KIPPINGTON
CAPITAL MANAGEMENT

P: +1 (847) 648-2667
F: +1 (847) 920-6703

1060 W Balmoral Ave
Ste G
Chicago, IL 60640

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February Market Review

Following a month of negative returns in US equities, February continued the downward slide with a total return (including dividends) of -8.23% for the S&P 500 and -8.42% for the Russell 2000 Index. For the Russell, this wiped out gains made all the way back to the middle of October of last year. Equally as attention-grabbing is the volatility in the month. The Russell saw a move of greater than 1% in 10 of the 19 trading days of the month with the average daily change being 1.2% either up or down. This led the Russell 2000 volatility index to its highest point since August of 2015.

The volatility and negative results for the month are due to a flight to quality with investors pulling capital out of risk assets and moving to safe havens. This pushed the yield on the 10-year treasury down to 1.15% at the end of the month, its lowest level in history.

The flight to quality was triggered by ongoing news that there may be more cases in the US (and other countries) of COVID-19, the coronavirus strain originating in Wuhan, China, than previously thought. There have been cases of community spread reported in several states across the country. Community spread is the terminology used for the finding that those infected did not travel abroad or have close contact with someone who did, and it's much more difficult to trace back to the origin. With the US substantially increasing its number of tests for the virus and new cases of community spread being discovered, it's more than likely the total amount of reported cases in the US will accelerate over the coming days and weeks.

Just a few days ago the Federal Reserve cut its benchmark fed funds rate by 0.5% in an effort to support aggregate demand or bolster securities markets (it's hard to tell which nowadays). Though this was largely expected by the market, it was also widely agreed upon to be fairly futile leading the S&P 500 to close down 2.85% on the same day.

Investors are clearly running from equity exposure for fear of the economic impact COVID-19 will have. While it's tempting to look to history for a simple answer to that question, the truth is there's no easy comparison. Some have pointed to the similarities of the SARS outbreak in late 2002 through 2004 in which the stock market continued upward almost unencumbered by the disease.

The contrasts are even more important, though. SARS was both less deadly and less widespread than COVID-19. The timing is important as well as SARS landed on the heels of the dot-com bust and several years of market declines. What's more, China was not "the world's factory" to the extent that it is today.

Others look to the Spanish Flu as a “bear case” for how bad the current virus could be. Breaking out in 1918, the Spanish Flu was both widespread and deadly. It’s estimated to have killed about 1.7% of the world’s population which would equate today to roughly 130 million people.

While this is an extreme estimate, especially after considering the strengths of modern medicine, investors like to cite that, similar to SARS, markets were also unfazed by the Spanish Flu. While this is technically correct, again, the contrasts are even more important. First, the Spanish Flu broke out towards the end of World War I. Whatever simple global supply chains may have existed that the virus could have impacted, the war had already eliminated. Second, the retreat and subsequent disappearance of the Spanish Flu coincided very closely with the end of World War I, a major bullish event that markets were likely much more concerned with.

I expect that, given the interconnectedness of global supply chains based significantly on manufacturing by southeast Asian nations, COVID-19 will continue to have a larger economic and market impact than prior global diseases. While aggregate demand may waver, supply chains will almost certainly be disrupted, and it will take time before they are fully functioning again. It’s impossible to know the length of time the virus will impact the global economy. The effects could take several quarters to reach a conclusion and yet another several quarters after that to fully flow through financial statements.

Equity investors, as always, should not be blind to the happenings of the short-term but should keep their focus on the long-term prospects of the businesses they invest in. With that said, the effects of COVID-19, whether felt for a quarter or a year, are in fact temporary. The recent decrease in market prices has brought to light some attractive investments, and it’s an overall healthy response to what could likely be lower earnings in the near-term across the board. Investors should keep a close eye on those businesses that have significant exposure to China (and other southeast Asian nations) in their supply chain, especially so if paired with a leveraged balance sheet.

We are building a new position in a business whose shares were previously much too richly valued but have since become fairly priced with the recent market declines. I look forward to sharing more information in the coming quarterly partner letters.

Conor Mahlmann