Market Commentary

Discipline Matters in Zombie Markets

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The Fed has said it will do whatever it takes, igniting a stampede into stocks and inflating the brokerage accounts for the "haves", but not creating jobs for those that need them, the "have-nots". The most common question we have fielded recently asks why the S&P 500 can recover to January 2020 levels when at least 20 million Americans have lost their jobs, when economic growth has contracted by more than $4 trillion, and corporate defaults have surged over this same period of time.

We ask ourselves the same question.

The data is disastrous. A common assertion we have heard is that the worst is over, and recovery has begun. The reality is that the Fed has proclaimed from pulpits at news conferences and on 60 Minutes that the printing presses are rolling out money and Jay Powell and friends are ready for a shopping spree buying anything that is for sale. The Fed "support" is creating zombie markets: walking dead buyers gorging on walking dead companies, ones that can only survive from continued borrowing. While Wall Street gets wealthier, the unemployed on Main Street are left behind.

Taking a Step Back

Over the past year and more, we have offered the "Four Horsemen of the Apocalypse" as a framework, monitoring four pieces of data that together can indicate whether a recession is on the horizon. The reason that this is important is that it serves as a guidepost when the stock market falls by 10%; if the U.S. economy is heading into recession, the next leg after a 10% drop has historically been down and if the U.S. is not heading into recession, history shows that the drop is a buying opportunity.

Like clockwork, as these Four Horsemen appeared on the horizon, the evidence increasingly supported the view of a darkening U.S. economy. In fact, the U.S. is officially in recession with the National Bureau of Economic Research (NBER) pinning the start of economic contraction to February. The Four Horsemen symbolizing the end of the world, in this case, the end of the bull market, foreshadowed this and the omen that 10% stock market declines in front of recessions are followed by further declines proved out.

As a recap, the Four Horsemen of the Apocalypse are:

- **The yield curve inverts**. Specifically, the 2-year Treasury rises above the 10-year, an event that occurred

in August 2019 and was met with a chorus of "it's different this time." It wasn't different this time.

- **Housing starts decline**. A sensitive indicator, housing starts are quick to react to tepid buyers and year-over-year housing starts decline. This happened in late October 2018 and into the first months of 2019.
- **Consumer sentiment peaks**. Falling consumer confidence consumers can come through in the data ahead of a recession. While sentiment stayed at higher than normal levels, it peaked in March 2018 and has turned down.
- **Unemployment rises over above its 12-month moving average**. The increase in unemployment was swift and sharp and this last confirmation of recession occurred at the end of March 2020.

Now What?

Our view is to expect volatility and drawdowns in the weeks and months ahead and to prepare accordingly.

In March, we began asking and writing: when it comes time to buy, will you do it? The time of maximum pessimism is often the time of maximum opportunity, as widely stated by wise investors from Warren Buffett to Sir John Templeton and more. We relied, as always, on our rules-based, tactical approach to define entry points for our clients and that sent us back into a buying mode when various asset classes rose, despite the overflowing pessimism.

This has proven productive, but has everything come back a little too far too fast? The reality is that nearly everything takes the stairs up and the elevator down. In other words, investments generally go up a lot more slowly than they decline. Recently, though, the snapback has been nearly as fast as the decline was. Surely, then, the probability of high volatility and painful drawdowns in the next months is high.

The run-up in risk-on looks like zombie markets: zombie investors, those that will buy anything, into buying even zombie assets, those issued by companies that can only survive from continued borrowing. Discipline is key to manage the current risks this presents. In a time where the economic data is disastrous and the markets are shrugging, the possibility of high volatility and painful drawdowns are real.

Investing means answering three questions: when to buy, when to sell, and the third question, what to buy? We focus the rest of this piece on that third question.

To meet our goals of managing drawdowns while seeking productive returns:

- **We favor emerging markets debt (EMD) over emerging markets equity**. The credit quality of a substantial part of EMD is typically investment grade, but these bonds can still offer juicy yields. Also, the coupon cushion against price declines while the stocks of emerging countries frequently take a wilder ride to similar returns.

- **We favor preferred stocks over financial common stocks**. Preferred stocks are generally issued by financial institutions, but versus financial stocks, we believe preferreds nearly always have a superior risk/return profile. Preferreds are senior in the capital structure and generate a high enough yield that often results in cushioning drawdowns and better returns than bank stocks.

- **We recommend high yield corporate bonds over small-cap stocks**. Issuers of high yield corporate bonds are typically smaller companies that need growth capital, much like the stocks of small companies. Again, though, the returns are often similar, but the risks are lower for high yield corporate bonds than small-cap stocks.

To summarize, the plunge into recession was foreshadowed by the Four Horsemen. When the stock market began to creak, dropping 10% in the last 2 weeks of February, history has shown that the next move is down when the economy is approaching or at the start of a recession. In fact, that first 10% drop was rapidly followed by further sharp declines on the elevator down. Since the March 23 bottom, risk-on assets have staged a remarkable recovery, in large part a product of the Fed's creation of zombie markets.

We believe the near-term economic future is not bright. At this point, the risks are high, and the probability of drawdowns and volatility are too. For these reasons, we urge investors to consider the trade-offs available and participate where gains can materialize with more limited drawdowns. Discipline matters.

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Terri Spath is Chief Investment Officer at Sierra Investment Management. She jointly oversees the investment activities of the organization and appears frequently in the financial press.

Definitions

The **S&P 500 Index** is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

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