Bell Bank
Wealth Management

EQUITY & FIXED INCOME OUTLOOK MARCH 2020

There are known knowns, there are known unknowns and there are unknown unknowns.

The coronavirus falls into the "unknown unknown" category. By definition, this means the virus was not anticipated by the economy or the markets. With the coronavirus now spreading, the genie is out of the bottle. Its humanitarian impacts are hard on psychology.

Mechanically, the markets are trying to figure out what the coronavirus means for the economy, both domestically and internationally. China, where the virus originated, has become the manufacturer for the world – and currently there are large swaths of people quarantined in China who are not going to work to manufacture anything. The market calls this "supply chain disruption."

The other challenge is defining the depth of the predicament and the length of time it will take to develop and distribute a vaccine and get back to normal. Combined, this is an operational example of having "all our eggs in one basket." (By the way, concentration of production is also a developing problem in the utility sector. As utilities try to comply with tightening environmental regulations, they are moving toward more generation of cleaner natural gas, while abandoning other traditional sources of generation before adequate sources of new energy production are in place.)

A History of Unanticipated Events

It is important to remember that the coronavirus is one of many historical events that have challenged the economy and the markets – and that unanticipated events like these will continue to occur. There have been viruses in the past. Since 2003, we have seen SARS (with a market impact of -13%), Avian flu (-7%), MERS (-7%), Ebola (-6%), Zika (-13%) and now the coronavirus with its full impact to be determined. Other events – the Asian financial crisis, long-term capital management meltdown, tech stock bubble and 2008 financial crisis – have also had negative impact. Nobody knows what this list of historical, market-impacting events looks like five years from now, but there certainly will be additional entries to the register.

This is why it is so important to focus on long-term goals, using a long-term plan supported by long-term asset allocations and long-term commitment to savings. Removing the phrase "long-term" from any part that sentence (and your plan) causes problems – transaction fees, timing risk, misallocation risk, reinvestment risk and disrupting cash flow goals, to name a few. Yes, if you turn on CNBC, you'll have professionals telling you how you should change your portfolios to respond to the virus. But we all know that we don't build our portfolios to respond to a virus; we build them to respond to our long-term goals. If we drive from Fargo to Minneapolis and encounter a construction detour, do we change our destination? No. The same applies here. This is one of many market detours that will happen along the lifecycle of investing.

Other Reasons for Market 'Nerves'

Coronavirus issue aside, are there other reasons for market edginess? This is the longest economic expansion in history. It doesn't mean it has to come to an end, but statistically, the longer it goes, the more likely that we run into some difficulty. Can growth be nudged into slowing? Yes. Quarantines, travel cancellations and other responses to the coronavirus already are taking people away from work, travel and leisure plans – and that is having a direct and rather immediate impact on the economy and supply chains.

Another potential reason for nerves is overall stock valuations. Our previous monthly outlooks outlined elevated stock valuations, overall market valuation measures compared to historical averages and slowing earnings growth. The market seemingly had been ignoring these fundamentals, but current events have a way of putting the focus back on underlying factors.

Markets also may be wrestling with growing support for a socialist-leaning U.S. Presidential candidate. Socialism is an economic system based on public or collective ownership of the means of production, emphasizing equality rather than achievement. (Communism is a more intense implementation of this idea.) While it might sound great on paper, it tends to reveal itself in mediocracy. To quote Winston Churchill, "The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal distribution of misery."

Advice for Disruptive Times

Yes, it is uncomfortable moving through market disruptions – whatever the reasons may be. Uncertainty is high, fear creeps into our psychology, we question past decisions, we doubt the ability of the economy and markets to move beyond current events – and we have a hard time sleeping because of all of these concerns.

Past market activity suggests the stock market sells off about 5% three times a year, about 10% once every 18 months and about 20% once every three years. The last time the market sold off about 20% was the fourth quarter of 2018. The market has already declined 10% from its recent highs and is currently trading near last October's levels. Of course, the mathematical calculation for averages suggests that boundaries are somewhat fuzzy (which is why the law of averages exists in the first place). In any case, our advice continues to be to focus on long-term goals, using an allocation consistent with your personal investment profile.

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