MILITARY CONFLICT, TERRORISM, HEALTH EPIDEMICS AND THE MARKETS:
HOW INVESTORS KEEP CALM AND CARRY ON

It sounds so easy: buying low and selling high – yet in practice it is very difficult. One reason this is so challenging is when stocks are low, meaning attractively valued, many times there is something happening to shake our confidence in the markets and question if we should even consider owning such risk-based assets.

Several examples that could shake investor confidence include: economic recessions, military conflicts, terrorist attacks and/or health epidemics. Clearly when these events happen, given so many unknowns that accompany each, investors find themselves questioning how long it will last, how it could impact economic fundamentals and ultimately, how to respond when the stock market reacts.

MILITARY CONFLICT

The difficulty in buying low always comes down to timing. World War II serves as a perfect example.

The United States entered World War II on December 7, 1941 when Japan bombed Pearl Harbor. As expected, the stock market sold off. One school of thought is to return to buying stocks when we receive the "all clear" signal, which perhaps would have been when Japan formally surrendered on September 2, 1945. But if we were looking to buy low, historical data indicates the time to buy would have actually been in April of 1942, long before the war was over.

The bottom of the market occurred on April 27, 1942 shortly after Lt. Doolittle led the famous "Tokyo Raid," the U.S. bombing raid on Tokyo. At that time, the S&P 500 was at 7.61. When the war ended in 1945, the S&P 500 stood at 15.5. This means investors had an opportunity to more than double their money in the middle of a war. It seems buying stocks was not top of mind after the U.S. bombed Tokyo.

Now let's take a look at a more recent situation: the Gulf War in 1991.

In August of 1990 Iraq invaded Kuwait. The U.S. got involved immediately by building up troops in a deployment called Operation Desert Shield. The combat phase, Desert Storm, began January 16, 1991 and the war ended shortly after that on April 6, 1991. In this conflict example, the S&P 500 bottomed in October 1990, again long before the conflict was resolved. At that time the S&P 500 was at 295, and by the end of the war it was at 378, or up 28 percent in less than six months.

You can see that buying low requires an investor to buy risk-based assets when the crowd is running away from markets and selling assets. The time to buy is when uncertainty is peaking and emotions are running high. However, no one knows how long military conflicts may last and what they might do to the fundamentals of the underlying economy. For anyone that has found yourself fearful of the market reaction during military conflicts in the past, I suggest you look at historical data during times of military conflict as a starting point before making any dramatic investment decisions.

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TERRORISM

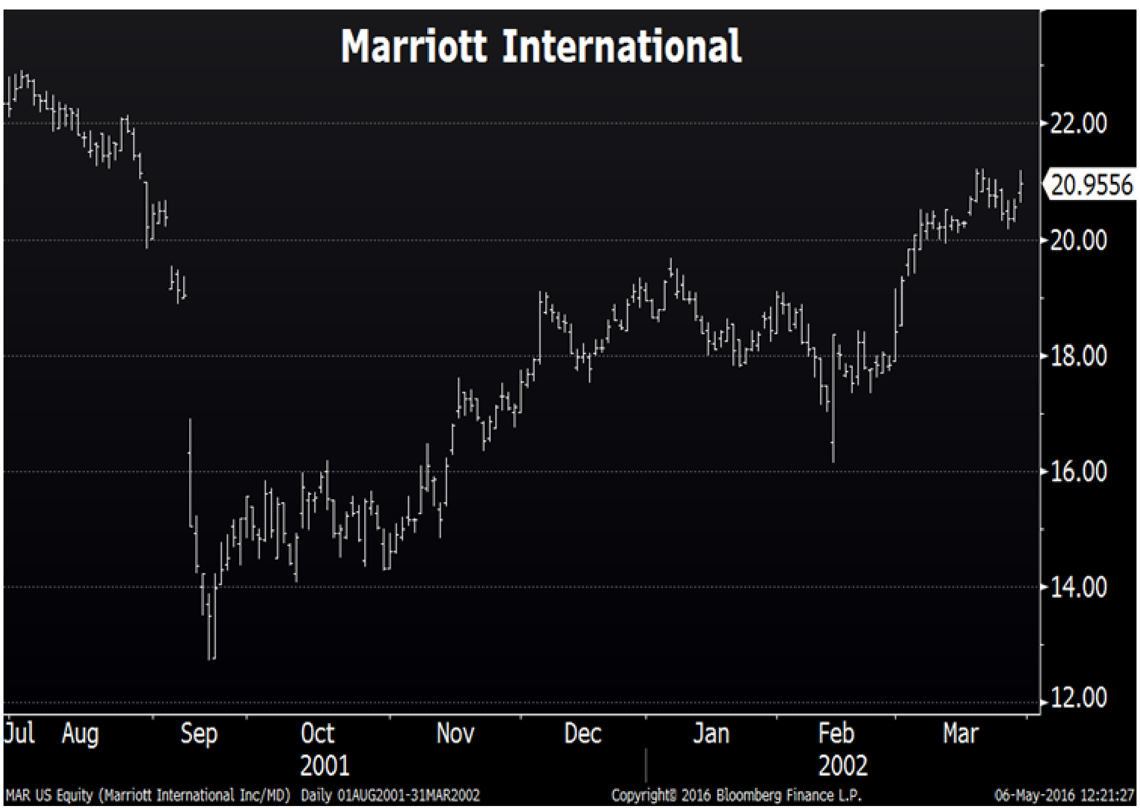
Terrorism, unfortunately, has plagued the globe for many decades. One might think that terrorism would have an impact on financial markets, but in fact, terrorism has little impact on markets. History tells this story as well.

One of the worst acts of terrorism on American soil occurred on September 11, 2001 (9/11). Four hijacked airliners resulted in 2,996 fatalities and thousands injured. In addition, the twin towers of the World Trade Center, also considered the most important financial hub in the U.S., were destroyed. This caused the financial exchanges in New York to be closed for four trading days, the longest shutdown since 1933. On September 17, 2001, the first day of New York Stock Exchange trading since the attack, the S&P 500, expecting chaos, lost 684 points or 7.1 percent - the largest loss in history for one trading day. By the end of the week, the S&P 500 was down 11.6 percent.

Many expected the markets would be down and out for several months. Yet it took only 30 days for the Dow Jones, the NASDAQ and the S&P 500 to regain their pre-9/11 price levels.

As I mentioned, some industries may sustain a more material impact. The airline industry suffered significant losses after 9/11 as the fear of additional hijacks escalated. The major airlines saw their stock prices tumble approximately 40 percent at the opening of the market on September 17. Steep declines also hit the travel, tourism, hospitality, entertainment and financial services industries. Marriott International, the hotel chain, is a perfect example. On September 1, 2001 Marriott's stock traded at $20.44; the stock bottomed on September 20th at $13.50. By March 2002 the stock was back at $20.50. See the chart below illustrating Marriott's pattern during this time.

But even as the number of terrorist attacks rise, it appears the markets have learned that they don't change the fundamentals of the economy. We all remember the recent Bataclan Theater shooting in Paris in November 2015, killing 137 and wounding 368. This represented the most fatal event on French soil since World War II. It happened on a Friday night and over the weekend I met with my staff to conduct research on what this could mean to the markets on Monday when clients would surely be expecting some communication from us. We spent hours reviewing historic events



and researching any other relevant data we could get our hands on. What's interesting is the market closed up, not down on Monday. Investors refocused on the prospects for growth worldwide as the Federal Reserve considered increasing interest rates. In addition, oil rallied sending the energy sector higher.

Unfortunately terrorism is now part of our lives. Does anyone remember the 1998 bombing of the United States embassies in Nairobi and Dar es Salaam? 214 people were killed and 4,000 wounded. In the weeks following, the market went up. Or how about the Baga massacre in January 2015? That conflict ended with at least 200 dead and another 200 unaccounted for in northern Nigeria. The market didn't flinch.

My point is not to desensitize these issues, but to strictly investigate the economic data and market action around these events. It is clear that, at least historically, terrorism does not change the fundamentals of the economy. It may have a material impact on specific industries, however much of that has proven to be temporary.

HEALTH CRISES

From time to time the human population becomes concerned with potential healthcare scares or epidemics. In 2013 an Ebola outbreak in Africa began. In September of 2014 the CDC confirmed a case of Ebola in Dallas. Once again the markets sold off and recovered to pre-event levels less than 30 days later. Even major epidemics haven't materially impacted economics. For example, look at the Great Influenza Epidemic of 1918. This is widely known as one of the most deadly outbreaks in history and was responsible for the deaths of 50 to 100 million people around the world. The virus spread easily as soldiers returned home from WWI. During that year the Dow Jones industrial average increased 10.5 percent; however it is notable that WWI also ended in 1918 as well.

I caution you to keep in mind when analyzing these events and market reactions that other variables will always concurrently impact markets. Market action is a function of the news of the day; with the question being: what news is nothing but noise and what news changes the underlying fundamentals? You may have news of a terrorist attack and favorable earnings reports on the same day. And while the market will react to uncertainty in the short-run, only a change in the fundamentals will cause a long-term market reaction.

Trying to time the market has been proven to be fruitless over time. Market troughs are created when bad things happen – and uncertainty is abundant – long before we get the "all clear" signal. Wars, terrorism and healthcare scares have the potential to affect the fundaments of the underlying economy, depending on how long the crisis lasts, but for the most part they don't change the fundamentals. We do know, at least historically, these events have a material impact on certain industries, but again they prove to be relatively short-lived.

Buying low can be difficult, but selling low becomes easy when investors erroneously react to events without knowing what truly impacts markets and companies' fundamentals. Perhaps the most profitable strategy is to invest in great companies and continue to deploy capital into the markets when there is a high level of uncertainty. I believe it was Warren Buffet who once said, "The best time to buy a farm is in a drought." Nobody wants to buy a farm in a drought.

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