Greeting the Bear

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Markets have been infected with fear and uncertainty due to the Novel Coronavirus. With speculators dumping stocks, the Dow finally succumbed to the bear yesterday by falling more than 20% from its most recent peak. Losses have accelerated as speculators try to evaluate the immediate impact on earnings, viewed through the lens of the consumer.

The U.S. economy is driven primarily by the consumer. That is, we get paid for work and then we go out and buy stuff. The Coronavirus is impacting that pattern. So far, it hasn't significantly impacted employment and wages, although layoffs, particularly in travel and leisure and retail likely are around the corner. It has definitely impacted spending in specific industries such as travel, and we will see more impacts as social distancing is encouraged and/or mandated.

It should be noted that this coronavirus is not the only theme which is driving markets. Over the last decade, the U.S. has become the number one producer of oil, thanks mostly to development of efficient fracking technology. Fracking, however, isn't cheap, and there's some floor on the price of oil below which many frackers fail to make money. With the demand shock due to virus concerns lowering the price of oil, Saudi Arabia decided to pick a fight directly with Russia, and indirectly with the U.S. Instead of cutting production to support the price of oil, the Saudis are increasing production, pressuring the price of oil and potentially forcing several frackers out of business. This is bad news for the highly levered oil patch and was a big reason for the selloff which occurred on Monday. The point is there are other themes driving global markets beyond the virus.

How far can markets fall on all this bad news? That is, of course, the crystal ball question. I'll save the suspense – I don't know, and that's the point. Markets abhor uncertainty, and right now, it's difficult to forecast the length of the disruption and the decline in earnings.

According to Goldman Sachs research, bear markets which are event-driven have, on average, seen falls of 29%, last for about 9 months, and recover within 15 months.[1] Whether this downturn will follow the same pattern remains to be seen. By contrast, bear markets which are structurally driven (triggered by imbalances or a bubble), tend to experience more protracted declines which average a 57% drawdown. The risk is that this event-driven decline lasts long enough to break parts of the economy, morphing into a structural decline.

Should you time the market by selling out now in hopes of buying at a lower point? While that sounds good in theory, in practice, it's much more difficult to pull off. Many investors who try this strategy end up buying back in once some form of "all clear" has been signaled. However, by that point, markets generally have moved higher than the exit point, resulting in an inferior market returns. The more realistic approach is to acknowledge that the cost of pursuing a higher return over longer periods is volatility in the short run and to look to the potential for markets to recover over the coming market cycle.

That does not have to mean sitting idly by. Tweaking the risk profile of the portfolio is different from timing the market. Those adjustments can be made by increasing credit quality in fixed income or using hedged strategies to offset some of the potential equity downside while not completely giving up recovery participation. That also could mean taking some profits – yes, even after the decline of the last few weeks, most equity portfolios remain positive over the last decade's bull run.

I'll close by providing a quote I borrowed from a colleague: *"During this period, cover your nose and mouth for your health, and cover your eyes and ears for your sanity."*

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1 "Bear Essentials: a guide to navigating a bear market," Goldman Sachs Global Macroscope, March 9, 2020