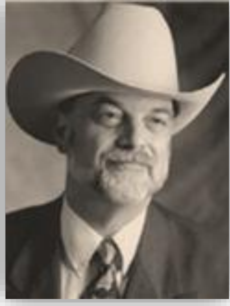

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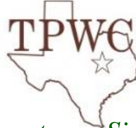

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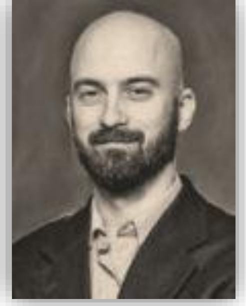

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March 13, 2020

TPWC Market and Economic Update

Two Black Swans and a Bear

In markets and in the economy a totally unexpected negative event that moves markets is referred to as a "black swan." Having one is unusual but tends to happen about once a decade. In the last two weeks we had two. The obvious first black swan was the advent of COVID-19, aka "the coronavirus." The second was Saudi Arabia's switch from often being the only adult in OPEC and friends, reliably stabilizing the oil markets for the last four decades or so, to suddenly being the instigator of what may be the most destabilizing price war in the history of petroleum. The result of two black swans was a bear market. Bear markets are defined as a relatively sudden decline in the value of the S&P 500 by 20% or more. This bear market appears to be quite a lot different from the bear of 2008-2009 or even that of 2000-2002. This one is heavily front-loaded and so far, does not seem to be a result of a structural deficiency in our economy, instead it is exogenic, meaning it came from the outside. Exogenic bears tend to be front loaded, relatively short, and "V" shaped, rather than the "L" shape of bears that resulted from structural excesses inside our economy.

The Markets

The S&P 500 Stock Index (SPX) topped out at 3,386.15 back on February 19, hit a presumptive bottom of 2,480.64 on March 12, for a total drop of 905.51 points, or 26.7% but then came roaring back on Friday the 13th, rising 9.36% to close at 2711.02, down 19.93% from its recent all-time high, and down 8.79% for the week. There is no way of telling at this point which way the SPX will go from here, so this may be a temporary reprieve or the shortest bear market on record. Our gut reaction is that this event is not over but if we could tell you the future you couldn't afford to ask! The key here is to recognize that this bear market was caused by two very temporary if severe events. More on that below.

The U.S. Treasury 10-year note, the benchmark for bonds in general was the real shocker. The yield on the 10-yr. note closed at 0.569% on March 9 and despite the still-plunging stock market, for the next three days, the yield rose, and then rose again with the stock market surge on Friday. That means, beginning on Tuesday, March 10, the value of bonds fell substantially, even as the stock market declined! The spot price of gold, the mythical "safe haven" peaked on March 5, at $1,675 and then preceded to fall to $1,532 by Friday the 13th, down 8.62% for the week. The behavior of bonds and gold may seem irrational if you believe in safe havens, but what appears to have happened was that people and businesses suddenly found themselves faced with a cash-crunch and sold both Treasury bonds and gold to raise cash. We saw the same behavior in 2009. Things just "ain't" what they used to be, and probably never were.

The real market shocker was the price of oil. West Texas Intermediate (WTI) closed at $32.97, down 21% for the week. The WTI price per barrel has now declined over 46% since the beginning of the year. The Saudis are opening their spigots, leasing super tankers, and flooding the market with cheap oil. Their stated target is the Russians, but the back blast is likely to sink a lot of shale drillers in the U.S.

The Economy

The American and world economies are faced with three major challenges. First, the COVID-19 coronavirus is the real thing. The best historical model we have for it is the 1918 "Spanish" flu epidemic. COVID-19 is a "novel" virus, meaning that no one has any immunity to it. It is very contagious and in a best-case scenario has about a 1% death

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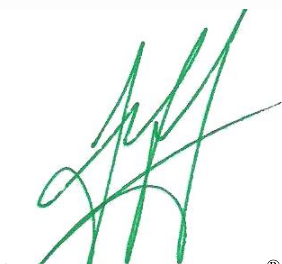
rate. That may not sound like much but if only 40% (a low estimate) of Americans get it, we may see 1,300,000 deaths in the next six months or so. As a point of reference, influenza kills between 12,000 and 61,000 people per year. In a worst-case scenario where we all get sick at about the same time and overwhelm the hospitals, four to five times that number could die. Get ready to see restaurants, movie theaters, malls, convention centers, big box stores and anywhere else people congregate suddenly become empty money-losers. The light at the end of the tunnel is that in 1918 the worst was over in about six months. In that pandemic, another wave hit a year later in 1919, but we are confident that a year from now we will have an effective vaccine and nearly universal immunity. The key for the present is to slow the spread so we all don't get sick at the same time.

The second challenge is the disruption of the global and domestic supply chains. Any complex item, and most things are pretty complex here in the 21st century, is composed of parts made by many suppliers. All it takes is one supplier of a critical part dropping out of the chain and the others grind to a halt. That may take longer to address than the virus. Our estimate is that getting things running smoothly again will take about a year but could come sooner. That is only an educated guess.

The third challenge may ultimately be the biggest. We have written before that the ultra-low interest rates have created the largest total corporate debt (~$74 trillion) by any standard since such things have been measured. There will be a lot of companies that will be unable to make their debt payments over the next year or so and declare bankruptcy. The banks and the credit system will be stressed. Despite the size of this problem, it is one we are structured to handle. The Federal Reserve just announced that it will be injecting $1.5 trillion (yes, trillion) into the banking system starting today (3/13). A lot of stockholders in those companies will lose their investments, but it is unlikely to be disastrous because the last crisis taught us how to deal with it. We unfortunately have a lot of dead wood in the system. Cleaning it out will not be pretty nor pleasant but better now than wait until it ignites in a conflagration.

In summary, things are going to be rough for the next nine months to a year, but we will recover, and we believe what will follow may be the biggest economic boom in the history of this country.

Until next week, we will remain at our physical or digital posts to answer your questions and chart a reasonable course through the storm of market volatility.



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