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WEALTH MANAGEMENT

Monthly Insight

The US Economy Is Re-Opening: What's Next?

Investors have just weathered two of the most challenging months in recent memory. As the Coronavirus pandemic swept across the globe, economies around the world shuttered, to one degree or another. Financial markets reacted swiftly, with measures of volatility not seen since the onset of the Great Recession, and maybe before. Portfolio valuations shrank; in addition to being worried about whether they

might be infected with COVID-19, many were worrying at the same time whether their finances might have contracted a terminal illness. Central banks worldwide staged dramatic interventions, slashing interest rates and doing their best to flood the markets with liquidity.

Now, though many US states are in various stages of cautiously re-opening their economies, uncertainties still abound. And while, at this writing, the market has recovered nearly half of the value it lost during March and early April, some investors are wondering if another crash is coming, especially if, as some epidemiologists are warning, we see a resurgence, or “second wave” of Coronavirus infections in the latter part of the year, as the “regular” cold and flu season begins.

And what about the massive rise in unemployment? Are we really out of the woods? If we aren’t, what’s next?

In an interview on May 5, Richard Clarida, vice chair of the Federal Reserve Bank, indicated that the US economy would likely need more intervention in order to minimize the effects of the recession. He indicated a belief that the economy could begin to rebound in the third quarter of the year, but at the same time, he reiterated that the Fed would continue to provide whatever support was needed as the US labor market struggles to recover from record unemployment and small businesses struggle to keep their doors open. In other words, even the vice chairman of the Fed, while holding out cause for hope, is reminding us that we cannot perfectly foresee future events.

As I work with my clients, whether they are thriving retirees, women in transition, family stewards, or investors with long-range goals, these questions continue to come up in various forms. And on one level, the best answer is, “We don’t know.” As I have said many times, it’s impossible to predict with any certainty what the markets will look like a year, six months, or even a quarter into the future. On the other hand, there are some observations that could prove useful as investors

make plans for the coming months and years.

First, as we think about market exposure and the possibility of a second wave of Coronavirus, it might seem that the best thing to do is to either dramatically reduce or completely eliminate equity investments (stocks) from the portfolio. Or, as many people ask me, “Wouldn’t it be better to just put everything in cash and wait until things settle down?” The answer to this question, almost invariably, is “no.”

Why does it make sense to stay invested, even in the face of future uncertainties? The answer goes back to my earlier comment: none of us can accurately predict market movement. In fact, research demonstrates clearly that attempting to time the market—getting in and out at the “right” times—is not only impossible for even the most sophisticated investors to accomplish with any consistency, it is harmful to the long-term performance of the portfolio.

One of the reasons for this is that timing the market requires making two correct decisions: when to get out, and when to get back in. To maximize returns, it’s not enough to just pull your money out before the bottom; you must also re-invest before the top. This problem is compounded by the fact that the conflicting emotions of fear and greed cripple our ability to make rational decisions. The end result is that most market timers end up buying high—as greed and the wisdom of the crowd make the market irresistible—and selling low—as falling prices supercharge the instinct to follow the panicked multitudes.

Another aspect of the problem is that, while major market drops tend to happen quickly and dramatically—as they did during March and early April—gains typically come in fits and starts and usually over longer periods of time, making them just as unpredictable as the drops. This means that by the time the “sell” signal is obvious, most of the losses have already occurred, and the “buy” signals tend to be more

subtle. Ultimately, investors who flee the market “until things settle down” typically miss many of the upside moves that add the most value to portfolios over time. When investors are out of the market, they miss those rebounds and, when they do get back in, tend to do so later and at higher prices.

A recent report from Dimensional Fund Advisors offers some interesting insights about stock investment performance following major market downturns.

Performance of Premiums Following 20% Market Declines

US Stocks, July 1963–December 2019

Dimensional

	Small Minus Large			Value Minus Growth			High Profitability Minus Low Profitability		
	1YR	3YR	5YR	1YR	3YR	5YR	1YR	3YR	5YR
Average Cumulative Return Differences	4.16%	4.83%	40.55%	7.49%	8.47%	29.82%	2.75%	13.21%	14.44%
Average Annualized Return Differences	4.16%	1.32%	4.57%	7.49%	1.83%	4.81%	2.75%	4.11%	1.88%

Source: Dimensional Fund Advisors

As the chart illustrates, equity investments can be categorized across several dimensions. In this table, looking at US stocks from July 1963 to December 2019, we can see comparisons of three of those dimensions: small capitalization vs. large capitalization; value stocks vs. growth stocks; and highly profitable stocks vs. less profitable stocks. What’s interesting for our present discussion is the performance of these stocks following market declines of at least 20%. Those who remained invested in diversified portfolios through the downturn were able to capture significant premiums as the equity markets rebounded. Those who were on the sidelines, however, were forced to play catch-up.

So, what happens if there is a “second wave”? Here again, indications

from recent days are surprising. For example, the Chinese stock market was the runner-up for best performer in the world during the first quarter of this year, even though that is where the first Coronavirus outbreak started. In other words, if there is a second wave —and we don't yet know that for certain—it may be difficult to predict its ultimate effect on the financial markets. This is another argument in favor of maintaining a balanced portfolio with an asset mix calibrated for your specific risk tolerance and stage of life.

There is no question that we are in uncharted waters as our economy slowly emerges from the coma imposed by the Coronavirus pandemic. We cannot be certain that there will not be more downturns, both in public health and in the financial markets. What we can know for certain, however, is that the markets will continue to digest all the available information and, almost instantaneously, set the fairest possible price for investments. Rather than trying to outguess that process or wait out something that is constantly in dynamic motion, your best course is to "stay the course": maintain a diversified portfolio that is tailored to your needs and goals. Helping you achieve your financial goals through careful portfolio design and authoritative advice is my mission and my daily focus.

If I can put that focus to work for you, please get in touch.

Stay Safe, Stay Hopeful!

KIMBERLY FOSS

President, CFP®, CPWA®

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