EPIC INVESTMENT MANAGEMENT

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Coronavirus

We begin with an unaltered copy of a mid-quarter letter sent exclusively to clients, followed by updated thoughts on coronavirus, our economy, and financial markets.

For the tenth time in the past 14 years, the US equity market has suffered a decline of ten percent or more. In this case, the decline measures 13 percent to date and certainly could continue lower. And as with most previous corrections, this one feels different.

Indeed it is unusual, in that this decline has taken place in such a short time span. It was less than two weeks ago that US markets were making all-time highs, with numerous asset classes rising in unison, be it equities, bonds, gold, or the US dollar. The sudden swoon is also unusual in that it is related to a global health crisis.

The proximate cause of the rapid reversal is the coronavirus (aka COVID-19), and its unexpected sweep of the globe. Just weeks ago, the virus was thought to be contained to a region of China, and though while deadly, the virus posed neither a regional nor global health risk. That assessment proved wildly wrong. COVID-19, having circled the globe, is now seen as a threat to worldwide health and economies, and therefore financial markets.

There are two extreme sentiments regarding the health risks posed by COVID-19. The first is dismissive, noting that influenza is responsible for far more deaths (36,000 on average in the US) than this novel virus. This is true, but misleading. COVID-19 has barely started its infectious cycle, and we do not know how pernicious it will become. The second sentiment seems dire, although it is too early to disprove. A health expert from Harvard University estimates that 70 percent of the world's population will eventually be infected. If this is correct, and the death rate of over two percent is sustained, the human toll will be an almost unfathomable figure, well into the millions. While patients are receiving care for the virus, there is no vaccine and it is questionable how effective any treatment has been.

The most likely case is that the truth lies between these two extremes -- although the virus will spread to a large population, through vigilance or nature or scientific breakthrough, COVID-19 will become manageable. The difficulty facing governments, businesses, and citizens is that, at this time, the outcome is unknowable.

Worldwide, government and business leaders have taken dramatic steps to counter the spread of the virus, including massive quarantines, factory and store closings, travel restrictions, work-from-home edicts, and school suspensions. From a health standpoint this may be justified. From an economic basis, it is a contractionary force pushing the global economy toward recession.

Consider that China's first quarter gross domestic product is likely to shrink for the first time in decades, no matter what the official statistics claim. In the fourth quarter, Japan's economy fell at a six percent annualized rate after the implementation of a large tax hike. Germany grew its economy by less than one percent last year, despite the European Central Bank offering all the monetary stimulus it could imagine. That's three of the world's top four economies on the brink of recession, leaving the US as the sole engine of growth. And while the US economy overall may prove resilient, stockholders invest in companies, many of which have become global in nature, from their supply chains to their end markets. A global downturn is a real threat.

Government officials and investors are highly alert to the health and economic threats at hand. The Federal Reserve is expected to ease, perhaps as early as this month; although with rates already at historic lows, it may amount to pushing on a string. Fiscal policy has little to offer, as the US is already running a trillion-dollar budget deficit. If global supply chains are broken and consumer demand is shocked into a stupor, it is difficult to imagine an effective policy response short of curtailing the virus itself.

On the corporate side, earnings estimates will surely be trimmed, with the potential for a second straight year of zero profit growth. Stock market liquidity remains problematic. Investors can buy and sell at will in normal times, but once a problem arises, liquidity dries up. For the past decade we have remarked that markets are now built for speed, not for depth and stability. Rapid sell-offs are the result and in that regard this one is no different.

This leaves equity markets in a bind. Prices are already down 13 percent and the possibility of a bear market (down 20 percent) cannot be dismissed. In the fourth quarter of 2018, a bear market hit for no good reason, certainly nothing as serious as this circumstance. On the positive side, short-term signals suggest a rebound is in order. Any good news on COVID-19 will undoubtedly spark a rally, and if the virus amounts to nothing more than a newer version of the flu, stocks should regain their prior highs. The problem is, either expecting a favorable outcome or a worst-case scenario, it is all speculation at this point. One of the oldest and mostly useless clichés on Wall Street is that markets hate uncertainty. Well, at this point, uncertainty is all we have.

Eventually, we expect new equity highs to be attained, as the long-term bull cycle remains intact. But that does not convince us the next sustained move is up. We have remained inactive through these past few weeks and do not see a need to step into the breech just yet. Further downside risk exists, including a possible bear market, at which point we would be more encouraged that prices have re-set to attractive levels. Sometimes discretion is the better part of valor; just as watchful waiting can be the preferred medicine.

Update

What a difference 30 days makes, and how easy it all fits together with the benefit of hindsight. The health crisis spread deeper, our economy suffered greater, and financial markets seized up faster than we could imagine just a month ago.

The market correction of early March turned into a full-fledged bear market with a kicker. The stock market dropped so far, so fast -- moving at record speed -- that it is being called "a crash". If we accept the label, this is the third market crash of the past century.

The first crash took place in October 1929 and became known as the starting point of the Great Depression. Yet the 1929 bear market becoming associated with economic calamity was more a question of subsequent policy failures than of investor prescience. Indeed, from trade wars, to monetary tightening, to tax hikes, the 1930s was a disaster of government's making.

October 1987 was a beast of a different type. In one day, stock prices fell 22 percent, sending economic historians to dust off their textbooks in search of wisdom from the 1929 debacle. But it was not to be. The crash of 1987 was a market phenomenon, not an economic event. We suffered no recession, no earnings decline, no dividends cuts. The market bottomed, and moved on from there, never to re-visit its infamous lows.

Then what of 2020? As with the prior two equity crashes, this time really is different. It is neither the start of a decade-long economic calamity, nor is it solely a market event. Instead it is a reflection of the economic fallout of a health care crisis.

For all their unique circumstances, most bear markets display certain similarities. First, when markets become illiquid, and investors need to sell either due to margin calls or mutual fund redemptions or just pure panic, stock prices lose their connection to economic reality. Trading reverts to a simple case of supply and demand. If there are too many sellers, prices fall. The selling stops when it stops, not when some measure of fair value is reached.

Second, it always feels like the world is coming to an end... that this is the big one, from which we will never recover. And history says, over and over, don't you believe it.

The virus itself is a real global health crisis. Experts suggest it is more contagious than the winter flu, and 10 times more lethal. Run the numbers and the conclusion is obvious -- slowing or halting the spread of the virus is the only acceptable policy response.

The economic fallout from our emergency policy is severe. The second calendar quarter is likely to show the largest, swiftest contraction on record; worse than the global financial crisis of 2008, or any three months of the Great Depression. What we do not know is the duration of the downturn. As of now, the best guess is this will be a short, sharp recession, measuring two quarters, followed by a

sustained recovery. This is what happens when a large portion of the US economy is shut down, then re-started. So they say… there is no historical analog.

All short-term pain notwithstanding, this shut-down is the correct response. We can argue over the duration of the policy later, when normalcy has returned.

It bears reminding that economic downturns -- recessions -- are not the end of the world. They are a normal part of economic/ business cycles. On the other side, when we come out of recession, we will enjoy the tailwind of enormous stimulus -- fiscal and monetary combined.

The Federal Reserve recently cut its policy rate to zero, and is providing liquidity to financial markets on at an unprecedented level. Congress and the Administration have agreed to a two trillion-dollar spending plan supportive of displaced workers and damaged businesses. To put this in context, two-trillion dollars represents approximately nine percent of our annual output, and takes the estimated budget deficit for this year above three trillion dollars, 14 percent of our gross domestic product. It doesn't end there. Another stimulus plan is in the works, probably for an additional one-to-two trillion dollars. Extraordinary times require drastic measures. We will figure out how to pay for it, if that issue ever arises, at a later date.

Markets are well ahead of the economy, both on the downturn and likely on the upswing. We need not wait for sure signs of the economic recovery; equity prices will anticipate it. They always do. But timing is never easy. After a sharp market rally in late March, it makes sense that equity prices will back and fill, creating some type of re-test of recent lows.

History says there are two strategic mistakes made by equity investors: first, they ignore high valuations and speculative fervor when markets are frothy, believing that good times last forever. Second, they give up hope when things look grim, failing to recognize that market pricing is ahead of their thinking, that selling when assets are cheap is a fundamental mistake offering little hope for recovery. We try to remember the first mistake, and are determined not to commit the second.

Additional Thoughts

The weakness in our financial markets is all about the economy. The problem with our economy is all about coronavirus. The fix for the first two is in finding a solution to the virus, plain and simple.

We really do not need our government for much. But when we do, and it has been 'preparing' for pandemics and biological warfare for more than a decade, it still fails miserably… too few gloves, masks, test kits, ventilators, hospital beds. State governments plan their own responses, on their own timelines. Spring break, anyone? When Winston Churchill famously observed, "You can always count on Americans to do the right thing -- after they've tried everything else", he succinctly described our government.

The two trillion-dollar stimulus and relief package passed by Congress is the third bill related to coronavirus and its effect on our economy. Expect a fourth bill later this year, probably with another trillion-dollar price tag. The good news is enormous stimulus will limit the economic fallout. The bad news is Washington is injecting itself into our economy at a level not seen since World War II. That war ended; this power grab may not.

How do we pay for all this spending? We borrow more money than we have ever borrowed in our history. Basic economic theory says the increase in debt will lead to higher interest rates. In the 1970s, the Federal Reserve tried to mitigate this by monetizing the debt. This caused runaway inflation, which led to higher bond yields anyway. This go-round, our central bank is doing something similar, yet interest rates are falling, and no one is worried about inflation. It is a neat trick: our Treasury issues debt, and our central bank buys it. Two parts of the same government are playing a shell game. So far, nobody is complaining. Then again, nobody has seen the ending.

In a story out of the UK, a noted epidemiologist estimated deaths from Covid-19 to total 2.2 million in the US, and 500,000 in the UK. After receiving some critical scrutiny, the UK estimate was reduced to 20,000. From half a million to 20,000 -- a 96 percent reduction -- all with the skillful use of an eraser. Weeks later, US officials tossed out a possible death toll of 100,000 to 240,000 Americans. We'll call that a 90 percent reduction, and hope it is far too pessimistic. So far, it's all a bunch of guesswork.

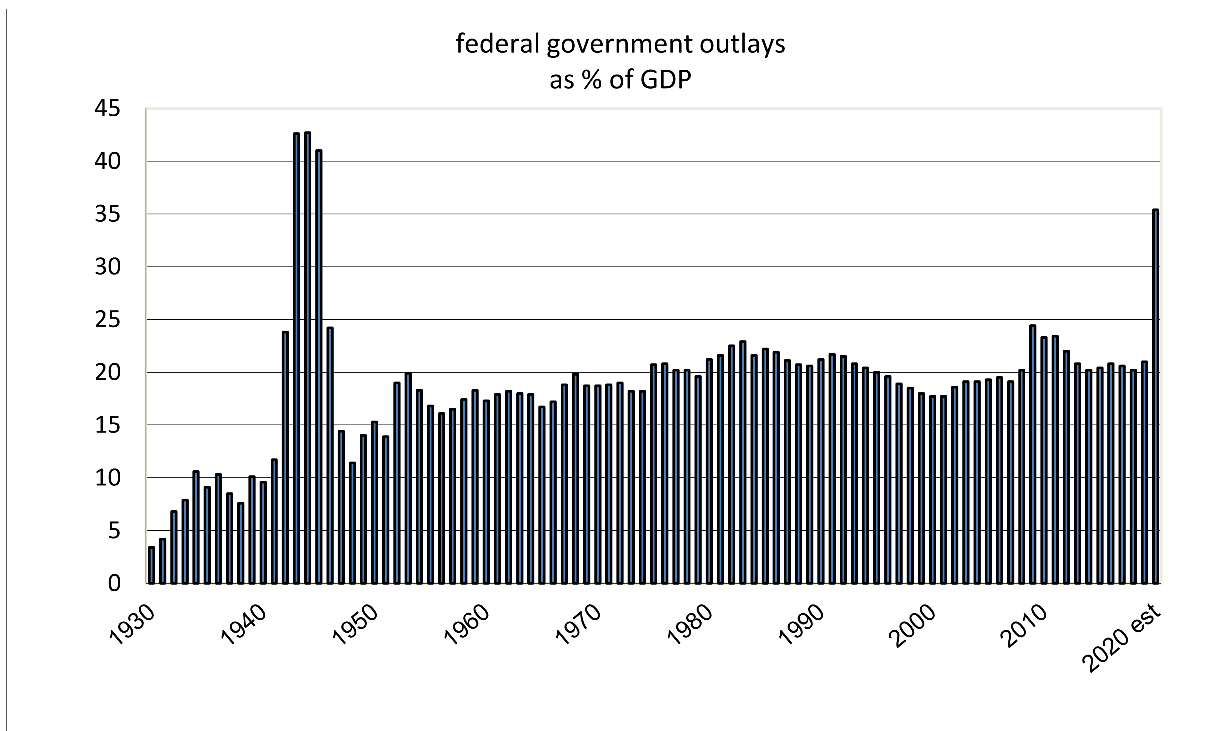
Wash your hands, stay healthy.

How large is Washington's fiscal response to this downturn?
In the post WWII-era, it is unprecedented.

Let's start with a running federal budget of 4.8 trillion dollars, then add two trillion dollars of additional spending already approved by Congress and signed by the President. Next let's assume another one trillion dollars in a 'phase 4' stimulus plan later this year.

That gets us to 7.8 trillion dollars of federal spending, compared to a gross domestic product of roughly 22 trillion dollars, equaling 35 percent of the economy.

If we assume the next spending bill is two trillion dollars, the percentage jumps to 40 percent, right up to World War II spending levels.



data source: Office of Management and Budget

Tidbits…

US and France reach trade war truce, defer action on France's proposed digital service tax until 2021.
US and China sign 'phase one' of trade deal.
UK crosses Brexit Rubicon, officially leaves European Union.

Seem like forgotten issues at this time.

Chocolate alert: Cocoa producers Ivory Coast and Ghana, producing 60 percent of world's cocoa, form cartel, intend to raise prices.

Retailer Pier 1 files bankruptcy.
Job furloughs at Macy's, Gap, Kohl's measure in hundreds of thousands as retailers retrench.
Department stores share of retail sales fall from 9.5 percent in 1980, to 1.2 percent today.

Virus fallout accelerates shift to e-commerce, much of it unlikely to return.

BioMarin Pharmaceutical proposes price tag of two-to-three million dollars for hemophilia gene therapy treatment.

McClatchy, newspaper chain with 30 newsrooms across US, including Miami Herald and Sacramento Bee, files bankruptcy.

OPEC + fails to reach oil output agreement, Saudi Arabia responds with price war, production ramp.
Crude oil prices collapse, approach two-decade lows.

Bankruptcies ahead for oil patch.

New York Stock Exchange trading floor temporarily closes in face of coronavirus, all trading goes electronic.
Internal Revenue Service extends tax return deadline to July 15 in response to coronavirus crisis.
US air travel falls 90 percent compared to year ago levels; entire system may shut down.

US one-month and three-month Treasury bill rates briefly drop to negative yields.

Initial jobless claims in US spike by 11-fold in one week, to record 3.3 million new claims, then double again to 6.6 million claims.

Justice Department opens investigation of Congressional members suspected of selling stocks based on confidential information of coronavirus severity.

String 'em up, drain the swamp.

World index of economic freedom reaches record high, US ranks 17th of 180 nations.

World's funniest headline:
United States's long-term issuer default rating was affirmed by Fitch at AAA.

Source:
Bloomberg
Office of Management and Budget
The Heritage Foundation
The Wall Street Journal