The Winter of Our Discontent

Global equity markets, about which most investors continued to find myriad reasons for optimism across the first seven weeks of 2020, gave way to rising fears of a worldwide coronavirus pandemic toward the end of February. The result: a sea change in investor sentiment, which shifted from widespread optimism to rampant pessimism within a single week and drove equity markets down nearly -13% from an all-time market high on February 19. The euphemism for what has transpired is a "market correction" (a price decline of -10% or worse). But labeling what has occurred this week as "panic selling" (i.e., three days of -3% or worse price changes) does not, to us, feel particularly hyperbolic.

To state the obvious, neither people nor financial markets like the uncertain outcomes of something like the coronavirus. It is the type of confidence-shaking event that we recently (see our January 2020 *Annual Market Perspective*) described as an unknown unknown. With respect to the coronavirus, we leave the epidemiology questions and issues to medical professionals. And the critical policy decisions to relevant government entities. The only clarity we have from a financial market perspective *at this very early juncture:* anecdotal evidence that consumers and businesses alike may be starting to adjust their spending plans in the face of uncertainty. The natural consequence of such collective pullbacks – if they continue for a period of time – would be an economic slowdown. And, of relevance to the stock market and investors therein, lower quarterly/annual earnings for publicly traded companies.

Suffice it to say that it is far too soon to make any predictions as to what, if any, impact the coronavirus will have on the US and global economies, much less the earnings that underpin equity market prices. Or what it will take for investors' collective sense of panic to ease. Selling seems to beget selling in markets like this until investors collectively "catch their breath" and re-evaluate the prospective returns available on stocks in comparison to the risks taken.

Prior Short-Term Panics: A Recent Case History

Previously, we have cited the sharp downturn of -15% in late 2018 as a recent example of another precipitous sell-off. It occurred between December 3-24, came atop a more gradual decline of -4% that had begun that October, and brought the overall late-2018 decline to nearly -20%. As shown in this table, it too was the product of a rapid (in this case, over a total of 16 trading days) reassessment of market prices in the face of uncertainty. What shook markets at the time: higher interest rates (the Fed boosted rates four times in 2018, with the last such increase coming on December 19) and growing concerns that Federal Reserve policies were increasing the possibilities of an economic slowdown in 2019. But as shown, at the time (and even earlier that Fall) consensus earnings estimates were not being revised downward.

	Est EPS	P/E Ratio	Price
Values			
12/3/2018	$ 163.83	17.0	2,790
12/24/2018	$ 162.45	14.5	2,351
1/31/2019	$ 168.24	16.1	2,704
Changes			
12/3 to 12/24	-0.8%	-15.0%	-15.7%
12/24 to 1/31	3.6%	11.1%	15.0%
12/3 to 1/31	2.7%	-5.6%	-3.1%

Although using the term panicked selling to describe a decline of nearly -16% across 7 trading days may seem overdone, it is a succinct way to capture then-prevailing investor sentiment. Ultimately, it was not a backtracking of Federal Reserve policy that staunched the 2018 sell-off; the decision to hold rates steady came in January 2019. Rather, by late-December valuations had reached a level (i.e., a P/E of 14.5x estimated earnings) at which the consensus shifted to a view that the market was oversold; that prices more than fully discounted the risks of a modest economic slowdown and a potential hit to earnings. Defying most year-end bearish predictions, investors collectively shook off their angst in early January 2019, with a combination of improved earnings expectations and rising valuations thereafter offsetting most of December's losses.

The Current Environment: How Far Can Prices Fall

Intra-year market corrections of -10% or greater are a near certainty in global equity markets, with the most notable recent exceptions to this rule-of-thumb occurring in 2017 and 2019 during which the largest US stock price declines were only -3% and -7%, respectively. True Bear Markets are (fortunately) rarer; most investors will recall and hope to never repeat the terrible experiences of 2000-2002 (-47%) and 2008-2009 (-55%).

We cannot predict the level at which the current stock market downturn will bottom-out or when. We can, however, more reliably calculate a range of potential go-forward outcomes based on two variables: changes in consensus earnings estimates and changes in market valuations. There is insufficient current economic data to predict the first variable (earnings), but it seems a better-than-even proposition that earnings estimates will decline (not increase) due to the coronavirus crisis versus the optimistic consensus views of just one week ago. Likewise, valuations (P/E ratios) would seem unlikely to approach the elevated mid-month (19.5x) level anytime soon. An adverse – though not necessarily pre-ordained – outcome would be earnings pessimism (e.g., a -7.5% cut in 2020 earnings estimates due to coronavirus-related economic softness) twinned with a further downtrend in valuations.

This table shows a range of *potential outcomes* beyond the -13% decline that has occurred since mid-February. As highlighted, prices could drop a further -4% if valuations fall to only modestly from here (to 16.0x) and earnings expectations are unchanged. But additional double-digit losses could result from even more conservative earnings estimates as the coronavirus crisis unfolds and still-lower valuations are applied to them (as highlighted, for example, additional losses of -16% loss if earnings estimates are cut -7.5% and valuations are trimmed to 15x).

P/E	Change in Estimated Earnings			
Ratio	-10.0%	-7.5%	-5.0%	0.0%
18.0	-2%	0%	3%	8%
17.0	-8%	-5%	-3%	2%
16.0	-13%	-11%	-8%	**-4%**
15.0	-19%	**-16%**	-14%	-10%
14.0	-24%	-22%	-20%	-16%

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The Longer-Term Case for Equities

Any decision to exit equity investments -- or to put more cash to work in equities – should be made with some considerations given to the prospective returns available on other asset classes. The "flight to safety" trade characteristic of most equity market corrections – in which investor buying of Treasury bonds pushed their prices higher and their yields lower- has recurred this month. Yields on 10-year Treasury bonds have fallen from an already low 1.66% in early February to an all-time low of 1.30% currently. As attractive as a near-guaranteed positive return on bonds appears in an environment of -15% returns on stocks, the long-term mathematics show a near-certainty that stock market investments will ultimately achieve multiples of the bond market's annualized outcomes.

This table shows a range of possible returns on stocks across various time horizons and varying final valuations (assuming +6% annual earnings growth and 2.1% dividend yields; both factors are consistent with historical results and our forward-looking models). It suggests that, whether the market remains pessimistic (and applies a P/E of just 14x to earnings) or again becomes more optimistic (e.g., P/E of 18x), equity returns will likely far outstrip those of a comparable maturity Treasury bond (as shown at the bottom of the table) across an interim or longer-term time horizon.

Ending Valuation (P/E)	Time Horizon (Years) 3	5	7	10
18.0	11.1%	10.0%	9.5%	9.1%
17.0	9.0%	8.7%	8.6%	8.5%
16.0	6.9%	7.4%	7.6%	7.8%
15.0	4.6%	6.0%	6.6%	7.1%
14.0	2.2%	4.6%	5.6%	6.4%
Treasury Bond	1.1%	1.1%	1.2%	1.3%

Conclusions

History is not always a good guide to what comes next– aspects of the coronavirus are unique as is the more globalized world in which it has emerged – but historical precedents of how not to react to free-falling markets are both numerous and a mostly reliable guidance for what to do next. **Selling when stocks fall this rapidly is rarely a good plan**. And with the track record of past price recoveries suggesting that the speed with which any bounce-back occurs will be slower than the rate of decline, investors will have time to consider if they want to put additional money to work (perhaps at potentially better prices). Although the prospective short-term returns on "safe" alternatives to stocks – chiefly taxable and tax-exempt bonds – look good when investors writ large are panicking, equity market investments will more than amply reward long term investors who stay-the-course presently.

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