

# Investment Perspective

America is in a battle to defeat a new kind of threat

We are in uncharted waters. A global pandemic is engulfing the world and America is in a battle to defeat a new kind of threat. As investors, we learn to “expect the unexpected,” but the effects of this pandemic have been shocking, leading to a classic black swan event - a rare, unpredictable occurrence with severe consequences. Responses to this unforeseen pandemic include regional lockdowns, social distancing and the closure of many activities and businesses. As a result, stock markets around the world tumbled, energy prices collapsed, and government bond yields sank to new lows. The S&P 500 experienced the swiftest 35% loss in stock market history between February 19 and March 23 and March was the most volatile month ever recorded. The sense of panic paralleled declines in 1974, 1987, 2002 and 2008 – infamous years in stock market history. We are fighting an invisible enemy for an indeterminate period with limited visibility.

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For now, the priority is to support the healthcare system and mitigate this highly contagious infection. The next priority is to safely restart the economy. Fortunately, the largest nations have responded forcefully with policy responses that are significant and historic in size and scope. Stock markets will recover as investors gain confidence that the virus is contained and normal activities can resume. Just as we saw a historic drop in prices, we are experiencing an epic rally. The Dow Jones Industrials gained 15% for the two weeks ending April 17 – its best two-week return since 1938. We expect the stock market to back-and-fill and rebuild its momentum over time. It may also retest the March lows. During volatile times, it is important to stay focused on the company fundamentals that support individual equities rather than the overall stock market. Stock prices are heavily influenced by indiscriminate short-term trading patterns caused by computerized trading programs, panic selling and margin calls. We try to insulate our long-term decisions from this frenzy of activity. Furthermore, it is important to maintain a consistent and disciplined investment approach that emphasizes quality growth companies with strong cash flows and healthy balance sheets. We patiently await a more favorable environment as the virus’s effects will diminish. A summary of index returns for the quarter ending March 31, 2020 is as follows:

Dow Jones Industrials	-22.7%	Russell 2500	-29.7%
MSCI EAFE	-22.8%	S&P 500	-19.6%
NASDAQ Composite	-14.0%	Wilshire 5000	-20.8%

## GLOBAL ECONOMY

The global economy is heading into a deep recession with GDP expected to decline this year because of the Great Virus Crisis. The geographic breadth and depth of the recession is unprecedented as most major economies are declining simultaneously. The last major global health crisis of similar scale was the influenza of 1918 and the last major global downturn of a larger magnitude was the 1930’s depression. The U.S. and Europe (and

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other regions) will experience sharp economic downturns – greater than the 2008 financial crisis, but not as bad as the 1930s depression. It is difficult to be precise with so much uncertainty, which is evident in a very wide range of GDP forecasts. China’s economy may also decline somewhat after prior expectations of 6% growth. Emerging economies will also experience significant stress this year.

Positively, despite the sudden drop in demand, many consumers and businesses will be ready to resume activity once the environment is safe enough to restart. Unfortunately, the U.S. jobless rate will soar with most forecasts of 15% unemployment and some higher. The coronavirus will have a severe negative impact on the service-oriented segment of the economy. The rippling effect of business closures, lost jobs, and defaults on loans, mortgages and rents will present challenges in the short-term. Today, the government is the only significant prop for the economy and its spending role will rise to post-WW II highs. As a percent of GDP, the federal deficit may rise to 12% vs. prior expectations of 4.9%. Importantly, the virus has not destroyed infrastructure and so the economic means of production are ready and waiting to resume growth. We expect the decline in U.S. economic activity to stabilize in late 2020 followed by recovery in 2021 because of strong fiscal and monetary support. We must remain patient and optimistic while we wait for the virus and its catastrophic effects to subside. It is important to note that many lifestyles and workstyles will be different during recovery mode with certain industries weakened and others strengthened by the disruption. Our next goal will be adjusting to the “new normal.”

## FISCAL & MONETARY POLICY

The rapid outbreak of the coronavirus over the last 60 days produced massive government stimulus. The Federal Reserve acted forcefully and Congress passed powerful measures to counteract the cyclical downturn that is developing in response to quarantine measures. The Fed is employing several unconventional tools in its vast arsenal to rescue the economy from credit tightness and illiquidity. Chairman Powell said that the Fed will do “whatever it takes.” Its three major initiatives include reducing short-term interest rates to near zero, buying more bonds in the open market to reduce long-term interest rates, and backstopping numerous credit facilities to reduce credit spreads and ensure appropriate access to liquidity. Many of the programs are similar to actions taken during the Great Financial Crisis, except the Fed added a new tactic of directly supporting the corporate bond markets with outright purchases. There is ample capital within the American banking system and the Fed is ensuring that the financial system will work effectively. Ultimately, the central bank’s actions should lower interest rates, compress credit spreads, ensure access to liquidity and improve confidence.

From a fiscal perspective, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law on March 27, 2020 by President Trump. This \$2.2 trillion stimulus bill is the largest stimulus package in U.S. history and represents approximately 11% of GDP. This Act provides financial support and resources to businesses, educational institutions, hospitals, individuals and state & local governments affected by the pandemic. It is a counter-cyclical measure to soften the hardship associated with widespread closures

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that have disrupted society. Elements of the package quickly put money in the hands of individuals and organizations who need it the most. For example, the federal government is supporting enterprises and individuals with aid, loans and payments. These fiscal and monetary measures total approximately \$7 trillion to date and are unprecedented in size and scope. Echoing Powell, Treasury Secretary Mnuchin said that the government will do “whatever is necessary.” Nearly every other major government has taken similar actions and, as a result, the world is primed with massive reflationary measures.

## INVESTMENT OUTLOOK

Looking ahead, we will eventually overcome this pandemic, the global economy will grow and stock prices will rise. But today, it is difficult to find optimistic forecasts. The world has changed significantly in the last 90 days with most investment commentary filled with doom and gloom associated with the coronavirus. Clearly, fundamental economic indicators will worsen before improving and uncertainty is high. Given the steep market correction, stock prices appear to reflect many of the negatives, but the key question is this: How much bad news is implied in current market prices? No one knows the answer. What we do know is that most companies will cut their forecasts forcing investors to look out to 2021 and beyond. Currently, the markets are trading on sentiment linked to bending the coronavirus curve. Stock prices are rallying as the infection rate is slowing. The focus will soon shift to the corporate fundamentals driving equities. Admittedly, the business metrics supporting equities are weak, but stock prices typically bottom several quarters before the inflection point in earnings. We do not know when things will improve. However, over the last 80 years, major shocks to the stock market produced average bottom and recover periods of 22 and 47 days, respectively. The longest bottom and recovery periods were 2.4 and 10 months after the attack on Pearl Harbor. Given the history of human behavior during stock market corrections, equities appear reasonably priced at these levels.

Credit market dysfunction, panicked selling and margin calls in mid-March created a “purge” that swiftly pushed stock prices down to extremely low levels, but they quickly rebounded off the bottom. Technically, the financial markets appear to be in early stages of recovery. From a fundamental perspective, it is challenging to value companies during a recession as earnings are disproportionately suppressed by a slowdown in sales growth (e.g. sales might decline 10% while earnings could be down 20%.) Studies show virtually no relationship between annual changes in earnings and stock prices – only correlations in long-term trends. We assume S&P operating earnings may decline 20-25% in 2020 to approximately \$125, but it is too early for a reliable forecast. However, given the willingness of investors to look over the trough, the important question becomes the timing and magnitude of a recovery in 2021. It is plausible for earnings in 2021 to match the levels of 2019. Assuming S&P operating earnings of \$163 next year, the stock market is selling for 17x earnings – a fair valuation considering the 10-year Treasury yield at 0.65% with low inflation. Also, the 2% dividend yield on the S&P 500 exceeds the 10-year Treasury yield by a historically high amount – this is a positive for stocks versus bonds.

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Where do we go from here? Prior to a recovery phase, the stock market will likely continue to consolidate and rebuild its base. It may also retest the March lows. Investors have little prior experience with a global pandemic of this scale which adds to the risk and uncertainty. We do not know if this massive lockdown effort is a single episode or if it will repeat later. We expect we are entering a “new normal” and individuals will have to proceed carefully with new habits to avoid widespread reinfections. A cautious approach to re-opening the economy adds to the uncertain timing of the recovery. Investors might experience positive surprises like the eradication of the virus, the discovery of treatments and the implementation of vaccines leading to increases in immunity. However, fear of extended quarantines, a second wave of infections, reinfections among “cured” patients and mutated versions of the virus may linger. We remain alert for developments that might change the investment landscape. In the short term, we accept the risks associated with owning stocks with volatile prices although we acknowledge that the declining market and volatility have been uncomfortable. Patience is necessary until longer term fundamentals and rationality weigh more favorably in the pricing of equities.

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In our opinion, quality small and medium-sized growth companies provide the best opportunity to achieve above-average returns over the next few years. We believe that this market environment is an appropriate time to reiterate the attractiveness of ACM’s investment strategy and the key principles of our stock selection process. We focus on companies capable of growing 50% faster than the average company in the S&P 500 index. Specifically, we target those businesses which provide valuable products and services that have achieved defensible market positions within their niche. These companies generally do not compete in commoditized industries. Importantly, they are typically well managed with above-average profitability and financial strength. These companies fund their growth primarily through their own cash flow rather than the capital markets. We firmly believe a portfolio comprised of quality growth companies purchased at attractive prices is an excellent strategy for long-term wealth creation.

These considerations are important in this market environment for a few reasons. First, a company offering a valuable franchise-like product or service will likely weather this economic storm and emerge stronger than competitors who may be weakened during the downturn. Second, a strong financial position enables growth independent of the capital markets and provides more flexibility to take advantage of opportunities. Third, quality growth companies will command a premium during a period of general corporate sluggishness. Fourth, attractively positioned small and medium-sized companies will become acquisition targets as the path to economic recovery becomes more visible. We look forward to a time when more favorable fundamentals will reward our perseverance during this challenging period. We believe the current market environment should prove to be an outstanding opportunity to accumulate quality investments for superior returns in the years ahead.