COVID-19 - Financial Implications Should Be Temporary

COVID-19, though scary, should be a temporary phenomenon. Of the major epidemics since 1983, all had healthcare solutions quickly and stock markets recovered with confidence. In fact, the average S&P 500 surge was 16.3% within six months of the low point of the crisis.

Let's Get Some Perspective

As of the close of major world markets yesterday the following is noteworthy:

Index	Peak To Trough Decline	Prior Date of Similar Index Price
TSX – Composite	19%	Jan. 2019
S&P 500	18.8%	Mar. 2019
MSCI World	19.1%	Jan. 2019

That is, although international stock markets have suffered a significant and rapid decline, they have only erased the performance of a very strong 2019.

As a result of this month's market decline, we have also experienced a sharp rise in yields on dividend paying securities, such as TD Bank, and the lowering of its Price to Earnings ratio to an historically attractive 8.99, the lowest in the past 5 years. This situation is very different from credit-driven recessions which can alter the economic and financial landscape for years to come.

What many may not recognize is that China's response has been the most aggressive in the world (even praised by the World Health Organization), which is beginning to pay off with the number of infections now falling along with a slowing rate of daily new infections and deaths.

For over a decade now, industry colleagues have been asking about how long the bull market could last after its recovery from 2009. The consistent answer has been "there is no economic catalyst for a similar decline". But does recent market action challenge that view?

In some ways, this feels like 2008. US long bonds just delivered their best 2-week performance and declining global stock markets have been tripping exchange circuit breakers. A meeting between OPEC and its allies collapsed over the weekend, causing Brent crude prices to plunge more than 30%; and, apparently, people are now fighting over toilet paper supplies. (tip: don't google the footage).

The major risk is always the same: people's reactions to fear vastly amplify the real economic pain, causing a vicious feedback loop into financial markets. Event cancellations, reduced travel and tourism, and other economic interruptions will no doubt produce some ugly statistics in the coming months. Yet, the idea that this is similar to 2008 rests on a few flimsy pillars. In fact, there are significant differences:

No Major Global Imbalances

To start, there are no major imbalances like the ones we saw in the run-up to the global financial crisis. The biggest macro story since 2008 has been the unwinding of massive private sector excesses in the two major growth regions of the world: the US and Eurozone. Deleveraging has now occurred in these regions. The household sector is in much better shape than prior to the crisis. Banks have cleaned up their balance sheets, and globally, aggregate imbalances in these economies have now diminished substantially. No credit unwinding threatens the entire financial system. This also remains true for emerging markets who have built up significant buffers to protect against another 1990s-style balance of payments crisis.

Policy Stimulus Has Become Pre-Emptive

Western governments are now under pressure for more drastic action. Nothing can be ruled out at this stage. Even the Fed needs to do more (apparently 50 basis points wasn't enough). We would not be surprised to see both the Fed and ECB start to make large scale purchases of equities soon.

Yet the big lesson from China is that fiscal policymakers must take a "shock and awe" approach to stabilize economies and market expectations. This is key to prevent a virus-driven contraction from cascading into a longer lasting recession. And fiscal action is new in the post-crisis period. The fiscal bazooka is now being loaded.

Investment Implications

This is now the fourth market decline in the post-crisis period where recession seemed imminent (for those counting: 2011 EU debt crisis, 2015-2016 oil collapse, 2019 trade wars and now coronavirus). Investors should recognize that these seeming near-death episodes serve as a kind of system re-boot, providing lower interest rates, better valuations and decreased investor expectations. Ultimately, this reset should extend the life of the cycle. This latest episode should be no different.

So what actions will Portfolio Stewards be taking? We plan to further reduce Canadian equity exposure to the energy and resources sectors; we will also shift some of the Canadian equity allocation in favour of U.S. equities where we believe there will be a much deeper pool of quality opportunities when the recovery occurs. In the medium to long term we are investigating several strategies that have the potential to reduce a portfolio's expected volatility and enhance expected returns; we will be communicating further information about these potential strategies in upcoming newsletters.

Although we believe there could be more volatility in equity markets in the short run, the aftermath of coronavirus should see a return to healthy economic growth. Interest rates are at historically low levels, oil prices at the lowest in years and there is strong stimulus in the financial system. That means the recovery should be of the "V shape" variety. Stocks should rally before this takes place (investors should tattoo this on their foreheads: financial markets are discounting mechanisms, quickly pricing in future probabilities before they occur).

These are not normal times, but it's hardly 2008. Most definitely, the smart move is not to stress over markets or toilet paper supplies, but rather readying to buy deeply discounted financial assets.

Conclusion

Financial markets are and will continue to be volatile and although we will see periods of strength during these volatile periods, it is difficult to truly identify when this decline will reach a bottom and get back on track to more positive movements.

We are not healthcare professionals and for us to even consider making predictions on when the spread of the Coronavirus will abate or what the financial impact will be is irresponsible. Cancellations of business conferences and sporting events to avoid the spread of the virus are gaining momentum and journalists will use this as an opportunity to sensationalize and increase fear in the viewing public.

If you are a longer-term investor and are fully invested, it is not a time to over-react to the declines of the past month. Time will help you to overcome your current losses and get you back on track to achieving your financial goals. If you need your invested funds in the next few months, you should use any rallies to liquidate your investments because time is not on your side.

If you have funds to invest, you may be experiencing a major opportunity to buy great companies at great prices and to generate above average results over the next five years.

We will continue to update you as more information is available and we get back to being able to focus on the fundamentals of investing rather than dealing with the emotions of highly volatile prices driven by concerns about a global emergency. In the short run, patience is the name of the game during periods like this.