

Coronavirus outbreak: investment ramifications

In this issue of the Thinking Man, we offer our answers to what we believe are the main investment questions surrounding the spread of the Covid-19 coronavirus. While we are still in the midst of the outbreak, it has become apparent that investors and governments initially underestimated (and some would argue, downplayed) the severity of the threat.

In order to contain the outbreak, mandatory quarantines will likely be put in place across the world over the next few weeks, inevitably pushing the global economy into a recession. Central banks and governments will continue to use all the ammunition at their disposal to ensure the capital markets continue to function well and to mitigate the impact from the now widely expected severe economic downturn.

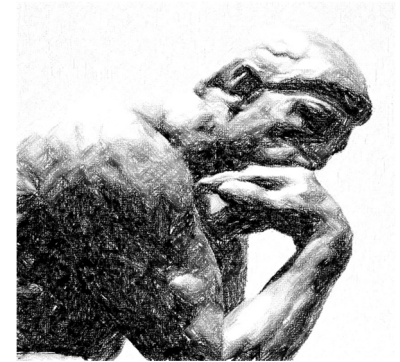
In our view, the most likely scenario is that the U.S. economy will have two negative quarters of GDP growth starting in the second quarter of 2020. If the outbreak is successfully contained and the economic crisis does not become a financial one, we could reasonably expect an economic rebound towards the end of the year.

Given the sharp decline in asset prices since February 19, 2020 equities and corporate bonds have become more attractively priced. If the situation starts to normalize over the next few months, long term investors are likely to find high quality companies at compelling valuations. Companies with sound business models and great fundamentals will survive the current downturn and benefit from the market bounce back that will follow at some point in the future.

What is the Coronavirus?

The coronaviruses are a kind of virus that causes an infection to the nose, sinuses, or upper throat. They were first discovered in the 1960s, and their name comes from the crown-like shape they show when observed under a microscope. Most coronaviruses cause the regular common cold and are not dangerous. However, certain types have been more dangerous causing

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- The novel coronavirus outbreak has completely disrupted the economy and financial markets, and reshaped our lives towards a stay-home model, resulting in a short-term collapse of stock prices and a widening of bond spreads.
- As of the time of this writing, governments worldwide are still scrambling to define the best strategy to contain the outbreak, and seem to be leaning towards a “whatever it takes” approach.
- A worldwide quarantine with travel restrictions seems to be the only (or preferred) solution, which will inevitably push the global economy into a recession.
- Both equities and credits are more attractive from a valuation perspective, and will probably yield attractive returns for long-time investors.
- However, valuation metrics are not good market timing indicators. The market will be driven by technical factors and new information regarding the containment of the virus over the short-term.

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potential major outbreaks, such as the Severe Acute Respiratory Syndrome (SARS) of 2003, the Middle East Respiratory Syndrome (MERS) and the current COVID-19.

The COVID-19 originated at the end of 2019 in Wuhan, Hubei province, China. Although several hypotheses have been floated, including that it was transmitted from bats to humans, it is not yet clear how the first patient got infected. Some reports have tracked its origin as far back as towards the end of November. Since then, the virus has spread quickly, first throughout the Hubei province and the rest of mainland China, and since January of 2020 to the rest of the world. As of March 17, 2020, there are almost 200 thousand confirmed cases around the world, with approximately 8 thousand deaths. Currently, the worst hit countries have been China, Italy, Iran and Spain with approximately 81 thousand, 31 thousand, 16 thousand and 12 thousand cases, respectively, according to data from the World Health Organization (WHO)¹. However, the outbreak is rapidly spreading to other regions around the world, including the United States, where its true dimension will only be revealed over the next couple of weeks with government mandated increases in testing. Taking China as an example, and more recently Italy and Spain, countries around the world have started to prepare for the worst.

What has happened to global financial markets?

The news of the outbreak was made public during the beginning of January 2020, when the WHO announced the identification of a new type of coronavirus that had originated in Wuhan. Initially, investors worldwide seemed more worried with a possible confrontation between the U.S. and Iran and quickly shrugged-off the information. Over the next few weeks, the first deaths caused by the disease were reported, and so were the first cases outside of mainland China. However, the news was completely overshadowed by the signing of the Phase 1 trade agreement between the U.S. and China. Investors cheered the easing of global trade tensions which had caused serious disruptions during the past few years, and pushing global markets to record highs and continuing the rally of 2019.

The potential magnitude of the coronavirus outbreak started to become apparent during the last week of January 2020 when the Chinese government ordered the forced quarantine of over 50 million people in the Hubei province and its surrounding regions. Stocks worldwide fell sharply with the news, as supply chains were anticipated to be disrupted because of the quarantine, potentially affecting corporate profits, as well as Chinese GDP growth. Even as weeks passed and the numbers of infected and dead continued to rise worldwide, investor sentiment was boosted by better than expected corporate earnings for the fourth quarter of 2019 and the acquittal by the Senate of President Donald Trump. This pushed U.S. equities to historical highs towards the middle of February 2020.

Nevertheless, since February 19, 2020, the market has completely turned into mayhem, as the continued increase in coronavirus cases outside of China, and the quarantine of Italy's Lombardy region, led to a

¹ The World Health Organization is a specialized agency of the United Nations concerned with global public health. It was established on or about April 7, 1948 as the successor to the Health Organization, an agency of the League of Nations.



sharp sell-off towards the end of the month. The trend continued and deepened entering March 2020, with all three major benchmarks indices in the U.S. suffering their worst weekly drops since October 2008. The S&P 500 lost more than four months' worth of gains in just seven trading days. The decision by the Federal Reserve (Fed) to lower its benchmark rate by half a percentage point caused more panic in the process. By the end of the first week of March 2020, the yield on the 10-year U.S. Treasury note had touched its all-time low, around 0.3%, and finished the week with a yield of approximately 0.709% as investors poured into safe haven assets. As if the news were not bad enough already, investors received more bad news at the start of the second week of March with another "black swan" event stemming from the Saudi-Russian confrontation over oil production. Oil prices fell to below \$30/barrel and equity markets had to be temporarily suspended, as all major indices dropped more than 7% at the open on Monday, March 9th 2020. The rest of that week was basically a continuation of the wild swings from the previous sessions.

In an unprecedented move to enhance liquidity, over this past weekend the Fed announced an additional cut of 100 bps to its reference rate to the 0-25% range. It also announced the start of an additional round of quantitative easing (QE) worth \$700 billion. The move was coordinated with other central banks, which also slashed rates and are set to announce similar asset purchase programs. At the start of this week, the market had to be halted once again on Monday 16th 2020 after losing a tenth of its value just at the opening, as investors started to grapple with the reality that the virus will not be contained, and will cause severe economic destruction in the short term. The session ended with yet again the largest percentage drop for the equity market since 1987.

What can we expect over the next couple of weeks?

The virus is not contained at this time and the number of infections is likely to continue increasing exponentially as well as the number of deaths. Since there is no cure for the disease, it is possible that a large percentage of the world population could catch it over the next few months. According to WHO studies, statistically speaking, for every 100 persons that get the disease, 80 percent have either no symptoms or mild ones similar to the common cold. Another 15 percent gets moderate symptoms that feel more like the flu. The remaining 5% presents critical symptoms which require hospitalization with 1.5% requiring specialized treatment at an Intensive Care Unit (ICU).

This leaves two approaches to overcome the disease. The first is the approach that seems to be currently adopted by the British. As a vast majority of the population is likely to get the disease, a quarantine or isolation will just destroy the economy in the short term, and won't be effective in saving many lives in the long run. The British apparently believe that it is better for their population to get exposed to the disease immediately so their bodies can create the necessary antibodies. Even as the economy continues to function "normally", the problem with this approach is that the British will end up dealing with what happened with the healthcare system in Wuhan and now in Italy and Spain. The contagion quickly spreads through the population, overrunning the capacity of the healthcare system. When hospital beds and ICU



ventilators are completely occupied, new patients cannot be properly handled, leading to a spike in deaths stemming from treatable complications under regular conditions.

The other approach to combat the coronavirus outbreak is the one implemented by the rest of the world. Even if the disease cannot be contained, some measures can actually delay the rate of transmission, allowing the healthcare system a fighting chance to keep up over a prolonged period. That is what is referred to in the medical community as “flattening the curve”. Even when in the long run, the system is likely to treat the same number of patients, it is not the same when the sick cluster around a few weeks causing a collapse of the healthcare system, rather than being spread throughout several months. The problem with this approach is that it requires isolating people for several weeks if not months, as has been the case in Wuhan, affecting directly the local and national economy.

As mentioned, most countries around the world are adopting the second approach of quarantine and isolation. During this past weekend, many countries around the globe have totally or partially closed their borders, banning the entry of foreigners. Citizens that come from abroad are now placed in a preventive two-week quarantine. Schools have been shut down and gatherings of more than 10 - 50 people have been banned, forcing the cancellation of sporting events, conferences, and concerts amongst others. Most people have chosen to self-isolate, but as cases and deaths continue to mount, the next step for many countries around the world, following Italy's and now Spain's example, is a forced quarantine of all its citizens. Some projections estimate that large countries such as the U.S., and Germany, are following the same trajectory as Italy and Spain, but are just a couple of days/weeks behind. With this in mind, the rest of March is likely to be hectic, as we anticipate more and more countries will start imposing quarantines to slow the spread of the virus.

This is already having devastating consequences for companies in sectors like tourism, entertainment and aviation. In the long term, it will impact almost all industries, and the overall economy, as production stops and consumption dries up. The sharp drop in asset prices over the last weeks means that much of the information is already priced in. However, as the situation continues to deteriorate and new information is released almost daily, we strongly believe that the recent spike in volatility will remain in place for the foreseeable future.

What does this mean to the economy, financial markets and client portfolios?

As mentioned above, much of the negative effects will depend on the strategy implemented by countries around the world to contain the spread of the virus. Since most of the countries are leaning towards the second option (i.e. quarantine, isolation), it will produce severe consequences for the global economy in the short and medium term. Several of the major banks and research outlets that we follow, are in fact forecasting a most probable recession throughout the remainder of the year. The decade-long bull market has come to an end, and we have officially entered a bear market. It is our belief that the severity of the recession will be driven by two shocks.



The first one comes from the **sudden stop in consumption**. As cities enter into quarantine and businesses support isolation efforts, all non-essential businesses will be shut down. This translates to a forced closure of all restaurants, cafes, movie theaters, sporting arenas, concert venues and shopping malls. Many companies in the U.S. have already started shutting down their operations preemptively such as Apple. As was the case in China and is now in Spain and Italy, only supermarkets and pharmacies will remain open. As so, developed countries such as the U.S. that rely heavily on consumption to drive economic growth will immediately be impacted. A good portion of the workforce will probably suffer layoffs and cash-starved small and medium businesses will be forced into bankruptcy, hurting even further the prospects of economic growth. If this is the only shock that materializes, then when the virus starts to be contained, maybe in a couple of months, we could expect a sharp rebound in economic activity driven by pent-up demand. Under this scenario, we should have a shallow recession, with negative GDP growth during the second and third quarters of 2020, followed by a rebound during the fourth quarter.

The second shock is driven by a **long-term continuation of the crunch** that we have started to witness over the last few days in the credit markets. Even though we are not in a financial crisis as was the case in 2008, but rather a sanitary one, credit has essentially dried up in recent weeks. Even as most investors are fixated with the collapse in equity markets, the collapse in credit market has been equally or even more pronounced. Spreads in junk bonds have widened dramatically, and there has basically been no bond emissions over the last few days. Even as banks are much better capitalized than they were before the financial crisis, main street companies are actually more leveraged than they were a decade ago. Many of these companies require access to credit markets to fund their daily operations, especially in times of crisis. If credit markets continue in this trajectory, some of these companies will inevitably have to close operations and declare bankruptcy.

Even some adequately capitalized companies might feel the pinch in the form of credit downgrades. As quarantines gain traction and companies close temporarily, their cash generation dries leading to potential problems servicing their debt. Credit rating agencies are well aware of this dynamic and have already started a credit revision and downgrade process, which will continue to fuel the widening of spreads and the credit crunch. If many companies start defaulting on their loans, the sanitary crisis can quickly escalate into a financial one, producing a deep recession that could probably drag on for several quarters. The Fed and other global central banks are well aware of the issue, and are trying to respond aggressively to enhance liquidity. Not only are 0% rates and additional rounds of QE aimed at addressing this issue, but is the recent announcement to reopen the Commercial Paper Funding Facility last used during the financial crisis to improve liquidity in the short-term funding market.

For obvious reasons the first companies to suffer from the credit crunch would come from the oil and energy industry. As a result of the collapse in the price of oil due to a drop in demand, as well as the price war stemming from the failed OPEC+ agreement, high-cost North American producers would be the first to be squeezed out. This would be followed by companies from the airline, cruise line and entertainment industries primarily. Collapses of major players in these industries would not have minor economic effects, but rather profound and long lasting ones. The U.S. is also well aware of this problem and a fiscal stimulus



package to support these industries should be coming from the White House shortly. However the scope could be limited as the bailouts of major banks during the financial crisis remain on the minds of the American public. On a normal year this should not be an issue, but we are currently in an election year where both Democrats and Republicans will try to avoid upsetting their base, rather than using all tools at their disposal to fight the impending crisis.

Even as the Fed, global central banks and worldwide governments use all the tools at their disposal to protect economic growth, we should still be in for a bumpy ride. As mentioned previously, the equity market is almost 30% down from its peak, making for the fastest drop to bear market in history. In our view, the collapse appears to be discounting most of the information we have discussed so far. Nonetheless, as more information becomes readily available it will quickly get priced in. Hence, we expect large market movements to persist over the short term in equity, fixed income, currency and commodity markets. Volatility, as measured by the VIX², is also likely to remain near all-time highs.

So should we and our clients surrender to panic? We would actually like to argue the opposite. Even if the situation is likely to get worse before it starts to get better, markets are currently trading at attractive valuations, in our view. Since companies are going to suffer in 2020, it does not make sense to look at valuation metrics using earnings forecasts for 2020, since these won't be representative of the company's earnings under normal circumstances. Using earning projections for 2021 and 2022, when the situation should have improved with companies getting back to business as usual, the valuation multiples look very reasonable to us. At the overall market level, Goldman Sachs is currently estimating 2021 earnings per share for the S&P 500 of \$175, which at current levels implies a price to earnings multiple of around 13.5x. In fact, this could end up being a once in a generation opportunity for long time investors to purchase equities at very discounted prices, similar to what happened during the 2008 – 09 financial crisis. In the short term, even though valuations are more attractive than they were recently, we believe that valuation metrics will not work as good market entry indicators, since sentiment will be more likely driven by technical analysis, as well as the evolution of the pandemic.

Historically, markets have bottomed when new infections start to peak, and that does not seem likely in the near future. We can also try to anticipate the market by looking at similar historical events. According to Strategas, S&P 500 **bear markets** (defined by 20% declines) since 1929:

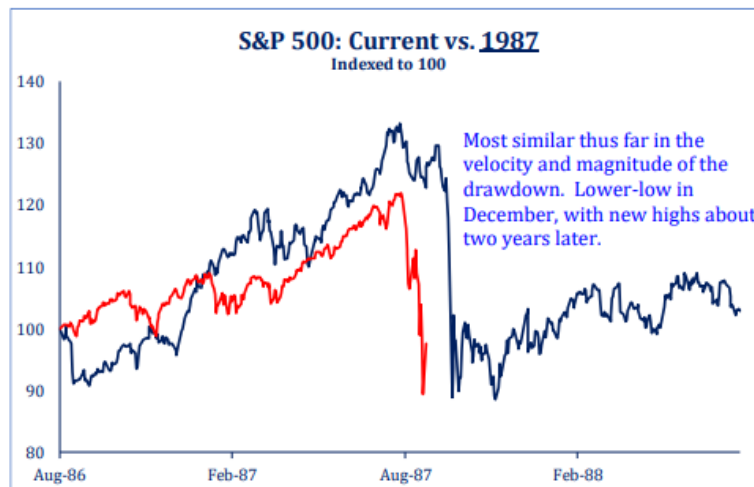
- Have had a median peak-to-trough price decline of around 30% (we are currently at 26.7%);
- Have had a peak to trough trailing P/E compression of 18x to 12x (we are currently at 13.9x);
- Have lasted approximately a year and half (it has just been over 3 weeks);
- Have had a peak of the market that preceded an economic recession (if one occurred) by three quarters;
- Have had varied earnings per share (EPS) peaks occurring on average two quarters after the market peak;

² VIX is a real time market index calculated by the Chicago Board Options Exchange representing the market's expectations for volatility over the coming 30 days.



- Have seen EPS recessions (which have not occurred in every bear market) with an average 20% peak-to-trough decline

The most similar market environment in terms of velocity and magnitude is the crash of 1987 that can be seen in the graph below. In that year, the market quickly collapsed over a few trading sessions, and then had a very hard time to recover. It actually took the market more than two years to reach new-highs. If both shock scenarios described previously were to materialize, this could very well end up being the performance of equity markets for the next couple of years. However, our base case is that only the first scenario materializes and that we will see a quick recovery.



Source: Strategas

2020 - 1987

Bear in mind that if central banks and government take adequate measures to protect the economy, this should remain a sanitary crisis, which could quickly reverse investor sentiment once it becomes clear that the end of the crisis is near. Most likely, there will be many opportunities for patient investors to pick-up high quality stocks at cheap valuations. Balance sheet risk is the key in times like this. Companies with strong fundamentals such as positive net cash, low net debt ratios and resilient business models will survive the recession and rebound with the market.

The same recommendation applies to credit markets. In our view, investment opportunities have opened recently as a result of the credit crunch that has widened spreads and increased yields. As mentioned before, even with the government and central bank support, some overleveraged and cash dry companies are unlikely to survive the current downturn. However, companies with good balance sheets and long-term sound business models will survive. In the current environment, investors are selling indiscriminately in the rush to liquidate portfolios and raise cash, measuring all companies with the same stick. As a result, before the dust settles, there will be great opportunities for bargain hunters to buy high quality credits at steep discounts, offering potential huge returns.



Finally we believe that even as safe havens, sovereign bonds and precious metals are currently expensive, and this is not the adequate time to be thinking about adding them to the portfolio. It might be even prudent to take some profit from the recent rally in safe havens. In the meantime please take the outbreak very seriously. As is widely recommended, wash your hands regularly, avoid social interactions, and try to self-isolate as much as possible. We will do our best to keep you updated on any development that might require additional attention. In the meantime feel free to reach out if you have any questions. As the old adage reads "this too shall pass".



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