Stegent Equity Advisors, Inc. Investment Letter

Market Review
April 2020

The first quarter's decline in the S&P 500 Index was breathtaking for the speed (and the magnitude) of the sell-off. From February 19th to March 23rd, the Index fell by 34%, eclipsing the amount of time it took for other famous (or infamous) peak to trough declines, including the Great Depression and the 1987 crash. Notably, a 34% decline is well within the parameters of historical bear markets where the average bear market decline is -35%, and the average decline after the stock market had just made a new all-time high is -39%. Fortunately, only about 1% of all SEA clients are invested in a portfolio that is allocated 100% in risk assets, with the remaining 99% of clients owning a balanced portfolio designed to significantly reduce client exposure to the risks of unexpected stock market declines. And while returns for the first quarter of 2020 were certainly disappointing on an absolute basis, they may not lead to a disaster that requires a change of lifestyle for clients.

Party Like It's 1999?

As we start the second quarter, the equity and credit markets also have experienced their fastest-ever recoveries. However, much of the S&P's strength has been concentrated in five technology-related mega-cap stocks. The FMAGA group [Facebook (FB), Microsoft (MSFT), Apple (AAPL), Google parent Alphabet (GOOGL) and Amazon.com (AMZN)] accounts for 20% of the market. These giants undeniably have been more resilient against economic shocks, but they are not entirely immune from the economic conflagration in which we now find ourselves and they now look eerily similar to the tech darlings of late 1999 and early 2000. See graph below:

Veteran economist Gary Shilling points out that the stock market also staged a sharp rally after the 1929 crash, which was seen at the time as a proper correction of the excess exuberance of the Roaring Twenties. Once investors came to realize the seriousness of what would become the Great Depression, the Dow Jones Industrial Average would fall some 86% from its highs, he related in a recent interview.

Having gone through the initial phase of fears that the coronavirus would wipe out civilization, investors now think it has all been brought under control with fiscal and monetary stimulus, as Shilling describes the exaggerated swings in sentiment. But saying everything is OK is very much like the complacent attitude in 1929. "My feeling is we face a serious, long recession with disruptions in supply chains," he says.

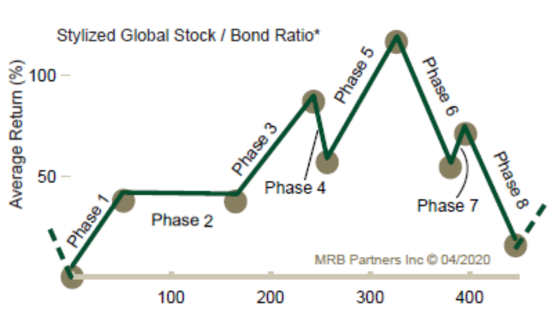
Light or Locomotive at the End of the Tunnel?

A troublesome new development, that reinforces the need to tread carefully in equities in the near run, has been a stall in the narrowing of credit spreads. As with equities, credit investors have been encouraged by central bank support, but much narrower credit spreads (and thus much higher equity prices) await a clear light at the end of the economic tunnel. Moreover, the modest boost to equities from lower government bond yields has ended, with German Bund, and now Treasury, yields seemingly at rock-bottom levels. The only silver lining on this front is that the offer of no or little coupon income will, over time, spur demand for risk assets, albeit only once economic sentiment is on firmer ground.

The Macro Research Board (MRB), an independent global macro investment strategist, also sees significate downside ahead for equities. According to their MRB Stylized Investment Cycle framework, we are most likely still the countertrend equity bear market rally phase, what they call Phase 7, rather than in the early stages of the next bull market (see graphs below). Tracking the early-responding countries fighting COVID-19 is not yet providing much comfort, in that it is a hard slog to re-start economic activity (as witnessed in China). Moreover, the pronounced second up wave of infections in Singapore is a clear reminder that the way forward is going to be gradual and fraught with setbacks until a medical breakthrough occurs.

Last week's PMI flash estimates for April were grim, especially for the nearly-closed service sectors. The optimistic spin is that things can only improve from here, as most indexes are at all-time lows. The sudden and purposeful halt in economic activity means that most companies can re-start if given a green light. The light is still red in many sectors/industries, and only turning yellow in select areas. The longer the shutdown persists, the greater the odds of permanent damage, underscoring the mounting pressure on politicians to re-start activity. Nevertheless, absent successful treatments or a vaccine, it will be challenging to fully re-start economic activity.

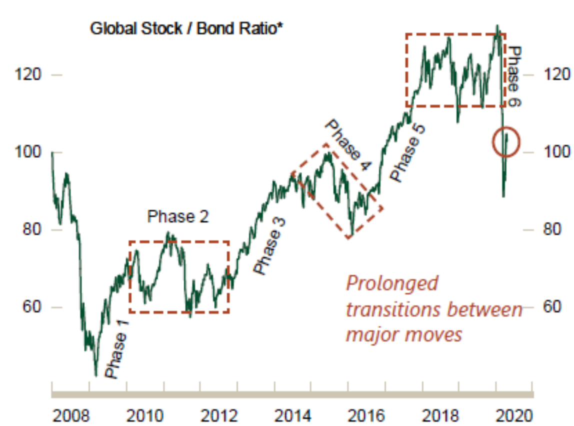
MRB Stylized Investment Cycle



Phase 1: Policy-Induced Rally
Phase 2: Awaiting Validation
Phase 3: Lower-Conviction Rally
Phase 4: Countertrend Pullback
Phase 5: Higher-Conviction Rally
Phase 6: First Bear Market Downleg
Phase 7: Countertrend Bounce
Phase 8: Final Flush

* Based on the four cycles in the global stock/bond ratio between 1974 and 2009

Current Investment Cycle: Now In *Phase 7*



* Global MSCI stock market total return index divided by 10-year G7 government bond total return index; rebased

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Big Trouble in Technical Indicators

Looking at technical indicators, the major U.S. market indexes are painting a bearish picture...

- The S&P 500 and Dow are both stuck below their falling intermediate-term trendlines
- They have a lot more work to do before they'll even approach their falling long-term trendlines
- In short, they continue to be in downtrends
- Small-cap stocks look even worse (bottoms are usually marked by small cap stocks leading the rally)

With a mostly bearish picture in the major U.S. indexes, we still expect stocks to make another move lower. We may have to eat our words, but from our viewpoint, the market's downside risks currently outweigh the upside potential.

Now, as we head into the seasonally weak period of the worst six months of the year, it looks like the perfect setup for the bear to hit the market with another swipe of its paw. And when that happens, we may enter the Phase 7 described above by MRB – where stocks fall even harder and take out the previous low.

Further evidence of the potential for another significant move down may be seen in the long-term monthly chart of the S&P 500 plotted along with its 20-month exponential moving average (EMA) on the next page.

The upper righthand corner of the chart demonstrates how the S&P has rallied all the way back up to test its 20-month EMA from below. This is exactly what we should expect to happen during a bear market bounce. Note how the bear market bounces in the early stages of the 2001 and 2008 bear markets brought the S&P 500 back up to test its 20-month EMA from below. And, a similar move this time around would push the index up to 2900 or so.

Because the bigger picture isn't one of strength, we have sold some positions and are still waiting to redeploy that cash when the bear market cycle has run its course. You may be thinking, "I have locked in my losses and if I don't buy now, I'll miss the entire recovery... And I'll never get back to where I was." Taking a paper loss does lock in our loss, temporarily, but it also protects our capital from further loss, giving us the chance to get back in at lower prices or buy something else that is likely to do better in the new economy that is emerging from this pandemic.

What's the Plan?

The US, along with other nations, still doesn't have an exit strategy when it comes to COVID-19. With new "confirmed" US cases per day still hovering around 30,000 (and with total new cases per day up around 300,000+), reopening the economy will surely create a second wave. Equity investors have recently been framing the narrative as a one-and-done natural disaster, so they have been filtering out all the nightmarish economic prints as they arrive.

China is about two months ahead of the U.S. in terms of dealing with the coronavirus. Starbucks, for example, already has 98% of its Chinese locations open. Taking a look at how the reopening in China is going may provide clues for what to expect in the U.S.

Starbucks operates 4,351 stores in China. Their recent earnings forecast said it's seeing substantial sequential monthly improvement. Whereas comparison sales to the same month last year in China were down 90% in February and down 64% in March, they had improved to "only" down 35% in April. That's certainly a marked improvement. But in normal times, even a 5% decline in comp sales would be considered alarming.

Because retailers and restaurants have high fixed expenses – also known as "high operating leverage" – declines in sales cause even greater declines in profits. During the second quarter, operating margins for Starbucks China plummeted to 4% from 19% in the prior-year period. Even in the U.S., where operations were normal for all but two or three weeks in the quarter, operating margins fell from 20% to 14%.

Management noted that while every dollar in lost sales typically flows through to generate $0.50 in lost earnings, the company is currently seeing every lost dollar leading to $0.80 in lost profits. This flow-through is higher right now because of the extra costs Starbucks is absorbing to maintain safety standards, avoid layoffs and deal with the extreme decline in sales. Increased delivery orders don't help much due to higher associated costs.

While Starbucks declined to give any outlook for how it expects stores in the U.S. to perform during the third quarter, the company provided guidance for China sales for the remainder of the year. After logging a 50% decline in comp sales in the second quarter, Starbucks expects its Chinese stores to be down 25% to 35% next quarter, and be between negative 10% and flat in the fourth quarter. Altogether, for the full year (ending September 30), comp sales are expected to be down 15% to 25% in China.

While management expects each quarter to be "less bad" than the previous one, few restaurants would be profitable at negative 20% comp sales, and many would go out of business altogether. Because Starbucks was an exceptionally profitable company before COVID-19, the company may still remain slightly profitable even if it ends the year with comp sales down 20%. But remember, China is two months ahead of the U.S. in its COVID-19 recovery. If stores in China will be down 20% this year, it's a good bet that U.S. stores will be down even more. Not only are we behind China on the timeline, but also this is the first time Americans are experiencing a pandemic and social distancing. After SARS, this isn't China's first rodeo, so it may be better able to adapt to current conditions.

There's no "V-shaped" recovery happening for Starbucks in China, so it seems a bit optimistic to expect one here – which the stock market seems to be expecting.

In the months ahead, we will want to focus on two key pieces of macro-data: initial and continuing unemployment claims. It looks like initial claims peaked at 6.9 million the week ending March 28 and have since declined four weeks in a row, to a still humongous 3.8 million the week ending April 25. However, continuing unemployment claims are still rising every week, hitting 18 million, and will likely keep doing so for at least another month. Watch continuing claims carefully: we expect a peak in continuing claims, whenever it happens, to signal the bottom for the recession.

Our Current Stance

When markets crash, one problem that investors face is to find data to evaluate whether the change in prices is rational or if the markets have overshot or undershot in waves of panic selling. In this case, the 34% decline in the S&P 500 Index occurred with little corresponding data regarding U.S. economic performance or corporate earnings. We know that analysts who follow corporations usually rely on guidance from the companies they follow in making their forecasts, and we know that companies will have a very difficult time giving investors any help in light of the unprecedented halt to business activity. Consequently, we expect consensus analyst estimates for the second quarter and the rest of the year to be all over the map.

Historically this amount of uncertainty is not typically supportive of higher stock prices. The equation of bad COVID-19 news + bad earnings news + bad economic news offset by news of overwhelming policy intervention both on Main Street and on Wall Street = a dilemma for us as investors. That's especially true when considering the magnitude of the bear market decline we've already gone through, and the bounce higher we are experiencing as of this writing.

We executed a series of trades once the market began its first bounce to take our portfolios to a significantly defensive posture. Our current investment thesis is that we expect, in the short-term, the stock market will digest the upcoming earnings news and gradually grind its way back to the prior lows set on March 23rd. At that point, we may use the opportunity to begin adding risk on very selective basis back into the portfolio in anticipation of an extended bear market.

We would look to add or increase exposure to healthcare, consumer staples, selected technology and digital assets. Importantly for our clients, we expect markets to normalize over the next year or two, not the next quarter or two, especially with the election looming this fall.

Considering the amount of stimulus in the pipeline, we feel good about our 10% exposure to precious metals and miners, as well as an additional 10-15% in class A commercial real estate and hard infrastructure assets that include toll roads, farm land, timber and agriculture.

Conclusion

We will get through this challenge. As we do, please know you have a team of concerned, dedicated, well-educated, very competent professionals to help guide you through this tumultuous time. Know that we are making constant evaluations of the financial markets, the new tax rules and the PPP loan programs, so that we can understand and help. Above all, know you are not in this alone, and that together we will get through it. Please stay safe and healthy.

As always, we are grateful for the opportunity to continue to serve as your trusted advisor. Please reach out with any questions or concerns.

Loyd J. Stegent, President
Stegent Equity Advisors, Inc.