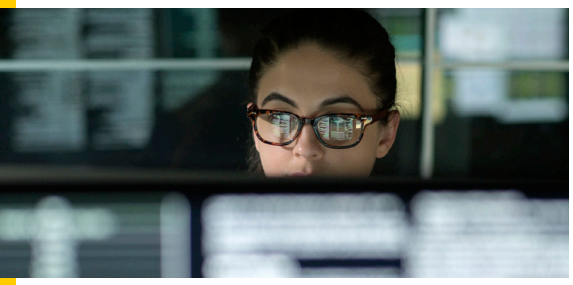

Prescription for Panic

5 Key Takeaways from the Market Selloff

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This is what panic feels like. Stocks have had plenty of pullbacks over the past 10 years, but the velocity of this selloff resembles fear and panic more than economic or financial reality. Sparked by fears of the spreading coronavirus, the S&P 500 has fallen more than 12% and the Dow has shed 4,000 points since Feb. 19.[1]

10% Corrections	# of Days to Drop 10%	Turned into a Bear Market?
2/21/2020	5	?
1/26/2018	14	No
5/21/2015	13	No
4/29/2011	157	No
4/23/2010	18	No
10/9/2007	48	Yes
8/22/2002	48	No
4/7/2000	21	Yes
7/16/1999	16	No
8/20/1998	28	No
10/7/1997	20	No
1/2/1990	28	No

Source: FactSet, S&P 500 Index.

What now?

For starters, we don't think this volatility will subside quickly, as coronavirus uncertainties will linger amid rising new cases and ongoing speculation over consumer reactions. At the same time, economic conditions are not in the freefall that this type of selloff seems to suggest.

An effective vaccine for this type of market panic is a combination of time, discipline and perspective. Here are five takeaways to help you navigate this terrain:

1. This time is different.

Those are four dangerous words when it comes to investing. But contributing to the magnitude of this volatility is the fact that the source is biological, not financial. Market pullbacks are traditionally driven by (real or perceived) economic weakness, monetary policy headwinds or financial market imbalances. Stocks drop as investors reprice developing or expected shifts in these conditions.

This does not mean all pullbacks are warranted or rational, but they often possess a quantifiable element. For example, with last year's trade war volatility, markets declined in response to risks that exports (12% of U.S. GDP), manufacturing (less than 10% of the labour force) or inflation (higher consumer prices) would slow the economy. With the coronavirus, the biological nature of the threat is presenting more questions than answers and a wide range of potential outcomes that require medical solutions, not just financial market adjustments or monetary policy solutions. No one can predict the spread of this virus, but the market reaction appears to be pricing in a fairly severe scenario in which responses (quarantines, school closings, altered work schedules, limited travel, etc.) produce a recession.

It's likely there will be confirmed cases across the U.S., with an outbreak in the largest metropolitan areas potentially prompting the greatest market reactions. Adding to the uncertainty are the limited historical comparisons. Experiences from SARS (2003), swine flu (2009) and Ebola (2014) suggest the global economic impacts could be far less than catastrophic. However, the most comparable – SARS – occurred at a time when China's global contribution and integration were significantly smaller, not to mention its global spread was smaller than the degree currently feared with coronavirus. On the positive side, a collective evaluation of prior epidemics shows that economic and financial market impacts have historically been fairly short-lived.

[1] As of March 3, 2020.

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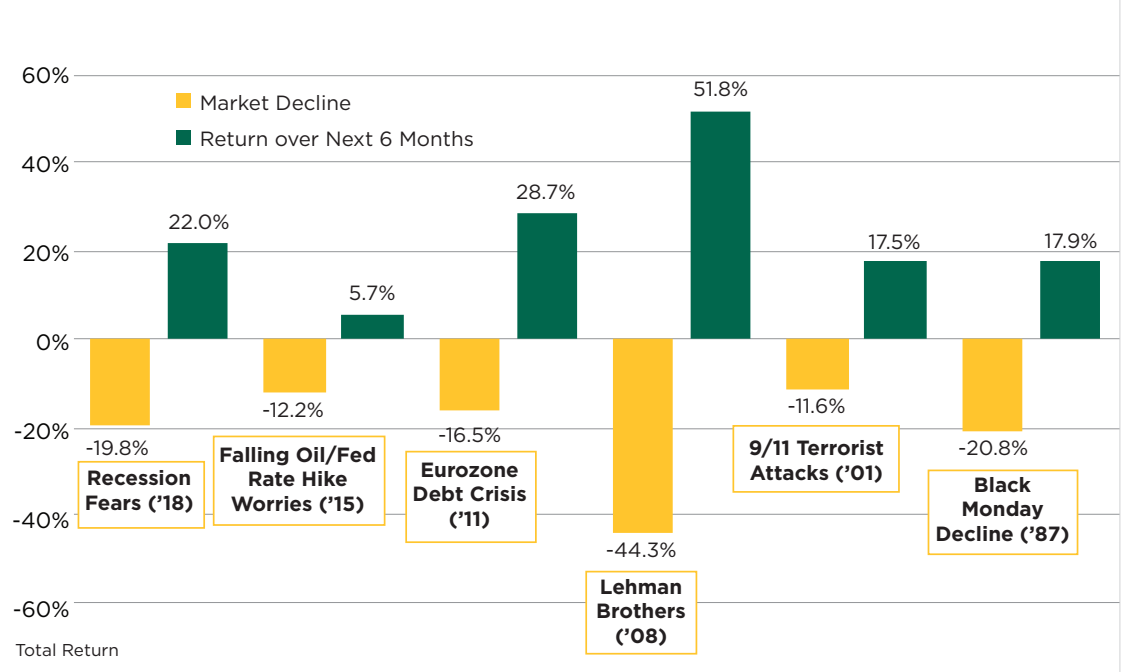
2. But this time is certainly *not* different.

Market selloffs can raise emotions and fear, but historical experience should provide investors some comfort. The eurozone debt crisis in 2011, oil price collapse in 2015 and Federal Reserve rate hikes/trade war/manufacturing slowdown in 2018 all produced selloffs amid headlines of an impending market collapse. Market pullbacks are common, even in the best of times. Headlines and panic can take the wheel for short spurts, but what shapes the longer-term outcome is the broader path for the economy, corporate profits and interest rates.

The economy and profits will take a noticeable virus-induced dent in early 2020, but as we progress this year, we think these fundamental conditions can resume much of their footing. Prolonged, severe bear markets are nearly always accompanied by recessions, so while markets are prone to panic-driven overreactions, history shows that fundamentals occupy the driver's seat over the longer haul. We believe that six or 12 months from now, a look back will reveal this relationship once again proved true, with the economic foundation supporting a rebound as the virus uncertainty and panic fade.

Perspective on Prior Pullbacks



Source: FactSet, S&P 500 total return. return. Past performance of the market is not a guarantee of how it will perform in the future.

3. There is more volatility to come, but perspective provides a positive view.

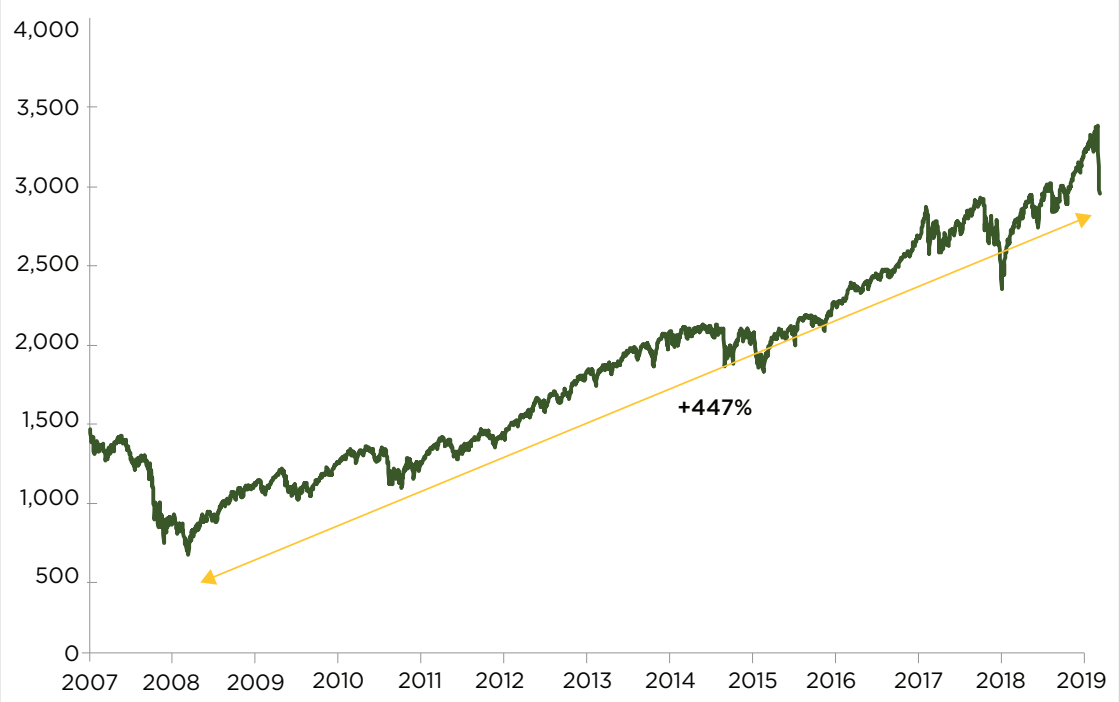
Volatility can be truly painful if you let it drive you to a short-sighted decision. Large swings often come in bunches, and the velocity of recent moves is likely to beget ongoing volatility in the coming days and weeks. Perspective is particularly important in periods like this. Consider the following:

- This is just the fifth-worst pullback in this bull market, with declines of more than 13% occurring in 2010, 2011, 2016 and 2018.
- Sharp daily declines capture the attention, but some of the strongest up days tend to occur around big down days. This highlights the importance of avoiding the temptation to bail on your long-term strategy in hopes of dodging short-term dips.
- The stock market is still up 8% over the past 12 months and has returned 32% over the last three years.

We expect the stock market to remain highly sensitive to incoming news on the virus. What's more, market expectations around additional Fed stimulus and its effectiveness will also add to the volatility. The Fed announced a 0.50% interest rate cut on March 3 to help support the economy through this virus-induced soft patch.

On the positive side, this may help soothe investor jitters and inject a bit of confidence into the financial markets. However, we're not convinced lower rates are the needed cure for this particular headwind, and the relationship between market expectations and future Fed actions represents an additional source of volatility (both up and down) as we advance.

The Market Is Back to Late 2019 Levels



Source: FactSet, S&P 500 Index.

4. There's a solid foundation for an eventual rebound.

Short-term pullbacks often find a bottom as the downdraft overshoots reality and pessimism reaches a fever pitch. It's not clear that the panic has been exhausted, but we remain confident that a turnaround will eventually materialize, although the unique and uncertain nature of this issue suggests a rebound will take time and occur in fits and starts. Given the near-term economic outcome will be heavily influenced by containment efforts/policies and consumer reactions, we could see a dramatic slowdown in GDP to start 2020. However, the economy entered this situation on firm ground. Ultimately, we think a market rebound can be built on this foundation:

- U.S. unemployment is near a 50-year low, and wage growth has been solid. Labour market conditions may see temporary disruption, but we think households remain in good shape looking forward.
- Housing market indicators were on the upswing, and the drop to new lows in mortgage rates could offer further support.
- Fed policy and interest rates are likely to remain highly supportive for the foreseeable future. Credit markets are not currently signaling the stress that would be consistent with a more sustained economic downturn.

5. Diversification isn't flashy, but it helps.[2]

Diversified portfolios have generally benefited in this selloff. Bonds have rallied, delivering solid gains to help offset recent equity market declines. And international equities have outperformed U.S. stocks during this pullback, demonstrating further diversification value.

As we progress, we recommend you consider the following to help navigate the path ahead:

- **Don't lose sight of why you're investing –** It's tempting to make changes to your strategy under the weight of market declines. But remember that your goals are longer-term than the coronavirus. Your goals, rather than the headlines, should be guiding your decisions.
- **Re-assess your comfort with risk –** Use the recent volatility to gauge your ability to weather short-term swings in your portfolio. An increased allocation to fixed income can help protect the downside in your portfolio but will also impact long-term growth potential.
- **Be opportunistic –** Long-term investors are blessed with the advantage of time and perspective. We think an eventual look back on this correction will reveal it was a compelling buying opportunity. This does not mean you have to capture it all today, but consider rebalancing strategies and systematic strategies that may be appropriate for you to take advantage of volatility in the market.

Past performance of the markets is not a guarantee of how they will perform in the future.

[2] Source: Bloomberg. Diversification does not ensure a profit or protect against loss in a declining market.

Investors should make investment decisions based on their unique investment objectives and financial situation.

Before investing in bonds, you should understand the risks involved, including credit risk and market risk. Bond investments are also subject to interest rate risk such that when interest rates rise, the prices of bonds can decrease, and the investor can lose principal value if the investment is sold prior to maturity.

Special risks are inherent to international investing, including those related to currency fluctuations and foreign political and economic events.

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