

COVID-19 and Equity Markets

My wife's family is from Tuscany, and Italian is her first language. Four years ago, she wanted to get out of London for the summer, and headed over to Italy with the kids. But instead of visiting her cousins, aunts, and uncles in Florence, she chose instead to spend 40 days in Venice.

Before Vasco de Gama and Cristoforo Colombo (Christopher Columbus) shook things up by introducing new sea routes to basically everywhere, Venice was one of the most affluent cities in all of Europe. The city-state enjoyed a near monopoly on European foreign trade in the 13th and 14th centuries, with over 3,000 ships and 30,000 sailors calling it home.

Many of these ships were built in the *Arsenale di Venezia*, which was a big industrial shipyard long before the industrial revolution. It was constructed in the 12th century, and it is still there.

Venice is a scenic, quirky place. They have a soccer stadium in the southeast of the main island that few outside of Veneto could find without Google Maps; and 600 meters from Piazza San Marco there is a bookstore, made out of books.

And along with the *Arsenale*, it has many homages to its maritime past, and a special regional accent. They in fact speak a dialect of Italian, and although overshadowed by the Renaissance writers and their Tuscan dialect, the Venetians still managed to contribute several words to the English language. One of them was "arsenal" as noted above. They've also given us casino, contraband, and, of course, gondola.



Alia's favorite bookstore, the Libreria Acqua Alta

They've supplied another word that we've all been using a lot this year. I can guarantee that 99.9% of us have been using it more here in 2020 than in all our lifetimes.

When those 15th century merchant ships would return to port in Venice¹, word would be sent ahead on the condition of the crew. If they had been potentially stricken by the Black Plague or other illness, instead of spending 40 days recovering in Venice like my wife did, they were forced to stay at sea for 40 more days.

The Venetians called this a "quarantena."

Today, over 500 years later, the quarantine is in effect again. Except this time it is for those living *on* the island of Venice. And in fact all of Italy. And most of Europe.² And most of Asia. And most of the Northern Hemisphere.

These are unprecedented times. Thanks to COVID-19, the global economy and its stock markets have gone from rude health to requiring a self-induced coma to mitigate further trauma. This happened within the space of three months.

¹ During their height of their powers, the Venetians also controlled the Republic of Ragusa, or modern-day Dubrovnik, now in Croatia. They first introduced a 30 day "trentino" there for returning plague-stricken sailors before introducing and extending the "quarantena" in Venice.

² The Swedish experiment will be fascinating to observe and review in hindsight. Either as a stable, sensible, level-headed policy, or as the single most deathly human experiment of all time.

Unlike the East Asian Crisis, or 9/11, or even the GFC, this isn't about a particular region or country or sector. It's about everything and everyone. All regions. All countries. All sectors.

All people.

It is important for us all to recognize that *people* are the key ingredient determining what things will look like tomorrow.

In the world of publicly-listed equities, people are extremely important. In this world, we call "people" Mr. Market. Mr. Market is starting to believe that 2020 is a write-off. We agree with him. We think 2020 is a write-off. We also believe it is a game-changer. Whatever theses we had three months ago about our investments must be different today.

So let's let those be our initial conditions. Let's start right here.

Here, in the short term, we think companies will broadly be excused if they miss numbers; and many are going to miss numbers tremendously. We expect that in most cases, there will be few additional penalties for withdrawing guidance, and limited marginal selling after dividends are reduced or cut entirely. In fact, for those management teams that were contemplating if or when to release bad news, or indeed kitchen sink things to wipe the slate clean, now is the time.

That's because equity markets, broadly, are starting to reflect a negative view, and have done so quite swiftly. The stories are similar (if not worse) in Europe, but I will use the US market as a global proxy here. On March 16, the S&P 500 was down 12% in a day, the biggest single day drop since October 19, 1987, and before that, you have to go all the way back to 1929. If we use the Dow Jones Industrials as a proxy for "the market" we can go back even further, and see that March 16, 2020 was even worse than the fifth worst day, on December 14 of 1899.³

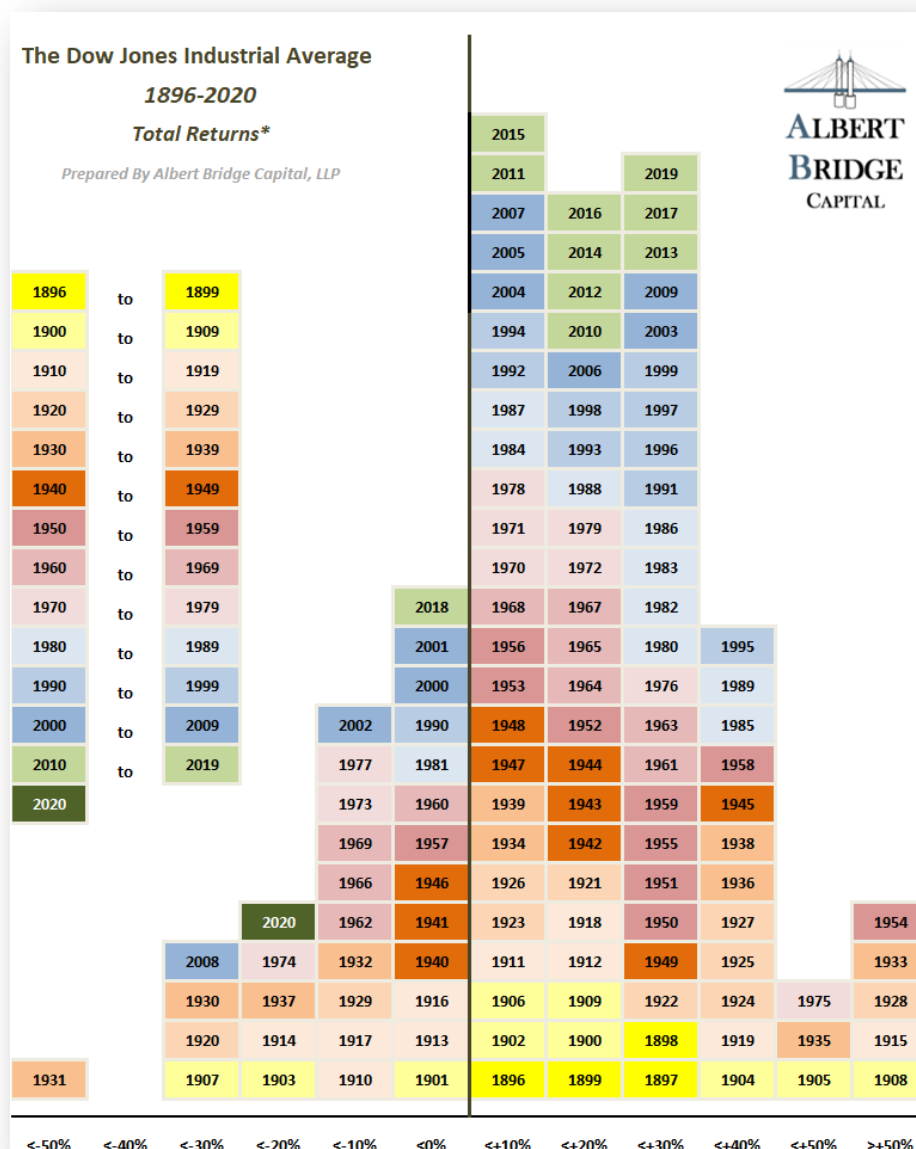
October 19, 1987	-22.61%
December 14, 1914	-20.53%
October 28, 1929	-13.47%
March 16, 2020	-12.93%
December 18, 1899	-11.99%

In six trading days starting on March 5, the Dow dropped over 20%. That was the fastest 20% drop, ever. If we add 11 trading days to both sides, in the 23 trading days from the February 20 peak to the March 23 trough, the Dow dropped over 36%. It hadn't seen a move like that since 1931.

November 13, 1929	-43.66%
November 12, 1929	-40.56%
November 14, 1929	-38.09%
October 5, 1931	-37.02%
March 23, 2020	-36.65%
November 11, 1929	-36.42%
October 29, 1929	-35.36%
December 24, 1914	-34.60%
December 23, 1914	-34.49%
March 20, 2020	-34.41%

³ For those of you that insist that the Dow Jones Industrials Average is not as good a proxy as the S&P 500, the comparisons are similar. Since the S&P index started in 1928, March 16, 2020 was the third worst move ever (and worst since October 28, 1929), and sixth worst 23-day move ever (and worst since October 29, 1929).

In fact, if we froze the year on March 31, 2020, it would already be one of the worst full years on record.



Yet there is much discussion that equity markets haven't fallen enough yet to reflect just how dire the situation is now. According to many, at the March lows, we were merely back to December of 2016 levels in the S&P 500. And after the subsequent rally into month end, we were already back to levels seen just 16 months ago in December of 2018.

In this view, the economic effects of this pandemic are worse than anything we dealt with during the Great Financial Crash of 2008. Global economies will grind to a halt, there will be an unprecedented number of bankruptcies, and severe, paralyzing job losses. Meanwhile, these bears say, we already exhausted our monetary ammunition by bringing interest rates down to 0% following the GFC, and most (if not all) governments will consequently be unable to provide the fiscal stimulus of the magnitude required. The monetary bazooka will be shooting blanks, so to speak.

There are very smart people saying these things. These folks are trying to look past this year, and out into 2021 and 2022, and they think the economy will get much, much worse than Mr. Market expects.

And they may very well be right.

You will also hear a lot of very smart people describe how the economy in 2021 and 2022 will be much *better* than anyone expects today. These folks will point out that once the lockdown is over – and it will be over within just a few months – ambiguity will recede, people will jubilantly and triumphantly return to work, governments will be dropping trillions of dollars on the economy, and with cheap oil and low interest rates, we will stage a massive post-wareseque recovery.

They will point out that equity markets – particularly once you look beyond the Amazons, Netfixes, Krogers and Cloroxes of the world – are starting to assume the very worst, if not already strongly overreacting. They will then suggest that Mr. Market has extrapolated expected negative datapoints long into the future, and purged 25-75% of the value of many businesses simply because they are going to have one extremely and exogenously-driven bad year. One very bad year which will be followed by an almost mathematically certain severe recovery.

And *they* may very well be right.

We can't know the answer today. What we do know today is that the current economic data is going to get much, much worse. We also know that COVID-19 cases and deaths are going to get much, much worse. It's a moving target, but it looks like things will peak in the US and Europe sometime this spring. There are additional wild cards in terms of other countries that may not be reporting the magnitude of their problem, like China or Turkey; and those that don't yet seem to have a problem, but actually might have a big problem, like India or Bangladesh.

The more anyone on either side of the debate raises their voice and declares without uncertainty that things for the economy beyond the summer are going to be horrible or fantastic, the more you should dismiss their claims. People just don't know. People really don't have a clue how people will respond to all this.

Sometime in 2021 or 2022 we will have the benefit of hindsight. We'll have a bunch of datapoints, and we will be less biased and hyperbolic in our interpretation of the data. Only then will we be able to open up Schrödinger's box and observe if the equity market is dead or alive.

In the meantime, the behavior of stock market participants (and thus the market itself) will be reflexive. As people start leaning one way or the other, others will join them. Things indeed may sway one direction, and then another. Or we may keep heading lower. Or we may have seen the lows.

It is unpredictable today. But what eventually will matter is what the world will look like after we get past the virus. And despite what anyone tells you otherwise, it will ultimately be fundamentals that drive share prices and equity valuation.

And to be clear, we *will* get past the virus. Life will, believe it or not, go back to normal. Sure, we may do more Zoom calls, and order more things online than we did before the virus struck – but at some point in the future, we will all again be queueing at airport security checks, eating dinner out, going to movies, and watching baseball games. And we probably won't be buying as much Lysol disinfectant.

This is important to remember.

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