RBC Global Asset Management

# Market Update

## A week of extraordinary volatility, with a look beyond...

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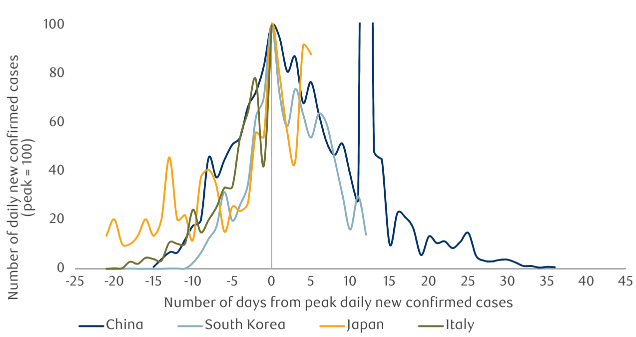
Following a week that has included the worst single day for stocks since the 1987 crash, owners of risk assets are no doubt feeling bruised and uneasy. The size of the threat from Covid-19 is still undefined and policy responses have not, so far, contained the fear. Into the mix, an oil price war casts a long shadow on a critical sector already under pressure. A sense of foreboding and vulnerability has entered our living rooms with quickly cancelled spring vacations, school closures, the NBA, NHL and MLB halting operations, celebrities and politicians sharing their own health crises and for an increasing number, work from home or even quarantine reordering their routine.

**How should investors respond?** It's hard to do right now, but take a step back. At least 114 countries have been drawn into the crisis and for most, case counts are probably early in their uptrend. A few though, including China, South Korea and Japan – the first in – appear to be moving beyond with daily reports of new infections beginning to decline 2 to 5 weeks ago and now flat lining at very low levels. A cycle seems to be appearing that looks like 2 weeks of rapid additions, a peak, and then consistent daily reduction of new cases. No doubt these cycles will be influenced by local factors including the fitness of the health care system, the ability to effectively isolate and personal hygiene standards, but the data indicates a path out of the crisis and, for those first in, light at the end of the tunnel.

### Tracking Covid-19
The rise and fall of new cases over time




Note: As of 3/12/2020. New clinically diagnosed cases included for China starting 2/17/2020 and spikes above 100 on 2/17/2020 due to methodology change. Number of daily new cases for Italy and Japan may not have peaked. Source: WHO, Macrobond, RBC GAM

That's not to say we can begin to minimize or even shape the ultimate impact of the Covid-19 pandemic on individuals, companies and regional and global economies. All that depends on the number of locations dragged in, the duration and intensity of each local cycle and the degree to which cycles overlap, compounding damage in that period or, should they pop up sequentially, lessening the immediate impact but stretching the pain out over a longer period of time. Importantly, it also depends on the collateral damage that the pandemic deals to business and consumer confidence, balance sheets and the free flow of credit.

We don't have the answer to any of these questions, but we can estimate the size of the impact already priced into markets. We can also look beyond the crisis, because it will end, and begin to think about appropriate positioning for the ultimate recovery in risk assets. For example, we have just entered the twenty-first bear market of the past 150 years (defined as a decline for the S&P 500 of 20% or more). For the full list, the average drop from the peak has been 36% and, for those that occurred during what we refer to as supercycle bull periods – which we believe we entered as the financial crisis ended – the scale of decline reduces to an average of 27%. So the recent decline in stocks is not the worst we have seen. At 27% though (the peak to trough decline as at March 12), it is three-quarters of the way to an average experience and compared to these associated with supercycle bulls, the bear could already be long in the tooth even though it's only 17 trading days since the downturn began.

Another way of thinking about this is to consider the transitory nature of the pandemic versus the proven earnings capacity for companies in the stock market index. Following every crisis, correction, crash and bear market, the prior peak in earnings for the S&P 500 has eventually been achieved, usually within 3 years and frequently after crawling out of recession. This time, S&P 500 earnings per share peaked at $165. If the decline and subsequent recovery in profits follows the average experience, we will be back at that level by early 2023. Ultra-low interest rates and benign inflation are now even more likely to remain a fixture, so we think price/earnings (P/E) multiples will be similar to those of the just-ended bull market at around 18.3 times. That places the index at 3,020 three years out, producing a 9.3% compound annual return, including dividends, from here to there. More conservatively, the climb back for earnings could be sluggish, perhaps in line with the 51 month period following the financial crisis, delaying full recovery until 2024 and lowering compound annual total returns for the index to 7%. Or residual risk aversion could reduce the P/E to, say, a full standard deviation and 2 multiple points below the "fair value" level noted above. At just 16.3 times and with an average earnings recovery period of 3 years, compound annual total returns still come in at 5%. Of course, as with the Covid-19 cycles detailed above, these are simply crude roadmaps based on a rather limited history and with a wide range of outcomes within the sample. Moreover, we recognize that every cycle comes with its own unique features.

How bad could this get and what might this bear market's unique features be? It would be naive to believe with any certainty that we have already seen the lows. Crises have a way of exposing the most aggressive and poorly timed plans. The significant growth, frequent use of relatively high leverage and lack of transparency in private equity is definitely a concern. Should the economy stall, some shade of which feels almost certain now, and especially if recovery is delayed, highly leveraged firms may struggle to survive. Carlyle Group and Blackstone, both dominant private equity managers, have encouraged their portfolio companies to tap credit lines to prepare for a period of limited cash flows. Add to that the oil sector, hammered by sudden price cuts forcing crude to levels that will force hard choices on many energy companies if weakness persists. Central banks are scrambling to respond, working to contain liquidity pressures before they morph into a much more serious solvency threat.

But let's assume for a moment that these crude roadmaps for the pandemic and S&P 500 are not altogether wrong. Those who reflexively de-risk during such an intense decline could be placing their savings program in even more jeopardy. When the crisis clears, the economy will gather additional strength from four sources: a recapture of the activities deferred and transactions delayed through the crisis period; the interest rate relief already piled in and that which is still to come; additional fiscal programs that seem almost certain to lie ahead; and, to the extent the oil price war continues, lower energy costs.

No doubt, interest rates will eventually respond to recovering growth, but levels all along the yield curve won't be much above those of the past decade as demographics and a variety of other factors suppress the real rate. For savers, the portfolio ballast provided by fixed income investments is surely being appreciated right now. Looking ahead though, sovereign bonds especially may be locked into very low single digit returns, and for a very long period of time.

Meeting long-term goals – likely established based on historic asset class returns – will be a challenge without accepting some degree of risk in portfolios. Stocks should ultimately recover along a path that reflects their earnings power and valuations consistent with prevailing (low) inflation and interest rates. Indeed, if savings and investment programs were to be redrawn to reflect just the "new normal" of modest growth, inflation and interest rates that has settled in since the financial crisis, these would likely feature a boost in risk assets, not a reduction.

Volatility is hard to take in the moment, but an appropriate time horizon is essential to a plan's success and, related to that, so too is the resolve to stick to the plan. Our portfolios are built to ensure diversification and to reflect more than our 'most likely' forecast scenarios, providing resilience through periods where events take an alternative course. For those with patience and a well-considered savings and investment plan, we believe this bear market will pass without compromising their ultimate goals.

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