March 3rd, 2020

In light of recent major market movements which have largely been driven by the global coronavirus outbreak and its potential effects, we at Parcion Private Wealth would like to provide you with an update of our tactical investment views, highlights of recent events, and outlook moving forward.
As you may recall from my February 11th email entitled "Happy New Year/New Decade…", we have been concerned about the stock market due to weakening economic fundamentals, high valuations, and overall market complacency. It's extremely difficult to predict the catalyst that reminds investors to refocus on fundamentals, but a global health scare is a pretty good example of what could do just that! It's important not to overreact to issues such as Covid-19 (the disease caused by the Coronavirus), but rather to be prepared for it. Both from a health standpoint, as well from an investment portfolio standpoint. I'll let everyone consult with their trusted healthcare source in regards to protecting yourself and your loved ones from catching the flu, but we did want to let you know some of the things we have been doing for portfolios in advance of something like this occurring.

How We Have Positioned

Over the last three quarters, we've favored the following asset classes within the scope of our investment framework:

- Over-weight cash relative to strategic target allocation levels
- Over-weight gold relative to strategic target allocation levels
- Over-weight defensive equities relative to strategic target allocation levels

Where appropriate, we have also incorporated certain investment solutions and trading techniques such as:

- Market-linked structured notes with potential for upside participation and downside protection
- Active loss harvesting for tax-conscious investors that have taxable account structures
    - Triggering realized losses to offset previous or anticipated gain, while swapping into highly correlated securities to maintain market exposure
    - Parcion Private Wealth does not provide tax advice and investors should consult their tax professional on their situation

It is important to note that each client situation varies and while the views contained in this email are those of the firm, they are for informational purposes only and are not intended to constitute an investment recommendation for advice to any specific person.

What's Important?

Last week, nearly every major asset class in the equities market sold off with velocity reserved for financial collapses, with the S&P 500 finishing 11% lower than where it closed Friday 2/21/20. The culprit of this selloff is the coronavirus, otherwise known as COVID-19, which has spread around the globe resulting in many companies such as Microsoft, Apple, and Mastercard lowering their Q1 earnings guidance.

There are many unknowns surrounding COVID-19, such as the severity it will have on the global economy and whether warm weather alone may slow down its spread. Those unknowns, coupled with the CDC's expectations of the spread getting worse before they get better, are what we believe fueled last week's selloff.

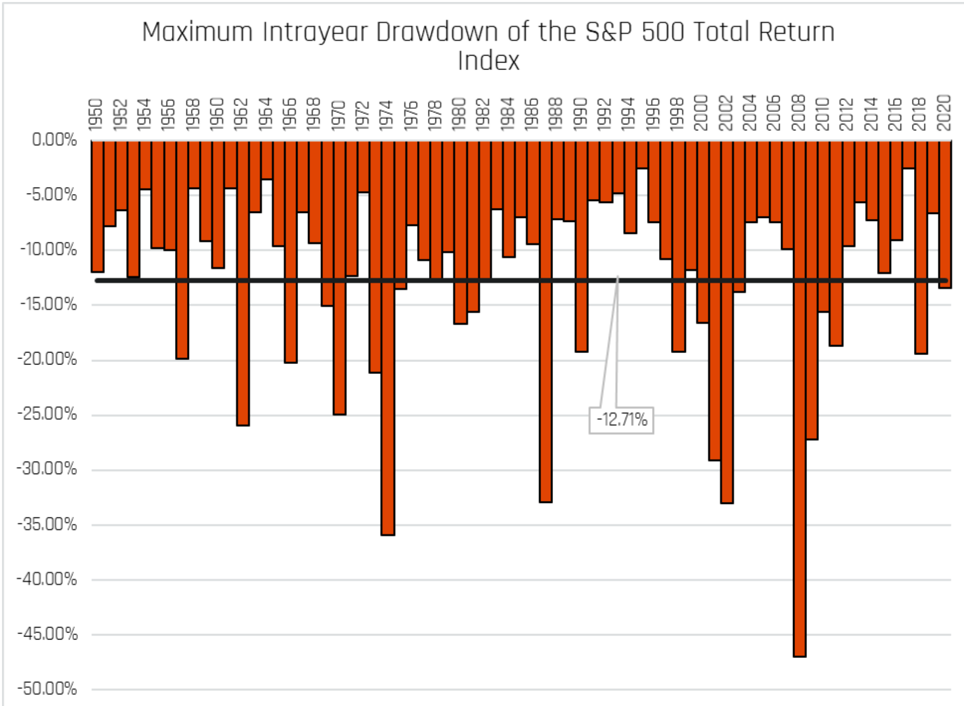
There are three main components to the economic risk associated with COVID-19.

1. The impact on the growth of countries who are reliant on other crises-hit countries for their goods. Here we are examining import/export reliance of all countries and their potential impacts.
2. Global supply chain disruption due to containment efforts in crisis-hit countries. This is difficult to track due to data limitations from those countries.
3. Financial contagion due to a country's stock market that is reliant on other regions for corporate earnings.

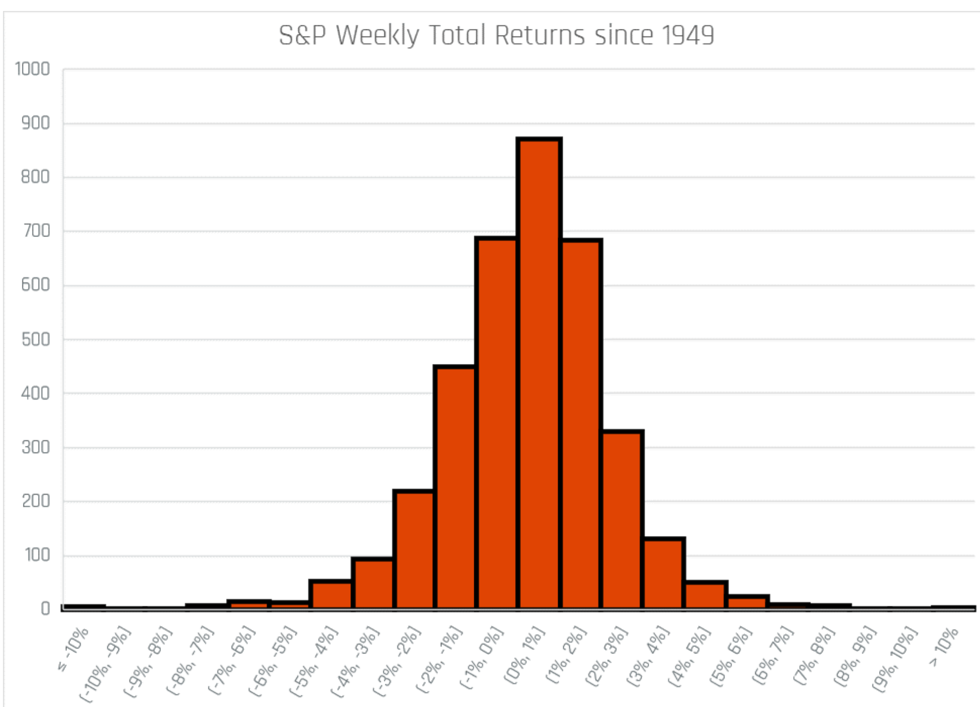
Before we examine those three components, let's look at the price action that occurred in the market last week.

What's different between this correction and the others?

When we look at the average pullback that occurs in the S&P 500 during any given year since 1950, we can see that the average decline is 12.7%, meaning that declines and corrections are commonplace in the market. As of the market close on Friday, 2/28/20, we were close to that number, and many would interpret this as regular market selling activity.



However, the decline we experienced last week was not normal at all when compared to historical market activity. As you can see in the chart below, the weekly returns from the S&P 500 since 1949 have mostly sat in the range of -3 to +3% returns. Any double-digit move to either the up or the downside is barely recognizable on this chart because they rarely ever happen!

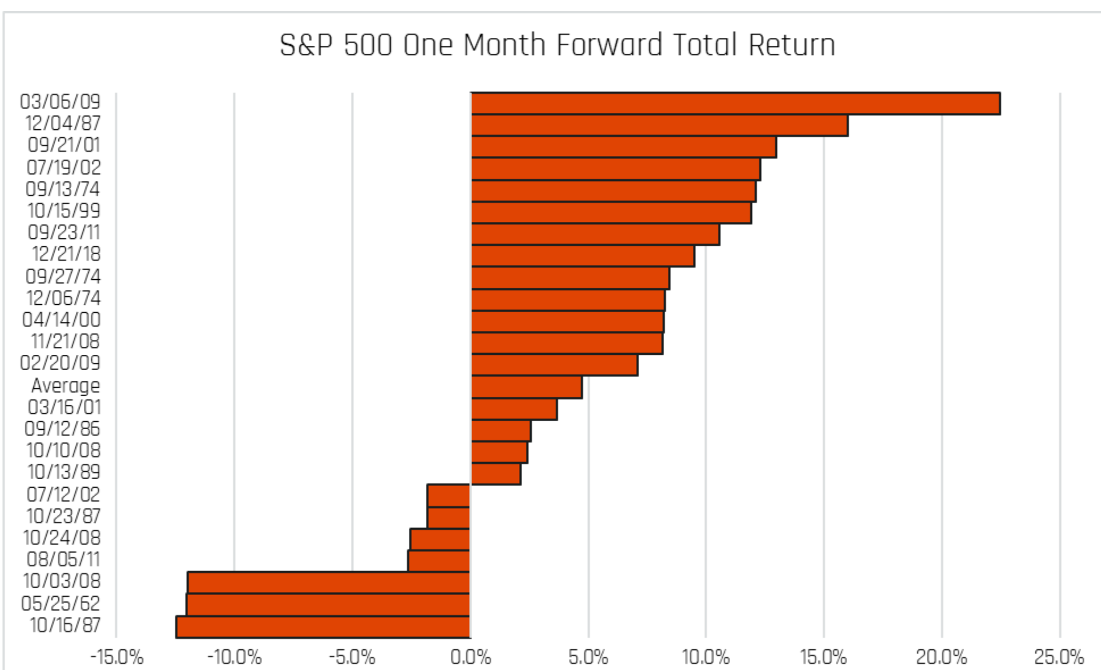


Why is it important?

"Large changes tend to be followed by large changes, of either sign, and small changes tend to be followed by small changes" - Benoit Mandelbrot (1).
Most investors think of volatility as something that only occurs on the downside. However, volatility is a double-edged sword that is measured both on the upside and the downside. Too much of either is a signal that markets are behaving differently than when in a normal state. What we've learned from Mandelbrot's work, along with many others, is that volatility tends to cluster. Said another way, when big swings happen in the market, it is reasonable to assume that there is more to come.

Academic research has also taught us that volume in trading activity is positively correlated to volatility. Meaning, the more people are trading in terms of dollars, the more volatility we can expect. When looking at the trading volume which occurred this week, we see some record-breaking numbers in both equities positions as well as fixed-income positions. Furthermore, when we look at the S&P 500's forward returns following the worst 24 weeks (any week with a greater than 7% loss) since 1949, we see a wide-spread in the results both one week and one month after the selloff.

What do we think about its potential impacts?



Unfortunately, there are many unknowns when it comes to COVID-19. However, previous selloffs since the Great Financial Collapse of 2008 were disjointed from global economic conditions, which allowed them to rally back and create new all-time highs in a relatively quick amount of time. An example of that experience would be the end of 2018 when tariff discussion scuttled the S&P 500 nearly -20% off its all-time high. Currently, we are faced with the potential of a global growth slowdown. Not only could we see corporate earning guidance become reduced in the near-term, but we could also see fundamental data become muted as well. When we accompany that viewpoint with the volatile nature of this week's selling as outlined above, the potential for the selling to continue should not be ignored. We anticipate defensive measures to be taken by the Federal Reserve, as well as other central banks around the world, and that might buy some time for world governments to control the outbreak and calm investor's bias of loss aversion. However, in the near-term, the markets may be in for more heightened volatility.

Conclusion

The price action on display in the market this week was ahistorical by nature, and there are many unknowns left to be settled. What we do know is that volume tends to feed volatility, volatility tends to cluster, and forward returns from a historical perspective are spread out between great and painful. What is different between the current selloff and previous selloffs is that there is an economic component that has the potential to carry the current market sentiment for an extended period. Although current overall economic conditions remain favorable, market conditions are not. While we wait to be provided clarity on the potential economic impacts of COVID-19, we expect the strategies deployed will mitigate risk as they are designed. Of course, no investment strategy can provide a guarantee against loss or a guarantee of positive returns.

"A major point of having an investment philosophy AND disciplined trading strategy is to have a plan for times like this. If your approach is changing this week, you have neither." – Peter Mallouk

As always, please don't hesitate to reach out if you have any questions or would like to discuss your investment portfolio further

Citations

(1) - B. B. Mandelbrot (1963) The variation of certain speculative prices, Journal of Business, XXXVI (1963), pp. 392–417.

Important Disclosures:

Source: S&P Dow Jones Indices LLC.

The launch date of the S&P 500 was March 4, 1957
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