ClearBridge Investments

Encouraging Signs Are on the Horizon

Key Takeaways

- A recession is likely, yet compared to recent weeks, there are encouraging signs in policy response and market activity.
- We are now likely at the lower end of leverage in the system and the volatility associated with recent deleveraging should start to dampen.
- Higher-quality companies with durable business models and a high degree of visibility into their earnings profiles should weather this storm better than most.

The brunt of the damage done by the coronavirus (COVID-19) has shifted from Asia to Europe and the U.S. in recent weeks. Along with the westward move of this unfolding health care crisis, markets have declined and become increasingly volatile. Steeply falling oil prices have worsened the situation. The toll on those affected will be large, though there is some growing (if still early) solace in recent developments. Based on the experiences of China and South Korea, we know that with significant testing and severe restrictions on social interaction the virus can be contained. China has now reported consecutive days of no new local cases. While still a difficult situation, Italy appears to be making progress and cases may have peaked.

The current decline differs from prior ones insofar as it appears no asset class or industry has been spared. Assets across the board have seen losses on a global basis. It is somewhat frustrating to date, as there is no or little differentiation, within U.S. equity markets at least, in terms of factors: quality, size, beta, balance sheet, dividends. But this is not to say differentiation will not come.

To provide some context on the current volatility: behind the correlated selling is a liquidity event. Across the globe there has been an insatiable thirst for dollars and liquidity. The financial system has already seen an enormous amount of deleveraging. Commodity trading accounts, volatility funds, risk parity funds and other client-oriented funds, as well as hedge funds, levered ETFs, MLPs — you name it — have delevered in the past two weeks. We are now likely at the lower end of leverage in the financial system. The volatility associated with this deleveraging should start to decrease as we go forward.

We are trying to make a bottom, but that is a process and not a day. It will ultimately depend on news flow and our ability to get a handle on the depth and length of the crises. If you look at the recessions we've had going back to the 1940s, from peak to trough, the markets lost 32% on average. Before the rally on March 24, we were near that 32% level. At the start of the year, markets had clearly priced in a soft landing where earnings growth was projected to return to 10% in 2020. With the high likelihood of a recession, valuations need to come down very dramatically. This has happened to some extent: the forward 12-month price-earnings ratio for the S&P 500 Index was 18.2x on December 31, 2019, and 13.9x on March 19 (Exhibit 1).

From a social and economic perspective, the more drastic and restrictive we are in terms of movement and distance — the more seriously we take it — the deeper the pain will be shorter term, but I also believe the shorter the duration of the recession and the quicker people can go back to work. There is evidence that these actions work. The U.S. is focused on solutions, and compared to roughly a week ago, I'm much more encouraged today.

State and federal governments are taking this seriously. Significantly, the response has been more reminiscent of 9/11 than 2008: there is less a feeling of blame and more a feeling of coming together. That's important in terms of getting this solved.

The Fed and global central banks around the world have not only lowered rates to zero, but they're also purchasing all types of collateral to ensure the plumbing of the financial system operates. This is unprecedented: they will basically do whatever it takes. We would like to see fixed income spreads stabilize — this is important for both the broader financial system and the equity markets.

Fiscal actions being taken are also unprecedented. Despite some back and forth, Congress is providing enormous resources. The talk is of extending or flattening the curve — reducing the number of immediate cases to prevent health systems from being overwhelmed. From the stock market perspective, the goal is to compress the curve, making it shorter, but deeper. The role of Congress and the enormous resources it is providing — a total of roughly $2 trillion in direct financial aid to individuals, robust unemployment insurance, loans to small and large businesses and resources to health care providers — will help us bridge a portion of the economic gap. Such measures are reminiscent of wartime measures, yet they are appropriate and encouraging.

Medicines, treatments, vaccines are coming, although they won't come immediately. There is an unbelievable amount of time, money and intellectual power going into developing solutions, and they will be coming.

Exhibit 1: Stock Multiples Have Compressed

Data as of March 19, 2020. Source: ClearBridge Investments, FactSet.

I've been managing portfolios for almost 30 years, and I've been trained to look for high-quality stocks with good dividends, strong balance sheets and sustainable growth. Now I see them available. I believe clients are going to make reasonable returns if they hold these types of stocks over time. This is no different from the long-term perspective ClearBridge takes at all times.

The volatility is not over. This is the most oversold market in terms of investor sentiment measures since 1983. It has been a monolithic asset liquidation where the market has not differentiated between good and bad and most companies have become cheap. Many businesses will face net losses, but for most companies it will be short-lived. It is a good time to focus on stocks with strong balance sheets, free cash flow generation and durable business models. Today's volatility is ultimately an opportunity to upgrade portfolios and focus on long-term strategies. That is what we are doing.

About the Author

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