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April Market Review

April, 2020 was the best month for the large-cap stock indices since January, 1987. The Dow Jones and the S&P 500 both had quick rebounds off their lows posted at the end of March delivering gains of 11.08% and 12.68%, respectively. The Russell 2000 posted a total return of 13.74%. With this past month's gains, the Russell is down 23% from its high on Jan 16 of this year. The large cap indices are down only in the mid-teens from their highs made in February.

These results would be encouraging given a material change in facts perhaps relating to the length or severity of the coronavirus' economic impacts, but few, if any, of such facts have surfaced. Total initial unemployment claims for six weeks from mid-March to the end of April show just over 30 million people have lost their jobs. In keeping with the parallel I made to the 2008 financial crisis in the prior month's letter, roughly the same amount of people filed for unemployment in the past six weeks as in over 15 months starting at the beginning of 2008. With reasonable assumptions, the US' implied unemployment rate is over 20%, a level not seen since the 1930s.

These are hardly data points that engender confidence in investors which has led many to scratch their heads at the recent performance in the US equity market. This surely contributed to the net equity fund outflows during the month of April. Regardless of what has caused this significant relief rally, whether it be the prospect of the country opening sooner than anticipated or all the added liquidity from the Fed, it is crucial for equity investors to focus on valuation and use conservative earnings estimates in order to avoid further pain.

Looking Forward

Certain states are lifting their stay-at-home orders and allowing businesses to reopen in an attempt to bring their shuttered economies back online. What federal and state governments cannot control, however, is the actual demand for the goods and services those businesses offer once they do reopen. A recent Washington Post – University of Maryland poll showed that, regardless of current restrictions, 67% of their 1,000 respondents were uncomfortable going to a retail clothing store. Fully 78% were uncomfortable eating out in a restaurant. In an NPR – PBS – Marist poll, 80% of those interviewed said it was bad idea to open restaurants at this point. Plenty more polls with similar outcomes abound. Given the strength of the virus and the magnitude of the symptoms that can potentially accompany it, it seems that people simply don't think going out to these businesses is worth the risk.

While there are prospects for a vaccine against the virus, the unfortunate truth is that vaccines generally take 10+ years to be fully studied and deemed safe for human use. The FDA may allow shortcuts in that process which could bring about a resolution sooner, but based on the available information, it's likely any vaccine is several years away from approval. What's more, production and execution on the scale needed to inoculate billions of people would take even more time.

All this is to say that there will be an extended period of time where business will be done while the only solution to the virus is caution. This will lead to substantial ongoing impacts to businesses. Airlines will no longer be able to cram people tightly together, and your favorite restaurant that's always packed will have to cut out a portion of its tables. With other businesses, there will be a likely diversification or migration of supply chains in case this ever happens again. There are changes such as these in many industries, and investors must take them into account and make conservative forward estimates.

Given these impacts coupled with the demand-side impact from record unemployment, it is difficult to reconcile equity markets just 15-20% below their optimistic, early 2020 highs. We have built a new position in Boot Barn Holdings, Inc using a valuation model more akin to a stress test, and we have also taken advantage of some unreasonably high prices in other investments to make small sales. From a long-term perspective, I agree with Warren Buffett who said it best recently at Berkshire Hathaway's annual meeting (held as an online live-stream for the first time): "The American miracle, the American magic has always prevailed."

Best regards,

Conor Mahlmann
Kippington Capital Management