The Selloff Continues

LCNB Investment Update | March 9, 2020

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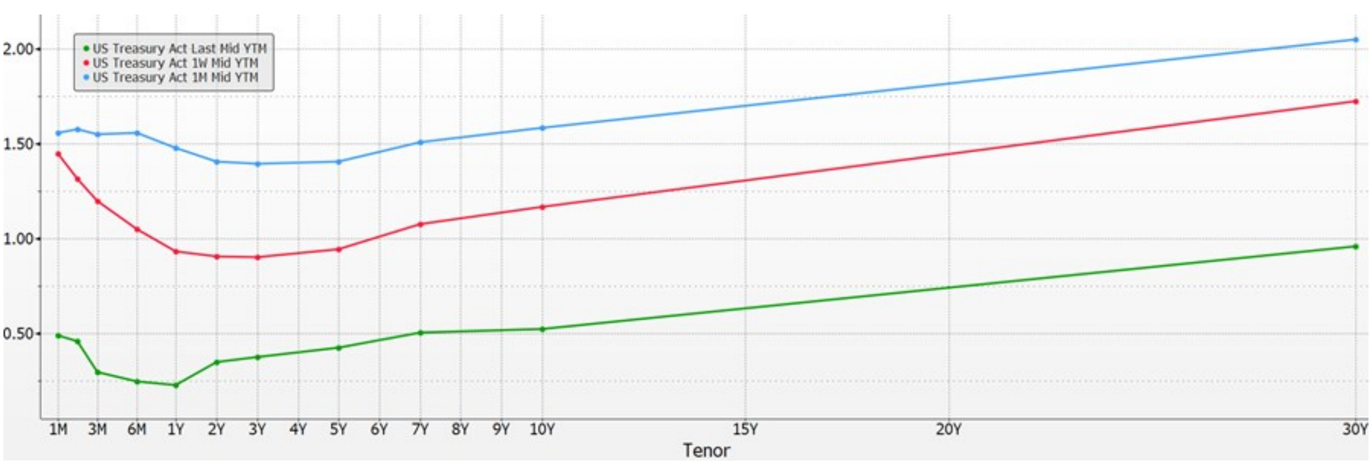
In our last update, we noted that the S&P 500 Index would likely find some initial support around the 200 day moving average of 3044 or if that didn't hold, possibly near 2850. Last week the index appeared to make a double bottom between these two levels at 2972. However, as news developed over the weekend it became apparent that these initial support levels would not hold. So what changed and where do we go from here?

Markets and economic data have been sending some late cycle indicators for well over a year now. However, as we noted in the past, economic cycles don't die of old age. Given the strength of the U.S. consumer, we have suggested that it would take some exogenous shock to the consumer to ultimately bring an end to this record breaking cycle. It now appears as though the fear caused by the spread of COVID-19, or the coronavirus, may be enough of a shock to tip the U.S. into a recession.

While a recession is not a foregone conclusion, the economy is being hit on multiple fronts. The first hit is coming in the form of a supply shock with output in China grinding to a halt since late December. The second hit is from the demand side as consumption for travel and leisure is slowing dramatically. With the economy already on the ropes, a collapse in oil prices over the weekend delivered a third blow and will likely lead to a slowdown in oil production.

Bond markets are already pricing in a potential recession. The 10 year Treasury note is trading around 40 basis points and the 30 year bond dipped well below 1%. Additionally, the spread between low quality corporates and treasuries is widening. Last week, the Fed announced an emergency 50 basis point cut to the Fed funds rate and the market is currently pricing in an additional 75 basis points in rate reductions later this month. As I write, stocks are trading down over 5% overseas with a similar decline likely at the open this morning in U.S. markets.



The bottom in stocks may still be several weeks away. If a worst case recession scenario does play out, a decline from peak to trough of 25-30% would not be unusual. The fourth quarter 2018 low was near 2400 on the S&P 500 Index. It is possible that we could wipe out all of 2019's gains and revisit that low in the coming weeks. With bond yields where they are, stock valuations will start to look very attractive again if we approach those levels.

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We again remind investors to stay disciplined. The key is to have proper asset allocation and ample liquidity to weather the storm. We have been moving portfolios into higher quality stocks and bonds for well over a year now. We dialed back from overweight to neutral on our stock target weightings way back in 2017. As bad as things look near-term, we have reason to hope that it won't last very long and we will look for opportunities to rebalance portfolios during the coming weeks.

Reports out of China indicate that manufacturing has bottomed and is starting to come back online. Demand for travel and leisure is likely to get worse before it gets better, but will not last indefinitely. At some point, spread of the virus will peak and consumer behavior will return to normal. The drop in oil prices will be a hit to producers, but will provide a stimulus to consumers in the form of lower gas prices. The dramatic drop in interest rates will not provide a cure to consumer behavior with respect to travel or dining out. However, lower rates will lead to refinanced mortgages, first time home purchases, and other purchases on credit that will help the economy recover.

Finally, the tight labor market should help as well. Businesses will be reluctant to layoff employees if they feel the slowdown is short-term. We will keep a close eye on labor data in the months ahead. As long as the consumer remains in a healthy financial condition, the economy should regain its footing as soon as fears subside.

We hope that we are exceeding your expectations. The best compliment we could receive would be a referral of your friends and family. Please contact Mike Miller at 513.932.1414, ext. 59101 or mmiller@LCNB.com for more information .

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