Lessons from the Panic of 1907

At 3 a.m. on November 2, 1907, John Pierpont Morgan sat in his midtown Manhattan library playing hand after hand of solitaire, a habit he often turned to when struggling to solve pressing problems. The one on his mind that night: preventing the collapse of the US financial system. The Panic of 1907 had started two weeks earlier, destroying trusts and banks, threatening to engulf even the House of Morgan itself. It was time to end the panic.

At 5 a.m., he put the cards away and joined the trust presidents holed up in the library's east wing to present his plan. The 120 trust presidents had been summoned to resolve the panic. Now they were Morgan's prisoners, as he had locked the library doors hours earlier. The setup was classic Morgan: trapped opponents kept waiting for hours, outrageous last-minute demands, and an immediate decision expected. And it worked.

The trust presidents agreed to bailout the weaker trusts, and in exchange Morgan would finance a transaction for US Steel, adding capital to support the teetering financial markets. For his trouble, he took a hefty fee; this too was classic Morgan. The panic was halted and Morgan was hailed as a hero.

From a financial perspective, addressing a pandemic is similar to addressing a panic. Delay is key. The goal is to preserve the economic ecosystem by postponing all reckonings, giving companies breathing room until markets normalize. Delay long enough and eventually the panic/pandemic will subside. A regulator's playbook will unleash a flood of capital, slash rates, relax regulations, lower reserve requirements, allow deferred payments, and eliminate penalties on forbearance.

In response to COVID-19, the Federal Reserve has essentially followed this plan. The Fed's balance sheet deluged markets with capital, providing even weak companies with a lifeline. Availability of capital has allowed companies to refinance and extend maturities to wait out the virus. Large asset managers have provided capital when banks have been slow to act. Fiscal measures have put money into the hands of consumers and businesses. Now investors are waiting to see what happens when the eye of the storm passes.

After the jump, we talk about which sectors have been hit hardest and the broader trends shaping financial markets.

Q3 Economic and Market Performance Summary

Economic Performance

Although 2020 will be a miserable year for the economy, with full year GDP estimated to decline 8%, Q3 GDP growth is expected to grow by more than 30% on an annualized basis, according to the Atlanta Fed's latest estimate as of October 1st.

Employment is recovering, albeit slowly. There were 22 million jobs lost in March and April and less than half have returned. Currently over 25 million people are receiving unemployment support. The official unemployment rate according to the Bureau of Labor Statistics is 7.9%, but is almost certainly higher given the amount of involuntary part-time work and numerous discouraged workers not seeking employment.

Monetary Policy Overview

The Federal Reserve continued to flood the financial markets with liquidity, supporting equity and credit asset prices, further delinking those assets from underlying fundamentals. Monetary relief has provided companies with breathing room for the interminable pandemic to run its course. In Q3, the Fed announced that it will let inflation run hot, i.e., over two percent, and maintain a loose monetary stance indefinitely. Expect rates to remain near zero for years.

US and Global Equity Market Summary

The S&P 500 has clawed its way back to even through Q3 after plunging on virus concerns and soaring with Fed intervention. A sector analysis by representative ETF shows the worst performer being Energy, down 50% YTD, and the best performing sector being Technology, up 27%.

Outside the US, COVID-19 hit global equity markets hard. Global markets experienced a modest 6% bump in Q3, not nearly enough to make up for the massive declines from the first half of the year.

Broad equity market indices may be seen as a bet on a widely available vaccine.

Credit Markets

Credit Markets were up materially for the quarter. Investment Grade returned 6.64% YTD after a 1.5% gain in Q3. High Yield (HY) is back in positive territory YTD after a 4.6% gain on the quarter. Leveraged Loans are down 0.66% YTD, after a 4.14% increase in Q3[1].

Thanks to central bank support, credit market issuance is robust – BofA estimates global central banks are buying over $1 billion worth of bonds per hour. For the trailing year ending in August, investment grade bond issuance increased 70% to $1.50 trillion. Over the same period, HY issuance exceeded $387 billion, a 120% increase. Robust issuance hasn't improved yield. As one strategist at JP Morgan puts it: "Fixed income is now 100% fixed and 0% income."

The economic impact of the coronavirus has been tempered by strong monetary and fiscal policy responses, favorable asset price performance, and a strong credit market. We are now in the calm eye of the economic storm. What will the economy look like if high unemployment, low consumption and no mass gatherings continue for another quarter? Will a vaccine – over 250 candidates are now being tested (according to a McKinsey article in July on COVID-19 vaccines) – be available and accepted? Below we discuss what sectors will fall or ball going forward.

More Businesses Will Close for Good

In Mid-March Dan Stone, the owner of North Light, an Oakland cafe hip enough to play MF Doom on an actual turntable, closed the place down. Business had been reduced to a trickle even before the Bay Area's shelter-in-place orders, and now even that traffic was gone. Unable to pay his staff, lease, or suppliers, he had no choice but to close temporarily, as he noted in an essay in the California Sunday Magazine. With that decision, Dan Stone joined the 163,735 businesses that have closed since the start of the pandemic, nearly 100,000 of them permanently, according to Yelp's economic data.

Business closures are especially pronounced in big cities with higher rents. Lending Tree data confirms small businesses are hurting. Over 43% have seen revenue drop by more than 50%, with 6% closing for good.

Restaurants Continue to Suffer...

Yelp data shows the hardest hit business segments are retail and restaurants. The biggest losses are in the breakfast and brunch establishments, with 56 of every 1,000 places closing since March. Even pre-COVID, restaurants were known for having a precarious cash position (restaurants have a median cash buffer of 16 days, one of the lowest of any industry). Restaurants in big cities require crowds of diners for profitability, an untenable situation with reduced seating and delivery not profitable enough to pay pre-COVID level rents.

... As Certain Sectors Remain Resilient...

Over the same period the most resilient Yelp business sectors have been in the home, local, professional business service areas. Lawyers have had the lowest number of firm closures, with only 1.6 closures for every 1,000 businesses.

Larger firms are in a better position to tap the capital markets and get through an extended economic lull. Carnival Cruise, for example, has raised over $7 billion in debt since the start of the pandemic. Small and solo entrepreneurs face severe liquidity constraints. Small and medium sized businesses already working with asset managers are well positioned to access capital. Large asset managers have acted as a backstop during the pandemic, quickly supplying capital to businesses, even as banks cut their exposure.

...and Other Sectors Thrive.

Certain industries have thrived during the lockdown. Consumers were quick to adopt digital channels for banking, groceries, and health-related needs. Indeed, 75% of those first-time adopters plan to keep using digital channels post-pandemic.

Consumers trapped at home turned to online entertainment options. Social media providers, online gaming platforms, and at home workout services all saw use skyrocket during the pandemic. Extended periods of lockdown may habituate consumers to a new baseline of normal, locking in quarantine habits long after the virus is eradicated. Information technology companies will be the primary beneficiaries of the shift to online entertainment options.

As a high cost necessity, healthcare has been ripe for disruption. Telemedicine has now become normalized, allowing doctor's visits without any risky in-person contact, freeing doctors to see more patients, now unconstrained by geography. COVID-19 has accelerated telemedicine 'by a decade' according to Chris Jennings, a policy consultant and health care adviser. At-home-care and home health aides may also see long term growth, as people avoid places where the pandemic concentrated, such as assisted living facilities and nursing homes.

Repricing Assets and Reshaping Cities

Tech giants Amazon, Google and Facebook are in no rush to return to the office. Twitter says its workers never have to come back. (On the other hand, Netflix's Reed Hastings calls working from home "a pure negative.") As the quarantine stretches on, some companies now see an office as a burden.

The canary in the coal mine has been the retail market. In NYC, where retail sales have plummeted nearly 80% since Q1, retail rents have declined, dipping up to 38% in some areas. Asset repricings will ripple through the real estate market in the coming quarters and investors will have to adjust their return expectations. Yields for REITs have already shrunk.

In response to the virus, flexible leasing structures are already being put in place. Percentage leasing or income-based rent arrangements are now on the table, which gives landlord more skin in the game. As risk-shifting arrangements become more common, real estate investors will find new opportunity and innovation.

Tourism and Leisure Industries Face a Long Recovery

Visitors to Atlantic City casinos now gamble behind clear Plexiglas, shouting instructions through mandated face masks. With only three gamblers to a table, the atmosphere is restrained; winning just isn't as fun without a crowd. Like a library, casino floors now have no food, no beverages, and no smoking – all banned for health reasons. Tourist spots throughout the world are facing a similar dilemma, balancing health precautions with fun.

The tourism sector is larger than most people think. Worth $9 trillion, the tourism economy is three times larger than agriculture and accounts for nearly 10% of global GDP, according to the World Travel & Tourism Council. Since the lockdown started, tourism has declined by 60 – 80%. In the US, tourist heavy states, such as Nevada and Hawaii, have the highest level of unemployment and the highest rate of business closures. Disney recently laid-off 28,000 park workers, as it doesn't see a theme park recovery happening anytime soon. Nearly 50% of Americans don't feel comfortable getting on a plane until the virus is no longer a threat. A recent McKinsey report on the tourism sector estimates pre-COVID spending won't return until 2024. All hope is not lost for investors in this sector who can still find favorable risk-return trade-offs with enough research. A passive approach to investing will likely lag broader indices.

Final Thoughts

Change brings opportunity. As the world adapts to the virus, entrepreneurs will continue to experiment, new ways of working will take hold, and businesses will evolve – Dan Stone's North Light now does brisk trade in to-go cocktails and takeout meals.

The Federal Reserve was created in response to the Panic of 1907, as we couldn't always count on Morgan to save us. From the Panic, new institutions were created; the vulnerability of the financial markets was seen as a problem that no private citizen should control. The painful impact of the virus may, in hindsight, propel the world to new heights.

The Federal Reserve has committed to low rates for the next several years. In 2020, capital is abundant and yield is rare. For investors who need income, bonds alone no longer do the trick. The need for yield will drive investors away from passive investments into strategies that are more responsive to the market changes. Well-positioned asset managers have found opportunities in the pandemic chaos. Allocation flexibility and the ability to hold for long periods were strengths that savvy investors capitalized on during the market turmoil throughout the pandemic.

What was true for Morgan in the depths of the Panic of 1907 is true today: opportunity awaits for those who remain steady in the face of turmoil and have the capital to stay in the game.

[1]Return data for Investment Grade, High Yield, and Leveraged Loan indices sourced via Bloomberg as of September 30, 2020. Return data is based on closing price and does not account for reinvestment of distributions.