

Pandemics, Riots, and Stock Rallies

THE S&P 500 IS UP MORE THAN 40% SINCE MARCH 23RD, DESPITE THE NEGATIVE HEADLINES



Some investors are understandably baffled by the 40% rally in the S&P 500 since the market low on March 23rd. Against the tragic and disturbing backdrop of the COVID-19 pandemic, record levels of unemployment, and now the protests and social unrest that has swept the country, how is it possible that stocks have risen so much? This week, we would like to focus on this question and try to offer reasons for the market's gains. We will also explain why we have been adding equities back into our portfolios since April 9th and added some more last week.

When less bad is good: In our experience, markets usually react to the *rate of change* in the data rather than the level. We expect economic and earnings data to continue to be very bad in absolute terms. However, the message from the stock market is that investors expect the data to improve now that the lock-down has ended. A good example of this was last week's employment report which showed that unemployment is still very high at 13%, but there were 2.5 million non-farm payroll gains and the unemployment rate fell from last month.

What is happening to stocks is consistent with other recessions and the Great Recession of 2008/09. The S&P 500 bottomed in March of 2009 and rose every month for the next 6 months, recovering 50% of its losses by the end of the year. This happened well in advance of any meaningful improvement in earnings, but rather in the expectation that the improvement would follow... which it did. The following table from Ned Davis Research shows that the S&P 500 surprisingly has its best returns when economic growth is low (below 0.5%). We believe this is because stocks typically fall dramatically as the economy slows, but also recovers quickly as investors anticipate improvement.

| S&P 500 Gain/Annum When: (3/31/1960 - 3/31/2020) | | |
|---|------------|-----------|
| Y/Y Change of Real GDP Is: | Gain/Annum | % of Time |
| Above 6.1 | -4.6 | 8.7 |
| Between 0.8 and 6.1 | 7.1 | 78.3 |
| * 0.8 and Below | 12.1 | 12.9 |

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Process Over Prediction: Over the last month we have repeated our mantra of 'process over prediction' several times. This means we believe that an unemotional,

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- **Markets usually react to the rate of change in the data rather than the level.**

- **We believe the rally above 2950 on the S&P 500 was significant, even though the quickness and magnitude of the breakout was unexpected.**

- **Research suggests pessimistic thinking blocks out creative ideas and solutions.**

disciplined process for managing risks and opportunities is more effective than anchoring on any one forecast. As Yogi Berra said, “It’s tough to make predictions, especially about the future.” Considering the current environment, we are looking at the forecasts with caution as they are highly dependent on the potential occurrence of a second wave of the virus and how quickly consumers return to more normal behavior. Based on the rally, stock investors are currently taking an optimistic view. A second wave would likely cause the data to deteriorate again, raise the level of uncertainty and increase expectations of the length of the recession, all likely resulting in the stock market giving back some of its gains.

Due to the difficulty of forecasting, especially since what we are experiencing is unprecedented, we are continuing to focus on process, acknowledging the wisdom of crowds. Since the market reflects the summation of collective insights from investors around the world, it also acts as the final arbiter of news. Our “Don’t fight the trend” rule is the recognition of this.

In our view, the rally above 2950 on the S&P 500 was significant, even though the quickness and magnitude of the breakout was unexpected by many financial professionals, including our investment team. We believe the recent strength in the stock market highlights that most investors believe the reopening of the economy will have a larger positive impact on stocks than the potential headwinds caused by the recent protests and riots. Therefore, the combination of a humble approach and disciplined process has encouraged us to add back equity risk, even when it feels uncomfortable and we are buying as prices rise.

The Pessimistic Trap: In times of crises, many investors fall into the trap of extrapolating the dire situation far into the future. In fact, most humans are genetically wired to think this way. There are many studies to suggest that pessimism is more tempting than optimism. As psychologist Daniel Kahneman pointed out, “organisms that treat threats as more urgent than opportunities have a better chance to survive and reproduce.”

Many times, pessimistic thinking blocks out creative ideas and solutions. For example, while there is understandable fear of a rise in COVID-19 cases due to the protest gatherings, if we don’t see a wave of virus cases in the next few weeks, it might suggest the worst of the pandemic is behind us. The policy response to an economic shock is also critical to how markets behave. Just as the pandemic has been unprecedented in modern times, so has the size of the global coordinated policy mix of fiscal and monetary stimulus. The pessimists will point to a growing and potentially unsustainable budget deficit. However, the optimistic view is that all this money will have to flow somewhere, and it could support asset prices initially and then the economy. In other words, risk takers will be rewarded while savers are punished by extremely low interest rates and the risk of inflation over time, in our view.

As an investor, this type of optimism can be extremely uncomfortable. As financial columnist Morgan Housel points out, “In investing, a bull sounds like a reckless cheerleader, while a bear sounds like a sharp mind who has dug past the headlines.” However, history suggests that long-term optimistic thinking (with regards to the stock market) is a much more profitable exercise. According to data from Ned Davis Research, the S&P 500 has posted positive total return in 79% of calendar years from 1972-2019, averaging roughly 12% return per year over that time frame.

The reality is that we are all operating with incomplete and imperfect information. This, combined with the human tendency to focus on the pessimistic outcomes, can lead to suboptimal investment decisions, especially when relying on forecasts instead of a disciplined process.

Working with a trusted advisor can help navigate emotionally charged times like this: We believe that one of the most important pieces of advice we can offer investors is to get some professional help. The process of investing can trigger all sorts of emotions for individuals, especially when headline risks surrounding global

pandemics, racial tensions, and national debt are involved. For these reasons, we believe it's valuable to get an unbiased opinion from an advisor that can focus on financial goals. With the proper financial plan, many times the best portfolio action in a time of crisis is to do nothing. However, our human nature makes that type of inaction extremely difficult, especially without the help of a professional.

Bottom Line: The pandemic and the social unrest happening all over the country have caused emotions to become highly charged, and understandably so. We agree that these are uncertain and trying times for Americans and for the world. However, we believe that the best investment decisions are made when investors unemotionally weigh all the information and focus on the news that is most likely to have meaningful investment implications. Beneath the unsettling headlines, the burgeoning reopening of the economy in the US and Europe is a logical economic catalyst for stock market strength, in our opinion. For investors, we believe the final arbiter of news is the market itself and thus far the optimists are prevailing. So even though there are many risks on the horizon, our process incorporates the message of the markets and thus has been gradually adding to stocks since early April. As we wait for additional clarity and ultimate resolution of many of today's headlines, we will stay vigilant, and will continue to adjust our portfolios accordingly.

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You cannot invest directly in an index

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