning

Our investment team has just concluded our quarterly investment strategy process. Over the last 17 years, Forstrong has conducted 68 of these sessions. The latest session brought back memories of March 2009 — the cathartic low of the global financial crisis. Conditions are very similar: growth expectations have collapsed, sentiment readings have hit extremes and many investment valuations are compelling.

Emotions are also high. But fear, that wild and foreboding thing that has settled over all of us, is not a sentiment to be wasted. In fact, in the world of managing money it is essential to outperform. Investors must act now. We are. The strategies outlined below have been initiated in client portfolios as of March 24, 2020.

Cash and Currencies

Reduced cash weightings

- Investor panic in recent weeks has created numerous price dislocations in financial markets.
- We have drawn down cash levels opportunistically to capitalize on these mis-pricings.
- Cash is now below neutral levels in each of our respective investment strategies.

Protecting against US dollar vulnerability

- Tightening US dollar liquidity conditions have pushed the already overvalued currency to new heights; even against other "safe haven" currencies such as the Japanese yen and Swiss franc.
- With the US Federal Reserve implementing significant measures to shore up liquidity and protect financial markets, the US dollar is now susceptible to a reversal.
- To protect against this risk, US dollar exposure is sharply underweight. Conversely, we are sharply overweight currencies that have been indiscriminately sold off. Many of these reside in the Asian emerging market universe.

Global Equities

Increased equities to sharp overweight stance

- Equities are now incorrectly pricing in a deep and prolonged recession.
- The COVID-19 pandemic will surely cause severe economic damage in the short-term. However, our base case is for a transitory shock, with central banks and governments worldwide flooding the global economy with substantial monetary and fiscal stimulus.
- We have materially increased equity exposure this quarter to position for a rebound.

Back to North America

- Exposure to Canadian and US equities have been increased this quarter following steep sell-offs in each nation.
- In Canada, a combination of a well-capitalized banking sector and an extremely cheap currency should be highly supportive of long-term returns.
- The US has arguably taken the most decisive fiscal and monetary action of any nation or bloc worldwide. These actions should help limit economic downside and restore investor confidence.
- While our favored nations still reside in emerging Asia, Canadian equity exposure is set at an overweight position (although limited in our more globally-oriented strategies)
- An underweight position in US equities has been closed for now. We anticipate reducing exposure again at some point.

Global Fixed Income

Decreased fixed income

- While ultra-low bond yields have been a defining feature of the global economy over the past decade, the flight to safety in recent weeks has pushed yields to extreme levels.
- Not only do most government bonds offer insufficient income, but at current prices they carry an elevated risk of capital losses as supply increases to fund fiscal stimulus measures.
- Overall fixed income exposure has been moved to a pronounced underweight.

Finding value in credit

- Credit spreads have expanded rapidly as corporate bond markets seized up amidst the recent market turmoil.
- Already, the US Federal Reserve has announced an unprecedented plan to purchase corporate bonds and ETFs. This effectively provides a much needed "backstop" for the market. We expect similar measures to be announced shortly from other major central banks.

- Fixed income exposure remains tilted towards short-term corporate bonds, which limit interest rate risk and should benefit from a re-tightening of credit spreads.

Opportunity Investments

Rebalancing and reaffirming our structural views

- The recent market dislocation was particularly acute amongst opportunity investments, which often focus on niche and less liquid areas of the global financial markets.
- Given that we expect COVID-19 to be a transitory shock, longer-term themes (what we call "Super Trends") will re-assert themselves once the panic is over. In fact, many of these trends will accelerate.
- Key areas of focus include the following: the rise of the emerging Asian middle class (establishing core exposure to Asian equities), a rotation away from US global leadership (limiting exposure to US stocks), the ongoing move away from fossil fuels and "globalization 2.0" (avoiding direct oil and gas exposure and aligning with a post-industrial global economy) and the entrenchment of aggressive government policies (setting the stage for an inflationary outlook in the 2020s).
- With a large proportion of opportunity investments out of line with their underlying economic reality and fair value, we elected to rebalance in order to restore exposure to the most deviated asset classes and reiterate our risk-on positioning.

Investment Outlook: It's Still Not 1929, 1999 or 2008

As always, we will continue to monitor the evolving pandemic and continue to adjust portfolios accordingly. However, looking ahead, clear lines have been drawn in the global outlook debate. On one side, many believe that coronavirus is a clear catalyst to a longer running downturn — even a depression. On the other, a transitory shock is forecasted. We are squarely in this camp. Much ink has been spilled by our investment team on this subject (see "Corrections, Coronavirus and Crisis – No Time To Panic").

However, it is worth re-affirming our view. The key is to differentiate what is unfolding now (a temporary liquidity and demand shock followed by a return to trend growth) from a classic recession (a longer-running change in trend driven by monetary tightening or the bursting of a major financial imbalance). To date, the evidence strongly suggests that this is more of a technical recession.

Consider past episodes. The 1930s depression was a classic credit crunch, exacerbated by counterproductive policy measures and protectionism. The bursting of the technology bubble in the late 1990s had its root in financial excesses and capital overspending. The crisis in 2008 was a perfect storm with the bursting of a major asset bubble and years of financial deleveraging afterward. What do all of these have in common? Deep financial imbalances that took years to work out.

The current episode is far different. Heading into 2020, the degree of leverage in the global financial system was far less than 2008. Households in the major economies (the US and Eurozone) have deleveraged substantially over the last decade. Most of the leverage in the corporate sector is on the financial engineering side rather than capital over-spending. And, the banking system is very healthy around the world. Systemic risks were low.

Of course, financial contagion risks are elevated today. We are now in the grips of a full-blown financial market panic. The major risk is always the same: people's reactions to panic can amplify the real economic pain, causing a vicious feedback loop into financial markets. The jury is still out whether this is the death of the cycle, where the world is pushed into a self-reinforcing period of rising unemployment and investment cutbacks. Or is it a health crisis that is sharp, sudden but, importantly, survivable?

Here there is room for optimism. Policy is key. News this week has been pivotal. On Monday, in a move reminiscent of March 2009, the Federal Reserve relaxed accounting rules for banks, launched a whole suite of programs to reduce private sector balance sheet risk and, most ground-breaking, enlarged their mandate to allow corporate bond purchases. This last point is crucial because the recent liquidation of corporate bonds has driven capital costs higher for all types of companies. The Fed's move is a major assault on the cost of borrowing.

Now it is up to fiscal policymakers to provide stimulus. This is happening not just in the US but all around the world (see our recent note "Hello Fiscal Stimulus, We Have Been Expecting You"). The speed with which things have been rolled out has been unprecedented. In the last 3 weeks, we have seen all of the policies become operational that took 18 months during the financial crisis. And the stimulus is likely to be much larger. The combined policy response in the US is estimated to be at least $4 trillion … equivalent to an eye-watering 20% of GDP. For investors still using 2008 as a playbook, adjustments should be made not only for the rapidity of the market decline, but the speed in which the responses have been rolled out.

Now it may seem premature to talk about market stabilization and even recovery. After all, the scale and duration of the economic decline is still unknowable. But what we do know is that changes in trend matter most. Financial markets sniff this out long before the actual inflection point. In a typical recession, that means stock markets bottom a few quarters before stability arrives. This happened in March 2009, with US equity indexes surging months before unemployment, housing vacancies and household leverage started to normalize.

At this juncture, we also know that risk has been radically re-priced. Worst-case scenarios are close, if not fully, priced into most asset prices. No matter the future economic outlook (and we will continue to stress test our base case), equity risk is now far lower than it was before the crash. Many asset classes are deeply on sale.

Of course, no one knows where the bottom may lie. But we do know that the conditions for a meaningful rally are here. This liberates us from trying to call the exact bottom and instead align portfolios with the various risk and return tradeoffs available across capital markets.

The conditions for upside surprises are also here. The cost of borrowing for corporations could ease substantially in the coming weeks. Or positive signs could come from the evolving pandemic. A massive global effort is underway to find a vaccine. And, as panic spreads in the broader public, the population has been shell-shocked into respecting social-distancing practices, even without more draconian government directions. Italy, which serves as a reasonable template for the US, may be witnessing peak infection rates as we write. Of course, the opposite could occur. Relapse is possible too, where the virus boomerangs and returns to countries that have seen declining infection rates. Our investment team is closely monitoring this situation.

Final Thoughts

For now, the chief mission for investors, is to stay calm and rational. Most of all, one must not embrace the cardinal sin of investing — selling into a panic. At this time, it is very difficult to imagine that the situation will look better 2 to 3 months from now. But, very likely, it will.

And, in many ways, this crisis will bring the world closer together. We have been moved by acts of kindness happening all around the world: Italians playing music together from their balconies, homeowners projecting classic films onto building fronts for neighbors to enjoy and, most of all, children delivering groceries to the elderly. It has never paid to bet against the expanding prosperity, ingenuity and innovation of our species. We fully anticipate it won’t be different this time.