

## Black & White Swans

In the last week the US equity market has seen its fastest correction in US market history with the S&P 500 losing over 10% in only 4 trading days and we are now 13% below the mid-February highs. For investors without a good plan or those that are prone to emotional reactions these are scary times. Black and White Swan events have combined with fully valued asset prices to cause the sharp retreat.

A Black Swan event is an event beyond what is normally expected that can have potentially serious consequences. The term was popularised by Nassim Taleb, a finance professor and Wall Street trader who in 2008 authored the book "The Black Swan: The Impact of the Improbable". By their nature such events are only easily identifiable in hindsight, a bit like the maths problem at school which seems hard only until you solve it, and then its obvious. The Black Swan that has struck the markets in the past week is the seriousness of the Covid-19 virus outbreak as it spreads well beyond the Chinese mainland to South Korea, Italy and Iran in a fashion that has destroyed market hopes the virus was peaking, and the White Swan is the prospect of Bernie Sanders, the self-described "Democratic Socialist" becoming the Democratic nominee for President. Both of these threats have potentially very serious consequences for markets but equally both could fade away in coming weeks which would likely see markets recover very fast.

Of the two threats Covid-19 appears the more serious as it has the potential to change human behaviour in an economically damaging way and hit the lynch pin of economic activity, Western consumers. A wider outbreak globally will be very bad for growth and investment but ultimately will pass. The real issue is the extent of damage to global growth before the virus either peaks naturally or a vaccine is widely available to neutralise human panic. A global recession is possible, but a key point is that the markets will likely recover before the news cycle turns for the better and pent-up demand should see a fast recovery.

The White Swan, the rise of Bernie Sanders, is a predictable event but nevertheless one with serious

consequences. His policy prescriptions are quite radical, like nationalising the US healthcare system. In his younger years the 78-year old Sanders was an admirer of the Soviet Union. A Sanders Presidency would be at least as interesting as Trump's has been but much less friendly for investors. Markets in general will likely react poorly if it looks like Sanders is heading for the Democratic nomination and more so if he looks a chance of winning the main race. Thankfully Sanders is still a relative outside in a match up with Trump (Sanders winning is at 3:1 odds) and Biden's comprehensive win at the weekend in the South Carolina Democratic primary might see the Sanders's risk reduce but Super Tuesday (tonight NZ time) will see 14 states hold primaries and by the end of the week there should be a clear Democratic frontrunner. If Sanders performs strongly then the markets will focus more on the national polls and whether Sanders can upset Trump in November.

These types of events, rare but potentially very disruptive, emphasise the need for investors to have a) a plan, and b) emotional control as these will serve you well when the markets are testing your mettle. In our last newsletter "Patience is a Virtue" we looked at how patience can help you in investing and that principle is worth remembering when the markets get volatile. Often the best thing an investor can do when the markets behave like they are now is nothing. If you are an investor with a longer-term plan, then the question is are current events going to do irreparable damage to that plan or is the current volatility likely to be temporary. In 12-months' time will the world care about Covid-19 anymore? Will Bernie Sanders be US President? or will Trump have been re-elected. For financial markets the best outcomes appear to be that Trump is re-elected (or if he loses it is to a moderate Democrat like Joe Biden) and that Covid-19 has peaked and /or there is an effective vaccine available. It is perilous to make predictions, but that scenario seems most likely to us and that should see markets recover once the short-term pain has run its course.

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