CUBICASSET MANAGEMENT, LLC

2014 4th Quarter Stock Market Commentary

INVESTING IS NOT ALWAYS EBOLA CHERRIES

"Nobody ever went broke underestimating the intelligence of the American public."
– H. L. Mencken

July 4, 1776 is one of the most significant days in American history. That is the day that the colonists declared independence from France. Or so one out of every six Americans believes. Fortunately, though, five percent of the population knows this to be ridiculous. They think we fought off the tyrannical reign of the Canadians. The average American's knowledge of our history and form of government is simply appalling.

According to a Newsweek poll a whopping 70% of the population does not know that the Constitution is the highest law in the land, and almost half do not know that the first ten amendments constitute the Bill of Rights. Freedom of Speech is the only amendment that more than half of the respondents could identify. Two thirds were unaware that the American economy is capitalistic, or market-based. And this ignorance is not limited to some undereducated minority. Among college graduates a majority do not know the length of the term for either a Congressman or a Senator, or the significance of the Emancipation Proclamation. It is unlikely to get much better, either, as only 18% of American colleges and universities require any history course for graduation. More than 40% of the citizenry is not capable of passing the American citizenship exam we require of immigrants seeking to become naturalized citizens.

This type of obliviousness often serves as fodder for late night television hosts. When several streets were closed in Los Angeles in October because of a visit by Joe Biden, Jimmy Kimmel took to the streets and asked a dozen people on Hollywood Boulevard, "Who is Joe Biden?" Not one person could answer correctly. One guessed he was a movie star, another that he was the governor of California. One thought he was "that old dude from Pineapple Express," while another thought he was a member of a terrorist group. One did get close, though, guessing that he was "the assistant President."

The 18th century English poet Thomas Gray coined the phrase "Ignorance is Bliss" in his *Ode on a Distant Prospect of Eton College*. If, in fact, ignorance is bliss, America must be ecstatic.

While it may seem unrelated, these musings were prompted by the stock market's October swoon. From its high on September 19 to its trough on October 16, the S&P 500 fell 9.84% from 2019.26 to 1820.66, almost meeting the technical criterion for a market correction of a 10% decline. Spooked by the market's tendency to give up ground in October, financial news networks and publications trotted out a series of talking heads to analyze the reasons for the drop. These included:

1) data signaling an economic slowdown in China, which has been the primary growth engine for the world economy;

2) worries about Eurozone weakness, including weak industrial production figures and negative GDP from Germany and the severe drag imposed on Europe by sanctions against Russia after its aggression against Ukraine;

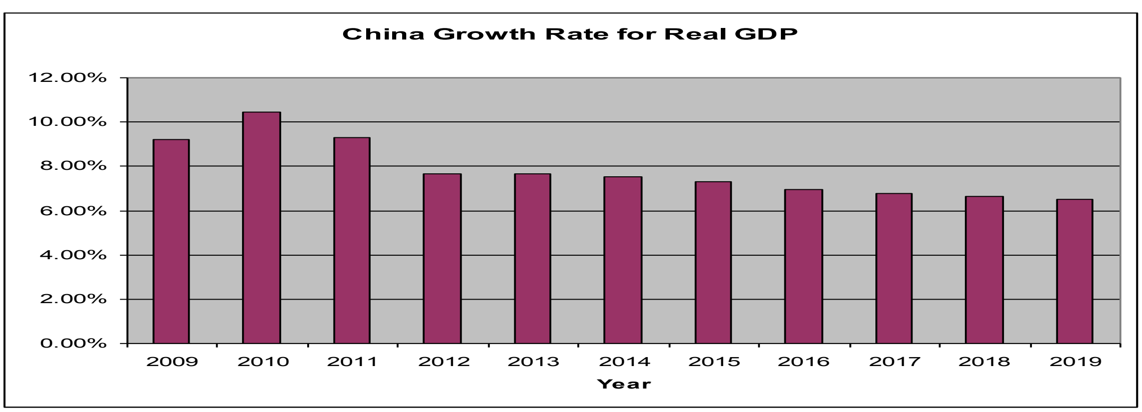
3) the termination of quantitative easing by the U.S. Federal Reserve, potentially causing a rise in interest rates;

4) plummeting oil prices, which correlate to reduced growth worldwide, and which threaten the principal source of high-paying job growth in the U.S.;

5) tensions arising from the military success of ISIS followed by the resumption of air strikes in Syria and Iraq;

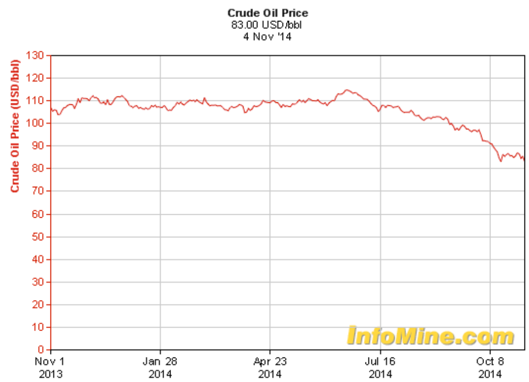
6) news of the first confirmed case of Ebola in the United States, which would possibly crimp the travel and hospitality sectors, and dampen economic activity.

In our opinion, though, with one exception, the factors cited had negligible impact. Consider, for example, the slowdown in the growth rate of the Chinese economy. Below, we have created a chart showing the real (that is, adjusted for inflation) growth rate in China GDP from 2009-2014, together with IMF forecasts for 2015-2019. The growth rate peaked in 2010 at 10.45%, dropped sharply in 2011 to 9.3%, and then even more sharply to 7.65% in 2012. How did the U.S. stock market fare during this period of deceleration?

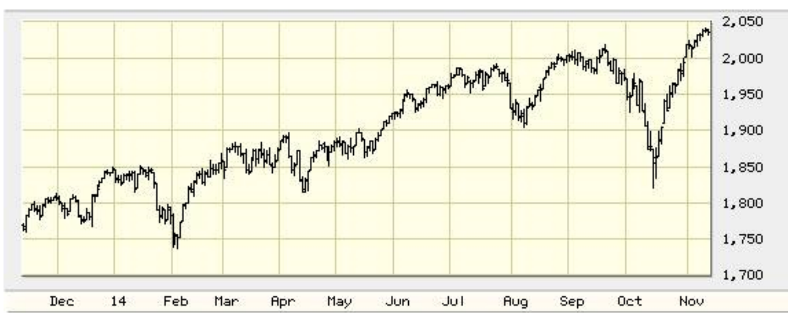


It rose 16.46%, or 7.94% per year on an annualized basis. Going forward, the growth rate is predicted to fall from 7.54% in 2014 to 7.29%, much smaller than the decline that the market shrugged off two years ago.

Perhaps, then it was the decline in oil prices that caused investors to panic. Again, it seems unlikely. The graph below shows the price per barrel of a generic barrel of crude oil from November 2013 through the end of October 2014. Oil peaked at the end of June.



But a glance at the chart below of the S&P 500 for 2014 shows that the market rose from June 24, 2014 (the date that oil prices peaked) through the end of September. Investors did not seem particularly concerned, instead viewing falling oil prices as a positive for consumers, analogous to a massive tax cut.



Similarly, Russian aggression in the Ukraine, the threat posed by ISIS, and the well-telegraphed end of quantitative easing, all began before the market's drop, and were conveniently overlooked by bullish investors.

So what was different in September and October? The answer is a recognition of the threat posed by the spread of the Ebola virus. In early September both Medecin Sans Frontieres (Doctors Without Borders) and the United Nations warned that the disease was not being contained by a tepid world wide response. On September 30 the Centers for Disease Control confirmed that Thomas Eric Duncan was the first case of Ebola in the United States. The news media went into overdrive, terrifying the public into believing that everyone was at risk. In Hazelhurst, Mississippi, parents pulled hundreds of middle school students from class after learning that the school's principal had traveled recently to Zambia to attend a family funeral. No matter that Zambia, in southern Africa, is 3,028 miles from Liberia, a longer distance than from New York to Los Angeles. A Maine public school teacher was put on administrative leave for 21 days after attending a conference in Dallas (where Thomas Duncan was first diagnosed), despite the fact that she stayed at a hotel 10 miles away from Texas Health Presbyterian Hospital. Navarro College, a two-year college about 60 miles from Dallas, sent out rejection letters to applicants from Nigeria because the country had a few Ebola cases.

Stocks plummeted across the board, wiping out roughly $1.5 trillion in market value. Airline and hospitality company shares were especially hard hit as investors feared that Americans would opt to simply stay home rather than risk exposure. But was a drop of this magnitude warranted, or was this simply an overreaction which offered a buying opportunity? Here is where a bit of knowledge of history would have been helpful. First of all, only two people have died in the United States from Ebola of the ten that have been infected. There have been many epidemics in the United States which affected far more people. Shortly after the birth of our nation there was a yellow fever epidemic in Philadelphia which killed an estimated 2,000 people. Half a century later there was a cholera epidemic responsible for an estimated 150,000 deaths. In the early twentieth century, the Spanish Flu of 1918 (a misnomer since it neither originated in Spain nor affected Spain more than other countries) killed 675,000 Americans. Even more recently, in 1957 there was an outbreak of Asian flu, a variant of influenza A, the same type of virus that causes swine flu and bird flu. The virus was identified quickly and a vaccine was developed within a year, but not before the disease had killed an estimated 70,000 Americans. This list is far from comprehensive. There have been epidemics of smallpox, polio and cryptosporidium, all within my lifetime. But it shows that periodic epidemics have occurred throughout the nation's history, almost all of which affected many more Americans than the current Ebola infection event.

But our concern is with the investment implications of the epidemic, not its prevalence or virulence. Here it is useful to look at the closest recent analog, the SARS epidemic (severe acute respiratory syndrome) of 2002-2003. This epidemic originated in China, where officials did not acknowledge the problem and simply treated it like the typical flu, despite the severity of its symptoms. It came to the media's attention when an American businessman traveling from China became ill with pneumonia-like symptoms while on a flight to Singapore. The plane stopped in Hanoi, Vietnam, where the victim died. Several of the medical staff who treated him soon developed the same disease despite utilizing basic hospital procedures to avoid infection. The severity of the symptoms and the infection of hospital staff alarmed global health authorities fearful of another emergent pneumonia epidemic. On March 12, 2003, the World Health Organization issued a global alert, followed by a health alert by the United States Centers for Disease Control and Prevention (CDC). Before the epidemic ran its course it affected roughly 8,300 people in 17 countries, and killed 10% of those infected. Twenty seven Americans contracted the disease.

All epidemics extract a considerable economic cost and the SARS epidemic was no exception. Obviously, there were substantial direct medical costs for treating patients in a sterile environment. There were also the costs associated with prevention and basic research. Workers at airports and retailers in affected areas were issued infection preventing masks, for example. But these direct expenses were dwarfed by the costs associated with changed behavior. Fear of SARS infection led to a substantial decline in consumer demand, especially for travel and retail sales service. The fear of contagion made people avoid social interactions in affected regions.

Additionally, the fact that the future course of the epidemic was uncertain dampened investment. For example, since China was the locus for the start of the disease, foreign investors reduced the flow of funds into China.

In a paper entitled *Estimating the Global Economic Costs* Jong-Wha Lee of Korea University and Warwick J. McKibbin of the Australian National University and the Brookings Institution estimated the reduction in GDP in each country infected by the health crisis. Not surprisingly, SARS had the biggest impact on China, where GDP was reduced by a whopping 2.34%. But in the United States, with its superior health care system and greater transparency, GDP was lowered by 0.07%. Currently U.S. GDP is about $16.8 trillion, so a comparable reduction would amount to $11.8 billion. This is a substantial amount of money, but not enough to prompt $1.5 trillion in stock market losses. Those investors who had a sense of history were wise to use the decline as an entry point in advance of the powerful rally that followed.