DM MARKET UPDATE
March 2020

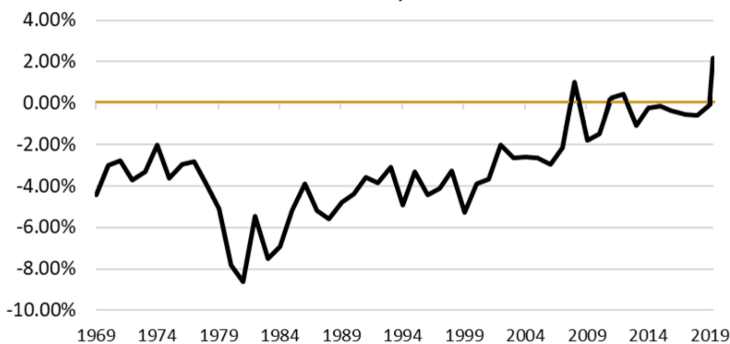
HEALTH AND MARKET CRISES ACCELERATE

Just days ago, we issued our March comment outlining our thoughts on COVID-19 and its likely effect on investment portfolios. Like virtually everyone at the time, we vastly underestimated the ability of the virus to cross seas, proliferate, and wreak havoc on our economy and markets. The reckoning has been swift, with indices staging their most rapid decline in history and measures of internal market stress reaching and, in some cases, exceeding levels marked during the 2008/09 financial crisis. This has left little room to gather one's thoughts, let alone reorient portfolios holdings or adjust allocations.

Still, we've been able to use the crisis as an opportunity to 'high grade' our equity mandates, liquidating names exposed to vulnerable areas such as energy and shifting capital to companies with strong balance sheets and business models that should bounce back quickly in an economic recovery. These trades have been collectively rewarded thus far on a relative basis and have helped our equity portfolios against the broad market. Still, as an investing sage once quipped, *"you can't eat relative returns"*.

So where to from here? Comparing current events to those of '08/09, we believe that we are in a condition of 'delayed', rather than 'destroyed', economic activity. Granted, this setback will inflict a deep rut and it's impossible to say how long it will last, but we're confident that postponed purchases, cancelled cruises, and other suspended expenditures will eventually be reinitiated. During the financial crisis, on the other hand, there was genuine fear that the entire financial system had been broken, that banks would never fully recover, that households would be buried in debt, even that the US dollar would lose its status as a reliable store of value. Though markets may be behaving similarly to 11 years ago, we don't believe that underlying circumstances and the eventual road to recovery are analogous.

One way to gauge the relative value of stocks is through a ratio called the "Equity Risk Premium", which measures the earnings yield on a given benchmark against that of 10-year government bonds – when the ERP is positive, it's generally regarded as a positive signal for stocks. Because there's no way to know what earnings will be for the next 12 months, however, we've instead plotted the long run difference between the S&P 500 dividend yield and the prevailing 10yr US Treasury rate (we've chosen this metric because we're fairly certain that most large companies will have the financial wherewithal to maintain dividend payments in coming quarters, regardless of what happens to net income in the short term).



As you can see on the first chart, dividend yields have rarely exceeded 10-year bond rates over the past half century, but have now blown through them (this effect is even more pronounced in Canada). The second chart zooms in on the past five years to reveal how dramatic the recent move has been. While this measure doesn't guarantee that the selling will stop tomorrow, it does provide a sense of how far the rush to liquidity has compressed equity valuation. If we can offer one piece of counsel at this very difficult time, it would be to avoid turning what will most likely be a temporary, albeit steep, loss into a permanent one by abandoning the shares of high quality companies in a moment of virtually unprecedented market duress.