Legacy Trust

Investment Perspectives

Update on Investment Outlook Amidst Covid-19 Outbreak

March 23, 2020

Since the date of our last update just two weeks ago, market and economic conditions have changed significantly. Government officials across the U.S. are taking dramatic steps to slow the spread of the Covid-19 coronavirus by shutting down non-essential businesses, closing schools, limiting large gatherings of people, and in some cases ordering residents to shelter in place. Each passing day has brought new developments as policy makers respond and financial markets react. The S&P 500 closed on Friday March 20 at 2,304.92, a -31.9% decline from its February 19 peak closing level of 3,386.15, as investors attempt to price in the impact of these unprecedented events.

- The social distancing measures and forced closures in place across much of the country have effectively **put an abrupt stop to many aspects of the normal U.S. economy, and it now appears all but certain that we are entering a recession** for the first time since the Global Financial Crisis. Economists are forecasting significant declines in GDP in March and April with the assumption that growth will begin to recover in the latter half of the year. Consumer spending is plummeting, particularly in industries like travel, sports, entertainment, hotels and restaurants, while unemployment is expected to spike.

- Investors have reacted to the rapidly changing environment in recent days by selling indiscriminately in favor of holding extra cash. This has **driven even traditionally safe haven investments like Treasuries and gold to post recent price declines**. **This phenomenon is fear-driven and likely to be short-lived**, and we encourage investors to hold fast to their strategic allocation plans through this period of turmoil.

- **Covid-19 is an external shock to the economy versus a structural problem that would take much longer to fix. This should help the economy heal much more quickly once individuals and corporations are able to resume normal activities.** It will also allow markets to recovery more quickly than they normally do following a typical recession. Efforts by both fiscal and monetary authorities to support liquidity and help ease the burden of unemployed workers should soften the blow as well.

- However, at this time there is **still too much uncertainty surrounding the path of the viral outbreak to fully determine the duration of the economic impact and the effect it will have on company earnings**. Many analysts have yet to adjust their earnings estimates given the lack of available information. 2020 estimates for the S&P 500 could drop as much as 40% as economic activity is paused for a period of time before recovering later in the year. For perspective, forward earnings estimates declined 33% during the depths of the Global Financial Crisis. Based on that context, we view a decline of 40% as a fair estimate, if not conservative in this case. A cut of that magnitude would **imply 2020 S&P 500 earnings per share of $106, down from the $177 that was expected at the beginning of the year.**

- Given this backdrop, we believe **it is too early to rebalance back into equity allocations** until more is known about the extent and expected duration of the outbreak and the related economic fallout. We expect market volatility to be heightened for the foreseeable future and think there are still enough risks to the downside that it would be imprudent to buy in until we have more concrete information. As more testing is done and we gain a better understanding as to how social distancing measures are impacting the spread of the virus, we can begin to estimate the length of the economic slowdown. Seeing progress on viral treatments and an eventual vaccine will also be key to help markets find their footing.

- It should be noted, however, that economic and company data will trail market developments and the stock market has likely already priced in a great deal of the decline with the >30% losses that have already been experienced. **Based on currently available information, we think there is a fundamental case to be made that the floor for the S&P 500 is somewhere around the 2,000 level.**

- Valuations are likely to rise, not fall, as we move through the year. We began the year with stocks valuations near their highs, but have seen those come down dramatically over the past month. Stocks are now trading at a Price/Earnings (P/E) ratio of less than 15, down 32% since the year began. This is similar to the magnitude of decline we saw during 2008 when the P/E multiple dropped from 15 to 10, roughly in-line with the expected decline in forward earnings estimates. By the end of 2009 it had risen to 24. If we assume an even greater decline in earnings this time around, **we could see the P/E ratio drop from about 22 at the beginning of 2020 to a low of around 13, before it begins to rise in anticipation of an economic recovery. Such a decline in valuation would imply an S&P level around 2,100. Other valuation methods imply a range between 1,900 and 2,100.**

- While we aren't ready to add to risk assets yet, **we have been active during this period of market disruption to implement tactical portfolio adjustments that make sense given the changing outlook, and we are planning for how we will want to be positioned for the eventual recovery**. Despite the near-term hit, we expect the domestic economy to outperform other developed market countries as we emerge from this crisis and we have further underweighted international equities as a result. We are using the proceeds to buy into high quality U.S. businesses at discounted prices, and we have also taken the opportunity to harvest tax losses which will provide a financial benefit down the road. We expect to implement additional adjustments in the coming weeks.

We will continue to share our thoughts with you as events unfold. We know that this is an unsettling time that is presenting many new challenges and we are confident that, while the outlook is cloudy now, the recovery will come and we will be prepared to make the most of it when it does. Please don't hesitate to reach out to the Legacy Trust team with any questions.

Laina Mills, CFA, CFP®	Steven A. Doorn, CFA
Chief Investment Officer	Director of Portfolio Management