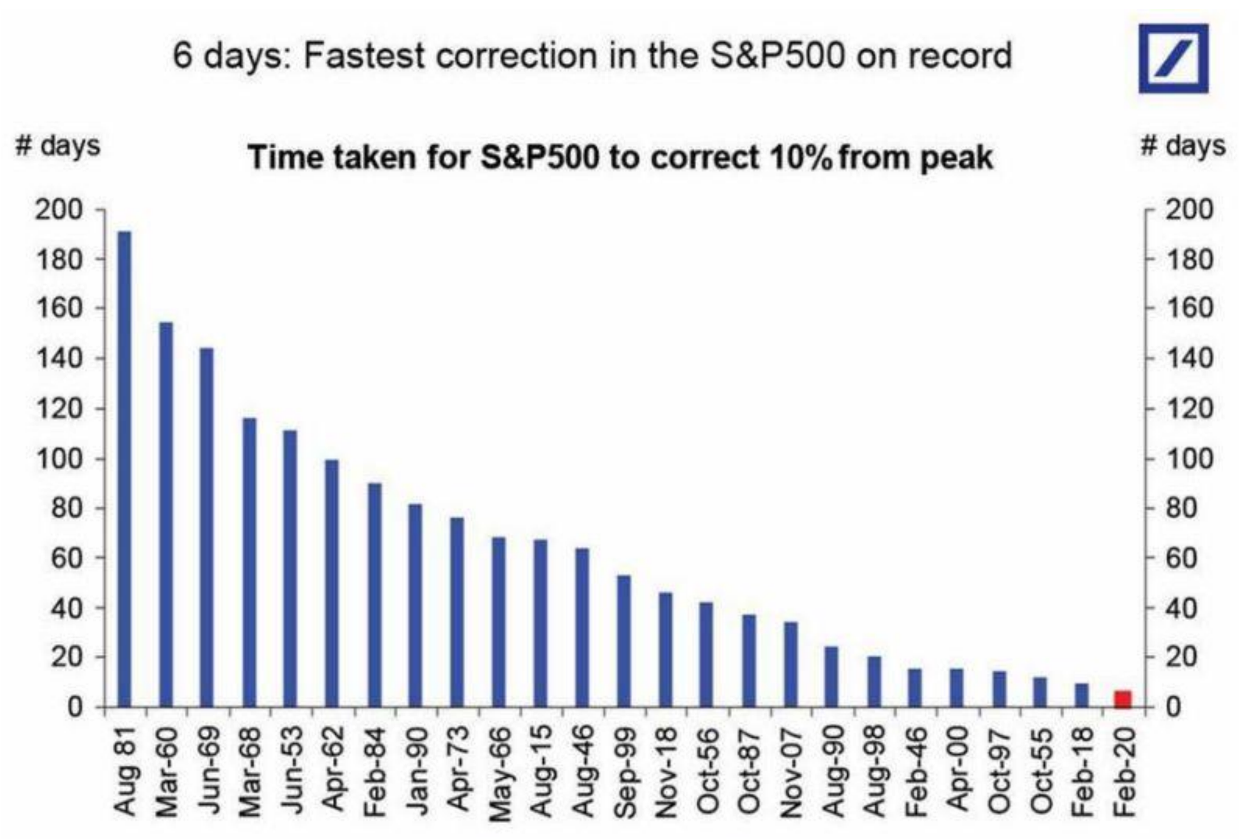
The Recent Market Correction

by Martin Karcz, *Portfolio Manager, Senior Vice President*

February 28, 2020

It was just nine sessions ago that Wall Street celebrated new all-time highs of 29,560 on the DOW, with most analysts calling for the DOW to reach 30,000 within days.

What a difference a week makes! (or nine trading sessions exactly). As of this morning, all major indices around the globe (including the Dow and the TSX) are fully in correction territory (defined as a >10% drop from highs). What is more, as the chart below suggests, the selloff has been more rapid than anything we have seen before.



Source: Bloomberg Finance LP, DB Global Research

Right now it is all about the Coronavirus
What caused the market reaction? In mid-January, markets began to react to news flow that COVID-19, a novel coronavirus, was rapidly spreading and a resulting slowdown may impact global economic growth. Within days however, market participants convinced themselves that that the damage would be largely isolated to China's economy and was likely temporary in nature. As a result, the market hit new highs.

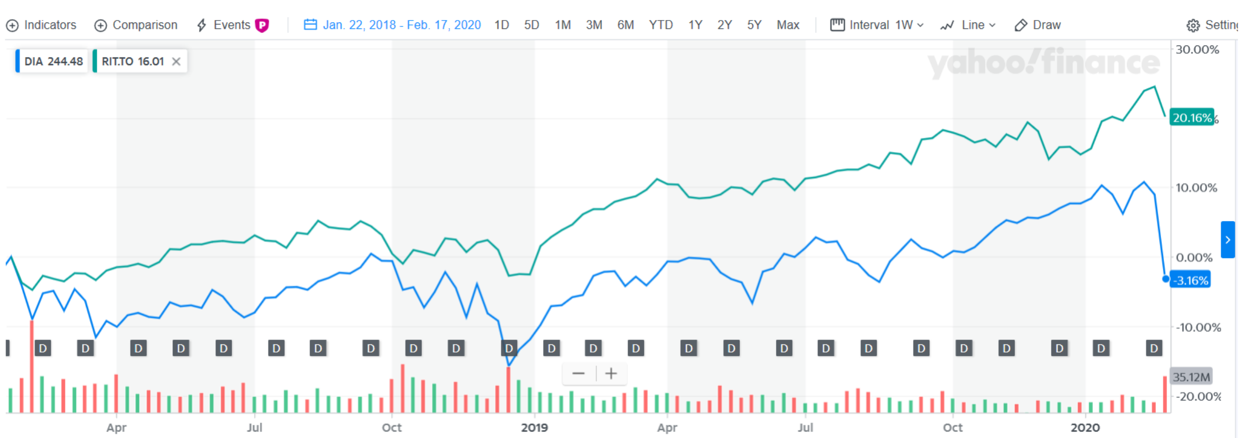
It all changed this week. Over the last weekend, it was reported that more than 30 countries now have at least one incidence of infection, with South Korea, Japan and Italy reporting over 100 cases each. The market sell-off started in earnest.

Over the last 4 days some sub indices (like the airlines and oil) have sold off more than 25% from their recent highs. Financials (in response to the all-time lows in bond yields) dropped nearly 20%. The general market as measured by the DOW, S&P500 or the Nasdaq are all down from their recent highs in excess of 11%.

What does it all mean to you?
We have seen this before – maybe not the COVID-19 virus – but an event that puts global growth into question and creates an extreme selloff.

We, at KWM, have argued for the last several months that the market valuations were reaching extreme levels. The heavy lifting up in the recent months was done mostly by a small group of "super stocks" - Amazon, Apple, Alphabet, Microsoft, Tesla, Nvidia to name a few. The rally, in our opinion, was not sustainable and a correction, we argued, would be a welcome respite to the overheated market.
Given the above, we have been positioning the portfolios in a defensive manner, increasing our weighting in cash and limiting our equity participation to alternative investments like structured notes (with downside protection) and REITs.

Our caution has paid off, and up until mid week, the REITs were still making new highs as the market correction was in full swing. The below chart shows the REIT index as compared to the Dow over the last 2 years (since January 2018). The latter is **down 3.1%** over the last 24 months while the **REIT index is up 29%** (with dividends reinvested).



Source: Yahoo Finance (data range January 1 2018 – Feb 27, 2020)

With all of the fireworks of great performance last year and the market hitting new highs, today we are back (or below) where we started over 2 years ago in January 2018! The old trading adage, that the market takes the stairs up and the elevator down, has proven apt once again.

Where do we go from here?

Though tempting, trying to time the market is a loser's game. Data shows that $10,000 continually invested in the S&P500 over the past 20 years, would be worth over $48,000, but if you missed just the best 30 days, your investment was reduced to $9,900.

As our long-term clients know, we strongly believe that a bear market creates the most opportunities for a disciplined investor. We have been there before, and this too will pass.

In fact, as the quote at the top of this letter states, we make the most money from opportunistic investing during market corrections like this. "Be brave when others are fearful" – that old investing adage has served us well in the past and today's market will not be an exception.

The essence of our reasoning is also the essence of our investing mantra – know what you own, own quality and get paid while you wait (invest in income generating securities).

During times like this, the worst thing to do is to panic. The best thing to do is to take advantage by acquiring incredible businesses at a very discounted pricing. It is the time to buy the names that one always wanted to own but didn't because the price was too high. It is also the time to upgrade to the strongest companies in their industries – the ones that shape and will continue to shape the future of the global economy.

Constructive view on high quality Real Estate in Canada and US

Over the last several years we have been avid proponents of allocating 20-30% of the portfolios into high quality real estate holdings across the North American continent via ownership of publicly traded Real Estate Investment Trusts. As the chart on the previous page shows, our belief proved to be correct. In 2019 we saw the best REIT performance in a decade – our managed portfolios in that sector moved up more than 20%.

Is there still room for upside?

We believe that there is. The shortage of good quality, income producing real estate is becoming more impactful when over 30% of global sovereign debt is in negative yield territory. (The European Central Bank actually has programs that give away negative yielding loans!). In North America, 10 year Canadian and US bond yields have hit all time lows of 1.08% and 1.15% respectively.

The purchasers of what seems to be "overvalued real estate" are therefore not individuals but government and private pension funds that need to meet their long term actuarial obligations by providing positive returns (as opposed to investing in assets like the 30 year Swiss bond yielding -0.5% as of today).

There is another caveat to owning real estate in North America – with all the advancements in technology, outsourcing and automation - the concept of shelter (as in a place to live and conduct business from) has not become obsolete and cannot be outsourced. Furthermore, it needs to stay here, in North America – neither your house, the Amazon fulfillment center, nor the local Pharmacy can be imported from, or exported to, somewhere overseas.

Therefore, owning high quality real assets in a safe and stable political jurisdiction will continue to be a relatively safe choice for pension funds and individuals alike. We may just have to get used to lower rental yields, just as pensioners need to get used to lower bond yields.

What's next?
What we know for sure is that this too shall pass, and that the pent up demand, subdued during the shutdown of factories and diminished travel will most likely propel the market to new highs in the years to come. Today, we are not only long-term investors, we are net investors as well – we keep adding to our portfolios all the time searching for quality. Over time quality and common sense ultimately prevails.

Back in 2018, during the market swoon known today as "The Christmas Massacre", we reminded our readers of our long standing investment mantras:

- There is no single magic formula or style for all seasons
- There are no perfect hedges
- No one rings a bell at major tops or bottoms
- Don't invest in countries that don't or won't collect taxes
- Accept the fact of uncertainties - realize how different responses are in bull markets than in bear markets
- The Future is never clear…Uncertainty is the friend of the buyer of long-term value (Warren Buffet)
- Don't try and figure out what the market is doing. Figure out a business you understand. (John Maynard Keynes)
- Recognize that you have to make decisions on imperfect information
- Never cease studying history, but don't expect an exact repetition

Martin Karcz, MBA, CIM
Portfolio Manager
Senior Vice President
T: 604.643.7762
mkarcz@cgf.com

Canaccord Genuity Wealth Management
2200-609 Granville St.,
Vancouver, BC
V7Y 1H2
karczwealthmanagement.com