STONEBRIDGE
Capital Advisors

The Stonebridge Market Commentary

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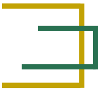


Equity Market Commentary

Well I'd have to say that after a rousing, if unexpected, 2019 we entered 2020 with an impeachment to look forward to. Questions about earnings abounded and the market seemed ready for a little R&R. There is an old saying about January: as goes the first day, the first week and the first month, so goes the year. So how did we do so far? Day 1, up. Week 1, up. Month 1, down. January was up until Friday's 600 point drop. The whole year? We'll see. Heck, we were entering the Roaring 20's 2.0. We had an agreement with the Chinese on trade issues and the passage of the USMCA NAFTA re-do. Everything was going along according to plan and then…

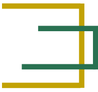
Enter the coronavirus pandemic. Since the news entered the mainstream on January 21, we have been treated to a never-ending stream of opinion and outright fear mongering. Some days it seems that this will be worse than SARS was in 2002-2003. Then some snippet will come out that seems to allay those worst case fears. One thing that we can say at this point is there is way more conjecture than true facts. We will know much more by April than we do now. It seems obvious that with travel being locked down and the fact that China is 16% of global GDP, the effects of this will shave GDP, by how much is anyone's guess.

Below is a chart comparing the current coronavirus outbreak with SARS in 2003.

While we can't see into the future it would seem obvious that the health care community has learned a thing or three about how to handle outbreaks of this nature from the swine flu, Ebola and SARS pandemics. There are trials using retroviral drugs used to treat AIDS for example. While the Chinese tendency of non-transparency is certainly not helpful, the attention of the health care community should help to rein this in before the direst warnings become fact. There is a scare in the air and I don't think it'll be over as fast as the markets are now hoping.

So how should the markets perform in light of such a fast changing scenario? We had a few shock down days followed by a retracement move followed by another big down day. Friday was a rout. The history suggests that the markets in the U.S will get pushed lower while the number of cases is increasing

Source: @ErikSTownsend



How markets were affected by the SARS epidemic:

SARS Stages		Period	DXY	USDJPY	EURUSD	CHFEUR	FX VIX	UST 10y (bp)	DBR 10y (bp)	ACGB 10y (bp)	S&P 500	VIX
1. Escalation	(a)	Nov 16 2002 - Jan 2 2003	-1.96%	-0.34%	2.61%	0.89%	0.61	0.00	-0.15	-0.29	-0.09%	-1.26
	(b)	Jan 2 2003- Mar 12 2003	-4.68%	-2.25%	6.08%	-1.05%	-0.04	-0.45	-0.48	-0.06	-11.53%	8.12
	(c)	Mar 12 2003- Apr 10 2003	1.69%	1.95%	-1.91%	-1.87%	-0.37	0.36	0.31	0.17	8.38%	-7.91
2. Stabilization		Apr 10 2003- May 13 2003	-5.13%	-2.41%	6.96%	-1.15%	0.53	-0.34	-0.24	-0.17	8.11%	-5.69
3. De-escalation		May 13 2003- Jul 31 2003	2.31%	3.23%	-2.60%	-1.65%	-0.56	0.80	0.29	0.35	5.09%	-0.42

Source: Morgan Stanley Research, Bloomberg

substantially, and as the rate of increase slows recovery should take place. Right now the travel stocks are getting hit and some health care stocks are doing ok. There is an evolving travel ban that mostly effects China, so airlines, hotels (think Macao), and select restaurants are particularly effected.

It is important to note that there is a great deal that we don't know right now, and there is certainly a great deal of fear regarding the unknown. Usually these epidemic scares dissipate with the advent of spring, with the exception of Ebola. Right now spring seems a long way off. How much damage will this cause to GDP worldwide and how much will this slow the U.S. GDP? All of these unknowns make predictions all the more difficult. So far, earnings are going pretty well, so there's that.

As for the first month of the year? Dow down .99%, NASDAQ up 1.99% and the S&P down .16%.

Other notable events in January:

Brexit happened. Britain was out of the EU @ 11:00 1/31.

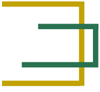
Fixed Income Commentary

After such a strong 2019 it is hard to believe bonds could continue to rally so strongly, but that they did to start off 2020. For the month of January alone, the ICE BofA 1-22 Year Municipal Index returned 1.58% and the ICE BofA 1-10 Year US Corporate and Government Index gained 1.40%.

January is typically a good month for municipal performance. Bond investors face a dearth of supply and fewer options before new issues start to pick back up again after the usual surge to get deals done before year-end. This year municipal bond yields were pulled lower by a rallying Treasury market, but also by the continued supply/demand dynamics we have been seeing as a growing number of borrowers opt for taxable bonds over tax-exempts. Remember, the TCJA of 2017 eliminated issuers' ability to advance refund outstanding tax-exempt debt with new tax-free bonds but has no limit on refinancing with new taxable bonds.

Corporate bonds in general also turned in solid performance, the ICE BofA US Corporate Index returned 2.38% during the month. Yield spreads did weaken though toward month-end on investment grade and high-yield credits, mostly attributed to fears over a more widespread coronavirus outbreak ultimately softening company earnings.

This latest rally in fixed-income markets has made an already challenging time for finding new



attractive investments even more so. Yet nowhere has been as difficult to find relative value recently as the tax-exempt market. Demand for tax-free income has pushed AAA-rated benchmark yields on the front end of the curve down below 60% of comparable Treasuries. That's breakeven or worse, even for investors in the highest tax bracket. While yield spreads have compressed on nearly every other rating category down even into high-yield and non-rated bonds as buyers stretch for any return, some relative value can still exist—buyers just need to largely focus on the secondary market and keep ratios at the forefront when making investment evaluations.

It has been slightly easier to find value in taxable bonds in this environment. But even in there we do not feel investors are compensated with adequate yield for reaching too far down the credit spectrum. It can be tempting then to max out duration to pick up income in a yield starved market. However, with such a flat curve where only about 60 basis points (just over half a percent) separates 2-year Treasuries from 30-years, the risk/reward trade-off continues to favor short to intermediate duration bonds.

Sources:
Data sourced through Bloomberg, Morningstar and ErikSTownsend.
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