NLP Financial Management Ltd

Coronavirus Update

16th March 2020

On Thursday 12th March last week we witnessed the biggest fall in stock markets since Black Monday in October 1987, with London's index of top shares ending the day nearly 10% lower. The S&P 500 fell 9.51% and Dow Jones was down 9.99% and officially entered bear market territory, defined as a fall of 20% or more from the previous high point. The German and French markets fell 12% and the Italian market was down over 17%. Japan's Nikkei 225 fell 15.4% and the MSCI World Index of global markets was down 20.2%.

The full implications of the coronavirus outbreak are becoming clearer and countries are taking decisive measures to delay the speed and path of the outbreak as far as they can. The markets were impacted by the sudden unilateral US travel ban on 30 European countries. New York announced a state of emergency last Friday. Italy had already entered a complete lockdown and Germany predicted that up to 70% of its population would be infected. The Prime Minister said as many as 10,000 Britons are already infected. However, the Chief Medical Officer has laid out how the predicted course of the virus will unfold over the next 10 to 14 weeks.

Central banks have stepped forward with significant policy announcements to try to settle the markets. The Bank of England announced last Wednesday a 0.5% cut to the base rate, the biggest single cut since the Global Financial Crisis (March 2009), the Chancellor unveiled a £30bn package to help guide the economy through the outbreak. In the US, over the weekend, the Federal Reserve announced it would cut interest rates by 1% bringing them down to near zero. They will also inject a massive $700 billion dollars to support markets. In Europe, the European Central Bank president Christine Lagarde initially implied they would not act to calm bond markets but later clarified comments saying they would start a new €120 billion bond purchase and offer ultra-low rates to lend money to banks. Other major central banks in Japan, Canada and Switzerland will co-ordinate efforts to provide liquidity in foreign currency markets.

Despite these very significant measures the markets opened down on Monday morning both in the Far East in Japan, Hong Kong, and Australia and then later here in the UK and Europe. The markets all followed suit falling around 7% each. It is clear that propping up the financial system is vitally important going forward, to support banks and businesses through this challenging period. But this is a public health emergency on a scale unknown and no one knows exactly how developments will unfold from here.

The longer-term issues for the global economy and financial markets due to the impact of the coronavirus outbreak is very difficult to quantify at this stage, but it is likely to be significant and will last well beyond the summer. Travel and tourism are sectors which are taking the initial brunt of the hit with airlines grounding fleets, hotel bookings being cancelled, sporting events, including the Premier League, and public events being postponed and people travelling less to work and conferences. Leisure sectors like cinemas, theatres, museums, restaurants, and cafes will also struggle as many people will avoid large gatherings and stay at home. But many other industries and businesses will find the next few months increasingly difficult.

The Historic Perspective – What are the Lessons?

We can also look at the historic impact on stock markets following the outbreak of a major epidemic. We preface our words with a caveat that we do not know as yet the full nature of this virus from an epidemiological perspective, and so many aspects such as infection and mortality rates have not been quantified. However, there are some similar patterns we can observe when examining the technical market reaction to such occurrences in the past, especially how markets reacted following the first reported cases.

If we look back into the history of stock markets, we find that this has been the second worst day for the UK stock market since 'Black Monday' in October 1987. There have been a number of trading days since then when the market fell significantly such as when the technology bubble burst in 2001, and around the time of the global financial crisis in October and November 2008. With the benefit of hindsight, we see that however traumatic those times were, the markets rallied in the following months and bounced back strongly in the following months and beyond, from their lows. In 1987, the market actually finished the year up 2%. In fact, in the 35 years since then, the market has averaged an intra-year decline of 14% and only ended the calendar year in negative territory on 9 occasions. By selling out too soon in mid-year, many investors miss the potential rebound by sitting in cash on the sidelines.

We also observe that there are benefits to maintaining a long-term perspective rather than getting caught up in the short-term panic of others. Using data from the S&P 500, we find that in the six months following the SARS outbreak in April 2003, the market rose 14.6%. We see a similar response following Bird Flu in June 2006, the market rose 11.7%; Swine Flu (H1N1) in April 2009, a rise of 18.7%; MERS in May 2013 10.7%; and Zika in January 2016, 12%. On average, the S&P index was up in 11 out of 12 cases over the last 40 years with an average rise of 8.8% over the next six months. The change over the following 12 months was even higher at 13.6%.

As noted above, the serious and global nature of Covid-19 appears to be on a different scale to these other epidemics and therefore the impact on the global economy could be more significant. Therefore, in another study of market behaviour, we looked at the S&P 500 following its 15 largest single day losses and subsequent performance. We can see that on average the index produced positive returns for those investors prepared to hold on to their investment and remain committed to their long-term investment goals. On average, the index returned 22.38% over one year, and then 11.7% annualised over 3 years, and 11.58% annualised over 5 years.

The results are set out in the table below and show annualised returns;

S&P 500 performance after its worst days;

Date	1 Day Return	1 Year Later	3 Years Later	5 Years Later	10 Years Later
19/10/1987	-20.47%	+23.19%	+11.60%	+13.04%	+15.43%
15/10/2008	-9.03%	+20.79%	+10.49%	+13.34%	+11.72%
01/12/2008	-8.93%	+35.85%	+15.10%	+17.21%	+12.96%
29/09/2008	-8.79%	-4.14%	+1.60%	+8.86%	+10.17%
26/10/1987	-8.28%	+23.59%	+10.20%	+12.93%	+15.25%
09/10/2008	-7.62%	+17.76%	+8.29%	+12.73%	+12.21%
27/10/1997	-6.87%	+21.48%	+16.30%	+0.47%	+5.76%
31/08/1998	-6.80%	+37.93%	+5.80%	+1.04%	+2.97%
08/01/1988	-6.77%	+15.31%	+8.96%	+12.01%	+14.66%
20/11/2008	-6.71%	+45.05%	+17.34%	+18.81%	+13.38%
28/05/1962	-6.68%	+26.14%	+16.79%	+10.39%	+7.14%
08/08/2011	-6.66%	+25.26%	+19.94%	+14.27%	N/A
13/10/1989	-6.13%	-10.07%	+7.05%	+6.99%	+14.44%
19/11/2008	-6.12%	+35.75%	+14.65%	+17.26%	+12.80%
22/10/2008	-6.10%	+21.87%	+11.35%	+14.37%	+11.88%
Average	-8.13%	+22.38%	+11.70%	+11.58%	+10.72%

Source: First Trust, S&P 500 Performance after its worst days, Q4 2019, using Bloomberg. Performance is price return only (no dividends). The charts are for illustrative purposes only and not indicative of any actual investment. Returns are average annualized returns, except those for periods of less than one year, which are cumulative. Index returns do not reflect any fees, expenses, or sales charges. Stocks are not guaranteed and have been more volatile than the other asset classes. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index.

Conclusion

Stock markets are constantly subject to swings in performance, called volatility, and sometimes this can be extreme over short periods. We understand why the natural inclination of most investors is to exit the market at such times. Many investors tend to react negatively during periods when the market falls sharply but by selling out too soon miss out on positive future returns. We have seen that during periods of previous epidemics the market has responded positively over the 12 months following an outbreak. Following days on which the market experiences its largest ever falls, the returns over the following 1, 3, 5 and 10 years have also been positive.

Our View

We believe it will be important to protect the portfolios as much as possible from extreme moves in the markets over the coming months. Therefore, we have reduced our exposure to Asian and Emerging Market equities and exited Japanese equities. We exited one of our UK holdings that was largely exposed to cyclical businesses. Many of the proceeds from these moves have been held in cash, short-dated bonds and gilts, as liquid assets such as these give us the ability to reinvest after the market gyrations have abated and new opportunities present themselves. We remain cautious in the immediate term as the situation continues to develop rapidly. Our aim remains to mitigate the effects of volatility on your investments and protect your wealth as far as possible.

Andrew Graham

NOTE: This material has been written for information purposes only and must not be considered as financial advice.