

The Advisor

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Market Update – *Second Quarter, 2020*

THE VIRUS AND THE BEAR - On February 19, 2020, the price of the S&P 500 was at an all-time high. Just sixteen trading days later, on March 12, the S&P 500 closed the session in bear market territory. A bear market is defined as a 20% decline from the high. The culprit, of course, was the Coronavirus-19 pandemic. It was the fastest bear market in history. By March 23, the S&P 500 closed the session down 34% from its high while the Dow Jones Industrial Average was down 37%, shedding nearly 11,000 points.

There were hardly any asset classes spared from the carnage. Oil was crushed under the realization that demand was evaporating while at the same time OPEC and Russia were engaging in a price war and subsequently dumping supply onto the world market.

Investment grade corporate bonds sold off and their high yield counterparts were hammered even more as the global shutdown stoked fears of rising default rates and investors fled to cash. Some safety did exist inside U.S. treasuries and gold but even they experienced volatility.

Speaking of volatility, the chart below from a study by Scott R. Baker at the Kellogg School of Management at Northwestern University clearly shows the historical fear expressed in the markets. One has to go back to 1987 to find comparable volatility levels. The next stop from there is basically the Great Depression.

Professor Baker went on to illustrate how Covid-19 has had an unprecedented impact on markets. The study, *The Unprecedented Stock Market Reaction to COVID-19*, examined next-day, or that evening's, newspaper explanations for each daily move in the U.S. stock market greater than 2.5%, up or down, during the period from January 2, 1900 to March 24, 2020.

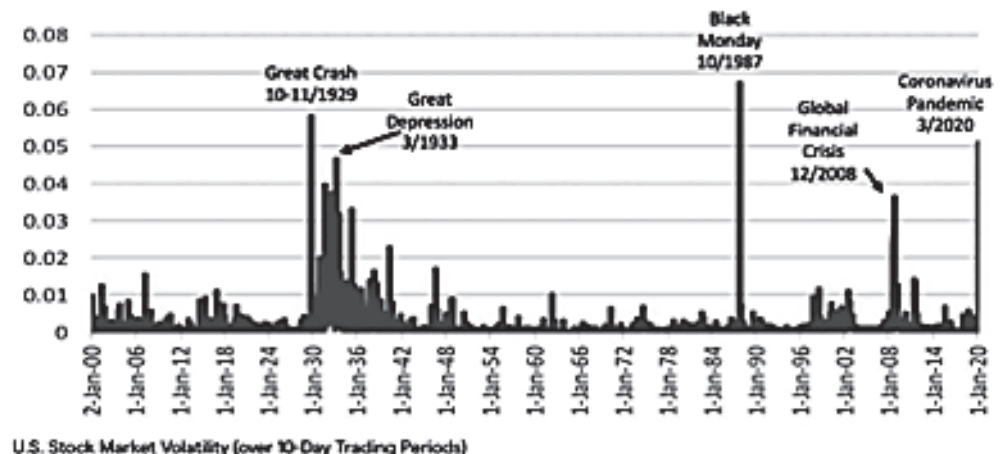
The explanations were classified into one of sixteen categories. Here are the results:

According to Baker, zero contemporary journalistic accounts attributed the stock market volatility to infectious-disease outbreaks or policy responses to such outbreaks in the period from January 2, 1900, to February 24, 2020.

Over the next month, from February 24th to March 24th, there were 18 days of market moves greater than 2.5%. Seven of those days were attributed to the Covid-19 pandemic and eight times the volatility was attributed to the policy responses to the pandemic.

Let's recap, examining the last 120 years, the analysis could not find one instance where the newspapers attributed the market moves to infectious diseases or policy responses to such diseases. Yes, this includes the Spanish Flu pandemic that killed an estimated 2% of the global population. However, from late February 2020, to late March 2020, there were 18 market moves greater than 2.5% and 15 of those moves (the actual number was 15.4) were attributed to news about Covid-19.

In summary, the study finds there has never been an infectious-disease episode that has influenced the stock market in the same way that Covid-19 has to date.



So where do things go from here? For starters, the market has staged an impressive rally, rising over 20% from the low on March 23. This rapid climb provides evidence to our belief that it is critical for long-term investors to stay invested even in times of extreme volatility. Research shows that cashing out and missing as little as the ten best days of recovery will dramatically reduce portfolio returns.

Additional fuel to the recent market rally can be attributed to The Fed, along with global central banks, utilizing monetary policy to keep liquidity in the system and provide a backstop for markets to function properly. This was crucial and the right move. Capital markets must have liquidity and access to safe assets, namely cash, to function properly. And make no mistake, without functioning financial markets there is no hope for economic health.

The Trump Administration and Congress also crafted several rounds of stimulus designed to assist workers and businesses. The size of the financial commitment from the government is on par with levels last seen during WWII.

Let's shift the conversation to what a recovery could look like. Keep in mind, every bear market and economic crisis, so far in history, has recovered and healed itself. We believe this will be the case for the Covid-19 induced one as well.

To differentiate the scenarios and provide a visual illustration of the possibilities we'll look at the letters V, U, L and W. Applicable to each scenario is the degree to which we are able to control the virus. Meaning, the course the disease takes from here will impact the course and length of recovery across the globe.

V: In this scenario a recovery occurs, essentially, by year's end. This case is heavily influenced by positive developments to combat the virus such as a vaccine, mass testing or other advances in the treatment of the disease. Moreover, hotspots that have been severely impacted must show improvement and a move towards normalcy. The stimulus in the system creates a ripe environment for commerce to storm back alongside a crescendo effect of demand from the consumer.

U: Here we are looking out mid-to-late 2021 before we see healthy recovery. Three factors stand out in this scenario. One is an echo effect from the virus where pockets of the infectious disease take hold again. The second is the fear and disruption that has gripped consumer behavior takes longer to dissipate. And finally, extreme market volatility causes credit

and financial conditions to tighten and counteract some of the stimulus in the system. Any one of these factors in isolation, or combination, would derail the V and produce a U.

L: By our definition, in the L, a full and healthy recovery does not happen in the foreseeable future. The global shutdown is extended. Unemployment and consumer demand worsen, bankruptcies and credit defaults accelerate and the supply side is decimated. Bottom line, there is permanent economic damage that strips away the prospect of recovery.

W: This recovery path is basically a combination of the other scenarios overlapping. The V-shaped path underpins the start to the recovery while a degree of U and L take hold as the economy and markets realize the foundation is not strong enough to support the move. Eventually, conditions do stabilize and give way to an accelerating recovery that takes us to pre-covid levels, if not stronger.

There is no debate that the world has changed from this pandemic. It will cause us to evaluate so many different aspects of not only our healthcare systems but our economic and behavioral practices as well. What will not change is the opportunity that capital markets present to those investors willing to remain patient, disciplined and committed to the long-term.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an unbiased opinion based on your specific situation.



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