Market Commentary

INVESTMENT STRATEGY GROUP | FEBRUARY 28, 2020

The Markets React to Coronavirus Fears

BACKDROP

We see the headlines that keep coming, but it seems like the more that is uncovered about coronavirus disease 2019 (COVID-19), the less is actually known. Infection rates are in question and rising with speculation. What is predictable is that the less confidence financial markets have in the near-term, the less risk they're willing to take with asset prices. The market response to this virus bears that out: growth-related assets like stocks and commodities have sold off while gold and Treasury bonds have rallied. This is the way markets prepare for more uncertainty.

Investing for the long-term is different than investing to reduce volatility. The two objectives are completely at odds, but both are necessary. Any promising long-term investment will fluctuate uncomfortably during times of uncertainty, which we know will arise now and again. These periods can come with a very real, and potentially unnerving, narrative that differentiates from prior times. This episode with the coronavirus is no different. Warren Buffett once said, "The stock market is designed to transfer money from the active to the patient." Patience and discipline are premium assets in market selloffs.

We believe the key to remaining calm at times of uncertainty is to be in a position where you are not forced to make a decision to sell at the wrong time because of liquidity needs. Stocks are not short-term investment instruments and should therefore be evaluated on a longer-term basis. As a long-term asset, the two largest drivers of stock returns are earnings growth and valuation multiples, such as Price to Earnings (P/E).

Earnings growth

Earnings growth has been slowing for some time, but this has been masked by share buybacks. Supply chain disruptions related to COVID-19 containment efforts will without a doubt hurt growth further in 2020. No one is certain of just how much growth will be impacted. However, there is no reason to believe (at this point) that the virus will have a long-term growth effect. Supply chains are resilient. Technological innovations aren't threatened, which augurs well for growth. On the demand side, excessive consumer debt is what topples asset prices and dismantles growth, but the consumer appears to be in fine shape. Corporations and governments have excessive debts, but the Fed is still very accommodative to that end. So, we're seeing only minimal stress to demand so far. We see plenty of room for the current economic situation to decline before it would approach the pessimistic growth scenarios that we factor into our valuation models.

Valuation multiples

As it stands, the global stock markets have a pre-existing condition: high valuations. P/Es were high coming into the year; investors were paying more and expecting future growth. The disappointment that growth could be delayed is getting expressed in a stock market selloff. We believe valuations were high for most reasonable future growth scenarios around the globe, whether in the U.S. or abroad. And they're still too high. We have modeled contractions in stock valuation multiples for some time now, so this is nothing new. COVID-19 is acting as a catalyst to bring stocks toward fair value. We view this as being positive.

Changes in P/E have more price impact in the short term. Longer term, elevated valuations will eventually give way to growth, which will become the larger determinant of returns. No one knows when that will happen. This is where patience comes in and why an investor's time frame matters.

WHAT DOES THIS MEAN FOR YOU?

Just as markets are preparing for more uncertainty, investors should do the same. This doesn't mean you should sell your stocks, nor does it mean that you should buy more stocks. To us, being prepared means two things:

1. Review your financial plan to make sure you have the right amount of short duration assets to meet any cash flow needs you have over the next few years.
2. Ensure that you fully understand what your portfolio is designed to do (and not do).

While no one can know what twists and turns we'll face going forward, we know that market prices don't always reflect fundamentals. We will watch both very closely in a disciplined way to look for opportunities to reposition portfolios in order to increase the chances of successful future outcomes for our clients.
