Mitch on the Markets

Portfolio Manager Investing Insights

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3 Investment Mistakes to Avoid in This Market

All 50 states have now moved to ease Covid-19 restrictions, and signs of revived activity are returning to the U.S. and global economy. Initial jobless claims peaked in March, truckloads are starting to fill back up, air travel and hotel bookings are inching higher, mortgage applications are rising, and people are applying to open new businesses again.[1] Meanwhile, the stock market's rally since late March has been powerful and sustained (so far).

In short, things are looking up.

Signs of an economic rebound may serve as a signal for some investors to take action. Whether that's getting back into the market, taking some profits off the table, or reallocating a portfolio to fit the 'new economic normal,' the nascent recovery may motivate investors to make some changes. If that sounds like you, here are three mistakes to avoid making now.

1. Selling into the Rally/Taking "Profits Off the Table"

As the stock market rallies off the March 23 lows,[2] investors may be wondering whether this is just a "dead cat bounce" within a bear market. Investors who are convinced that there is more downside left to go might see now as a good time to take some profits off the table, wait until the next down leg of the bear market, then get back in.

This investment thesis may hold up, but it also could be dead wrong. The point is that no one can know for sure, and guessing means in engaging in market timing – which I do not advocate doing.

Historically, event-driven bear markets have been steeper on the downside and shorter in duration than structural or cyclical bear markets, and event-driven bears have taken less time to recover. We also know that bear markets bottom out, on average, four months *before* a recession ends.[3] So, if the economy starts growing again by late summer, historical evidence says we could already be in a new bull market.

Selling into the rally now may mean missing out on some of the returns of an early stage bull market, which could adversely impact long-term returns. In my view, the opportunity cost of being on the sidelines during a bull market is greater than the cost of participating in some downside in the short term if you're wrong.

2. Making Company or Sector-Specific Bets

The race for a Covid-19 vaccine has spawned quite a bit of speculation over which pharmaceutical company will win. The guessing game has made a household name out of the company Moderna, for example, as they have seen some promising early results. But at the end of the day, we cannot know who will be the first to develop a vaccine, and it is even less certain whether the drug will ultimately be profitable for the company or the pharmaceutical sector. It's all just speculation, in my view, and that is a mistake for investors.

Other examples may include betting on companies that have thrived during the crisis, like grocery delivery services, video conferencing companies, or the producers of household cleaning products. Demand for all of these products and services are no doubt rising, but the thesis to own a company should go much further than assessing whether they did well during the crisis. An investor should also look at cash flow, profitability, debt, management, market share, and more.

3. Adjusting Your Asset Allocation Based on Your Idea of the "New Normal"

Finally, I think it would be a mistake to adjust a portfolio's asset allocation based on a personal assessment of what the economy's "new normal" looks like. In the current environment, that may mean removing an energy allocation altogether and replacing it with more technology exposure. Or perhaps adding a significant overweight to healthcare and removing exposure to retailers and consumer discretionary stocks.

These allocation decisions may make sense on paper, but the end result could be a portfolio that is less diversified – and therefore riskier.

Bottom Line for Investors

As the economy shows signs of rebounding and the stock market rallies, investors may feel more, or less, confident about what lies ahead. At the end of the day, we are not out of the woods on this crisis yet, and I expect market volatility to continue.

Making a few tweaks to a portfolio allocation to reflect a changing economic outlook is always a good exercise. What I want to caution investors against doing, however, is using the market rally, gut feelings, or 'new normal' predictions to dictate market timing decisions or wholesale changes to an otherwise diversified portfolio. In other words, now is a time to stay the course and be nimble – not a time to change your course altogether.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] The Wall Street Journal, May 25, 2020. https://www.wsj.com/articles/for-economy-worst-of-coronavirus-shutdowns-may-be-over-11590408000

[2] Yahoo Finance, May 26, 2020. https://finance.yahoo.com/quote/%5EGSPC?p=^GSPC

[3] Goldman Sachs, Bear Essentials: A guide to navigating a bear market, March 9, 2020.

IN FOCUS THIS WEEK

- The U.S. Economy is slowly reopening
- Projections for the shale industry in 2020
- Older adults will outnumber children for the first time in U.S. history

The U.S. Economy is Moving Again, But Slowly

Signs of life are starting to appear again across the United States, now that all 50 states have eased restrictions to varying degrees. Truckloads are starting to move and grow again; flight, hotel, and restaurant bookings are ticking up slightly; mortgage applications are up, and data compiled by Google shows that people are moving around more. On balance, however, the return of economic activity is happening at a much slower pace so far, and plenty of weakness remains – retail sales data for April showed steep declines, and Americans are still losing jobs, albeit at an increasingly slower pace.[1] The bottom line is that the worst of the economic crisis may be over – which may help explain the ongoing stock market rally – but no one can know for sure at what pace the economy is likely to recover from here. According to the Fed's recent beige book survey, many businesses "expressed hope that overall activity would pick up as businesses reopened, [but] the outlook remained highly uncertain and most [businesses] were pessimistic about the potential pace of recovery." For stocks, the question may not be how quickly and/or robustly the economy recovers, but whether the economic recovery exceeds expectations.

The Shaky State of the Shale Industry

Before the pandemic spread across the world, the US was producing a record of 13+ million barrels of oil per day. Many shale companies were slightly stretched with oil prices hovering in the $60 range, but times were largely good. Then the economic shutdowns happened, and large-scale demand disruption caused oil production to fall over 10% to 11.5 million barrels a day by mid-May. As a result, crude oil prices have sunk. According to Rystad Energy AS, U.S. companies spent an average of $35.60 to produce a barrel of oil, which is about where the price for a barrel of Brent Crude stands today. In other words, margins for shale producers are basically non-existent. As a result, several companies have had to file for bankruptcy, and even the bigger players, like Exxon Mobil, are making major cuts to capital spending. According to the International Energy Agency (IEA), investment in the US shale sector is likely to fall by 50% in 2020. The IEA similarly expects global spending on oil and gas production to fall by a third, with financing for new energy projects also plummeting.[2]

The U.S. Population Keeps Getting Older

America is aging. In 2030, one in five Americans will be 65 or older, and immigration is projected to overtake births as the primary driver of population growth. By 2034, older adults will outnumber children for the first time in US history. Not helping matters is the fact that American women had babies at record-low rates in 2019, pushing US births to their lowest levels in 35 years. About 3.75 million babies were born in the US last year, which may sound like a lot, but actually represents the lowest fertility rate since the government started collecting data in 1909.[3] The Millennial generation appears to be the culprit for the lower birth rates, as they have been slower to form families than previous generations and are less financially secure than the generation before them.

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[1] The Wall Street Journal, May 27, 2020. https://www.wsj.com/articles/u-s-businesses-see-limited-recovery-evidence-through-mid-may-11590606792

[2] The Wall Street Journal, May 27, 2020. https://www.wsj.com/articles/investment-in-u-s-shale-projects-to-halve-in-2020-iea-says-11590552000

[3] The Wall Street Journal, May 20, 2020. https://www.wsj.com/articles/u-s-birthrates-fall-to-record-low-11589947260

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