April 1, 2020

And they said March Madness was canceled. While the college basketball postseason was indeed shut down, the coronavirus-induced chaos that has upended our lives, our economy, and our financial markets has, unfortunately, continued. We'll do our best to make some sense of the latter two in this limited space.

After a record-long eleven-year run, the bull market was finally taken down by a black swan. Market pundits refer to an unpredictable event with serious and unavoidable effects as a black swan, and the Covid-19 pandemic certainly qualifies as one. The stock market rallied sharply last year on the expectation that an easing of the trade tensions with China and an improving economy would lead to strong corporate earnings growth in 2020. The coronavirus contagion and the aggressive social-distancing measures taken to combat it will instead likely result in an unprecedented hard stop to the U.S. economy, with entire industries grinding to a halt and unemployment soaring from a 50-year low. The U.S. is undoubtedly now in a recession, with the second quarter likely to produce the largest economic contraction (> 10%) since World War II and a decline in corporate earnings at a multiple of that. Given that the market has effectively been whipsawed by the drastic change in expectations, it is not surprising that its reaction has been so volatile, including the fastest-ever fall from an all-time high to a bear market.

Adding to the stock market volatility have been signs of distress in the credit markets. While a flight to safety by investors has sent U.S. Treasury yields to record lows, the yields on many corporate and municipal bonds have risen sharply. Many entities have also found it difficult to issue new bonds or obtain much-needed short-term loans. Though some of this difficulty is the natural result of risk aversion caused by the economic downturn, a good portion of it has resulted from dislocations in the credit markets due to a lack of liquidity. Given that a significant disruption to the credit markets could further weaken an already fragile economy, the Federal Reserve has responded aggressively by utilizing everything in its arsenal, including slashing its benchmark short-term interest rate to zero, agreeing to buy an unlimited amount of Treasury and mortgage securities, and creating massive lending facilities in multiple areas of the credit markets to improve access to funds for businesses and households. While not a cure-all, these measures have significantly reduced the stress in the credit markets. And by all indications, the Fed will do whatever it takes to keep the credit markets functioning properly.

As difficult as the pandemic and economic contraction will undoubtedly be, they are expected to be relatively short-term in nature. Once the virus is contained and the social-distancing measures are reduced, the economy should be in a pretty good position to begin its recovery. Economists have been debating an alphabet soup of potential recovery paths, including "V-shaped" (economy surges as quickly as it plunged), "U-shaped" (a slow and gradual recovery), and "L-shaped" (marked by an extended period at the bottom). It will certainly prove to be more difficult to turn the economy back on than it has been to shut it down given that some businesses and a portion of the workforce will endure significant damage in the days to come. However, that blow should be cushioned in part by the fact that businesses and consumers were on pretty solid footing before the pandemic began. In addition, the recently enacted $2 trillion federal stimulus package along with the massive amount of monetary stimulus in the system should aid in the recovery. As such, we think the shape of the recovery will likely fall somewhere between the V and U-shaped scenarios. Though we expect the economic recovery to be fairly strong, it will probably take multiple quarters to regain all of the lost ground given the magnitude of the coming contraction. We anticipate that a recovery in corporate earnings will follow a similar path.

Sharp market pullbacks such as this one can understandably be unnerving for investors. And with so much uncertainty remaining over the trajectory of the pandemic and the effects it will have on the economy and corporate earnings in the coming months, the market is likely to remain volatile for a while. However, it is important for investors to maintain a long-term perspective during such times. As unpleasant as they may be, bear markets are a natural part of the investment process. Since our founding in 1956, we have been through a number of similarly unpleasant market stretches and remain more convinced than ever that the combination of owning high-quality, financially-strong companies that are built to withstand difficult times and having the patience to stick with them during such volatile periods is key to achieving long-term investment success. While even quality stocks are not immune to the gravitational pull of bear markets, we believe they will weather the storm and ultimately reward the patient investor in the long run. As Warren Buffet has said, “The stock market is a device for transferring money from the impatient to the patient.” Volatility is the friend of the long-term investor as it can present opportunities to buy quality stocks at significant discounts to their intrinsic values. For the first time in quite a while, we are seeing such opportunities, and we will selectively take advantage of them as they arise.

Sincerely,

Alison

Alison Gamble, President
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