Clark Capital Management Group

Commentary

Navigator® Market Update

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Into the Unknown

We are certainly living in scary and uncertain times. The outbreak of the coronavirus has turned the world upside down, the likes of which we have never dealt with before. The number of infected people and deaths continue to mount at a staggering rate. People are concerned for their families, friends, co-workers and their employment.

Much of the country is now under conditions that are approaching martial law. Non-essential businesses are being forced to close, large gatherings are forbidden, and many home goods are being rationed. These seemingly draconian measures are necessary to limit the spread of the virus, help keep the healthcare system from being overwhelmed, and to ultimately save lives.

Coming into this event, the U.S. economy was on solid footing. Jobless claims were low, the unemployment rate was at a 50-year low, housing starts were hitting cycle highs, and global PMI's were turning higher. That all changed quickly. The recession has started both in the U.S. and globally as a result of the response to stopping the spread of COVID-19. This is something that we have never seen—a combination of a global health and economic crisis.

The economy has ground to a halt as cities and states across the U.S. issue stay at home orders to try and stem the spread of the virus. In the coming weeks and months, we are going to see economic damage like we have never witnessed before. We are already now starting to see jobless claims rise, and they are likely to skyrocket starting this week.

Bracing for GDP Impact

There is so much unknown about the extent of the economic weakness we will face over the next (hopefully) only two quarters. As social distancing measures increase in a greater number of areas and as financial conditions tighten further, the negative effects on near-term GDP growth become that much greater.

The economy didn't really shut down until midway through March. First quarter GDP will be marginally positive, at best, with we believe a 1% growth rate. However, GDP is going to be down significantly in the 2nd quarter, initial jobless claims and unemployment will skyrocket, and retail sales will plummet as consumers are confined at home.

As a result, we expect 2nd quarter GDP to decline somewhere between 10%-15%. The 3rd quarter will likely be a transition period during which people slowly start to return to work. That quarter may also have negative GDP or slightly positive economic growth and will largely depend on how quickly active cases peak in the U.S. and when social behavior returns to some normalcy.

We believe the 4th quarter should be the rebound quarter and is likely to exhibit stronger than trend growth as depleted inventories are replenished and pent up retail demand is unleashed. We expect the 4th quarter to grow by at least 5%, which should set the stage for a strong economic rebound year in 2021.

Navigate Your Future. Enjoy the Journey.

Volatility Continues in Equity and Appears in Fixed Income

The markets are discounting a deep economic crisis. We just experienced the fastest decline into bear market history on record. The S&P 500 has fallen to 3-year lows and is down 32% since making a high on February 19th; the period since has featured a sequence of generational moves that are unprecedented in their magnitude.

According to Goldman Sachs, the 10-day realized volatility for S&P 500 was less than 7% just one month ago. Today, it stands at 116%. That is the highest level since 1987 and is higher than during the Financial Crisis of 2008/2009.

It's not just stocks that have seen unprecedented sell-offs and volatility. Fixed income has been under pressure in virtually all sectors. Anything that trades on a spread relative to Treasuries has widened out considerably.

For example, mortgage backed securities, investment grade corporate debt, and high yield spreads are now hitting their highest levels since the Credit Crisis. There is an incredible amount of stress right now in fixed income. We have witnessed liquidity dry up in both corporate bonds and municipal bonds and have witnessed indiscriminate mutual fund redemptions and associated forced selling of bonds.

According to Lipper, investors yanked $16.7 billion from equity mutual funds for the week ending March 18th. Even more astonishing is that investors pulled $55.9 billion from taxable bond funds, $35.6 billion from investment grade bond funds and $12.2 billion from municipal bond funds over that same time period.

All of the outflows from bonds are weekly records. Investors usually turn to bonds to provide stable cash flow and offset the volatility of stocks. Bonds are normally viewed as investors' safe money, and with good reason. Since the inception of the Bloomberg Barclays U.S. Aggregate Bond Index in 1976, there have only been 3 calendar years in which the Index had a negative total return—the worst of which was in 1994, which experienced a negative return of -2.92%. In our opinion, this will present an incredible opportunity similar to late in the Credit Crisis.

We believe there are several factors that the market is focusing on:

1) **A stabilization or flattening out of the infection rate curve in the U.S. and Europe**
   This still seems like a few weeks away as the rate of infections in the U.S. is growing exponentially. Health experts are hopeful that with social distancing and closing of non-essential businesses, that the peak in infections will be by the end of April. The extreme measures adopted by many U.S. states to enforce social distancing are having a draconian impact on the economy, but also increasing the likelihood that the health crisis will be over sooner rather than later.

2) **Sufficiently large global stimulus**
   Global central banks and governments around the world have stepped up to the plate and acted incredibly fast to try and stabilize the economy and markets. The Federal Reserve essentially deployed its entire 2008 financial crisis playbook in the span of a little over two weeks.

   The Fed cut rates to the zero bound, stepped in with massive liquidity to support the funding markets, committed over $5 trillion of liquidity through month end, and set up a Commercial Paper Facility to backstop money markets. Fiscal stimulus is coming through in a big way. Congress is now trying to pass a fiscal stimulus bill worth at least $2 trillion. But as usual, both sides of the aisle can't agree. However, we believe that should change as we expect a substantial fiscal plan early this week.

3) **Improvement in credit conditions**

   Credit conditions continue to deteriorate with high yield and investment grade spreads blowing out to their highest levels since the Credit Crisis. About 50% of investment grade corporate bonds are trading at the bottom rung of investment grade ratings.

   The amount of debt rated BBB is currently larger than the entire high yield market. That has many people concerned about the spillover effect on the high yield market if a large share of these BBB bonds get downgraded to junk. Those fears are real now, as companies have levered up by issuing debt to buyback stock.

   Many are now vulnerable to downgrades as the economy came to an abrupt stop. Our view has been, and still is, that this may present a tremendous opportunity should it occur, and we believe we are well positioned to capitalize on that opportunity with our active and tactical approaches to managing fixed income.

In our opinion, the equity markets are severely oversold, investor sentiment is massively pessimistic, and volatility has surged. Conditions can continue to deteriorate, but conditions are also in place for the market to stage a rebound rally. A spark is needed to turn the tide. Last week alone, the S&P 500 declined by almost 15%. This sure does feel like the market is approaching, or has already made, a selling climax.

As we mentioned in our update "It is Always Darkest Before the Dawn," these types of extreme declines never feel good, but we do know that this too shall pass. As always, we believe that the surest way for clients to achieve financial success is to remain focused on their long-term goals and objectives. Clark Capital is committed to helping you and your clients navigate these changing and challenging market conditions. Please reach out to us with any questions—we are here for you and with you, with the common goal of helping investors.