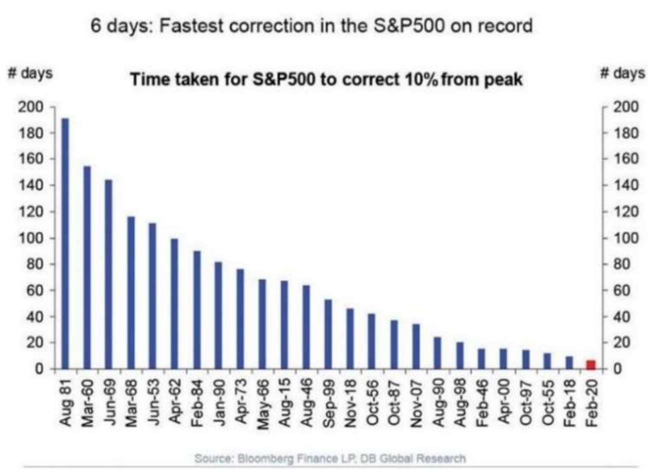
COMMENTARY

March 2020

"Stocks take the escalator up and the elevator down". It is one of the oldest adages on Wall Street, and it has never been truer than the experience of the last 5 months. From October 1st through February 20th, the S&P 500 rose 15% in almost a straight line, to a new all-time high. In the 6 trading days that followed, it gave up all of those gains and more. In fact, the recent correction (as defined by a 10% drop from peak) has been the *fastest in history*. This sudden correction has been driven, as you all know, by fears of global pandemic in the form of the novel coronavirus, COVID-19, which was first identified on January 7th, and has had an escalating impact ever since. While COVID-19 is foremost a tragedy for those affected, it is increasingly impacting the global economy. Markets initially ignored the virus, believing the economic impact to be limited and restrained predominantly to China, which had begun draconian efforts to quarantine citizens. By mid-February, an increasing number of global corporations had started to warn of weak results driven by virus impacts, and the global spread showed no signs of slowing. By February 20th, reported spikes in cases in places as varied as South Korea, Iran, and Italy set off alarms of a truly global pandemic, and the stock market finally cracked.



In assessing the economic impact of COVID-19, one of the most interesting debates has been between "supply" vs "demand" shocks. For those that are not trained economists, a supply shock is an event that suddenly decreases the supply of a good or service, while a demand shock is an event that suddenly decreases the demand of a good or service. To use an ubiquitous product as an example of the differences; is Apple worried about being able to produce enough iPhones or are they worried that they will be able to sell all of the iPhones they have produced? In recent times, most economic worries have revolved around demand shocks. With China acting as the de facto factory of the world, there has been ample capacity to create as many products at a low cost as the world can consume for the past few decades. With virus fears growing, much of China has "shut down" since the start of the year: schools closed, stores closed, and, most relevant to investors, factories closed. The shutdown's impact has recently been confirmed, as recent China PMI data, an indicator of economic activity, showed a sharper drop in Chinese manufacturing than during the depths of the financial crisis. Much of the recent fear in financial markets is that the second order effects of supply chain disruptions are unknown. Does a two week shut down of a plant mean a two week delay in the end product to the consumer, or does it mean a two month or longer delay? Will a delay of a single component in a 200 part product mean that all levels of production come to a halt? These are the types of scenarios that can cause real pain for businesses that become self-perpetuating: delays of sales lead to cash flow shortages which lead to layoffs which lead to falls in future orders which lead to fewer future sales. On a positive note, there are glimmers of progress in recent days, with the extraordinary measures implemented by the government seemingly stabilizing the situation in China. Apple, which has already warned Wall Street that they will not meet quarterly sales forecasts due to supply issues, has come out in recent days with reassuring commentary around reopening factories.

As the virus has spread outside of China, and increasingly around the world, there is also an increasing worry about "demand" shocks. Consumer confidence, especially in areas stricken with outbreaks, may weaken quickly and dramatically. This demand impact has already been seen most acutely in industries tied to "going out", as companies cancel industry conventions, families cancel vacations, and governments limit mass gatherings such as sporting events and concerts. Aviation, tourism, and hospitality are among the sectors that have been preannouncing expected sales declines due to spillover effects.

In the face of both supply and demand shocks, there is increasingly talk of global central banks "taking action." As of this writing, the U.S. Federal Reserve just cut their benchmark interest rate by 0.5%. While cuts have just happened, the efficacy of central bank action in the face of pandemic is being hotly debated. If factories are closed and people are not leaving their homes due to a health crisis, will lowering borrowing costs really spur this situation to change? This action seems more likely to help aid a stronger recovery in spending once confidence returns than to help ease consumer and business worries near term. However, we are going to need to see a real stabilization in both the fear and spread of COVID-19 for the economy and markets to stabilize.

As of intraday last Friday, the stock market had fallen back to its high reached in January 2018. History shows that it rarely has been a good idea to sell into weakness this severe, and equity markets have begun to rally off extremely oversold conditions. While we certainly do not know how wide this contagion will spread, or how long it will take for markets to fully "price in" the challenges to the global economy, our own experience has shown that periods of extreme market stress produce buying opportunities for long-term investors. Looking back at portfolio activity over the past 20 years, we can see the evidence of this, with many of our best-performing holdings purchased in the wake of the dot-com crash and the financial crisis. While long-term clients know that we do not make drastic, or sudden, changes in portfolio holdings, we did use weakness last week to make several purchases in both Growth and Income categories as the week progressed. We will continue to closely monitor the impact of COVID-19 on client portfolios, while searching for potential investment opportunities arising from the economic dislocations.