High Probability ADVISORS

INVESTING INSIGHTS

Unprecedented

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I've watched more television news in the past few weeks than I've seen in the past few years. One word that keeps popping up is "unprecedented". Undoubtedly, we've not been in similar circumstances to the current environment. However, the sensational rhetoric dominating the news channels might make investors think that the current crisis is entirely different than prior bear market experiences. In my view, there are some novel circumstances but many clear precedents for these times.

A NEW PLAGUE?

Coronavirus? Clearly not a new phenomenon; these viruses are omnipresent and like all viruses, constantly mutating. Each iteration of mutation brings different impacts to host carriers (humans, animals). The current mutation is more troublesome than most in that it is less deadly (lower mortality rate) than the worst (MERS, SARS) but more deadly than the typical Coronavirus. Thus, it spreads widely among the general population, resulting in a greater number of severe illnesses and death. A good comparison is Influenza A & B, which have even lower mortality rates and infect far greater numbers- resulting in high numbers of deaths to vulnerable populations. There are plenty of precedents here.

SOCIETAL RESPONSE

Undoubtedly, the global response to Covid-19 is unprecedented. We've chosen to severely reduce societal interaction with the aim of limiting the contagion. This approach has worked in several countries that were early sites of the outbreak (China, South Korea and others). It will work elsewhere too, including the US. The collateral impact of this limitation is a global economic decline. There have been other times when an overt government action has slowed the economy, such as the dramatic raising of interest rates in the early 1980s to break the progression of inflation or the curtailment of travel and consumption following the 9/11 attacks. Recessions followed those decisions. The current curtailment is greater in scope and the result will be a recession. The depth and duration are an open question, but not the inevitability of an economic recovery.

INVESTMENT MARKETS

Major investment market events are usually a mix of new and old elements. Bull market peaks are created from periods of economic growth that deliver rewards to investors and embolden ever greater risk taking. The result is high valuation for stocks, real estate and other assets and slim yield spreads for lower quality fixed income. The "new elements" are typically an emerging technology growth story or a new consumer market (social media, marijuana, etc.) that drive the enthusiasm of investor by offering rapid growth rates. The names of the rapid growth businesses change, but the phenomena remain the same at the different historical peaks.

Bear market swoons share a similar mix: a bit of "unprecedented" surrounded by lots of precedent. They almost always involve an unexpected event that tips the economy into a decline. However, the events often have some similarities: oil price increases triggered the 1973-74 and the 2008-09 decline, while rising interest rates set the stage for the 1981-82 bear and were at least an element in the 1987 market decline. Armed conflict was the driver of the 1990-91 and 2001-02 decline. These elements create a broad drag on the economy, which exposes people and companies with excessive debt leverage. The leveraged players suffer dramatically and defaults mushroom. Decline in specific areas create feedback mechanisms which bring on decline in economic activity broadly as people and enterprises become more conservative in their spending. Plenty of precedent there.

The current decline was driven by the Coronavirus response, which is indeed unusual for a bear market. With economic growth accelerating in January and February, the abrupt "hitting the brakes" on the economy in March due to efforts to reduce the spreading of the virus came as a shock. This caused markets to react rapidly; a crisis atmosphere developed quickly. However, this crisis shares a lot of precedent with past panics. ***Especially noteworthy is that fear, uncertainty and doubt cause us all to shift our time horizon to the short term: what will happen tomorrow? We agonize over the potential for further losses in the next month and become blind to the improved outlook for returns over the next year.***

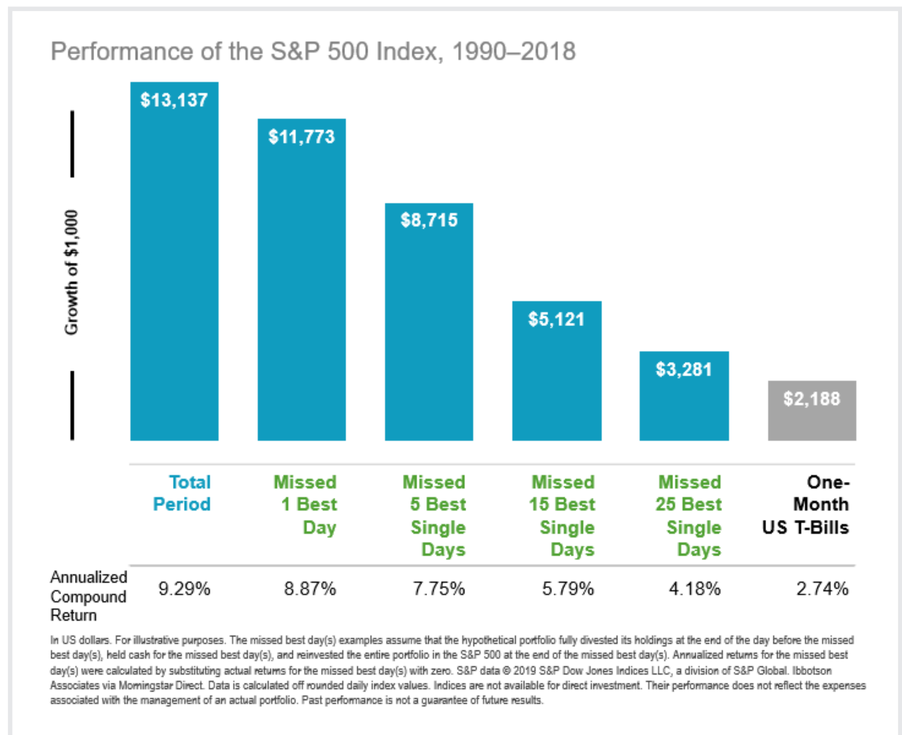
We see this myopia in the bond markets. With yield spreads widening dramatically in the bond market, corporate bonds and municipal bonds have performed poorly. Treasury bonds soared- the only safe haven. Now, with the relative yield attractiveness of corporate and municipal bonds greatly improved, many people are fearful and wondering if they should sell.

I read some thoughtful analysis from Goldman Sachs Investment Strategy Group that put the stock market in similar light. Their models, which are based on the history of valuation during bear market conditions since WWII, show the probable bottom for the S&P 500 in a range between $1950 and $2250. With Monday's opening, we are already within the range. Applying their models to a scenario of rebounding economic growth in 2021, Goldman Sachs has a price target of $2950 to $3050 for the end of 2020. In their view, the stock market offers a range of returns between -10% and +35%, which seems like an attractive risk/reward scenario.

FROM "THE LIGHT AT THE END OF THE TUNNEL", GOLDMAN SACHS - SUNDAY NIGHT INSIGHT, MARCH 22, 2020

- The average P/E ratio on trough corporate earnings at market bottoms during periods of low and stable inflation has been around 17x. If we apply that to our newly lowered 2020 EPS estimate range of $120-125, that implies an S&P 500 level of 2040–2125.
- The recovery in GDP growth in 2021 implies around $170 of earnings next year. If the equity risk premium reverted to its post-crisis average of 4.4% and the 10-year Treasury yields stood at 1.25% by yearend, this would imply an S&P 500 level of 3009.

You might quibble with the assumptions in Goldman's models – no one has a certified crystal ball. However, using evidence-based models based on historical precedent seems the only logical approach. Goldman Sachs was not trying to predict the bottom in the market. However, they are illustrating that with reasonable assumptions, the stock market offers attractive return potential provided investors have staying power and are in the market to reap the reward. Missing just a few days of strong performance can drastically impact overall long-term performance as captured by the graph below.



I submit that few investors seem to be focused on what the market conditions might look like at year end…that seems like a lifetime from here! Yet, our investment decisions should be based on five+ year time horizons, not nine months or next week.

IT'S DIFFERENT THIS TIME

This caption has been called "the most dangerous phrase in investing". Thinking that a brand-new paradigm has arrived has been the ruin of many investors: those who thought historic data didn't apply to growth manias ***or*** crisis panics. When the word "unprecedented" is applied liberally in the media, it might lead us to forget that much of the economic and investing experience has broad precedent. As Mark Twain is reputed to have said, "History doesn't repeat itself, but it rhymes".

In my view, the global response to the current Coronavirus will cause an unexpected economic slowdown, which has been rapidly discounted by the stock, bond, commodity and real estate markets. However, it seems highly unlikely that there will be long lasting demand destruction due to the virus. In due course, the demand and supply components of a functioning economy will return to drive assets prices, which are likely to rise as the situation normalizes. Appropriate responses to the bear market include rebalancing to your long-term asset allocation objective and harvesting tax losses (if appropriate). While a few aspects of the current circumstances are "unprecedented", the tenets of sensible investing have not changed.