Mitch on the Markets

Portfolio Manager Investing Insights

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How Should Investors React to the Coronavirus

Many readers are likely growing concerned about the spread of the coronavirus and the potential impact on the market (and your health). I understand the emotional difficulty of the moment, and I understand the challenges of keeping a cool head amidst the media and market frenzy. Market volatility, accompanied by a blitz of negative news coverage, will make any situation feel totally dire.

In times like these, it often feels like the worst-case scenario is the only possible outcome…***even though history consistently implores us not to think this way.*** It's not our fault – humans are hard-wired to overreact to the negative while underplaying the positive, which I think describes the current investment environment. Panicking now means giving into this classic investment error, in my view, and is also the precise reason many investors fail to achieve their desired long-term investment outcomes.

Throughout history, there have been dozens of virus outbreaks, epidemics, and a handful of pandemics. *Virtually all of them resulted in* ***short-term*** *volatility and downside*, followed by long-term price appreciation. In my view, it is very reasonable to expect a wild ride for the next few weeks. But that does not mean the right move now is to sell or panic. Longer-term, the actual impact to the equity markets has almost always been fleeting.

The Virus Cycle: Short-Term Pressure Followed by Longer-Term Recovery

Epidemic	1-month	3-month	6-month
Pneumonic Plague	-2.79%	-4.67%	-4.30%
SARS	+8.64%	+16.39%	+21.51%
Avian Flu	-0.18%	+2.77%	+10.05%
Swine Flu	+10.9%	+19.73%	+39.96%
MERS	-0.29%	+2.15%	+8.58%
Zika	-6.05%	-0.88%	-0.57%
Ebola	-0.09%	+2.37%	+4.37%
Average	**+1.45%**	**+5.41%**	**+11.37%**

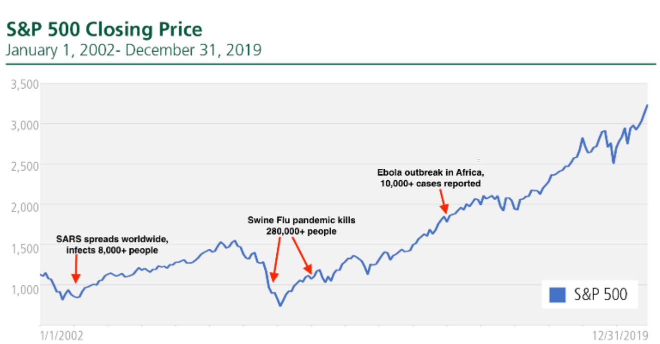
Source: Charles Schwab[1]

A closer look at more recent outbreaks unveils a similar pattern to what we're seeing today. Historically, the number of confirmed cases in various epidemics has tended to rise sharply for 8 to 10 weeks, then peaked. A short-term dip in stocks generally accompanies the initial (frantic) rise in confirmed cases, with a recovery in prices as the situation comes under control. Over a 38-day trading period during the height of the SARS virus back in 2003, the S&P 500 index fell by -12.8%. During the Zika virus, which occurred at the end of 2015 and into 2016, the market fell by -12.9%. Panic-selling episodes happen, but they have never lasted.

The 1957 Asian flu pandemic was another very significant pandemic in modern history. Advancements in scientific and medical technology allowed the virus to be detected and treated within a year, a time frame we might reasonably expect to be 1-2 months today. The S&P 500 went up +24% in 1957 and 2.9% in 1958.[2]

Even though it was only 10 years ago, many people forget the scope and gravity of the Swine Flu pandemic. The Centers for Disease Control estimates that from April 12, 2009 to April 10, 2010, there were 60.8 million cases, 274,304 hospitalizations, and 12,469 deaths in the U.S. alone. Globally, the numbers approached *1 billion infected* and some 280,000 deaths.[3] But as the virus spread and hysteria enveloped the media and the world, the S&P 500 was beginning one of the biggest bull runs of all time. Selling into the Swine Flu pandemic would have been a mistake.

Historically, Selling into Virus Outbreaks Has Been Proven Costly



Source: Zacks Investment Research[4]

Bottom Line for Investors

My goal in this column is not to downplay the seriousness of the coronavirus outbreak. As of this writing, there are over 90,000 confirmed cases and over 3,000 deaths.[5] But at the same time, history tells me – as an investor – that that the *fear* of the virus outbreak will likely far outweigh the actual economic and market impact it will have. Selling now, in my opinion, would mean pricing-in a lengthy recession and bear market—neither of which seem likely.

In my view, selling into virus outbreaks has proven costly throughout history because the stock market's value is not based on what happens in the next quarter or two. Equity value is based on longer-term corporate earnings generation, which is driven by interest rates, inflation, business investment, innovation, and the regulatory environment. I think these macro conditions are still conducive to growth, even as the virus spreads.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Listed returns are for the MSCI World Index, price returns. Past performance is no guarantee of future results.
Charles Schwab, February 24, 2020.
https://www.schwab.com/resource-center/insights/content/market-volatility

[2] Fidelity, April 6, 2019.

[3] Centers for Disease Control and Prevention, June 11, 2019.
https://www.cdc.gov/flu/pandemic-resources/2009-h1n1-pandemic.html

[4] Zacks Investment Research

[5] The World Health Organization, March 3, 2020.
https://www.who.int/emergencies/diseases/novel-coronavirus-2019/situation-reports/

IN FOCUS THIS WEEK

- Volatility persists, but for how long?
- Rate cuts are less effective than fiscal spending and time
- Don't forget economic fundamentals in the backdrop
- The Federal Reserve changes rules for big banks

Equity Market Volatility Persists, and is Likely to Continue

During times like these, sometimes the best course of action is to watch as little news as possible and completely refrain from checking your portfolio value, in our view. The goal of taking these two actions is simple: remove emotion from the decision-making process and stay focused on the long-term. The last few trading days offer a case in point: coming off a horrendous final week of February, the S&P 500 took another nosedive (-2.8%) on Tuesday even as the Federal Reserve cut interest rates by half a percentage point. The following day, however, the S&P 500 rallied by +4.22%, which many news outlets credited to Joe Biden's surge in Super Tuesday voting.[1] In our view, there is no real way to attribute the S&P 500's losses or gains to single events or data points. During market corrections, the S&P 500's changes are impossible to predict – what happens one day often has no bearing on what happens the next. Investors who try to time their exits and entries in the market during a correction are almost sure to make big mistakes, in our view. Often times, the best days in the market follow the worst days, so getting in-and-out leaves wide open the possibility of selling into a rally or buying right before another downdraft. With equity market volatility likely to persist, we think it's better to keep a cool head and ignore the noise.

Rate Cuts Are Probably Less Effective than Fiscal Spending and Time

We believe most economic weakness that results from the coronavirus will come from a supply shock – production delays, supply chain issues, trade bottlenecks. These are all issues we think can be amended quickly, once the crisis abates and the affected countries resume business as usual. That's also why we think interest rate cuts are far less effective than fiscal stimulus and, simply put, time. A 0.5% rate cut won't help to restart a factory or stimulate global trade. But a few months of time can, in our view. Fiscal stimulus can also be effective during crises like these, for two reasons: it sends a signal to markets that governments are willing to spend to address the crisis, and it helps to make up for the shortfall in consumer spending that is likely to occur as people stay home and change their normal habits. Though many news outlets pointed to Joe Biden's Super Tuesday wins as fuel for Wednesday's market rally, a different take might assert that stocks were responding to the $8 billion spending bill that quietly passed in the House.[2]

The Federal Reserve Changes Rules for Big Banks (In a Good Way)

In a much-anticipated revision of the 2010 Dodd-Frank rules, the Federal Reserve voted almost unanimously to restructure the 'capital requirement' rules for the biggest US banks, like JP Morgan, Citigroup, and Bank of America. There was a good argument, in our view, that the Dodd-Frank set of bank regulations had noble intentions but flawed structure and enforcement. Lawmakers struggled for years to clarify the complex set of rules, while banks operated with a high degree of uncertainty over what the playing field would ultimately look like. This most recent Fed overhaul simplifies the "post-crisis capital framework for banks," with new rules that essentially streamline stress tests and reduce the number of capital requirements down to 8 (from 13).[3]

Remember Economic Fundamentals in the Backdrop

Before the coronavirus absorbed global headlines, the US economy was looking steady and reasonably strong. Housing and construction spending were trending nicely; hiring remained robust and wages were ticking higher; the stock market was hitting new all-time highs; the US and China had made positive moves towards easing the trade war; and consumer spending was reflecting the strong labor market. In all, the US economy was positioned to grow in the middling but still nicely positive 2.5% range, with corporate earnings poised to make a comeback off a weak 2019.[4] The coronavirus will almost certainly require downward adjustments to earnings and growth forecasts, but we believe the conditions that existed before the virus outbreak can exist after it, too.

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[1] The Wall Street Journal, March 2, 2020. https://www.wsj.com/articles/global-growth-to-slow-sharply-as-coronavirus-takes-heavy-toll-says-oecd-11583143200

[2] ZIM may amend or rescind the "Feeling Bearish? This is How Stocks Deal with Uncertainty" guide for any reason and at ZIM's discretion

[3] https://docs.house.gov/billsthisweek/20200302/BILLS-116hr6074-SUS.pdf?mod=article_inline

[4] The Wall Street Journal, March 4, 2020. https://www.wsj.com/articles/federal-reserve-retools-capital-rules-for-largest-u-s-banks-11583359910?tesla=y&mod=article_inline

[5] The Wall Street Journal, March 3, 2020. https://www.wsj.com/articles/apple-supplier-foxconn-expects-coronavirus-hit-labor-shortage-in-china-to-ease-11583227609

[6] ZIM may amend or rescind the "Feeling Bearish? This is How Stocks Deal with Uncertainty" guide for any reason and at ZIM's discretion

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