



WHAT AN EQUITY WATERFALL DECLINE IMPLIES FOR EQUITY PROSPECTS

BY JOE WILLIAMS, CFA®

Commerce Trust Company Director of Investment Strategy Joe Williams, CFA®, has witnessed several economic downturns during his 42-year career in the investment industry. The month of March certainly added a new chapter to market reversals as the decline of 19.6% for the S&P 500 was the worst first quarter in history and March was the most volatile month ever. By comparison, we had three S&P 500 moves of 1% or more in 2019. In March 2020, we had three moves of 1% or less. As co-manager of the Commerce growth, mid-cap growth, and value strategies, Mr. Williams answers many client questions on market movements. Recently, one client asked about the cascading effect downward of an "equity waterfall decline." In this CTC commentary, Mr. Williams shares his answer.

Joe, what is an equity waterfall decline?

A waterfall decline, as the name implies, is a sharp drop in equity prices over two months. Over the last 105 years there have been 13 waterfall declines starting with 1929. Some of the more recent have been 1974, 1987, 2002, 2008, 2011 and 2018.

Is there a common denominator to these rapid declines in history?

These were all caused by different economic events, but none of them were caused by a virus shutting down the world economy. That's the dramatic difference today.

However, when you combine all 13 cases you get a roadmap of what could happen over the next several months or longer. Investors typically react in a similar fashion during a crisis.

Can you give us some insight on the stages of these downward cycles?

The initial phase is chaotic, as we have all witnessed. First, there is the "waterfall," typically a decline of 30%, this time 35%, as investors panic. Everything goes down and there is no differentiation among stock sectors or categories. Volume continues to build.

A bottom is made, and a sharp 10% relief rally ensues lasting a couple of days on continued high volume. The low was March 23rd and the rally was 20% in the next 3 days.

The rally fades and volume declines, but there are many large percentage moves both up and down. The market retests the low over the next two to three months. This occurred in 12 of the 13 waterfall events (2018 was the one exception, with no retest), so we can expect the S&P 500 to revisit the lows of March 23rd (2,191 was the low) sometime over the next several months. We are currently at 2,600. There is a 69% chance we move to lower lows with a mean decline of 7.2%. The worst decline was 2008 and 2009 of 22.5%

Of course, every time is different, but this gives us a roadmap of what could happen in the second quarter. The roadmap says it is too early to rebalance portfolios by increasing equities at the expense of fixed income investments, so we are going to be patient and see how this pandemic plays out, before increasing equities.

Can you break out the actual numbers to date?

As of Friday, April 3rd, larger companies fared better than small, and domestic fared better than international. Specifically, the S&P 500 was at -22.6%; Mid Cap sector at -33.4%; Small Cap sector at -36.8%; and International (EAFE) at -26.4%. Treasury issues posted positive returns and corporate bond returns were negative, as credit spread widened. High yield fixed income declined in the low double-digit range.

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