RBC Global Asset Management

# From the desk of Sarah Riopelle

APRIL 14, 2020

# Positioning for the future

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The first quarter of 2020 was historic for so many reasons. To get a comprehensive view of what it was like to make investment decisions during the extreme market volatility that took hold in the second half of the quarter, it's helpful to look a little further back at the environment that existed before the crisis.

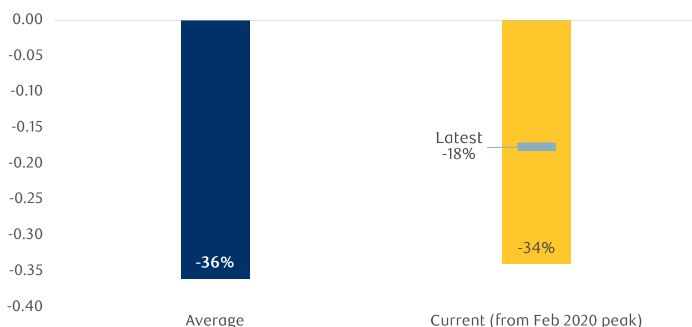
Strange as it may sound, the night before the crisis hit we had a stable and favourable macroeconomic backdrop. The global economy was on a solid footing, delivering mild growth and low inflation, and benefitting from prior interest-rate relief. Bond yields were historically low and spreads were very tight, so investors in credit instruments were not being well compensated for the corporate risk that they were taking. Valuations in equities were high but at levels that could be justified based on low interest rates, earnings were growing and a recession seemed unlikely. Based on all of this, our portfolios were positioned with a tilt toward equities.

The next day, all of those facts were suddenly and dramatically different. We were now faced with the second Black Swan event of my career.

In the days that followed, we would experience the fastest bear market in history. Since 1870, the average bear market has lasted 639 days (that's almost two years!) from its peak to its trough. For now, let's assume that we saw the low on March 23. That would mean that this bear market lasted only 33 days from peak to trough. That isn't to say that we are ready to conclude that the low of March 23 will be the ultimate bottom – it is still too soon to tell. Research from Gavekal[1] shows that bear markets rarely end after one sizeable decline. In their research, they looked at 15 bear markets since 1950 and there was only one instance when we did not see the initial major low tested within 3 months. In all other cases, the low was tested once or twice. Since it is likely that news flow in this crisis will worsen before it improves, a retest of the March 23 low is possible, although the various monetary and fiscal emergency programs put in place over the past few weeks have limited the threats that the market was contemplating during the worst of its fall.

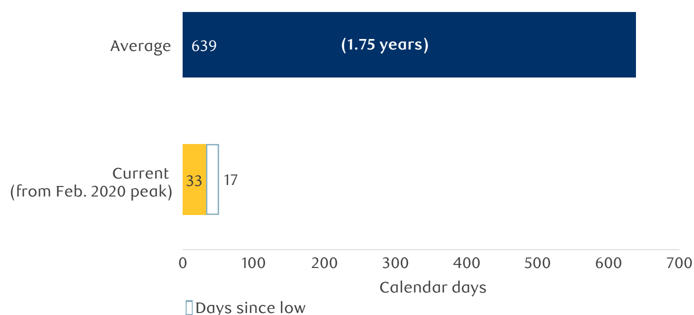
[1] *Strategy Monthly: Lockdowns And Lost Output*, Gavekal Research, April 2020

**Bear market depth**
S&P 500 Index peak-to-trough declines




Note: Based on 24 bear markets of at least 20% decline since 1870.
As of April 9, 2020. Source: RBC GAM

**Bear market duration**
S&P 500 Index calendar days from peak to trough



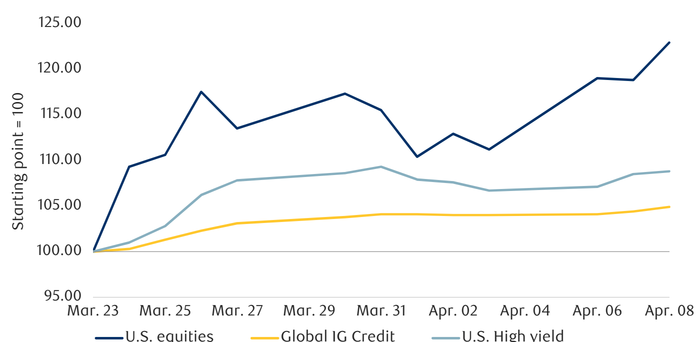

Note: based on 24 bear markets of at least 20% decline since 1870.
As of April 9, 2020. Source: RBC GAM

The RBC Select Portfolios (the portfolios) entered this environment with higher allocations to risk assets such as equities and corporate credit. Given the sudden change in the outlook for the economy and the speed and size of the decline in markets (we saw double-digit daily moves in equity markets), repositioning the portfolios to a more defensive stance was challenging. We also wanted to position the portfolios for the recovery, which we know will come eventually, even though it is impossible to predict exactly when. So, we have to take advantage of the opportunities as they present themselves – both in terms of prices and availability (i.e. liquidity). Since we can't predict when the absolute bottom and subsequent recovery will come, we were incrementally adding to our equity and credit positions as the markets sold off and spreads widened. I thought that the investor Howard Marks captured it well in his recent update to clients: "Not buying anything at the new low prices would be a mistake." He went on to say that "this process is one of gradual readjustment, not a matter of all or nothing."[2] We agree with this approach of gradually buying as asset prices become more attractive.

While incrementally adding to our equity weight, we found that the best opportunities were in the credit market and wanted to take advantage of that at a time when liquidity was available. An increase in liquidity generally happens at the point when many investors are giving into their fear and selling. That's when we can step in and buy at good prices.

However, we also must ensure that we are adhering to our risk budget which is based on the desired or expected returns of the portfolio. Our goal is to efficiently distribute risk throughout the portfolio so that no individual asset class or position accounts for too large a portion of the total risk budget. In this particular case, we slowed our pace of equity buying as we were adding to our credit positions. The net effect is that we were increasing our overall corporate risk in the bond portion of the portfolios rather than through equities. As a result, the portfolios have been held back somewhat through the recovery so far as equities have rebounded more quickly than corporate credit.

**Market performance since March 23, 2020**
(normalized = 100)




Note: Data as of April 8, 2020. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results. Source: RBC GAM, Bloomberg. U.S. equities = S&P 500 Index (USD), Global IG Credit = Barclays Global Agg. Corporate Index (US$ Hedged), U.S. High yield = ICE BofA U.S. High Yield Master Index (USD).

Overall, we remain underweight fixed income and overweight equities. We continue to expect that total returns from sovereign bonds will be poor relative to the prospects for equities over the medium to long term. We believe that the portfolios are well positioned for the recovery when it comes, and we are confident in prospects for the future once this crisis period passes.

[2] *Memo to Oaktree Clients Re: Calibrating*, Howard Marks, April 6, 2020

## Disclosure

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Publication date: April 14, 2020