The Covid crucible: A play in three acts

Tracking the crisis in real time delivered remarkable lessons on how it was different from previous upheavals

By Paul McCaffrey

ASWATH Damodaran, a professor at New York University, determined early on not to treat the Covid-19 crisis like previous market shocks. As the pandemic unfolded, he could see how it was developing and realised it was having the same three-stage effect on investors as previous financial upheavals.

"First you lose perspective. Why? Because in the middle of chaos, things are melting down," he explained in his virtual presentation, "Crisis as Crucible".

"The second thing that happens is you lose faith in (the valuation tools) that you thought mattered... And the third thing is you outsource your thinking."

Prof Damodaran experienced this process like everyone else, but he decided that he would do things differently this time and keep a record of his thoughts and impressions in real time.

Why? Because hindsight is always 20-20: "It's impossible to keep out what you already know," he said. "So you write about the 2008 crisis in 2010. You know how it unfolded. You know the ending. So you can act like you knew it right from the beginning."

But with Covid-19, he determined not to let himself fall into that trap. So on Feb 26, 2020, he wrote the first post in his pandemic-focused series.

It was about two weeks after the true global ramifications of the coronavirus started to come into focus. His post reflected the confusion that everyone felt, and underscored how much we didn't yet know about the coronavirus.

And over the next eight months, he recorded his evolving perspectives on the crisis, writing the 14th and final entry in the series in early November 2020. Looking back over his account of those tumultuous months, he came to a conclusion: "This is a play in three acts," he said. "The meltdown, the melt-up, the recalibration."

Act I: The meltdown

Stocks entered 2020 with considerable momentum. "What they came in with was a full head of steam," Prof Damodaran said. "2019 was a great year for stocks. US equities were up about 30 per cent."

And for the first six weeks of 2020, they kept rising further and approached all-time highs. But then, on Feb 14, the Italian government announced that it had found 200 Covid-19 cases that couldn't be traced back to a cruise ship or to Asia. It was clear that the pandemic was not contained and had gone global.

"So we woke up to the crisis," Prof Damodaran said. "And for the next five weeks, remember what happened? We had a meltdown."

Lockdowns were instituted, schools and borders were closed, and much of the global economy ground to a halt. Both the S&P 500 and Nasdaq plummeted by 30 per cent or more. And it wasn't just US markets. Equity indices around the world went into a nosedive. "On March 20, the very darkest day, they were all down," he said. "There wasn't a single index that was unaffected."

The plunge in equities initiated a flight to safety and US Treasuries. "Across the board, Treasury yields dropped," Prof Damodaran said. "Thirty-year, 20-year, 10-year T-bills all down in the first five weeks."

The US Federal Reserve stepped in and announced on March 15 that it would resume quantitative easing. But that wasn't enough.

"The markets yawned and said, who cares?" Prof Damodaran said. "It looked like the world was ending. In fact, on March 23, if you looked at the news stories, it was doomsday. People said, Sell your stocks, head for the hills, the end is coming."

Act II: The melt-up

But then, just as the markets looked poised to plunge into another global financial crisis (GFC) or Great Depression, they abruptly stabilised.

What happened? On March 23, the Fed initiated even more substantive measures, pledging to serve as a safety net in the private lending markets. "You know what they meant, right?" Prof Damodaran asked. "They would lend to companies in trouble, buy low rated corporate bonds. And for better or worse, that seemed to turn the crisis around."

Private lenders started lending and the markets halted their downward spiral. "For whatever reason, we woke up on March 24, and everything seemed to have cleared," he said. And in the ensuing months, the equity markets not only recovered everything they'd lost, they headed to new heights. "By Sep 1, stocks were up to about where they were on Feb 14," he said. "The crisis was in the rearview mirror."

Act III: The recalibration

Over the next two months, the markets looked to achieve an equilibrium. "Between Sept 1 and Nov 1, there was a recalibration," Prof Damodaran said. "We had good days and bad days, but the market was trying to find a steady state."

So, how had the crisis reshaped the markets in those eight months?

The worst-performing industrial economy was the United Kingdom, which had to weather Brexit on top of the pandemic. The worst-performing regions were Russia, Eastern Europe, Africa, and Latin America.

Why these four? Because of their reliance on natural resource and heavy infrastructure companies, which were disproportionately impacted by the economic disruption.

Prof Damodaran also identified the sectors most affected by the pandemic through Nov 1. Based on his analysis of S&P global companies, consumer discretionary, technology, and healthcare came out well, while energy, real estate and utilities fared poorly, with financials falling with them.

"In most crises, young companies suffer at the expense of old companies, risk-on companies get hurt more than risk-off companies," Prof Damodaran said. "This crisis seems to have flipped the script."

The only exception to that rule was debt: High-debt firms performed worse than their low-debt counterparts. But otherwise, high-growth beat low-growth, non-dividend beat high-dividend, and high P/E beat low P/E.

Indeed, the major story in the equity markets during those eight months was the reallocation from risk-off to risk-on companies.

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>
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Postscript: The lessons

So what else was different about this crisis? For one thing, markets usually melt down first and bring the larger economy with them. In this case, it was the other way around. "The sequencing was off," Prof Damodaran said. "And it came with a timer. The timer, of course, was a complete lie: that in six months, we'll all be back to doing the normal stuff."

Another distinction was the role of venture capital (VC), which tends to sit on the sidelines amid financial panics, as initial public offerings (IPOs) are put on hold. But the venture capitalists never left the field.

"They stayed in the game all the way through," Prof Damodaran said. "In fact, the third quarter of 2020 was an all-time high for the number of IPOs."

And the investor class underwent something of a transformation during the pandemic. The big portfolio managers of Boston, New York, and London saw their roles diminished. "The composition of investors has changed," Prof Damodaran said. "This is a market driven by the masses of investors where the portfolio managers have to track the masses. They hate it. They like to call the shots but they no longer control this game."

Still, the larger story of the eight months between Feb 14 and Nov 1 is the effect the pandemic had on risk-on companies, six of them in particular: Facebook, Amazon, Apple, Netflix, Google, and Microsoft. "These six companies were up about US$1.3 trillion," he said. Over the same period, all other US equities were down US$1.3 trillion.

"You know why US equities are back?" he asked. "It's because of these six companies. You take these six companies out of the mix, all of that upside disappears. The stronger become stronger."

The writer is the editor of *Enterprising Investor* at CFA Institute