

Coronavirus outbreak: looking beyond the recession

In this issue of the Thinking Man we give a brief update on the coronavirus outbreak, summarizing the key actions taken by central banks and governments and the market reaction to those measures.

We believe the market has already priced in an economic recession and we reiterate our view that current market levels will likely provide significant upside for long-term investors.

We expect the next bull market to start before the current recession ends, as it's historically been the case. It is our opinion that the new bull market will be structurally different from the one that just ended, which was driven by mega-cap technology stocks. We expect the new bull market to have broader industry participation, including a re-rating of value stocks.

We believe hedge assets play a crucial role in portfolios, which is evidenced in times of crisis and is key to protect portfolios. We show how this played out in the 2020 market crash.

Last but not least, we believe there are a number of structural reasons why the 2020 market decline has been the fastest crash in history, driven by indiscriminate selling by some market participants. We see this as a unique opportunity for bargain hunters to buy securities of strong companies at very attractive valuations.

Update on recent events

Over the last two weeks, since we published the previous [Thinking Man](#), we have seen a rapid escalation of events surrounding the coronavirus outbreak.

The U.S. now has the highest number of confirmed Covid-19 cases in the world. The hardest hit state is New York, accounting for a little bit less than half of the confirmed cases in the country. The government expects the self-isolation and shelter in place orders to start having a significant effect in reducing the number of virus infections (i.e. flattening the curve) over

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- On Covid-19: Bill Gates, co-founder of the Bill and Melinda Gates Foundation has said that the number of U.S. cases has not yet peaked and the country won't likely be able to return to normal life by April.
- We will likely see a U.S. and a global recession in 2Q 2020 and 3Q 2020 and more extreme market volatility in the near term.
- However, we see attractive investment opportunities for long term investors, especially if we, as a society, are able to beat Covid-19 in the next several months.
- Policy makers have provided the most aggressive policy response in history. This gives us comfort that a Depression scenario is very unlikely. Moreover, we see a strong rebound in the U.S. in 4Q 2020 and 1Q 2021.
- Long-term investors with no leverage have time on their side and a unique opportunity to take advantage of attractive valuations in equities and wide credit spreads.
- We recommend focusing on high quality companies that are market leaders within their industries and have strong balance sheets.
 - For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com



the next few weeks. President Trump had publicly announced his desire to start opening the economy in parts of the country by the middle of April, against the recommendation of leading epidemiology experts. However, over this past weekend, he backed out of his previous comments, and extended the government social distancing guidelines until April 30, 2020. Nevertheless, it is important to remember that the states have full autonomy in imposing or lifting restrictions.

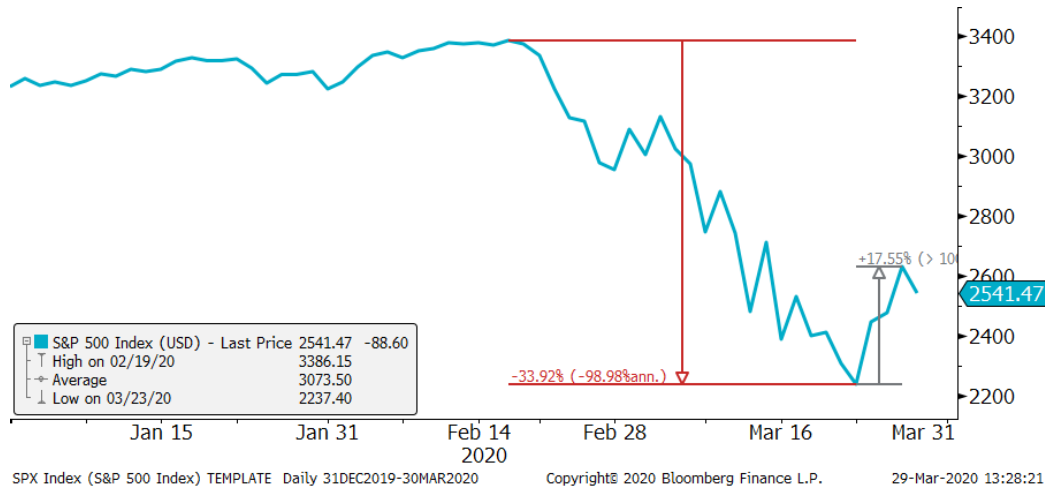
In terms of monetary policy, the Federal Reserve (Fed) and other Central Banks continue to use all the ammunition at their disposal to support the economy and the markets. The Fed expanded the \$750 billion quantitative easing (QE) program that it initially announced, to a “whatever it takes” approach, and broadened the asset classes it is allowed to purchase. It also continued to reopen many of the lending facilities created during the Great Financial Crisis (GFC) to unfreeze credit markets. Similarly, the European Central Bank (ECB), announced a €750 billion round of QE, and other central banks worldwide have followed suit.

The most notable development over the last couple of weeks was on the fiscal front. The U.S. Congress approved an unprecedented \$2 trillion stimulus package, aimed primarily at providing monetary aid to lower income households, protecting employees in the current workforce, and rescuing small and medium size businesses. Similarly, the European Union is actively looking at all alternatives to increase fiscal spending in its member states, either by using the European Stability Mechanism, a €500 billion bailout fund, or by issuing common debt instruments for the first time.¹

Both governments and central banks have understood the urgency of the matter and have unleashed a full range of measures to protect consumers, businesses and the economy. They have been able to quickly draw from the playbook used during the GFC, responding to the threat with unprecedented speed. The combination of both fiscal and monetary stimulus have been well received by the market in general.

Since the markets peak on February 19, 2020, U.S. equity markets moved in a downward slide, reaching a low on March 23, 2020. As can be seen in the chart below, measured by the S&P 500, the market dropped 34% from peak to trough, marking the fastest bear market on record. After the market close on March 23rd, investors cheered the good news coming from Congress with the fiscal stimulus bill, a measure that could prevent the economy from entering into a deep recession. As a result, over the next 3 trading sessions the market had a steep reversal, with the S&P 500 rising almost by 18% from its lows.

¹ The European Stability Mechanism is a European Union agency that provides financial assistance, in the form of loans, to euro-zone countries or as new capital to banks encountering difficulty. It is a permanent agency, based in Luxembourg, and has replaced the temporary European Financial Stability Facility (EFSF).



Recent behavior of fixed income markets seems equally positive. After a tremendous expansion of spreads, on both investment grade and high yield bonds, spreads have started to compress over the last few days. For example spreads in global high yield expanded from 430 bps in mid-February of 2020 to almost 1200 bps on March 23, 2020, only to contract to just over 1000 bps points recently. More importantly, credit markets have slowly started to unfreeze, and even corporate bonds have been issued for the first time in several weeks. Remember from our previous Thinking Man, that a well-functioning credit market is vital to prevent a solvency crisis, which could unleash a deeper and longer lasting economic downturn.

Markets anticipate economic developments

In the previous issue of the Thinking Man (“Coronavirus outbreak: investment ramifications”), we mentioned our belief that the market was in a “bottoming process” that was likely correlated with a peak in the number of new contagions in the U.S. Despite the strong market rebound from recent lows as a result of the massive fiscal stimulus package recently approved, the main issue of the virus outbreak remains unresolved. Thus, it is difficult to say if the ultimate market bottom of this crisis was touched last week. A retesting of the recent lows is likely in our view, especially if the situation continues to significantly deteriorate in New York, and there is another major city with an outsized outbreak, or if the virus takes longer to peak than the 4-6 weeks currently projected. In fact, Bill Gates, co-founder of the Bill and Melinda Gates Foundation, has said on major media outlets that the number of U.S. cases has not yet peaked and the country will likely not be able to return to normal life by April of 2020. We believe such a scenario would entail an extension of isolation measures by local governments, possibly forced quarantines, and likely requiring an additional stimulus package from the government.

Even if that were the case, we continue to believe that the current market levels will most likely provide significant upside for long-term investors. We believe that time is on the side of investors like our clients, with no leverage in their portfolios. Markets are discounting mechanisms. Investors waiting for a confirmation of the recession and its severity, could be greatly disappointed potentially missing out on tremendous market upside, in our view. As has been the case historically, by the time we get confirmation



from the data that we are in fact in a recession, the market will have already incorporated the recession, and we could potentially be several weeks well into the next bull market.

Currently, the consensus base case scenario is that the virus will peak in the U.S. towards the end of April, 2020, and gradually decline from there over the next few months. Even though a definitive cure such as a vaccine is not expected until next year, a cocktail of drugs is likely to be developed that will at least help fight and minimize the symptoms of the disease. As a result, analysts are expecting a strong economic rebound in the last quarter of 2020 into the first quarter of 2021. Furthermore, both central banks and governments are using all the ammunitions at their disposal to protect the economy and avoid a depression. This differs significantly from what happened during the 1929 Great Depression, where interest rates were raised while monetary policy was tightened and taxes were raised, which worsened the problem. The current mix of low rates, high liquidity, and fiscal stimulus could prove to be the necessary inputs to generate an economic boom and a resumption of the bull market after we exit the virus-induced economic halt and associated recession.

The new bull market

In one year's time, with the virus hopefully behind us, and the economy back to normal, we expect to be at the beginning of a new economic cycle. That said, we do believe that the outbreak will have an effect not only in our daily lives, but also on the markets. The last bull market was driven mainly by almost zero interest rates, as well as consecutive rounds of QE. Low reference rates and huge liquidity inflows pushed yields to historical lows, gradually forcing fixed income investors out of their comfort zone, either to lower rated issuers or, in many cases, to equities. This dynamic helped fuel the impressive rally of the stock market during the last decade. However, as we have mentioned on prior editions of The Thinking Man, we were concerned that the rally had been narrow and concentrated in mega-cap tech companies supporting lofty valuations.

We do not expect this dynamic to continue over the next cycle. We believe that the new bull market might have a different narrative where value stocks outperform, as was the case during the first years of the century. Historically, recessions have proven necessary to reverse cyclical trends, such as the massive underperformance of value stocks since the end of the 2008 Great Financial Crisis. Morgan Stanley believes that the outperformance of value stocks could be caused by two factors. First, elevated valuation premiums of growth stocks relative to the current declining earnings expectations are not justified, resulting in a contraction of valuation multiples. Earnings revisions could also affect value stocks, but since they are currently trading at valuations close to historical lows, there is no significant room for multiple contraction. Second, the beginning of the new cycle will boost productivity and inflation, lifting GDP and interest rates, paving the way for the lead of cyclical value stocks. Following the same line of thought, we believe that international stocks, which by nature are more value oriented, could potentially be in a more advantageous position than U.S. stocks, which are much more growth oriented.



Regarding the industries that are best positioned to bounce back from the current bear market, an analysis by Strategas Research Partners, LLC (“Strategas”)² shows that the entertainment, aerospace and defense, airlines, metals and mining, consumer finance and truckers are the industries that tend to outperform the market coming out of recessions. All these are industries that quickly benefit from a recovery in economic activity, leading to gains in the equity market. In our view, the industry from this list that is not going to have a quick rebound is the airline industry for several reasons. First, they are likely to come out of the recession with the government as a stakeholder, which will limit the use of funds to enhance shareholder value. Second, we believe that as long as there is not a cure for Covid-19, people will not feel safe travelling, either for leisure or for work, dampening demand for air travel.

A similar analysis from Morgan Stanley found that when markets drop more than 25% in the face of a recession, as is currently the case, cyclical stocks from sectors such as banking, semiconductors, and consumer durables tend to outperform. However, when markets bottom, technology, consumer cyclicals, and industrials take the lead. Both analyses seem to agree that financial stocks are well positioned to benefit, coming out of the recession. This is particularly interesting as financials were probably the biggest losers of the previous cycle.

The role of hedge assets

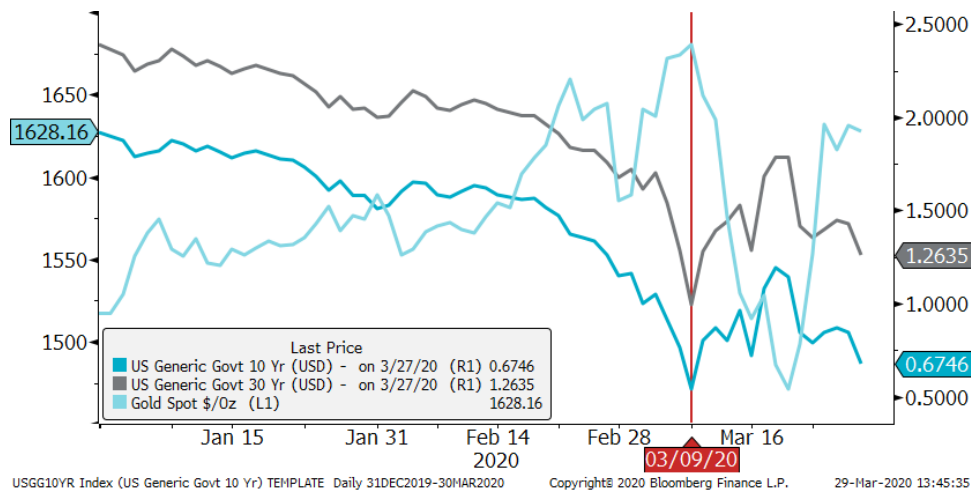
Even before the latest market cycle became the longest in history, many analysts were sounding warning alarms that hedge assets, specifically Treasuries and sovereign debt from developed countries and markets, were not likely to adequately protect portfolios in an eventual market downturn. Low and in many cases negative interest rates also prevented investors from holding these hedge assets. Also many investors felt that sovereign yield curves had been completely manipulated by the Fed and other central banks as a result of QE. Even if investors believe this to be true, once the virus threat became a certainty, global investors rushed into “safe haven” assets. For example the yield of the 10-year Treasury fell from 1.9% at the start of the year, to an intraday low of 0.31% on March 9th. Similarly, the yield of the 30-year Treasury fell from 2.4% at the start of the year to an intraday low of 0.7%. Even with a flat curve, completely distorted by the manipulation of the Fed over several rounds of QE, both short and long term maturities, to a greater or lesser extent, helped protect portfolios. Other sovereign bonds from developed countries and markets, such as Gilts and even negative yielding Bunds also successfully hedged portfolios from the crash.

Other traditional “safe haven” assets such as gold, also temporarily increased in value as investors rushed for protection, mainly in February of 2020, as the coronavirus outbreak escalated from China to the rest of the world. However, the current downturn had an unforeseen characteristic. As can be seen in the chart below, at the height of the panic, following March 9th, 2020, investors started to quickly divest from hedge assets at the same time that they were selling risky assets in a desperate attempt to raise cash. As a consequence, sovereign bond prices and gold had a sharp reversal from the peak, at the same time that

² Strategas is an institutional brokerage and advisory firm serving clients in more than twenty countries around the world. www.strategasrp.com



equity and credit markets were collapsing. Recently, as market sentiment has started to improve, ironically so has the appetite for “safe havens”, recovering most of the short-term losses.



For long term investors, not having exposure to hedge assets, has significantly increased portfolio losses. We believe that this is one of the long-lasting lessons that should be remembered by investors for the next bull market.

Parting thoughts

The current market crash has been the fastest in history. It only took 22 calendar days and 16 trading days to enter into a bear market, and just over a month to register the current 34% peak to trough decline. Even in the face of an unprecedented crisis caused by the pandemic, we believe that most of the sudden downturn can be attributed to the recent developments in financial technology. The emergence and quick adoption of products such as Exchanged Traded Funds (ETF), have in a way democratized market trading, allowing retail investors to easily become market participants that can unfortunately amplify the velocity of the crash once panic mode sets in. This is true not only for equity ETFs, but particularly for fixed income ETFs that got severely punished when credit markets froze. At the height of the current sell-off, some fixed income ETFs were trading at massive discounts to their net asset values, highlighting a lack of confidence on mark to market valuations.

Most private clients have stayed invested, maybe as a result of the velocity of the market collapse mentioned before, but since then have understood the attractiveness of current market conditions, slowly starting to increase their risk asset exposure near the recent market bottom. On the other hand, we believe several hedge funds suffering massive losses and outflows have been the biggest losers in this market downturn. Other institutional market players that were forced sellers came from risk parity, target volatility and other types of fast money strategies. When those managers have to unwind their positions, the selling is indiscriminate without regard to the prospects of sectors, industries or individual stock's fundamentals.



We believe this is the ideal scenario for bargain hunters to pick up stocks with strong fundamentals and sound business models, at incredible valuations. That is why we have been actively looking to add strong balance sheet names to our BSP Equity List, and have given the same recommendation to our clients.

Finally, turning our attention back to the coronavirus outbreak, the next couple of weeks are going to be critical from a health perspective. After several weeks of quarantine, the outbreak seems to finally be starting to peak in Italy and Spain. In the U.S., even with the extension of social distancing guidelines, the reality coming from the number of contagions is that harsher measures are probably needed, at least for the hardest hit states, before a relaxation can be discussed. With the Fed and the government having already provided near term assistance, the market will now revert its focus to the escalation of the outbreak, and as a result, a pick-up in market volatility can be expected. From our side, we will continue monitoring the situation, issuing any updates whenever we deem necessary. Nevertheless, feel free to reach out if you have any questions or concerns. In the meantime, please stay safe and keep washing your hands.



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