TERRA NOVA
ASSET MANAGEMENT

U.S. Financial Markets
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777 Third Avenue | New York, NY 10017 | USA | tel. +1.212.355.1234 | fax +1.212.355.8873

Stock Market Development

Financial markets had expected a bright start in January buoyed by the phase one of a China-U.S. trade deal. But in January the deadly coronavirus emerged to become a threat to the global economy, serious, but short-lived was the assumption at first. The S&P-500 Index was still up 5% YTD by February 19 until it went into a tailspin correction of 33% between February 21 and March 23 when it became clear that this was a pandemic with no quick solution in sight. In addition, an 80% at the peak, collapse in oil prices due to oversupply accelerated the market collapse. All industry sectors were down double digits, with energy being the worst followed by financials, and industrials. Between March 23 and April 30 the market made back 30% closing April with -9.8% for the year. The simple explanation for the V-shape recovery of the stock market is the historic phenomena that markets look 6-8 months ahead, whereas economic data always reflects the past. Institutional investors, with a long-term time horizon, are the first to take advantage of rock bottom prices because they can afford the risk as they have the means to average down their positions at any given time if necessary. Since we went into this "medically" induced crisis with an intact economy, we expect markets to remain nervous and trade in a range but that they will find their footing as the world re-opens their economies in the coming months, and we learn to pursue our lives in a "new normal", and in co-existence with the coronavirus until antibody tests and finally vaccination come to market.

Fixed Income Markets

Bond markets came under stress as investors sold bonds to raise cash. When equity markets began their plunge from record highs in February, prices of high quality bonds initially rose and provided protection for investors' portfolios. But when the government started to restrict economic activities to slow the spread of the virus, investors sought cash, and started to sell bonds from riskier high-yield to investment-grade bonds which upended the familiar relationship between stocks and bonds when bonds would offset losses from stocks. The result from the rush to cash resulted in a broad sell-off in both stocks and bonds, and thus caused additional stress in the markets trying to meet the demand for liquidity. The Fed stepped in by cutting interest rates and instituting programs to ensure the smooth operation of bond markets. High-quality corporate bonds are likely to benefit from the Fed's actions as companies can borrow more cheaply to sustain their businesses. Large-cap corporate issuers with credit ratings of BBB and above in the cable/telecommunications, defense, regulated utilities, and consumer staples sectors look undervalued. However, despite the Fed injecting liquidity into the markets, corporate earnings are expected to fall due to the 50% plunge in oil prices, and the economic shut-down which affected industries like travel, retail, restaurants, and energy in particular which increases the risk of debt being downgraded.

Economy

There is no precedent, and, therefore, no playbook of the recession which is unfolding worldwide because the underlying cause originated from outside the economic and financial sphere. The speed and intensity of the coronavirus induced recession has rendered many economic indicators out of date before they are published. The economy has plunged into a large downturn due to mass layoffs. The lock down is likely to result in a 37% contraction in real GDP in Q2 after -4.8% in Q1. Given the swift and large monetary and fiscal response, and in the absence of major imbalances in the real economy, that would require a prolong adjustment, we expect the economy to transition from intense near-term pain during the virus suppression phase to gradual healing over the next 6 to 12 months, once the spread of the novel corona-virus under control, and the restrictions are being lifted. We expect a U-shape recovery. The restrictions on economic activity will likely be lifted only gradually, and at different speeds for different industry sectors and regions.

Federal Reserve Bank Policy

The coronavirus crises prompted the Fed to cut interest rates to the zero to 0.25% range, and is likely to triple its balance sheet from $4.2 trillion to exceed 50% of GDP if it utilizes its full emergency lending capacity. The Fed is committed to holding interest rates until employment has returned to a 4%-5% range from an expected 10% (after a peak of 20% in Q2) by the end of 2020. Major deflationary pressures are likely to emerge from a combination of low oil prices, weak commodity prices, a strong dollar, rising labor slack, and abundant spare capacity. Headline inflation is likely to quickly fall into negative territory due to the collapse in oil prices.

Corporate Earnings

The impact of the coronavirus on corporate earnings will not be fully reflected in Q1, but in Q2. Sixty six percent of companies reported Q1 earnings. Positive earnings surprises reported by companies in the Energy, Information Technology, and Healthcare sectors were mainly responsible for the decrease in the overall earnings decline so far, which is expected to be -13.7% for the quarter. Six sectors are reporting year-over-year growth in earnings, led by the Healthcare, and Consumer Staples sectors. Five sectors are reporting a year-over-year decline in earnings: Consumer Discretionary, Financials, Industrials, Materials, and Energy.

Outlook

A brief, but strong recession seems to be factored in stock prices, in particular in sectors that top the list of those being especially hard hit by the coronavirus. Also, the oil price drop of 50% this year increases the risk of a profit recession. We do not expect this trend to be long term, however, as demand is likely to return more briskly than expected once the economy has fully reopened.

Equity market multiples and real interest rates have an inverse relationship suggesting that the rally in yields with the two-year-treasury minus inflation being at -1.8% is ultimately likely to support stocks. When real interest rates last were in negative territory, in February 2017, the average stock PEs for the S&P-500 expanded to 21. Excluding the largest tech stocks in the market, the S&P-500 forward P/E multiple has dropped well below its long term average, potentially presenting significant value.

However, although the recent recovery in stock prices in April has been impressive, economic uncertainties remain, and the magnitude of the coronavirus impact on earnings will only be fully reflected in Q2 earnings. Among the many factors that could drive U.S. equity market performance in 2020, and beyond are inflation, monetary and fiscal policy.

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