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LePoidevin Group

March 4, 2020

Coronavirus – What History Tells Us May Surprise You

Fears of economic fallout, from a drop in travel to a ban on public gatherings, have created fear and uncertainty, leading to the biggest weekly loss for global stocks since the 2008 financial crisis. From the recent highs of just two weeks ago, U.S. stocks as measured by the Dow Jones Industrial Average ("the Dow") fell 14% (as of end of February), making this the 16th decline (at 5% or more) since the bull market began in 2009. The previous 15 declines all proved to be temporary, but this will be the first decline originating from a disease since SARS in 2003.

I have no medical expertise so I cannot add anything that has not already been said by experts over the last few weeks. What I did check was how stocks have historically reacted to epidemics and was quite surprised by the history lesson.

There have been 6 major epidemics and fast-moving diseases since 1900, the worst being the Spanish Influenza, which killed more than 20 million people worldwide. All 6 caused a sharp drop in stock prices; however, Wall Street's reaction is often short-lived.

Epidemic	Year	Dow Jones Calendar Return
Spanish Influenza	1918	+10.5%
Asian Flu Pandemic	1957	-12.8%
Hong Kong Influenza	1968	+4.3%
Swine Flu	1976	+17.9%
Avian Flu	1997	+22.6%
SARS	2003	+25.3%
Average		+11.3%

Most remember the SARS outbreak when stocks dropped by 13% but, by year-end, the stock market had recovered all the losses and finished substantially higher.

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Of the 6 global disease epidemics, the Dow has finished up 5 out of 6 times; the only year it ended lower was 1957 and even then, it was up 34% by the next year. Out of the last 20 years, the Dow has finished up 13 times and down 7 times. In other words, in the face of an epidemic, the Dow has gone up more than it has on average over the last 20 years (86% vs. 65%).

Obviously, each epidemic created a real economic contraction, which is why stocks experience an initial sell-off. What is interesting is that by year-end, the stock market has shrugged off the slowdown to close out the year higher in almost all cases.

One likely explanation is central bankers of the world, when faced with economic contraction, typically react by lowering interest rates and expanding money supply. Long time readers of the LePoidevin Letter know that the most important rule of investing is “Don’t Fight the Fed.”. The Fed is the Federal Reserve Board, which sets the U.S. interest rate policy. The bond and futures markets are now pricing in the likelihood of at least 3 interest rate cuts over the next few months. 10-year U.S. bond yields fell to a record low of 1%. Government of Canada 30-year bonds fell to 1.2%, a record low. These bonds would compound to achieve a 43% return over 30 years. At current Canadian inflation rates, one would need 103% just to keep pace.

In an interview on CNBC, Jeremy Siegel (Professor of Finance at Wharton and author of “Stocks for the Long Run”) suggested that about 5% of a stock’s value is based on what a company will earn in a particular year but 95% of a stock’s value is what the market thinks the company will earn for the next twenty years.

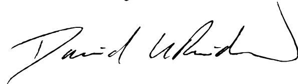
Consider a consumer staple, Coca Cola, whose stock traded over $60/share before the most recent stock sell-off, rendering its $1.64 dividend to yield 2.73%. On February 28th, when Coke was trading at $51.58, the yield effectively jumped to 3.18%. This year’s profits may be impacted but the stock market will look beyond the current crisis at some point.

Another point to consider is that for the last 10 years Coke has raised its dividend every year – including the year of the financial crisis. In other words, Coke has increased its dividend 86% over the past ten years. Moreover, the drop in interest rates makes dividend paying stocks more valuable, not less.

I often get calls from clients, asking to liquidate their accounts until the crisis ends. Like the recent trade war declines in stocks, as soon as the markets sense some clarity, the stock market has tended to react with outsized higher moves. $100,000 invested in U.S. stocks 30 years ago will be worth $1.72 million today. Missing just the 10 best days of the market would be worth $861 thousand – half of the total return!

Bond investors face a future of negative interest rates relative to inflation and tax. Investors looking for low-risk higher returns need only venture outside of government bonds.

Sincerely,



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