MV CAPITAL MANAGEMENT

Weekly Market Flash

Black Swan, Defined

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Sometimes it is useful to take a well-worn phrase out of the abstract and attach it to a definite event playing out in real time. The worldwide outbreak of Covid-19, the coronaviral disease that began in China last month, is a textbook case of a "Black Swan" – an event that suddenly manifests in the absence of any prior knowledge that it even existed. In December 2019 nobody, anywhere, was factoring "China-originated respiratory virus going global" into their 2020 scenario modeling, because there was not a single reference point to indicate even the latent, let alone active presence of such a threat. The arrival of a number of patients at hospitals in Wuhan City, Hubei Province, China with an unusual variation of pneumonia did not happen until early January, and even then it was unclear to anyone whether this was anything other than a statistical anomaly.

And yet here we are, with the month of February drawing to a close, and over 82,000 known cases of Covid-19 in all continents except Antarctica. The S&P 500 set a milestone of the type nobody ever wants to see this week: six straight days of decline and the fastest percentage drop (12 percent as of Thursday's market close) for that time period since the one-day wonder of Black Monday in 1987. And this morning's pattern (we are writing this just as trading is getting under way) suggests that the fear element has not completely played itself out. This is one of those times that tests nerve, patience and resistance to fear.

What We Know…

There are a few reference points on hand from which to make comparisons about how this current outbreak is playing out and the potential impact it might carry. Here is what we know about Covid-19 in relation to two other fairly recent viral outbreaks: the SARS epidemic in 2003, which was also a coronaviral disease, and the Ebola episode in 2014-15 (Ebola was a different form of virus). According to the World Health Organization there was a total of 8,096 cases of SARS before the outbreak was pronounced contained in July 2003. The mortality rate was about 9.5 percent (during that time there were 115 SARS cases in the US but zero deaths). The disease had no perceptible impact on investment markets (at the time China was only in the very early stages of its supersized growth cycle and was not yet home to all the intricate supply chain webs that exist today).

The Ebola crisis that began in March 2014 was a much more deadly epidemic, with a mortality rate of 41 percent and a total of 26,300 cases, almost all in West Africa, before it ended in late 2015. Ebola had a brief impact on global securities markets that coincided with a single Ebola-related death in the US. That week, in early October 2014, the S&P 500 briefly fell over 7 percent from its recent high but recovered almost immediately and regained its previous high in just one month. The containment of the disease in a region of the world with very little global economic impact kept wider fears in check.

In contrast to both SARS and Ebola, the known mortality rate of Covid-19 at this point is about 3.4 percent, but that is probably overstated because it reflects a preponderance of early cases in Hubei Province where the outbreak began. More recent cases in other parts of the world suggest a lower mortality rate, with some experts opining that it could be as low as 0.4 percent. By comparison, the common flu virus that shows up every winter (which itself is a coronaviral disease) has an average mortality rate of around 0.1 percent. The larger concern with Covid-19 is the fast rate at which it seems to spread. As of Thursday this week there were over 82,000 known cases of the disease.

…And What We Don't Know

There have been a great many questions about why markets seemed to pay little attention to Covid-19 until late last week. Part of the answer, we believe, goes back to those earlier instances of SARS and Ebola – there wasn't much of an impact from them on the market as the potential economic consequences seemed rather contained. What has become more apparent in recent days this time is that (a) there are more unknowns about how long the disruptions happening now will last, such as quarantines, school closures and shut-downs of retail and production facilities in affected countries; and (b) health policy experts seem to be converging on a consensus opinion that outbreaks will gain further pace, potentially to the point of being declared a pandemic (the WHO's current position is that Covid-19 is not yet a pandemic). There is much that is still very unclear about the nature of this disease.

Under different scenarios the economic impact could be relatively light – if the incidence of outbreaks stabilizes in a relatively short time frame and the mortality rate does not spike – or it could be sustained if economically productive activity is curtailed for a longer period of time. Already, we are seeing companies revising their sales and earnings guidance down for the current quarter when they report those numbers in April and May. That will have a negative impact on already stretched valuation levels. It could potentially tilt the Eurozone into recession given the impact on countries like Germany and Italy which were already on the fence. And Japan is likely to face an excruciatingly difficult year economically.

In the absence of clearer knowledge about the disease, the spread rates and also the potential time frame for a vaccine or other preventive measures, it will be difficult to put meaningful probabilities around these scenarios (remember that by definition a "Black Swan" is something that cannot be modeled with probabilistic accuracy). What we have to do is remain disciplined and come to work each day ready to absorb new information and incorporate it into a sober analysis of the risks and opportunities at hand.

Diversification

For much of the past several years prudent diversification among different asset classes has not been a friend to portfolio managers. A relatively small number of large-cap US stocks, mostly in higher-growth industry segments, has outperformed pretty much every other class of assets over this period. One could be forgiven for wondering if diversification was an "old school" obsession that should be tossed aside in the brave new world of money and markets.

What diversification does, though, is to provide some amount of protection in the event of a Black Swan materializing from nowhere. The carnage in markets this week has not been kind to anyone caught fully exposed to the risk – there have been scant relief rallies providing an opening to reposition, for example. When the good times are rolling, diversification can seem fusty and boring. When weeks like this week happen, though, we are reminded that the mandate to diversify is as profound as ever.

We know these events are unsettling at many levels – a global virus is not just about economics and markets, but more importantly it is about lives. Please know that we are here to talk to you about any concerns you may have, and that we will continue to focus our attention every day to analyzing, understanding and communicating the progress of things as they unfold.

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