The Type 2 Investor

March 9, 2020

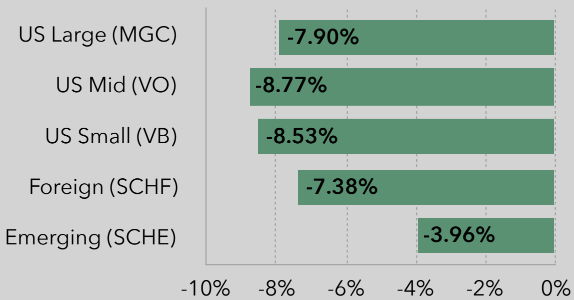
February 2020

Economic Data

- US payrolls rose 273,000 in February; the unemployment rate edged down one-tenth to 3.5%
- Retail sales were up 0.3% in January
- Y/y inflation (CPI) rose two-tenths to 2.5% in January
- Existing home sales declined 1.3% in January
- The Conference Board Leading Economic Index (LEI) increased 0.8% in January after briefly turning negative on a year-over-year basis for the first time this cycle the previous month

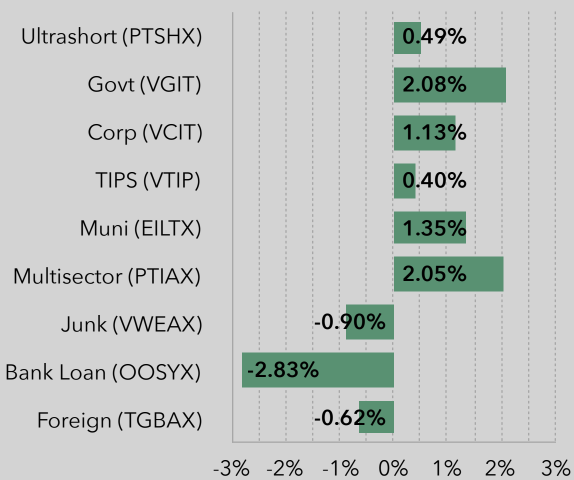
Stocks

February Returns



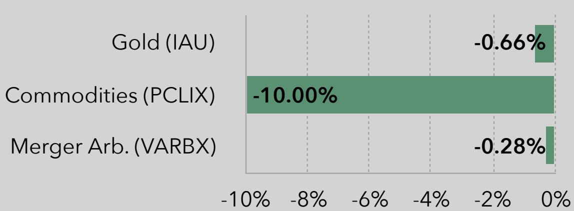
Bonds

February Returns



Alternatives

February Returns



Performance data provided by Morningstar.

The brain uses two systems to process information. The first type is intuitive but lazy, rapidly forming judgements with no conscious input. The second system is slow, reflective, and is not guided by emotions. It is that second system — type 2 — that we want in control of our investment portfolios.

Fed Cures Coronavirus With Lower Interest Rates

No, not really. But it was worth a shot, I suppose. The Fed called an emergency meeting last week and cut their target interest rate by 50 basis points to a range of 1.00% to 1.25%. The market cheered the news for all of three minutes, which was apparently how long it takes to realize what that action really meant. The emergency rate cut essentially says the Fed views COVID-19 to be as big of a threat to the economy as the Lehman bankruptcy, or the tech bubble, or 9/11. But lowering interest rates isn't going to cure COVID-19, or calm a panicked stock market, nor will it coax a newly germaphobic populous to hop on a cruise ship or attend a concert with thousands of other people.

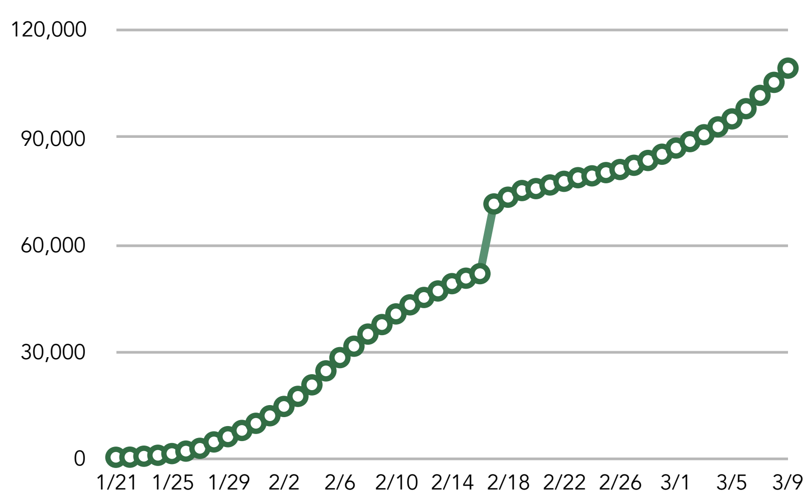
The S&P 500 fell 12% in just six days near the end of February, making it the fastest correction—defined as a 10% drop from a peak—in US history. We've seen one-day drops, like Black Monday in 1987, that were bigger, but that market had peaked in August of the same year. The point remains that it is the most rapid fall from a high. February 27 was the worst single-day since 2011, and today has proven to be even worse with the S&P 500 down 7.6%.

Meanwhile, safe-haven assets like gold and US Treasury bonds have been rallying. The 10-year Treasury note yield hit an all-time low on February 25. but it didn't stop there. It has continued to drop since then, falling below 1% on March 3 after that emergency rate cut, and it got as low as 0.32% today, more than a full point below its historical low prior to all this.

Adventures in Amateur Epidemiology

In last month's newsletter, I commented on how the data from the World Health Organization was indicating the spread of the virus appeared to be slowing. We now know that China was under-reporting confirmed cases, and that was reflected in the WHO's data on February 17. Daily new cases trended down, hitting a trough on February 24 of 520 new global cases. Since then, however, the number has been increasing and is now close to 4,000.

Global Confirmed Cases of COVID-19



Source: World Health Organization

In the fictional film *World War Z*, the country of North Korea effectively halts the spread of the zombie virus by removing the teeth of all of its citizens in a 24-hour period. China's response hasn't been quite as draconian, but they did take a number of swift measures in an effort to contain the spread, including locking down Wuhan, a city of more than 11 million people and the purported source of the virus. If we can believe the data—we've already been fooled once—China has reached a point where the daily increase in new cases is now well below resolved cases (classified as cured or deceased). Which would mean the worst is behind them. But for the rest of the world, things appear to just be getting started. And authoritarian-type measures aren't likely to be as well-received in more democratic nations.

The virus is very contagious and deadly to certain at-risk groups, so I don't want to downplay it. But I do want to put things into perspective. At the time of this writing, only 22 people have died from COVID-19 in the US. Meanwhile, the CDC estimates that common seasonal flu has caused 34 to 49 million illnesses in the US between October 1, 2019 and February 29, 2020, with flu-related deaths being between 20,000 and 52,000. The WHO is reporting a mortality rate of 3.4%. The data suggests it's higher—closer to 4%—but what do I know? However, that is skewed by the elderly with pre-existing conditions—also known as beloved family members to some. The fatality rate for those 80+ is 74 times that of those aged 10-39, according to data in a paper by the Chinese CCDC released on February 17 and published in the Chinese Journal of Epidemiology (again, Chinese data). No deaths were reported for the very young (age 0-9), which is a relief. Another silver lining, NASA data shows that pollution has fallen significantly in China during the lockdown.

It is not so much the virus that is the problem to the economy, but rather the response to it. Quarantining and shutting down offices and factories is going to cause a great deal of financial damage. It's worth noting that three of the four flu pandemics over the past century were followed shortly thereafter by US recessions. The exception was the 2009 H1N1 outbreak, which occurred at a time when the economy was already a disaster. People will be traveling less, eating out less, and in general just spending less. Lower interest rates aren't going to change that. Fiscal policy is likely going to be more effective at this point in time, which goes beyond just funding for virus detection and treatment. Airlines, a critical service, might find themselves in need of support if the current situation persists for too long. Maybe we'll see payroll tax cuts, or one-time stimulus checks like we did back in the days of the Financial Crisis. People can use that to add Disney+ to their streaming lineup, spend it on a new Playstation, or order pizza for delivery. Things that will make home life a little easier.

Binge Box

The Last Ship (Hulu)

In the spirit of the COVID-19, I am recommending one of the best virus outbreak shows on television, *The Last Ship*. The USS Nathan James has been sent away to the arctic, on what they believed was a research mission. When they emerge from their communications blackout, they find more than half the world's population has been wiped out by a devastating pandemic. Commander Thomas Chandler (Eric Dane) decides to defy orders from what's left of the US government to return home, and instead believes humanity's best hope is for Dr. Rachel Scott (Rhona Mitra) to try to develop a cure aboard his Destroyer.

Tactical Asset Allocation

Asset Class	Heavy Under-weight	Under-weight	Neutral	Over-weight	Heavy Over-weight
Fixed Income			●		
Ultrashort					●
US Govt.		●			
TIPS			●		
Multisector			●		
Bank Loans	●				
Foreign Bonds				●	
Equities		●			
Large Cap	●				
Mid Cap		●			
Small Cap	●				
Developed Intl.			●		
Emerging			●		
Alternatives				●	
Commodities				●	
Hedging					●

Oil Plunges

Let's not forget about oil. A spat between the Russians and the Saudis caused oil to fall the most since 1991 today. Saudi Arabia has opened the taps and discounted its prices to in an effort to maintain market share, starting a price war. U.S. West Texas Intermediate (WTI) crude fell by as much as $13.94, or 33.8%, to below $30 a barrel.

Portfolio Positioning

The time for positioning was before the selloff started, not in the middle of the panic. We were already at a heavy underweight to US stocks and risky credits, and an overweight to cash-like investments, gold, and merger arbitrage, so there isn't much more to do there. Asset managers who were overweight equities can simply say this whole virus kerfuffle was an unforeseeable event, but the truth is stocks were already overvalued. The S&P 500 price-to-sales ratio was at an all-time high prior to the sell-off, and there was no earnings growth in 2019. So even with the correction, I still believe US stocks are overvalued. Things will likely get worse before they get better, especially when the extent of the economic impact starts showing up in the data and earnings. But it, like all things, will eventually come to pass. For now, we ride it out and wait for a better opportunity to start buying stocks again.

Actions you can take now:

- Review your emergency savings
- Increase regular investment contributions to take advantage of the volatility
- Consider refinancing your home as mortgage rates are at an all-time low

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About EmeraldSpark

EmeraldSpark Investments, LLC is a Registered Investment Adviser based in Chicago, IL. We were founded by Ryan P. Layton, CFA in 2015 to provide personalized financial planning and fiduciary investment management services to select clients. Our investment process blends the foundations of Modern Portfolio Theory with the latest research in the field of behavioral finance. We specialize in asset allocation and investment due diligence to help provide our clients with investment strategies personalized to match their specific goals and risk comfort zone.