An Epidemic of Fear - When does it end? How does it end?

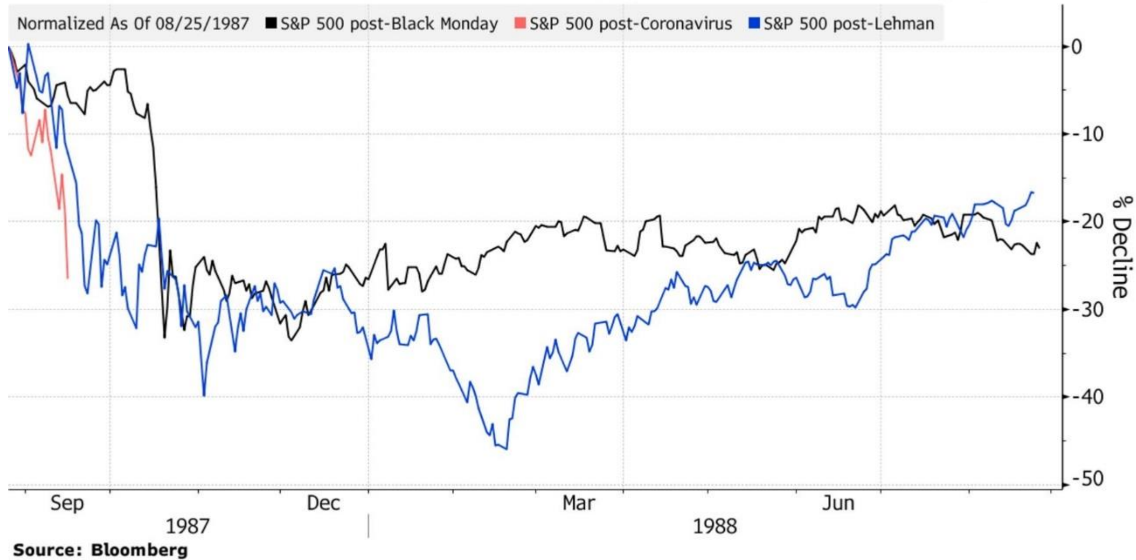
Article by Sam Sweitzer

To think in narratives is human. We like understanding the world through stories. In times such as these, my job as a portfolio manager is to help clients make sense of the disparate and widely diverging pieces of information. We need to know the plot of this story, when it ends, and how it ends.

The current COVID-19 sell-off and situation are like nothing we've ever seen. The largest countries are only starting to respond with severe mobility restrictions, which will last for at least several weeks, and potentially several months. The dual shocks of coronavirus and an oil price war will almost certainly push the global economy into recession. A significant drop in economic activity seems almost certain as people stay home, and the bustle of life slows considerably.

Yesterday (Tuesday), we saw the 3rd most substantial decline in US markets on record. This decline followed last week's drop, where all the major US stock markets reach 20%+ declines from their recent peaks. In previous bear markets, this process took more than four months. This time, it took just three weeks. If previous bear markets tell us anything, it is that bone-jarring volatility—both up and down—is likely to continue.

This is the fastest descent from an all-time high on record. The two big exogenous shocks, from the oil price war and coronavirus, make this different from any other stock market crash, but there are still plenty of similarities. The chart below compares the fall from the February 19th peak to the decline from the pre-Black Monday high in 1987, and the drop from the weekend of the Lehman bankruptcy in 2008. The last example starts when the market was already down a lot, but Lehman was perceived at the time to change everything, and the market behaved similarly to 1987:



Sell-offs this violent generally have some big bounces along the way, as we have seen. Having embarked on such a descent, we can expect to fall a bit further. In terms of time, if not of distance, however, when markets move this quickly, they usually finish their adjustment in short order. In general, stock markets spend most of their time climbing slowly, punctuated by sharp corrections.

FactSet Research conducted a study of all post-World War II bear markets in the US. They concluded that when bear markets are not associated with a recession, they have averaged a 24% decline. But when a recession accompanies the bear market, the fall averages 37%. This study leads me to conclude that another 10% down from current levels is a genuine possibility.

To be clear, I do not believe that we are in another 2008 or 1929 scenario. Unlike in 2008, this crisis did not originate in the financial system. Banks are much healthier and better capitalized than they were 12 years ago.

The Fed has also been swift to act by providing massive liquidity to markets in the past

week. Countries that experienced coronavirus early (China, Singapore, Taiwan, and S. Korea) are already seeing consistent declines in new cases.

In sum, perhaps the best narrative is this: We entered the dual shocks of coronavirus and an oil price war on solid, but slowing economic data. The majority of the developed world—as I have been saying for over a year—was in the late stages of the business cycle. US equity markets were overvalued. These shocks have struck markets with unprecedented speed and depth. We are likely already in a recession, but this recession may not last very long. Central banks are acting aggressively, and governments will soon enact equally aggressive fiscal stimulus.

Depending on your age and risk tolerance, now may be an excellent time to begin thoughtfully increasing your allocation to risk assets. No one picks bottoms perfectly, but when fear is palpable—as it is now—markets generally reward investors who step forward and buy.