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Opaque Investing in the Summer of 2020

This is a different type of economic crisis than usual, and global markets are not used to this disruption. The novel coronavirus inflicted human devastation on the world and has caused major contraction of the global economy in the second quarter of 2020 with huge effects on employment and business profitability.[1] As of June 30, 2020 over 10 million people contracted the disease worldwide and more than 500,000 have died from it. The U.S. accounts for about a quarter of each figure.[2] In the second quarter of 2020 world economies have contracted substantially, including the U.S. economy declining by 10% with over 20 million unemployed. The economic policy response to Covid-19 has been rapid and extraordinary, as both central banks and governments have stepped in to prevent a recession turning into a depression. Although this is a highly uncertain and rapidly evolving situation, the impact on markets since the March 23rd low has been impressive.[3] There were gains in the S&P 500 TR Index of 20.5%, in the MSCI EAFE Index (USD Net) of 14.9%, and in the MSCI World Index (USD Net) of 19.3% for the second quarter of 2020.

Covid-19, the disease caused by the novel coronavirus known as SARS-CoV-2, was a predictable phenomenon because of the four previous influenza pandemics of 1918, 1957, 1968, and 2009. As Covid-19 circled the globe, the biomedical community grasped its severity too late. Having failed to identify the threat in time, the medical scientists subsequently failed again by endorsing contradictory advice and enforcing inadequate measures. The confusion has led to frustration, as there is no idea of what to fully anticipate from this dreaded virus.[4] Different governments have adopted different responses to the pandemic with different results. Some placed severe restrictions on the movement of people early on, and some did so later. Others imposed few restrictions relying on individuals to modify their own behavior.[5]

In June 2020, markets reacted negatively to the rise of new virus case data. However, the transmission rate (R) or the number of cases transmitted per infected person appears to be slowing. The markets are positively reacting to the number of European countries, that managed to ease their lockdowns with no meaningful second infection wave.[6] Most importantly deaths have not seen the same increase as the global rise in new cases. The falling trend in deaths may be the more important factor to watch since the trend in stocks and earnings expectations are more closely aligned with deaths than cases. The trend in deaths will be a driver of how people and policymakers respond to a second wave.[7]

The liquidity infusions by the world's central banks have allowed markets to return almost to pre-disturbance conditions. While uncertainty continues as banks pull back credit for loans due to lack of employment data, economic growth rates are picking up. The Conference Board survey of consumer confidence rose to 98.1 in June, with increases month over month in both the present situation and expectations components. The present situation reflects recent improvements in the U.S. labor market. U.S. employers added 4.8 million jobs in June, and the unemployment rate dropped to 11.1 per cent from 13.3 per cent in May, the second consecutive month that the figures have beaten expectations after a fall of more than 20 million jobs in April. The improvement in expectations fits with rising values of risk assets. This is important because confidence correlates inversely with the U.S. saving rate, which has risen dramatically from 8% in 2019 to 23% in 2020, as services spending has been restrained due to Covid-19 concerns.[8] U.S. nominal retail sales bounced off lockdown numbers, surging 17.7% month over month in May. Clothing store sales increased 188%. Separately U.S. industrial production rose 1.4% month over month with capacity utilization increasing to 64.8%. The NAHB homebuilders index also rose a record 21 points to 58, indicating a solid bounce in U.S. housing. The near zero interest rate level has lowered the cost of borrowing for homes, cars, furniture, and other big-ticket items. Record strong growth numbers are following record weak readings.[9]

The pressing quandary for investors is balancing secularly poor economic data and a secularly generous fiscal and monetary response. On a macro view, the battle between the central banks' easy monetary policies and economic growth prospects explains the market volatility. The equity risk premium soared as Covid-19 hit the economy, and then shrank as central banks and governments stepped in to provide support. Assuming that the world economy can overcome future rising infection rates, a falling risk premium could combine with continued cheap money from the central banks to support high equity valuations.[10]

The present uncertainty is focusing our attention more sharply on the resilience of the companies in which we invest during this time of duress. Martin Investment Management, LLC believes that transparency of data, high liquidity, and low leverage contribute to the long-term sustainability of an investment. Stocks that can promise earnings growth regardless of what the economy does and/or those that benefit from the lockdown, such as providers of food, social media, and online deliveries receive the benefit of the discount rate without any offset. We avoid complicated investments, which may prove especially challenging in these opaque times. When corporate governance and accounting standards are lax, information is distributed more unevenly to investors. Typically, illiquidity rises in a crisis and remains elevated after the crisis has abated. Our focus is security specific investment decisions in understandable businesses with high liquidity and strong return on capital.

The Covid-19 crisis will likely accelerate transformations that were already underway, such as working from home rather than commuting to an office, buying online versus in a store, manufacturing products essential to national security domestically rather than importing them, and meeting new people online versus in person. There

continue to be profound changes in what is produced, how it is made, and the way in which people live and work. Investors need to recognize where innovation is occurring. In 1900, technology and health care companies were totally absent from the stock market, but they now represent some of the most innovative companies and a substantial portion of the equity market. Coinciding with new developments, there are changes to the investable universe of industries represented on major stock exchanges. Differentiating unparalleled expansion between a bubble in which fundamentals do not apply and a justifiable boom becomes paramount.

Because of the new wave of Covid-19 outbreaks throughout the world this June, we are reminded that the fight against Covid-19 is not over. The new outbreak does not change our thoughts on economic recovery worldwide. We believe that only a large second wave of deaths could lead to a second wave of declines for economies, corporate earnings, and the stock markets. We are looking forward to the recovery of world economies to previous levels of activity, output, and profitability. Fiscal and monetary stimulus, pent up demand, and less supply side disruption support this growth. Credit markets appear to be easing further, and risk assets continue to gain as investors increasingly learn that the long-term consequences of Covid-19 will be limited. We anticipate the timely developments of therapeutics and a vaccine to arrest the broad behavioral accommodations needed to suppress Covid-19. The market is a forward-looking discounting mechanism and is signaling better days ahead.

Wishing you, your family, friends, and associates a very healthy summer!

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Note:

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