In search of the silver lining

Opinions as of March 17, 2020

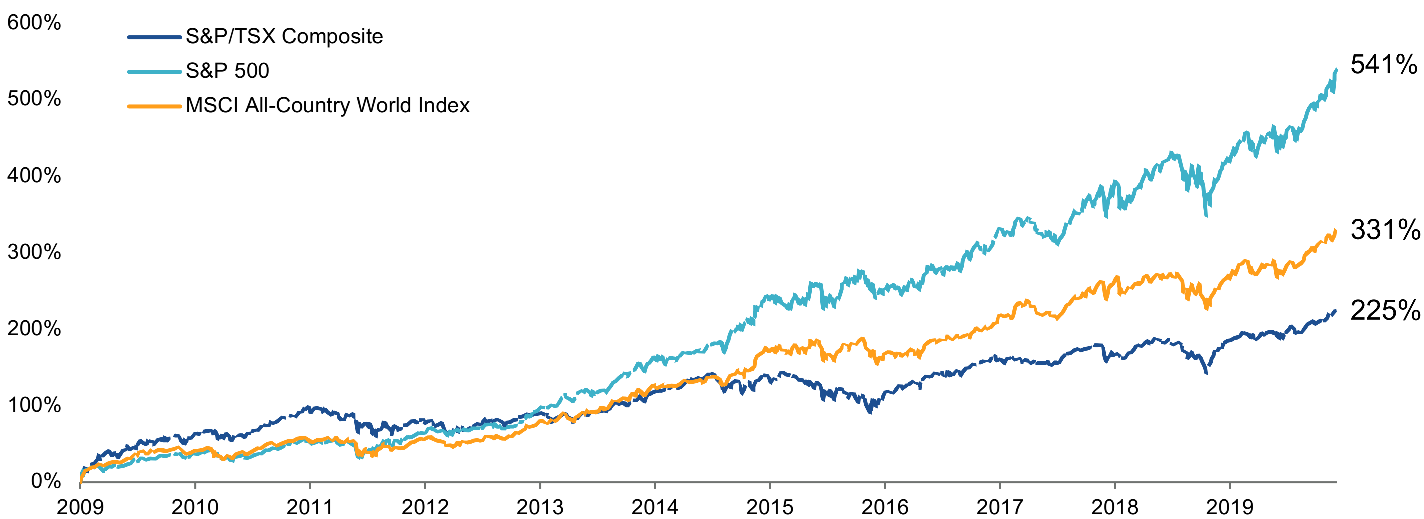
It's official: we are in a bear market. And as the saying goes, "all good things must come to an end."

The fact is, the U.S.-led global equity rally that started in 2009 couldn't be sustained indefinitely. Last year alone we saw a near-30% return in U.S. equities, during a period in which corporate earnings grew basically 0%. Yes, central bank accommodation was a major factor, and the year-end numbers should be considered in the context of the pullback we saw in Q4 2018. Even so, we continued to see equity markets reach all-time highs as recently as February 2020, capping an exceptionally strong period of equity market growth.

When we put the gains over the past 11 years in perspective, it looks like this:

Equity market cumulative total return (in C$)

Mar 9 2009 to Feb 12 2020 (trough-to-peak)



Source: Bloomberg. Data accessed March 13, 2020.

But for the last five years, it seemed that every minor correction brought with it whispers of a larger drop. Then, on March 11, 2020, the day the COVID-19 outbreak was declared a pandemic and oil prices plunged following the collapse of OPEC+, we got our first 20% peak-to-trough drop in the Dow Jones Industrial Average since the 2008 financial crisis. The day after, it only got worse.

In the months leading up to the selloff, investors were already worried about slowing global growth and U.S.-China trade tensions. Meanwhile, a decade of global central bank accommodation in the form of rate cuts and asset purchases has pushed debt levels to new highs. This has led to heightened concern over financial system vulnerability, and the worry that central banks have less and less ammunition to combat the next economic downturn. In recent years there have been increasing calls for fiscal stimulus to help boost economic growth, which have led to bold ideas such as "helicopter money" and Modern Monetary Theory.

What this all boils down to, is that even before the coronavirus hit markets, we were well into the late stage of the current economic expansion cycle.

Below, we share some factors that are helping guide our decision-making process as long-term investors and stewards of our clients' portfolios.

This is not 2008, thankfully

There were multiple asset bubbles that burst around the world in 2008, including the U.S. housing market. That collapse, and the precipitous fall in debt instruments related to the U.S. housing market, pushed the global financial system into crisis. Households around the world experienced a significant loss in wealth, including real estate, that for many has yet to be recovered.

The coronavirus outbreak, on the other hand, can be characterized as an "exogenous supply and demand shock." Countries are now focused on reducing the human costs through various containment efforts that will create a drag on economic activity. While this means the global economy may experience a period of recession, the virus is unlikely to collapse the financial system as was the case in 2008. Once the virus is contained, economic activity should rebound to pre-containment levels.

Historically, pandemics haven't lasted long. The Spanish flu of 1918, the worst pandemic in modern history, lasted about two years. Europe currently appears to be at the height of the contagion and North America is just getting started. China and South Korea, two of the initial countries to be affected, are already seeing a tapering off in the number of reported cases. Eventually the virus will go away. It's a just a matter of when.

A stress test for the U.S. healthcare system and the importance of containment

We believe the wildcard here is the U.S., where authorities have barely started widespread testing. Once they do, we expect to see a similar trajectory as in Europe and Asia. That said, we have little confidence the U.S. will be able to contain the virus in the same manner as China or South Korea. While the U.S. initially botched containment efforts, they have recently focused on "flattening the curve." That is, slowing the spread to ease the immediate impact on the healthcare system. To that end, many sporting events have been cancelled/postponed, as have large entertainment gatherings and many large conferences. The U.S. government finally declared a national emergency last Friday, providing nationwide testing as part of the countermeasures.

But this will only provide partial relief. When the pandemic reaches its peak in the U.S., it will place an enormous strain on the healthcare system that many call inefficient, particularly for the millions that do not have adequate coverage. It may be farfetched, but this could be the catalyst that forces policymakers to tackle healthcare reform (again).

Corporations will emerge better prepared for future crises

Companies around the world are now in full business continuity plan mode. Part of the reason that Asia has managed a more successful containment is that countries already went through this with SARS back in 2003, so they were quick to act. This is the first time in decades that Western countries are dealing with a full-blown pandemic. No doubt there will be near-term disruption, but any businesses struggling with their contingency plans will become that much better prepared for future disasters.

The world is working together

Authorities everywhere are making coordinated efforts to stop the virus. For example, last week China flew a team of COVID-19 experts to Italy. Communication has been much better than during previous global outbreaks. During a time of increased nationalism and populist movements, this kind of cooperation is not a bad thing.

Fiscal stimulus is on the table

As clearly indicated by market reaction, supply chain disruptions and a reduction in hours worked caused by virus containment efforts cannot be solved with monetary policy. Government spending is fraught with political challenges at the best of times. Yet the coronavirus has escalated the urgency of such measures, and now we're finally seeing policymakers come around to the idea of stimulus. Canada has announced a $1B stimulus package, the U.S. has announced a US$8.3B stimulus package, and even Germany, eurozone's champion of austerity, is prepared to do "whatever is necessary" to combat the virus.

Whereas monetary policy is often described as a "blunt instrument," fiscal policies can target specific industries, sectors, tax brackets, income levels, and more. If politicians get comfortable with the idea and it's executed well, fiscal policy can have effects that last beyond cushioning the short-term coronavirus impact. This could be the stimulus developed economies need to get us out of this period of sluggish global growth.

A potential catalyst for our energy transition

China's response efforts and their economic shutdown, along with the unfortunate timing of the collapse of OPEC+, have not only reduced oil demand but also increased its supply as Russia and Saudi Arabia crank up production. This could force Ottawa to take an even harder look at the nation's oil dependency. An oil crash happened in 2015, and it's happening again now. And with each oil shock, more projects get shelved, and more production cuts get made. We hope the federal government is inspired to take serious steps and come up with a concrete plan to transition our economy to a more sustainable future.

Investment implications

Equity and bond markets are pricing in a global recession, but we expect it would be relatively short. Prices of low-risk assets such as government bonds have soared and are now at or near record levels. On the other hand, riskier assets such as equities and credit are starting to look increasingly attractive. Indiscriminate selling often creates opportunities for active managers who can purchase quality companies at cheap prices.

For our part, we remain vigilant as always, assessing market action and economic data points and inputting that information into our asset allocation model. When we eventually emerge from the crisis, we expect to take advantage of opportunities to help drive higher long-term returns for our clients.

Whether equity markets rebound next week, next month or later will largely depend on the success of North America and Europe in containing the virus. The lessons from Asia and Italy are clear: we need to slow the spread. Access to tests is critical, as are social distancing practices. We will likely need to see new cases peak and start to fall before the markets bottom. Once we're past the peak in new cases, the markets will begin to price in a recovery. When this happens, the rebound could be quick. Let's not forget, some of the best days in the market come right after the worst days.