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What Happened?

This week has been the most volatile week for stocks since the financial crisis. Let's walk through what we think happened, the potential causes of recent volatility, and what to do next.

March 13, 2020

What Happened?

It's hard to know what moves the market on a daily basis. Since traders are not required to explain their reasons for executing trades, all we can do is look for patterns and confer with other institutional investors.

That being said, although coronavirus headlines most likely fueled the sell off, we feel that two additional forces were at play.

First, there seemed to be a lot of forced selling from big institutional investors. Banks and other large financial institutions typically employ teams that manage risk. They create rules that attempt to limit exposure to various types of risk. One example would be to cap the number of loans a bank gives to energy companies to prevent risk of default if oil prices crash.

Others create rules around how much exposure to the stock market they should have at any given time. For example, if a pension fund wants to keep its stock market risk contained, its risk managers might create a line in the sand. If stocks fall below this threshold, they would sell to lower their exposure to equities.

Keep in mind that the decision to sell has little to do with the fundamentals of the economy, nor is it data driven. It is purely a mechanical response to market activity and often done more to appease regulators and executives than based on an investment thesis.

We think that much of the selling today was a result of this exact circumstance – forced selling by institutions not because they feel the world is ending but because they are following rules.

The second catalyst likely came from the bond market. Bondholders appear to be worried over the impact of the coronavirus and recent oil market selloff. The concern is that the ability for borrowers to repay their loans could risk rising default rates.

Making matters worse, the bond market has surged over the last 15 months and pushed prices to meteoric levels. When assets are priced for perfection, they need to be perfect. Right now, things are not perfect, particularly in the energy sector.

These fears appear to be pressuring the bond market, which can often create a ripple effect on stocks.

Why All The Selling?

An asset's "liquidity" is measured by how easy it is to sell. A publicly traded stock is very "liquid" because it can be sold instantly with relatively low transaction costs. This is one of the best qualities of stocks and also one of the worst.

During times of extreme stress in financial markets, we tend to see stocks, bonds, and even sometimes gold move together for one reason and one reason only – they are liquid. Meaning, since they are so easy to sell, they get sold first. Little else gets factored into the decision.

For example, if someone had to start selling assets to pay bills, they tend to sell what sells fastest first. Homes and cars take a while to sell, but stocks and bond funds sell immediately. Again, this decision is not based on some thesis that indicated a looming recession. It is based off a need to raise cash and do it fast.

Going back to markets, what we are seeing is quite rare. It hasn't happened since the financial crisis. Anything that was liquid, including stocks, bonds, gold, and most other tradable assets, was sold.

Add it all up and this is textbook panic selling. The U.S. economy is a monstrous $20 trillion machine. Think of it as an oil tanker - course corrections take a long time, and if you watch closely, you can get a pretty good sense of where it's headed. So, when the stock market moves around like a speed boat, that tells me something other than the economy is driving stocks.

Right now, that something is panic. But here's the thing about panic and pretty much every other emotion out there – they don't last. Nor are they likely to derail the entire U.S. economy. It's just too big. Eventually, the market will go back to being fueled on the economy, but it's impossible to know when.

Why Aren't We Panicking?

There are three reasons why we believe this will pass.

The first is that this, in no discernable way, resembles the weeks leading into the financial crisis (the last time panic selling like this happened). The table below compares the economic data that really matters from back then to now:

	Pre-Crisis	Today
Unemployment	6.1%	3.5%
Inflation	5.4%	1.7%
Interest Rates	5.2%	1.25%
Corporate Debt	High	Low
Consumer Debt	High	Low

Source: Bureau of Labor Statistics, Federal Reserve Bank

The economy was a mess well before the financial crisis began. Inflation was multiples higher of where it is today, unemployment kept rising monthly, and the Fed had been raising interest rates to slow down the economy and control inflation.

Today, we have the lowest peacetime unemployment in 70 years. Inflation is below the threshold where the Fed would want to slow down the economy, and debts are nowhere near the dangerous levels seen back then. It's apples and oranges.

There is no question that the coronavirus pandemic will impact the U.S. economy. However, there is much debate to the severity and duration of impact. Here, we expect economic activity to be delayed, not destroyed.

If I want the new iPhone but a manufacturing shutdown in China keeps it off the shelf, I won't cancel my Verizon contract. I'm just going to stick with my old phone and wait until the new one is available.

This behavior will likely have a temporary impact in the second quarter. We expect to see no growth in the U.S. (perhaps even negative growth) with a rebound in the second half of the year.

The second reason we are not panicking is the Federal Reserve Bank (Fed) is on our side. The Fed is pretty much the only entity that can move the entire U.S. economy because they control interest rates and access to capital, and this is a big deal.

Since 88% of the U.S. economy is fueled by consumer spending (70%) and business spending (18%), interest rates are the life and blood of the economy. When rates are low and cash is accessible, people and companies buy more stuff.

Right now, access to cash has arguably never been better, and the Fed has made several moves over the last two weeks to ensure this does not change. They also have other tools in their arsenal if things deteriorate further from here. All of this indicates to us that the last thing the Fed wants is a recession and will do what they can to keep the economy moving.

The third reason is that we feel we prepared for this long ago. Our investment philosophy focuses more on managing risk than taking risk. Meaning, rather than try to guess when bad stuff will happen, plan for it in advance through diversification. That way we can aim for a smoother ride.

Furthermore, we had already adjusted our investment models prior to the panic. Well run companies tend to adapt to new environments, so our preference for quality remains intact. Given the reaction in financial markets, the models appear to be behaving in line with our expectations.

What To Do Now?

Trading through times like these is like trying to break up a fight at a hockey game. No matter what your intentions, you are probably going to get hurt really bad, so it's best to just let it run its course. Eventually, the brawlers (traders) will get tired, emotions will normalize, and you will have probably saved yourself a trip to the ER.

I cannot stress enough the risk that individual investors take when they succumb to the temptation of panic selling. It's human instinct to seek protection during times of stress, and while the perceived safety of cash may seem appealing, it's almost always a trap.

Let's go back to the financial crisis. What really caused people to lose so much back then? It wasn't the evil hedge funds, or massive debts, or subprime loans. None of that. People lost money because they sold into the panic. It is that simple.

What makes this so tough is since this doesn't happen very often, even some of the "professionals" will run around with their heads cut off. It's been too long since the last bout of panic selling, so most have forgotten what it looks like, but more importantly what it feels like.

Pundits on television only make this situation worse by prophesizing cataclysmic outcomes for investors. Predicting bad stuff sounds smart and helpful, while suggesting optimism sounds sensational and more like a sales pitch. That's what happens in times like these (although Jim Cramer's recommendation to the IRS to suspend all taxes gets my full endorsement)[1].

The bottom line is that panic selling is in full gear. I don't know when it will stop, but the absolute worst thing to do is to act on emotion. We feel prepared to weather this storm and will remain focused on data and facts to guide our investment decisions. Right now, these are telling us to steer clear of this fight.

Sincerely,

Mike Sorrentino, CFA

Three Key Points

1. This week has been the most volatile week for stocks since the financial crisis.
2. This is what panic selling looks like.
3. Steer clear of this fight.

Sources

1 https://www.marketwatch.com/story/jim-cramers-epic-rant-the-government-should-suspend-tax-collection-2020-03-12

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