Financial Markets Perspective

April 2020

Capitalism to the Rescue

Unforeseen Events

Almost two years ago, an investor asked us what could bring a halt to the long bull market in stocks. Our answer was that the economy should continue to improve, and that corporate America was in excellent shape so that the end of the bull market could only occur if there was some exogenous event that would shock the markets. In March of this year, two unexpected events terminated the bull market and potentially set back the American economy and financial markets beyond the expectations of even the most bearish stock market prognosticators. The two shocks were the Coronavirus and the 60% decline in oil prices.

The following exhibit reflects the record rise in several asset classes since the end of the Global Financial Crisis in March of 2009 and highlights the record decline in stock prices from the February 2020 peak to the end of March. The speed and depth of the decline is unprecedented in stock market history.

Shock #1: The Coronavirus

According to the World Health Organization, the first report of a cluster of pneumonia-like cases of unknown cause had taken place in Wuhan, China on January 4, 2020. The first death attributable to the virus occurred on January 11, 2020. Some three months later, the virus had spread worldwide causing war-like preparations by governments at all levels to fight the virus as it spread geometrically; with isolation as the best defense. In response to this rapid advance, governments have resorted to a variety of protection mechanisms, few of which are having a meaningful impact on slowing the speed of the spread. The latest response to the war on Covid-19 has been implementing lockdowns and social distancing by requesting that people stay at home except for trips to buy food and medicine and keeping a minimum of 6 feet from others.

Overnight, individuals have had to shift from a daily routine of going to the gym to work out, going to Starbucks, going to the office and meeting friends at a restaurant to staying at home, joining a virtual exercise class and ordering groceries online for delivery. Additionally, students are no longer attending classes in person but are becoming more competent in using technology to learn and take tests. According to Bay View Analysis, over 70% of college faculty have never taught a class online!

Just how Amazon has pushed many bricks and mortar companies to the brink of extinction, adopting online classrooms could have the same impact on bricks and mortar colleges. The virtual life will also likely change the corporate boardroom as executives won't need to travel to be physically present for meetings. This phenomenon will have a domino-effect on other industries forever changing the "old" way of conducting business and providing investors with many opportunities.

To confront the impact of the virus across the economy, the Federal Reserve and the Treasury launched multiple monetary and fiscal measures to ensure the stability of the financial system as well as provide stopgap financing for businesses and individuals displaced by the lockdown. These programs amount to trillions of dollars and have given both equity and fixed income markets a reason to be optimistic. By the end of March, equity markets had rallied over 20% even though the outlook for economic growth remained uncertain. Government bonds soared in price and yields collapsed to below 0.75% as nervous investors rushed to the perceived "safety" of these instruments.

Few Americans are around today that remember the efforts to respond to the crisis at the beginning of World War II. The efforts of private industry to collaborate with government guidance gave us the capacity to win that war. Today is no different; the president has enlisted the help of the private sector to make a difference. All one needs to do is listen to the government's daily briefings that demonstrate the private sector's commitment to winning the war against this invisible enemy sooner rather than later.

Shock #2: Collapse in Oil Prices

In the middle of March, Russia and Saudi Arabia had a disagreement over the level of OPEC oil production and entered an all-out price war by increasing production. As a result, the price of oil fell from $54 to $30 per barrel – a decline of 44%! Moreover, coronavirus concerns and country lockdowns further impacted world demand for oil sending the price down to just under $20 per barrel by the end of March. At this writing, oil prices are down 59% year-to-date. Unfortunately, consumers have been unable to take advantage of this decline due to required social distancing and state-wide lockdowns. Just recently, Russia and Saudi Arabia agreed to resolve their differences as both countries would suffer from a deep global recession. President Trump has also stepped in to encourage an agreement to allow oil to rise in price, giving some stability to the financial structure in the energy industry.

Where Do We Go from Here?

Investors had no place to hide as all asset classes have declined. Equity markets have experienced historic volatility as have fixed-income markets. Commodities have suffered due to concerns over a global slowdown and commercial real estate is under pressure from mall closings and the shift to online shopping and communicate. Unemployment exploded last week to 6.6 million new claims. This number could continue to rise in a "closed" economy. Shutting down the economy on a state-by-state basis will leave traditional measures of economic growth in the dark for some time to come. Currently, economists at major firms are forecasting an annualized drop in GDP between 14 and 25% for the second quarter. Third quarter estimates are better, and most are predicting a gain in economic growth by the end of the year. From now until we resume a fully functional "business as usual" environment, economic data reports will not be meaningful and any comparisons to periods before the virus are not useful. After the crises are over, we expect the economy to snap back to the condition it was in February, if not better. We are amid a medical and energy crisis that has triggered an economic response that will reduce output for at least two quarters even if there is a change in the outlook for overcoming the effects of the virus.

Progress on slowing the spread of the disease is encouraging, as several countries in Asia have taken measures that appear to be working. The term "flattening the curve" has gained usage in describing progress on slowing the virus. By ordering people to stay home and by closing businesses, the government hopes to slow the disease's spread and buy time until there are the supplies necessary to protect health workers, increase testing capabilities and ultimately coming up with a vaccine that neutralizes the virus.

As we look out of our office windows over the main shopping artery in downtown Charleston, (King Street) we see a ghost town instead of a steady stream of shoppers. This scene is very much the same in many other cities in the world. The sense of isolation has never been greater and has not occurred in America before. We have likened the coronavirus to a hurricane in past writings. Currently, we are in worst part of the storm waiting to get back to our regular routines eager for the storm to pass but fearful of the day-to-day developments and hoping that our preparations are adequate.

Government to the Rescue…

Can the government rescue us from the catastrophe? By itself, with its entire prowess as demonstrated by enormous spending plans and Federal Reserve printing presses, they (federal, state and local) cannot do it alone. The necessary ingredient to attain a solution is the private sector—Corporate America. This is the time where productivity and innovation can bring solutions to problems quicker than public sector hand-outs. Every day there are moving stories about how the private sector is stepping up to the challenge. For example, the New England Patriot football team sent its passenger jet to China to pick up safety masks for medical professionals. Tesla, the electric car manufacturer, is creating ventilators out of car parts! MMM promised to produce 167 million protective masks over the next three months. Even Lady Gaga raised over $34 million to help deal with this virus crisis.

The daily briefings by President Trump and various experts provide us with ongoing evidence as to how the private sector is answering the call and pitching in to eliminate the virus. Beyond safety masks and ventilators, several pharmaceutical companies are working on therapeutic solutions to treat people with the disease and, ultimately, a vaccine that will protect against it. The experience of this event is invaluable because it has forced the development of procedures that are critical to fighting a biological attack.

Conclusions:

This year will go down as “The Year of the Virus.” Financial markets have been blindsided by two unexpected events: the coronavirus and the oil price meltdown. Dealing with these crises simultaneously has put enormous pressure on the federal government since it decided to shut down the economy and finance the costs of this decision. This action is unprecedented in the history of our country. As the battle raged between front line medical workers and the enemy virus, financial markets plunged, then rallied, and then became divided between virus and energy winners and losers.

Making investment decisions during a period when there are critical unknowns is challenging. One of us has developed a slight twitch in the left shoulder. Our strategy has been to recognize that there will be unusual volatility in the short-term. We expect pessimism will continue if investors fear that the virus has the upper hand and that the shutdown will be longer than anticipated. When investors perceive that we are getting ahead of the virus, markets could rally even though the residual pain of the economic shutdown will manifest in the disastrous economic statistics that are likely to be reported over the second and third quarters of this year.

When the coronavirus crisis is over, the world will be a little different than before. The “good old days” may not return, as aspects of “normal” life have been forced to advance at a record pace. Stock market leadership may change as a result, with emphasis on Information Superhighway and Quality Healthcare themes. Wall Street is awash with ideas that will characterize the new economy. For example, Zoom, a startup videoconferencing company, had 10 million daily calls in December and 200 million in March! Being pushed to work remotely, many may experience enjoyment—getting away from the daily trudge to and from work with all the associated benefits accruing to a higher standard of living. Some other byproducts of social distancing have had a positive impact. The cessation of all those automobile and airplane emissions are leaving our air healthier. Habits to sanitize our environment may also protect us from traditional infections such as the traditional influenza.

In April of 1942, some four months after the U.S. entered World War II, the stock market bottomed and rose by well over 100% over the next four years -- even though the outcome of the war wasn’t decided until 1944. Maybe the recent rally in the stock market is a forecast of better times ahead. The parallel is that equity markets anticipate solutions to problems well ahead of the resolution. April showers could very well bring May flowers.

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