COVID19 Silver Linings Playbook: Forbearance

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Forbearance is all about buying time: to find a vaccine, to lessen the burden on healthcare, to pay our debts, and to plan for the future. Forbearance is patient self-control, restraint, and tolerance. Now more than ever, being thoughtful and considering the consequences of every decision is the best strategy. We believe a patient data-driven approach will be the driving force behind future investment returns.

We hear the word forbearance used frequently related to COVID, often in the context of rent strikes and delayed mortgage, utility, student loan, and credit card payments. Forbearance implies understanding on the part of the creditor that the debtor needs a break and time to regroup before being able to make good on their payment obligations. Likewise, COVID-related sheltering in place is buying time to find treatments, to ramp up testing, to produce and distribute PPE, and to plan for how to move forward and balance economic and health risks. Forbearance also describes the patience needed in our current world of self-isolation where being apart from friends, family, and colleagues, and losing out on frequent face-to-face communication, can lead to escalating tensions and misunderstandings. In times of crisis it may appear that action is required just at the very moment when patience is the superior strategy. Forbearance instructs us to *think before we act*, and thoughtfully consider the data and potential unintended consequences of our actions. Nowhere does this hold more true than in investing.

WHAT WE THOUGHT WE KNOW, WE DON'T KNOW

We are writing this on Earth Day, April 22, which seems appropriate when writing about a global pandemic that serves as a dress rehearsal for the Climate Change Crisis on the horizon. Two months ago, we somewhat glibly wrote, "Markets hate unexpected bad news, but when the bad news is quantifiable, investors assess impact, react accordingly, and move on." Back then, we thought for sure that by now, in late April, we would have a reasonable sense of where we are heading post-COVID. Instead, people are starting to remove the "post" and calling it just a COVID

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world full stop. Six weeks ago, when many European countries and much of the US shut down, we did not fully consider or appreciate the implications of a multi-month shutdown with no obvious end in sight. Fast forward to yesterday's New York Times, when, in response to the question, "Doctors, if you could go back in time, what would you tell yourselves in early March?" the answer is, "What we thought we know, we don't know." For investors, the uncertainty that leads to difficult markets continues, with no end in sight for now.

Rewinding the clock, what are some of the things we thought we knew, or thought would be resolved by now, that we no longer feel confident about? As we approach three million diagnosed cases worldwide, what are some of the unexpected developments over the past two months?

Medical developments

- Many experts are quashing hopes for a vaccine solution, pointing out that flu vaccine approaches do not apply and stressing the lack of success in previous attempts to create coronavirus vaccines.
- So far, there remain no effective treatment options, though many studies are ongoing. Hydroxychloroquine, heavily touted by the Trump administration as an effective COVID treatment, is known for its cardiotoxicity that precludes its use in patients with cardiovascular disease. Since COVID seems to damage the heart in many patients, and since cardiovascular disease is a risk factor for poor outcomes in COVID, use of the drug in severely ill patients can hasten death, and is not recommended.
- Data show that ventilator use does not appear to improve outcomes for most patients, and that moving and turning patients and using less invasive oxygen delivery are preferable. This means that ventilators may no longer be a bottleneck to treating patients successfully, nor helpful in improving outcomes.
- Observed reinfections, albeit at a low rate, may challenge one-and-done and herd immunity assumptions.

Public Health and Political developments

- Testing, critical to being able to reopen economies safely, has seen a slower than expected ramp up due to shortages of technology-specific testing reagents, swabs, and personnel.
- Supply chain disruptions, increased protectionism, and uncoordinated sourcing has resulted in persistent shortages of PPE.
- In the US, even as front-line COVID healthcare providers are stretched to their limits, working double shifts, enduring great stress, and getting ill and dying, massive layoffs are occurring in "non-essential" healthcare that comprises the bulk of the US healthcare system overall.
- There are significant variations in spread patterns, disease severity and death rates of COVID in different regions around the globe. The differences are generally attributed to age, underlying health conditions, and healthcare capacity, but other emerging variables impacting outcomes include different viral strains, gender, and socioeconomic factors.
- A political push for lifting lockdowns before sufficient data, testing, PPE, and startup procedures are available, is laying the groundwork for a likely bigger infection wave to come.
- Female leaders of nations are being recognized as much better managers of the crisis so far. Germany's Angela Merkel, New Zealand's Jacinda Ardern, among others, are praised for effective messaging and decisive action, in stark contrast to the arrogant and logic-defying approaches of several of the world's most prominent male leaders.

Human and economic developments

- 26 million people have filed for unemployment in the US over the past month.
- The International Labor Organization forecasts that international unemployment will likely double, to nearly 400 million full-time-equivalent jobs lost, much worse than the global financial crisis.
- The world food program expects a doubling of acute hunger on a global basis this year and estimates that 300,000 people a day are dying of hunger due to COVID. In the US, Foodbanks are running out of food just as demand is spiking, partly due to food supply chains unable to shift from commercial to retail, as evidenced by 20% of milk production being poured out because of inability to redirect to store shelves.
- Many shuttered small businesses have already filed for bankruptcy and don't plan to reopen.
- The IMF currently expects a 3% drop in global GDP this year, 6% in developed economies, 1% in emerging nations.

- The Trump administration is using the crisis to roll back environmental and climate rules, regulations, and protections while other world leaders roll back human rights and privacy protections.

Market developments

Global markets suffered a 35% correction from mid-February to mid-March on fears and uncertainty surrounding COVID impact, but have since retraced 50% of their losses in the US, and about 35% abroad. The recovery points to investors feeling that the worst is behind us and that a recovery from the crisis is in sight. There are many discrepancies in market logic, however. First and foremost, the gap between Main Street and Wall Street seems to have widened dramatically, as per all the previously mentioned unexpected outcomes so far, which point to increasing uncertainty.

But, what we thought we know, we don't know.

When reporting companies discuss their results and expectations post-COVID, there is no such confidence that the worst of the crisis is behind us. Delta airlines says that the recovery will take at least 3 years; Biogen says that a significant new drug's approval has been put off because of COVID; in fact, most large Pharma and Biotech companies rely on profits from non-COVID healthcare that is currently mothballed. Second order effects, such as the cost of forbearance in allowing a significant number of customers to put off payments, negatively impacts traditionally defensive cash flow streams for the likes of telecommunication companies, utilities, and REITs. In the case of REITs, there is a real question of how much demand will permanently disappear, and how big the drop in occupancy will be. Technology is loved above all for its high margins and cash flows, but what happens when customer orders disappear and supply chain disruptions persist? The energy sector demonstrates the tremendous losses incurred when demand dries up while large constituents fight for market share. Non-commodity business models are not immune from similar industry dynamics taking hold. And nowhere is the market yet discounting mass bankruptcy and credit destruction. Furthermore, the inefficient allocation of bailout funds can skew investor perception of resilient versus failing business models.

The challenge facing all decision makers right now, from politicians to CEOs to heads of households to asset managers, is that we are all trying to build a boat while navigating a sudden major storm, with limited tools, and without a clear destination. As we wrote in our last COVID piece, "How similar or different the post-COVID markets are from our pre-COVID world depends on how rapidly we can mitigate the crisis as one global humanity. The longer the crisis lasts, the more dramatic the change from pre to post." We would observe that the lessons from the last two months are that more forbearance is required, rather than a quick return to a previous normal. The future "normal" will look increasingly different the longer our forbearance is required.

FORBEARANCE REQUIRES THOUGHTFULNESS AND PERSPECTIVE

It is one thing for the markets to plow ahead with a post-COVID recovery in mind. But investor action without considering unintended outcomes is very likely to generate additional volatility and dissapointment. Now is the time to reconsider pre-COVID playbooks and maxims like, "the trend is your friend," "don't fight the Fed," and "invest in what you know (and management teams who look and think like you)." The world is shifting beneath our feet, which requires a broader perspective and being more thoughtful investors.

One of the beautiful things about the US and other large economies is that their resilience derives from being complex and multifaceted. This complexity means that when shut down, we see unintended consequences, and starting up is even more complex. Small businesses and parts of supply chains may have gone bankrupt. Restarting a complex economy is more like restarting a nuclear reactor: it needs to be done step by step and carefully considering unseen connections. And we fear inducing a second health crisis by restarting too soon. But the longer economies are locked down, the harder and more complicated it is to restart.

Before the crisis, corporate and student debt were at all-time highs, and now all corporations have drawn down credit lines to hoard cash they may need. Record government fiscal and monetary stimulus further drives up debt levels. This increases the potential of stagflation akin to the 1970s as we “restart” the economy in waves that may ebb and flow. The central banks are already all in. What if we have another shock? This makes consumers, companies and governments more cautious, conservative and anxious going forward.

When we emerge from this crisis, we will do so with an increased understanding of our interconnectedness as a human race. This interconnectedness reflects the synchronicity we spoke of in our last piece. We all went through this together at the same time. And yet, our response so far has been to separate, as individuals and as states and countries, and focus on how we can be less dependent on each other. If the US and other regions go nativist and try to bring manufacturing home in its present state, we would reverse years of improving margins and wage growth by re-importing lower margin and lower wage work, and needlessly expanding the global manufacturing base. AI and robotics can ease the transition of factories coming back “home,” but unwinding supply chains is laborious and costly and carries its own unintended consequences. Together, or separately, the path we are on is tortuous and fraught with uncertainty.

It is paramount today, more than ever, to invest dispassionately, using data, and with patience and forbearance. The importance of supporting diverse leaders and managers with diverse views who consider all risks, including environmental, social, and governance risks, has never been higher. The world and the markets are making clear that the normal modes of investing are simply no longer sufficient. We must think outside the usual extrapolative finance box because we are more likely to adapt to a changing world and capture elements of a future that looks very different from the mental models of our pre-COVID past.

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