Sentinel Trust
Together, families prosper℠

2001 Kirby Drive, Suite 1200
Houston, Texas 77019-6081
www.sentineltrust.com

March 10, 2020

Market Update After Yesterday's 7% Decline in US Stocks

Executive Summary

- Since we last wrote to you on February 27th, stocks have declined another 8% largely due to the markets' reactions to depressed energy prices and increasing Coronavirus cases outside of China.
- US stock markets have experienced a ~19% peak-to-trough decline, which is slightly above the average 14% annual peak-to-trough decline we have experienced since 1980. The markets closed yesterday very close to a bear market (20% decline from the recent high).
- Despite the recent extreme volatility, we believe it is important to remain calm and focus on the long-term. Volatility has accelerated, at least in part, as a result of computers trading 90% of recent daily trading volume, despite neither humans nor machine knowing how the Coronavirus will ultimately play out in the short-term.
- Although anticipated 2020 corporate earnings are under pressure, we consider that next year's earnings are a small fraction of the future cash flows we earn as long-term equity investors.

Recent Stock Market Volatility

Since we last wrote to you on February 27th, volatility, or the day-to-day movements of stocks and other assets, has remained exceptionally high. The S&P 500 nearly closed January with a record-breaking streak of 70+ days without moving up or down by more than 1%. Since then, we have experienced extreme volatility on par with some of the most infamous episodes in financial history. With stocks off another 7% yesterday and oil down ~30% since just last week (due to a clash between OPEC+ members, Saudi Arabia and Russia), we felt that it is again important to communicate our views on current markets.

Sentinel Trust's Views

We noted in our year-end letter that "we expect increased volatility and lower expected returns heading into 2020" and that we "generally will be looking to add risk when other investors are fearful and move closer to our long-term targets." Yet, with fears of the Coronavirus rising, equity prices falling and volatility surging, we noted on February 27th that we had made no major asset class changes to date. We were then and still are not reducing our overweight to cash or our underweight to equities just yet. Why?

First, we previously noted that although equity prices had fallen, they still had not reached the 14% intra-year peak-to-trough decline that the S&P 500 has experienced on average over the past 40 years. After yesterday, markets had experienced a ~19% loss from all-time highs set just last month, a slightly greater peak-to-trough loss than what they have averaged historically. Although not exceptional compared to historical averages, we recognize that the pace of the decline in such a short two-week period is abnormal. We think the speed of the selloff is largely due to the fact that just 10% of daily trading is done by humans and all traders, including the machines responsible for most of the volume, are struggling with handicapping the impact of the Coronavirus.

We note two key takeaways, as follows:

(1) Although this episode of volatility has emerged quite suddenly, the magnitude of market losses is still pretty close to the normal peak-to-trough fluctuations that equities typically experience within a given year.

(2) We view these types of short-term losses as the price investors pay for owning equities, which on average over the past 40 years have delivered 8.9% per annum growth. All else being equal, the

fact that market declines have now exceeded the average peak-to-trough losses in such short order leaves us more inclined to buy equities than to sell them.

The second reason we gave – just eight business days ago – for not "buying the dip" was that while stocks had declined in price, they had not necessarily become cheaper. Companies from Apple to United Airlines are having a difficult time forecasting their 2020 earnings outlook. As a result, the stock market's "P/E ratio" (price divided by current year expected earnings, a common valuation metric) is uncertain, with many companies and stock analysts scrambling to forecast earnings in the face of the Coronavirus.

Based on yesterday's closing price, and if we assume that S&P 500 companies earn the same profits as last year, then they currently have a P/E ratio of 16.6X, which is about the average value we have seen over the past 25 years. On the other hand, if the Coronavirus were to result in a typical recession – or, a 13% decline in earnings – then next year's P/E ratio would be 19.2X, which is above historical averages. In short, US stocks are neither exceptionally cheap nor exceptionally rich at this point, based on price to earnings ratios.

All else equal, these ratios cause us to remain in the camp of waiting for cheaper valuations to buy the dip, with one important caveat. Although we are not virologists and view 2020 outcomes with uncertainty, we do anticipate that in a year's time, the situation surrounding the Coronavirus will be much more certain and that companies like Apple and United Airlines will be back to something like business as usual. Stocks are not just a claim to next year's earnings, but also to earnings of a company into perpetuity. When we value the market based on what we expect companies to earn in 2021 and beyond, especially when juxtaposed against today's historically low interest rates on bonds and cash, we are significantly more optimistic and more likely to buy stocks on further weakness. Today's dividend yield on the S&P 500 for example, is 1.9% versus just 0.6% for a 10-year US Treasury Bond. This difference stands at a 15-year high and we should remember that S&P 500 companies typically continue to grow their dividends over time.

Finally, though we did not state it in our last missive, we have previously noted that we would generally look to be greedy when others are fearful. With markets off ~19% peak-to-trough and 7% just yesterday, there is certainly some palpable fear in the market, but we do not think markets have reached peak fear just yet. While volatility is high and viewed by many as the "fear gauge," other indicators like investor sentiment have yet to reach levels associated with peak pessimism. In China, where the Coronavirus first appeared, the market did not find a bottom until after new cases of the virus had peaked and began declining. Considering that the Chinese government used tactics that are less likely in the West, we suspect that the daily number of new US cases will continue to increase over the next month or two, and that this will continue generating fear and pressure in markets.

Conclusion

In sum, at the asset class level we have not made any major changes to our holdings of US equities. We are certainly not panicking and reducing risk, since we expect that the Coronavirus will pass as other similar outbreaks (including SARS, H1N1 and Ebola) have in the past. So, while we are focused on short-term valuations and the changing expectations for 2020, we remain convicted of the long-term return proposition of equities – the notion that stocks are a claim to a company's cash flows in perpetuity – and assess these claims as currently quite attractive versus historically low interest rates on bonds. As such, we will continue looking for opportunities to add risk when stocks are cheaper and fear is more prevalent.

Within our other managed asset classes and comingled vehicles, we have been very active in the past month leading up to this current crisis. First and foremost, we have been and continue to actively harvest tax losses to reduce the current and future tax bills on our investments. Second, we have been building our liquidity and reducing the leverage of our underlying holdings across the portfolio. On February 27th when we last wrote, we were concurrently selling a high yield bond fund where liquidity was suboptimal, while also rotating the proceeds into a more conservative, active manager who has 15% in cash awaiting opportunities. Also, in terms of reducing leverage, we have exited a number of investment partnerships that held more indebted companies, and have instead focused on new partners that are identifying companies with strong balance sheets and cash flow that can gain market share during periods of stress like the present. We will continue monitoring the situation closely and expect there will likely be more volatility ahead, where we are much more likely to buy US stocks following the recent pull back.