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market news

Building a New Wall of Worry: Coronavirus, Recession and Bernie

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There is an old saying that the stock market climbs a "Wall of Worry." This was very much the case in 2019 as worries over the Federal Reserve, the economy and the trade conflict weighed on the market over the course of the year. As we gradually saw these issues resolve themselves, we were left with higher markets and a lack of things to worry about. It is safe to say that problem has now been solved and we now have plenty to worry about again. Borrowing back to our analogy in last summer's commentary the football has once again been pulled away from Charlie Brown. Obviously, the largest concern is the potential health risk the virus may present and we will leave those comments to the medical experts and focus on the potential economic impact.

The emergence of the coronavirus has created an entirely new set of concerns for the markets and the economy. We have begun to see meaningful economic disruptions in Asia and there is concern those disruptions will spread to the U.S. if we are not successful in containing the virus soon. An economic pause in the short term and the potential for a recession has increased modestly, though from a very low probability. The final brick in the wall of worry is that an extended period of economic weakness could damage the president's re-election chances and open the door for an extreme progressive candidate like Bernie Sanders.

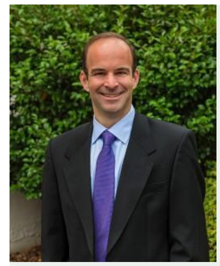
Coronavirus

While we have no scientific or medical value to add to the discussion of the coronavirus, there is an element of perspective that we will endeavor to provide. The panic and fear that is being caused by this virus is not unique or unprecedented. We have seen many examples of fear and uncertainty causing dramatic moves in financial markets and feel it is logical to expect this time to follow a similar pattern as past experiences. History has shown this type of panic, while intense and frightening, does tend to be short lived. Historical outbreaks like this have followed something of an "S" pattern, where there is a period of rapid contagion that moderates and slows as awareness and prevention efforts take hold. There are early signs that this maybe occurring already in China, which combined with the now high level of awareness globally, may be a reason for optimism.

Awareness of this illness is now very high. Similarly, I would argue that governments are now aggressively focused on this issue and taking actions to contain and manage it. Businesses are also responding by canceling conferences and reducing travel in favor of electronic meetings. While none of these are overnight solutions, history has shown them to be effective in reducing the rate at which viruses have spread in the past. As time passes, the probability of developing a treatment and or a vaccine also increases.

Recession

The ultimate path of the markets and the economy likely hangs on the degree to which we are able to manage the economic impact of this panic.



Scott consults with TSWM clients and relationship managers to implement their financial plans through building diverse portfolios of high quality, low-cost investments relative to individual goals. Scott helps clients to gain better understanding and peace of mind in a complex and often confusing world. He strives to bring patience and objectivity to the investment process on a daily basis in order to avoid the destructive impact emotional reactions can have on financial decisions. Scott joined TSWM in 2006.

Without question, the coronavirus has caused an economic disruption and an economic pause. The question now is "how quickly are we able to bounce back from this disruption?".

The definition of a recession is two consecutive quarters of negative economic growth. Prior to this outbreak the odds of a recession were low, and I would argue at this point they are still low but have somewhat increased.

Our base case of how things unfold in the near term would be that we would have a "V" shaped drop in economic growth as we get our hands around the virus. This implies a sharp decline in economic activity as supply chains are disrupted and activity declines. The good news is that provided the virus is contained relatively quickly, the economy should bounce back. If this scenario unfolds, we would expect the equity markets to be able to look past what will likely be a quarter or two of weaker earnings and we should see little long-term impact. Our concern around a recession would grow if we saw an extended disruption in economic activity that impacted consumer and business confidence. This could create more extended damage to the economy that would take longer to repair. One of the most likely places we would see this is in a softening in the labor market which we will be watching. The good news is that the tight labor market is such an issue for companies, that we think they will be patient. Additionally, we entered this period in a pretty strong place which should allow us some cushion to absorb the shock before we have serious economic harm.

Bernie

Perhaps under the surface the market actions are being driven somewhat by an increase in concern that this event could weaken the economy, which is seen as the president's greatest strength politically. This concern combined with Bernie Sanders taking the early lead in the democratic primary has added an additional layer of uncertainty to the picture. Politics aside, the shock to the markets that would be caused by many of the policies Sanders endorses would be significant and negative for investors.

Historically, it is very hard for a president to win re-election if a recession occurs during the election year. So the economic impact of the coronavirus takes on an added level of significance for investors. Additionally, we entered this correction with the equity market forecasting a much higher probability that the president would be re-elected then we were seeing from other indicators. It was likely that this divergence would correct itself at some point and perhaps the virus was just the catalyst that caused this.

So what do we do?

I am fond of saying that investing begins with the assumption that the world will not end. To that point, we think it is very important not to make decisions out of fear but try to remain objective and try to make the most out of the opportunity created. We are always looking to upgrade our portfolios and take advantage of opportunities created in these periods of dislocation. Additionally, there are some actions we can take like rebalancing and tax loss harvesting to help clients take advantage of this period of panic.

There are also some steps clients may want to take to both take advantage of what has happened and prepare for what could come to pass:

1. Check your budget and let us know if you expect to need any additional funds this year. We never want to be forced to sell on any given day so the more time we have to prepare for cash needs the better we can opportunistically raise the funds.

2. Refinance – interest rates are at all-time lows (again) with 30 year loans around 3.25%, 15 year loans around 2.875% and in 2020, the conventional loan limit was raised to $510,400. This might be a way you can take advantage of this situation.

3. Educate yourself – we all know that social and traditional media can add to panics of this nature so we would encourage you to educate yourself. We have included a basic overview of the virus and recommend checking out the Center for Disease Control "CDC"' website https://www.cdc.gov/coronavirus/2019-ncov/index.html.

4. Call us – if you are worried we want to talk through your personal situation. The markets are still much higher than they were a year ago and we are happy to review your financial plan and discuss your concerns.

5. Be patient – ultimately time is the most important factor in resolving this challenge. We know we will get past it and know that the probability of an effective treatment or vaccine increases with each passing day.

We are hopeful that we are making progress in the battle against this virus and it is important to remember that the markets likely will bottom before the news flow does. We will continue to watch, listen, learn and adjust our advice as the situation evolves. For now we are of the opinion that we are building a new wall of worry for the market to climb and hope to begin that ascent in the not too distant future.