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Commentary on Financial Market Volatility and COVID-19 Economic Impact

"The day the music…died"
-Don McLean

It may have felt like this watching the stock market Monday. Or perhaps more accurately one could point to February 12th, less than a month ago when the Dow and S&P 500 both achieved new record highs, as the day the music stopped.

For several years now in this extended economic cycle it has felt like this market had an uncanny ability to shrug off any uncertainty, met its ultimate match in something completely unpredictable – a global pandemic. The stock market, of course, has a long history of overreacting – in *both* directions.

Notwithstanding stock prices, what was abundantly clear of late was the fact stock *valuations* were clearly stretched. As of Friday March 6th, 98% of S&P 500 companies have reported earnings for 2019 and the aggregate annual growth rate for the year was 0.5% – essentially flat despite a >31% increase in stock prices over the same period[1]. Given this, it's easy to conceive high expectations were riding upon a strong earnings recovery in 2020. Coming into the year analysts' estimates for 2020 forecasted robust earnings growth of 9.6%[2]. If realized, these profit gains would've helped validate current prices. These expectations have dramatically diminished over recent weeks as the collateral effects of COVID-19 on the U.S. and Global economy became more pronounced. No longer isolated to China, the virus pandemic has essentially become the catalyst no one foresaw for a wide-scale suppression of economic activity, and coincident rapid shift in investor sentiment. Sentiment, of course, is likely to worsen further given the dearth of COVID-19 testing taken place in the U.S. to date (reported to be approximately 3,000 as of March 9th) – based upon patterns observed in Asia and more recently Italy, we have every reason to see the number of confirmed cases in the U.S. to increase *exponentially* over the coming weeks. Containment domestically is unlikely to be achieved for weeks, if not months.

Containment measures, whether imposed by government or individuals' voluntary measures, are at the root of the economic impact. Approximately 70% of U.S. GDP is tied to consumer activity and no one can assess with any reasonable accuracy the depth or duration of adverse economic impact (how much consumer activity is temporarily suppressed vs. lost for good). It's all but certain Japan and Europe will enter recession in 2020 given their tepid economic growth coming into the virus outbreak. For the U.S. at this point it's borderline; it can't help but follow the global trend yet the economy's underlying momentum coming into the year may be sufficient to forestall the two consecutive quarters of negative growth required by definition to be a declared a recession. Nonetheless, recession or not the economic impact will be significant and to many consumers and businesses will feel like one regardless of whether the statistical threshold is ultimately met.

Amidst all this uncertainty, it's not surprising previously elevated stock prices have been subjected to a dramatic market correction. As of Monday's close the S&P 500 Index has declined 15% year to date and 18.7% from its February 12th peak, retreating to levels last seen June 3, 2019. Small cap stocks as measured by the Russell 2000 Index have fared worse, experiencing a 21% decline year to date and 22% from it's February peak. International stocks represented by the MSCI EAFE Index have seen slightly lesser declines - 16.9% from their peak, owing largely to the fact they saw lesser gains on the upside previously.

The human mind is known to have a disproportionately negative response to losing value than the beneficial feeling of asset gains. Acknowledging this it's important not to dwell on the market decline or it's related effect on your portfolio value over the past four weeks, both of which are in the rearview mirror. In investing (as with driving) the more important view is what lies ahead, and here is where there are significant reasons to be optimistic. Although the COVID-19 outbreak will continue to play out, the economy itself is reasonably sound and should be able to weather disruption in the near-term. More importantly, we do not feel the present situation is in any way comparable to the 2008-2009 Financial Crisis which had far more potential to be apocalyptic economically; the banking/financial system is much better positioned (attributed both to lessons learned and regulatory changes enacted) and American households are in dramatically better shape having experienced a recovery in housing prices and a strong employment market for several years. We do not foresee a likelihood of either of these situations materially reversing in the near-term; most likely the U.S. will weather this storm, learn in the process, and (hopefully) be better prepared for the next potential pandemic.

Now is not the time to panic; markets and portfolios will most certainly recover over time and it's important to maintain focus on long-term investment objectives whilst enduring recent swings (on both sides, although admittedly the latter is far more painful). History has demonstrated rebounds following market corrections can be swift and substantial, so it's important not to prematurely resign in the hopes of identifying the market bottom, by the time one is confirmed a good portion of the rebound will already have been observed.

Principally of course, this is first and foremost a public health issue; the faster the U.S. can contain and mitigate the virus the sooner we'll be able to limit and assess the related economic impact. However, until we turn the corner on this outbreak, estimating the near-term (calendar 2020) economic effect is highly speculative and subject to significant error – substantial market volatility should be expected as the norm in the interim.

As always, we welcome your questions and feedback. Feel free to reach out at any time.

With that, I'll conclude in the same fashion in which I started this update, with a quotation:

"If you can keep your wits about you while all others are losing theirs...[t]he world will be yours…"
- Rudyard Kipling

[1] FactSet Earnings Insight, 3/6/2020
[2] FactSet Earnings Insight, 1/3/2020