Market Trends & Analysis

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Managing through a down market

Multi-Asset Solutions Team

We are New York Life Investments' specialists in multi-asset investing, assisting our partners in their pursuit of investment success.

In our 2020 outlook, we expressed concerns of economic and market vulnerability. Companies, having experienced decelerating profits since 2015, did not have an adequate buffer against risk. Valuations were elevated, forward-looking economic data had grown a bit wobbly, and trade frictions had tested global supply chains. The threat to investment portfolios was that the bull market's end could come swiftly and without warning.

COVID-19's spread, or more specifically, efforts to contain the spread, have magnified these late cycle dynamics. On its own, the financial ramifications of the virus to the U.S. would be serious. Exacerbated by these pre-existing economic weaknesses, it risks creating a chain reaction. Our chief concern is that even short term impacts of the virus will cripple corporate activity, putting some companies out of business, restricting credit availability, and further damaging earnings, hiring, sentiment, and spending.

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Substantial market volatility will persist in the coming months. Government responses will take time to become effective, and school and social distancing efforts will continue. Lower price growth, prompted by falling demand and intensified by the recent oil price war, adds to market shifts. To manage through the crisis, we are structurally underweight risk assets, and we are taking a tactical approach to sentiment-driven market moves.

We are maintaining our equity underweight. We would need to see a peak in COVID-19 case numbers and spread, as well as a coordinated and effective policy response, before anticipating a durable improvement in market sentiment. The size of our equity underweight has decreased over the past month for two reasons. First, valuations have reset, and second, higher volatility means that a smaller active underweight is required to achieve similar active risk. The big picture for investors is that we remain structurally underweight risk assets.

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There are reasons to believe we remain in the early stages of contagion in several countries, including the U.S., and the severe economic damage from precautionary measures will dominate economic data releases in the next few months. When the virus' impact ultimately fades, fiscal and monetary stimulus could fuel a cyclical turnaround. But, in the near term, the downside risks will continue to outweigh the upside potential.

Bias to large caps. At first glance, slowing global growth, dollar strength, and risks to global supply chains present a greater threat to large multi-nationals. However, weaker earnings prospects, less cash cushion, and higher debt burdens leave small caps more susceptible to risk overall and to late cycle dynamics. We are expressing a bias to large-cap equity in our portfolios, as their larger cash reserves will be better suited to handle funding storms in the near term.

Quality over style. Significant uncertainty means that traditional style boxes, such as value, growth, cyclical, or defensive, are not always appropriate decision-making frameworks. We are focusing on the combination of quality, revenue printing, and cash-distributing companies that add value to investor portfolios without relying solely on price appreciation. As the economic impacts of the crisis deepen, the characteristics of what constitutes a "cash distributing" company could evolve. Working with good active managers who can source these opportunities may be more important than the style choice.

International perspectives will be fluid. COVID-19 originated in emerging markets, but its impact there may already be in the rear-view mirror to a considerable degree. In the short term, though, a series of conditions will strongly shape developments in those parts of the world: U.S. monetary conditions and dollar strength, energy prices, and the global policy response to COVID-19. Countries with foreign debt loads will remain most vulnerable to risk-off swings.

Europe and Japan were already struggling with a weak growth profile, which may become more pronounced and more protracted with the virus' impact to global growth and manufacturing. Europe has limited policy ammunition on the monetary side, and widespread fiscal ease from the core will require time. There will be an entry point later, but effects from a potential U.S. downturn makes the timing of that opportunity unclear.

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Tactically removing duration. Fixed-income duration helped to bolster portfolios during the recent equity pullback. Now, big market moves always provide a prudent opportunity to rebalance. On a tactical basis the volatility in rates provides good opportunities to generate profits in fixed income. For strategic investors, with the U.S. 10-year yield at historic lows, additional significant gains in the long term are unavailable.

Concerned about credit. Prior to the COVID-19 shock, we felt that investors were not being appropriately compensated for the risk in high yield. Early indicators such as a rapid decline in interest rates, widening credit spreads, and a reduction in new issuance — point to continued challenges for the asset class. If these shifts in credit and funding markets are sustained over the coming weeks, credit channels will amplify the economic disruption from the coronavirus. We have lowered our credit exposure on a tactical basis. Strategic investors should focus on default avoidance.

A note on investor behavior: In times of high volatility, it is important for investors to remain steadfastly committed to their goals. Timing economic and credit cycles is extremely difficult, and volatility is sure to be present. For most investors, it is appropriate to move toward a more defensive posture, focusing on generating income across a broad range of sources without a wholesale abandonment of asset class targets. High quality securities that deliver income through consistent dividends and coupon payments can help them weather the storm by relying less on price appreciation and extraordinary yield to add value.

Key themes and investor takeaways

Theme	Market Implication	What We're Watching	How to Invest
THE UNDERLYING ECONOMY WAS ALREADY ON ITS LAST LEGS *China's slowdown, a trade war, and decelerating profit margins left companies with little buffer against a demand shock.*	A defensive portfolio posturing is likely to be appropriate for many investors in the near term.	**New unemployment claims** will give early indications of stress in company hiring, which could further impact demand. **Company profits** will indicate whether businesses can weather the ongoing demand shock.	**Continue to tilt investments toward quality** Companies with strong balance sheets and stable revenue should be less sensitive to economic disruption. Consistent cash flows that are returned to shareholders reduce reliance on price appreciation to add value. ▪ U.S. large caps ▪ Companies likely to maintain dividends despite hard times
THE BULL MARKET IS INFECTED *Risk assets will experience volatility until we see a coordinated policy response to COVID-19 and decline in case volumes and geographic spread.*	Valuations are fragile. COVID-19 and related fiscal and monetary policy reactions will drive investor sentiment and market moves.	**Policy measures** such as extending liquidity to small businesses and households, fiscal support for struggling households and businesses, reducing regulatory constraints on bank balance sheets, or even direct intervention in short-term funding markets from central banks and governments, could ease pressure on the real economy.	**Manage risk and diversify source as income potential** ▪ Shareholder yield ▪ Convertible bonds ▪ Real estate debt/equity
BUSINESS AND CONSUMER FUNDAMENTALS WILL DETERMINE THE SHAPE OF RECOVERY *COVID-19 impacts can only be transitory (albeit still severe) if households and businesses can weather the storm.*	Keeping financial conditions under control is important for the real economy, and affects the pace at which we can recover from COVID-19's impacts.	**Stable lending conditions** in public and private markets are essential for company longevity. **Rising default rates** would exacerbate the negative market impacts. Company closures would mean a rise in unemployment, creating a drag on future economic conditions.	**Build flexibility for recovery when the time comes** **Today:** ▪ Cash & Cash proxies ▪ Gold ▪ Government bonds ▪ High-grade corporates **Tomorrow:** ▪ Short-duration assets ▪ Small caps ▪ Value ▪ Middle market debt ▪ High yield **All weather (long-term)** ▪ Multi asset

Source: New York Life Investments, Multi-Asset Solutions team, 3/16/20.

About Risk

All investments are subject to market risk, including possible loss of principal. Past performance is no guarantee of future results.

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