Jay Allan McCormick
Peter John Quinn
Thomas Jay Barrett, Jr.

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Bears and Bulls

A one-two punch from a virus with global aspirations and an ill-tempered oil war between Saudi Arabia and Russia has knocked the stock market on its tail. As of the date of this newsletter, the S&P 500 index is down almost 19% since it hit a record closing high February 19, just barely above the bear-market threshold of 20%. (These thresholds and some of the other numbers in this letter come from Standard & Poor's keeper of all things index, Howard Silverblatt.) Several other stock indexes representing smaller corporations and overseas companies already have fallen more than 20% and are presently in a bear market. All of this has happened in just a few weeks, adding to the sense of stress in the markets.

We have enjoyed an unusually long spell between bear markets in the U.S. – almost 11 years. In the past, bear markets came along typically every two to seven years. Bears come in all shapes and sizes. All seem scary at the time but some are relatively mild, like the 22%-down bear market in 1966, or the barely bear market that led stocks down 20% in 1990. Others such as the 2008-2009 plunge of more than 55% are truly terrifying and typically represent some larger economic problem such as that era's overheated housing and lending markets and subsequent wave of home foreclosures and failed lenders.

In the end, bear markets are a normal part of the stock market cycle. They serve to help clean out overly speculative trades in some sectors. Also, they are followed (by definition!) by bull markets. For investors who have selected an asset allocation plan appropriate to their tolerance for risk, these bear and bull cycles bring opportunities to rebalance and buy low and sell high to stay at the allocation target.

That's not to say we all should wave off the rapid spread of Covid-19/new coronavirus as a non-event. Supply chains for many goods, including technology, autos and pharmaceuticals, have been disrupted by the shutdown of large parts of China and now all of Italy. That's called a supply shock. At the same time, consumer and company worries about the illness have led to a big drop in air travel and cruises as well as cancellations of many meetings and conferences. So parts of the economy are suffering from a demand-related shock. Both of these economic effects will take a while to work through. Economic growth will be lower and some countries might see a dip in their gross domestic product (GDP) figures for a quarter or two.

Governments throughout the world already are working in various ways to mitigate the economic effects of the virus and to protect against more rapid spread of the virus. The Fed cut short-term interest rates by half a percentage point last week. The administration and Congress are working on fiscal stimulus measures possibly including tax breaks, help for workers who have no company-paid sick leave and government guarantees of the debts of the most affected companies such as cruise operators.

As for the oil price war, there's a bit of historic symmetry involved and a mixed message now for the U.S. due to the sudden plunge in oil prices. As for the history: One of the more severe bear markets since World War II came in 1973 and 1974, when OPEC first flexed its muscle as an oil cartel and cut production to drive oil and gasoline prices higher. There was widespread panic about being able to buy gas and long lines of cars formed at gas stations across the country. The S&P 500 index plunged more than 48% by October 1974 as inflation spiked and the effect of suddenly higher gas prices (equivalent to a tax hike in its economic effect) gripped the nation.

Today, one of the big drivers of the stock market's sudden turn toward bear territory was OPEC's inability to convince Russia to go along with cuts in production to offset a sudden downturn in demand for oil due to the new coronavirus. When Russia declined to cut production, the Saudis decided to increase their own production and offer customers discounts on Saudi oil. That is leading to a glut of oil worldwide and sharply lower prices. Some have called this the end of OPEC. But the sudden drop in oil and gas prices, while terrible news for U.S. energy companies and perhaps banks that did a lot of lending in that sector, both reduces inflation and acts as a boon for consumers who will shell out significantly less for their driving.

Just as the one-two punch of the effects of the new coronavirus and the sudden onset of a price war in the oil markets came on quickly and unexpectedly, so too might an economic recovery and rebound in the markets – once the world economies work their way through the effects of the virus and the reverse oil shock. There still could be bumps in this road that cause the markets to slip into a bear market. But at some point, the recovery when it comes will have some extra power behind it thanks both to pent-up demand among consumers and manufacturers as well as all the stimulus measures being worked on around the world.

In the end, the lesson is not to just roll with the punches but to be prepared, when the occasion arises, to give your portfolio a few counter-punch jabs of your own. Markets fall but they get back up and move on to higher heights. Bear markets are scary, and this one could get more frightening before things start to get better. But the long-term strategy is the key thing. Long term, stocks will provide a total return of 9% to 10%. You have to stay in the game to collect those returns. Remember that we are in your corner to help with all of this. Please do not hesitate to call or drop us an e-mail with any questions or concerns that you may have.