It’s the Economy, Stupid

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As the markets continue to look for something on which to focus, I believe it is a good time to recall a phrase James Carville coined when he was a strategist in Bill Clinton’s successful 1992 presidential campaign against incumbent George H. W. Bush: “It’s the economy, stupid.”

The markets continue to react to news of COVID-19 cases, fatality rates, and treatments. That is understandable, because those things are important, and they can be (relatively easily) measured and reported. The effect of the pandemic on the economy is not as easily measured in real-time, as we discussed in “Nonlinear Thinking in a Linear Market.”

The ultimate effect of the virus on the economy is key, however, because for each day countries remain in total or partial lockdown, the worse the impact is.

Importantly, if the market is going to focus on what it can measure in the short run, it is pointless to fight that; instead, we must navigate it. And we have been doing a good bit of navigation in our portfolios.

For example, we recently increased equity exposure to the global energy sector. The sector has been decimated
during the past few years, to the point that it could be referred to as a value trap. However, even value traps have value. Banks were value traps in the global financial crisis, but have value today. The spot price of oil temporarily falling to negative $40 a barrel was an outlier related to storage capacity. We believe it is better to look farther out on the oil futures curve to understand the impact on energy companies. When we do so, we see that longer-term prices have also come down quite a bit below where we think the medium-term equilibrium price should be. This portfolio exposure has two purposes: It moves us into an extremely undervalued area, and it increases our beta.

We also bought Italian equities. Northern Italy was the bellwether of the market when the virus flared up, so should be one of the earliest to improve, and that could move markets if markets are reacting to cases and deaths. This exposure is a way to reflect what the market thinks is important and to which it will likely react in the short term, and also increases our beta.

We also bought Chinese equities, where we have been underweight. While it faces challenges, China is in an excellent position to do what many argue should be done: shut down the economy in a draconian manner, but make the shutdown as short as possible before getting the economy back on track.

Lastly, we bought Singapore equity. Singapore has been held out by many as the gold standard for dealing with the coronavirus as a result of its aggressive contact tracing, among other measures. While cases are rising, deaths have remained fairly steady.

At the same time, we sold Brazilian equities. There is tremendous instability there with the resignation of Justice Minister Sérgio Moro, one of the most popular and powerful figures in President Jair Bolsonaro’s administration. This creates the potential for a momentous political conflict just as Brazil struggles to contain the coronavirus pandemic, and this is upsetting markets. But we believe the chaos will be short-lived. We do not believe it will influence fundamental value, and we still see significant value in Brazil, which has positive underlying fundamentals.

These positions may be unwound by the time we post this. They might be unwound on an up market; they might be unwound on a down market. That’s because they are purely navigational and short-term in nature, a response to the market being focused on COVID-19 cases and fatality rates.

As fundamental investors, however, our process is rooted in long-term value. And in the intermediate to long term, we believe the economic impact of COVID-19 will ultimately be more important for market movements than case and death counts.

In the long run, it’s the economy, stupid, and that’s our beacon in the storm.

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