MID·CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

Special Edition: COVID-19, The Economy, and The Markets

Between February 19 and February 28, the S&P 500 index fell 15.8% on an intraday basis, the fastest correction (arbitrarily defined as a drop of 10% or more) from an all-time high in history. The proximate cause of the decline was sudden and dramatic investor concern – "panic" is probably not too strong of a word – over the potentially significant economic disruption from the COVID-19 virus that continues to spread globally.

Already the impact in China is very significant. Goldman Sachs economists estimate that the Chinese economy will contract at a 6% annual rate this quarter, its worst performance since the financial crisis, and one of the worst short-term shocks to any modern economy ever. Spillover effects to the rest of the world will be meaningful, as exports to China will fall and supply chains will be dislocated.

In the US, the spread of the virus appears limited so far, but this could be illusory; widespread testing is not occurring, and it's likely that there are many more cases that have not been identified. *Thus, the effect on the US economy so far has been mostly due to fear.* But fear is enough to be problematic, when hundreds of enterprises are cancelling meetings and conventions, businesses are banning travel, and families are engaging in self-imposed "social distancing" that keeps them from dining out or attending public events. Uncertainty about the depth and length of this episode is at the heart of the aforementioned "panic". There is universal agreement that it *will* be temporary, because the virus is respiratory and thrives on cooler outside temperatures to spread. But there is no consensus on what could happen before the outbreak has run its course. The simple fact is that no one knows.

How should investors respond to a development that they can be confident will be temporary, but is unpredictably bad? One should start by keeping in mind that 2020 began from a broad position of economic strength, buoyed by a robust consumer, increasing wages, a solid outlook for employment and housing, and healthy corporate earnings. An economy that was performing well at the time of the outbreak will be in better position to withstand any ensuing short-term shocks.

There is an understandable temptation, given the market's well-established historical ability to rebound from bouts of volatility, to treat this decline as an opportunity to buy. For patient investors with significant cash holdings, or meaningful underexposure to equities (relative to their own long-term targets), there are good opportunities emerging. But to the typical *Consilium* reader with standard levels of equity market exposure, the most useful message is simply: don't sell.

Selling during anxious, volatile market environments has almost always been a mistake if one were willing to look a few months into the future, beyond a valley of unknown depth. Even if the valley is deep, fear has typically been worse than the eventual reality, and sales executed in a downdraft must be reversed in an updraft. *Many investors are selling because they are panicking about other people's panic.*

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For example, we are confident that Amazon can roughly double its earnings per share in the next four years or so. The stock price should roughly follow. Does that make Amazon immune from nervous selling that could send the stock sharply lower? No. During periods of market stress, sellers are much more focused on where a stock might be in four days or weeks – not four years. Under these conditions, it is simply impossible to tell where any individual stock, or the market overall, will reach a sustainable bottom. But we know that it will and selling due to fear of potential short-term losses will have been a money-losing mistake.

A reader may notice that what we are describing is the mirror image of a market bubble, where buyers of speculative equities are not focused on whether fundamentals justify rising prices, but simply on the potential for stock prices to rise in the very short run. Bubbles likewise do not last and buying into them also ultimately leads to regret.

The most important questions facing investors are almost always the same: Is the economic environment supportive? Are we facing a recession? Do valuations leave room for good long-term returns? We devoted considerable ink to these questions in our late-2018 issue of *Consilium*, during a period of even greater market stress. We parsed an array of indicators with good forecasting ability and concluded that economic conditions were good, that selling was overdone, and that patience would be rewarded in 2019. Subsequent results favored the investors that held their positions.

These reliable indicators paint a generally similar picture today, but we will be monitoring them closely for signs of change. The situation today is unique and fluid, and we must consider all possible outcomes, adjusting as necessary.

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We would be remiss not to observe that this is the most important policy challenge the US has faced since the financial crisis and one must assume it will be top of mind for voters in November (i.e., its cumulative economic impact by that time, and how the administration is graded on its handling of the matter). We will have more to say about the unfolding political season in a future issue of *Consilium*. But suffice it to say that investors have more external stimuli to respond to than normal in 2020, and investment success this year will rest on the ability to differentiate between meaningful developments and noise to be ignored.

Maintaining an appropriate long-term perspective on the markets with a focus on identifying, buying, and holding high-quality, growing companies remains the principal objective of Mid-Continent Capital during current and all investment environments.

Sources: Bloomberg, Wall Street Journal, Goldman Sachs