MV CAPITAL MANAGEMENT

MVF Special Update

May 12, 2020

To Our Valued Clients:

We hope you and your loved ones are staying safe and healthy during these challenging times. In keeping with our commitment to help you navigate these unprecedented economic conditions, we want to share our perspective on current developments in the financial markets.

As states and municipalities take the initial steps toward easing lockdown restrictions, our fellow citizens will emerge from isolation into a harsh economic reality. Around 33 million Americans had filed unemployment claims as of April 30, and some experts are predicting a high single-digit (or even low double-digit) decline in GDP for the year.

The Stock Market vs. Economic Reality

Yet, as is often the case, the U.S. stock market is decoupled from reality, as investors lurch between fear and greed. The S&P 500 hit its last high on February 19, 2020, before falling to a near-term low March 23. Since then, the index has recovered about half its losses and was about 14.9% below its February high on May 8. Over this same time period, bond prices have rallied and yields have fallen. This suggests that investors in both stocks and bonds are being guided more by emotion (and central bank policies) than economic fundamentals.

Given the stock market's seeming resilience, some investors may be asking whether now is the time to become more aggressive with their portfolios and reallocate more to equities, to avoid missing out on a market recovery. At MV Financial, we think the simple answer is, "Not yet."

The optimistic argument is that investors are looking past the immediate problems and banking on a future recovery. What's wrong with this picture is that no one knows when that recovery will come, what shape it will take, and how much the global economy will differ from that which came before.

Aggressive Valuations and High Volatility

While the market has staged an impressive relief rally since the lows of late March, there is ample evidence that equities are decoupled from fundamentals. The forward price-to-earnings (P/E) ratio based on forecasted earnings for S&P 500 companies is higher than at any time since the fallout from the dot-com bubble at the beginning of this century. Valuations remain sky-high due to both rising stock prices and falling earnings forecasts since the beginning of this fiscal quarter. Given the pessimistic expectations for unemployment and GDP contraction, it seems clear that the stock market and the real economy live in vastly different neighborhoods.

Volatility, another important measure, remains very high. The average daily price movement (i.e. where stocks closed relative to where they opened) has been greater than 3.5% since early March, a degree of volatility that has no precedent for such a sustained time period. The CBOE VIX, an index that reflects the level of fear in the market, remains at very elevated levels relative to long- term averages.

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Medical Progress vs. Magical Thinking

Unlike past economic downturns, the critical factor today is not macroeconomic headlines or corporate earnings projections – it is medical science. We still don't have a full complement of testing and tracing capabilities to track and interdict the virus's spread. We don't fully understand the dynamics of antibodies in the systems of those exposed to and subsequently recovered from Covid-19. It is not possible to form a valid probabilistic economic scenario until we have a clearer sense of the pandemic's future trajectory and a timeline to a medical solution.

In the meantime, it makes sense for investors to keep the riskier components of their portfolio weighted towards the lower end of strategic approved ranges. This should provide protection in a period marked by a high level of economic uncertainty, while at the same time offering adequate exposure to eventual growth opportunities. We believe this measured approach is a more prudent portfolio construction technique than either jumping into an aggressive equity position too quickly or, conversely, building up too large a cash defense.

Our view is that investors should hold out for more definitive evidence of medical progress before having more conviction about increasing their equity exposure. The origins of the present economic distress are unlike any we've seen in our lifetimes, but the time-tested prescription – mitigate on the downside, participate on the upside – remains valid in today's market.

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