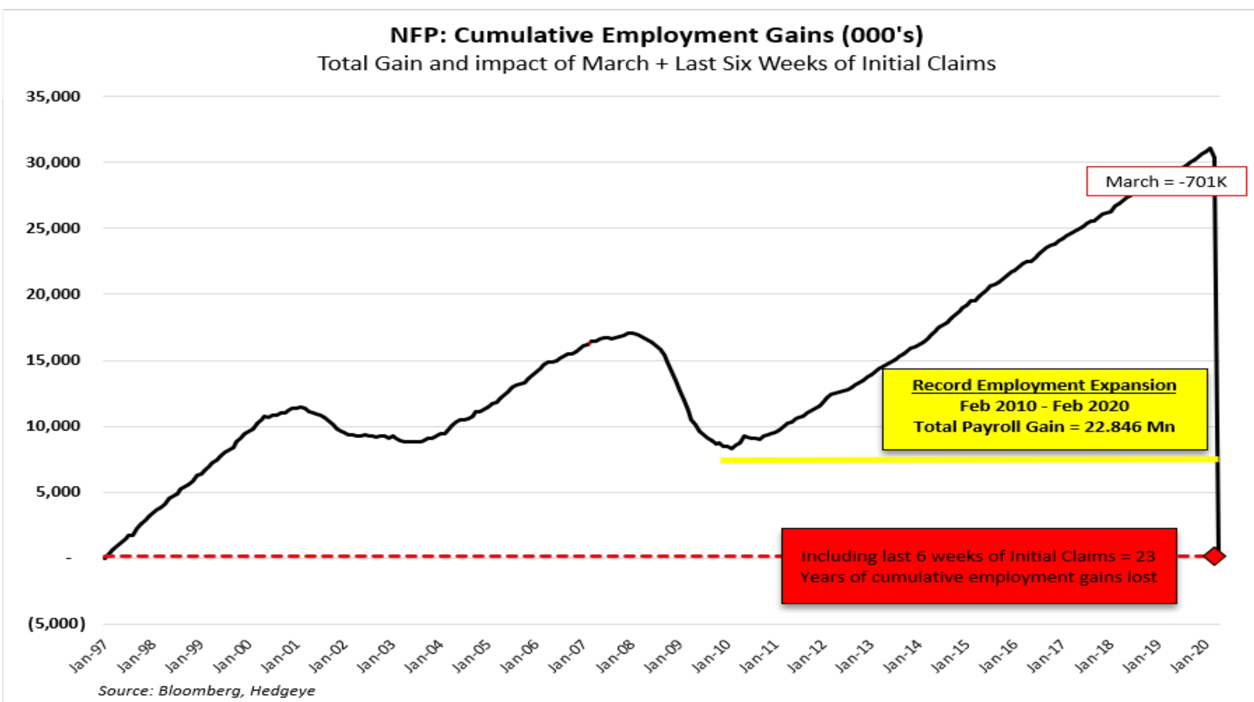
Investment Outlook - May 2020

In February 1957, a new influenza virus emerged in Singapore, triggering a pandemic that would eventually spread to the United States by summer. It was called Asian Flu, and it killed more than 1.1-million people world-wide, and 116,000 in the United States. The U.S. population at the time was a little more than half of what it is today, so the Asian Flu was roughly comparable to what we're facing today in terms of mortality rates. Like the current outbreak, it was disproportionately deadly to the elderly, or those with respiratory issues. It hung on for ten years until it mutated to become the Hong Kong Flu in 1968. Yet, schools, restaurants, theaters, travel, sports, and other activities continued without interruption. A vaccine was developed in late 1957, but was not widely distributed. The major television networks were still six years away from expanding their nightly news reports from 15 minutes to 30 minutes, and there was no 24-hour cable news or social media. The virus was reported as a medical problem, when it was reported at all. There was never any consideration of a political solution.

The reasons why the world (not just the U.S.) has reacted to the current crisis so differently than similar crises in the past is frankly way above our pay grade. Social scientists and historians will study the question in time. Meanwhile, we are having to deal with the most serious economic conditions in 90 years, brought about by circumstances that have no precedent.

Since the economy began shutting down, 30.3-million Americans have lost their jobs. That represents almost 20% of the work force that existed less than two months ago. To give you a sense of the scale of the damage that has been done, the job losses that have occurred in just the last 6 weeks have all but erased the cumulative employment gains of the last 23 years!



In the past, we have pointed to the fact that our economy has become less cyclical as it has become more reliant on services rather than manufacturing. However, service industries are being particularly harmed by physical distancing measures. The impact on travel, leisure and retailing is widely understood, but hospitals are bleeding cash as elective surgeries are postponed to reserve capacity for Covid-19 patients, and health care is the country's largest employer.

The damage to brick & mortar retailers is well documented by now. J. Crew has filed for bankruptcy, and the future of Sears, J.C. Penney, and other highly leveraged companies is in doubt.

Data from manufacturing surveys has not weakened as much as feared, but analysts are cautioning that the numbers may be distorted by non-responses from firms that have completely shut down.

U.S. GDP declined 4.8% in the 1^{st} quarter, which included less than 3 weeks of the negative impact of the shutdown. Indications are that the economy could shrink by as much as 40% in the 2^{nd} quarter on an annualized basis.

The economic collapse means that state and local tax revenues will plunge in the coming months by as much as 20%, by some estimates. Since most states have balanced-budget requirements, it means that spending will have to be cut proportionately, just as funding needs are increasing for Medicaid and other benefits. Estimates for the amount of the cumulative shortfall among all states run as high as $360-billion, unless the federal government provides more assistance, an eventuality that is threatening to become politicized.

The point of this is not to depress our readers, or make your forced isolation more unbearable, but rather to suggest that, realistically, this is not a situation that is going to resolve itself in the next 2-3 quarters. Assurances from some public officials that the economy will “be rocking by July” as social distancing requirements are eased are self-serving and irresponsible. Consumers’ behaviors are going to change in ways that we can’t now forecast, but which will almost certainly slow the rate of an eventual economic recovery. Will restaurants be allowed to serve every third table; will theaters fill every 4^{th} seat; will airlines sell every other row? The range of possible outcomes is far too wide to forecast, but 30.3-million people are not likely to be re-hired in the next few months.

Even Warren Buffett, who habitually has seized upon economic crises to increase his equity positions, has sold his entire stake in the U.S. airline industry, and has declined to spend any of Berkshire Hathaway’s $137-billion cash hoard. At Berkshire’s recent annual meeting, also referred to as Woodstock for Capitalists, he repeatedly stated that too much was still unknown about the future course of the virus, as well as the timing and extent of an eventual economic recovery, to make significant bets in the stock market right now.

Following the market’s initial decline as the coronavirus began to spread, the Standard & Poor’s 500 has risen 30% from its March 23^{rd} low and is back within 16% of its all-time high. So why is the stock market doing so well when the economy is in a free-fall?

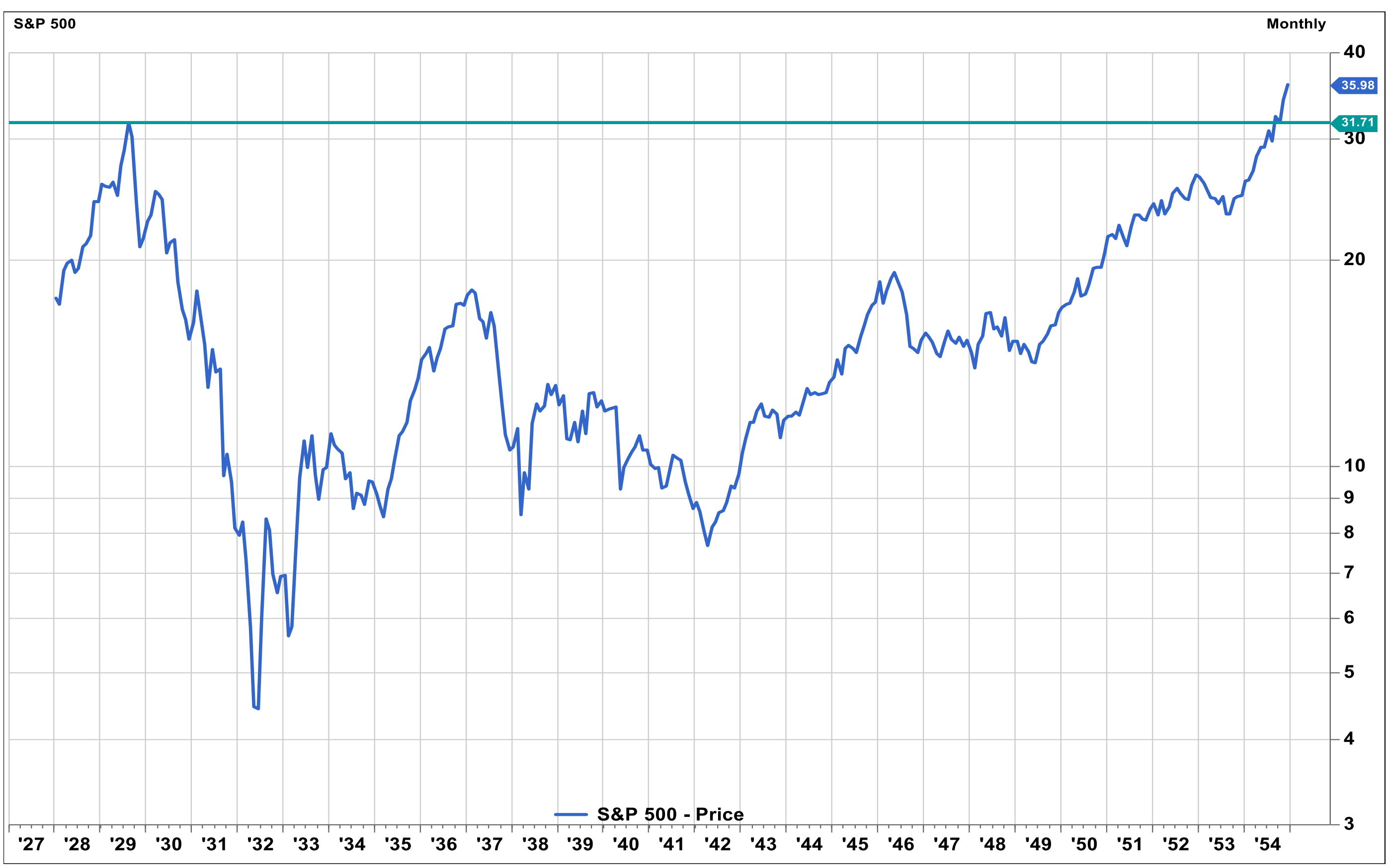
The obvious answer is that the Federal Reserve and the Congress have enacted extraordinary measures to pump liquidity into the economy and prop up the markets. Under such conditions, the current fundamentals don’t matter as much. To a lesser extent, it may also be that investors have nowhere else to go with their money. Bonds offer little or nothing in the way of returns, encouraging investors to take a longer view and take advantage of what appear to be bargains in the stock market.

The better answer, though, is that the stock market isn’t doing nearly as well as it seems.

The S&P 500 represents an index of 500 companies, but the 5 largest companies currently account for 20% of that index. These 5 stocks, Facebook, Amazon, Apple, Microsoft, and Google, have collectively come to be called by their acronym, FAAMG. While the S&P 500 is down about 10% year-to-date, the FAAMG stocks are actually *up* 10%. The other 495 companies in the index are down 13% over the same period (following chart).

Some important market sectors have fared even worse, with industrials down 21%, financials down 26%, and energy down more than 36%, on average. We mentioned earlier that the S&P 500 is now back within 16% of its high, but the FAANG stocks are only 3% below their highs. The rest of the stocks in the index are more than 29% below their highs, on average, and one-quarter of them are still down more than 40%.

The current situation is frequently being compared to the depression of the 1930s. In that instance, it is well to note that it took 25 years following the October 1929 crash for stocks to return to their prior levels. During that long period, there were several significant rallies and stomach churning declines. The market quadrupled from 1932 to 1936, fell more than 60% from 1936 to 1942, then tripled from 1942 to 1945.



We don't believe that today's economy compares to that of 1929. Such things as Social Security, unemployment benefits and FDIC insurance did not exist at the beginning of the Great Depression, and the scope of government intervention that is currently being brought to bear would have been unthinkable then. Stock prices fell more than 70% from 1929 to 1932, while the recent February-March decline was just 35% at its lowest point.

But Warren Buffett is right, there are too many unknowns to put much faith in the optimistic scenario that some analysts say the market is discounting. The future course of the virus is unknown, and the medical community is nearly unanimous in its conclusion that the current wave will not be the only wave. The efficacy of the treatments currently being tested is unknown, as is the timing and availability of a vaccine. The behavior of consumers coming out of isolation is unknown, corporate earnings estimates vary widely, and corporate earnings guidance is becoming increasingly guarded. And while government and central bank stimulus can alleviate the current liquidity crisis, the depth of the solvency crisis that might likely follow is also unknown. And as we have said, the market might also be discounting a less rosy outlook, if you look beyond the few large companies at the top of the index that are relatively unaffected by Covid-19.

The current outlook doesn't begin to approach the bleak and despairing economy of the 1930s, but the uncertainties are too great to begin to add risk back into equity portfolios in a major way. As in past times of economic stress, there will be market rallies that might lead us to a false sense of security, but we think it is too soon to conclude that all is well, even if the worst is behind us. Challenging times widen the gap between winners and losers, and we will continue to actively manage portfolios to identify opportunities, while maintaining higher than normal cash reserves to take advantage of them when they occur.

This storm will pass, as all storms do. Meanwhile, learn to dance in the rain. Stay healthy and happy.

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