MARKET OBSERVATIONS
MARCH 2020

SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Distancing

Globalization has brought the world closer in many ways. But one adverse outcome, the spread of infectious disease, now is pushing us apart as borders are closed. Closer to home, we are encouraged to practice social distancing. The immediate economic outcome is slower real growth. The immediate market outcome is a sell-off in risk assets, notably stocks, and a demand for safe-harbor assets, particularly U.S. Treasuries. Risk distancing seems to be the current antidote for market uncertainties, but returns are not achieved over time without taking risk. A look at some important relationships can provide perspective and investment implications.

PERSPECTIVE

Stock market risk has been pronounced as shown in Chart I. The sell-off of the Dow Jones Industrial Average ("DJIA") neared bear market territory (-20% or greater decline) on Monday, March 9. On that day alone, the DJIA declined -7.8%, the 28th largest one-day percentage price change in the 124-year history of the DJIA. The odds of this large a decline in this short a time period is only 3 chances in 1,000, perhaps small comfort as this low-odds event now is a reality.

March 9 also marked the anniversary of the start of an 11-year bull market. This long trend for the DJIA as well as the preceding bear market are shown in Chart II. The annualized 11-year return for the DJIA was +15.4%. Certainly, this gain followed a severe bear market in which the DJIA declined over -50%. During the course of the past eleven years, there have been several market corrections (declines of -10% or more) including the most recent sell-off. Stock markets rise over time but not without interruptions.

While the DJIA declined from its all-time high, U.S. Treasury yields were falling to historical lows. The 10-year U.S. Treasury yield broke below 1.0% for the first time ever on March 5 and then fell to 0.5% on March 9. Investors holding 10-year U.S. Treasury notes have enjoyed a price gain of about +11% while the DJIA declined -19.3%. Not all bonds have experienced this outcome and some even have experienced price declines. Nonetheless, bonds once again have proven their diversification value in mitigating the risk of stock investing.

Chart III displays the yield and price risk tradeoff for U.S. Treasury securities of various maturities. The current low yield levels are notable relative to long-term average yields. Also notable is the higher level of price risk at these low yields, especially for longer maturities. A thirty-year U.S. Treasury bond yielding about 1% has price risk approaching that of stocks. While this level of risk has been beneficial most recently, a period of rising yields would be commensurately adverse.

INVESTMENT IMPLICATIONS

Extreme distancing, i.e., isolation, is a strategy to avoid the Coronavirus risk. Similarly, a sure strategy for distancing stock market risk is allocation isolation, i.e., no ownership. Such a strategy, however, means isolation from the primary source of future portfolio growth. Especially at times of heightened uncertainty, following good practices and avoiding precipitous actions are warranted, for both physical and financial well-being. The first good financial practice is clear goals, time horizons and tolerance for risk. The second is no distancing between these building blocks and portfolio guidelines and structure. Diversification remains the foremost portfolio risk vaccine.

CHART I

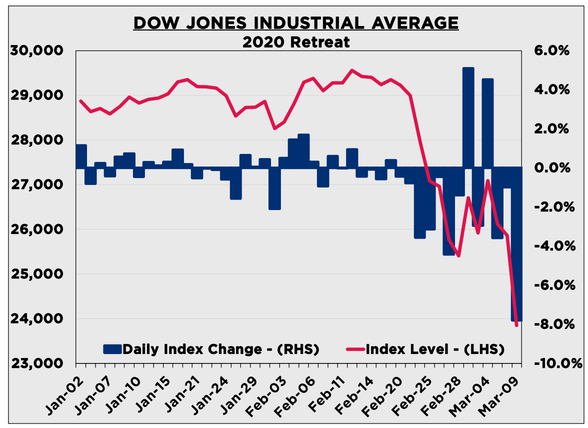


CHART II

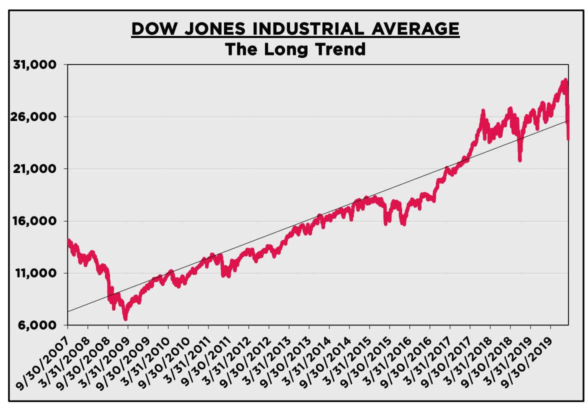
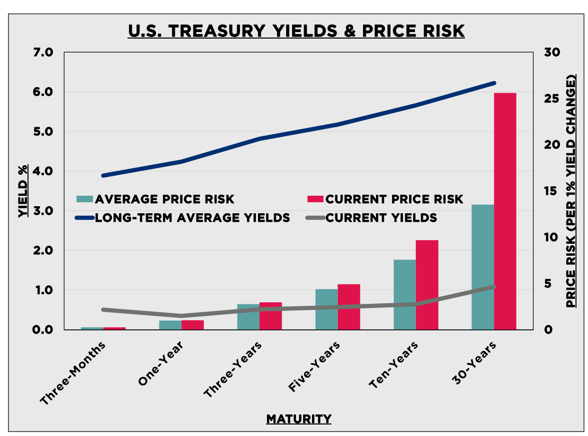


CHART III



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