



Fears of a global pandemic caused by the Coronavirus have sent shockwaves through the financial markets. To top it off, on Monday, March 9th markets were further rattled by a sudden and deliberate decline in oil prices.

There has been a significant slowdown worldwide as a result of the Coronavirus. Businesses around the globe, including in the United States, are cancelling meetings, travel and events in order to prevent or slow the spread of this virus. It's not a matter of whether the virus will cause a slowdown in the economy and corporate earnings, it's a matter of by how much. With investors' searching for a fair valuation for the markets, global markets have sold off. To make matters worse, the price of oil has collapsed as the Saudis and UAE increased production of oil. This is a directed affront to the Russians who were in talks earlier to cut production in hopes of increasing oil prices. This drop in oil prices has also contributed to the increased volatility in the markets.

What is a fair valuation for the market? To come up with a fair valuation for the market, we need to make an estimate for earnings going forward. We know that earnings are slowing because of the reduction of economic activity due to the Coronavirus and the drop in oil prices.

Many companies have already come out to say that their earnings will be negatively impacted but few, if any, have given any actual guidance to analysts as to what those earnings will be. Certain industries will be impacted more than others such as travel and entertainment. Companies doing a lot of business in China, Italy or Iran (if possible, with all the sanctions on Iran) will be most adversely affected. Such uncertainty with regard to earnings has led investors to a shoot first, ask questions later mentality when it comes to their stock holdings.

We are left with the task of making an educated guess as to where earnings will go to hone in on an appropriate valuation for the market. This is a very similar task to valuing the market after 9/11 and the financial crisis. In both of those cases, the markets overshot a reasonable valuation to the downside leading to market snapbacks in subsequent months following the initial crisis. A more recent "disease" crisis was the Ebola outbreak in 2014. The S&P 500 Index was actually up 5.34% six months after the outbreak and up 10.44% after 12-months.

In the 4th quarter 2001, following the 9/11 attacks, earnings on the S&P 500 Index had dropped 30% year-over-year but had already been steadily declining all year prior to the shock of 9/11. For the full year 2008, earnings had dropped 40% throughout the year. For the full year of 2014 which included the Ebola crisis, earnings increased 6.7%. These changes in the earnings are given for illustrative purposes to show the potential change in earnings in different environments. Both the 2001 and 2008 earnings declines took place with the economy already in recession when 9/11 occurred in 2001 and Lehman Brothers collapsed in 2008. We are not in a recession right now although many economists are predicting a recession. Economists' past record of predicting recessions is less than impressive, however, we must not turn a blind eye to the thought.

At the end of 2019 (pre-crisis), the market was selling at multiples many considered lofty. To get to our fair valuation estimate, we assume a decline in earnings on the S&P 500 Index of approximately 10% for 2020. Due to the added risk in the market, it probably cannot justify the lofty multiples it was selling at near the end of 2019. Therefore, we assume a contraction in multiples. With our adjustment to earnings and multiples, we come up with a fair valuation of 2,700 on the S&P 500 Index. It is likely, as is usually the case, that the market will overshoot to the downside suggesting the market could at least very temporarily drop even

further before settling back at the 2,700 level for the S&P 500 Index, from which we are hopeful for the formation of a market bottom.

Given the proximity of the current market valuation to 2,700, investors would be well advised to stay invested as it would be difficult to effectively “trade” your way around the current volatility.

With these wild swings in the markets, it is important for investors to understand exactly what their risk tolerance is. Are they truly diversified in non-correlated assets so everything is not going up and down in tandem? Bonds have performed reasonably well during this period of heightened volatility for the stock market. International stocks and emerging markets stocks have performed better than U.S. stocks over this time period.

Investors should be looking at the big picture; are they really long-term investors? Until we understand more about Coronavirus and its potential impact, volatility will be elevated. We have already officially experienced a market correction, which is defined as a drop of at least 10%, but not more than 20%. We are fast approaching bear market territory as we get closer to a 20% decline.

It may feel like the stock market is headed for zero. But it is not. There is real value here; the market is just searching for what fair value is.

In our last Quarterly Commentary published in January, we stated that we expected a correction this year and this current market behavior fulfills that expectation.

As financial industry professionals, we survived some of the most severe market corrections such as: The crash of 1987; The recession in early 1990; The dot-com bubble of 2000; The terrorist attacks of September 11th, 2001; The bear market of 2007; The great recession of 2008; The global market meltdown of 2018.

And yes, we will survive the Coronavirus of 2020.

As we also mentioned in the last Quarterly Commentary: Never forget the cliché “Stocks Take the Stairs Up and Elevator Down.” Well this has certainly been a dramatic elevator experience.

This too will pass and we will look back upon this event as another test of patience, nerves and the ability to stay focused while managing your portfolio within your risk tolerance.

As such, we are here to listen, counsel and provide direction to all of our clients, friends and prospective clients.

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