



A P O L L O N

W E A L T H M A N A G E M E N T

Equities Retreat on Coronavirus Concerns

February 2020

Historic volatility, late-cycle economic dynamics, Covid-19

Key Observations

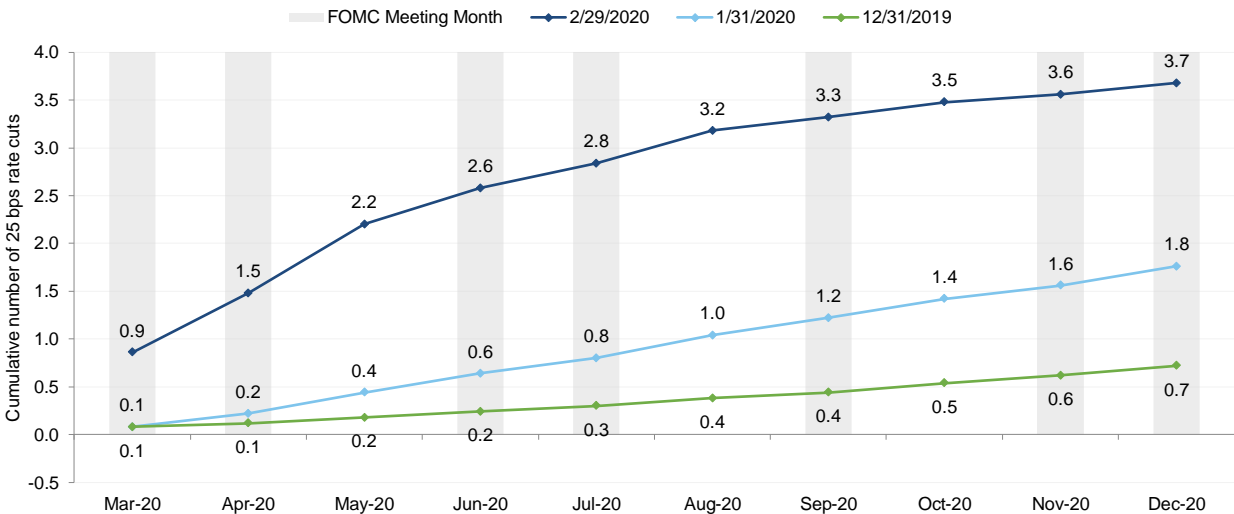
- The novel coronavirus (Covid-19) is a tragic outbreak with unimaginable and unmeasurable implications on those affected. While we rely on infectious disease specialists to infer potential humanitarian and social reverberations of the disease, we will attempt to assess the exogenous shock Covid-19 may present to macroeconomic and political conditions
- The VIX Index reached 40.1, a daily level among the highest 97.8 percent of daily observations since the index was introduced in January 1990, and provoked indiscriminate selling of risk-seeking assets.
- Household consumption growth, which represents approximately 70 percent of U.S. GDP, remains stuck in a sideways channel with downside risks from downstream effects of slowing business activity.
- Data through February 29 suggest the Covid-19 outbreak is improving, but South Korea, Italy and Iran bear monitoring for growth or decline in case counts.

The S&P 500 Index rose 5.0 percent during the first 19 days of the month, reached an all-time high of 3,386 points and then fell 12.8 percent on fears the coronavirus outbreak may disrupt global growth more than previously expected. The violent sell-off thrust the CBOE VIX Index (VIX) to 40.1, a daily level among the highest 97.8 percent of daily observations since the VIX was introduced in January 1990, provoking indiscriminate selling of risk-seeking assets. For the month, the index fell 8.2 percent but held up better than the MSCI EAFE and MSCI Emerging Market indices, which fell by 9.0 and 5.3 percent, respectively. Despite the U.S. market correction, defined as a peak-to-trough decline of more than 10 percent, but less than 20 percent, growth stocks continued to outperform value-orientated strategies and large-cap stocks again fared better than small-cap stocks.

Nominal yields moved sharply lower again in February on economic growth concerns and a flight to quality sentiment, which benefited safe-haven fixed income asset classes. While the S&P 500 Index etched a new all-time high, the 10-year U.S. Treasury recorded an all-time low yield of 1.15 percent. The 10-year yield fell 35.5 basis points in February and a staggering 76.9 percent year-to-date.

Federal fund futures eye multiple rate cuts

CME Group federal funds futures fully priced in three 25 basis point rate cuts and a 70 percent chance of a fourth 25 basis point rate cut in 2020, lowering the federal funds rate range to at least 0.75 – 1.25 percent. On December 31, 2019, the market priced in a 70 percent chance of just **one** rate cut in 2020.



Source: Bloomberg

Notably, the spread between one-month and three-year Treasuries stood at -52.8 basis points at the end of February, implying at least two-25 basis point rate cuts were necessary to move the yield curve from inverted to relatively flat.

The decline in nominal yields more than offset wider credit spreads, lifting the Bloomberg Barclays Aggregate Bond Index 1.8 percent for the month and 3.8 percent year-to-date. Treasury Inflation-Protected Securities (TIPS) returned 1.4 percent, buoyed by the fall in real rates as nominal yields fell more than market-implied inflation expectations. The flight to quality sentiment, driven by elevated volatility, weighed on riskier segments of the fixed income market. High yield and emerging market debt fell 1.4 percent and 3.4 percent, respectively.

Mounting concerns that the coronavirus outbreak would intensify the slowdown in business activity weighed on energy and industrial commodity sector-sensitive asset classes. West Texas Intermediate (WTI) oil prices slid 13.2 percent in February, pulling the Alerian MLP Index down 14.0 percent. Despite the sharp fall in nominal yields, historically a positive for U.S. REITs, the asset class fell 8.0 percent.

Economic Conditions

Incoming economic data from December and January provided evidence the U.S. economy was slowing before Covid-19 burst onto the scene. Household consumption growth, representing approximately 70 percent of U.S. GDP, remained stuck in a sideways channel since 2016 but slowed in January. Furthermore, private sector

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income, a function of both average hourly earnings and average weekly hours worked, indicate tighter household financial conditions.

Year-over-year, average earnings growth peaked in October 2019 and average hours worked peaked in June 2018. The personal saving rate peaked in November 2019 and revolving consumer credit outstanding bottomed in November 2019. These trends define our baseline outlook for household consumption growth trends to weather an exogenous economic shock. In our view, absent improved labor market dynamics, household financial conditions may have peaked before the outbreak of Covid-19. That said, we acknowledge that a fall in personal savings rates or increased credit usage could temporarily boost consumption in any given month.

The private business sector also provides clues for directional trends in household financial conditions. There we observed that 481 of the 500 firms comprising the S&P 500 Index reported fourth-quarter earnings as of February 29. While Factset reported that 71 percent of companies reported a positive earnings surprise, the table below shows aggregate earnings for the S&P 500 Index grew just 0.7 percent on 3.5 percent of revenue growth.

Astute observers will note the results indicate corporate margins declined in the fourth quarter (recall that margins expand when earnings grow faster than revenues and vice versa). Falling margins do not bode well for labor. Last month we cited Deloitte's latest CFO Signal Survey, indicating corporate leaders expect to cut discretionary spending and headcount in 2020 to alleviate potential headwinds from slowing consumer and business spending. In our view, this is a direct statement that executives will focus on margin expansion in 2020 which does not bode well for aggregate household financial conditions. Again, these figures precede the Covid-19 outbreak and suggest the emergence of asymmetric risks to the downside for private sector business conditions.

Margin Squeeze

Traditional retailers (Consumer Discretionary) represent the majority of companies yet to report fourth-quarter earnings; early indications are not encouraging.

S&P 500 Index Sector (GICS)	Reported	Sales Growth (%)	Earnings Growth (%)
All Securities	481 / 500	3.5	0.7
Energy	28 / 28	-6.2	-40.5
Materials	28 / 28	-18.7	-33.3
Industrials	70 / 70	-2.7	-4.6
Consumer Discretionary	52 / 63	3.2	-7.7
Consumer Staples	30 / 33	3.3	2.7
Health Care	58 / 60	12.3	9.3
Financials	66 / 66	6.3	4.5
Information Technology	69 / 71	6.7	6.9
Communication Services	22 / 22	8.5	9.2
Utilities	27 / 28	-1.0	19.6
Real Estate	31 / 31	4.3	2.3

Source: Bloomberg, as of 2/29/2020

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Upon evaluating more recent data on U.S. business conditions, we observed symptoms of late-cycle dynamics. The IHS Markit U.S. Composite Purchasing Managers Index (PMI), a tool used to monitor business activity in the manufacturing and service sectors, fell to 49.6 in February from 53.3 in January. Recall, a reading above 50 indicates expansion, while a reading below 50 indicates contraction in business activity. The slowdown was broad-based. Service sector activity fell below 50 for the first time in four years, while activity in the manufacturing sector slid to a six month low. While it is difficult to delineate the impact Covid-19 had on February data, the overall bargaining power of labor rises and falls with business activity trends. Therefore, our baseline outlook on household financial conditions rests on trends in business activity.

Market Outlook

Taking stock of portfolio risk and allocations can be difficult during market volatility. Our behavioral biases tend to vacillate between fear and greed, with ample doses of hope, and we can feel tempted to deviate from a predetermined investment strategy. During these periods, we remind investors that periods of elevated volatility results in both higher and lower market fluctuations. Amid this backdrop of elevated volatility and late-cycle dynamics, we will continue to monitor financial market conditions and track the data surrounding Covid-19.

While early, data through February 29 suggest the Covid-19 outbreak is improving. According to worldometer.info, there were 41,306 active cases of coronaviruses around the world, down 17,441 from the peak on February 17. Furthermore, the recovery rate continued to rise to 93.43 percent steadily. The situation remains fluid, but these statistics are positive. The caveat here is that 80,151 of those cases were in China. Therefore, we must acknowledge that data outside of China may be lagged. To date, coronavirus is affecting 76 countries and territories (including the Diamond Princess cruise ship) with South Korea, Italy and Iran reporting the most. Certainly, trends in those countries bear monitoring for growth or decline in case counts.

In summary, February was a historically volatile month for investors. Economic growth and corporate profit trends did not show evidence of a rebound. Instead, we observed more evidence that household financial conditions are tightening despite steady consumption trends on the heels of falling savings rates and rising borrowing trends.

We continue to believe that investors should be patient and adhere to a well-constructed, diversified investment portfolio anchored to your goals and time horizon.