CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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The Black Swan Event

Many investors were quite sanguine about the effect that coronavirus would have on economies and markets.

So much so that as recently as last week, the S&P 500 made a new all-time high. Then, oops, coronavirus spread to more than 40 countries.

The black swan appeared. Stock investors raced for the exit.

Coronavirus is the black swan event for the financial markets and the global economy. So strong has been the prevailing view that the stock market can only go up and that the Federal Reserve will prop the stock market no matter what is going on in the economy, that stocks blithely set new all-time highs only a week ago, weeks after the extent of the epidemic in China became known. In the last week in January stocks fell a bit, then resumed their upward march until February 20th. In the past six sessions, the S&P 500 has fallen by something more than 12 percent and is now down 8 percent for the year to date. Interestingly, however, throughout January and February, long-term US Treasury bonds, Core's largest investment for its clients, have continued to rise in price as their yields have fallen to all-time lows. Similarly, gold, our second largest investment, has moved smoothly and steadily higher, seen as a safe haven in this now more dangerous world. Long-term Treasuries are up by 9 percent this year and gold is ahead by 6 percent. As a result, Core's clients' accounts are markedly higher now, as the pandemic spreads, than before it emerged. Typical client accounts are up about 8 percent so far this year, although there is, of course, some variation in returns among accounts.

Given the very rapid selling in stocks in the last six sessions, they are quite 'oversold' on a short-term basis. And, unsurprisingly, long-term Treasuries and gold are 'overbought,' although to a lesser degree than stocks are oversold. It is quite reasonable to expect that in the short-term, the markets will reverse and that stocks will recover some of their losses, while bonds and gold give back some gains. However, unless, by some miracle, the coronavirus goes away suddenly, it is likely that bonds and gold will be selling at higher prices some months from now and that stocks will be lower than where they stand now.

We have made a couple of investment changes in the last month. First, we bought a small position in utilities stocks, our first investment in stocks in over a year. This is still based upon my thesis that the economy is weakening--and probably more rapidly because of coronavirus--and that investment capital will continue to flow to the safe and somewhat stodgy utilities. Folks do still need to turn the lights on, even if they are not spending and travelling as much. More recently, I sold our position in high-grade US corporate bonds. Our investment in these bonds, via an ETF with the symbol lqd, has been a good one, but I am concerned that, if the economy continues to weaken, especially with the uncertain path of coronavirus, corporate earnings may continue to weaken, even to the extent of not being able to meet their interest payments on their bonds. The risk is not a huge one, but, given that we can invest in US Treasuries with no repayment risk, it seems imprudent to hang on to the corporate bonds.

By

Jack Mayberry

One cannot know how coronavirus will develop and spread. One cannot know how it will affect economies. Caution is the best approach.

The trajectory of coronavirus is unknowable. It seems to spread easily, but the death rate for those who contract it appears to be somewhat low. Optimists acknowledge that the global economy is slowing because of its effects, but they hope for a 'V-shaped' recovery, implying that once coronavirus is 'under control,' the affected economies will rebound rapidly. Maybe. However, travel has certainly slowed, manufacturing, particularly in the affected parts of China, has stalled. Japan has closed schools; presumably parents will stay at home to look after their kids, instead of continuing work at their offices, shops, and factories. Such things will happen in country after country as the disease spreads.

Investment commentators expect the Fed and other central banks to come to the rescue, but short of developing an effective vaccine, it is hard to know what help central banks can offer. (Developing vaccines is not part of the central bank tool kit, at least as I understand it.) Coronavirus affects both supply-side economic issues and demand. Keeping people from work, disruption of just-in-time supply chains, uncertainties about the scope and extent of the disease, and impairment of companies' capacities to meet credit obligations all suppress the supply of goods and services. These in turn lessen demand for employment, cut disposable income, and lessen wealth and confidence. These matters are not readily correctable by central banks.

Core's plans. Our investments have not been adversely affected by coronavirus. Investors have turned to the safe havens of US Treasury bonds and gold in this crisis. Thus one could say that, to a degree, coronavirus has helped our investments. We cannot know how the epidemic will develop and spread; we cannot what will be its short-term and long-term economic effects; we cannot know what will be the financial market impacts of coronavirus. Thus, we will be cautious and watchful.

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