Policies Provide Economic Life Support
Quarterly Market Commentary
First Quarter 2020

- The arc of global financial markets during the first quarter corresponded with the unfolding realization that outbreak-induced shutdowns would cripple large cross-sections of the world economy.
- Investors' dash for cash created chaotic market conditions around the globe—prompting major central banks to resume global financial crisis-era policies in March, which have appeared to help markets return toward orderly function.
- If your portfolio is aligned with your goals, time horizon and risk tolerance, then time and patience should be on your side. We think selling now could mean missing the rebound that will inevitably happen.

SEI's Domestic View

Like the rest of the world, Canada is facing a sharp fall in economic activity as it tries to control the spread of the highly contagious novel coronavirus, which causes the disease COVID-19. The number of infections in the country already approached 16,000 as of April 5. Canada's infection curve has not been quite as steep as that of some other countries in the chart, but the number of cases is still doubling every three days. The country has had no choice but to engage in the same social distancing measures as those implemented in the U.S. and in Europe—including the shutdown of non-essential businesses.

Unfortunately, Canada's economy was already limping along before its least-necessary businesses were forced to shudder their doors. Even without the impact of the virus and the onset of the Saudi-Russian oil-price war, the country might have finished the first quarter with a slightly negative inflation-adjusted gross domestic product (GDP) as it faced several challenges: a decline in trade with China (which went into lockdown in February), severe winter weather, rail blockades, and a teachers' strike in Ontario. We expect Canada's GDP in the second quarter to be deeply in the red.

Like the U.S., monetary and fiscal policy measures have been quickly put into place, although the extent of the liquidity and stimulus injections appears to be less aggressive than those implemented south of the border. The Bank of Canada (BoC) cut its policy rate to 0.25% from 0.75% on March 27. The central bank also launched two new programs, one to ease the liquidity strains in various parts of the credit market, and the other a quantitative-easing (QE) program that will purchase government debt in the secondary market. Although the BoC QE program does not appear to be as open-ended as the one pursued by the U.S., the central bank says it is ready to do whatever it takes to alleviate the crisis.

Canada's fiscal-policy response also appears much less extreme than the approach taken by the U.S. It includes C$55 billion of tax deferrals in order to enhance the short-term liquidity of households and businesses and C$27 billion of direct support. The various measures in the emergency fiscal package add up to about 3.5% of GDP, much less than the recently passed U.S. fiscal program that totals more than 10% of its GDP.

In local-currency terms, the MSCI Canada and MSCI USA Indexes both plunged in the past month or so, and rebounded some toward the end of the quarter. Investors across the two markets endured about the same amount of pain during the first quarter—with Canadian equities down 20.28% and U.S. equities down 19.65% (both net, total returns). However, an extended timeline reveals that Canadian equities have been in a long relative downtrend versus the U.S.

The collapse in oil prices is another blow to the Canadian economy, although the pre-occupation with the outbreak-turned-pandemic has buried this story on the back pages. West Texas Intermediate (WTI) oil prices (WTI) decreased from $61.06 to $20.48 per barrel in the three-month period ending March 31; in Alberta, Western Canadian Select crude oil dropped to about $5 per barrel by the end of the quarter since the oil could not find an outlet. The price collapse in WTI amounted to 66%—matching the percentage drop sustained by Canadian small-cap energy companies for the quarter. Although Alberta's economy is expected to be most impacted by the oil-price collapse, the rest of Canada will undoubtedly also suffer. We have seen the price of crude rebound somewhat since the end of the first quarter, but it remains far below where it was prior to the start of the Saudi-Russian oil-price war and virus-related shutdowns of many economies. The price is well under the cost of production for many energy companies. We anticipate a number of bankruptcies and consolidations in the oil patch if prices do not bounce significantly higher in the coming months.

While oil prices have been heading south, gold has been one of the best-performing asset classes this year, rising 14.9% in Canadian dollars and 3.8% in U.S. dollars through March 31. So far this year, despite the climb in the price of the yellow metal, gold companies returned a negative 10.4% on the S&P/TSX Composite Index and a negative 28.6% on the S&P/TSX SmallCap Index. While outperforming their respective broad-market benchmarks, gold companies were significantly behind bullion. This goes to show that gold companies are not necessarily a good proxy for gold bullion.

SEI's Global View

Black swans, once largely presumed a myth because only the white variety was ever observed in nature, have become symbols of events that are exceptionally rare in occurrence and severe in impact. Today we are confronted with a black swan in the form of a pandemic, as COVID-19 continues its rapid spread and causes financial markets to plunge across much of the world.

The sudden and widespread stop in economic activity by government fiat is something that has never before been experienced on such a scale. The ultimate impact on gross domestic impact (GDP) is truly anybody's guess. The first quarter of 2020 could see a decline at an annual rate of between 3% and 5%. The second quarter will likely be one for the record books. Wall Street economists forecasted a quarter-to-quarter annualized decline ranging from 12% to 30% as of late March.

National governments have been quick to respond. All central banks are in crisis-fighting mode, having learned valuable lessons during the 2008-to-2009 great financial crisis, re-establishing unconventional bond-buying programs and creating some new facilities to expand the types of accepted collateral in order to extend cash to companies that need it.

The Fed and other leading central banks have moved with an alacrity and forcefulness that we find commendable. But central banks cannot single-handedly support this economic shutdown. In our view, fiscal policy—in the form of direct income support, tax deferrals, loan guarantees and outright bailouts of industries badly damaged by the halt of economic activity—must be the prime tool used to conduct the response to this crisis.

The fiscal response is occurring with a speed and decisiveness that has seldom been seen. Congress passed into law a fiscal response that should top 10% of GDP—meaning the overall deficit this year in the U.S. could approach 15% of GDP. Even before the ink dried on the latest package, there began talk of the need for another funding package for states and local governments.

Other developed countries are looking to pursue a similar strategy of massive income support and liquidity injections. Germany, a country that typically keeps its wallet closed, is setting the example for Europe. The government has proposed a package equivalent to a whopping 30% of the country's GDP, counting contingencies. Since Germany has built up large reserves in its existing income-support program, the supplementary budget is expected to push the country's on-budget deficit only toward 5% of GDP in 2020, following several years of surplus.

Few other countries in Europe have the fiscal strength of Germany. Italy, the European epicenter of the virus, will be particularly hard-pressed to do all that will be needed to stabilize its economy. Italy's government debt-to-GDP ratio is already well above other major European countries.

The only way an Italian financial crisis can be averted is through the ECB backing up the debt. This is now-or-never time for the EU and eurozone. The stronger countries must come to the aid of the weaker, or face an intensified popular backlash that could threaten the unity of the economic zone. Unfortunately, Germany and the Netherlands are not yet ready to come to the rescue and are standing in the way of the EU issuing "corona bonds." We anticipate this opposition will melt in front of the unfolding disaster.

The onslaught of developments presented by the spread of COVID-19 and a simultaneous collapse in oil prices has forced financial markets to recalibrate prices sharply as expectations about different industries and the overall economy shift at a breakneck pace. Investors should gain some reassurance, however, from the fact that a virus-containment-induced earnings recession is generally only expected to last a couple quarters or so. If market prices are based on a long-term, multi-year expectation, then this fallout should represent a relatively small part of the market's forward-looking focus.

In any event, there is no question that markets have entered deeply oversold territory in technical terms; although it is too soon to say that the market bottom has been established. Nonetheless, we are grateful that the chaotic trading seen in recent weeks has eased considerably thanks to the liquidity provided by central banks and the fiscal package passed by Congress.

Only time will tell whether markets have sufficiently discounted the pain that lies immediately ahead. We have to be cognizant of the fact that earnings estimates will be coming down hard—maybe by 40% to 50% on a year-over-year basis—over the next two quarters. These waterfall declines in earnings could drag equities down with them, but likely not to the same extent. It all depends on how willing investors are to look beyond the valley. If there is a belief that the fiscal and monetary measures taken in the past two weeks will successfully prop up the global economy, then markets should prove resilient. We think a great deal of volatility is still ahead of us, but another big decline along the lines of the past month could be avoided. Indeed, if there are signs that the infection rate is beginning to peak in the U.S. and Europe, it might not matter at all where earnings go in the near term. Investors will likely begin to bid stock prices higher in anticipation of an economic recovery, as they almost always do.

During periods of chaos in financial markets, investors often picture professional portfolio managers frantically trading in an effort to avoid the worst of the carnage while seeking opportunities to profit. At SEI, that reality couldn't be further from the truth.

With a pandemic crippling the global economy and an oil glut exacerbated by suspended activity around the globe, we find ourselves in an environment almost completely void of reliable information—which, to us, makes frantic trading an especially unwise approach to financial stewardship. So, what are we doing?

We are sticking to our investment philosophy and process, maintaining our view that diversification is a sound approach over full market cycles, which include bull markets (some of which last for more than a decade) and bear markets (which can vary in terms of length and severity).

Right now, as always, we are exploring how to deliver portfolios that are as diversified as possible to all of our investors. We're considering the known risks inherent to the capital markets, as well as the uncertainty that comes with any long-term investing plan such as the black swan we've encountered in 2020.

At SEI, we build and maintain long-term-oriented portfolios by being attuned to the evolving correlations, or relationships, between asset classes. We believe our strategies are robust and built to handle environments just like this.

With this in mind, what now?

For one thing, we think checking your portfolio's balance every day is about as helpful as watching the news these days. It won't do anything to ease your nerves. At a portfolio level, we encourage investors to stay diversified and avoid short-term trading in these volatile markets.

If you are a goals-based investor—and your portfolio is aligned with your goals, time horizon and risk tolerance—be patient. Time should be on your side.

If your portfolio was not aligned with your goals as the selloff began, we think it's too late to sell now. Doing so may mean you'll risk missing the rebound that will inevitably happen. No one—including those of us in the financial-services industry—knows exactly when that will take place. But we are confident that the markets will eventually have their comebacks. It may take months—but order will be restored.

Until then, read, watch, listen and learn. You're seeing a real-life, albeit metaphorical, black swan. Use this experience to become a better, more informed investor. We will continue to monitor economic and financial-market developments and provide our insight to help you achieve your goals.

Economic Backdrop

The modern world has almost never before seen the kind of sudden, dramatic global transformation as it did in early 2020. The New Year brought major developments that included the signing of a "phase-one" trade deal between the U.S. and China, the U.K.'s official divorce from the EU, and the emergence of COVID-19 in Wuhan, China. February was defined by the world's evolving realization that COVID-19 would not be contained to China despite quarantines, border closures and air-travel restrictions. Halfway into the same month, the U.S. and Europe began to contend with a possible widespread outbreak that would demand extreme containment measures—all of which became reality by the middle of March, as both regions committed to suppression.

The arc of global financial markets during the first quarter of 2020 corresponded with the unfolding realization that controlling the outbreak would require government-mandated shutdowns of “non-essential” activity—impacting large cross-sections of the world economy. Governments issued stay-at-home orders as public health leaders preached “social distancing” in order to “flatten the curve” (that is, slow the rate of transmission in order to provide health systems time to manage the viral outbreak).

A dash for cash by investors concerned about the economic fallout created disorderly conditions across capital markets. Major developed government-bond rates plummeted to multi-year and all-time lows as credit spreads exploded for fixed-income securities regardless of credit quality, maturity, or other risk characteristics. A subsequent shortage in U.S. dollar funding caused its value to spike against other currencies. Emerging-market currencies came under heavy pressure amid investment outflows and collapsing output, partially on U.S. dollar scarcity and withering demand for oil (much of which is produced in emerging-market countries).

The Federal Reserve (Fed) and other major central banks responded to the widespread disorder in March with a rapid return to great financial crisis-era playbooks. This appears to have helped reroute markets back toward orderly function.

Equities in developed and emerging markets around the globe tumbled in the first quarter of 2020—by between approximately 20% and 30% in most major equity indexes. Peak-to-trough declines were even sharper in many areas since most stocks outside of China either climbed or remained buoyant through mid-February, before selling off as daily volatility returned to levels last seen during the depths of the great financial crisis.

U.S. stocks climbed to all-time highs before registering one of the fastest descents in history, triggering multiple exchange-wide circuit breakers that forced market closures for short periods of time during March. The CBOE Volatility Index (VIX) set an all-time high in mid-March, surpassing its high from the fall of 2008. The volatility cut in both directions as U.S. stocks earned their best three-day winning streak in more than 80 years during late March amid growing support for Congressional action.

Dysfunction, unfortunately, was not limited to financial markets. Hospitals in U.S. and European population centers reported shortages of medical supplies and personal protective equipment. Overextended health systems buckled under the strains; a scarcity of hospital beds spurred the construction of temporary field hospitals, from Milan’s fairgrounds to London’s ExCel Centre and Central Park in New York City. As the Western world was scrambling to build these facilities, China was already dismantling its temporary hospitals as the country’s infection rate slowed—closing its last just one day before the World Health Organization officially characterized COVID-19 a pandemic.

Economic fallout from widespread societal lockdown presented a separate severe challenge to governments around the globe. Trends that were many years in the making—including the explosion of online spending hurting brick-and-mortar retailers, the rise of video streaming entertainment at home, and the expanded business use of teleconferencing—accelerated due to the shift. Meanwhile, OPEC+ (that is, the Organization of the Petroleum Exporting Countries, led by Saudi Arabia—plus Russia) splintered in early March on plummeting demand. Russia would not agree to a proposed shared production cut intended to stabilize oil prices, which prompted Saudi Arabia to increase production in retaliation—triggering the largest one-day oil-price decline since 1991 on March 8, sending oil prices to their lowest levels in 18 years.

National government responses evolved sharply over time. In the U.S., the COVID-19 response differed at the state level, with governors of more than 30 states (who collectively represent over two-thirds of the national population) issuing stay-at-home orders by the end of the quarter, while others abstained from substantive lockdown measures. The number of Americans filing for unemployment benefits in the last full week of March hit a record-shattering high of 6.64 million, just one week after more than quadrupling the 1982 record of 695,000 jobless claims. President Donald Trump initially appeared to consider the outbreak a minor issue, but then shifted course, declaring a national emergency in mid-March, and eventually suspending import tariffs; enlisting the private sector to manufacture medical supplies; pausing evictions and foreclosures of government-sponsored mortgages; suspending government-sponsored student loan payments; and delaying most federal tax payments for three months. Congress passed three separate legislative acts appropriating more than $2 trillion in funding for large and small businesses, enhanced unemployment benefits, direct payments to Americans, state and local governments, and the health system.

The U.K. appeared intent on letting its population develop “herd immunity” through widespread infection in early March, acknowledging the likelihood of a high mortality rate. By mid-March, however, its government pivoted to suppression—closing most gathering places and recommending the postponement of local elections several months in advance. The country’s economic relief plans included replacing most of the income lost to suppression-related unemployment, additional health funding, faster paid sick leave and unemployment benefits, business relief via subsidized loans, and the refunding of sick pay to small firms.

The European Commission waived Maastricht limits (that is, requiring EU members to adhere to annual deficits of no greater than 3% of gross domestic product) in order to provide national governments fiscal budgetary flexibility. Italy passed one of the earliest government relief programs, although it will almost certainly need to do more given the severity of its outbreak. Germany and France, among other nations, have also been working to introduce major fiscal stimulus.

Against the backdrop of an unfolding global crisis, Russia's legislature and highest court affirmed a constitutional amendment allowing Vladimir Putin to remain president until 2036, adding another potential 12 years to his term.

Central Banks

- The BoC aggressively cut its policy interest rate in March; three separate 0.50% cuts left the policy rate at just 0.25%. Additionally, the BoC launched a new program called the Standing Term Liquidity Facility (STLF) to assist financial institutions in providing liquidity to their clients. As with most other central banks, the BoC seems prepared to do what is needed during the COVID-19 crisis. The next scheduled meeting in on April 15, 2020.

- The Federal Open Market Committee cut the federal-funds rate to near zero through two off-cycle cuts and committed to purchasing unlimited amounts of Treasurys and mortgage-backed securities (MBS). Additionally, the Fed established new, promoted existing, and revived retired facilities to support commercial-paper funding, primary dealer credit intermediation, money markets, investment-grade corporate bonds (in primary and secondary markets), asset-backed loans, and central bank foreign-exchange swaps, along with high levels of reverse repo funding.

- The Bank of England's (BoE) Monetary Policy Committee cut the Bank Rate to 0.1%, the lowest in the 325-year history of the lending rate. It also announced a £200 billion asset-purchase program, mostly of government bonds, to be conducted at a monthly pace that will eclipse previous rounds of quantitative easing (QE). Additionally, it launched a so-called funding-for-lending scheme to spur banks to lend to small- and medium-sized enterprises as well as a commercial paper facility with no cap limit, both to be financed by central-bank reserves.

- The European Central Bank (ECB) announced a new QE package—the Pandemic Emergency Purchase Programme—amounting to €750 billion, which should bring total QE-related asset purchases to more than €1.1 trillion in 2020. The central bank also altered issuer limits on the amounts and types of securities it can buy. If needed, the ECB can also use its Outright Monetary Transactions program to purchase an unlimited amount of short-term government bonds.

Economic Data

- For the sake of thoroughness we will recap some Canadian economic data, but also note that any backward looking data points are essentially useless as they do not include the full impact of the COVID-19 related lockdowns. According to Statistics Canada, the rate of inflation (as measured by the change in the Consumer Price Index (CPI) was up 0.1% in February and rose 2.2% for the prior 12 months. Excluding gasoline, the annual rate of change was slightly lower, at 2.0%. Producer prices have already begun to soften as a result of the COVID-19 crisis. The Industrial Product Price Index (IPPI) slipped 0.5% and the Raw Materials Price Index (RMPI) slumped 4.7% in February. On a year-over-year basis, the IPPI fell 0.3% while the RMPI was down 5.9%; the weak results were generally due to lower energy costs and falling commodity prices, especially for copper. The unemployment rate remained near all-time lows at 5.6% as of February; however, that number is likely to rise rapidly as jobs are lost due to the COVID-19 crisis.

Market Impact (Referenced Index Returns are in CAD)

Global equity markets were testing new highs early in the quarter as it appeared the COVID-19 crisis may have been contained to mostly China. As the virus quickly spread globally those hopes were dashed and equity markets plunged across the board. Domestic stocks were hit hard, especially in more cyclical areas such as consumer discretionary and energy, as these sectors were disproportionately impacted by the ever-increasing number of stay-at-home orders. Small companies, which are generally more risky and have a higher concentration of oil and materials companies, fell nearly twice as much as large companies. The story was generally similar in other countries. U.S. equity performance essentially mirrored that of Canadian equities, although the sharp depreciation of the loonie versus the U.S. dollar eased some of the pain for Canadian investors. Performance varied wildly for other foreign countries, particularly in emerging markets. Oil exporters like Brazil faced steep declines while oil importers fared relatively better. Of note, China was actually among the top-performing countries.

Fixed-income markets began the year on a high note, but indiscriminate selling as the COVID-19 crisis intensified resulted in significant losses across a number of sectors during March. Relatively speaking, government debt, which is often considered a “safe haven”, outperformed corporate bonds by a wide margin. Real-return bonds were considerably lower as expectations of inflation have markedly dimmed. High-yield bonds suffered due to a high concentration in oil company debt, rising default concerns and strong correlations with falling equity markets.

Index Data (Q1 2020)

- The S&P/TSX Composite Index plunged 20.90%.
- The FTSE Canada Universe Bond Index returned 1.56%.
- The S&P 500 Index, which measures U.S. equities, lost 11.75%.
- The MSCI ACWI (Net) Index, used to gauge global equity performance, returned -13.69%.
- The ICE BofA U.S. High Yield Constrained Index, representing U.S. high-yield bond markets, returned -13.86% (currency hedged) and -4.65% (unhedged).
- The Chicago Board Options Exchange Volatility Index, a measure of implied volatility in the S&P 500 Index that is also known as the “fear index,” surged from 13.78 to 82.69 on March 16, before settling at 53.54 by the end of the quarter.
- WTI Cushing crude-oil prices, a key indicator of movements in the oil market, plunged from US$61.06 to US$20.48 during the quarter. COVID-19-related stay-at-home orders and travel bans have dramatically reduced demand for oil at the same time that Saudi Arabia and Russia have sought to increase supply in an effort to gain market share.
- The Canadian dollar was significantly weaker, falling to C$1.42 per U.S. dollar. The U.S. dollar was generally stronger versus other major currencies, ending March at US$1.24 versus sterling, US$1.10 against the euro and at 107.96 yen.

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